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## North State Bancorp (NSBC- OTC Bulletin Board)

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**John A. (Buddy) Howard, CFA**  
**October 30, 2011**

<b>Price:</b>	\$3.50	<b>EPS *</b>	<b>2010A:</b> \$ 0.14	<b>P/E</b>	<b>2010A:</b> 25.0 x
<b>52 Wk. Range:</b>	\$2.62 - \$4.25	(FY: DEC)	<b>2011E:</b> \$ 0.10		<b>2011E:</b> 35.0 x
<b>Div/Div Yld:</b>	\$0.00 / 0.0%		<b>2012E:</b> \$ 0.26		<b>2012E:</b> 13.5 x
<b>Shrs/Mkt Cap:</b>	7.4 mm / \$26 mm	<b>Book Value: **</b>	\$ 5.18	<b>Price/Book Value:</b>	0.68 x

\* Earnings per share are diluted. \*\* Tangible book value is \$5.16 per share.

### Background

North State Bancorp ("the Company") is a single bank holding company headquartered in Raleigh, North Carolina with approximately \$633 million in assets at September 30, 2011. Its bank subsidiary is North State Bank, a commercial bank that began operations on June 1, 2000. North State Bancorp serves Wake and New Hanover Counties through seven full-service offices. The Company focuses on serving the total banking needs of professional firms, professionals, property management companies, churches, non-profits and individuals who highly value a mutually beneficial banking relationship in the Raleigh, Garner, greater Wake County and New Hanover County market areas. Product deposit services include demand deposits, money market accounts, consumer and business time deposits and sweep accounts. Loan products include business products, such as commercial lines of credit, loans for equipment, owner occupied commercial mortgages and other commercial real estate loans and personal lines of credit, such as home equity loans, first and second mortgages and auto loans. North State Bancorp also offers debit cards, ATM access, home and business banking via the Internet and courier services for businesses. Recent service enhancements include CommunityPLUS, a division serving property management firms, same day banking (i.e., transactions are processed on the same day they occur), telephone banking, lockbox and remote deposit capture capabilities. North State also operates a Mortgage Division and a Wealth Management Division. Insiders own approximately 51% of the outstanding stock.

### Third Quarter Results Were Very Encouraging

Although North State's earnings in the third quarter of 2011 were below the year-ago quarter's, we were impressed with the quarterly results from several standpoints. First, the reported earnings were better than what we were anticipating. But additionally, we were encouraged by the nice pick up in net interest income, which had been declining on a sequential quarter basis since the end of 2010. Further, noninterest income reflected solid growth, only a small amount of which was due to nonrecurring items such as security gains. Finally, cost containment was excellent, as noninterest expense was lower than it has been in any one quarter in more than a year. While asset quality still remained challenging in the quarter, the level of NPAs did decline from the June 30, 2011 level. So all in all, it was a solid quarter from several standpoints.

Net income was \$233,000, or \$0.03 per diluted share, in 2011's third quarter, versus \$339,000, or \$0.05 per share, in the third quarter of 2010. Net interest income declined slightly (4%) from the year-ago level, though it rebounded sharply (up 8%) from the second quarter of 2011. While the margin was slightly below the year-ago level, it improved significantly to 3.99% in 2011's third quarter from 3.70% in 2011's second quarter, and accounted for most of the improvement in net interest income. As we have stated previously, some of this margin erosion has come from a growing focus on building core deposits, which tend to be far more stable than brokered deposits. Noninterest income likewise was below year-ago levels but showed strong sequential quarter improvement. Specifically, noninterest income excluding securities gains was \$1,314,000 in 2011's third quarter, versus

**ASSETS: \$633 MM**

**HQ: RALEIGH, NC**

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**3<sup>RD</sup> QUARTER HIGHLIGHTS:**

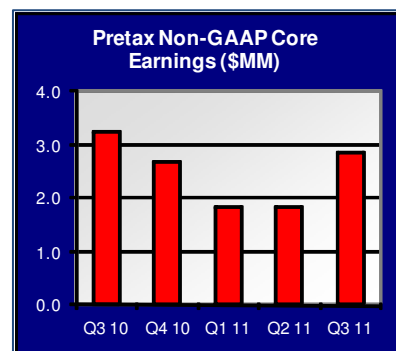
**THIRD QUARTER RESULTS WERE ENCOURAGING ON SEVERAL LEVELS**

**EPS: \$0.03 vs. \$0.05**

**NET INTEREST INCOME REBOUNDED FROM THE SECOND QUARTER OF 2011**

**ALTHOUGH THE MARGIN WAS BELOW THE YEAR-AGO LEVEL, IT IMPROVED SIGNIFICANTLY FROM 2011'S SECOND QUARTER**

\$1,464,000 in the year-ago quarter but up from \$836,000 in the second quarter of 2011. We were likewise impressed with the cost containment. Noninterest expense in 2011's third quarter declined 4% from the year-ago level and dropped 5% relative to 2011's second quarter, while the provision in 2011's third quarter was relatively unchanged from the year-ago level at \$2.1 million. As a final note, we would point out that the "core" earnings of the Company, while still below the year-ago level, were at a markedly improved level from where they have been so far this year, and bolster our optimism that the core fundamentals are improving for the Bank. (We have defined pretax non-GAAP core earnings as pretax income before the provision, security gains/losses and net foreclosed asset expense, net of rental income.)



**COST CONTAINMENT WAS GOOD AS WELL**

**PRETAX "CORE" EARNINGS (BEFORE PROVISION, ETC.) REFLECTED AN ENCOURAGING INCREASE**

**FIRST NINE MONTH RESULTS:**

**EPS: \$0.07 vs. \$0.16**

Nine month results somewhat mirrored the quarter, with earnings of \$547,000, or \$0.07 diluted share, in the first nine months of 2011, versus \$1,163,000, or \$0.16 per diluted share, in the year-ago period. Net interest income declined 3%, while noninterest income (which benefitted from the inclusion of the mortgage operation acquired in early 2010) was up 13% and noninterest expense increased 11%.

### Capital Ratios Are Strong; Balance Sheet Strategy and Positive Earnings Are Sustaining Them

North State continues to exercise good restraint in terms of balance sheet growth in order to boost its capital ratios. As can be seen in the adjacent table, all of the key capital ratios have increased over the past year, and all regulatory ratios comfortably exceed the regulatory minimums to be considered "well capitalized." Another factor that must be considered when analyzing capital adequacy is earnings trends, as it reflects whether capital is being eroded to bolstered.

In North State's case, earnings (particularly on a trailing 12 month basis, as we discussed in our last report) have consistently been positive, which essentially provides an extra level of protection to the Company's capital position. In our view, North State's strength will position it to benefit from the ongoing turmoil among many of the weaker institutions serving its markets.

**NORTH STATE'S CAPITAL RATIOS REMAIN STRONG, AND THE COMPANY'S ABILITY TO MAINTAIN POSITIVE EARNINGS SHOULD HELP IT TO MAINTAIN THIS CAPITAL STRENGTH**

	Q3 10	Q3 11	"Well Capitalized" Minimum
Equity/Assets	5.99	6.08	
Leverage Ratio	7.99	8.20	5.00
Tier 1 Risk Based	9.68	10.32	6.00
Total Risk Based	13.03	13.77	10.00

### NPA-to-Assets Ratios Remains Better Than for Most Peers

While the level of nonperforming assets increased from the year-ago level, it declined relative to June 30, 2011 and the ratio of NPAs to assets is still well below that of most North Carolina peer banks. As of September 30, 2011, NPAs were \$26.5 million (4.19% of assets), versus \$29.8 million (4.68% of assets) at June 30, 2011 and \$17.0 million (2.69% of total assets) at September 30, 2010. The median ratio of NPAs to assets for the Company's peers is approximately 8%. The allowance for loan losses as of September 30, 2011 was \$9.7 million (2.01% of loans) versus \$8.2 million (1.64% of loans) at the year-ago date.

**ASSET QUALITY IMPROVED RELATIVE TO THE SECOND QUARTER OF 2011**

**NPAs/ASSETS: 4.19%**

**RESERVES TO LOANS: 2.01%**

### Projections Maintained

We continue to project that 2011 earnings will be approximately \$750,000, or \$0.10 per diluted share, and are projecting 2012 earnings will be \$1.9 million, or \$0.26 per diluted share. Obviously, these projections could change significantly based on economic and other trends. For more information, please visit either North State Bancorp's web site at [www.northstatebank.com](http://www.northstatebank.com), or Equity Research Services' web site at [www.equityresearch.com](http://www.equityresearch.com).

**EPS PROJECTIONS**

**2010A: \$ 0.14**

**2011E: \$ 0.10**

**2012E: \$ 0.26**

ADDITIONAL INFORMATION UPON REQUEST

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