

SHORE BANCSHARES INC  
Form 10-Q  
August 09, 2007

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

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FORM 10-Q

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

For the Quarterly Period Ended June 30, 2007

OR

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

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

Commission file number 0-22345

**SHORE BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

|  |  |
|--|--|
| <u>Maryland</u><br>(State or<br>Other<br>Jurisdiction of<br>Incorporation<br>or<br>Organization) | <u>52-1974638</u><br>(I.R.S.<br>Employer<br>Identification<br>No.) |
|--|--|

|  |                            |
|--|----------------------------|
| <u>18 East Dover<br/>Street, Easton,<br/>Maryland</u><br>(Address of<br>Principal<br>Executive<br>Offices) | <u>21601</u><br>(Zip Code) |
|--|----------------------------|

(410) 822-1400

Registrant's Telephone Number, Including Area Code

N/A

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,379,707 shares of common stock as of August 1, 2007.

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

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

| <b>ASSETS:</b>   | June 30,<br>2007<br>(unaudited) | December 31,<br>2006 |
|--|---------------------------------|----------------------|
| Cash and due from banks  | \$ 16,743                       | \$ 26,511            |
| Interest bearing deposits with other banks   | 15,553                          | 33,540               |
| Federal funds sold   | 15,226                          | 19,622               |
| Investment securities:   |                                 |                      |
| Held-to-maturity, at amortized cost (fair value of \$13,750 and \$13,938 , respectively)       | 13,952                          | 13,971               |
| Available for sale, at fair value  | 112,353                         | 116,275              |
| Loans, less allowance for credit losses (\$6,885 and \$6,300, respectively)                    | 724,326                         | 693,419              |
| Insurance premiums receivable  | 487                             | 574                  |
| Premises and equipment, net  | 15,965                          | 15,973               |
| Accrued interest receivable on loans and investment securities                                 | 5,065                           | 4,892                |
| Investment in unconsolidated subsidiary  | 937                             | 937                  |
| Goodwill   | 11,939                          | 11,939               |
| Other intangible assets  | 1,421                           | 1,569                |
| Deferred income taxes  | 2,528                           | 2,092                |
| Other real estate owned  | 313                             | 398                  |
| Other assets   | 3,955                           | 3,937                |
| <b>TOTAL ASSETS</b>  | <b>\$ 940,763</b>               | <b>\$ 945,649</b>    |
| <b>LIABILITIES:</b>  |                                 |                      |
| Deposits:  |                                 |                      |
| Noninterest bearing demand   | \$ 110,305                      | \$ 109,962           |
| NOW and Super NOW  | 106,983                         | 112,549              |
| Certificates of deposit \$100,000 or more  | 156,688                         | 153,731              |
| Other time and savings   | 390,752                         | 397,940              |
| Total Deposits   | 764,728                         | 774,182              |
| Accrued interest payable   | 2,071                           | 2,243                |
| Short term borrowings  | 27,560                          | 28,525               |
| Income taxes payable   | 84                              | -                    |
| Long term debt   | 27,000                          | 25,000               |
| Other liabilities  | 4,390                           | 4,372                |
| <b>TOTAL LIABILITIES</b>   | <b>825,833</b>                  | <b>834,322</b>       |
| <b>STOCKHOLDERS' EQUITY:</b>   |                                 |                      |
| Common stock, par value \$.01 per share; authorized 35,000,000 shares; issued and outstanding: |                                 |                      |
| June 30, 2007  | 8,379,307                       |                      |
| December 31, 2006  | 8,383,395                       | 84                   |
| Additional paid in capital   | 29,487                          | 29,687               |
| Retained earnings  | 86,356                          | 82,279               |

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|  |                |                |
|--|----------------|----------------|
| Accumulated other comprehensive loss     | (997)          | (723)          |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>        | <b>114,930</b> | <b>111,327</b> |
| TOTAL LIABILITIES & STOCKHOLDERS' EQUITY | \$ 940,763     | \$ 945,649     |

See accompanying notes to Condensed Consolidated Financial Statements.

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## SHORE BANCSHARES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(Dollars in thousands, except per share amounts)

|  | Three months ended June 30, |           | Six months ended June 30, |           |
|--|-----------------------------|-----------|---------------------------|-----------|
|  | 2007                        | 2006      | 2007                      | 2006      |
| <b>INTEREST INCOME</b>                                       |                             |           |                           |           |
| Loans, including fees  | \$ 14,210                   | \$ 12,481 | \$ 27,834                 | \$ 23,936 |
| Interest and dividends on investment securities:             |                             |           |                           |           |
| Taxable  | 1,291                       | 1,045     | 2,575                     | 2,065     |
| Tax-exempt   | 135                         | 135       | 259                       | 278       |
| Other interest income  | 619                         | 282       | 1,477                     | 729       |
| Total interest income  | 16,255                      | 13,943    | 32,145                    | 27,008    |
| <b>INTEREST EXPENSE</b>                                      |                             |           |                           |           |
| Certificates of deposit, \$100,000 or more                   | 1,923                       | 1,215     | 3,849                     | 2,295     |
| Other deposits   | 3,479                       | 2,427     | 6,921                     | 4,665     |
| Interest on short-term borrowings                            | 248                         | 238       | 494                       | 502       |
| Interest on long-term debt                                   | 363                         | 154       | 734                       | 223       |
| Total interest expense                                       | 6,013                       | 4,034     | 11,998                    | 7,685     |
| <b>NET INTEREST INCOME</b>                                   | 10,242                      | 9,909     | 20,147                    | 19,323    |
| <b>PROVISION FOR CREDIT LOSSES</b>                           | 413                         | 240       | 655                       | 551       |
| <b>NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES</b> | 9,829                       | 9,669     | 19,492                    | 18,772    |
| <b>NONINTEREST INCOME</b>                                    |                             |           |                           |           |
| Service charges on deposit accounts                          | 782                         | 779       | 1,471                     | 1,523     |
| Gain on sale of securities                                   | 1                           | -         | 1                         | -         |
| Insurance agency commissions                                 | 1,562                       | 1,661     | 3,601                     | 3,992     |
| Other noninterest income                                     | 917                         | 879       | 1,836                     | 1,510     |
| Total noninterest income                                     | 3,261                       | 3,319     | 6,909                     | 7,025     |
| <b>NONINTEREST EXPENSE</b>                                   |                             |           |                           |           |
| Salaries and employee benefits                               | 4,715                       | 4,395     | 9,648                     | 8,863     |
| Expenses of premises and equipment                           | 822                         | 708       | 1,654                     | 1,440     |
| Other noninterest expense                                    | 2,210                       | 1,944     | 4,336                     | 3,835     |
| Total noninterest expense                                    | 7,747                       | 7,047     | 15,638                    | 14,138    |
| <b>INCOME BEFORE TAXES ON INCOME</b>                         | 5,343                       | 5,941     | 10,763                    | 11,659    |

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|                                      |          |          |          |          |
|--------------------------------------|----------|----------|----------|----------|
| Federal and state income tax expense | 1,987    | 2,190    | 4,004    | 4,357    |
| <b>NET INCOME</b>                    | \$ 3,356 | \$ 3,751 | \$ 6,759 | \$ 7,302 |
| Basic earnings per common share      | \$ .40   | \$ .45   | \$ .81   | \$ .87   |
| Diluted earnings per common share    | \$ .40   | \$ .45   | \$ .81   | \$ .87   |
| Dividends declared per common share  | \$ .16   | \$ .15   | \$ .32   | \$ .29   |

See accompanying notes to Condensed Consolidated Financial Statements.

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SHORE BANCSHARES, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)  
 For the Six Month Periods Ended June 30, 2007 and 2006  
 (Dollars in thousands, except per share amounts)

|   | Common<br>Stock | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>other<br>Comprehensive<br>Loss | Total<br>Stockholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|----------------------------------|
| Balances, January 1, 2007   | \$ 84           | \$ 29,687                        | \$ 82,279            | \$ (723)                                      | \$ 111,327                       |
| Comprehensive income:   |                 |                                  |                      |   |                                  |
| Net income  | -               | -                                | 6,759                | -   | 6,759                            |
| Other comprehensive gain, net of tax:   |                 |                                  |                      |   |                                  |
| Unrealized loss on available for sale securities, net of reclassification adjustment of \$0 | -               | -                                | -                    | (274)   | (274)                            |
| Total comprehensive income  |                 |                                  |                      |   | 6,485                            |
| Shares issued   | -               | 37                               | -                    | -   | 37                               |
| Stock-based compensation expense  | -               | 29                               | -                    | -   | 29                               |
| Stock repurchased and retired   | -               | (266)                            | -                    | -   | (266)                            |
| Cash dividends declared \$0.32 per share  | -               | -                                | (2,682)              | -   | (2,682)                          |
| Balances, June 30, 2007   | \$ 84           | \$ 29,487                        | \$ 86,356            | \$ (997)                                      | \$ 114,930                       |
| Balances, January 1, 2006   |                 |                                  |                      |   |                                  |
| Balances, January 1, 2006   | \$ 55           | \$ 29,014                        | \$ 73,642            | \$ (1,263)                                    | \$ 101,448                       |
| Comprehensive income:   |                 |                                  |                      |   |                                  |
| Net income  | -               | -                                | 7,302                | -   | 7,302                            |
| Other comprehensive loss, net of tax:   |                 |                                  |                      |   |                                  |
| Unrealized loss on available for sale securities, net of reclassification adjustment of \$0 | -               | -                                | -                    | (553)   | (553)                            |
| Total comprehensive income  |                 |                                  |                      |   | 6,749                            |
| Shares issued   | 1               | 413                              | -                    | -   | 414                              |
| Stock-based compensation expense  | -               | 24                               | -                    | -   | 24                               |
| Stock dividend paid   | 28              | (28)                             | (9)                  | -   | (9)                              |



|  |       |           |           |           |         |
|--|-------|-----------|-----------|-----------|---------|
| Cash dividends declared \$0.29 per share | -     | -         | (2,395)   | -         | (2,395) |
| Balances, June 30, 2006                  | \$ 84 | 29,423 \$ | 78,540 \$ | (1,816)\$ | 106,231 |

See accompanying notes to Condensed Consolidated Financial Statements.

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

|   | For the Six Months Ended June 30, |                  |
|---|-----------------------------------|------------------|
|   | 2007                              | 2006             |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                                   |                  |
| Net Income  | \$ 6,759                          | \$ 7,302         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |                  |
| Depreciation and amortization   | 743                               | 712              |
| Stock based compensation expense  | 29                                | 24               |
| Discount accretion on debt securities   | (62)                              | (47)             |
| Provision for credit losses   | 655                               | 551              |
| Gain on sale of premise and equipment   | -                                 | 4                |
| Net changes in:   |                                   |                  |
| Insurance premiums receivable   | 86                                | 586              |
| Accrued interest receivable   | (173)                             | (373)            |
| Other assets  | (271)                             | (215)            |
| Accrued interest payable  | (172)                             | 265              |
| Accrued expenses  | 102                               | (282)            |
| Net cash provided by operating activities   | 7,696                             | 8,527            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                                   |                  |
| Proceeds from maturities and principal payments of securities available for sale  | 15,343                            | 7,632            |
| Proceeds from sale of investment securities available for sale                    | -                                 | 52               |
| Purchase of securities available for sale   | (11,824)                          | (5,852)          |
| Proceeds from maturities and principal payments of securities held to maturity    | 9                                 | 743              |
| Purchase of securities held to maturity   | -                                 | (203)            |
| Net increase in loans   | (31,561)                          | (48,533)         |
| Purchase of premises and equipment  | (569)                             | (1,283)          |
| Proceeds from sale of other real estate owned                                     | 85                                | 255              |
| Net cash used in investing activities   | (28,517)                          | (47,189)         |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                                   |                  |
| Net decrease in demand, NOW, money market and savings deposits                    | (16,701)                          | (24,743)         |
| Net increase in certificates of deposit   | 7,247                             | 35,347           |
| Net decrease in short term borrowings   | (965)                             | (422)            |
| Proceeds from long-term borrowings  | 2,000                             | 21,000           |
| Proceeds from issuance of common stock  | 37                                | 414              |
| Stock repurchased and retired   | (266)                             | -                |
| Dividends paid  | (2,682)                           | (2,404)          |
| Net cash (used in) provided by financing activities                               | (11,330)                          | 29,192           |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>(32,151)</b>                   | <b>(9,470)</b>   |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>79,673</b>                     | <b>67,459</b>    |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$ 47,522</b>                  | <b>\$ 57,989</b> |

|   |    |        |           |
|---|----|--------|-----------|
| <b>Supplemental cash flows information:</b>     |    |        |           |
| Interest paid                                   | \$ | 12,170 | \$ 11,405 |
| Income taxes paid                               | \$ | 4,130  | \$ 3,985  |
| Transfers from loans to other real estate owned | \$ | -      | \$ 255    |

See accompanying notes to Condensed Consolidated Financial Statements

Shore Bancshares, Inc.  
Notes to Condensed Consolidated Financial Statements  
For the three and six Months Ended June 30, 2007 and 2006  
(Unaudited)

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Shore Bancshares, Inc. (the "Company") and its subsidiaries with all significant intercompany transactions eliminated. The consolidated financial statements conform to accounting principles generally accepted in the United States of America and to prevailing practices within the banking industry. The accompanying interim financial statements are unaudited; however, in the opinion of management all adjustments necessary to present fairly the financial position at June 30, 2007, the results of operations for the three and six-month periods ended June 30, 2007 and 2006, and cash flows for the six-month periods ended June 30, 2007 and 2006, have been included. All such adjustments are of a normal recurring nature. The amounts as of December 31, 2006 were derived from audited financial statements. The results of operations for the three- and six-month periods ended June 30, 2007 are not necessarily indicative of the results to be expected for any other interim period or for the full year. This Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Note 2 - Earnings Per Share

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

|   | Three Months Ended June 30,           |          | Six Months Ended June 30, |          |
|---|---------------------------------------|----------|---------------------------|----------|
|   | 2007                                  | 2006     | 2007                      | 2006     |
|   | (in thousands, except per share data) |          |                           |          |
| Net Income                                    | \$ 3,356                              | \$ 3,751 | \$ 6,759                  | \$ 7,302 |
| Weighted Average Shares Outstanding - Basic   | 8,378                                 | 8,367    | 8,380                     | 8,356    |
| Dilutive securities                           | 15                                    | 26       | 15                        | 34       |
| Weighted Average Shares Outstanding - Diluted | 8,393                                 | 8,393    | 8,395                     | 8,390    |
| Earnings per common share - Basic             | \$ 0.40                               | \$ 0.45  | \$ 0.81                   | \$ 0.87  |
| Earnings per common share - Diluted           | \$ 0.40                               | \$ 0.45  | \$ 0.81                   | \$ 0.87  |

There were no antidilutive stock options excluded from the calculation of earnings per share for the three and six months ended June 30, 2007 and 2006.

Note 3 - Significant Accounting Policy

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

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

| (Dollars in thousands)  | June 30,<br>2007 | December 31,<br>2006 |
|---|------------------|----------------------|
| Impaired loans with valuation allowance                             | \$ 1,781         | \$ 7,658             |
| Impaired loans with no valuation allowance                          | 144              | -                    |
| Total impaired loans  | \$ 1,925         | \$ 7,658             |
| Allowance for credit losses applicable to impaired loans            | \$ 869           | \$ 883               |
| Allowance for credit losses applicable to other than impaired loans | 6,016            | 5,417                |
| Total allowance for credit losses                                   | \$ 6,885         | \$ 6,300             |
| Interest income on impaired loans recorded on the cash basis        | \$ 133           | \$ -                 |

Interest income on impaired loans recorded on the cash basis \$ 133\$ -

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

#### Note 4 - Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At June 30, 2007, total commitments to extend credit were approximately \$243,745,000. Outstanding letters of credit were approximately \$26,002,000 at June 30, 2007.

#### Note 5 - Stock-Based Compensation

At June 30, 2007, the Company had four equity compensation plans: (i) the Shore Bancshares, Inc. 1998 Stock Option Plan; (ii) the Talbot Bancshares, Inc. Employee Stock Option Plan; (iii) the Shore Bancshares, Inc. Employee Stock Purchase Plan ("ESPP"); and (iv) the Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan. The plans are described in detail in Note 13 to the audited financial statements contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Stock-based awards granted to date are generally time-based, vesting 20% on each anniversary of the grant date over five years and, in the case of stock options, expiring 10 years from the grant date. ESPP awards allow employees to purchase shares of common stock at 85% of the fair market value on the date of grant. ESPP grants are 100% vested at date of grant and have a 27-month term.

The Company had stock options and restricted stock outstanding at June 30, 2007 under three equity compensation plans, each of which has been approved by our shareholders. During the second quarter of 2007 the Company granted 3,845 shares of restricted common stock at a value of \$25.31 per share. The outstanding restricted stock awards vest in equal annual installments on the first through the fifth anniversary dates of the grant subject to the employees' continued employment with the Company on the applicable anniversary date. Compensation expense for restricted stock awards is measured on the grant date fair value and then recognized over the respective service period, which matches the vesting period. None of the Company's outstanding restricted stock awards were vested at June 30, 2007.

The following table summarizes restricted stock award activity for the Company under the 2006 Plan from January 1, 2007 through June 30, 2007:

Weighted

|                                | Shares | Average grant<br>date fair<br>value per<br>common share |
|--------------------------------|--------|---|
| Outstanding at January 1, 2007 | -      | -   |
| Granted                        | 3,845  | \$ 25.31  |
| Vested                         | -      | -   |
| Cancelled                      | -      | -   |
| Outstanding at June 30, 2007   | 3,845  | \$ 25.31  |

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During the three- and six-month periods ended June 30, 2007 the Company recognized pre-tax stock-based compensation expense of \$17,000 and \$29,000, respectively, compared to \$12,000 and \$24,000 for the comparable periods last year. Such expense includes compensation expense for stock-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, and all awards granted subsequent to January 1, 2006, based on the grant-date fair value. The Company recognized compensation expense for stock option awards on a straight-line basis over the requisite service period of the award. The total of unrecognized compensation cost related to nonvested share-based compensation arrangements was \$92,451 as of June 30, 2007. The cost will be recognized over the remaining service period.

The Company granted options pursuant to its ESPP on January 31, 2006. The fair value of these options was estimated using the Black-Scholes valuation model using the following weighted average assumptions:

|                           | 2006   |
|---------------------------|--------|
| Dividend yield            | 2.40%  |
| Expected volatility       | 23.57% |
| Risk free interest        | 4.53%  |
| Expected lives (in years) | 2.25   |

The weighted average fair value of options granted was \$5.91 per share in 2006. No options were granted during the three- or six-month periods ended June 30, 2007.

The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at the time of the ESPP grant date. For valuation of the ESPP awards, the Company used the risk free interest rate on the date of grant. The expected life of the options represents the period of time that the Company expects the awards will be outstanding based on historical experience with similar awards. The computation of expected volatility for the ESPP awards is based on historical volatility of the underlying securities. The expected dividend yield is calculated by taking the total expected annual dividend payout divided by the average stock price. Stock-based compensation expense recognized in the consolidated statement of operation in the first quarter of 2006 and 2007 reflects forfeitures as they occur.

The following is a summary of changes in shares under option for all plans for the six-month period ended June 30, 2007:

|                                  | Number<br>of Shares | Weighted<br>Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|---------------------|---------------------------------------|---------------------------------|
| Outstanding at beginning of year | 37,515              | \$ 15.82                              |                                 |
| Granted                          | -                   | -                                     |                                 |
| Exercised                        | (2,525)             | 17.92                                 |                                 |
| Expired/Cancelled                | (77)                | 18.47                                 |                                 |
| Outstanding at end of period     | 34,913              | 15.73                                 | \$ 353,769                      |
| Exercisable at the end of period | 34,913              | \$ 16.19                              | \$ 359,769                      |

The following summarizes information about options outstanding at June 30, 2007:

| Options Outstanding |        | Options Outstanding and Exercisable |  |
|---------------------|--------|-------------------------------------|--|
|                     |        | Number                              | Weighted Average<br>Remaining<br>Contract Life |
| Exercise Price      | Number |                                     | Number   |



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|         |        |        |      |
|---------|--------|--------|------|
| \$21.33 | 5,075  | 5,075  | 1.55 |
| 14.00   | 4,005  | 4,005  | 2.55 |
| 13.17   | 17,495 | 17,495 | 3.92 |
| 18.47   | 8,338  | 8,338  | 0.83 |
|         | 34,913 | 34,913 |      |

The total intrinsic value of stock options exercised during the six -month periods ended June 30, 2007 and 2006 was approximately \$24,000 and \$537,000, respectively. Cash received upon exercise of options during the six-month periods ended June 30, 2007 and 2006 was approximately \$37,000 and \$222,000, respectively.

Note 6 - Segment Reporting

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

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

Selected financial information by line of business for the six months ended June 30 is included in the following table:

| (In thousands)                      | Community<br>banking | Insurance<br>products<br>and<br>services | Parent<br>Company(a) | Intersegment<br>Transactions | Consolidated<br>Total |
|-------------------------------------|----------------------|--|----------------------|------------------------------|-----------------------|
| <b>2007</b>                         |                      |  |                      |                              |                       |
| Net Interest income                 | \$ 20,119            | \$ 23                                    | \$ 5                 | \$ -                         | \$ 20,147             |
| Provision for credit losses         | 655                  | -  | -                    | -                            | 655                   |
| Net interest income after provision | 19,464               | 23                                       | 5                    | -                            | 19,492                |
| Noninterest income                  | 3,309                | 3,718                                    | 2,568                | (2,686)                      | 6,909                 |
| Noninterest expense                 | 12,585               | 3,080                                    | 2,659                | (2,686)                      | 15,638                |
| Income before taxes                 | 10,188               | 661                                      | (86)                 | -                            | 10,763                |
| Income tax expense                  | 3,790                | 246                                      | (32)                 | -                            | 4,004                 |
| Net income                          | \$ 6,398             | \$ 415                                   | \$ (54)              | \$ -                         | \$ 6,759              |
| Intersegment revenue(expense)       | \$ (2,279)           | \$ (183)                                 | \$ 2,462             | \$ -                         | \$ -                  |
| Average assets                      | \$ 931,205           | \$ 9,918                                 | \$ 3,635             | \$ -                         | \$ 944,758            |
| <b>2006</b>                         |                      |  |                      |                              |                       |
| Net Interest income                 | \$ 19,321            | \$ -                                     | \$ 2                 | \$ -                         | \$ 19,323             |
| Provision for credit losses         | 551                  | -  | -                    | -                            | 551                   |
| Net interest income after provision | 18,770               | -  | 2                    | -                            | 18,772                |
| Noninterest income                  | 2,993                | 4,104                                    | 2,102                | (2,174)                      | 7,025                 |
| Noninterest expense                 | 11,096               | 3,062                                    | 2,154                | (2,174)                      | 14,138                |
| Income before taxes                 | 10,667               | 1,042                                    | (50)                 | -                            | 11,659                |
| Income tax expense                  | 3,949                | 427                                      | (19)                 | -                            | 4,357                 |
| Net income                          | \$ 6,718             | \$ 615                                   | \$ 31                | \$ -                         | \$ 7,302              |
| Intersegment revenue(expense)       | \$ (1,872)           | \$ (113)                                 | \$ 1,985             | \$ -                         | \$ -                  |
| Average assets                      | \$ 843,765           | \$ 10,240                                | \$ 3,709             | \$ -                         | \$ 857,714            |

(a) Amount included in Parent Company relates to services provided to subsidiaries by the Company and rental income.

Note 7 - New Accounting Pronouncements

*SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments — an amendment of Financial Accounting Standards Board ("FASB") Statements No. 133 and 140."* SFAS 155 amends SFAS 133, "Accounting for Derivative Instruments and Hedging Activities" and SFAS 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities." SFAS 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends SFAS 140 to eliminate the prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The adoption of SFAS 155 on January 1, 2007 did not have a significant impact on the Company's financial statements.

*SFAS No. 156, "Accounting for Servicing of Financial Assets — an amendment of FASB Statement No. 140."* SFAS 156 amends SFAS 140. "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities — a replacement of FASB Statement No. 125," by requiring, in certain situations, an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. All separately recognized servicing assets and servicing liabilities are required to be initially measured at fair value. Subsequent measurement methods include the amortization method, whereby servicing assets or servicing liabilities are amortized in proportion to and over the period of estimated net servicing income or net servicing loss or the fair value method, whereby servicing assets or servicing liabilities are measured at fair value at each reporting date and changes in fair value are reported in earnings in the period in which they occur. If the amortization method is used, an entity must assess servicing assets or servicing liabilities for impairment or increased obligation based on the fair value at each reporting date. The adoption of SFAS 156 on January 1, 2007 did not have a significant impact on the Company's financial statements.

*FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN 48").* FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in an income tax return. FIN 48 also provides guidance on recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The adoption of FIN 48 on January 1, 2007 did not have a significant impact on the Company's financial statements.

*SFAS No. 157, "Fair Value Measurements."* SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company's financial statements.

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

*SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115."* SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company's financial statements.



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

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

### **Forward-Looking Information**

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities

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

### **Introduction**

The following discussion and analysis is intended as a review of significant factors affecting the financial condition and results of operations of Shore Bancshares, Inc. and its consolidated subsidiaries for the periods indicated. This discussion and analysis should be read in conjunction with the unaudited condensed consolidated financial statements and related notes presented in this report, as well as the audited consolidated financial statements and related notes included in the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2006.

Shore Bancshares, Inc. is the largest independent financial holding company located on the Eastern Shore of Maryland. It is the parent company of The Talbot Bank of Easton, Maryland located in Easton, Maryland ("Talbot Bank"), The Centreville National Bank of Maryland located in Centreville, Maryland ("Centreville National Bank") and The Felton Bank, located in Felton, Delaware ("Felton Bank") (collectively, the "Banks"). The Banks operate 17 full service branches in Kent, Queen Anne's, Talbot, Caroline and Dorchester Counties in Maryland and Kent County, Delaware. The Company offers a full range of insurance products and services to its customers through The Avon-Dixon Agency, LLC, Elliott Wilson Insurance, LLC, and Mubell Finance, LLC (collectively, the "Insurance Agency") and investment advisory services through Wye Financial Services, LLC, all of which are wholly-owned subsidiaries of Shore Bancshares, Inc. The shares of common stock of Shore Bancshares, Inc. are listed on the NASDAQ Global Market under the symbol "SHBI".

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

### **Critical Accounting Policies**

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

We believe that our most critical accounting policy relates to the allowance for credit losses. The allowance for credit losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic

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

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

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

## **OVERVIEW**

Net income for the second quarter of 2007 was \$3,356,000, or diluted earnings per share of \$.40, compared to \$3,751,000, or diluted earnings per share of \$.45, for the second quarter of 2006. Annualized return on average assets was 1.43% for the second quarter of 2007, compared to 1.75% for the same period in 2006. Annualized return on average stockholders' equity was 11.69% for the second quarter of 2007 compared to 14.57% for the same period in 2006.

Net income for the six months ended June 30, 2007 was \$6,759,000, or diluted earnings per share of \$.81, compared to \$7,302,000, or diluted earnings per share of \$.87, for the six months ended June 30, 2006. Annualized return on average assets was 1.43% for the six months ended June 30, 2007, compared to 1.70% for the same period in 2006. Annualized return on average stockholder's equity was 11.89% for the six months ended June 30, 2007, compared to 13.93% for the same period in 2006.

## **RESULTS OF OPERATIONS**

### **Net Interest Income**

Net interest income for the three- and six-month periods ended June 30, 2007 was \$10,242,000 and \$20,147,000, respectively, an increase of \$333,000 or 3.4% and \$824,000 or 4.3%, respectively, when compared to the same periods last year. These increases are attributable to increases in earning assets, mostly loans, and increased yields on earning assets. Total interest income increased by \$2,312,000 and \$5,137,000 for the three- and six-month periods ended June 30, 2007, respectively, when compared to the same periods last year.

The Company's net interest margin was 4.66% for the second quarter of 2007, compared to 5.00% for the second quarter of 2006. The market for deposits remained competitive throughout the second quarter of 2007, resulting in higher rates paid for interest-bearing deposits. The cost of funds increased 79 basis points from 2.15% to 2.94% for the quarter ended June 30, 2007 when compared to the same quarter in 2006. The competitive environment for deposits was the primary cause of the increase in the cost of funds.



Total interest expense increased \$1,979,000 and \$4,313,000 for the three- and six-month periods ended June 30, 2007 when compared to the same periods last year. The average balance of interest bearing deposits increased by \$68,618,000 for the six months ended June 30, 2007 when compared to the same period in 2006. The overall rate paid for interest bearing deposits increased 90 basis points to 3.24% as a result of higher rates paid for all deposits. For the six months ended June 30, 2007, the average balance of certificates of deposits, including those \$100,000 or more, increased by \$56,313,000 when compared to the same period last year, and the average rate paid for those certificates of deposit increased 50 basis points to 4.51%. Other certificates of deposit increased \$22,154,000 when compared to the same period last year, and the average rate paid for those deposits increased 111 basis points to 4.77%. Comparing the first six months of 2007 to the same period in 2006, interest bearing demand deposits increased by approximately \$4,272,000 and money management and savings deposits declined by \$14,122,000.

Loans comprised 79.2% and 80.8% of total average earning assets at June 30, 2007 and 2006, respectively.

### Analysis of Interest Rates and Interest Differentials.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid through June 30, 2007 and 2006:

| (Dollars in thousands)                     | Six Months Ended June 30, 2007 |                |            | Six Months Ended June 30, 2006 |                |            |
|--|--------------------------------|----------------|------------|--------------------------------|----------------|------------|
|  | Average Balance                | Income Expense | Yield Rate | Average Balance                | Income Expense | Yield Rate |
| <b>Earning Assets</b>                      |                                |                |            |                                |                |            |
| Investment securities                      | \$ 129,422                     | \$ 2,974       | 4.60%      | \$ 121,534                     | \$ 2,488       | 4.09%      |
| Loans                                      | 705,465                        | 27,873         | 7.90%      | 643,335                        | 23,962         | 7.45%      |
| Interest bearing deposits                  | 25,630                         | 667            | 5.20%      | 10,748                         | 242            | 4.50%      |
| Federal funds sold                         | 30,743                         | 810            | 5.27%      | 20,759                         | 487            | 4.69%      |
| Total earning assets                       | 891,260                        | 32,324         | 7.25%      | 796,380                        | 27,179         | 6.83%      |
| Noninterest earning assets                 | 53,498                         |                |            | 61,334                         |                |            |
| Total Assets                               | \$ 944,758                     |                |            | \$ 857,714                     |                |            |
| <b>Interest bearing liabilities</b>        |                                |                |            |                                |                |            |
| Interest bearing deposits                  | \$ 664,208                     | 10,770         | 3.24%      | \$ 595,590                     | 6,960          | 2.34%      |
| Short term borrowing                       | 26,832                         | 494            | 3.69%      | 30,417                         | 502            | 3.30%      |
| Long term debt                             | 27,000                         | 734            | 5.43%      | 10,684                         | 223            | 4.18%      |
| Total interest bearing liabilities         | 718,040                        | 11,998         | 3.34%      | 636,691                        | 7,685          | 2.41%      |
| Noninterest bearing liabilities            | 112,998                        |                |            | 116,202                        |                |            |
| Stockholders' equity                       | 113,720                        |                |            | 104,821                        |                |            |
| Total liabilities and stockholders' equity | \$ 944,758                     |                |            | \$ 857,714                     |                |            |
| Net interest spread                        |                                | \$ 20,326      | 3.91%      |                                | \$ 19,494      | 4.42%      |
| Net interest margin                        |                                |                | 4.56%      |                                |                | 4.90%      |

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate exclusive of the

alternative minimum tax rate of 35% and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

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

### Noninterest Income

Noninterest income for the three and six months ended June 30, 2007 totaled \$3.3 million and \$6.9 million, respectively, when compared to \$3.3 million and \$7.0 million for the same periods in 2006. The declines are primarily attributable to a decrease in insurance agency commissions relating to contingency income received, which varies from year to year depending on a number of factors outside of the control of the Company. The Company received an unusually large amount of contingency income in 2006. During the first half of 2007, service charge income declined \$52,000, insurance agency commissions, which includes contingency income, declined \$391,000 and other noninterest income increased \$326,000 when compared to the same six-month period in 2006. The increase in other noninterest income is primarily attributable to trust and investment management fee increases of approximately

\$144,000 due to growth in assets under management and increased commission income from mortgages originated for sale on the secondary market of \$309,000.

### **Noninterest Expense**

Noninterest expense for the three and six months ended June 30, 2007 increased \$700,000 or 9.9% and \$1.5 million or 10.6%, respectively, when compared to the same periods in 2006. The increases are primarily attributable to the increased cost of operating two additional bank branches, increased commission expense related to the increased income from the trust and advisory services and secondary market mortgage programs, as well as additional cost associated with segregating the CEO positions at Shore Bancshares and The Talbot Bank of Easton, Maryland, and hiring a new CEO for Talbot Bank in the third quarter of 2006. The Company also incurred additional operating expense in conjunction with the search to fill the CEO position at Centreville National Bank, following the retirement of the previous CEO on December 31, 2006.

### **Income Taxes**

The effective tax rate was 37.2% for each of the three and six month periods ended June 30, 2007 compared to 36.9% and 37.4%, respectively, for the same periods last year. Management believes that there have been no changes in tax laws or to our tax structure that are likely to have a future material impact on our effective tax rate.

## **ANALYSIS OF FINANCIAL CONDITION**

### **Loans**

Loans, net of unearned income, totaled \$731,211,000 at June 30, 2007, an increase of \$31,492,000 since December 31, 2006. Substantially all of the loan growth occurred during the second quarter of 2007. Average loans, net of unearned income, increased by \$62,130,000 or 9.7% for the six months ended June 30, 2007 when compared to the same period last of year.

### **Allowance for Credit Losses**

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

The provision for credit losses for the three- and six-month periods ended June 30, 2007 was \$413,000 and \$655,000, respectively, compared to \$240,000 and \$551,000, respectively for the same periods in 2006. The increase in the provision during the second quarter of 2007 when compared to the same period last year is attributable to the growth in the loan portfolio and the identification of losses in loans put on nonaccrual status during the second quarter. The overall credit quality of the portfolio remains strong as evidenced by loan delinquency and charge-off data at June 30, 2007. Management believes that we continue to maintain strong underwriting guidelines. Management also believes that the local economy remains stable, despite a slowing in the real estate market and that collateral values remain stable. Our historical charge-off ratios remain lower than those of similarly sized institutions according to the most recent Bank Holding Company Performance Report prepared by the Federal Reserve Board. Net charge-offs were \$70,000 for the six-month period ended June 30, 2007, compared to \$225,000 for the same period last year. The allowance for credit losses as a percentage of average loans was .98% at June 30, 2007, compared to .86% at June 30, 2006. Loans past due 90 days and still accruing at June 30, 2007 increased slightly during the quarter, totaling \$787,000, compared to \$641,000 at December 31, 2006. Nonaccrual loans continued to decline during the second quarter, totaling \$1,944,000, compared to \$3,974,000 at March 31, 2007 and \$7,658,000 at December 31, 2006. One loan totaling \$4,500,000, which was on nonaccrual at December 31, 2006, was paid in full during the first quarter of 2007. Another loan relationship with loans totaling approximately \$812,000 was paid in full during the second quarter

of 2007 and other loans totaling approximately \$1,173,000 were either paid in full or restored to accrual status due to significant improvements made by the borrower in reducing its outstanding debts with the Company as well as improvements made in its operations. Based on Management's quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision are adequate at June 30, 2007.

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

| (Dollars in thousands)  | Six Months Ended June 30, |            |
|---|---------------------------|------------|
|   | 2007                      | 2006       |
| Allowance balance - beginning of period   | \$ 6,300                  | \$ 5,236   |
| Charge-offs:  |                           |            |
| Commercial and other  | 35                        | 162        |
| Real estate   | -                         | 1          |
| Consumer  | 122                       | 144        |
| Totals  | 157                       | 307        |
| Recoveries:   |                           |            |
| Commercial  | 42                        | 34         |
| Real estate   | -                         | 1          |
| Consumer  | 45                        | 47         |
| Totals  | 87                        | 82         |
| Net charge-offs   | 70                        | 225        |
| Provision for credit losses   | 655                       | 551        |
| Allowance balance-end of period   | \$ 6,885                  | \$ 5,562   |
| Average loans outstanding during period   | \$ 705,465                | \$ 643,335 |
| Net charge-offs (annualized) as a percentage of average loans outstanding during period | .02%                      | .07%       |
| Allowance for credit losses at period end as a percentage of average loans              | .98%                      | .86%       |

Because most of our loans are secured by real estate, weaknesses in the local real estate market may have a material adverse effect on collateral values and the performance of our loan portfolio. We have a concentration of commercial real estate loans. Commercial real estate loans, excluding construction and land development loans, at June 30, 2007 were approximately \$207,851,000 or 28.4% of total loans, compared to \$223,743,000 or 32.0% of total loans at December 31, 2006. Construction and land development loans at June 30, 2007 were \$149,202,000 or 20.4% of total outstanding loans, compared to \$153,715,000 or 22.2% of total loans at December 31, 2006. We do not engage in foreign lending activities or subprime lending.

### Nonperforming Assets

The following table summarizes our past due and nonperforming assets (in thousands):

|  | June 30,<br>2007 | December 31,<br>2006 |
|--|------------------|----------------------|
| Nonperforming Assets:                  |                  |                      |
| Nonaccrual loans                       | \$ 1,944         | \$ 7,658             |
| Other real estate owned                | 313              | 398                  |
|  | 2,257            | 8,056                |
| Past due loans still accruing          | 787              | 641                  |
| Total nonperforming and past due loans | \$ 3,044         | \$ 8,697             |

### Investment Securities

Investment securities totaled \$126,305,000 at June 30, 2007, compared to \$130,246,000 at December 31, 2006. Reinvestment rates on bonds purchased during the first six months of 2007 were much higher than the yields on bonds that matured during this period. The average balance of investment securities was \$129,422,000 for the six months

ended June 30, 2007, compared to \$121,534,000 for the same period in 2006. The tax equivalent yields on investment securities were 4.60% and 4.09% for the six month periods ended June 30, 2007 and 2006, respectively.

**Deposits**

Total deposits at June 30, 2007 were \$764,728,000, compared to \$774,182,000 at December 31, 2006. Certificates of deposit of \$100,000 or more increased by \$2,957,000 during the first six months of 2007, NOW and SuperNOW declined \$5,566,000 and noninterest bearing demand remained relatively stable, increasing only \$343,000 since December 31, 2006. Other time and savings deposits have declined by \$7,188,000 during the six months ended June 30, 2007.

**Borrowed Funds**

Short-term borrowings at June 30, 2007 and December 31, 2006 were \$27,560,000 and \$28,525,000, respectively. Short-term borrowings consisted of securities sold under agreements to repurchase and short-term borrowings from a correspondent bank or the Federal Home Loan Bank.

**Long Term Debt**

At June 30, 2007, we had advances from the Federal Home Loan Bank totaling \$27,000,000. Maturities of outstanding advances are as follows:

|                |              |
|----------------|--------------|
| July 2007      | \$ 3,000,000 |
| September 2007 | 2,000,000    |
| October 2007   | 4,000,000    |
| November 2007  | 6,000,000    |
| February 2008  | 5,000,000    |
| June 2008      | 7,000,000    |

**Liquidity and Capital Resources**

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and Centreville National Bank are also members of the Federal Home Loan Bank of Atlanta and Felton Bank is a member of the Federal Home Loan Bank of Pittsburgh to which they have pledged collateral sufficient to permit additional borrowings of up to approximately \$132 million at June 30, 2007. Management is not aware of any trends or demands, commitments, events or uncertainties that are likely to materially affect our future ability to maintain liquidity at satisfactory levels.

Total stockholders' equity was \$114.9 million at June 30, 2007, an increase of 3.2% since December 31, 2006. Accumulated other comprehensive loss, which consists solely of net unrealized losses on investment securities available for sale, increased by \$274,000 during the first six months of 2007, resulting in accumulated other comprehensive loss of \$997,000 at June 30, 2007.

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

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

A comparison of our capital ratios as of June 30, 2007 to the minimum regulatory requirements is presented below:

|                           | Actual | Minimum Requirements |
|---------------------------|--------|----------------------|
| Tier 1 risk-based capital | 13.37% | 4.00%                |
| Total risk-based capital  | 14.32% | 8.00%                |
| Leverage ratio            | 11.08% | 3.00%                |

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

Our primary market risk is to interest rate fluctuation and Management has procedures in place to evaluate and mitigate this risk. This risk and these procedures are discussed in Item 7 of Part II of the Annual Report of Shore



Bancshares, Inc. on Form 10-K for the year ended December 31, 2006 under the caption "Market Risk Management". Management believes that there have been no material changes in our market risks, the procedures used to evaluate and mitigate these risks, or our actual and simulated sensitivity positions since December 31, 2006.

**Item 4. Controls and Procedures.**

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

An evaluation of the effectiveness of these disclosure controls as of June 30, 2007 was carried out under the supervision and with the participation of Management, including the CEO and the PAO. Based on that evaluation, the Company's management, including the CEO and the PAO, has concluded that our disclosure controls and procedures are, in fact, effective at the reasonable assurance level.

During the second quarter of 2007, there was no change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 1A. Risk Factors.

The risks and uncertainties to which our financial condition and operations are subject are discussed in detail in Item 1A of Part I of the Annual Report of Shore Bancshares, Inc. on Form 10-K for the year ended December 31, 2006. Management does not believe that any material changes in our risk factors have occurred since they were last disclosed.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The following table provides information about shares of common stock purchased by or on behalf of the Company and its affiliates (as defined by Exchange Act Rule 10b-18) during the three-month period ended June 30 2007:

#### Issuer Purchases of Equity Securities

| Period       | Total Number<br>of<br>Shares (or<br>Units)<br>Purchased (1) | Average Price<br>Paid<br>per Share (or<br>Unit) | Total Number<br>of<br>Shares (or<br>Units)<br>Purchased as<br>Part<br>of Publicly<br>Announced<br>Plans<br>or Programs | Maximum<br>Number<br>(or<br>Approximate<br>Dollar Value) of<br>Shares (or<br>Units)<br>that May Yet<br>Be<br>Purchased<br>Under<br>the Plans or<br>Programs |
|--------------|---|---|--|---|
| April 2007   |   |   |  |   |
| May 2007     | 234   | \$ 25.95  | 234  | 418,466   |
| June 2007    |   |   |  |   |
| <b>Total</b> | <b>234</b>  | <b>\$ 25.95</b>                                 | <b>234</b>   | <b>418,466</b>  |

#### Note:

(1) All shares were purchased under the Company's repurchase plan that was adopted on February 2, 2006 and amended on May 1, 2007. The adoption of this plan and its amendment were publicly announced on February 8, 2006 and May 3, 2007, respectively. The plan originally authorized the Company to purchase up to 165,000 shares of its common stock over a 60-month period in open market and/or private transactions. As amended, the plan now

authorizes the Company to repurchase up to 5% of the issued and outstanding shares of Company common stock (or 418,700 as of April 30, 2007) over the same 60-month period. The plan provides that the price at which the shares are purchased may not be less than the fair market value of a share of common stock as listed or quoted on the Nasdaq Stock Market on the date of purchase.

**Item 4. Submission of Matters to Vote of Security Holders.**

At the Annual Meeting of Stockholders held on April 25, 2007, the stockholders of Shore Bancshares, Inc. elected four individuals to serve as Class I Directors until the 2010 Annual Meeting of Stockholders and until their successors are duly elected and qualify. The Board of Directors submitted this matter to a vote through the solicitation of proxies. The results of the vote were as follows:

|                        | For       | Withheld | Abstain | Broker<br>Non-Votes |
|------------------------|-----------|----------|---------|---------------------|
| Election of Directors: |           |          |         |                     |
| William W. Duncan      | 6,444,338 | 58,027   | -       | -                   |
| Thomas H. Evans        | 6,431,293 | 71,072   | -       | -                   |
| Richard C. Granville   | 6,443,523 | 58,842   | -       | -                   |
| Christopher F. Spurry  | 6,443,523 | 58,842   | -       | -                   |

**Item 6. Exhibits.**

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

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SHORE BANCSHARES, INC.

Date: August 9, 2007

By: /s/ W. Moorhead Vermilye

\_\_\_\_\_  
W. Moorhead Vermilye  
President and Chief Executive Officer

Date: August 9, 2007

By: /s/ Susan E. Leaverton

\_\_\_\_\_  
Susan E. Leaverton, CPA  
Treasurer and Principal Accounting Officer

**EXHIBIT INDEX**

| Exhibit Number | Description  |
|----------------|--|
| 3.1            | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 of the Company's Form 8-K filed on December 14, 2000).  |
| 3.2            | Amended and Restated By-Laws (incorporated by reference to Exhibit 3.2 of the Company's Form 8-K filed on November 9, 2005).   |
| 10.1           | Form of Employment Agreement with W. Moorhead Vermilye (incorporated by reference to Appendix XIII of Exhibit 2.1 of the Company's Form 8-K filed on July 31, 2000).   |
| 10.2           | Employment Termination Agreement among Centreville National Bank, the Company, and Daniel T. Cannon dated December 7, 2006 (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on December 12, 2006). |
| 10.3           | Employment Agreement with Thomas H. Evans, as amended on November 3, 2005 (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on November 9, 2005).   |
| 10.4           | Summary of Compensation Arrangement for Lloyd L. Beatty, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on August 1, 2006).  |
| 10.5           | Amended Summary of Compensation Arrangement for William W. Duncan, Jr. (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 14, 2007, as amended by Form 8-K/A filed on May 3, 2007).      |
| 10.6           | Employment Agreement between The Avon-Dixon Agency, LLC and Mark M. Freestate (incorporated by reference to Exhibit 10.6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2006).                  |
| 10.7           | Shore Bancshares, Inc. 2007 Management Incentive Plan (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on April 3, 2007).  |
| 10.8           | Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated by reference to Exhibit 10.2 of the Company's Form 8-K filed on February 14, 2007)  |
| 10.9           | Deferral Election, Investment Designation, and Beneficiary Designation Forms under the Shore Bancshares, Inc. Amended and Restated Executive Deferred Compensation Plan (incorporated herein                                 |

by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 2, 2006).

- 10.10 Form of Centreville National Bank of Maryland Director Indexed Fee Continuation Plan Agreement with Messrs. Cannon, Freestate and Pierson (incorporated herein by reference to Exhibit 10.2 to the Company's Form 8-K filed on December 12, 2006).
- 10.11 Form of Centreville National Bank Life Insurance Endorsement Split Dollar Plan Agreement with Messrs. Cannon, Freestate and Pierson (incorporated herein by reference to Exhibit 10.3 to the Company's Form 8-K filed on December 12, 2006).
- 10.12 Form of Executive Supplemental Retirement Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.4 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2003).
- 10.13 Form of Life Insurance Endorsement Method Split Dollar Plan Agreement between The Centreville National Bank of Maryland and Daniel T. Cannon (incorporated by reference to Exhibit 10.5 of the Company's Quarterly Report on Form 10-Q for the period ended June 30, 2003).
- 10.14 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).

- 10.15 Talbot Bank of Easton, Maryland Supplemental Deferred Compensation Plan Trust Agreement (incorporated by reference to Exhibit 10.7 of the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2005).
- 10.16 1998 Employee Stock Purchase Plan, as amended (incorporated by reference to Appendix A of the Company's definitive Proxy Statement on Schedule 14A for the 2003 Annual Meeting of Stockholders filed on March 31, 2003).
- 10.17 1998 Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed with the SEC on September 25, 1998 (Registration No. 333-64319)).
- 10.18 Talbot Bancshares, Inc. Employee Stock Option Plan (incorporated by reference to Exhibit 10 of the Company's Registration Statement on Form S-8 filed May 4, 2001 (Registration No. 333-60214)).
- 10.19 Shore Bancshares, Inc. 2006 Stock and Incentive Compensation Plan (incorporated by reference to Appendix A of the Company's 2006 definitive proxy statement filed on March 24, 2006).
- 10.20 Form of Restricted Stock Award Agreement under the 2006 Stock and Incentive Compensation Plan (incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on April 11, 2007).
- 10.21 Changes to Director Compensation Arrangements (incorporated by reference to Exhibit 10.1 of the Company's Form 8-K filed on February 6, 2006).
- 31.1 Certifications of the CEO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
- 31.2 Certifications of the PAO pursuant to Section 302 of the Sarbanes-Oxley Act (filed herewith).
- 32.1 Certification of the CEO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).
- 32.2 Certification of the PAO pursuant to Section 906 of the Sarbanes-Oxley Act (furnished herewith).
- 99.1 Shore Bancshares, Inc. Dividend Reinvestment Plan (incorporated by reference to the Company's Registration Statement on Form S-3D (File No. 333-143002)).