DiamondRock Hospitality Co
Form 10-Q
October 20, 2009

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

FORM 10-Q

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

For the quarterly period ended September 11, 2009

OR

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

Commission file number 001-32514

DIAMONDROCK HOSPITALITY COMPANY

(Exact Name of Registrant as Specified in Its Charter)

Maryland	**20-1180098**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**
6903 Rockledge Drive, Suite 800, Bethesda, Maryland	**20817**
(Address of Principal Executive Offices)	**(Zip Code)**

(240) 744-1150

(Registrant s telephone number, including area code)

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. þ Yes o 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). o Yes o 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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The registrant had 118,264,516 shares of its $0.01 par value common stock outstanding as of October 20, 2009.

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Item 1. Financial Statements

DIAMONDROCK HOSPITALITY COMPANY
CONDENSED CONSOLIDATED BALANCE SHEETS
As of September 11, 2009 and December 31, 2008
(in thousands, except share amounts)

	September 11, 2009 (Unaudited)	December 31, 2008
ASSETS		
Property and equipment, at cost	$ 2,162,868	$ 2,146,616
Less: accumulated depreciation	(283,797)	(226,400)
	1,879,071	1,920,216
Deferred financing costs, net	3,788	3,335
Restricted cash	33,732	30,060
Due from hotel managers	51,563	61,062
Favorable lease assets, net	38,809	40,619
Prepaid and other assets	35,396	33,414
Cash and cash equivalents	119,256	13,830
Total assets	**$ 2,161,615**	**$ 2,102,536**
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Mortgage debt	$ 820,853	$ 821,353
Senior unsecured credit facility		57,000
Total debt	820,853	878,353
Deferred income related to key money, net	19,937	20,328
Unfavorable contract liabilities, net	83,213	84,403
Due to hotel managers	30,656	35,196
Accounts payable and accrued expenses	53,018	66,624
Total other liabilities	186,824	206,551
Stockholders Equity:		

Preferred stock, $.01 par value; 10,000,000 shares authorized; no shares issued and outstanding				
Common stock, $.01 par value; 200,000,000 shares authorized; 115,643,122 and 90,050,264 shares issued and outstanding at September 11, 2009 and December 31, 2008, respectively		1,156		901
Additional paid-in capital		1,238,747		1,100,541
Accumulated deficit		(85,965)		(83,810)
Total stockholders equity		1,153,938		1,017,632
Total liabilities and stockholders equity	**$**	**2,161,615**	**$**	**2,102,536**

The accompanying notes are an integral part of these condensed consolidated financial statements.

DIAMONDROCK HOSPITALITY COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
For the Fiscal Quarters Ended September 11, 2009 and September 5, 2008 and
the Periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008
(in thousands, except per share amounts)

	Fiscal Quarter Ended September 11, 2009 (Unaudited)	Fiscal Quarter Ended September 5, 2008 (Unaudited)	Period from January 1, 2009 to September 11, 2009 (Unaudited)	Period from January 1, 2008 to September 5, 2008 (Unaudited)
Revenues:				
Rooms	$ 88,318	$ 106,203	$ 253,661	$ 308,141
Food and beverage	40,836	45,746	122,423	141,525
Other	8,646	9,446	23,866	25,609
Total revenues	137,800	161,395	399,950	475,275
Operating Expenses:				
Rooms	23,912	25,422	66,868	72,830
Food and beverage	29,068	32,961	85,969	98,266
Management fees	4,907	6,844	13,243	19,857
Other hotel expenses	50,161	54,116	146,701	155,758
Impairment of favorable lease asset			1,286	
Depreciation and amortization	18,866	18,257	57,312	53,013
Corporate expenses	3,675	3,241	11,094	9,546
Total operating expenses	130,589	140,841	382,473	409,270
Operating profit	7,211	20,554	17,477	66,005
Other Expenses (Income):				
Interest income	(82)	(296)	(265)	(1,066)
Interest expense	11,090	11,632	33,673	33,757
Total other expenses	11,008	11,336	33,408	32,691
(Loss) income before income taxes	(3,797)	9,218	(15,931)	33,314

Income tax benefit		4,558		2,994		13,856		5,830
Net income (loss)	$	761	$	12,212	$	(2,075)	$	39,144
Earnings (loss) per share:								
Basic and diluted earnings (loss) per share	$	0.01	$	0.13	$	(0.02)	$	0.41

The accompanying notes are an integral part of these condensed consolidated financial statements.

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DIAMONDROCK HOSPITALITY COMPANY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008
(in thousands)

	Period from January 1, 2009 to September 11, 2009 (Unaudited)	Period from January 1, 2008 to September 5, 2008 (Unaudited)
Cash flows from operating activities:		
Net (loss) income	$ (2,075)	$ 39,144
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Real estate depreciation	57,312	53,013
Corporate asset depreciation as corporate expenses	101	115
Non-cash ground rent	5,350	5,321
Non-cash financing costs as interest	556	557
Impairment of favorable lease asset	1,286	
Amortization of unfavorable contract liabilities	(1,190)	(1,190)
Amortization of deferred income	(391)	(383)
Stock-based compensation	3,892	2,620
Yield support received		797
Changes in assets and liabilities:		
Prepaid expenses and other assets	(1,982)	(2,741)
Restricted cash	(1,700)	(1,935)
Due to/from hotel managers	4,958	(1,782)
Accounts payable and accrued expenses	(16,235)	(7,799)
Net cash provided by operating activities	49,882	85,737
Cash flows from investing activities:		
Hotel capital expenditures	(17,735)	(49,703)
Receipt of deferred key money		5,000
Change in restricted cash	(2,702)	(1,372)
Net cash used in investing activities	(20,437)	(46,075)
Cash flows from financing activities:		
Repayments of credit facility	(57,000)	(23,000)
Draws on credit facility		99,000
Proceeds from mortgage debt	43,000	
Repayment of mortgage debt	(40,528)	
Scheduled mortgage debt principal payments	(2,972)	(1,963)
Repurchase of common stock	(309)	(49,434)
Proceeds from sale of common stock	135,348	

Payment of costs related to sale of common stock		(470)		
Payment of financing costs		(1,008)		(13)
Payment of dividends		(80)		(70,383)
Net cash provided by (used in) financing activities		75,981		(45,793)
Net increase (decrease) in cash and cash equivalents		105,426		(6,131)
Cash and cash equivalents, beginning of period		13,830		29,773
Cash and cash equivalents, end of period	$	119,256	$	23,642
Supplemental Disclosure of Cash Flow Information:				
Cash paid for interest	$	35,905	$	33,089
Cash paid for income taxes	$	901	$	861
Capitalized interest	$	19	$	183
Non-Cash Financing Activities:				
Unpaid dividends			$	22,778

The accompanying notes are an integral part of these condensed consolidated financial statements.

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DIAMONDROCK HOSPITALITY COMPANY
Notes to the Condensed Consolidated Financial Statements
(Unaudited)

1. Organization

DiamondRock Hospitality Company (the Company or we) is a lodging-focused real estate company that owns, as of October 20, 2009, 20 premium hotels and resorts that contain approximately 9,600 guestrooms. We are committed to maximizing stockholder value through investing in premium full-service hotels and, to a lesser extent, premium urban limited-service hotels located throughout the United States. Our hotels are concentrated in key gateway cities and in destination resort locations and are all operated under a brand owned by one of the top three national lodging brand companies (Marriott International, Inc. (Marriott), Starwood Hotels & Resorts Worldwide, Inc. (Starwood) or Hilton Hotels Corporation (Hilton)).

We are owners, as opposed to operators, of hotels. As an owner, we receive all of the operating profits or losses generated by our hotels, after we pay fees to the hotel managers, which are based on the revenues and profitability of the hotels, and reimburse all of their direct and indirect operating costs.

As of September 11, 2009, we owned 20 hotels, comprising 9,586 rooms, located in the following markets: Atlanta, Georgia (3); Austin, Texas; Boston, Massachusetts; Chicago, Illinois (2); Fort Worth, Texas; Lexington, Kentucky; Los Angeles, California (2); New York, New York (2); Northern California; Oak Brook, Illinois; Orlando, Florida; Salt Lake City, Utah; Washington D.C.; St. Thomas, U.S. Virgin Islands; and Vail, Colorado.

We conduct our business through a traditional umbrella partnership REIT, or UPREIT, in which our hotel properties are owned by our operating partnership, DiamondRock Hospitality Limited Partnership, or subsidiaries of our operating partnership. We are the sole general partner of the operating partnership and currently own, either directly or indirectly, all of the limited partnership units of the operating partnership.

2. Summary of Significant Accounting Policies

Basis of Presentation

We have condensed or omitted certain information and footnote disclosures normally included in financial statements presented in accordance with U.S. generally accepted accounting principles, or GAAP, in the accompanying unaudited condensed consolidated financial statements. We believe the disclosures made are adequate to prevent the information presented from being misleading. However, the unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto as of and for the year ended December 31, 2008, included in our Annual Report on Form 10-K dated February 27, 2009.

In our opinion, the accompanying unaudited condensed consolidated financial statements reflect all adjustments necessary to present fairly our financial position as of September 11, 2009, the results of our operations for the fiscal quarters ended September 11, 2009 and September 5, 2008 and the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008 and cash flows for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008. Interim results are not necessarily indicative of full-year performance because of the impact of seasonal and short-term variations. We have evaluated the need for disclosures and/or adjustments resulting from subsequent events through October 20, 2009.

Our financial statements include all of the accounts of the Company and its subsidiaries in accordance with GAAP. All intercompany accounts and transactions have been eliminated in consolidation.

Reporting Periods

The results we report in our condensed consolidated statements of operations are based on results of our hotels reported to us by our hotel managers. Our hotel managers use different reporting periods. Marriott, the manager of most of our properties, uses a fiscal year ending on the Friday closest to December 31 and reports twelve weeks of operations for each of the first three quarters and sixteen or seventeen weeks for the fourth quarter of the year for its domestic managed hotels. In contrast, Marriott, for its non-domestic hotels (including Frenchman s Reef), Vail Resorts, manager of the Vail Marriott, Davidson Hotel Company, manager of the Westin Atlanta North at Perimeter, Hilton Hotels Corporation, manager of the Conrad Chicago, and Westin Hotel Management, L.P, manager of the Westin Boston Waterfront Hotel report results on a monthly basis. Additionally, as a REIT, we are required by U.S. federal tax laws to report results on a calendar year basis. As a result, we have adopted the reporting periods used by

Marriott for its domestic hotels, except that the fiscal year always ends on December 31 to comply with REIT rules. The first three fiscal quarters end on the same day as Marriott s fiscal quarters but the fourth quarter ends on December 31 and the full year results, as reported in the statement of operations, always include the same number of days as the calendar year.

Two consequences of the reporting cycle we have adopted are: (1) quarterly start dates will usually differ between years, except for the first quarter which always commences on January 1, and (2) the first and fourth quarters of operations and year-to-date operations may not include the same number of days as reflected in prior years.
While the reporting calendar we adopted is more closely aligned with the reporting calendar used by the manager of most of our properties, one final consequence of the calendar is we are unable to report any results for Frenchman s Reef, Vail Marriott, Westin Atlanta North at Perimeter, Conrad Chicago, or Westin Boston Waterfront Hotel for the month of operations that ends after its fiscal quarter-end because none of Westin Hotel Management, L.P., Hilton Hotels Corporation, Davidson Hotel Company, Vail Resorts and Marriott make mid-month results available to us. As a result, our quarterly results of operations include results from Frenchman s Reef, the Vail Marriott, the Westin Atlanta North at Perimeter, the Conrad Chicago, and the Westin Boston Waterfront Hotel as follows: first quarter (January, February), second quarter (March to May), third quarter (June to August) and fourth quarter (September to December). While this does not affect full-year results, it does affect the reporting of quarterly results.

Revenue Recognition

Revenues from operations of the hotels are recognized when the services are provided. Revenues consist of room sales, golf sales, food and beverage sales, and other hotel department revenues, such as telephone and gift shop sales.

Earnings (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss), adjusted for dividends on unvested stock grants, by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share is calculated by dividing net income (loss), adjusted for dividends on unvested stock grants, by the weighted-average number of common shares outstanding during the period plus other potentially dilutive securities such as stock grants or shares issuable in the event of conversion of operating partnership units. No adjustment is made for shares that are anti-dilutive during a period.

Stock-based Compensation

We account for stock-based employee compensation using the fair value based method of accounting. We record the cost of awards with service conditions based on the grant-date fair value of the award. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. No awards with performance-based or market-based conditions have been issued.

Intangible Assets and Liabilities

Intangible assets and liabilities are recorded on non-market contracts assumed as part of the acquisition of certain hotels. We review the terms of agreements assumed in conjunction with the purchase of a hotel to determine if the terms are favorable or unfavorable compared to an estimated market agreement at the acquisition date. Favorable lease assets or unfavorable contract liabilities are recorded at the acquisition date and amortized using the straight-line method over the term of the agreement. We do not amortize intangible assets with indefinite useful lives, but review these assets for impairment if events or circumstances indicate that the asset may be impaired.
We have a favorable lease asset with an indefinite life related to the right to enter into a favorable ground lease under our option to develop a hotel on an undeveloped parcel of land adjacent to the Westin Boston Waterfront Hotel. The fair value estimate of the favorable lease uses a discounted cash flow method. Inputs to the estimate include observable market inputs, including current ground lease rates and discount rates, and unobservable inputs such as estimated future hotel revenues. The fair market value of the ground lease declined during 2009 and, as such, we recorded an impairment charge of $1.3 million during the period from January 1, 2009 to September 11, 2009.

Straight-Line Rent

We record rent expense on leases that provide for minimum rental payments that increase in pre-established amounts over the remaining term of the lease on a straight-line basis as required by GAAP.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents. We maintain cash and cash equivalents with various high credit-quality financial institutions. We perform periodic evaluations of the relative credit standing of these financial institutions and limit our amount of credit exposure with any one institution.

Use of Estimates

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

Risks and Uncertainties

The state of the overall economy can significantly impact hotel operational performance and thus, impact our financial position. Should any of our hotels experience a significant decline in operational performance, it may affect our ability to make distributions to our stockholders and service debt or meet other financial obligations.

3. Property and Equipment

Property and equipment as of September 11, 2009 (unaudited) and December 31, 2008 consists of the following (in thousands):

	September 11, 2009	December 31, 2008
Land	$ 219,590	$ 219,590
Land improvements	7,994	7,994
Buildings	1,668,101	1,658,227
Furniture, fixtures and equipment	266,190	259,154
CIP and corporate office equipment	993	1,651
	2,162,868	2,146,616
Less: accumulated depreciation	(283,797)	(226,400)
	$ 1,879,071	$ 1,920,216

As of September 11, 2009, we did not have any accrued capital expenditures. As of December 31, 2008, we had accrued capital expenditures of $2.6 million.

4. Capital Stock

Common Shares

We are authorized to issue up to 200,000,000 shares of common stock, $.01 par value per share. Each outstanding share of common stock entitles the holder to one vote on all matters submitted to a vote of stockholders. Holders of our common stock are entitled to receive dividends out of assets legally available for the payment of dividends when authorized by our Board of Directors.

Follow-on Public Offering. On April 17, 2009, we completed a follow-on public offering of our common stock. We sold 17,825,000 shares of common stock, including the underwriters overallotment of 2,325,000 shares, at an offering price of $4.85 per share. The net proceeds to us, after deduction of offering costs, were approximately $82.1 million.

Controlled Equity Offering Program. We initiated a controlled equity offering program (CEOP) on July 27, 2009, which allowed us sell up to $75.0 million of common stock. During the fiscal quarter ended September 11, 2009, we sold 7,600,000 shares of our common stock through the CEOP at an average price of $7.04 per share, for which we received net proceeds of $52.8 million. Subsequent to September 11, 2009, we completed the CEOP by selling

2,621,394 shares of our common stock at an average price of $8.20, for which we received net proceeds of $21.3 million. Under the CEOP, we sold a total of 10,221,394 shares at an average price of $7.34.

Preferred Shares

We are authorized to issue up to 10,000,000 shares of preferred stock, $.01 par value per share. Our board of directors is required to set for each class or series of preferred stock the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications, and terms or conditions of redemption. As of September 11, 2009 and December 31, 2008, there were no shares of preferred stock outstanding.

Operating Partnership Units

Holders of operating partnership units have certain redemption rights, which enable them to cause our operating partnership to redeem their units in exchange for cash per unit equal to the market price of our common stock, at the time of redemption, or, at our option for shares of our common stock on a one-for-one basis. The number of shares issuable upon exercise of the redemption rights will be adjusted upon the occurrence of stock splits, mergers, consolidations or similar pro-rata share transactions, which otherwise would have the effect of diluting the ownership interests of the limited partners or our stockholders. As of September 11, 2009 and December 31, 2008, there were no operating partnership units held by unaffiliated third parties.

5. Stock Incentive Plans

As of September 11, 2009, we have issued or committed to issue 3,203,905 shares of our common stock under our 2004 Stock Option and Incentive Plan, as amended, including 1,917,327 shares of unvested restricted common stock and a commitment to issue 466,819 units of deferred common stock.

Restricted Stock Awards

As of September 11, 2009, our officers and employees have been awarded 3,068,447 shares of restricted common stock, including those shares which have since vested. Shares issued to our officers and employees vest over a three-year period from the date of the grant based on continued employment. We measure compensation expense for the restricted stock awards based upon the fair market value of our common stock at the date of grant. Compensation expense is recognized on a straight-line basis over the vesting period and is included in corporate expenses in the accompanying condensed consolidated statements of operations.

A summary of our restricted stock awards from January 1, 2009 to September 11, 2009 is as follows:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested balance at January 1, 2009	605,809	$ 13.02
Granted	1,517,435	2.82
Vested	(198,733)	15.49
Forfeited	(7,184)	14.61
Unvested balance at September 11, 2009	1,917,327	$ 4.69

The remaining share awards are expected to vest as follows: 631,576 shares during 2010, 779,942 shares during 2011 and 505,809 during 2012. As of September 11, 2009, the unrecognized compensation cost related to restricted stock awards was $6.5 million and the weighted-average period over which the unrecognized compensation expense will be recorded is approximately 24 months. For the fiscal quarters ended September 11, 2009 and September 5, 2008, we recorded $1.2 million and $0.7 million, respectively, of compensation expense related to restricted stock awards. For the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, we recorded $3.4 million and $2.1 million, respectively, of compensation expense related to restricted stock awards.

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Deferred Stock Awards

At the time of our initial public offering, we made a commitment to issue 382,500 shares of deferred stock units to our senior executive officers. These deferred stock units are fully vested and represent the promise to issue a number of shares of our common stock to each senior executive officer upon the earlier of (i) a change of control or (ii) five years after the date of grant, which was the initial public offering completion date (the Deferral Period). However, if an executive s service with the Company is terminated for cause prior to the expiration of the Deferral Period, all deferred stock unit awards will be forfeited. The executive officers are restricted from transferring these shares until the fifth anniversary of the initial public offering completion date. As of September 11, 2009, we have a commitment to issue 466,819 shares under this plan. The share commitment increased from 382,500 to 466,819 since our initial public offering because current dividends are not paid out but instead are effectively reinvested in additional deferred stock units based on the closing price of our common stock on the dividend payment date.

Stock Appreciation Rights and Dividend Equivalent Rights

In 2008, we awarded our executive officers stock-settled stock appreciation rights (SARs) and dividend equivalent rights (DERs). The SARs/DERs vest over three years based on continued employment. The SARs may be exercised, in whole or in part, at any time after the instrument vests and before the tenth anniversary of issuance while the DERs terminate on the eighth anniversary of the grant date. As of September 11, 2009, we had awarded 300,225 SARs/DERs to our executive officers with an aggregate grant date fair value of approximately $2.0 million and a strike price of $12.59. For the fiscal quarters ended September 11, 2009 and September 5, 2008, we recorded approximately $0.2 million and $0.2 million, respectively, of compensation expense related to the SARs/DERs. For the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, we recorded approximately $0.5 million and $0.4 million, respectively, of compensation expense related to the SARs/DERs. A summary of our SARs/DERs as of September 11, 2009 is as follows:

	Number of SARs/DERs	Weighted-Average Grant Date Fair Value
Balance at January 1, 2009	300,225	$ 6.62
Granted		
Exercised		
Balance at September 11, 2009	300,225	$ 6.62

One-third of the SAR/DER awards vested in 2009 and the remainder are expected to vest as follows: one-third in 2010 and one-third in 2011. As of September 11, 2009, the unrecognized compensation cost related to the SAR/DER awards was $1.0 million and the weighted-average period over which the unrecognized compensation expense will be recorded is approximately 18 months.

6. Earnings (Loss) Per Share

Basic earnings (loss) per share is calculated by dividing net income (loss) available to common stockholders by the weighted-average number of common shares outstanding. Diluted earnings (loss) per share is calculated by dividing net (loss) income available to common stockholders, that has been adjusted for dilutive securities, by the weighted-average number of common shares outstanding including dilutive securities. No effect is shown for our restricted stock and SAR s when the impact is anti-dilutive.

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The following is a reconciliation of the calculation of basic and diluted earnings (loss) per share (in thousands, except share and per share data):

	Fiscal Quarter Ended September 11, 2009 (unaudited)	Fiscal Quarter Ended September 5, 2008 (unaudited)	Period from January 1, 2009 to September 11, 2009 (unaudited)	Period from January 1, 2008 to September 5, 2008 (unaudited)
Basic Earnings (Loss) per Share Calculation:				
Numerator:				
Net income (loss)	$ 761	$ 12,212	$ (2,075)	$ 39,144
Less: dividends on unvested restricted common stock		(151)		(389)
Net income (loss) after dividends on unvested restricted common stock	$ 761	$ 12,061	$ (2,075)	$ 38,755
Weighted-average number of common shares outstanding basic	110,426,611	92,425,801	101,636,354	94,261,449
Basic earnings (loss) per share	$ 0.01	$ 0.13	$ (0.02)	$ 0.41
Diluted Earnings (Loss) per Share Calculation:				
Numerator:				
Net income (loss)	$ 761	$ 12,212	$ (2,075)	$ 39,144
Less: dividends on unvested restricted common stock		(151)		(389)
Net income (loss) after dividends on unvested restricted common stock	$ 761	$ 12,061	$ (2,075)	$ 38,755
Weighted-average number of common shares outstanding basic	110,426,611	92,425,801	101,636,354	94,261,449
Unvested restricted common stock	875,735	36,392		163,168
Unvested SARs				
Weighted-average number of common shares outstanding diluted	111,302,346	92,462,193	101,636,354	94,424,617
Diluted earnings (loss) per share	$ 0.01	$ 0.13	$ (0.02)	$ 0.41

7. Debt

We have incurred limited recourse, property specific mortgage debt on certain of our hotels. In the event of default, the lender may only foreclose on the pledged assets; however, in the event of fraud, misapplication of funds and other customary recourse provisions, the lender may seek payment from us. As of September 11, 2009, 12 of our 20 hotel properties were secured by mortgage debt. Our mortgage debt contains certain property specific covenants and restrictions, including minimum debt service coverage ratios that trigger cash management provisions as well as restrictions on incurring additional debt without lender consent. As of September 11, 2009, we were in compliance with the financial covenants of our mortgage debt.

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The following table sets forth information regarding the Company s debt as of September 11, 2009 (unaudited), in thousands:

	Principal Balance	Interest Rate
Courtyard Manhattan / Midtown East	$ 43,000	8.81%
Marriott Salt Lake City Downtown	33,449	5.50%
Courtyard Manhattan / Fifth Avenue	51,000	6.48%
Marriott Griffin Gate Resort	27,882	5.11%
Renaissance Worthington	57,289	5.40%
Frenchman s Reef & Morning Star Marriott Beach Resort	61,633	5.44%
Marriott Los Angeles Airport	82,600	5.30%
Orlando Airport Marriott	59,000	5.68%
Chicago Marriott Downtown Magnificent Mile	220,000	5.975%
Renaissance Austin	83,000	5.507%
Renaissance Waverly	97,000	5.503%
Bethesda Marriott Suites	5,000	LIBOR + 0.95 (1.235% as of September 11, 2009)
Senior unsecured credit facility		LIBOR + 0.95
Total debt	$ 820,853	
Weighted-Average Interest Rate		5.80%

Mortgage Debt

On September 11, 2009, we refinanced the debt that was secured by a mortgage on our Courtyard Manhattan/Midtown East hotel with $43.0 million of secured debt issued by Massachusetts Mutual Life Insurance Company, which will mature on October 1, 2014. The new mortgage debt bears a fixed interest rate of 8.81%. The prior mortgage debt was scheduled to mature on December 11, 2009.

On October 1, 2009, we repaid the $27.9 million loan secured by a mortgage on our Griffin Gate Marriott with corporate cash. The loan was scheduled to mature on January 1, 2010. On October 15, 2009, we repaid the $5.0 million mortgage debt on the Bethesda Marriott Suites with corporate cash. The mortgage debt was scheduled to mature in July 2010.

Senior Unsecured Credit Facility

We are party to a four-year $200.0 million unsecured credit facility (the Facility) expiring in February 2011. We may extend the maturity date of the Facility for an additional year upon the payment of applicable fees and the satisfaction of certain other customary conditions. As of September 11, 2009, we did not have an outstanding balance on the Facility.

Interest is paid on the periodic advances under the Facility at varying rates, based upon either LIBOR or the alternate base rate, plus an agreed upon additional margin amount. The interest rate depends upon our level of outstanding indebtedness in relation to the value of our assets from time to time, as follows:

	Leverage Ratio			
	60% or Greater	55% to 60%	50% to 55%	Less Than 50%
Alternate base rate margin	0.65%	0.45%	0.25%	0.00%
LIBOR margin	1.55%	1.45%	1.25%	0.95%

The Facility contains various corporate financial covenants. A summary of the most restrictive covenants is as follows:

	Covenant	Actual at September 11, 2009
Maximum leverage ratio(1)	65%	47%
Minimum fixed charge coverage ratio(2)	1.6x	2.2x
Minimum tangible net worth(3)	$839.6 million	$1.4 billion
Unhedged floating rate debt as a percentage of total indebtedness	35%	0.60%

(1) Maximum leverage ratio is determined by dividing the total debt outstanding by the net asset value of our corporate assets and hotels. Hotel level net asset values are calculated based on the application of a contractual capitalization rate (which range from 7.5% to 8.0%) to the trailing twelve month hotel net operating income.

(2) Minimum fixed charge ratio is calculated based on the trailing four quarters.

(3) Tangible net worth is defined as the gross book value of our real estate assets and other corporate assets less our total debt and all

other corporate liabilities. The tangible net worth is increased by 75% of the net proceeds from new equity offerings.

The Facility requires that we maintain a specific pool of unencumbered borrowing base properties. The unencumbered borrowing base assets are subject to the following limitations and covenants:

	Covenant	Actual at September 11, 2009
Minimum implied debt service ratio	1.5x	N/A
Maximum unencumbered leverage ratio	65%	0%
Minimum number of unencumbered borrowing base properties	4	8
Minimum unencumbered borrowing base value	$150 million	$533.5 million
Percentage of total asset value owned by borrowers or guarantors	90%	100%

In addition to the interest payable on amounts outstanding under the Facility, we are required to pay unused credit facility fees equal to 0.20% of the unused portion of the Facility if the unused portion of the Facility is greater than 50% or 0.125% of the unused portion of the Facility if the unused portion of the Facility is less than 50%. We incurred interest and unused credit facility fees on the Facility of $0.1 million and $0.6 million for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively, and $0.5 million and $1.2 million for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively.

8. Fair Value of Financial Instruments

The fair value of certain financial assets and liabilities and other financial instruments as of September 11, 2009 and December 31, 2008, in thousands, are as follows:

	As of September 11, 2009		As of December 31, 2008	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Mortgage Debt	$ 820,853	$ 736,949	$ 878,353	$ 750,899

We estimate the fair value of our mortgage debt by discounting the future cash flows of each instrument at estimated market rates. The carrying value of our other financial instruments approximates fair value due to the short-term nature of these financial instruments.

9. Commitments and Contingencies

Litigation

We are not involved in any material litigation nor, to our knowledge, is any material litigation threatened against us. We are involved in routine litigation arising out of the ordinary course of business, all of which is expected to be covered by insurance and none of which is expected to have a material impact on our financial condition or results of operations.

Income Taxes

We had no accruals for tax uncertainties as of September 11, 2009 and December 31, 2008. As of September 11, 2009, all of our federal income tax returns and state tax returns for the jurisdictions in which our hotels are located remain subject to examination by the respective jurisdiction tax authorities.

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

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and includes this statement for purposes of complying with these safe harbor provisions. These forward-looking statements are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project or similar expressions, whether in the negative or affirmative. Forward-looking statements are based on management s current expectations and assumptions and are not guarantees of future performance. Factors that may cause actual results to differ materially from current expectations include, but are not limited to, the risk factors discussed herein and other factors discussed from time to time in our periodic filings with the Securities and Exchange Commission. Accordingly, there is no assurance that the Company s expectations will be realized. Except as otherwise required by the federal securities laws, the Company disclaims any obligations or undertaking to publicly release any updates or revisions to any forward-looking statement contained in this report to reflect events, circumstances or changes in expectations after the date of this report.

Overview

We are a lodging-focused real estate company that owns, as of October 20, 2009, 20 premium hotels and resorts that contain approximately 9,600 guestrooms. We are committed to maximizing stockholder value through investing in premium full-service hotels and, to a lesser extent, premium urban limited-service hotels located throughout the United States. Our hotels are concentrated in key gateway cities and in destination resort locations and are all operated under a brand owned by one of the top three national lodging brand companies (Marriott, Starwood or Hilton).

We are owners, as opposed to operators, of hotels. As an owner, we receive all of the operating profits or losses generated by our hotels, after we pay fees to the hotel manager, which are based on the revenues and profitability of the hotels, and reimburse all of their direct and indirect operating costs.

As an owner, we believe we create value by acquiring the right hotels with the right brands in the right markets, prudently financing our hotels, thoughtfully re-investing capital in our hotels, implementing profitable operating strategies, approving the annual operating and capital budgets for our hotels and deciding if and when to sell our hotels. In addition, we are committed to enhancing the value of our operating platform by being open and transparent in our communications with investors, monitoring our corporate overhead and following corporate governance best practice.

We differentiate ourselves from our competitors because of our adherence to three basic principles:

- high-quality urban- and resort-focused branded real estate;
- conservative capital structure; and
- thoughtful asset management.

High-Quality Urban- and Resort-Focused Branded Real Estate

We own 20 premium hotels and resorts in North America. These hotels and resorts are primarily categorized as upper upscale as defined by Smith Travel Research and are generally located in high barrier to entry markets with multiple demand generators.

Our properties are concentrated in five key gateway cities (New York City, Los Angeles, Chicago, Boston and Atlanta) and in destination resort locations (such as the U.S. Virgin Islands and Vail, Colorado). We believe that gateway cities and destination resorts will achieve higher long-term growth because they are attractive business and leisure destinations. We also believe that these locations are better insulated from new supply due to relatively high barriers to entry and expensive construction costs.

We believe that higher quality lodging assets create more dynamic cash flow growth and superior long-term capital appreciation.

In addition, a core tenet of our strategy is to leverage national hotel brands. We strongly believe in the value of powerful national brands because we believe that they are able to produce incremental revenue and profits compared to similar unbranded hotels. In particular, we believe that branded hotels outperform unbranded hotels in an economic downturn. Dominant national hotel brands typically have very strong reservation and reward systems and sales organizations, and all of our hotels are operated under a brand owned by one of the top three national lodging brand companies (Marriott, Starwood or Hilton) and all but two of our hotels are managed by the brand company directly. Generally, we are interested in owning hotels that are operated under a nationally recognized brand or acquiring hotels that can be converted into a nationally branded hotel.

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Capital Structure

Since our formation in 2004, we have been consistently committed to a flexible capital structure with prudent leverage levels. During 2004 though early 2007, we took advantage of the low interest rate environment by fixing our interest rates for an extended period of time. Moreover, during the peak in the commercial real estate market in the past several years, we maintained low financial leverage by funding the majority of our acquisitions through the issuance of equity. This strategy allowed us to maintain a balance sheet with a moderate amount of debt. During the peak years, we believed, and present events have confirmed, that it would be inappropriate to increase the inherent risk of a highly cyclical business through a highly levered capital structure.

We prefer a relatively simple but efficient capital structure. We have not invested in joint ventures and have not issued any operating partnership units or preferred stock. We endeavor to structure our hotel acquisitions so that they will not overly complicate our capital structure; however, we will consider a more complex transaction if we believe that the projected returns to our stockholders will significantly exceed the returns that would otherwise be available.

We have always strived to operate our business with conservative leverage. During this economic downturn, our corporate goals and objectives continue to be focused on preserving and enhancing our liquidity. We have taken, or intend to take, a number of steps to achieve these goals, as follows:

- We completed a follow-on public offering of our common stock during the second quarter of 2009. We sold 17,825,000 shares of common stock, including the underwriters overallotment of 2,325,000 shares, at an offering price of $4.85 per share. The net proceeds to us, after deduction of offering costs, were approximately $82.1 million.
- We completed a $75.0 million controlled equity offering program, raising net proceeds of $74.0 million through the sale of 10.2 million shares of our common stock at an average price of $7.34 per share.
- Our Board of Directors recently authorized us to sell an additional $75 million of common stock under a new controlled equity offering program.
- We repaid the entire $52 million outstanding on our senior unsecured credit facility during the second quarter of 2009 with a portion of the proceeds from our follow-on offering.
- On September 11, 2009, we refinanced the debt that was secured by a mortgage on our Courtyard Manhattan/Midtown East hotel with $43.0 million of secured debt issued by Massachusetts Mutual Life Insurance Company, which will mature on October 1, 2014.
- On October 1, 2009, we repaid the $27.9 million loan secured by a mortgage on our Griffin Gate Marriott with cash on hand. The loan was scheduled to mature on January 1, 2010.
- On October 15, 2009, we repaid the $5 million mortgage debt on our Bethesda Marriott Suites with cash on hand. The mortgage debt was scheduled to mature in July 2010.
- We intend to pay our next dividend to our stockholders of record as of December 31, 2009. We expect the 2009 dividend will be in an amount equal to 100% of our 2009 taxable income. We intend to pay up to 90% of our 2009 dividend in shares of our common stock, as permitted by the Internal Revenue Service s Revenue Procedure 2009-15.
- We have focused on minimizing capital spending during 2009 and expect to fund approximately $6 million of 2009 capital expenditures from corporate cash.

We believe that we maintain a reasonable amount of fixed interest rate mortgage debt with limited near-term maturities. As of October 20, 2009, we have $787.7 million of mortgage debt outstanding with a weighted average interest rate of 5.9% and a weighted average maturity date of 6.3 years. In addition, we currently have ten hotels unencumbered by debt.

Thoughtful Asset Management

We believe that we are able to create significant value in our portfolio by utilizing our management s extensive experience and our innovative asset management strategies. Our senior management team has an established broad network of hotel industry contacts and relationships, including relationships with hotel owners, financiers, operators, project managers and contractors and other key industry participants.

In the current economic environment, we believe that our extensive lodging experience, our network of industry relationships and our asset management strategies position us to minimize the impact of declining revenues on our hotels. In particular, we are focused on controlling our property-level and corporate expenses, as well as working closely with our managers to optimize the mix of business at our hotels in order to maximize potential revenue. Our property-level cost containment includes the implementation of aggressive contingency plans at each of our hotels. The contingency plans include controlling labor expenses, eliminating hotel staff positions, adjusting food and beverage outlet hours of operation and not filling open positions. In addition, our strategy to significantly renovate many of the hotels in our portfolio from 2006 to 2008 resulted in the flexibility to significantly curtail our planned capital expenditures for 2009 and 2010.

We use our broad network of hotel industry contacts and relationships to maximize the value of our hotels. Under the regulations governing REITs, we are required to engage a hotel manager that is an eligible independent contractor through one of our subsidiaries to manage each of our hotels pursuant to a management agreement. Our philosophy is to negotiate management agreements that give us the right to exert significant influence over the management of our properties, annual budgets and all capital expenditures, and then to use those rights to continually monitor and improve the performance of our properties. We cooperatively partner with the managers of our hotels in an attempt to increase operating results and long-term asset values at our hotels. In addition to working directly with the personnel at our hotels, our senior management team also has long-standing professional relationships with our hotel managers senior executives, and we work directly with these senior executives to improve the performance of our portfolio.

We believe we can create significant value in our portfolio through innovative asset management strategies such as rebranding, renovating and repositioning. We are committed to regularly evaluating our portfolio to determine if we can employ these value-added strategies at our hotels. From 2006 to 2008 we completed a significant amount of capital reinvestment in our hotels completing projects that ranged from room renovations, to a total renovation and repositioning of the hotel, to the addition of new meeting space, spa or restaurant repositioning. In connection with our renovations and repositionings, our senior management team and our asset managers are individually committed to completing these renovations on time, on budget and with minimum disruption to our hotels. As we have significantly renovated many of the hotels in our portfolio, we chose to substantially reduce capital expenditures beginning in 2009.

Key Indicators of Financial Condition and Operating Performance

We use a variety of operating and other information to evaluate the financial condition and operating performance of our business. These key indicators include financial information that is prepared in accordance with GAAP, as well as other financial information that is not prepared in accordance with GAAP. In addition, we use other information that may not be financial in nature, including statistical information and comparative data. We use this information to measure the performance of individual hotels, groups of hotels and/or our business as a whole. We periodically compare historical information to our internal budgets as well as industry-wide information. These key indicators include:

- Occupancy percentage;
- Average Daily Rate (or ADR);
- Revenue per Available Room (or RevPAR);
- Earnings Before Interest, Income Taxes, Depreciation and Amortization (or EBITDA); and
- Funds From Operations (or FFO).

Occupancy, ADR and RevPAR are commonly used measures within the hotel industry to evaluate operating performance. RevPAR, which is calculated as the product of ADR and occupancy percentage, is an important statistic for monitoring operating performance at the individual hotel level and across our business as a whole. We evaluate individual hotel RevPAR performance on an absolute basis with comparisons to budget and prior periods, as well as on a company-wide and regional basis. ADR and RevPAR include only room revenue. Room revenue comprised

approximately 64% of our total revenues for the fiscal quarter ended September 11, 2009, and is dictated by demand, as measured by occupancy percentage, pricing, as measured by ADR, and our available supply of hotel rooms.
Our ADR, occupancy percentage and RevPAR performance may be impacted by macroeconomic factors such as regional and local employment growth, personal income and corporate earnings, office vacancy rates and business relocation decisions, airport and other business and leisure travel, new hotel construction and the pricing strategies of competitors. In addition, our ADR, occupancy percentage and RevPAR performance are dependent on the continued success of Marriott and its brands as well as the Westin and Conrad brands.

We also use EBITDA and FFO as measures of the financial performance of our business. See Non-GAAP Financial Matters.

Outlook

The impact of the severe economic recession on U.S. travel fundamentals and our operating results is likely to persist for some period of time. Lodging demand has historically correlated with several key economic indicators such as GDP growth, employment trends, corporate profits, consumer confidence and business investment. Although there have been recent signs that occupancy in the industry may have stabilized, the average daily rate has continued to decline. We expect lodging demand to follow its historical course and lag the general economic recovery by several quarters and thus, we anticipate a challenging operating environment for the balance of 2009 and into 2010.

New hotel supply remains a short-term negative and a long-term positive. Although the industry benefited from supply growth less than historical averages from 2004 through 2007, new hotel supply began to increase at the end of the last economic expansion. While some of those projects have been delayed or eliminated, the rate of new supply is expected to peak in 2009 and remain above historical averages in 2010 for our portfolio. We have been or will be impacted by new supply in a few of our markets, most notably Fort Worth, Texas during 2009 and Chicago and Austin in 2010. Due to a number of factors, we expect below average supply growth for an extended period of time beginning in 2011, when we expect minimal new supply to be a significant positive for operating fundamentals.

Our Hotels

The following table sets forth certain operating information for each of our hotels for the period from January 1, 2009 to September 11, 2009.

Property	Location	Number of Rooms	Occupancy	ADR($)	RevPAR($)	% Change from 2008 RevPAR
Chicago Marriott	Chicago, Illinois	1,198	73.9%	$ 169.30	$ 125.07	(16.6%)
Los Angeles Airport Marriott	Los Angeles, California	1,004	74.4%	108.71	80.92	(18.8%)
Westin Boston Waterfront Hotel (1)	Boston, Massachusetts	793	68.7%	191.91	131.80	(4.7%)
Renaissance Waverly Hotel	Atlanta, Georgia	521	63.8%	133.06	84.88	(15.2%)
Salt Lake City Marriott Downtown	Salt Lake City, Utah	510	53.5%	134.94	72.22	(24.5%)
Renaissance Worthington	Fort Worth, Texas	504	64.9%	161.74	104.90	(19.5%)
Frenchman s Reef & Morning Star Marriott Beach Resort (1)	St. Thomas, U.S. Virgin Islands	502	87.9%	222.47	195.52	(9.9%)
Renaissance Austin Hotel	Austin, Texas	492	62.2%	146.44	91.02	(17.9%)
Torrance Marriott South Bay	Los Angeles County, California	487	71.2%	112.02	79.77	(22.9%)
Orlando Airport Marriott	Orlando, Florida	486	75.0%	79.12	59.35	(11.6%)
Marriott Griffin Gate Resort	Lexington, Kentucky	408	62.8%	122.79	77.06	(15.2%)
Oak Brook Hills Marriott Resort		386	42.9%	117.40	50.42	(28.2%)

	Oak Brook, Illinois					
Westin Atlanta North at Perimeter (1)	Atlanta, Georgia	369	68.5%	102.07	69.93	(20.7%)
Vail Marriott Mountain Resort & Spa (1)	Vail, Colorado	346	64.0%	211.05	135.05	(23.6%)
Marriott Atlanta Alpharetta	Atlanta, Georgia	318	60.1%	124.47	74.79	(18.7%)
Courtyard Manhattan/Midtown East	New York, New York	312	85.6%	201.73	172.60	(34.0%)
Conrad Chicago (1)	Chicago, Illinois	311	73.6%	180.41	132.85	(23.5%)
Bethesda Marriott Suites	Bethesda, Maryland	272	63.2%	168.94	106.75	(22.8%)
Courtyard Manhattan/Fifth Avenue	New York, New York	185	89.4%	208.92	186.80	(27.5%)
The Lodge at Sonoma, a Renaissance Resort & Spa	Sonoma, California	182	61.6%	189.98	116.96	(26.1%)
TOTAL/WEIGHTED AVERAGE		9,586	68.8%	$ 153.49	$ 105.55	(18.9%)

(1) The Frenchman s Reef & Morning Star Marriott Beach Resort, Vail Marriott Mountain Resort & Spa, Westin Atlanta North at Perimeter, Conrad Chicago and the Westin Boston Waterfront Hotel report operations on a calendar month and year basis. The period from January 1, 2009 to September 11, 2009 includes the operations for the period from January 1,

2009 to
August 31, 2009
for these five
hotels.

Results of Operations

Comparison of the Fiscal Quarter Ended September 11, 2009 to the Fiscal Quarter Ended September 5, 2008

Our net income for the fiscal quarter ended September 11, 2009 was $0.8 million compared to net income of $12.2 million for the fiscal quarter ended September 5, 2008.

Revenue. Revenue consists primarily of the room, food and beverage and other operating revenues from our hotels. Revenues for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively, consisted of the following (in thousands):

	Fiscal Quarter Ended September 11, 2009	Fiscal Quarter Ended September 5, 2008	% Change
Rooms	$ 88,318	$ 106,203	(16.8%)
Food and beverage	40,836	45,746	(10.7%)
Other	8,646	9,446	(8.5%)
Total revenues	$ 137,800	$ 161,395	(14.6%)

Individual hotel revenues for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively, consist of the following (in millions):

	Fiscal Quarter Ended September 11, 2009	Fiscal Quarter Ended September 5, 2008	% Change
Chicago Marriott	$ 21.7	$ 24.6	(11.8%)
Westin Boston Waterfront Hotel (1)	18.5	18.4	0.5%
Frenchman s Reef & Morning Star Marriott Beach Resort (1)	11.4	13.5	(15.6%)
Los Angeles Airport Marriott	10.2	13.2	(22.7%)
Renaissance Waverly Hotel	6.9	7.1	(2.8%)
Conrad Chicago (1)	6.5	7.9	(17.7%)
Renaissance Austin Hotel	6.1	7.5	(18.7%)
Oak Brook Hills Marriott Resort	6.1	6.8	(10.3%)
Marriott Griffin Gate Resort	6.0	6.7	(10.4%)
Renaissance Worthington	5.5	6.7	(17.9%)
Courtyard Manhattan/Midtown East	4.9	7.4	(33.8%)
Torrance Marriott South Bay	4.8	6.3	(23.8%)
Vail Marriott Mountain Resort & Spa (1)	4.5	5.2	(13.5%)
Salt Lake City Marriott Downtown	4.4	5.9	(25.4%)
The Lodge at Sonoma, a Renaissance Resort & Spa	4.1	4.9	(16.3%)
Orlando Airport Marriott	3.9	4.1	(4.9%)
Westin Atlanta North at Perimeter (1)	3.7	4.2	(11.9%)
Courtyard Manhattan/Fifth Avenue	3.0	4.2	(28.6%)
Bethesda Marriott Suites	2.9	3.8	(23.7%)
Marriott Atlanta Alpharetta	2.7	3.0	(10.0%)

Total	$	137.8	$	161.4	(14.6%)

(1) The Frenchman s Reef & Morning Star Marriott Beach Resort, Vail Marriott Mountain Resort & Spa, Westin Atlanta North at Perimeter, Conrad Chicago and the Westin Boston Waterfront Hotel report operations on a calendar month and year basis. The fiscal quarters ended September 11, 2009 and September 5, 2008 include the operations for the period from June 1, 2009 to August 31, 2009 and June 1, 2008 to August 31, 2008, respectively, for these five hotels.

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Our total revenues declined $23.6 million, or 14.6%, from $161.4 million for the fiscal quarter ended September 5, 2008 to $137.8 million for the fiscal quarter ended September 11, 2009, reflecting the continued weakness in lodging fundamentals. The decline reflects a 16.9 percent decline in RevPAR, which is the result of a 13.2 percent decrease in ADR and a 3.2 percentage point decrease in occupancy. The following are the key hotel operating statistics for our hotels for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively:

	Fiscal Quarter Ended September 11, 2009	Fiscal Quarter Ended September 5, 2008	% Change
Occupancy %	73.3%	76.5%	(3.2) percentage points
ADR	$ 146.73	$ 169.05	(13.2%)
RevPAR	$ 107.50	$ 129.33	(16.9%)

Our RevPAR declined in the third quarter by 16.9%. Most of the decline in RevPAR can be attributed to a significant decline in the average daily rate and reflects a number of negative trends within our primary customer segments, as well as a change in the mix between those segments. Our room revenue by primary customer segment in the third quarter of 2009 and 2008 was as follows:

	Fiscal Quarter Ended September 11, 2009		Fiscal Quarter Ended September 5, 2008		
	$ in millions	% of Total	$ in millions	% of Total	% Change
Business Transient	$ 20.4	23.1%	$ 29.6	27.9%	(31.1%)
Group	33.0	37.4%	39.3	37.0%	(16.0%)
Leisure and Other	34.9	39.5%	37.3	35.1%	(6.4%)
Total	$ 88.3	100.0%	$ 106.2	100.0%	(16.9%)

Business Transient: Revenue from the business transient segment, traditionally the most profitable segment for hotels, has declined more than any other customer segment. Business transient revenue was partially replaced with lower-rated leisure and discount business. We expect business transient demand to remain depressed until there is an improvement in the overall economic climate in the United States.

Group: A number of groups have postponed, cancelled or reduced their meetings in response to the current economic recession. The deterioration in revenue is primarily due to a decline in group room nights and, to a much lesser extent, rate. As of the end of the third quarter, our 2009 group booking pace was 20% lower than at the same time last year, which represents the continued deterioration of group booking trends during the year.

Leisure and Other: The decline in revenue from leisure, discount and other business was driven by lower average daily rates.

Food and beverage revenues decreased 10.7% from the comparable period in 2008, reflecting a decline in both banquet and outlet revenues. Other revenues, which primarily represent spa, golf, parking and attrition and cancellation fees, decreased 8.5% from 2008.

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Hotel operating expenses. Hotel operating expenses consist primarily of operating expenses of our hotels, including non-cash ground rent expense. The operating expenses for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively, consist of the following (in millions):

	Fiscal Quarter Ended September 11, 2009	Fiscal Quarter Ended September 5, 2008	% Change
Rooms departmental expenses	$ 23.9	$ 25.4	(5.9%)
Food and beverage departmental expenses	29.1	33.0	(11.8%)
Other departmental expenses	7.0	7.2	(2.8%)
General and administrative	12.2	13.1	(6.9%)
Utilities	6.1	7.7	(20.8%)
Repairs and maintenance	6.7	7.2	(6.9%)
Sales and marketing	9.9	11.3	(12.4%)
Base management fees	3.6	4.4	(18.2%)
Incentive management fees	1.3	2.4	(45.8%)
Property taxes	5.9	5.3	11.3%
Ground rent- Contractual	0.5	0.5	0.0%
Ground rent- Non-cash	1.8	1.8	0.0%
Total hotel operating expenses	$ 108.0	$ 119.3	(9.5%)

Our hotel operating expenses decreased $11.3 million or 9.5%, from $119.3 million for the fiscal quarter ended September 5, 2008 to $108.0 million for the fiscal quarter ended September 11, 2009. We have been working with our hotel managers to lower operating expenses. As a result of these cost-containment measures, and an overall decline in occupancy, we have reduced the rooms, food and beverage and other hotel departmental expenses. The primary driver for the decrease in these operating expenses is an overall decline in wages and benefits. We expect the decreases in the rooms, food and beverage, and other hotel expenses to continue for the remainder of 2009.

Management fees are calculated as a percentage of total revenues, as well as a percentage of operating profit at certain hotels. Therefore, the decline in base management fees is due to the overall decline in revenues at our hotels. We only pay incentive management fees at certain of our hotels when operating profits are above certain thresholds. The decrease in incentive management fees of approximately $1.1 million is due to the decline in operating profits at those hotels as well as a number of our hotels falling below those operating profit thresholds in 2009 compared to 2008.

Depreciation and amortization. Depreciation and amortization is recorded on our hotel buildings over 40 years for the periods subsequent to acquisition. Depreciable lives of hotel furniture, fixtures and equipment are estimated as the time period between the acquisition date and the date that the hotel furniture, fixtures and equipment will be replaced. Our depreciation and amortization expense increased $0.6 million from $18.3 million for the fiscal quarter ended September 5, 2008 to $18.9 million for the fiscal quarter ended September 11, 2009 due to additional assets in service as of September 11, 2009.

Corporate expenses. Our corporate expenses increased from $3.2 million for the fiscal quarter ended September 5, 2008 to $3.7 million for the fiscal quarter ended September 11, 2009, due primarily to an increase in stock-based compensation expense. Corporate expenses principally consist of employee-related costs, including base payroll, bonus and restricted stock. Corporate expenses also include corporate operating costs, professional fees and directors fees.

Interest expense. Our interest expense decreased $0.5 million from $11.6 million for the fiscal quarter ended September 5, 2008 to $11.1 million for the fiscal quarter ended September 11, 2009. The decrease in interest expense is primarily due to the repayment of amounts outstanding on our credit facility in April 2009. The 2009 interest expense was comprised of mortgage debt ($10.8 million), amortization of deferred financing costs ($0.2 million) and interest and unused facility fees on our credit facility ($0.1 million). The 2008 interest expense was comprised of mortgage debt ($10.8 million), amortization of deferred financing costs ($0.2 million) and interest and unused facility fees on our credit facility ($0.6 million).

As of September 11, 2009, we had property-specific mortgage debt outstanding on twelve of our hotels. On all but one of the hotels, we have fixed-rate secured debt, which bears interest at rates ranging from 5.11% to 8.81% per year. Our weighted-average interest rate on our mortgage debt as of September 11, 2009 was 5.8%.

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Interest income. Interest income decreased $0.2 million from $0.3 million for the fiscal quarter ended September 5, 2008 to $0.1 million for the fiscal quarter ended September 11, 2009. Although our corporate cash balances are higher in 2009, the interest rates earned on corporate cash are significantly lower than the rates earned in 2008.

Income taxes. We recorded an income tax benefit of $4.6 million and $3.0 million for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively. The third quarter 2009 income tax benefit was incurred on the $11.8 million pre-tax loss of our taxable REIT subsidiary, or TRS, slightly offset by foreign income tax expense of $0.1 million related to the taxable REIT subsidiary that owns the Frenchman s Reef & Morning Star Marriott Beach Resort. The third quarter 2008 income tax expense was incurred on the $8.2 million pre-tax income of our TRS slightly offset by foreign income tax expense of $0.1 million related to the taxable REIT subsidiary that owns the Frenchman s Reef & Morning Star Marriott Beach Resort.

Comparison of the Period from January 1, 2009 to September 11, 2009 to the Period from January 1, 2008 to September 5, 2008

We incurred a net loss for the period from January 1, 2009 to September 11, 2009 of $2.1 million compared to net income of $39.1 million for the period from January 1, 2008 to September 5, 2008.

Revenue. Revenue consists primarily of the room, food and beverage and other operating revenues from our hotels. Revenues for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively, consisted of the following (in thousands):

	Period from January 1, 2009 to September 11, 2009	Period from January 1, 2008 to September 5, 2008	% Change
Rooms	$ 253,661	$ 308,141	(17.7%)
Food and beverage	122,423	141,525	(13.5%)
Other	23,866	25,609	(6.8%)
Total revenues	$ 399,950	$ 475,275	(15.8%)

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Individual hotel revenues for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively, consist of the following (in millions):

	Period from January 1, 2009 to September 11, 2009	Period from January 1, 2008 to September 5, 2008	% Change
Chicago Marriott	$ 58.1	$ 63.8	(8.9%)
Westin Boston Waterfront Hotel (1)	43.6	46.3	(5.8%)
Frenchman s Reef & Morning Star Marriott Beach Resort (1)	36.1	41.2	(12.4%)
Los Angeles Airport Marriott	33.8	41.1	(17.8%)
Renaissance Worthington	21.4	26.1	(18.0%)
Renaissance Waverly Hotel	21.3	24.4	(12.7%)
Renaissance Austin Hotel	20.9	24.1	(13.3%)
Vail Marriott Mountain Resort & Spa (1)	16.1	20.9	(23.0%)
Marriott Griffin Gate Resort	15.9	18.4	(13.6%)
Orlando Airport Marriott	15.0	17.5	(14.3%)
Courtyard Manhattan/Midtown East	14.3	21.2	(32.5%)
Torrance Marriott South Bay	14.3	18.0	(20.6%)
Salt Lake City Marriott Downtown	14.2	18.1	(21.5%)
Conrad Chicago (1)	14.1	17.7	(20.3%)
Oak Brook Hills Marriott Resort	14.0	17.0	(17.6%)
Westin Atlanta North at Perimeter (1)	10.0	12.4	(19.4%)
Bethesda Marriott Suites	9.8	12.2	(19.7%)
The Lodge at Sonoma, a Renaissance Resort & Spa	9.5	12.6	(24.6%)
Courtyard Manhattan/Fifth Avenue	8.9	12.0	(25.8%)
Marriott Atlanta Alpharetta	8.7	10.3	(15.5%)
Total	$ 400.0	$ 475.3	(15.8%)

(1) The Frenchman s Reef & Morning Star Marriott Beach Resort, Vail Marriott Mountain Resort & Spa, Westin Atlanta North at Perimeter, Conrad Chicago and the Westin Boston Waterfront Hotel report

operations on a calendar month and year basis. The periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008 include the operations for the periods from January 1 to August 31 for these five hotels.

Our total revenues declined $75.3 million, or 15.8%, from $475.3 million for the period from January 1, 2008 to September 5, 2008 to $400.0 million for the period from January 1, 2009 to September 11, 2009, reflecting the continued weakness in lodging fundamentals. The decline reflects an 18.9 percent decline in RevPAR, which is the result of a 13.0 percent decrease in ADR and a 5.0 percentage point decrease in occupancy. In addition, the operations year-to-date period of 2009 for our Marriott-managed hotels include five additional days as compared to the comparable period of 2008. The following are the key hotel operating statistics for our hotels for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively.

	Period from January 1, 2009 to September 11, 2009	**Period from January 1, 2008 to September 5, 2008**	**% Change**
Occupancy %	68.8%	73.8%	(5.0) percentage points
ADR	$ 153.49	$ 176.35	(13.0%)
RevPAR	$ 105.55	$ 130.12	(18.9%)

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Our RevPAR for the period from January 1, 2009 to September 11, 2009 declined by 18.9% from the comparable period in 2008. Most of the decline in RevPAR can be attributed to a significant decline in the average daily rate and reflects a number of negative trends within our primary customer segments, including a change in the mix between those segments. Our room revenue by primary customer segment for the period from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008 was as follows:

	Period from January 1, 2009 to September 11, 2009			Period from January 1, 2008 to September 5, 2008			
		$ in millions	% of Total		$ in millions	% of Total	% Change
Business Transient	$	63.2	24.9%	$	92.1	29.9%	(31.6%)
Group		94.1	37.1%		112.2	36.4%	(16.1%)
Leisure and Other		96.4	38.0%		103.8	33.7%	(6.9%)
Total	$	253.7	100.0%	$	308.1	100.0%	(17.7%)

Business Transient: Revenue from the business transient segment, traditionally the most profitable segment for hotels, has declined more than any other customer segment. Business transient revenue was partially replaced with lower-rated leisure and discount business. We expect business transient demand to remain depressed until there is an improvement in the overall economic climate in the United States.

Group: A number of groups have postponed, cancelled or reduced their meetings in response to the current economic recession. The deterioration in revenue is primarily due to a decline in group room nights and, to a much lesser extent, rate. As of September 11, 2009, our 2009 group booking pace was 20% lower than at the same time last year, which represents the continued deterioration of group booking trends during the year.

Leisure and Other: The decline in revenue from leisure, discount and other business was driven by lower average daily rates.

Food and beverage revenues decreased 13.5% from 2008, reflecting a decline in both banquet and outlet revenues. Other revenues, which primarily represent spa, golf, parking and attrition and cancellation fees, decreased 6.8% from 2008.

Hotel operating expenses. Hotel operating expenses consist primarily of operating expenses of our hotels, including non-cash ground rent expense. The operating expenses for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively, consist of the following (in millions):

		Period from January 1, 2009 to September 11, 2009		Period from January 1, 2008 to September 5, 2008	% Change
Rooms departmental expenses	$	66.9	$	72.8	(8.1%)
Food and beverage departmental expenses		86.0		98.3	(12.5%)
Other departmental expenses		20.8		21.1	(1.4%)
General and administrative		35.7		39.5	(9.6%)
Utilities		16.9		19.2	(12.0%)
Repairs and maintenance		19.7		20.6	(4.4%)
Sales and marketing		28.8		32.7	(11.9%)
Base management fees		10.5		13.0	(19.2%)
Incentive management fees		2.7		6.9	(60.9%)

Property taxes		18.2		15.8	15.2%
Ground rent- Contractual		1.3		1.5	(13.3%)
Ground rent- Non-cash		5.3		5.3	0.0%
Total hotel operating expenses	$	312.8	$	346.7	(9.8%)

Our hotel operating expenses decreased $33.9 million or 9.8%, from $346.7 million for the period from January 1, 2008 to September 5, 2008 to $312.8 million for the period from January 1, 2009 to September 11, 2009. We have been working with our hotel managers to lower operating expenses. As a result of these cost-containment measures, and an overall decline in occupancy, we have reduced the rooms, food and beverage and other hotel departmental expenses. The primary driver for the decrease in these operating expenses is an overall decline in wages and benefits. We expect the decreases in the rooms, food and beverage, and other hotel expenses to continue for the remainder of 2009.

Management fees are calculated as a percentage of total revenues, as well as a percentage of operating profit at certain hotels. Therefore, the decline in base management fees is due to the overall decline in revenues at our hotels. We only pay incentive management fees at certain of our hotels when operating profits are above certain thresholds. The decrease in incentive management fees of approximately $4.2 million is due to the decline in operating profits at those hotels, as well as a number of our hotels falling below those operating profit thresholds in 2009 compared to 2008.

Depreciation and amortization. Depreciation and amortization is recorded on our hotel buildings over 40 years for the periods subsequent to acquisition. Depreciable lives of hotel furniture, fixtures and equipment are estimated as the time period between the acquisition date and the date that the hotel furniture, fixtures and equipment will be replaced. Our depreciation and amortization expense increased $4.3 million from $53.0 million for the period from January 1, 2008 to September 5, 2008 to $57.3 million for the period from January 1, 2009 to September 11, 2009. This increase is primarily the result of having additional assets in service as of September 11, 2009, due primarily to our significant 2008 capital projects at the Chicago Marriott and the Westin Boston Waterfront.

Corporate expenses. Our corporate expenses increased from $9.5 million for the period from January 1, 2008 to September 5, 2008 to $11.1 million for the period from January 1, 2009 to September 11, 2009, due primarily to an increase in stock-based compensation expense. Corporate expenses principally consist of employee-related costs, including base payroll, bonus and restricted stock. Corporate expenses also include corporate operating costs, professional fees and directors fees.

Interest expense. Our interest expense decreased $0.1 million from $33.8 million for the period from January 1, 2008 to September 5, 2008 to $33.7 million for the period from January 1, 2009 to September 11, 2009. The decrease in interest expense is primarily attributable to lower interest expense on our credit facility than 2008 offset by six additional days of interest expense compared to the period from January 1, 2008 to September 5, 2008. The 2009 interest expense was comprised of mortgage debt ($32.6 million), amortization of deferred financing costs ($0.6 million) and interest and unused facility fees on our credit facility ($0.5 million). The 2008 interest expense was comprised of mortgage debt ($32.0 million), amortization of deferred financing costs ($0.6 million) and interest and unused facility fees on our credit facility ($1.2 million).

As of September 11, 2009, we had property-specific mortgage debt outstanding on twelve of our hotels. On all but one of the hotels, we have fixed-rate secured debt, which bears interest at rates ranging from 5.11% to 8.81% per year. Our weighted-average interest rate on our debt as of September 11, 2009 was 5.8%.

Interest income. Interest income decreased $0.8 million from $1.1 million for the period from January 1, 2008 to September 5, 2008 to $0.3 million for the period from January 1, 2009 to September 11, 2009 due to lower interest rates in 2009. Although our corporate cash balances are higher in 2009, the interest rates earned on corporate cash are approaching zero.

Income taxes. We recorded an income tax benefit of $13.9 million and $5.8 million for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively. The 2009 income tax benefit was incurred on the $37.4 million pre-tax loss of our taxable REIT subsidiary, or TRS, offset by foreign income tax expense of $0.8 million related to the taxable REIT subsidiary that owns the Frenchman s Reef & Morning Star Marriott Beach Resort. The 2008 income tax expense was incurred on the $18.1 million pre-tax loss of our TRS offset by foreign income tax expense of $1.0 million related to the taxable REIT subsidiary that owns the Frenchman s Reef & Morning Star Marriott Beach Resort.

Liquidity and Capital Resources

The current recession and related financial crisis has resulted in the continued deleveraging of the global financial system. As banks and other financial intermediaries reduce their leverage and incur losses on their existing portfolio of loans, the amount of capital that they are able to lend has materially decreased. As a result, it is a very difficult borrowing environment for all borrowers, even those that have strong balance sheets. While we have low leverage and a significant number of high quality unencumbered assets, we are uncertain if we could obtain new debt, or refinance existing debt, on reasonable terms in the current market.

Our short-term liquidity requirements consist primarily of funds necessary to fund future distributions to our stockholders to maintain our REIT status as well as to pay for operating expenses and other expenditures directly associated with our hotels, including capital expenditures as well as payments of interest and principal. We currently expect that our operating cash flows will be sufficient to meet our short-term liquidity requirements generally through net cash provided by operations, existing cash balances and, if necessary, short-term borrowings under our credit facility.

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Our long-term liquidity requirements consist primarily of funds necessary to pay for the costs of acquiring additional hotels, renovations, expansions and other capital expenditures that need to be made periodically to our hotels, scheduled debt payments and making distributions to our stockholders. We expect to meet our long-term liquidity requirements through various sources of capital, cash provided by operations and borrowings, as well as through our issuances of additional equity or debt securities. Our ability to incur additional debt is dependent upon a number of factors, including the current state of the overall credit markets, our degree of leverage, the value of our unencumbered assets and borrowing restrictions imposed by existing lenders. Our ability to raise additional equity is also dependent on a number of factors including the current state of the capital markets, investor sentiment and use of proceeds.

Our Financing Strategy

Since our formation in 2004, we have been consistently committed to a flexible capital structure with prudent leverage levels. During 2004 though early 2007, we took advantage of the low interest rate environment by fixing our interest rates for an extended period of time. Moreover, during the peak in the commercial real estate market in the past several years, we maintained low financial leverage by funding the majority of our acquisitions through the issuance of equity. This strategy allowed us to maintain a balance sheet with a moderate amount of debt. During the peak years, we believed, and present events have confirmed, that it would be inappropriate to increase the inherent risk of a highly cyclical business through a highly levered capital structure.

We prefer a relatively simple but efficient capital structure. We have not invested in joint ventures and have not issued any operating partnership units or preferred stock. We endeavor to structure our hotel acquisitions so that they will not overly complicate our capital structure; however, we will consider a more complex transaction if we believe that the projected returns to our stockholders will significantly exceed the returns that would otherwise be available.

We have always strived to operate our business with conservative leverage. During this economic downturn, our corporate goals and objectives continue to be focused on preserving and enhancing our liquidity. We have taken, or intend to take, a number of steps to achieve these goals, as follows:

- We completed a follow-on public offering of our common stock on during the second quarter of 2009. We sold 17,825,000 shares of common stock, including the underwriters overallotment of 2,325,000 shares, at an offering price of $4.85 per share. The net proceeds to us, after deduction of offering costs, were approximately $82.1 million.
- We completed a $75.0 million controlled equity offering program, raising net proceeds of $74.0 million through the sale of 10.2 million shares of our common stock at an average price of $7.34 per share.
- Our Board of Directors recently authorized us to sell an additional $75 million of common stock under a new controlled equity offering program.
- We repaid the entire $52 million outstanding on our senior unsecured credit facility during the second quarter of 2009 with a portion of the proceeds from our follow-on offering.
- On September 11, 2009, we refinanced the debt that was secured by a mortgage on our Courtyard Manhattan/Midtown East hotel with $43.0 million of secured debt issued by Massachusetts Mutual Life Insurance Company, which will mature on October 1, 2014.
- On October 1, 2009, we repaid the $27.9 million loan secured by a mortgage on our Griffin Gate Marriott with cash on hand. The loan was scheduled to mature on January 1, 2010.
- On October 15, 2009, we repaid the $5 million mortgage debt on our Bethesda Marriott Suites with cash on hand. The mortgage debt was scheduled to mature in July 2010.
- We intend to pay our next dividend to our stockholders of record as of December 31, 2009. We expect the 2009 dividend will be in an amount equal to 100% of our 2009 taxable income. We intend to pay up to 90% of our 2009 dividend in shares of our common stock, as permitted by the Internal Revenue Service s Revenue Procedure 2009-15.
- We have focused on minimizing capital spending during 2009 and expect to fund approximately $6 million of 2009 capital expenditures from corporate cash.

We believe that we maintain a reasonable amount of fixed interest rate mortgage debt with limited near-term maturities. As of October 20, 2009, we have $787.7 million of mortgage debt outstanding with a weighted average interest rate of 5.9% and a weighted average maturity date of 6.3 years. In addition, we currently have ten hotels unencumbered by debt.

Credit Facility

We are party to a four-year, $200.0 million senior unsecured credit facility (the Facility) expiring in February 2011. We may extend the maturity date of the Facility for an additional year upon the payment of applicable fees and the satisfaction of certain other customary conditions. On April 17, 2009, we repaid the outstanding balance of $52.0 million under the Facility with a portion of the proceeds from our follow-on public offering of common stock. Interest is paid on the periodic advances under the Facility at varying rates, based upon either LIBOR or the alternate base rate, plus an agreed upon additional margin amount. The interest rate depends upon our level of outstanding indebtedness in relation to the value of our assets from time to time, as follows:

	Leverage Ratio			
	60% or Greater	**55% to 60%**	**50% to 55%**	**Less Than 50%**
Alternate base rate margin	0.65%	0.45%	0.25%	0.00%
LIBOR margin	1.55%	1.45%	1.25%	0.95%

Our Facility contains various corporate financial covenants. A summary of the most restrictive covenants is as follows:

	Covenant	**Actual at September 11, 2009**
Maximum leverage ratio(1)	65%	47%
Minimum fixed charge coverage ratio(2)	1.6x	2.2x
Minimum tangible net worth(3)	$839.6 million	$1.4 billion
Unhedged floating rate debt as a percentage of total indebtedness	35%	0.60%

(1) Maximum leverage ratio is determined by dividing the total debt outstanding by the net asset value of our corporate assets and hotels. Hotel level net asset values are calculated based on the application of a contractual capitalization rate (which range from 7.5% to 8.0%) to the trailing twelve month

hotel net operating income.

(2) Minimum fixed charge ratio is calculated based on the trailing four quarters.

(3) Tangible net worth is defined as the gross book value of our real estate assets and other corporate assets less our total debt and all other corporate liabilities. The minimum tangible net worth increases by 75% of the net proceeds from new equity offerings.

Our Facility requires that we maintain a specific pool of unencumbered borrowing base properties. The unencumbered borrowing base assets are subject to the following limitations and covenants:

	Covenant	**Actual at September 11, 2009**
Minimum implied debt service ratio	1.5x	N/A
Maximum unencumbered leverage ratio	65%	0%
Minimum number of unencumbered borrowing base properties	4	8
Minimum unencumbered borrowing base value	$150 million	$533.5 million
Percentage of total asset value owned by borrowers or guarantors	90%	100%

If we were to default under any of the above covenants, we would be obligated to repay all amounts outstanding under our Facility and our Facility would terminate. Our ability to comply with two most restrictive financial covenants, the maximum leverage ratio and the fixed charge coverage ratio, depend primarily on our EBITDA. The following table shows the impact of various hypothetical scenarios on those two covenants.

		EBITDA Change from 2008				
	Covenant	**-10%**	**-20%**	**-30%**	**-40%**	**-50%**
Maximum leverage ratio	65%	42%	47%	53%	62%	74%
Minimum fixed charge coverage ratio	1.6x	2.6x	2.3x	2.0x	1.7x	1.4x

In addition to the interest payable on amounts outstanding under the Facility, we are required to pay unused credit facility fees equal to 0.20% of the unused portion of the Facility if the unused portion of the Facility is greater than 50% or 0.125% of the unused portion of the Facility if the unused portion of the Facility is less than 50%. We incurred interest and unused credit facility fees on the Facility of $0.1 million and $0.6 million for the fiscal quarters ended September 11, 2009 and September 5, 2008, respectively. We incurred interest and unused credit facility fees on the Facility of $0.5 million and $1.2 million for the periods from January 1, 2009 to September 11, 2009 and January 1, 2008 to September 5, 2008, respectively. As of September 11, 2009, we did not have an outstanding balance on the Facility.

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Sources and Uses of Cash

Our principal sources of cash are net cash flow from hotel operations, borrowings under mortgage debt, draws on the Facility and the proceeds from our equity offerings. Our principal uses of cash are debt service, asset acquisitions, capital expenditures, operating costs, corporate expenses and dividends.

Cash Provided by Operating Activities. Our cash provided by operating activities was $49.9 million for the period from January 1, 2009 to September 11, 2009, which was the result of our $2.1 million net loss adjusted for the impact of several non-cash charges, including $57.3 million of depreciation, $5.4 million of non-cash straight line ground rent, $0.6 million of amortization of deferred financing costs, $1.3 million of an impairment loss, and $3.9 million of stock compensation, offset by $1.2 million of amortization of unfavorable agreements, $0.4 million of amortization of deferred income and unfavorable working capital changes of $15.0 million.

Our cash provided by operating activities was $85.7 million for the period from January 1, 2008 to September 5, 2008, which is the result of our $39.1 million net income adjusted for the impact of several non-cash charges, including $53.0 million of depreciation, $5.3 million of non-cash straight line ground rent, $0.6 million of amortization of deferred financing costs, $0.8 million of yield support received and $2.6 million of stock compensation, offset by $1.2 million of amortization of unfavorable agreements, $0.4 million of amortization of deferred income and unfavorable working capital changes of $14.3 million.

Cash Used In Investing Activities. Our cash used in investing activities was $20.4 million for the period from January 1, 2009 to September 11, 2009. During the period from January 1, 2009 to September 11, 2009, we incurred capital expenditures at our hotels of $17.7 million and an increase in restricted cash of $2.7 million.

Our cash used in investing activities was $46.1 million for the period from January 1, 2008 to September 5, 2008. During the period from January 1, 2008 to September 5, 2008, we incurred capital expenditures at our hotels of $49.7 million and an increase in restricted cash of $1.4 million, which was offset by the receipt of $5.0 million of key money related to the Chicago Marriott Downtown.

Cash Provided by (Used in) Financing Activities. Our cash provided by financing activities was $76.0 million for the period from January 1, 2009 to September 11, 2009 and consisted of $135.3 million in proceeds from the sale of common stock and $43.0 million of proceeds from the new Courtyard Midtown/Manhattan East mortgage, offset by $3.0 million of scheduled debt principal payments, $0.3 million of share repurchases, $40.5 million for the repayment of the Courtyard Midtown, $57.0 million in repayments of our credit facility, $0.5 million of costs related to the sale of common stock, $1.0 million of financing costs for the Courtyard Midtown refinancing, and $0.1 million of vested dividend payments to SAR/DER holders.

Our cash used in financing activities was $45.8 million for the period from January 1, 2008 to September 5, 2008 and consisted of $2.0 million of scheduled debt principal payments, $49.4 million of share repurchases, and $70.4 million of dividend payments offset by $76.0 million in net draws under our credit facility.

Dividend Policy

We intend to distribute to our stockholders dividends equal to our REIT taxable income so as to avoid paying corporate income tax and excise tax on our earnings (other than the earnings of our TRSs and TRS lessees, which are all subject to tax at regular corporate rates) and to qualify for the tax benefits afforded to REITs under the Code. In order to qualify as a REIT under the Code, we generally must make distributions to our stockholders each year in an amount equal to at least:

- 90% of our REIT taxable income determined without regard to the dividends paid deduction, plus
- 90% of the excess of our net income from foreclosure property over the tax imposed on such income by the Code, minus
- any excess non-cash income.

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We intend to issue our next dividend to our stockholders of record as of December 31, 2009. We expect the 2009 dividend will be an amount equal to 100% of our 2009 taxable income. We intend to pay 90% of our 2009 dividend in shares of our common stock, as permitted by the Internal Revenue Service s Revenue Procedure 2009-15.

Capital Expenditures

The management and franchise agreements for each of our hotels provide for the establishment of separate property improvement funds to cover, among other things, the cost of replacing and repairing furniture and fixtures at our hotels. Contributions to the property improvement fund are calculated as a percentage of hotel revenues. In addition, we may be required to pay for the cost of certain additional improvements that are not permitted to be funded from the property improvement fund under the applicable management or franchise agreement. As of September 11, 2009, we have set aside $29.2 million for capital projects in property improvement funds, which are classified as restricted cash. Funds held in property improvement funds for one hotel are typically not permitted to be applied to any other property.

In 2009, we have focused our capital expenditures primarily on life safety, capital preservation, and return-on-investment projects. The total budget in 2009 for capital improvements is $35 million, only $6 million of which is expected to be funded from corporate cash and the balance to be funded from hotel escrow reserves. We spent approximately $17.7 million on capital improvements during the period from January 1, 2009 through September 11, 2009, of which approximately $4.1 million was funded from corporate cash.

Off-Balance Sheet Arrangements

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

Non-GAAP Financial Measures

We use the following two non-GAAP financial measures that we believe are useful to investors as key measures of our operating performance: (1) EBITDA and (2) FFO. These measures should not be considered in isolation or as a substitute for measures of performance in accordance with GAAP.

EBITDA represents net (loss) income excluding: (1) interest expense; (2) provision for income taxes, including income taxes applicable to sale of assets; and (3) depreciation and amortization. We believe EBITDA is useful to an investor in evaluating our operating performance because it helps investors evaluate and compare the results of our operations from period to period by removing the impact of our capital structure (primarily interest expense) and our asset base (primarily depreciation and amortization) from our operating results. In addition, covenants included in our indebtedness use EBITDA as a measure of financial compliance. We also use EBITDA as one measure in determining the value of hotel acquisitions and dispositions.

	Fiscal Quarter Ended September 11, 2009	Fiscal Quarter Ended September 5, 2008	Period from January 1, 2009 to September 11, 2009	Period from January 1, 2008 to September 5, 2008
Net income (loss)	$ 761	$ 12,212	$ (2,075)	$ 39,144
Interest expense	11,090	11,632	33,673	33,757
Income tax benefit	(4,558)	(2,994)	(13,856)	(5,830)
Real estate related depreciation	18,866	18,257	57,312	53,013
EBITDA	$ 26,159	$ 39,107	$ 75,054	$ 120,084

We compute FFO in accordance with standards established by the National Association of Real Estate Investment Trusts, which defines FFO as net (loss) income (determined in accordance with GAAP), excluding gains (losses) from sales of property, plus depreciation and amortization. We believe that the presentation of FFO provides useful information to investors regarding our operating performance because it is a measure of our operations without regard to specified non-cash items, such as real estate depreciation and amortization and gain or loss on sale of assets. We also use FFO as one measure in assessing our results.

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	Fiscal Quarter Ended September 11, 2009	Fiscal Quarter Ended September 5, 2008	Period from January 1, 2009 to September 11, 2009	Period from January 1, 2008 to September 5, 2008
Net income (loss)	$ 761	$ 12,212	$ (2,075)	$ 39,144
Real estate related depreciation	18,866	18,257	57,312	53,013
FFO	$ 19,627	$ 30,469	$ 55,237	$ 92,157

Critical Accounting Policies

Our consolidated financial statements include the accounts of the DiamondRock Hospitality Company and all consolidated subsidiaries. The preparation of financial statements in conformity with U.S. generally accepted accounting principles, or GAAP, requires management to make estimates and assumptions that affect the reported amount of assets and liabilities at the date of our financial statements and the reported amounts of revenues and expenses during the reporting period. While we do not believe the reported amounts would be materially different, application of these policies involves the exercise of judgment and the use of assumptions as to future uncertainties and, as a result, actual results could differ materially from these estimates. We evaluate our estimates and judgments, including those related to the impairment of long-lived assets, on an ongoing basis. We base our estimates on experience and on various other assumptions that are believed to be reasonable under the circumstances. All of our significant accounting policies are disclosed in the notes to our consolidated financial statements. The following represent certain critical accounting policies that require us to exercise our business judgment or make significant estimates:

Investment in Hotels. Acquired hotels, land improvements, building and furniture, fixtures and equipment and identifiable intangible assets are initially recorded at fair value. Additions to property and equipment, including current buildings, improvements, furniture, fixtures and equipment are recorded at cost. Property and equipment are depreciated using the straight-line method over an estimated useful life of 15 to 40 years for buildings and land improvements and one to ten years for furniture and equipment. Identifiable intangible assets are typically related to contracts, including ground lease agreements and hotel management agreements, which are recorded at fair value. Above-market and below-market contract values are based on the present value of the difference between contractual amounts to be paid pursuant to the contracts acquired and our estimate of the fair market contract rates for corresponding contracts. Contracts acquired that are at market do not have significant value. We typically enter into a new hotel management agreement based on market terms at the time of acquisition. Intangible assets are amortized using the straight-line method over the remaining non-cancelable term of the related agreements. In making estimates of fair values for purposes of allocating purchase price, we may utilize a number of sources that may be obtained in connection with the acquisition or financing of a property and other market data. Management also considers information obtained about each property as a result of its pre-acquisition due diligence in estimating the fair value of the tangible and intangible assets acquired.

We review our investments in hotels for impairment whenever events or changes in circumstances indicate that the carrying value of the investments in hotels may not be recoverable. Events or circumstances that may cause us to perform a review include, but are not limited to, adverse changes in the demand for lodging at our properties due to declining national or local economic conditions and/or new hotel construction in markets where our hotels are located. When such conditions exist, management performs an analysis to determine if the estimated undiscounted future cash flows from operations and the proceeds from the ultimate disposition of an investment in a hotel exceed the hotel s carrying value. If the estimated undiscounted future cash flows are less than the carrying amount of the asset, an adjustment to reduce the carrying value to the estimated fair market value is recorded and an impairment loss recognized.

Revenue Recognition. Hotel revenues, including room, golf, food and beverage, and other hotel revenues, are recognized as the related services are provided.

Stock-based Compensation. We account for stock-based employee compensation using the fair value based method of accounting described in Statement of Financial Accounting Standards No. 123 (revised 2004) (SFAS 123R), *Share-Based Payment*. We record the cost of awards with service conditions based on the grant-date fair value of the award. That cost is recognized over the period during which an employee is required to provide service in exchange for the award. No compensation cost is recognized for equity instruments for which employees do not render the requisite service. No awards with performance-based or market-based conditions have been issued.

Income Taxes. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities from a change in tax rates is recognized in earnings in the period when the new rate is enacted.

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We have elected to be treated as a REIT under the provisions of the Internal Revenue Code and, as such, are not subject to federal income tax, provided we distribute all of our taxable income annually to our stockholders and comply with certain other requirements. In addition to paying federal and state income tax on any retained income, we are subject to taxes on built-in-gains on sales of certain assets. Additionally, our taxable REIT subsidiaries are subject to federal, state and foreign income tax.

Inflation

Operators of hotels, in general, possess the ability to adjust room rates daily to reflect the effects of inflation. However, competitive pressures may limit the ability of our management companies to raise room rates.

Seasonality

The operations of hotels historically have been seasonal depending on location, and accordingly, we expect some seasonality in our business. Historically, we have experienced approximately two-thirds of our annual income in the second and fourth fiscal quarters.

New Accounting Pronouncements Not Yet Implemented

There are no new unimplemented accounting pronouncements that are expected to have a material impact on our results of operations, financial position or cash flows.

Item 3. Qualitative Disclosure about Market Risk

Market risk includes risks that arise from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market sensitive instruments. In pursuing our business strategies, the primary market risk to which we are currently exposed, and, to which we expect to be exposed in the future, is interest rate risk. As of September 11, 2009, we were exposed to interest rate risk on only $5.0 million of our debt, as the remaining 99.4% of our debt was fixed rate.

Item 4. Controls and Procedures

The Company s management has evaluated, under the supervision and with the participation of the Company s Chief Executive Officer and Chief Financial Officer, the effectiveness of the disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as required by paragraph (b) of Rules 13a-15 and 15d-15 under the Exchange Act, and has concluded that as of the end of the period covered by this report, the Company s disclosure controls and procedures were effective to give reasonable assurances that information we disc/font>

$

1,592

$

2,304

See Notes to Unaudited Consolidated Financial Statements

PART 1 - FINANCIAL INFORMATION
ITEM 1 - FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands, except share and per share amounts)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total
Balance, December 31, 2011	$ 2,063	$ 41,275	$ 25,304	$ 346	$ 68,988
Net Income			2,379		2,379
Other comprehensive loss				(75)	(75)
Cash dividends ($0.22 per common share)			(908)		(908)
Stock options and restricted stock expense		71			71
Issued 4,013 restricted shares	2	(2)			-
Balance, March 31, 2012	$ 2,065	$ 41,344	$ 26,775	$ 271	$ 70,455
Balance, December 31, 2012	$ 2,087	$ 42,029	$ 30,611	$ 101	$ 74,828
Net Income			1,816		1,816
Other comprehensive loss				(224)	(224)
Stock options and restricted stock expense		75			75
Issued 18,784 restricted shares	9	(9)			-
Balance, March 31, 2013	$ 2,096	$ 42,095	$ 32,427	$ (123)	$ 76,495

See Notes to Unaudited Consolidated Financial Statements

PART I-FINANCIAL INFORMATION
ITEM I-FINANCIAL STATEMENTS
EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands)

	Three Months Ended March 31, 2013	2012
OPERATING ACTIVITIES:		
Interest received	$ 7,638	$ 8,011
Fees received	3,301	3,107
Interest paid	(1,147)	(1,550)
Cash paid to employees and vendors	(8,009)	(7,058)
Cash contributed to pension plan	(95)	-
Income taxes paid	(461)	(720)
Proceeds from sale of loans held for resale	776	6,250
Originations of loans held for resale	(233)	(3,998)
Net cash provided by operating activities	1,770	4,042
INVESTING ACTIVITIES:		
Available for sales securities:		
Purchases	(3,487)	(17,759)
Proceeds from maturities and calls	3,759	9,009
Held to maturity securities:		
Purchases	-	(428)
Proceeds from maturities, calls, and payments	11	396
Additions to properties and equipment	(47)	(117)
Net increase (decrease) in loans	(5,865)	898
Net cash used in investing activities	(5,629)	(8,001)
FINANCING ACTIVITIES:		
Repayments of borrowings	(5,328)	(329)
Net increase in deposits	19,308	33,478
Net cash provided by financing activities	13,980	33,149
Net increase in cash and equivalents	10,121	29,190

CASH AND CASH EQUIVALENTS:		
Beginning of period	90,477	14,678
End of period	$ 100,598	$ 43,868

(continued)

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2013 AND 2012
(in thousands)

	Three Months Ended March 31,	
	2013	2012
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 1,816	$ 2,379
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	567	510
Deferred tax expense	109	87
Provision for loan and lease losses	450	(249)
Premium on loans sold	(25)	(53)
Stock options and restricted stock expense	75	71
Proceeds from sale of loans held for resale	776	6,250
Originations of loans held for resale	(233)	(3,998)
Cash contributed to pension plan	(95)	-
Changes in assets and liabilities affecting cash flow:		
Other assets	(699)	227
Other liabilities	(971)	(1,182)
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 1,770	$ 4,042

See Notes to Unaudited Consolidated Financial Statements

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PART 1 – FINANCIAL INFORMATION

ITEM 1 – FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2013 AND 2012

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies followed by Evans Bancorp, Inc. (the “Company”), a financial holding company, and its two direct, wholly-owned subsidiaries: (i) Evans Bank, National Association (the “Bank”), and the Bank’s subsidiaries, Evans National Leasing, Inc. (“ENL”), Evans National Holding Corp. (“ENHC”) and Suchak Data Systems, LLC (“SDS”); and (ii) Evans National Financial Services, LLC (“ENFS”), and ENFS’s subsidiary, The Evans Agency, LLC (“TEA”), and TEA’s subsidiaries, Frontier Claims Services, Inc. (“FCS”) and ENB Associates Inc. (“ENBA”), in the preparation of the accompanying interim unaudited consolidated financial statements conform with U.S. generally accepted accounting principles (“GAAP”) and with general practice within the industries in which it operates. Except as the context otherwise requires, the Company and its direct and indirect subsidiaries are collectively referred to in this report as the “Company.”

The accompanying consolidated financial statements are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the Company’s financial position and results of operations for the interim periods have been made. Certain reclassifications have been made to the 2012 unaudited consolidated financial statements to conform to the presentation used in 2013. During the quarter ended March 31, 2013, the Company revised the three month period ended, March 31, 2012 Consolidated Statement of Cash Flows to correct a $194 thousand error within “Depreciation and Amortization” and “Changes in Other Assets Affecting Cash Flow.” The Company has assessed the materiality of this correction and concluded, based on qualitative and quantitative considerations, that the adjustments are not material to the Consolidated Statements of Cash Flows as a whole.

The results of operations for the three month period ended March 31, 2013 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date of filing.

2. SECURITIES

The amortized cost of securities and their approximate fair value at March 31, 2013 and December 31, 2012 were as follows:

	March 31, 2013 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 27,210	$ 995	$ (78)	$ 28,127
States and political subdivisions	32,543	1,502	(13)	34,032
Total debt securities	$ 59,753	$ 2,497	$ (91)	$ 62,159
Mortgage-backed securities:				
FNMA	$ 13,811	$ 760	$ -	$ 14,571
FHLMC	5,737	178	(7)	5,908
GNMA	7,116	221	-	7,337
CMO	1,540	25	-	1,565
Total mortgage-backed securities	$ 28,204	$ 1,184	$ (7)	$ 29,381
Total securities designated as available for sale	$ 87,957	$ 3,681	$ (98)	$ 91,540
Held to Maturity:				
Debt securities				
States and political subdivisions	3,734	19	(46)	3,707
Total securities designated as held to maturity	$ 3,734	$ 19	$ (46)	$ 3,707
Total securities	$ 91,691	$ 3,700	$ (144)	$ 95,247

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	December 31, 2012 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 27,227	$ 1,137	$ (32)	$ 28,332
States and political subdivisions	29,912	1,567	(10)	31,469
Total debt securities	$ 57,139	$ 2,704	$ (42)	$ 59,801
Mortgage-backed securities:				
FNMA	$ 15,210	$ 867	$ -	$ 16,077
FHLMC	6,292	189	-	6,481
GNMA	7,750	263	-	8,013
CMO	1,663	28	-	1,691
Total mortgage-backed securities	$ 30,915	$ 1,347	$ -	$ 32,262
Total securities designated as available for sale	$ 88,054	$ 4,051	$ (42)	$ 92,063
Held to Maturity:				
Debt securities				
States and political subdivisions	3,744	23	(46)	3,721
Total securities designated as held to maturity	$ 3,744	$ 23	$ (46)	$ 3,721
Total securities	$ 91,798	$ 4,074	$ (88)	$ 95,784

Available for sale securities with a total fair value of $90.1 million and $68.0 million at March 31, 2013 and December 31, 2012, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

The Company uses the Federal Home Loan Bank of New York (“FHLBNY”) as its primary source of overnight funds and also has several long-term advances with FHLBNY. The Company had a total of $12.0 million and $19.0 million in borrowed funds with FHLBNY at March 31, 2013 and December 31, 2012, respectively. The Company has placed sufficient collateral in the form of residential and commercial real estate loans at FHLBNY that meet FHLB collateral requirements. As a member of the Federal Home Loan Bank (“FHLB”) System, the Bank is required to hold stock in

FHLBNY. The Bank held $1.5 million in FHLBNY stock as of March 31, 2013 and $1.8 million as of December 31, 2012 at amortized cost.

The scheduled maturities of debt and mortgage-backed securities at March 31, 2013 and December 31, 2012 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	March 31, 2013		December 31, 2012	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
	(in thousands)		(in thousands)	
Debt securities available for sale:				
Due in one year or less	$ 2,477	$ 2,497	$ 2,766	$ 2,797
Due after one year through five years	18,231	19,016	16,797	17,561
Due after five years through ten years	30,944	31,897	29,280	30,344
Due after ten years	8,101	8,749	8,296	9,099
	59,753	62,159	57,139	59,801
Mortgage-backed securities available for sale	28,204	29,381	30,915	32,262
Total available for sale securities	$ 87,957	$ 91,540	$ 88,054	$ 92,063
Debt securities held to maturity:				
Due in one year or less	$ 2,241	$ 2,230	$ 2,241	$ 2,228
Due after one year through five years	312	316	317	322
Due after five years through ten years	511	483	516	490
Due after ten years	670	678	670	681
	3,734	3,707	3,744	3,721
Total held to maturity securities	$ 3,734	$ 3,707	$ 3,744	$ 3,721

Information regarding unrealized losses within the Company's available for sale securities at March 31, 2013 and December 31, 2012, is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities. All unrealized losses are considered temporary and related to market interest rate fluctuations.

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	March 31, 2013					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 5,921	$ (78)	$ -	$ -	$ 5,921	$ (78)
States and political subdivisions	963	(10)	105	(3)	1,068	(13)
Total debt securities	$ 6,884	$ (88)	$ 105	$ (3)	$ 6,989	$ (91)
Mortgage-backed securities:						
FNMA	$ 34	$ -	$ -	$ -	$ 34	$ -
FHLMC	1,930	(7)	-	-	1,930	(7)
GNMA	-	-	-	-	-	-
CMO'S	-	-	-	-	-	-
Total mortgage-backed securities	$ 1,964	$ (7)	$ -	$ -	$ 1,964	$ (7)
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 2,644	$ (46)	$ 16	$ -	$ 2,660	$ (46)
Total temporarily impaired securities	$ 11,492	$ (141)	$ 121	$ (3)	$ 11,613	$ (144)

December 31, 2012

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 3,968	$ (32)	$ -	$ -	$ 3,968	$ (32)
States and political subdivisions	1,192	(10)	-	-	1,192	(10)
Total debt securities	$ 5,160	$ (42)	$ -	$ -	$ 5,160	$ (42)
Mortgage-backed securities:						
FNMA	$ 34	$ -	$ -	$ -	$ 34	$ -
FHLMC	-	-	-	-	-	-
GNMA	-	-	-	-	-	-
CMO'S	-	-	-	-	-	-
Total mortgage-backed securities	$ 34	$ -	$ -	$ -	$ 34	$ -
Held To Maturity:						
Debt securities:						
States and political subdivisions	$ 2,660	$ (46)	$ -	$ -	$ 2,660	$ (46)
Total temporarily impaired securities	$ 7,854	$ (88)	$ -	$ -	$ 7,854	$ (88)

In regard to municipal securities, the Company's general investment policy is that in-state securities must be rated at least Moody's Baa (or equivalent) at the time of purchase. The Company reviews the ratings report and municipality financial statements and prepares a pre-purchase analysis report before the purchase of any municipal securities. Out-of-state issues must be rated by Moody's at least Aa (or equivalent) at the time of purchase. The Company did not own any out-of-state municipal bonds at March 31, 2013 or December 31, 2012. Bonds rated below A are reviewed periodically to ensure their continued credit worthiness. While purchase of non-rated municipal securities is permitted under the Company's investment policy, such purchases are limited to bonds issued by municipalities in the Company's general market area. Those municipalities are typically customers of the Bank whose financial situation is familiar to management. The financial statements of the issuers of non-rated securities are reviewed by the Bank and a credit file of the issuers is kept on each non-rated municipal security with relevant financial information.

Although concerns have been raised in the marketplace recently about the health of municipal bonds, the Company has not experienced any significant credit troubles in this portfolio and does not believe any credit troubles are imminent with respect to its portfolio. Aside from the non-rated municipal securities to local municipalities discussed above that are considered held-to-maturity, all of the Company's available-for-sale municipal bonds are investment-grade government obligation ("G.O.") bonds. G.O. bonds are generally considered safer than revenue bonds because they are backed by the full faith and credit of the government while revenue bonds rely on the revenue produced by a particular project. All of the Company's municipal bonds are issued by municipalities in New York State. To the Company's knowledge, there has never been a default of a NY G.O. in the history of the state. The Company believes that its risk of loss on default of a G.O. municipal bond for the Company is relatively low. However, historical performance does not guarantee future performance.

Management has assessed the securities available for sale in an unrealized loss position at March 31, 2013 and December 31, 2012 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities' amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company had not recorded any other-than-temporary impairment ("OTTI") charges as of March 31, 2013 and did not record any OTTI changes during 2012. The gross unrealized losses in the Company's securities portfolio were at an immaterial level during each of those periods, amounting to less than 0.2% of the total fair value of the securities portfolio at March 31, 2013 and December 31, 2012. Nevertheless, it remains possible that there could be deterioration in the asset quality of the securities portfolio in the future. The credit worthiness of the Company's portfolio is largely reliant on the ability of U.S. government sponsored agencies such as FHLB, Federal National Mortgage Association ("FNMA"), Government National Mortgage Association ("GNMA"), and Federal Home Loan Mortgage Corporation ("FHLMC"), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The relatively stable past performance is not a guarantee for similar performance of the Company's securities portfolio going forward.

3. FAIR VALUE MEASUREMENTS

The Company follows the provisions of ASC Topic 820, “Fair Value Measurements and Disclosures.” Those provisions relate to financial assets and liabilities carried at fair value and fair value disclosures related to financial assets and liabilities. ASC Topic 820 defines fair value and specifies a hierarchy of valuation techniques based on the nature of the inputs used to develop the fair value measures. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

There are three levels of inputs to fair value measurements:

- Level 1, meaning the use of quoted prices for identical instruments in active markets;
- Level 2, meaning the use of quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in markets that are not active or are directly or indirectly observable; and
- Level 3, meaning the use of unobservable inputs.

Observable market data should be used when available.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis at March 31, 2013 and December 31, 2012:

	Level 1	Level 2	Level 3	Fair Value
March 31, 2013				
Securities available-for-sale:				
U.S. government agencies	$ -	$ 28,127	$ -	$ 28,127
States and political subdivisions	-	34,032	-	34,032
Mortgage-backed securities	-	29,381	-	29,381
Mortgage servicing rights	-	-	455	455
December 31, 2012				
Securities available-for-sale:				
U.S. Treasury and other U.S. government agencies	$ -	$ 28,332	$ -	$ 28,332
States and political subdivisions	-	31,469	-	31,469
Mortgage-backed securities	-	32,262	-	32,262
Mortgage servicing rights	-	-	467	467

Securities available for sale

Fair values for securities are determined using independent pricing services and market-participating brokers. The Company's independent pricing service utilizes evaluated pricing models that vary by asset class and incorporate available trade, bid and other market information for structured securities, cash flow and, when available, loan performance data. Because many fixed income securities do not trade on a daily basis, the evaluated pricing applications apply information as applicable through processes, such as benchmarking of like securities, sector groupings, and matrix pricing, to prepare evaluations. In addition, model processes, such as the Option Adjusted Spread model, are used to assess interest rate impact and develop prepayment scenarios. The models and the process take into account market convention. For each asset class, a team of evaluators gathers information from market sources and integrates relevant credit information, perceived market movements and sector news into the evaluated pricing applications and models. The company's service provider may occasionally determine that it does have not sufficient verifiable information to value a particular security. In these cases the Company will utilize valuations from another pricing service.

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis the Company reviews changes in the market value of its security portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis the Company has its entire security portfolio priced by a second pricing service to determine consistency with another market evaluator. If, on the

Company's review or in comparing with another servicer, a material difference between pricing evaluations were to exist, the Company may submit an inquiry to the service provider regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than the initial evaluation it can submit a challenge for a change to that security's valuation. There were no material differences in valuations noted in the first quarter of 2013 or during fiscal year 2012.

Securities available for sale are classified as Level 2 in the fair value hierarchy as the valuation provided by the third-party provider uses observable market data.

Mortgage servicing rights

Mortgage servicing rights ("MSRs") do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider determines the fair value by discounting projected net servicing cash flows of the remaining servicing portfolio. The valuation model used by the provider considers market loan prepayment predictions and other economic factors which management considers to be significant unobservable inputs. The fair value of MSRs is mostly affected by changes in mortgage interest rates since rate changes cause the loan prepayment acceleration factors to increase or decrease. All assumptions are market driven. Management has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of MSRs to enable management to maintain an appropriate system of internal control. Mortgage servicing rights are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for mortgage servicing rights during the three month periods ended March 31, 2013 and 2012, respectively:

	Three months ended March 31,	
	2013	2012
Beginning balance, Dec 31	$ 467	$ 407
Losses included in earnings	(20)	(7)
Additions from loan sales	8	54
Ending balance, March 31	$ 455	$ 454

Quantitative information about the significant unobservable inputs used in the fair value measurement of MSRs at the respective dates is as follows:

	3/31/2013	3/31/2012
Servicing fees	0.25 %	0.25 %
Discount rate	10.05 %	10.09 %
Prepayment rate (CPR)	15.06 %	15.48 %

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at March 31, 2013 and December 31, 2012:

	Level 1	Level 2	Level 3	Fair Value
March 31, 2013				
Impaired loans	$ -	-	13,103	$ 13,103
December 31, 2012				
Impaired loans	$ -	-	12,303	$ 12,303

Impaired loans

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Each loan's collateral has a unique appraisal and management's discount of the value is based on factors unique to each impaired loan. The significant unobservable input in determining the fair value is management's subjective discount on appraisals of the collateral securing the loan, which ranges from 10%-50%. Collateral may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management's expertise and knowledge of the client and the client's business.

The Company has an appraisal policy in which appraisals are obtained upon a commercial loan being downgraded on the Company internal loan rating scale to a 5 (special mention) or a 6 (substandard) depending on the amount of the loan, the type of loan and the type of collateral. All impaired commercial loans are either graded a 6 or 7 on the internal loan rating scale. For consumer loans, the Company obtains appraisals when a loan becomes 90 days past due or is determined to be impaired, whichever occurs first. Subsequent to the downgrade or reaching 90 days past due, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change

in the condition of the collateral, or feedback from local appraisers. Impaired loans had a gross value of $14.2 million, with a valuation allowance of $1.1 million, at March 31, 2013, compared to a gross value for impaired loans of $13.6 million, with a valuation allowance of $1.3 million, at December 31, 2012.

FAIR VALUE OF FINANCIAL INSTRUMENTS

At March 31, 2013 and December 31, 2012, the estimated fair values of the Company's financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis, were as follows:

	March 31, 2013		December 31, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Level 1:				
Cash and cash equivalents	$ 100,598	$ 100,598	$ 90,477	$ 90,477
Level 2:				
Available for sale securities	91,540	91,540	92,063	92,063
FHLB and FRB stock	2,946	2,946	3,249	3,249
Level 3:				
Held to maturity securities	3,734	3,707	3,744	3,721
Loans and leases, net	577,932	612,984	573,163	607,916
Mortgage servicing rights	455	455	467	467
Financial liabilities:				
Level 1:				
Demand deposits	$ 123,084	$ 123,084	$ 123,405	$ 123,405
NOW deposits	73,016	73,016	65,753	65,753
Regular savings deposits	391,739	391,739	380,924	380,924
Junior subordinated debentures	11,330	11,330	11,330	11,330
Commitments to extend credit	90	90	49	49
Securities sold under agreement to repurchase	13,784	13,784	12,111	12,111
Level 2:				
Other borrowed funds	12,000	12,377	19,000	19,503
Level 3:				

Time deposits	110,461	113,347	108,910	111,883

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practical to estimate that value.

Cash and Cash Equivalents. For these short-term instruments, the carrying amount is a reasonable estimate of fair value. “Cash and Cash Equivalents” includes interest-bearing deposits at other banks.

FHLB and FRB stock. The carrying value of FHLB and FRB stock approximate fair value.

Securities held to maturity. The Company holds certain municipal bonds as held-to-maturity. These bonds are generally small in dollar amount and are issued only by certain local municipalities within the Company’s market area. The original terms are negotiated directly and on an individual basis consistent with our loan and credit guidelines. These bonds are not traded on the open market and management intends to hold the bonds to maturity. The fair value of held-to-maturity securities is estimated by discounting the future cash flows using the current rates at which similar agreements would be made with municipalities with similar credit ratings and for the same remaining maturities.

Loans and Leases, net. The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities, net of the appropriate portion of the allowance for loan losses. For variable rate loans, the carrying amount is a reasonable estimate of fair value. This fair value calculation is not necessarily indicative of the exit price, as defined in ASC 820.

Deposits. The fair value of demand deposits, NOW accounts, muni-vest accounts and regular savings accounts is the amount payable on demand at the reporting date. The fair value of time deposits is estimated using the rates currently offered for deposits of similar remaining maturities.

Junior Subordinated Debentures. The carrying amount of Junior Subordinated Debentures is a reasonable estimate of fair value due to the fact that they bear a floating interest rate that adjusts on a quarterly basis.

Commitments to extend credit and standby letters of credit. As described in Note 8 - “Contingent Liabilities and Commitments” to these Unaudited Consolidated Financial Statements, the Company was a party to financial instruments with off-balance sheet risk at March 31, 2013 and December 31, 2012. Such financial instruments consist of commitments to extend permanent financing and letters of credit. If the options are exercised by the prospective borrowers, these financial instruments will become interest-earning assets of the Company. If the options expire, the Company retains any fees paid by the counterparty in order to obtain the commitment or guarantee. The fees collected for these commitments are recorded as “unearned commitment fees” in Other Liabilities. The carrying value approximates the fair value.

Securities Sold Under Agreement to Repurchase. The fair value of the securities sold under agreement to repurchase approximates its carrying value.

Other Borrowed Funds. The fair value of the short-term portion of other borrowed funds approximates its carrying value. The fair value of the long-term portion of other borrowed funds is estimated using a discounted cash flow analysis based on the Company’s current incremental borrowing rates for similar types of borrowing arrangements.

4. LOANS, LEASES, AND THE ALLOWANCE FOR LOAN AND LEASE LOSSES

Loan and Lease Portfolio Composition

The following table presents selected information on the composition of the Company’s loan and lease portfolio as of the dates indicated:

	March 31, 2013	December 31, 2012
Mortgage loans on real estate:	(in thousands)	
Residential Mortgages	$ 74,713	$ 68,135
Commercial and multi-family	321,777	323,777
Construction-Residential	991	811
Construction-Commercial	26,789	28,941
Home equities	54,787	56,366
Total real estate loans	479,057	478,030
Direct financing leases	929	1,612
Commercial and industrial loans	105,982	99,951
Consumer loans	1,047	1,294
Other	340	1,342
Net deferred loan origination costs	731	666
Total gross loans	588,086	582,895
Allowance for loan losses	(10,154)	(9,732)
Loans, net	$ 577,932	$ 573,163

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three month periods ended March 31, 2013 and 2012, the Bank sold mortgages to FNMA totaling $0.8 million and $6.2 million, respectively. At March 31, 2013, the Bank had a loan servicing portfolio principal balance of $70.4 million upon which it earns servicing fees, as compared with $73.7 million at December 31, 2012. The value of the mortgage servicing rights for that portfolio was $0.5 million at March 31, 2013 and December 31, 2012. Residential mortgage loans held-for-sale were $0.4 million at March 31, 2013, compared with $0.9 million at December 31, 2012. The Company had no commercial loans held-for-sale at March 31, 2013 and at December 31, 2012. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

As noted in Note 1, these financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012. Disclosures related to the basis for accounting for loans and leases, the method for recognizing interest income on loans and leases, the policy for placing loans and leases on nonaccrual status and the subsequent recording of payments and resuming accrual of interest, the policy for determining past due status, a description of the Company's accounting policies and methodology used to estimate the allowance for loan and lease losses, the policy for charging off loans and leases, the accounting policies for impaired loans, and more descriptive information on the Company's credit risk ratings are all contained in the Notes to the Audited Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the Company's year ended December 31, 2012. Unless otherwise noted in this Form 10-Q, the policies and methodology described in the Annual Report for the year ended December 31, 2012 are consistent with those utilized by the Company in the three months ended March 31, 2013.

Credit Quality Indicators

The Bank monitors the credit risk in its loan portfolio by reviewing certain credit quality indicators ("CQI"). The primary CQI for its commercial mortgage and commercial and industrial ("C&I") portfolios is the individual loan's credit risk rating. The following list provides a description of the credit risk ratings that are used internally by the Bank when assessing the adequacy of its allowance for loan and lease losses:

- 1-3-Pass
- 4-Watch
- 5-O.A.E.M. (Other Assets Especially Mentioned) or Special Mention
- 6-Substandard
- 7-Doubtful
- 8-Loss

The Company's consumer loans, including residential mortgages and home equities, and commercial leases are not individually risk rated or reviewed in the Company's loan review process. Consumers are not required to provide the Company with updated financial information as is a commercial customer. Consumer loans also carry smaller balances. Given the lack of updated information since the initial underwriting of the loan and small size of individual loans, the Company uses delinquency status as the credit quality indicator for consumer loans.

There were no changes in the Company’s allowance for loan and lease loss methodology in the three month period ended March 31, 2013.

The following tables provide data, at the class level, of credit quality indicators of certain loans and leases for the dates specified:

March 31, 2013
(in thousands)

Corporate Credit Exposure – By Credit Rating	Commercial Real Estate Construction	Commercial and Multi-Family Mortgages	Total Commercial Real Estate	Commercial and Industrial
3	$ 24,445	$ 280,137	$ 304,582	$ 84,157
4	671	26,025	26,696	14,209
5	934	7,810	8,744	4,453
6	739	4,087	4,826	2,570
7	-	3,718	3,718	593
Total	$ 26,789	$ 321,777	$ 348,566	$ 105,982

December 31, 2012
(in thousands)

Corporate Credit Exposure – By Credit Rating	Commercial Real Estate Construction	Commercial and Multi-Family Mortgages	Total Commercial Real Estate	Commercial and Industrial
3	$ 24,461	$ 273,843	$ 298,304	$ 77,095
4	2,023	40,346	42,369	14,681

5	1,728	3,081	4,809	5,229
6	729	2,911	3,640	2,308
7	-	3,596	3,596	638
Total	$ 28,941	$ 323,777	$ 352,718	$ 99,951

Past Due Loans and Leases

The following tables provide an analysis of the age of the recorded investment in loans and leases that are past due as of the dates indicated:

March 31, 2013
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans and Leases
Commercial and industrial	$ 991	$ 136	$ 689	$ 1,816	$ 104,166	$ 105,982	$ -	$ 1,169
Residential real estate:								
Residential	562	-	938	1,500	73,213	74,713	-	1,413
Construction	-	-	-	-	991	991	-	-
Commercial real estate:								
Commercial	14,658	-	3,457	18,115	303,662	321,777	-	4,719
Construction	1,099	-	-	1,099	25,690	26,789	-	-
Home equities	129	58	544	731	54,056	54,787	18	573
Direct financing leases	24	-	108	132	797	929	-	124
Consumer	120	7	-	127	920	1,047	-	20
Other	-	-	-	-	1,071	1,071	-	-
Total Loans	$ 17,583	$ 201	$ 5,736	$ 23,520	$ 564,566	$ 588,086	$ 18	$ 8,018

December 31, 2012
(in thousands)

	30-59 days	60-89 days	90+ days	Total Past Due	Current Balance	Total Balance	90+ Days Accruing	Non-accruing Loans and Leases
Commercial and industrial	$ 564	$ 141	$ 135	$ 840	$ 99,111	$ 99,951	$ -	$ 914
Residential real estate:								

Residential	1,015	62	872	1,949	66,186	68,135	-	1,443
Construction	-	-	-	-	811	811	-	-
Commercial real estate:								
Commercial	12,658	169	3,658	16,485	307,292	323,777	-	4,309
Construction	1,505	201	729	2,435	26,506	28,941	-	729
Home equities	32	215	572	819	55,547	56,366	-	618
Direct financing leases	31	7	123	161	1,451	1,612	-	171
Consumer	17	4	23	44	1,250	1,294	-	44
Other	-	-	-	-	2,008	2,008	-	-
Total Loans	$ 15,822	$ 799	$ 6,112	$ 22,733	$ 560,162	$ 582,895	$ -	$ 8,228

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Allowance for loan and lease losses

The following tables present the activity in the allowance for loan and lease losses according to portfolio segment, for the three month periods ended March 31, 2013 and 2012:

March 31, 2013

(in thousands)	Commercial and Industrial	Commercial Real Estate Mortgages*	Consumer **	Residential Mortgages*	HELOC	Direct Financing Leases	Unallocated	Total
Allowance for loan and lease losses:								
Beginning balance	$ 3,617	$ 4,493	$ 18	$ 662	$ 746	$ 47	$ 149	$ 9,732
Charge-offs	(10)	(13)	(10)	(6)	(91)	-	-	(130)
Recoveries	97	1	3	1	-	-	-	102
Provision	51	266	4	91	85	(47)	-	450
Ending balance	$ 3,755	$ 4,747	$ 15	$ 748	$ 740	$ -	$ 149	$ 10,154
Allowance for loan and lease losses: Ending balance:								
Individually evaluated for impairment	$ 387	$ 412	$ 4	$ 5	$ 7	$ -	$ -	$ 815
Collectively evaluated for impairment	3,368	4,335	11	743	733	-	149	9,339
Total	$ 3,755	$ 4,747	$ 15	$ 748	$ 740	$ -	$ 149	$ 10,154
Loans and leases: Ending balance:								
Individually evaluated for impairment	$ 1,417	$ 7,867	$ 20	$ 1,441	$ 573	$ 115	$ -	$ 11,433
Collectively evaluated for impairment	104,565	340,699	1,367	74,263	54,214	814	-	575,922
Total	$ 105,982	$ 348,566	$ 1,387	$ 75,704	$ 54,787	$ 929	$ -	$ 587,355

* Includes construction loans

** Includes other loans

NOTE: Loan and lease balances do not include $731 thousand in net deferred loan and lease origination costs as of March 31, 2013.

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March 31, 2012

(in thousands)	Commercial and Industrial	Commercial Real Estate Mortgages*	Consumer **	Residential Mortgages*	HELOC	Direct Financing Leases	Unallocated	Total
Allowance for loan and lease losses:								
Beginning balance	$ 4,085	$ 4,670	$ 36	$ 793	$ 768	$ 994	$ 149	$ 11,495
Charge-offs	(409)	(59)	(3)	-	(13)	-	-	(484)
Recoveries	18	-	4	-	6	-	-	28
Provision	252	(46)	6	(74)	24	(411)	-	(249)
Ending balance	$ 3,946	$ 4,565	$ 43	$ 719	$ 785	$ 583	$ 149	$ 10,790
Allowance for loan and lease losses:								
Ending balance:								
Individually evaluated for impairment	$ 637	$ 609	$ 14	$ -	$ 102	$ 280	$ -	$ 1,642
Collectively evaluated for impairment	3,309	3,956	29	719	683	303	149	9,148
Total	$ 3,946	$ 4,565	$ 43	$ 719	$ 785	$ 583	$ 149	$ 10,790
Loans and leases:								
Ending balance:								
Individually evaluated for impairment	$ 1,999	$ 7,948	$ 46	$ 1,047	$ 1,204	$ 712	$ -	$ 12,956
Collectively evaluated for impairment	101,108	332,546	1,900	73,179	53,837	3,800	-	566,370
Total	$ 103,107	$ 340,494	$ 1,946	$ 74,226	$ 55,041	$ 4,512	$ -	$ 579,326

* Includes construction loans

** Includes other loans

NOTE: Loan and lease balances do not include $374 thousand in net deferred loan and lease origination costs as of March 31, 2012.

Impaired Loans and Leases

The following tables provide data, at the class level, of impaired loans and leases as of the dates indicated:

	At March 31, 2013					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
With no related allowance recorded:	(in thousands)					
Commercial and industrial	$ 287	$ 399	$ -	$ 301	$ 5	$ 1
Residential real estate:						
Residential	1,109	1,253	-	1,132	38	-
Construction	-	-	-	-	-	-
Commercial real estate:						
Commercial	3,818	4,065	-	3,831	39	31
Construction	739	739	-	739	-	6
Home equities	537	568	-	539	8	-
Direct financing leases	115	117	-	135	2	-
Consumer	-	-	-	-	-	-
Other	-	-	-	-	-	-
Total impaired loans and leases	$ 6,605	$ 7,141	$ -	$ 6,677	$ 92	$ 38

	At March 31, 2013					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
With a related allowance recorded:	(in thousands)					
Commercial and industrial	$ 3,029	$ 3,089	$ 640	$ 3,041	$ 11	$ 30
Residential real estate:						
Residential	304	318	5	304	6	-
Construction	-	-	-	-	-	-
Commercial real estate:						
Commercial	3,310	3,486	412	3,341	52	16
Construction	934	934	49	934	-	8
Home equities	36	36	7	36	1	-
Direct financing leases	-	-	-	-	-	-
Consumer	20	51	4	24	1	-
Other	-	-	-	-	-	-
Total impaired loans and leases	$ 7,633	$ 7,914	$ 1,117	$ 7,680	$ 71	$ 54

	At March 31, 2013					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
Total:	(in thousands)					
Commercial and industrial	$ 3,316	$ 3,488	$ 640	$ 3,342	$ 16	$ 31

	-	-	-	-	-	-
Residential real estate:						
Residential	1,413	1,571	5	1,436	44	-
Construction	-	-	-	-	-	-
	-	-	-	-	-	-
Commercial real estate:						
Commercial	7,128	7,551	412	7,172	91	47
Construction	1,673	1,673	49	1,673	-	14
	-	-	-	-	-	-
Home equities	573	604	7	575	9	-
	-	-	-	-	-	-
Direct financing leases	115	117	-	135	2	-
	-	-	-	-	-	-
Consumer	20	51	4	24	1	-
	-	-	-	-	-	-
Other	-	-	-	-	-	-
Total impaired loans and leases	$ 14,238	$ 15,055	$ 1,117	$ 14,357	$ 163	$ 92

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	At December 31, 2012					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
With no related allowance recorded:	(in thousands)					
Commercial and industrial	$ 277	$ 289	$ -	$ 392	$ 10	$ 6
Residential real estate:						
Residential	1,437	1,558	-	1,444	56	12
Construction	-	-	-	-	-	-
Commercial real estate:						
Commercial	3,313	3,555	-	3,711	174	94
Construction	729	814	-	778	26	-
Home equities	938	973	-	856	26	14
Direct financing leases	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Other	-	-	-	-	-	-

Total impaired loans and leases	$ 6,694	$ 7,189	$ -	$ 7,181	$ 292	$ 126

	At December 31, 2012					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
With a related allowance recorded:	(in thousands)					
Commercial and industrial	$ 2,509	$ 2,662	$ 747	$ 2,938	$ 49	$ 107
Residential real estate:						
Residential	6	6	-	6	-	-
Construction	-	-	-	-	-	-
Commercial real estate:						
Commercial	3,241	3,425	471	3,267	172	3
Construction	934	934	49	934	-	30
Home equities	-	-	-	-	-	-
Direct financing leases	164	178	13	266	14	-
Consumer	44	121	9	60	9	-
Other	-	-	-	-	-	-
Total impaired loans and leases	$ 6,898	$ 7,326	$ 1,289	$ 7,471	$ 244	$ 140

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	At December 31, 2012					
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Foregone	Interest Income Recognized
Total:	(in thousands)					
Commercial and industrial	$ 2,786	$ 2,951	$ 747	$ 3,330	$ 59	$ 113
	-	-	-	-	-	-
Residential real estate:						
Residential	1,443	1,564	-	1,450	56	12
Construction	-	-	-	-	-	-
	-	-	-	-	-	-
Commercial real estate:						
Commercial	6,554	6,980	471	6,978	346	97
Construction	1,663	1,748	49	1,712	26	30
	-	-	-	-	-	-
Home equities	938	973	-	856	26	14
	-	-	-	-	-	-
Direct financing leases	164	178	13	266	14	-
	-	-	-	-	-	-
Consumer	44	121	9	60	9	-
	-	-	-	-	-	-
Other	-	-	-	-	-	-
Total impaired loans and leases	$ 13,592	$ 14,515	$ 1,289	$ 14,652	$ 536	$ 266

The Company had three commercial loans identified as impaired with an unpaid principal balance of $2.8 million as of March 31, 2013, and two commercial loans identified as impaired with an unpaid principal balance of $2.6 as of December 31, 2012, in which it was unable to perform an appropriate impairment calculation due to the lack of reliable financial information from the borrower. The reserve on these loans were $0.3 million at March 31, 2013 and December 31, 2012, as determined according to the credit risk rating per the Company's allowance for loan and lease losses methodology, as described in Note 1 – “Organization and Summary of Significant Accounting Policies” within the Annual Report for the year ended December, 31, 2012.

Non-performing loans and leases

The following table sets forth information regarding non-performing loans and leases as of the dates specified:

	March 31, 2013	December 31, 2012
	(in thousands)	
Non-accruing loans and leases:		
Commercial and industrial loans	$ 1,169	$ 914
Residential real estate:		
Residential	1,413	1,443
Construction	-	-
Commercial real estate:		
Commercial and multi-family	4,719	4,309
Construction	-	729
Home equities	573	618
Direct financing leases	124	171
Consumer loans	20	44
Other	-	-
Total non-accruing loans and leases	$ 8,018	$ 8,228
Accruing loans 90+ days past due	18	-
Total non-performing loans and leases	$ 8,036	$ 8,228
Total non-performing loans and leases to total assets	0.98 %	1.02 %
Total non-performing loans and leases to total loans and leases	1.37 %	1.41 %

Troubled debt restructurings

The Company had $12.0 million in loans and leases that were restructured in a troubled debt restructuring ("TDR") at March 31, 2013, compared with $11.5 million at December 31, 2012. $5.7 million and $6.0 million of those balances were in non-accrual status at March 31, 2013 and December 31, 2012, respectively. Any TDR that is placed on non-accrual is not reverted back to accruing status until the borrower makes timely payments as contracted for at least six months. Those loans and leases that are in accruing status have shown evidence of performance for at least six months as of March 31, 2013 and December 31, 2012. One residential mortgage for $0.4 million was made under a government assistance program in 2012. Two commercial loans with a combined balance of $0.3 million restructured in 2013, in addition to five loans restructured prior to 2013 with a combined balance of $1.1 million, are covered under the Bank's loss-sharing arrangement with the FDIC. For additional details on this agreement, see discussion under "Covered Loans and the Related Allowance" below. All of the Company's restructurings were allowed in an effort to maximize its ability to collect on loans and leases where borrowers were experiencing financial difficulty. Modifications made to loans in a troubled debt restructuring did not have a material impact on the Company's net income for the three month periods ended March 31, 2013 and 2012. The reserve for a TDR is based upon the present value of the future expected cash flows discounted at the loan's original effective rate or upon the fair value of the collateral less costs to sell, if the loan is deemed collateral dependent. This reserve methodology is used because all TDR loans are considered impaired. As of March 31, 2013, there were no commitments to lend additional funds to debtors owing loans or leases whose terms have been modified in TDRs. The Company's TDRs involve interest only payments and lengthening of terms as concessions to try and maximize the collectability of the loans.

The following tables summarize the loans and leases that were classified as troubled debt restructurings as of the dates indicated:

	March 31, 2013 ($ in thousands)			
	Total	Nonaccruing	Accruing	Related Allowance
Commercial and industrial	$ 3,199	$ 1,052	$ 2,147	$ 280
Residential real estate:				
Residential	503	475	28	-
Construction	-	-	-	-
Commercial real estate:				
Commercial and multi family	5,852	3,443	2,409	412
Construction	2,365	691	1,674	-
	-	-	-	-
Home equities	-	-	-	-
Direct financing leases	115	51	64	-

Consumer loans	-	-	-	-
Other	-	-	-	-
Total troubled restructured loans and leases	$ 12,034	$ 5,712	$ 6,322	$ 692

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	December 31, 2012 ($ in thousands)			
	Total	Nonaccruing	Accruing	Related Allowance
Commercial and industrial	$ 2,592	$ 720	$ 1,872	$ 335
Residential real estate:				
Residential	509	509	-	-
Construction	-	-	-	-
Commercial real estate:				
Commercial and multi family	6,203	3,958	2,245	471
Construction	1,663	729	934	-
				-
Home equities	320	-	320	-
Direct financing leases	164	70	94	13
Consumer loans	-	-	-	-
Other	-	-	-	-
Total troubled restructured loans and leases	$ 11,451	$ 5,986	$ 5,465	$ 819

The following table shows the data for TDR activity for the three month periods ended March 31, 2013 and 2012:

	Three Months Ended March 31, 2013 ($ in thousands)			Three Months Ended March 31, 2012 ($ in thousands)		
Troubled Debt Restructurings	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment

Commercial and Industrial	2	$ 330	$ 330	2	$ 256	$ 256
Residential Real Estate:						
Residential	1	28	28	-	-	-
Construction	-	-	-	-	-	-
Commercial Real Estate:						
Commercial & Multi-Family	-	-	-	1	85	85
Construction	2	739	739	-	-	-
Home Equities	-	-	-	-	-	-
Direct financing leases	-	-	-	-	-	-
Consumer loans	-	-	-	-	-	-
Other	-	-	-	-	-	-

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The general practice of the Bank is to work with borrowers so that they are able to pay back their loan or lease in full. If a borrower continues to be delinquent or cannot meet the terms of a TDR and the loan or lease is determined to be uncollectible, the loan or lease will be charged off. The following table presents loans and leases which were classified as TDR's during the previous 12 months which have defaulted during the three month periods ended March 31, 2013 and 2012:

	Three Months Ended March 31, 2013 ($ in thousands)		Three Months Ended March 31, 2012	
Troubled Debt Restructurings That Subsequently Defaulted	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Commercial and Industrial	-	$ -	4	$ 1,272
Residential Real Estate:				
Residential	-	-	-	-
Construction	-	-	-	-
Commercial Real Estate:				
Commercial and Multi-Family	-	-	6	4,289
Construction	-	-	-	-
Home Equities	-	-	-	-
Direct financing leases	-	-	-	-
Consumer loans	-	-	-	-
Other	-	-	-	-

Covered Loans and the Related Allowance

On July 24, 2009, the Bank entered into a definitive purchase and assumption agreement with the FDIC under which the Bank assumed approximately $51.0 million in liabilities, consisting almost entirely of deposits, and purchased substantially all of the assets of Waterford Village Bank. The loan portfolio acquired in the transaction totaled $42.0 million. The loans acquired in that acquisition are referred to as "covered" loans because they are "covered" by a loss sharing agreement with the FDIC. The agreement calls for the FDIC to reimburse the Bank for 80% of losses up to $5.6 million and 95% of losses beyond that threshold. At acquisition, the Company marked the covered loan portfolio to its market value and the allowance for loan and lease losses related to the covered loans was zero. Since acquisition, management has provisioned for any incremental increases in estimated credit losses due to deterioration in specific loans or increased risk factors on pools of loans. As a result of the FDIC guarantees, the provision for loan and lease losses and the allowance for loan and lease losses at March 31, 2013 and December 31, 2012 are presented net of FDIC guarantees related to covered loans. The following table depicts the allowance for loan and lease losses related to covered loans as of March 31, 2013 and December 31, 2012:

	March 31, 2013	December 31, 2012
	(in thousands)	
Covered loans	$ 17,444	$ 20,787
Incremental estimated credit losses since acquisition	885	595
FDIC guarantee	(708)	(476)
Allowance for loan and lease losses, covered loans	$ 177	$ 119

5. PER SHARE DATA

The common stock per share information is based upon the weighted average number of shares outstanding during each period. For the three month period ended March 31, 2013, the Company had an average of 36,617 dilutive shares. The Company had an average of 4,674 dilutive shares for the three month period ended March 31, 2012.

Potential common shares that would have the effect of increasing diluted earnings per share are considered to be anti-dilutive and not included in calculating diluted earnings per share. For the three month periods ended March 31, 2013 and 2012, there was an average of 90,071 and 203,394 shares, respectively, that were not included in calculating diluted earnings per share because their effect was anti-dilutive.

6. OTHER COMPREHENSIVE INCOME

The following tables summarize the changes in the components of accumulated other comprehensive income (loss) during the three months ended March 31, 2013 and 2012:

	Balance at December 31, 2012	Net Change	Balance at March 31, 2013
Net unrealized loss on investment securities	$ 2,457	$ 261	$ 2,196
Net defined benefit pension plans adjustments	(2,356)	(37)	(2,319)
Total	$ 101	$ 224	$ (123)

	Balance at December 31, 2011	Net Change	Balance at March 31, 2012
Net unrealized loss on investment securities	$ 2,534	$ 115	$ 2,419
Net defined benefit pension plans adjustments	(2,188)	(40)	(2,148)
Total	$ 346	$ 75	$ 271

	Three Months Ended, March 31,					
	2013			2012		
	Before-Tax Amount	Income Tax (Provision) Benefit	Net-of-Tax Amount	Before-Tax Amount	Income Tax (Provision) Benefit	Net-of-Tax Amount
Unrealized loss on investment securities:						
Unrealized loss on investment securities	$ (426)	$ 165	$ (261)	$ (188)	$ 73	$ (115)

Reclassification from accumulated other comprehensive income for (losses) gains	-	-	-	-	-	-
Net change	$ (426)	$ 165	$ (261)	$ (188)	$ 73	$ (115)
Defined benefit pension plans adjustments:						
Net actuarial (loss) gain	$ -	$ -	$ -	$ -	$ -	$ -
Reclassifications from accumulated other comprehensive income for (losses) gains						
Amortization of prior service cost [(a)]	17	(7)	10	22	(8)	14
Amortization of actuarial loss [(a)]	44	(17)	27	43	(17)	26
Net change	$ 61	$ (24)	$ 37	$ 65	$ (25)	$ 40
Other Comprehensive Loss	$ (365)	$ 141	$ (224)	$ (123)	$ 48	$ (75)

(a) Included in net periodic pension cost, as described in Note 9 – “Net Periodic Benefit Costs”

7. SEGMENT INFORMATION

The Company is comprised of two primary business segments, banking and insurance agency activities. The following tables set forth information regarding these segments for the three month periods ended March 31, 2013 and 2012.

	Three Months Ended March 31, 2013 (in thousands)		
	Banking Activities	Insurance Agency Activities	Total
Net interest income (expense)	$ 6,854	$ (28)	$ 6,826
Provision for loan and lease losses	450	-	450
Net interest income (expense) after provision for loan and lease losses	6,404	(28)	6,376
Non-interest income	1,311	-	1,311
Insurance service and fees	91	1,908	1,999
Non-interest expense	5,906	1,170	7,076
Income before income taxes	1,900	710	2,610
Income tax provision	529	265	794
Net income	$ 1,371	$ 445	$ 1,816

	Three Months Ended March 31, 2012 (in thousands)		
	Banking Activities	Insurance Agency Activities	Total
Net interest income (expense)	$ 6,883	$ (31)	$ 6,852
Provision for loan and lease losses	(249)	-	(249)
Net interest income (expense) after provision for loan and lease losses	7,132	(31)	7,101
Non-interest income	1,344	-	1,344
Insurance service and fees	-	1,945	1,945
Non-interest expense	5,668	1,241	6,909
Income before income taxes	2,808	673	3,481
Income tax provision	842	260	1,102
Net income	$ 1,966	$ 413	$ 2,379

8. CONTINGENT LIABILITIES AND COMMITMENTS

The unaudited consolidated financial statements do not reflect various commitments and contingent liabilities, which arise in the normal course of business, and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities consist of commitments to extend credit and standby letters of credit. A summary of the Bank's commitments and contingent liabilities is as follows:

	March 31, 2013	December 31, 2012
	(in thousands)	
Commitments to extend credit	$ 152,955	$ 135,028
Standby letters of credit	7,115	8,042
Total	$ 160,070	$ 143,070

Commitments to extend credit and standby letters of credit include some exposure to credit loss in the event of nonperformance of the customer. The Bank's credit policies and procedures for credit commitments and financial guarantees are the same as those for extensions of credit that are recorded on the Company's unaudited consolidated balance sheets. Because these instruments have fixed maturity dates, and because they may expire without being drawn upon, they do not necessarily represent cash requirements of the Bank. The Bank has not incurred any losses on its commitments and has not recorded a reserve for its commitments during 2012 and 2013.

Certain lending commitments for construction residential mortgage loans are considered derivative instruments under the guidelines of GAAP. The changes in the fair value of these commitments, due to interest rate risk, are not recorded on the consolidated balance sheets as the fair value of these derivatives is not considered material.

The Company is subject to possible litigation proceedings in the normal course of business. As of March 31, 2013 and December 31, 2012, there were no claims pending against the Company that management considered material.

9. NET PERIODIC BENEFIT COSTS

On January 31, 2008, the Bank froze its defined benefit pension plan. The plan covered substantially all Company employees. The plan provides benefits that are based on the employees' compensation and years of service. Under the freeze, eligible employees will receive at retirement the benefits already earned through January 31, 2008, but have not accrued any additional benefits since then. As a result, service cost is no longer incurred.

The Bank used an actuarial method of amortizing prior service cost and unrecognized net gains or losses which result from actual expense and assumptions being different than those that are projected. The amortization method the Bank used recognized the prior service cost and net gains or losses over the average remaining service period of active employees.

The Bank also maintains a nonqualified supplemental executive retirement plan covering certain members of the Company's senior management. The Bank uses an actuarial method of amortizing unrecognized net gains or losses which result from actual expense and assumptions being different than those that are projected. The amortization method the Bank uses recognizes the net gains or losses over the average remaining service period of active employees.

The Bank contributed $95 thousand to the defined benefit pension plan in the first three months of 2013 and plans to contribute an additional $135 thousand before the end of the year.

The following table presents the net periodic cost for the Bank's defined benefit pension plan and supplemental executive retirement plan for the three month periods ended March 31, 2013 and 2012:

	Three months ended March 31, (in thousands)			
	Pension Benefits		Supplemental Executive Retirement Plan	
	2013	2012	2013	2012
Service cost	$ -	$ -	$ 41	$ 45
Interest cost	48	53	31	38
Expected return on plan assets	(65)	(57)	-	-
Amortization of prior service cost	-	-	17	22
Amortization of the net loss	17	16	27	27
Net periodic cost	$ -	$ 12	$ 116	$ 132

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10. RECENT ACCOUNTING PRONOUNCEMENTS

Accounting Standards Update ("ASU") 2012-06, Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution. Accounting for a business combination requires that at each subsequent reporting date, an acquirer measure an indemnification asset on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount, and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset. The objective of this ASU is to address the diversity in practice about how to interpret the terms on the same basis and contractual limitations when subsequently measuring an indemnification asset recognized in a government-assisted (Federal Deposit Insurance Corporation) acquisition of a financial institution that includes a loss-sharing agreement (indemnification agreement). The new guidance is effective for interim and annual periods beginning after December 15, 2012. The Company adopted this ASU effective January 1, 2013. The Company does have an indemnification agreement with the FDIC related to its acquisition of Waterford Village Bank in July 2009. The agreement ends for non-single family loans in July 2014 and for single family loans in July 2019. The adoption of the ASU did not have a material impact on the Company's financial statements.

ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of this ASU is to improve the reporting of reclassifications out of accumulated other comprehensive income by requiring an entity to report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income, if the amount being reclassified is required to be reclassified into net income in its entirety. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. This ASU is effective for reporting periods beginning after December 15, 2012. The Company adopted this ASU effective January 1, 2013, as noted herein at Note 6 – "Other Comprehensive Income."

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

This Quarterly Report on Form 10-Q may contain certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), that involve substantial risks and uncertainties. When used in this report, or in the documents incorporated by reference herein, the words “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “pla “seek,” and similar expressions identify such forward-looking statements. These forward-looking statements include statements regarding the Company’s business plans, prospects, growth and operating strategies, statements regarding the asset quality of the Company’s loan and investment portfolios, and estimates of the Company’s risks and future costs and benefits.

These forward-looking statements are based largely on the expectations of the Company’s management and are subject to a number of risks and uncertainties, including but not limited to general economic conditions, either nationally or in the Company’s market areas, that are worse than expected; increased competition among depository or other financial institutions; inflation and changes in the interest rate environment that reduce the Company’s margins or reduce the fair value of financial instruments; changes in laws or government regulations affecting financial institutions, including changes in regulatory fees, monetary policy, and capital requirements; the Company’s ability to enter new markets successfully and capitalize on growth opportunities; the Company’s ability to successfully integrate acquired entities; changes in accounting pronouncements and practices, as adopted by financial institution regulatory agencies, the Financial Accounting Standards Board and the Public Company Accounting Oversight Board; changes in consumer spending, borrowing and saving habits; changes in the Company’s organization, compensation and benefit plans; and other factors discussed elsewhere in this Quarterly Report on Form 10-Q, as well as in the Company’s periodic reports filed with the SEC, in particular the “Risk Factors” discussed in Item 1A of the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2012. Many of these factors are beyond the Company’s control and are difficult to predict.

Because of these and other uncertainties, the Company’s actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. Forward-looking statements speak only as of the date they are made. The Company undertakes no obligation to publicly update or revise forward-looking information, whether as a result of new, updated information, future events or otherwise.

APPLICATION OF CRITICAL ACCOUNTING ESTIMATES

The Company’s Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q are prepared in accordance with U.S. GAAP and follow general practices within the industries in which it operates. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the Company’s Unaudited Consolidated Financial Statements and Notes. These estimates, assumptions and judgments are based on information available as of the date of the Unaudited Consolidated Financial Statements. Accordingly, as this information changes, the Unaudited Consolidated Financial Statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments, and as such, have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When third-party information is not available, valuation adjustments are estimated in good faith by management primarily through the use of internal cash flow modeling techniques. Refer to Note 3 – "Fair Value Measurements" to the Company's Unaudited Consolidated Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q for further detail on fair value measurement.

Significant accounting policies followed by the Company are presented in Note 1 – "Organization and Summary of Significant Accounting Policies" to the Audited Consolidated Financial Statements included in Item 8 in its Annual Report on Form 10-K for the year ended December 31, 2012. These policies, along with the disclosures presented in the other Notes to the Company's Audited Consolidated Financial Statements contained in its Annual Report on Form 10-K and in this financial review, provide information on how significant assets and liabilities are presented in the Company's Unaudited Consolidated Financial Statements and how those values are determined.

Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the determination of the allowance for loan and lease losses and valuation of goodwill to be the accounting areas that require the most subjective or complex judgments, and as such, could be most subject to revision as new information becomes available.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses represents management's estimate of probable losses in the Company's loan and lease portfolio. Determining the amount of the allowance for loan and lease losses is considered a critical accounting estimate because it requires significant judgment on the part of management and the use of estimates related to the amount and timing of expected future cash flows on impaired loans and leases, estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan and lease portfolio also represents the largest asset type on the Company's Unaudited Consolidated Balance Sheets. Note 1 to the Audited Consolidated Financial Statements included in Item 8 in the Company's Annual Report on Form 10-K for the year ended December 31, 2012, describes the methodology used to determine the allowance for loan and lease losses.

Goodwill

The amount of goodwill reflected in the Company's Unaudited Consolidated Financial Statements is required to be tested by management for impairment on at least an annual basis. The test for impairment of goodwill on the identified reporting unit is considered a critical accounting estimate because it requires judgment on the part of management and the use of estimates related to the growth assumptions and market multiples used in the valuation model. The goodwill impairment testing is typically performed annually on December 31st. No impairment charges were incurred in the most recent test and the fair value of the tested reporting unit substantially exceeded its fair value. There were no triggering events in the three month period ended March 31, 2013 that resulted in an interim impairment test.

ANALYSIS OF FINANCIAL CONDITION

Loan and Lease Activity

Total loans and leases grew to $588.1 million at March 31, 2013, reflecting a $5.2 million or 0.9% increase from $582.9 million at December 31, 2012. Since March 31, 2012, the loan portfolio has grown $8.4 million, or 1.4%.

Loans secured by real estate were $479.1 million at March 31, 2013, an increase of $1.0 million or 0.2% from December 31, 2012. The Company's commercial real estate portfolio has historically been the fastest growing part of the portfolio. However, with rates at all-time lows, several customers have decided to pay off their loans before maturity, despite prepayment penalties, and re-finance their loans at lower rates with other institutions. Financial institutions are generally healthier after enduring a difficult credit cycle during the recession. In addition, banks are experiencing higher liquidity levels with loan demand relatively weak while deposit growth remains steady. These circumstances have converged into an environment of stiff competition for loans over the past year, making loan growth difficult. Commercial and multi-family loans decreased 0.6% from $323.8 million at December 31, 2012 to $321.8 million at March 31, 2013.

With commercial real estate loan growth slowing and investment yields at all-time lows, the Company retained more of its originated residential mortgages during the first quarter of 2013, selling fewer loans to FNMA than it has in the past. Residential mortgages increased to $74.7 million at March 31, 2013, a $6.6 million, or 9.7% increase from $68.1 million at December 31, 2012. Residential mortgage originations increased to $8.6 million in the three month period ended March 31, 2013, compared with $7.3 million in the three month period ended March 31, 2012.

The Bank sells certain fixed rate residential mortgages to FNMA, while maintaining the servicing rights for those mortgages. During the three month period ended March 31, 2013, the Bank sold mortgages to FNMA totaling $0.8 million, compared with $6.2 million during the three month period ended March 31, 2012. At March 31, 2013, the Bank had a loan servicing portfolio principal balance of $70.4 million upon which it earns servicing fees, as compared with $73.7 million at December 31, 2012. The value of the mortgage servicing rights for that portfolio was $0.5 million at March 31, 2013 and December 31, 2012. Residential mortgage loans held-for-sale were $0.4 million at March 31, 2013 and $0.9 million at December 31, 2012. The Company has never been contacted by FNMA to repurchase any loans due to improper documentation or fraud.

The Company continues to focus on commercial and industrial ("C&I") lending as a way to diversify its loan portfolio, which has historically experienced strong growth rates in real estate loans. However, the Company faces the headwinds of a low growth economy and a very competitive local market. Declining line of credit usage and loan payoffs had resulted in a decrease in C&I balances during 2012. In 2013, line of credit usage increased such that C&I balances increased 6.0% in the first quarter of 2013, from $100.0 million at December 31, 2012 to $106.0 million at March 31, 2013.

The leasing portfolio continued to roll-off under the Company's 2009 decision to exit the direct financing leasing business. Direct financing leases were $0.9 million at March 31, 2013, compared with $1.6 million at December 31, 2012.

Credit Quality of Loan Portfolio

Total non-performing loans and leases, defined as accruing loans and leases greater than 90 days past due and non-accrual loans and leases, totaled $8.0 million, or 1.37% of total loans and leases outstanding, at March 31, 2013, compared with $8.2 million, or 1.41%, of total loans and leases outstanding at December 31, 2012.

While non-performing loans and leases were flat in the quarter, “special mention” and “substandard” commercial credits increased from $10.0 million and $5.9 million, respectively, at December 31, 2012 to $13.2 million and $7.4 million at March 31, 2013. As noted in Note 4 to these Unaudited Financial Statements, internal risk ratings are the credit quality indicators used by the Company’s management to determine the appropriate allowance for loan and lease losses for commercial credits. Special mention and substandard loans are weaker credits with a higher risk of loss than “pass” or “watch” credits. While there were several upgrades and downgrades as part of the risk rating balances increasing, there were two loans driving the overall increase – a $6.5 million commercial real estate loan was downgraded to special mention and a $1.0 million commercial real estate loan was downgraded to substandard. While management increased the allowance for loan and lease losses as a result of the increased risk inherent in the downgrades, it should be noted that the loans are not impaired and management continues to expect to collect full principal and interest as contracted.

The allowance for loan and lease losses totaled $10.2 million, or 1.73% of total loans and leases outstanding as of March 31, 2013, compared with $9.7 million or 1.67% at December 31, 2012. The increase in the allowance over the prior year end resulted from a $0.5 million provision for loan and lease losses recorded during the first quarter of 2013, and minimal net charge-offs of less than $0.1 million during the quarter. The provision for loan and lease losses resulted from the increase in special mention and substandard loans discussed above. The net charge-off ratio in the first quarter of 2013 equated to 0.02% of average net loans and leases. This compares with a 0.32% ratio in the first quarter of 2012.

The coverage ratio of the allowance for loan and lease losses to non-performing loans and leases increased from 118% at December 31, 2012 to 126% at March 31, 2013 as the allowance for loan and lease losses increased while non-performing loans and leases decreased during the first quarter of 2013.

Investing Activities

Total securities were $95.3 million at March 31, 2013, compared with $95.8 million at December 31, 2012. Interest-bearing deposits at other banks, which consist of overnight funds kept at correspondent banks and the Federal Reserve, increased from $78.1 million at December 31, 2012 to $88.1 million at March 31, 2013. Interest-bearing cash increased as deposit growth outpaced loan growth in the first quarter. Securities and interest-bearing deposits at correspondent banks made up 23.5% of the Bank’s total average interest earning assets in the first quarter of 2013, compared with 18.4% in the first quarter of 2012.

The Company's highest concentration in its securities portfolio is in tax-advantaged debt securities issued by state and political subdivisions with 35.7% at March 31, 2013, compared with 32.9% at December 31, 2012. The concentration in U.S. government-sponsored agency bonds was 29.5% of the portfolio at March 31, 2013, compared with 29.6% of the portfolio at December 31, 2012. U.S. government-sponsored mortgage-backed securities comprised 30.8% of the securities portfolio at March 31, 2013, compared with 33.7% at December 31, 2012.

The credit quality of the securities portfolio as a whole is believed to be strong as the portfolio has no individual securities in a significant unrealized loss position. While interest rates remained near historic lows, long-term rates were slightly higher at March 31, 2013 when compared with December 31, 2012. As a result, the net unrealized gain position of the available-for-sale investment portfolio decreased from $4.0 million at December 31, 2012 to $3.6 million at March 31, 2013.

The Company monitors extension and prepayment risk in the securities portfolio to limit potential exposures. Available-for-sale securities with a total fair value of $90.1 million at March 31, 2013, as compared with $68.0 million at December 31, 2012, were pledged as collateral to secure public deposits and for other purposes required or permitted by law. The Company has no direct exposure to subprime mortgages, nor does the Company hold private mortgage-backed securities, credit default swaps, or FNMA or FHLMC preferred stock investments in its investment portfolio.

Funding Activities

Total deposits at March 31, 2013 were $698.3 million, reflecting a $19.3 million or 2.8% increase from December 31, 2012. The growth was driven by seasonal inflows of municipal deposits. The growth in municipal deposits in the first quarter totaled $20.1 million and was spread across several deposit categories: demand ($2.8 million), NOW ($5.1 million), and savings ($12.2 million). It is expected that the Company's municipal deposits will decline through the rest of the year due to normal seasonal fluctuations.

The Company's retail deposit growth vehicle for the last three years has been its complementary Better Checking and Better Savings products, which are included in the NOW and regular savings deposit categories, respectively, on the Company's balance sheet. The Better Checking product is unique in the Bank's Western New York footprint as it pays a premium interest rate as a reward to customers who demonstrate a deep relationship with the Bank as evidenced by regular use of their debit card, use of direct deposit, and electronic statements. However, the growth in NOW and savings deposits slowed in the first quarter as the Better Checking and Better Savings products begin to mature and the Company continued to lower rates on selected deposit products given the Company's current excess liquidity and declining net interest margin in this extended low rate environment.

Time deposits were $110.5 million at March 31, 2013, an increase of $1.6 million, or 1.4%, from December 31, 2012. Time deposit rates remain near historic lows, resulting in balance declines or low growth for the past three years, as customers have preferred liquid savings deposits.

Other borrowings, which typically include the Bank's overnight line of credit and other advances with the FHLBNY, were $12.0 million at March 31, 2013 and $19.0 million at December 31, 2012 as a $7.0 million advance with FHLBNY matured and was not replaced. The Company's deposit growth has outpaced its loan growth this year and remains in an overall liquid position. Therefore, the Company has not needed to replace or add to its wholesale borrowings.

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ANALYSIS OF RESULTS OF OPERATIONS

Average Balance Sheet

The following tables present the significant categories of the assets and liabilities of the Company, interest income and interest expense, and the corresponding yields earned and rates paid for the periods indicated. The assets and liabilities are presented as daily averages. The average loan and lease balances include both performing and non-performing loans and leases. Investments are included at amortized cost. Yields are presented on a non-tax-equivalent basis.

	Three Months Ended March 31, 2013			Three Months Ended March 31, 2012		
	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	Interest Earned/ Paid	Yield/ Rate
	(dollars in thousands)			(dollars in thousands)		
ASSETS						
Interest-earning assets:						
Loans and leases, net	$ 575,953	$ 7,252	5.04 %	$ 568,863	$ 7,508	5.28 %
Taxable securities	63,974	417	2.61 %	70,928	545	3.07 %
Tax-exempt securities	34,146	269	3.15 %	34,411	306	3.56 %
Interest bearing deposits at banks	78,426	18	0.09 %	23,271	9	0.15 %
Total interest-earning assets	752,499	$ 7,956	4.23 %	697,473	$ 8,368	4.80 %
Non interest-earning assets:						
Cash and due from banks	14,376			11,470		
Premises and equipment, net	11,219			10,417		
Other assets	35,719			36,720		
Total Assets	$ 813,813			$ 756,080		
LIABILITIES & STOCKHOLDERS' EQUITY						
Interest-bearing liabilities:						
NOW	$ 67,836	$ 113	0.67 %	$ 55,116	$ 139	1.01 %

Regular savings	380,783	327	0.34 %	348,166	585	0.67 %
Time deposits	110,209	450	1.63 %	112,079	518	1.85 %
Other borrowed funds	17,989	153	3.40 %	22,000	181	3.29 %
Junior subordinated debentures	11,330	79	2.79 %	11,330	87	3.07 %
Securities sold U/A to repurchase	14,374	8	0.22 %	9,182	6	0.26 %
Total interest-bearing liabilities	602,521	$ 1,130	0.75 %	557,873	$ 1,516	1.09 %
Noninterest-bearing liabilities:						
Demand deposits	122,359			114,783		
Other	12,856			13,418		
Total liabilities	$ 737,736			$ 686,074		
Stockholders' equity	76,077			70,006		
Total Liabilities and Equity	$ 813,813			$ 756,080		
Net interest earnings		$ 6,826			$ 6,852	
Net interest margin			3.63 %			3.93 %
Interest rate spread			3.48 %			3.71 %

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Net Income

Net income decreased to $1.8 million, or $0.43 per diluted share, in the first quarter of 2013, down 23.7% from net income of $2.4 million, or $0.58 per diluted share, in the first quarter of 2012. The decline in net income reflected a $0.7 million year-over-year increase in the provision for loan and lease losses. Return on average equity was 9.55% for the first quarter of 2013 compared with 13.59% in the first quarter of 2012.

Other Results of Operations – Quarterly Comparison

Net interest income was $6.8 million for the 2013 first quarter, down 0.4% when compared with the first quarter of 2012, and down 3.9% when compared with the fourth quarter of 2012. The performance of net interest income has been driven by slow growth in the loan portfolio and a declining net interest margin. Average net loans and leases of $576.0 million in the first quarter of 2013 were $7.1 million, or 1.2% higher than last year's first quarter, but $9.5 million, or 1.6% lower than the average balance in the fourth quarter of 2012.

The Company's net interest margin decreased to 3.63% for the first quarter of 2013, down from the fourth quarter 2012 margin of 3.78% and down from 3.93% in the first quarter of 2012. The decrease in the net interest margin is a result of the continued declining interest rate environment. When compared with last year's first quarter, the Company was able to only partially offset the 57 basis point decrease in yield on interest-earning assets through re-pricing its interest bearing liabilities by 34 basis points. The contribution of interest-free funds declined by 7 basis points in the first quarter of 2013 when compared with the first quarter of 2012.

The Company's loan and investment portfolios continue to re-price into lower yields, as evidenced by a decrease in yield on interest-earning assets of 25 basis points from the fourth quarter of 2012.

The provision for loan and lease losses increased to $0.5 million in the first quarter of 2013 from a reserve release of ($0.2) million in the prior year's first quarter. The first quarter of 2012 benefitted from a release of $0.4 million in leasing reserves after continued improvement in the leasing portfolio's performance, compared with less than $0.1 million in leasing reserve release in the first quarter of 2013. The provision for loan losses (excluding leases) increased from $0.2 million in the first quarter of 2012 to $0.5 million in first quarter of 2013 due to the increase in special mention and substandard loans, as discussed in the "Credit Quality of the Loan Portfolio" section of the "Analysis of Financial Condition," above, in this Management's Discussion and Analysis.

Non-interest income, which represented 32.7% of total revenue in the first quarter of 2013, increased 0.7%, or $22 thousand, to $3.3 million when compared with the first quarter of 2012. Insurance agency revenue of $2.0 million was up $54 thousand, or 2.8%, when compared with the 2012 first quarter due mostly to an increase in commercial lines revenue. Service charges on deposits increased 10.6% to $0.5 million due to more competitive pricing and the acquisition of commercial deposit customers. These positive variances were somewhat offset by decreases in premiums on loans sold and a lower mortgage servicing rights value due to fewer loans being sold to FNMA.

Total non-interest expense was $7.1 million in the first quarter of 2013, an increase of 2.4%, from $6.9 million in the first quarter of 2012. The largest component of the increase was in occupancy expense and salaries and employee benefits expense. The increase in occupancy expense of $0.1 million can be attributed to a write-off of software which is no longer going to be utilized. The increase in salaries and benefits expense of $0.1 million, or 1.8%, reflects merit salary increases for employees.

As a result of the increase in non-interest expense and lack of growth in revenue, the efficiency ratio increased to 69.20% for the first quarter of 2013 from 67.10% for the first quarter of 2012.

Income tax expense for the quarter ended March 31, 2013, was $0.8 million, representing an effective tax rate of 30.4% compared with an effective tax rate of 31.7% in the first quarter of 2012. The decrease in tax rate in the first quarter was primarily due to the recognition of a previously unrecognized tax benefit related to the expiration of a statute from the 2009 tax year.

CAPITAL

The Company consistently maintains regulatory capital ratios measurably above the federal "well capitalized" standard, including a Tier 1 leverage ratio of 9.87% and 9.69% at March 31, 2013 and December 31, 2012, respectively. Book value per share of the Company's common stock was $18.26 at March 31, 2013, compared with $17.94 at December 31, 2012. Tangible book value per share (a non-GAAP measure) at March 31, 2013 was $16.26, compared with $15.92 at December 31, 2012. The increase in both book value and tangible book value per share is a result of the Company's $1.8 million in net income.

Tangible book value per share is a non-GAAP financial measure. [The Company calculates tangible book value per share by dividing tangible book value by the number of common shares outstanding, as compared to GAAP book value per share, which the Company calculates by dividing GAAP book value by the number of common shares outstanding.] Management believes that this information is consistent with treatment by bank regulatory agencies, which exclude intangible assets from the calculation of risk-based capital

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ratios. Accordingly, management believes that this non-GAAP financial measure provides information that is important to investors and that is useful in understanding the Company's capital position and ratios. Further, management believes that presentation of this measure, together with the accompanying reconciliation, provides a complete understanding of factors and trends affecting the Company's business and allows investors to view the Company's performance in a manner similar to management, the financial services industry, bank stock analysts and regulatory agencies. However, this non-GAAP financial measure is supplemental and is not a substitute for an analysis based on GAAP financial measures. Note that other companies may use different calculations for this measure, and therefore the Company's presentation of tangible book value per share may not be comparable to similarly titled measures reported by other companies. Investors should review the Company's consolidated financial statements in their entirety and should not rely on any single financial measure. A reconciliation of this non-GAAP financial measure, tangible book value per share, to the most directly comparable GAAP financial measure, book value, is set forth in the following table:

($ in thousands, except per share data)	March 31, 2013	December 31, 2012
Stockholders' equity ("book value")	$ 76,495	$ 74,828
Goodwill	(8,101)	(8,101)
Intangible assets	(266)	(329)
Tangible book value	$ 68,128	$ 66,398
Number of common shares outstanding	4,190,257	4,171,473
Tangible book value per share	$ 16.26	$ 15.92

On December 12, 2012, the Company declared an accelerated cash dividend of $0.24 per share on the Company's outstanding common stock. The dividend was paid on December 31, 2012 to shareholders of record as of December 24, 2012. The dividend represented an accelerated payment of the Company's semi-annual dividend that otherwise would have been paid in April 2013.

LIQUIDITY

The Bank utilizes cash flows from the investment portfolio and federal funds sold balances to manage the liquidity requirements related to loan demand and deposit fluctuations. The Bank also has many borrowing options. As a member of the FHLB the Bank is able to borrow funds at competitive rates. Advances of up to $139.5 million can be drawn on the FHLB via an Overnight Line of Credit Agreement between the Bank and the FHLB. An amount equal to 25% of the Bank's total assets could be borrowed through the advance programs under certain qualifying circumstances. The Bank also has the ability to purchase up to $14.0 million in federal funds from its correspondent banks. By placing sufficient collateral in safekeeping at the Federal Reserve Bank, the Bank could borrow at the discount window. The Bank's liquidity needs also can be met by more aggressively pursuing time deposits, or accessing the brokered time deposit market, including the Certificate of Deposit Account Registry Service ("CDARS") network. The Company's primary source of liquidity is dividends from the Bank. Additionally, the Company has access to capital markets as a funding source.

Cash flows from the Bank's investment portfolio are laddered, so that securities mature at regular intervals, to provide funds from principal and interest payments at various times as liquidity needs may arise. Contractual maturities are also laddered, with consideration as to the volatility of market prices. At March 31, 2013, approximately 5.0% of the Bank's securities had contractual maturity dates of one year or less and approximately 25.3% had maturity dates of five years or less.

Management, on an ongoing basis, closely monitors the Company's liquidity position for compliance with internal policies, and believes that available sources of liquidity are adequate to meet funding needs in the normal course of business. As part of that monitoring process, management calculates the 90-day liquidity each month by analyzing the cash needs of the Bank. Included in the calculation are liquid assets and potential liabilities. Management stresses the potential liabilities calculation to ensure a strong liquidity position. Included in the calculation are assumptions of some significant deposit run-off as well as funds needed for loan closings and investment purchases. At March 31, 2013, in the Company's internal stress test, the Company had net short-term liquidity of $56.5 million as compared with $75.5 million at December 31, 2012. Available assets of $186.5 million, divided by public and purchased funds of $130.0 million, resulted in a long-term liquidity ratio of 143% at March 31, 2013, compared with 155% at December 31, 2012.

Management does not anticipate engaging in any activities, either currently or in the long term, for which adequate funding would not be available and which would therefore result in significant pressure on liquidity. However, continued economic recession could negatively impact the Company's liquidity.

The Company believes that the Bank maintains a sufficient level of U.S. government and government agency securities and New York State municipal bonds that can be pledged as collateral for municipal deposits.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Additional information responsive to this Item is contained in the Liquidity section of Management's Discussion and Analysis of Financial Condition and Results of Operations, which information is incorporated herein by reference.

Market risk is the risk of loss from adverse changes in market prices and/or interest rates of the Bank's financial instruments. The primary market risk the Company is exposed to is interest rate risk. The core banking activities of lending and deposit-taking expose the Bank to interest rate risk, which occurs when assets and liabilities reprice at different times and by different amounts as interest rates change. As a result, net interest income earned by the Bank is subject to the effects of changing interest rates. The Bank measures interest rate risk by calculating the variability of net interest income in future periods under various interest rate scenarios using projected balances for interest-earning assets and interest-bearing liabilities. Management's philosophy toward interest rate risk management is to limit the variability of net interest income to changes in net interest rates. The balances of financial instruments used in the projections are based on expected growth from forecasted business opportunities, anticipated prepayments of loans, and expected maturities of investment securities, loans and deposits. Management supplements the modeling technique described above with analysis of market values of the Bank's financial instruments and changes to such market values given changes in the interest rates.

The Bank's Asset-Liability Committee, which includes members of senior management, monitors the Bank's interest rate sensitivity with the aid of a model that considers the impact of ongoing lending and deposit taking activities, as well as interrelationships in the magnitude and timing of the repricing of financial instruments, including the effect of changing interest rates on expected prepayments and maturities. When deemed prudent, management has taken actions, and intends to do so in the future, to mitigate exposure to interest rate risk through the use of on- or off-balance sheet financial instruments. Possible actions include, but are not limited to, changing the pricing of loan and deposit products, and modifying the composition of interest-earning assets and interest-bearing liabilities, and other financial instruments used for interest rate risk management purposes.

The following table demonstrates the possible impact of changes in interest rates on the Bank's net interest income over a 12-month period of time:

SENSITIVITY OF NET INTEREST INCOME TO CHANGES IN INTEREST RATES

	Calculated increase in projected annual net interest income (in thousands)	
	March 31, 2013	December 31, 2012
Changes in interest rates		
+200 basis points	$ 1,279	$ 1,055
+100 basis points	1,755	1,588
-100 basis points	NM	NM
-200 basis points	NM	NM

Many assumptions were utilized by management to calculate the impact that changes in interest rates may have on the Bank's net interest income. The more significant assumptions related to the rate of prepayments of mortgage-related assets, loan and deposit volumes and pricing, and deposit maturities. The Bank assumed immediate changes in rates including 200 basis point rate changes. In the event that the 200 basis point rate changes cannot be achieved, the applicable rate changes are limited to lesser amounts such that interest rates cannot be less than zero. These assumptions are inherently uncertain and, as a result, the Bank cannot precisely predict the impact of changes in interest rates on net interest income. Actual results may differ significantly due to the timing, magnitude, and frequency of interest rate changes in market conditions and interest rate differentials (spreads) between maturity/repricing categories, as well as any actions such as those previously described, which management may take to counter such changes. In light of the uncertainties and assumptions associated with the process, the amounts presented in the table and changes in such amounts are not considered significant to the Bank's projected net interest income.

ITEM 4 - CONTROLS AND PROCEDURES

DISCLOSURE CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's principal executive officer and principal financial officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2013 (the end of the period covered by this Report). Based on that evaluation, the Company's principal executive and principal financial officers concluded that as of March 31, 2013 the Company's disclosure controls and procedures were effective.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING

No changes in the Company's internal control over financial reporting were identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 under the Exchange Act that occurred during the fiscal quarter ended March 31, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 6 – EXHIBITS

The information called for by this item is incorporated herein by reference to the Exhibit Index included immediately following the signature page to this Quarterly Report on Form 10-Q.

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.

Evans Bancorp, Inc.

DATE

May 3, 2013/s/David J. Nasca______________________

David J. Nasca

President and CEO

(Principal Executive Officer)

DATE

May 3, 2013/s/Gary A. Kajtoch_____________________

Gary A. Kajtoch

Treasurer

(Principal Financial Officer)

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EXHIBIT INDEX

Exhibit No.	Name	Page No.
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	44
31.2	Certification of the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	45
32.1	Certification of Principal Executive Officer pursuant to 18 USC Section 1350 Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	46
32.2	Certification of Principal Financial Officer pursuant to 18 USC Section 1350 Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	47
101	The following materials from Evans Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Unaudited Consolidated Balance Sheets – March 31, 2013 and December 31, 2012; (ii) Unaudited Consolidated Statements of Income – Three months ended March 31, 2013 and 2012; (iii) Unaudited Statements of Consolidated Comprehensive Income – Three months ended March 31, 2013 and 2012; (iv) Unaudited Consolidated Statements of Stockholder's Equity – Three months ended March 31, 2013 and 2012; (v) Unaudited Consolidated Statements of Cash Flows – Three months ended March 31, 2013 and 2012; and (vi) Notes to Unaudited Consolidated Financial Statements.*	

*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.