

SANDY SPRING BANCORP INC

Form 10-Q

May 07, 2007

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**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended March 31, 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: O-19065

Sandy Spring Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Maryland

52-1532952

(State of incorporation)

(I.R.S. Employer Identification Number)

17801 Georgia Avenue, Olney,
Maryland

20832

301-774-6400

(Address of principal office)

(Zip Code)

(Telephone Number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to 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.

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 Exchange Act)

YES NO

The number of shares of common stock outstanding as of April 23, 2007 is 15,735,864 shares.

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

Sandy Spring Bancorp, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEETS

| (Dollars in thousands, except per share data) | March 31, 2007 | December 31, 2006 |
|--|-------------------|-------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 61,145 | \$ 54,945 |
| Federal funds sold | 48,138 | 48,978 |
| Cash and cash equivalents | 109,283 | 103,923 |
| Interest-bearing deposits with banks | 28,192 | 2,974 |
| Residential mortgage loans held for sale | 9,660 | 10,595 |
| Investments available-for-sale (at fair value) | 282,023 | 256,845 |
| Investments held-to-maturity fair value of \$266,937 (2007) and \$273,206 (2006) | 261,208 | 267,344 |
| Other equity securities | 17,709 | 16,719 |
| Total loans and leases | 2,036,182 | 1,805,579 |
| Less: allowance for loan and lease losses | (22,186) | (19,492) |
| Net loans and leases | 2,013,996 | 1,786,087 |
| Premises and equipment, net | 50,834 | 47,756 |
| Accrued interest receivable | 16,485 | 15,200 |
| Goodwill | 53,913 | 12,494 |
| Other intangible assets, net | 15,244 | 10,653 |
| Other assets | 86,930 | 79,867 |
| Total assets | \$ 2,945,477 | \$ 2,610,457 |
| LIABILITIES | | |
| Noninterest-bearing deposits | \$ 449,604 | \$ 394,662 |
| Interest-bearing deposits | 1,824,718 | 1,599,561 |
| Total deposits | 2,274,322 | 1,994,223 |
| Short-term borrowings | 325,657 | 314,732 |
| Other long-term borrowings | 8,274 | 1,808 |
| Subordinated debentures | 35,000 | 35,000 |
| Accrued interest payable and other liabilities | 26,905 | 26,917 |
| Total liabilities | 2,670,158 | 2,372,680 |
| COMMITMENTS AND CONTINGENCIES | | |
| STOCKHOLDERS' EQUITY | | |
| Common stock par value \$1.00; shares authorized 50,000,000; shares issued and outstanding 15,724,895 (2007) and 14,826,805 (2006) | 15,725 | 14,827 |

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| | | |
|--|--------------|--------------|
| Additional paid in capital | 60,520 | 27,869 |
| Retained earnings | 203,044 | 199,102 |
| Accumulated other comprehensive loss | (3,970) | (4,021) |
| Total stockholders' equity | 275,319 | 237,777 |
| Total liabilities and stockholders' equity | \$ 2,945,477 | \$ 2,610,457 |

See Notes to Consolidated Financial Statements.

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CONSOLIDATED STATEMENTS OF INCOME

| (In thousands, except per share data) | Three Months Ended March 31, | |
|--|---------------------------------|---------------|
| | 2007 | 2006 |
| Interest Income: | | |
| Interest and fees on loans and leases | \$34,574 | \$28,858 |
| Interest on loans held for sale | 195 | 150 |
| Interest on deposits with banks | 90 | 10 |
| Interest and dividends on securities: | | |
| Taxable | 3,871 | 3,031 |
| Exempt from federal income taxes | 2,727 | 3,016 |
| Interest on federal funds sold | 437 | 112 |
| TOTAL INTEREST INCOME | 41,894 | 35,177 |
| Interest Expense: | | |
| Interest on deposits | 13,788 | 7,674 |
| Interest on short-term borrowings | 3,481 | 3,749 |
| Interest on long-term borrowings | 610 | 577 |
| TOTAL INTEREST EXPENSE | 17,879 | 12,000 |
| NET INTEREST INCOME | 24,015 | 23,177 |
| Provision for loan and lease losses | 839 | 950 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES | 23,176 | 22,227 |
| Noninterest Income: | | |
| Securities gains | 2 | 0 |
| Service charges on deposit accounts | 2,308 | 1,848 |
| Gains on sales of mortgage loans | 638 | 782 |
| Fees on sales of investment products | 800 | 718 |
| Trust and investment management fees | 2,281 | 2,116 |
| Insurance agency commissions | 2,690 | 2,108 |
| Income from bank owned life insurance | 684 | 553 |
| Visa check fees | 590 | 535 |
| Other income | 913 | 1,186 |
| TOTAL NONINTEREST INCOME | 10,906 | 9,846 |
| Noninterest Expenses: | | |
| Salaries and employee benefits | 13,434 | 12,471 |
| Occupancy expense of premises | 2,417 | 2,126 |
| Equipment expenses | 1,602 | 1,316 |
| Marketing | 529 | 341 |
| Outside data services | 926 | 781 |
| Amortization of intangible assets | 802 | 742 |
| Other expenses | 3,904 | 2,579 |

| | | |
|----------------------------|----------|----------|
| TOTAL NONINTEREST EXPENSES | 23,614 | 20,356 |
| Income Before Income Taxes | 10,468 | 11,717 |
| Income Tax Expense | 2,923 | 3,377 |
| NET INCOME | \$ 7,545 | \$ 8,340 |

See Notes to Consolidated Financial Statements.

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Sandy Spring Bancorp, Inc. and Subsidiaries
CONSOLIDATED STATEMENTS OF INCOME (Continued)

| (In thousands, except per share data) | Three Months Ended | |
|---|--------------------|--------|
| | March 31, | |
| | 2007 | 2006 |
| Basic Net Income Per Share | \$0.49 | \$0.56 |
| Diluted Net Income Per Share | 0.49 | 0.56 |
| Dividends Declared Per Share | 0.23 | 0.22 |
| See Notes to Consolidated Financial Statements. | | |

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Sandy Spring Bancorp, Inc. and Subsidiaries
 CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Dollars in thousands)

| | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income | \$ 7,545 | \$ 8,340 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,393 | 2,066 |
| Provision for loan and lease losses | 839 | 950 |
| Stock compensation expense | 226 | 142 |
| Deferred income taxes (benefits) | (960) | (16) |
| Origination of loans held for sale | (73,782) | (55,018) |
| Proceeds from sales of loans held for sale | 75,356 | 58,585 |
| Gains on sales of loans held for sale | (638) | (662) |
| Securities gains | (2) | 0 |
| Net (increase) in accrued interest receivable | (108) | 293 |
| Net (increase) decrease in other assets | (4,417) | 702 |
| Net decrease in accrued expenses and other liabilities | (2,272) | (4,826) |
| Other net | (654) | 244 |
| Net cash provided by operating activities | 3,526 | 10,800 |
| Cash flows from investing activities: | | |
| Net (increase) decrease in interest-bearing deposits with banks | (25,218) | 67 |
| Purchases of other equity securities | (118) | (749) |
| Purchases of investments available-for-sale | (4,967) | (10,000) |
| Proceeds from the sales of other real estate owned | 192 | 0 |
| Proceeds from maturities, calls and principal payments of investments held-to-maturity | 9,613 | 4,840 |
| Proceeds from maturities, calls and principal payments of investments available-for-sale | 12,382 | 30,531 |
| Net increase in loans and leases | (34,651) | (57,821) |
| Purchase of loans and leases | 0 | (2,148) |
| Acquisition of business activity, net | (28,039) | 0 |
| Expenditures for premises and equipment | (660) | (1,245) |
| Net cash (used in) investing activities | (71,466) | (36,525) |
| Cash flows from financing activities: | | |
| Net increase in deposits | 83,134 | 36,145 |
| Net increase (decrease) in short-term borrowings | (6,513) | 3,563 |
| Retirement of long-term borrowings | (64) | 0 |
| Proceeds from issuance of common stock | 346 | 245 |
| Dividends paid | (3,603) | (3,255) |
| Net cash provided by financing activities | 73,300 | 36,698 |

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| | | |
|--|------------|-----------|
| Net increase in cash and cash equivalents | 5,360 | 10,973 |
| Cash and cash equivalents at beginning of period | 103,923 | 53,443 |
| Cash and cash equivalents at end of period | \$ 109,283 | \$ 64,416 |

Table of ContentsSandy Spring Bancorp and Subsidiaries
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

| (Dollars in thousands) | Three Months Ended | |
|---|--------------------|-------------------|
| | 2007 | March 31, 2006 |
| Supplemental Disclosures: | | |
| Interest payments | \$ 17,196 | \$ 11,511 |
| Income tax payments | 5,910 | 317 |
| Reclassification of borrowings from long-term to short-term | 87 | 87 |
| Details of acquisition: | | |
| Fair value of assets acquired | \$ 252,487 | 0 |
| Fair value of liabilities assumed | (224,956) | 0 |
| Stock issued for acquisition | (32,977) | 0 |
| Purchase price in excess of net assets acquired | 39,914 | 0 |
| Cash paid for acquisition | 34,468 | 0 |
| Cash acquired with acquisition | (6,429) | 0 |
| Acquisition of business activity, net | 28,039 | 0 |

See Notes to Consolidated Financial Statements.

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Sandy Spring Bancorp, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

| | Common | Additional | Retained | Accumulated | Total |
|--|-----------|------------|------------|---------------|--------------|
| (Dollars in thousands, except per share data) | Stock | Paid-in | Earnings | Other | Stockholders |
| | | Capital | | Comprehensive | Equity |
| | | | | Income | |
| | | | | (loss) | |
| Balances at January 1, 2007 | \$ 14,827 | \$ 27,869 | \$ 199,102 | \$ (4,021) | \$ 237,777 |
| Comprehensive income: | | | | | |
| Net income | | | 7,545 | | 7,545 |
| Other comprehensive income, net of tax effects and reclassification adjustment | | | | 51 | 51 |
| Total comprehensive income | | | | | 7,596 |
| Cash dividends \$0.23 per share | | | (3,603) | | (3,603) |
| Stock compensation expense | | 226 | | | 226 |
| Common stock issued pursuant to: | | | | | |
| Acquisition of Potomac Bank- 886,989 shares | 887 | 32,090 | | | 32,977 |
| Stock option plan 6,200 shares | 6 | 190 | | | 196 |
| Employee stock purchase plan 4,901 shares | 5 | 145 | | | 150 |
| Balances at March 31, 2007 | \$ 15,725 | \$ 60,520 | \$ 203,044 | \$ (3,970) | \$ 275,319 |
| Balances at January 1, 2006 | \$ 14,794 | \$ 26,599 | \$ 179,259 | \$ (594) | \$ 220,058 |
| Comprehensive income: | | | | | |
| Net income | | | 8,340 | | 8,340 |
| Other comprehensive loss, net of tax effects | | | | (393) | (393) |
| Total comprehensive income | | | | | 7,947 |
| Cash dividends \$0.22 per share | | | (3,255) | | (3,255) |

| | | | | | |
|---|-----------|-----------|------------|----------|------------|
| Stock Compensation Expense | | 142 | | | 142 |
| Common stock issuance pursuant to: | | | | | |
| Stock option plan 2,950 shares | 3 | 91 | | | 94 |
| Employee stock purchase plan 4,997 shares | 5 | 146 | | | 151 |
| Balances at March 31, 2006 | \$ 14,802 | \$ 26,978 | \$ 184,344 | \$ (987) | \$ 225,137 |

See Notes to Consolidated Financial Statements.

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The foregoing financial statements are unaudited. In the opinion of Management, all adjustments (comprising only normal recurring accruals) necessary for a fair presentation of the results of the interim periods have been included. These statements should be read in conjunction with the financial statements and accompanying notes included in Sandy Spring Bancorp's 2006 Annual Report on Form 10-K. There have been no significant changes to the Company's Accounting Policies as disclosed in the 2006 Annual Report on Form 10-K. The results shown in this interim report are not necessarily indicative of results to be expected for the full year 2007.

The accounting and reporting policies of Sandy Spring Bancorp, Inc. (the Company) and its wholly-owned subsidiary, Sandy Spring Bank (the Bank), together with its subsidiaries, Sandy Spring Insurance Corporation, The Equipment Leasing Company, and West Financial Services, Inc., conform to accounting principles generally accepted in the United States of America and to general practices within the financial services industry. Certain reclassifications have been made to amounts previously reported to conform to current classifications.

Consolidation has resulted in the elimination of all significant intercompany accounts and transactions.

Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks and federal funds sold (which have original maturities of three months or less).

Note 2 Acquisitions

In January 2006, the Company completed the acquisition of Neff & Associates (Neff), an insurance agency located in Ocean City, Maryland. Under the terms of the acquisition agreement, the Company purchased Neff for cash totaling approximately \$1.9 million. Additional contingent payments may be made and recorded in 2008 based on the financial results attained by Neff in that year.

In the transaction, \$0.3 million of assets were acquired, primarily accounts receivable, and \$0.3 million of liabilities were assumed, primarily operating payables. The acquisition resulted in the recognition of \$0.5 million of goodwill, which will not be amortized, and \$1.4 million of identified intangible assets which will be amortized on a straight-line basis over a period of 5 to 10 years. This acquisition is considered immaterial and, accordingly, no pro forma results of operations are provided for the pre-acquisition periods.

On February 15, 2007, the Company completed the acquisition of Potomac Bank of Virginia (Potomac), a bank headquartered in Fairfax, Virginia. Potomac operated five branch offices in the Northern Virginia metropolitan market at the time of the acquisition. The primary reason for the merger with Potomac was to gain entry into the northern Virginia high growth market. The total consideration paid to Potomac shareholders in connection with the acquisition was \$64.4 million. The results of Potomac's operations have been included in the Company's consolidated financial results subsequent to February 15, 2007. The assets and liabilities of Potomac were recorded on the Consolidated Balance Sheet at their respective fair values. The fair values were determined as of February 15, 2007 and are subject to further refinement as further information becomes available. The transaction resulted in total assets acquired as of February 15, 2007 of \$252.5 million, including approximately \$196.0 million of loans and leases; liabilities assumed were \$225.0 million, including \$197.0 million of deposits. Additionally, the Company recorded \$39.9 million of goodwill, \$5.1 million of core deposit intangible (CDI) and \$0.3 million of other intangibles. CDI are subject to amortization and are being amortized over seven years on a straight-line basis.

The acquisition of Potomac is considered immaterial for purposes of the disclosures required by FAS No. 141,

Business Combinations.**Pending Acquisitions**

In December 2006, the Company entered into a merger agreement to acquire CN Bancorp Inc. (CNB) and its wholly owned subsidiary, County National Bank (County National). CNB is the holding company for County National and had consolidated total assets of \$164 million at March 31, 2007. County National, with assets of \$158 million as of March 31, 2007, is a commercial bank headquartered in Pasadena, Maryland, with four full-service branches located in Anne Arundel County, Maryland.

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Under the terms of the agreement, each outstanding share of CNB's common stock will be converted into either \$25.00 in cash or 0.6657 of a share of the Company's common stock. Each shareholder of CNB will be entitled to elect the number of shares of Potomac common stock to be exchanged for cash or shares of the Company's common stock, subject to a proration which will provide that the Company will pay cash for a minimum of 40% and a maximum of 50% of the outstanding shares of CNB common stock and issue shares of the Company's common stock in exchange for a minimum of 50% and a maximum of 60% of the outstanding shares of CNB common stock. The total purchase price is estimated to be \$46.2 million, including \$22.6 million in stock issued and stock options assumed and \$21.6 million in stock purchased and options settled for cash, and approximately \$2.0 million of estimated other direct acquisition costs.

The acquisition is subject to approval by both the CNB shareholders and applicable bank regulatory authorities and is expected to be completed during the second quarter of 2007. As a result of the acquisition, County National will become a newly formed division of Sandy Spring Bank.

Note 3 New Accounting Pronouncements

Adopted Accounting Pronouncements

In February 2006, FASB issued SFAS 155, *Accounting for Certain Hybrid Financial Instruments*, which permits, but does not require, fair value accounting for any hybrid financial instrument that contains an embedded derivative that would otherwise require bifurcation in accordance with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. The statement also subjects beneficial interests in securitized financial assets to the requirements of SFAS 133. This statement is effective for all financial instruments acquired, issued, or subject to remeasurement for fiscal years beginning after September 15, 2006. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets, and an amendment of FASB Statement No. 140*. The statement amends SFAS No. 140 by (1) requiring the separate accounting for servicing assets and servicing liabilities, which arise from the sale of financial assets; (2) requiring all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; and (3) permitting an entity to choose between an amortization method or a fair value method for subsequent measurement for each class of separately recognized servicing assets and servicing liabilities. This statement is effective for fiscal years beginning after September 15, 2006, with earlier adoption permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations or cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. This interpretation applies to all tax positions accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the application of SFAS No. 109 by defining the criteria that an individual tax position must meet in order for the position to be recognized within the financial statements and provides guidance on measurement, de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition for tax positions. This interpretation is effective for fiscal years beginning after December 15, 2006, with earlier adoption permitted. The Company has evaluated the impact of the adoption of this interpretation and has determined that it will not have a material impact on its financial position, results of operations or cash flows.

In June 2006, the EITF released Issue 06-05, *Accounting for Purchases of Life Insurance-Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance*. On September 7, 2006, the EITF concluded that a policyholder should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract. Amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized. Amounts that are recoverable by the policyholder in periods beyond one year from the surrender of the policy should be discounted utilizing an appropriate rate of interest. The effective date of EITF 06-05 is for fiscal years beginning after December 15, 2006. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations or cash flows.

Table of Contents**Pending Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity operates. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations or cash flows.

At its September 2006 meeting, the Emerging Issues Task Force (EITF) reached a final consensus on Issue 06-04, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*. The consensus stipulates that an agreement by an employer to share a portion of the proceeds of a life insurance policy with an employee during the postretirement period is a postretirement benefit arrangement required to be accounted for under SFAS No. 106 or Accounting Principles Board Opinion (APB) No. 12, Omnibus Opinion - 1967. The consensus concludes that the purchase of a split-dollar life insurance policy does not constitute a settlement under SFAS No. 106 and, therefore, a liability for the postretirement obligation must be recognized under SFAS No. 106 if the benefit is offered under an arrangement that constitutes a plan or under APB No. 12, if it is not part of a plan. Issue 06-04 is effective for annual or interim reporting periods beginning after December 15, 2007. The Company has endorsement split-dollar life insurance policies totaling \$19.0 million as of December 31, 2006 and is currently assessing the financial statement impact of implementing EITF 06-04.

In November 2006, the EITF released Issue 06-10, *Accounting for Deferred compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements*. On November 29, 2006 the FASB ratified the tentative conclusions reached by the EITF on this Issue and approved the issuance of a draft abstract for a public comment period. This Issue addresses questions raised about whether the consensus reached in Issue 06-4 should apply to collateral assignment split-dollar life insurance arrangements and the recognition and measurement of the employer's asset in such arrangements. The EITF concluded that an employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either SFAS No. 106 or APB No. 12 based on the substantive agreement with the employee. In addition the EITF reached a conclusion that an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar arrangement based on what future cash flows the employer is entitled to, if any, as well as the employee's obligation and ability to repay the employer. The effective date of EITF 06-10 is for fiscal years beginning after December 15, 2007. The Company had no collateral assignment split dollar life insurance policies as of March 31, 2006 and does not expect that the implementation of EITF 06-10 will have a material impact on its financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement permits entities to choose, at specified dates, to measure eligible items at fair value. This election is referred to as the fair value option and must generally be applied on an instrument by instrument basis; is irrevocable, unless a new election occurs; and is applied only to an entire instrument, not to only specified risks, specific cash flows, or portions of an instrument. A business entity that elects the fair value option, must report any unrealized gains and losses on the items involved, in earnings at each subsequent reporting date. The statement also establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The effective date of SFAS No. 159 is for fiscal years beginning after November 15, 2007. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations or cash flows.

Note 4 Stock Based Compensation

At December 31, 2006, the Company had three stock-based compensation plans in existence, the 1992 and 1999 stock option plans (both expired but having outstanding options that may still be exercised) and the 2005 Omnibus Stock Plan, which is described below.

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The Company's 2005 Omnibus Stock Plan (Omnibus Plan) provides for the granting of non-qualifying stock options to the Company's directors, and incentive and non-qualifying stock options, stock appreciation rights and restricted stock grants to selected key employees on a periodic basis at the discretion of the Board. The Omnibus Plan authorizes the issuance of up to 1,800,000 shares of common stock of which 1,464,263 are available for issuance at March 31, 2007, has a term of ten years, and is administered by a committee of at least three directors appointed by the Board of Directors. Options granted under the plan have an exercise price which may not be less than 100% of the fair market value of the common stock on the date of the grant and must be exercised within ten years from the date of grant. The exercise price of stock options must be paid for in full in cash or shares of common stock, or a combination of both. The Stock Option Committee has the discretion when making a grant of stock options to impose restrictions on the shares to be purchased in exercise of such options. Outstanding options granted under the expired 1992 and 1999 Stock Option Plans will continue until exercise or expiration.

Options awarded prior to December 15, 2005 vest ratably over a two-year period, with one third vesting immediately upon grant. Effective October 19, 2005, the Board of Directors approved the acceleration, by one year, of the vesting of the then outstanding options to purchase approximately 66,000 shares of the Company's common stock granted in December 2004. These included options held by certain members of senior management. This effectively reduced the two-year vesting period on these options to one year. The amount that would have been expensed for such unvested options in 2006 had the Company not accelerated the vesting would have been approximately \$0.4 million. Additionally, stock options granted in 2004 have a ten year life. The other terms of the option grants remain unchanged.

Effective December 13, 2006, the Board of Directors approved the granting of approximately 105,623 stock options, subject to a three year vesting schedule with one third of the options vesting each year as of December 13, 2007, 2008, and 2009, respectively. In addition, on December 13, 2006, the Board of Directors granted 31,483 restricted shares subject to a five year vesting schedule with one fifth of the shares vesting each year as of December 13, 2007, 2008, 2009, 2010, and 2011, respectively. Compensation expense is recognized on a straight-line basis over the stock option vesting period. The fair value based method for expense recognition of employee awards resulted in expense of approximately \$0.2 million, net of a tax benefit of approximately \$15 thousand, for the three month period ended March 31, 2007, and \$0.1 million, net of tax benefit of \$22 thousand, for the three month period ended March 31, 2006.

The fair values of all of the options granted during the last three years have been estimated using a binomial option-pricing model.

The total intrinsic value of options exercised during the quarters ended March 31, 2007 and 2006 was \$35,000 and \$9,000.

No options were granted for the three month periods ended March 31, 2007 and 2006.

A summary of share option activity for the three month period ended March 31, 2007 follows:

| | Number of Shares | Weighted Average Exercised Share Price (Unaudited) | Weighted Average Remaining Contractual Life(Years) | Aggregate Intrinsic Value |
|---|------------------------|---|--|---------------------------------|
| <i>(Dollars in thousands, except per share data):</i> | | | | |
| Balance at January 1, 2007 | 1,032,585 | \$ 33.77 | 6.1 | \$ 3,762 |
| Options (at fair value) related to option plan of acquired Bank | 60,503 | 18.10 | 5.6 | |
| Exercised | (6,200) | 31.73 | 5.5 | |
| Forfeited or expired | (4,837) | 38.31 | 8.0 | |
| Balance at March 31, 2007 | 1,082,051 | \$ 33.55 | 5.9 | \$ 5,237 |

| | | | |
|-------------------------------|---------|----------|----------|
| Exercisable at March 31, 2007 | 899,247 | \$ 31.18 | \$ 5,237 |
| | 10 | | |

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A summary of the status of the Company's nonvested options as of March 31, 2007, and changes during the three month period then ended, is presented below (unaudited):

| | Number Of Shares | Weighted Average Grant-Date Fair Value |
|------------------------------|---------------------|---|
| Nonvested at January 1, 2007 | 183,075 | \$ 7.54 |
| Granted | 0 | 0 |
| Vested | 0 | 0 |
| Forfeited | (271) | 8.14 |
| Nonvested at March 31, 2007 | 182,804 | 7.54 |

The number of options, exercise prices, and fair values has been retroactively restated for all stock dividends occurring since the date the options were granted.

The total of unrecognized compensation cost related to nonvested share-based compensation arrangements was approximately \$1.2 million as of March 31, 2007. That cost is expected to be recognized over a weighted average period of approximately 2 years.

The Company generally issues authorized but previously unissued shares to satisfy option exercises.

Note 5 Per Share Data

The calculations of net income per common share for the three month periods ended March 31, 2007 and 2006 are as shown in the following table. Basic net income per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding and does not include the impact of any potentially dilutive common stock equivalents. The diluted earnings per share calculation method is derived by dividing net income available to common stockholders by the weighted average number of common shares outstanding adjusted for the dilutive effect of outstanding stock options, the unamortized compensation cost of stock options, and the accumulated tax benefit or shortfall that would be credited or charged to additional paid in capital.

| (Dollars and amounts in thousands, except per share data) | Three Months Ended March 31, | |
|--|---------------------------------|----------|
| | 2007 | 2006 |
| Basic: | | |
| Net income available to common stockholders | \$ 7,545 | \$ 8,340 |
| Average common shares outstanding | 15,269 | 14,798 |
| Basic net income per share | \$ 0.49 | \$ 0.56 |
| Diluted: | | |
| Net income available to common stockholders | \$ 7,545 | \$ 8,340 |
| Average common shares outstanding | 15,269 | 14,798 |
| Stock option adjustment | 132 | 127 |
| Average common shares outstanding-diluted | 15,401 | 14,925 |
| Diluted net income per share | \$ 0.49 | \$ 0.56 |

Options for 674,922 shares and 587,571 shares of common stock were not included in computing diluted net income per share for the three month periods ended March 31, 2007 and 2006, respectively, because their effects are

antidilutive.

Note 6 Pension, Profit Sharing, and Other Employee Benefit Plans

Defined Benefit Pension Plan

The Company has a qualified, noncontributory, defined benefit pension plan covering substantially all employees. Benefits equal the sum of three parts: (a) the benefit accrued as of December 31, 2000, based on the formula of 1.50% of the highest five year average salary as of that date times years of service as of that date, plus (b) 1.75% of each year's earnings after December 31, 2000 through December 31, 2005, plus (c) 1.00% of each year's earnings after December 31, 2005. In addition, if the participant's age plus years of service as of January 1, 2001, equal at least 60 and the participant had at least 15 years of

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service at that date, he or she will receive an additional benefit of 1.00% of year 2000 earnings for each of the first 10 years of service completed after December 31, 2000. Early retirement is also permitted by the Plan at age 55 after 10 years of service. The plan invests primarily in a diversified portfolio of managed fixed income and equity funds. Contributions provide not only for benefits attributed to service to date, but also for the benefit expected to be earned in the coming years. The Company's funding policy is to contribute at least the minimum amount necessary to keep the plan fully funded when comparing the fair value of plan assets to the accumulated benefit obligation. The Company, with input from its actuaries, estimates that the 2007 contribution will be approximately \$1.3 million which will maintain the pension plan's fully funded status based on its accumulated benefit obligation.

FASB Statement No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, requires changes to the existing reporting for defined benefit postretirement plans that, among other changes, requires the Company to recognize on its balance sheet the overfunded or underfunded status of the above described defined benefit pension plan measured as the difference between the fair value of plan assets and the projected benefit obligation. Such funding difference was recorded as an adjustment to the beginning balances of retained earnings and/or other comprehensive income. At December 31, 2006 the projected benefit obligation of the plan exceeded the fair value of plan assets by \$1.9 million. This amount may change significantly by December 31, 2007 due to a management decision to change the amount of the 2007 contribution.

Net periodic benefit cost for the three month periods ended March 31 includes the following components:

| (In thousands) | Three Months Ended March 31, | |
|---|---------------------------------|--------|
| | 2007 | 2006 |
| Service cost for benefits earned | \$ 320 | \$ 276 |
| Interest cost on projected benefit obligation | 341 | 308 |
| Expected return on plan assets | (379) | (344) |
| Amortization of prior service cost | (44) | (44) |
| Recognized net actuarial loss | 136 | 111 |
| Net periodic benefit cost | \$ 374 | \$ 307 |

Cash and Deferred Profit Sharing Plan

The Company has a qualified Cash and Deferred Profit Sharing Plan that includes a 401(k) provision with a Company match. The profit sharing component is non-contributory and covers all employees after ninety days of service. The 401(k) plan provision is voluntary and also covers all employees after ninety days of service. Employees contributing under the 401(k) provision receive a matching contribution up to 4% of compensation. The Plan permits employees to purchase shares of Sandy Spring Bancorp common stock with their 401(k) contributions, Company match, and other contributions under the Plan. The Company had expenses related to the qualified Cash and Deferred Profit Sharing Plan of \$0.4 million for both of the three month periods ended March 31, 2007 and 2006, respectively.

The Company also has a performance based compensation benefit which is integrated with the Cash and Deferred Profit Sharing Plan and which provides incentives to employees based on the Company's financial results as measured against key performance indicator goals set by management. The Company had expenses related to the performance based compensation benefit of \$0 and \$0.5 for the three month periods ended March 31, 2007 and 2006, respectively.

Supplemental Executive Retirement Agreements

The Company has Supplemental Executive Retirement Agreements (SERAs) with its executive officers, providing for retirement income benefits as well as pre-retirement death benefits. Retirement benefits payable under SERAs, if any, are integrated with other pension plan and Social Security retirement benefits expected to be received by the executives. The Company is accruing the present value of these benefits over the remaining years to the executives retirement dates. The Company had expenses related to the SERAs of \$0.3 million and \$0.2 million for the three month periods ended March 31, 2007 and 2006, respectively.

Table of Contents**Executive Health Insurance Plan**

The Company has an Executive Health Insurance Plan that provides for payment of defined medical, vision and dental insurance costs and out of pocket expenses for selected executives and their families. Benefits, which are paid during both employment and retirement, are subject to a \$6,500 limitation for each executive per year. The Company had expenses related to the Executive Health Insurance Plan of \$28 thousand and \$21 thousand for the three month periods ended March 31, 2007 and 2006, respectively.

Note 7 Unrealized Losses on Investments

Shown below is information that summarizes the gross unrealized losses and fair value for the Company's available-for-sale and held-to-maturity investment portfolios.

Gross unrealized losses and fair value by length of time that the individual available-for-sale securities have been in a continuous unrealized loss position at March 31, 2007 and 2006 are as follows:

| <i>(In thousands)</i> | Fair Value | Continuous unrealized losses existing for: | | Total Unrealized Losses |
|---|------------|--|---------------------|-------------------------|
| | | Less than 12 months | More than 12 months | |
| Available for sale as of March 31, 2007 | | | | |
| U.S. Agency | \$ 175,997 | \$ 30 | \$ 1,011 | \$ 1,041 |
| U.S. Treasury Notes | 599 | 0 | 1 | 1 |
| Mortgage-backed | 2,190 | 3 | 5 | 8 |
| | \$ 178,786 | \$ 33 | \$ 1,017 | \$ 1,050 |

| <i>(In thousands)</i> | Fair Value | Continuous unrealized losses existing for: | | Total Unrealized Losses |
|---|------------|--|---------------------|-------------------------|
| | | Less than 12 months | More than 12 months | |
| Available for sale as of March 31, 2006 | | | | |
| U.S. Agency | \$ 200,022 | \$ 1,576 | \$ 1,385 | \$ 2,961 |
| U.S. Treasury Notes | 592 | 8 | 0 | 8 |
| Mortgage-backed | 328 | 4 | 3 | 7 |
| | \$ 200,942 | \$ 1,588 | \$ 1,388 | \$ 2,976 |

Approximately 100% of the bonds carried in the available-for-sale investment portfolio experiencing continuous losses as of March 31, 2007 and 2006 are rated AAA. The securities representing the unrealized losses in the available-for-sale portfolio as of March 31, 2007 and 2006 all have minimal duration risk (1.05 years in 2007 and 1.66 years in 2006), low credit risk, and minimal loss (approximately 0.58% in 2007 and 1.46% in 2006) when compared to book value. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. These factors coupled with the fact that the Company has both the intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in fair value substantiates that the unrealized losses in the available-for-sale portfolio are temporary.

Gross unrealized losses and fair value by length of time that the individual held-to-maturity securities have been in a continuous unrealized loss position at March 31, 2007 and 2006 are as follows:

(In thousands)

| | Fair Value | Continuous unrealized losses existing for: | | Total Unrealized Losses |
|---------------------------------------|---------------|--|---------------------------|-------------------------------|
| | | Less than 12 months | More than 12 months | |
| Held to Maturity as of March 31, 2006 | | | | |
| U.S. Agency | \$ 33,853 | \$ 0 | \$ 558 | \$ 558 |
| State and municipal | 13,803 | 7 | 62 | 69 |
| | \$ 47,656 | \$ 7 | \$ 620 | \$ 627 |

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| <i>(In thousands)</i> | Fair Value | Continuous unrealized losses existing for: | | Total Unrealized Losses |
|---------------------------------------|---------------|--|---------------------------|-------------------------------|
| | | Less than 12 months | More than 12 months | |
| Held to Maturity as of March 31, 2006 | | | | |
| U.S. Agency | \$ 33,236 | \$ 1,164 | \$ 0 | \$ 1,164 |
| State and municipal | 38,930 | 86 | 202 | 288 |
| | \$ 72,166 | \$ 1,250 | \$ 202 | \$ 1,452 |

Approximately 84% and 86% of the bonds carried in the held-to-maturity investment portfolio with continuous unrealized losses as of March 31, 2007 and 2006, respectively, are rated AAA and 16% and 14% as of March 31, 2007 and 2006, respectively, are rated AA1. The securities representing the unrealized losses in the held-to-maturity portfolio all have modest duration risk (4.34 years in 2007 and 4.89 years in 2006), low credit risk, and minimal losses (approximately 1.30% in 2007 and 1.97% in 2006) when compared to book value. The unrealized losses that exist are the result of market changes in interest rates since the original purchase. These factors coupled with the Company's intent and ability to hold these investments for a period of time sufficient to allow for any anticipated recovery in fair value substantiates that the unrealized losses in the held-to-maturity portfolio are temporary.

Note 8 Segment Reporting

The Company operates in four operating segments: Community Banking, Insurance, Leasing, and Investment Management. Only Community Banking currently meets the threshold for reportable segment reporting; however, the Company is disclosing separate information for all four operating segments. Each of the operating segments is a strategic business unit that offers different products and services. The Insurance, Leasing, and Investment Management segments are businesses that were acquired in separate transactions where management at the time of acquisition was retained. The accounting policies of the segments are the same as those described in Note 1 to the consolidated financial statements included in the 2006 Annual Report on Form 10-K. However, the segment data reflect intersegment transactions and balances.

The Community Banking segment is conducted through Sandy Spring Bank and involves delivering a broad range of financial products and services, including various loan and deposit products to both individuals and businesses. Parent company income is included in the Community Banking segment, as the majority of parent company activities are related to this segment. Major revenue sources include net interest income, gains on sales of mortgage loans, trust income, fees on sales of investment products and service charges on deposit accounts. Expenses include personnel, occupancy, marketing, equipment and other expenses. Included in Community Banking expenses are noncash charges associated with amortization of intangibles related to acquired entities totaling \$0.5 million and \$0.4 million for the three month periods ended March 31, 2007 and 2006, respectively.

The Insurance segment is conducted through Sandy Spring Insurance Corporation, a subsidiary of the Bank, and offers annuities as an alternative to traditional deposit accounts. In addition, Sandy Spring Insurance Corporation operates the Chesapeake Insurance Group and Wolfe and Reichelt Insurance Agency, general insurance agencies located in Annapolis, Maryland, and Neff & Associates, located in Ocean City, Maryland. Major sources of revenue are insurance commissions from commercial lines and personal lines. Expenses include personnel and support charges. Included in insurance expenses are non-cash charges associated with amortization of intangibles totaling \$0.1 million for both of the three month periods ended March 31, 2007 and 2006.

The Leasing segment is conducted through The Equipment Leasing Company, located in Sparks, Maryland, a subsidiary of the Bank that provides leases for such items as computers, telecommunications systems and equipment, medical equipment and point-of-sale systems for retail businesses. Equipment leasing is conducted through vendors located primarily in states along the east coast from New Jersey to Florida and in Illinois. The typical lease is a small

ticket by industry standards, averaging less than \$30,000, with individual leases generally not exceeding \$500,000. Major revenue sources include interest income. Expenses include personnel and support charges.

The Investment Management segment is conducted through West Financial Services, Inc., a subsidiary of the Bank that was acquired in October 2005. This asset management and financial planning firm, located in McLean, Virginia,

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provides comprehensive financial planning to individuals, families, small businesses and associations including cash flow analysis, investment review, tax planning, retirement planning, insurance analysis and estate planning. West Financial has approximately \$676.0 million in assets under management as of March 31, 2007. Major revenue sources include noninterest income earned on the above services. Expenses include personnel and support charges. Included in investment management expenses are non-cash charges associated with amortization of intangibles totaling \$0.2 million for both of the three month periods ended March 31, 2007 and 2006.

Information about operating segments and reconciliation of such information to the consolidated financial statements follows:

| (In thousands) | Community Banking | Insurance | Leasing | Investment Mgmt. | Inter-Segment Elimination | Total |
|--|----------------------|-----------|-----------|---------------------|------------------------------|--------------|
| Quarter ended March 31, 2007 | | | | | | |
| Interest income | \$ 41,509 | \$ 15 | \$ 644 | \$ 15 | \$ (289) | \$ 41,894 |
| Interest expense | 17,910 | 0 | 258 | 0 | (289) | 17,879 |
| Provision for loan and lease losses | 839 | 0 | 0 | 0 | 0 | 839 |
| Noninterest income | 6,953 | 2,877 | 149 | 1,083 | (156) | 10,906 |
| Noninterest expenses | 21,306 | 1,290 | 270 | 904 | (156) | 23,614 |
| Income before income taxes | 8,407 | 1,602 | 265 | 194 | 0 | 10,468 |
| Income tax expense | 2,108 | 634 | 105 | 76 | 0 | 2,923 |
| Net income | \$ 6,299 | \$ 968 | \$ 160 | \$ 118 | \$ 0 | \$ 7,545 |
| Assets | \$ 2,946,888 | \$ 11,611 | \$ 33,200 | \$ 8,937 | \$ (55,159) | \$ 2,945,477 |
| Quarter ended March 31, 2006 | | | | | | |
| Interest income | \$ 34,826 | \$ 21 | \$ 508 | \$ 3 | \$ (181) | \$ 35,177 |
| Interest expense | 12,023 | 0 | 157 | 1 | (181) | 12,000 |
| Provision for loan and lease losses | 950 | 0 | 0 | 0 | 0 | 950 |
| Noninterest income | 6,485 | 2,294 | 275 | 1,001 | (209) | 9,846 |
| Noninterest expenses | 18,110 | 1,386 | 220 | 849 | (209) | 20,356 |
| Income before income taxes | 10,228 | 929 | 406 | 154 | 0 | 11,717 |
| Income tax expense | 2,778 | 368 | 170 | 61 | 0 | 3,377 |
| Net income | \$ 7,450 | \$ 561 | \$ 236 | \$ 93 | \$ 0 | \$ 8,340 |
| Assets | \$ 2,498,948 | \$ 10,022 | \$ 26,971 | \$ 6,940 | \$ (43,304) | \$ 2,499,577 |

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Note 9 Comprehensive Income

The components of total comprehensive income for the three month periods ended March 31, 2007 and 2006 are as follows:

| <i>(In thousands)</i> | For the three months ended March 31, | | | | | |
|---|--------------------------------------|--------------------------------------|---------------|------------------|--------------------------------------|---------------|
| | Pretax Amount | 2007 Tax Benefit/ (Expense) | Net Amount | Pretax Amount | 2006 Tax Benefit/ (Expense) | Net Amount |
| Net Income | | | \$ 7,545 | | | \$ 8,340 |
| Other comprehensive income: | | | | | | |
| Unrealized holding (losses) gains arising during the period | 733 | (290) | 443 | (650) | 257 | (393) |
| Reclassification adjustment for (gains) losses included in net income | (2) | 1 | (1) | 0 | 0 | 0 |
| Adjustment for pensions (FAS 158) | (643) | 252 | (391) | 0 | 0 | 0 |
| Total change in other comprehensive income | 88 | (37) | 51 | (650) | 257 | (393) |
| Total comprehensive income | | | \$ 7,596 | | | \$ 7,947 |

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

Sandy Spring Bancorp makes forward-looking statements in the Management's Discussion and Analysis of Financial Condition and Results of Operations and other portions of this Form 10-Q that are subject to risks and uncertainties. These forward-looking statements include: statements of goals, intentions, earnings expectations, and other expectations; estimates of risks and of future costs and benefits; assessments of probable loan and lease losses; assessments of market risk; and statements of the ability to achieve financial and other goals. These forward-looking statements are subject to significant uncertainties because they are based upon or are affected by: management's estimates and projections of future interest rates, market behavior, and other economic conditions; future laws and regulations; and a variety of other matters which, by their nature, are subject to significant uncertainties. Because of these uncertainties, the Company's actual future results may differ materially from those indicated. In addition, the Company's past results of operations do not necessarily indicate its future results.

THE COMPANY

The Company is the registered bank holding company for Sandy Spring Bank (the Bank), headquartered in Olney, Maryland. The Bank operates thirty-eight community offices in Anne Arundel, Carroll, Frederick, Howard, Montgomery, and Prince George's Counties in Maryland and Fairfax and Loudoun counties in Virginia, together with an insurance subsidiary, an equipment leasing company and an investment management company in McLean, Virginia.

The Company offers a broad range of financial services to consumers and businesses in this market area. Through March 31, 2007, year-to-date average commercial loans and leases and commercial real estate loans accounted for approximately 53% of the Company's loan and lease portfolio, and year-to-date average consumer and residential real estate loans accounted for approximately 47%. The Company has established a strategy of independence, and intends

to establish or acquire additional offices, banking organizations, and non-banking organizations as appropriate opportunities may arise.

Table of Contents**CRITICAL ACCOUNTING POLICIES**

The Company's financial statements are prepared in accordance with generally accepted accounting principles (GAAP) in the United States of America and follow general practices within the industry in which it operates. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions, and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions, and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions, and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. The estimates used in management's assessment of the adequacy of the allowance for loan and lease losses require that management make assumptions about matters that are uncertain at the time of estimation. Differences in these assumptions and differences between the estimated and actual losses could have a material effect.

Non-GAAP Financial Measure

The Company has for many years used a traditional efficiency ratio that is a non-GAAP financial measure as defined in Securities and Exchange Commission Regulation G and Item 10 of Commission Regulation S-K. This traditional efficiency ratio is used as a measure of operating expense control and efficiency of operations. Management believes that its traditional ratio better focuses attention on the operating performance of the Company over time than does a GAAP-based ratio, and that it is highly useful in comparing period-to-period operating performance of the Company's core business operations. It is used by management as part of its assessment of its performance in managing noninterest expenses. However, this measure is supplemental, and is not a substitute for an analysis of performance based on GAAP measures. The reader is cautioned that the traditional efficiency ratio used by the Company may not be comparable to GAAP or non-GAAP efficiency ratios reported by other financial institutions.

In general, the efficiency ratio is noninterest expenses as a percentage of net interest income plus total noninterest income. This is a GAAP financial measure. Noninterest expenses used in the calculation of the traditional, non-GAAP efficiency ratio exclude intangible asset amortization. Income for the traditional ratio is increased for the favorable effect of tax-exempt income, and excludes securities gains and losses, which can vary widely from period to period without appreciably affecting operating expenses. The traditional measure is different from the GAAP-based efficiency ratio. The GAAP-based measure is calculated using noninterest expense and income amounts as shown on the face of the Consolidated Statements of Income. The traditional and GAAP-based efficiency ratios are presented and reconciled in Table 1.

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Table 1 GAAP based and traditional efficiency ratios

| <i>(Dollars in thousands)</i> | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Noninterest expenses-GAAP based | \$ 23,614 | \$ 20,356 |
| Net interest income plus noninterest income- GAAP based | 34,921 | 33,023 |
| Efficiency ratio-GAAP based | 67.62% | 61.64% |
| Noninterest expenses-GAAP based | \$ 23,614 | \$ 20,356 |
| Less non-GAAP adjustment: Amortization of intangible assets | 802 | 742 |
| Noninterest expenses-traditional ratio | 22,812 | 19,614 |
| Net interest income plus noninterest income- GAAP based | 34,921 | 33,023 |
| Plus non-GAAP adjustment: Tax-equivalency | 1,285 | 1,442 |
| Less non-GAAP adjustments: Securities gains (losses) | 2 | 0 |
| Net interest income plus noninterest Income traditional ratio | 36,204 | 34,465 |
| Efficiency ratio traditional | 63.01% | 56.91% |

A. FINANCIAL CONDITION

The Company's total assets were \$2.9 billion at March 31, 2007, increasing \$335.0 million or 13% during the first three months of 2007. Earning assets increased by 11% or \$274.1 million in the first three months of 2007 to \$2.7 billion at March 31, 2007. These increases were mainly the result of the acquisition of Potomac Bank in February, 2007.

Total loans and leases, excluding loans held for sale, increased 13% or \$230.6 million during the first three months of 2007, to \$2.0 billion. This increase was mainly the result of the acquisition of Potomac Bank. During this period, commercial loans and leases increased by \$211.1 million or 23%, attributable primarily to commercial loans (up 35%) and commercial mortgage loans (up 22%.) Consumer loans increased by \$12.8 million or 4%, primarily due to an increase in home equity loans. Residential real estate loans grew by \$6.7 million or 1% due to an increase in residential mortgage loans. Residential mortgage loans held for sale decreased by \$0.9 million from December 31, 2006, to \$9.7 million at March 31, 2007. Virtually all of the above increases were due to the acquisition of Potomac Bank of Virginia during the first quarter of 2007. Excluding the Potomac acquisition, the loan portfolio increased 1% over December 31, 2006. This was comprised of a 4% increase in commercial loans which was somewhat offset by small declines in consumer and residential real estate loans.

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Table 2 Analysis of Loans and Leases

The following table presents the trends in the composition of the loan and lease portfolio at the dates indicated:

| (In thousands) | March 31, 2007 | % | December 31, 2006 | % |
|-----------------------------------|-------------------|------|-------------------------|------|
| Residential real estate | \$ 548,921 | 27% | \$ 542,251 | 30% |
| Commercial loans and leases | 1,129,654 | 55 | 918,511 | 51 |
| Consumer | 357,607 | 18 | 344,817 | 19 |
| Total Loans and Leases | 2,036,182 | 100% | 1,805,579 | 100% |
| Less: Allowance for credit losses | (22,186) | | (19,492) | |
| Net loans and leases | \$ 2,013,996 | | \$ 1,786,087 | |

Certain loan terms may create concentrations of credit risk and increase the lender's exposure to loss. These include terms that permit the deferral of principal payments or payments that are smaller than normal interest accruals (negative amortization); loans with high loan-to-value ratios (LTV); loans, such as option adjustable-rate mortgages, that may expose the borrower to future increases in repayments that are in excess of increases that would result solely from increases in market interest rates; and interest-only loans. The Company does not make loans that provide for negative amortization. The Company originates option adjustable-rate mortgages infrequently and sells all of them in the secondary market. At March 31, 2007, the Company had a total of \$42.8 million in residential real estate loans and \$1.8 million in consumer loans with a LTV greater than 90%. Commercial loans, with a LTV greater than 75% to 85% depending on the type of loan, totaled \$33.8 million at March 31, 2007. Interest only loans at March 31, 2007 include almost all of the \$200.9 million outstanding under the Company's equity lines of credit, (included in the consumer loan portfolio) and \$72.2 million in other loans. The aggregate of these loan concentrations was \$351.5 million at March 31, 2007, which represented 17% of total loans and leases outstanding at that date. The Company is of the opinion that its loan underwriting procedures are structured to adequately assess any additional risk that the above types of loans might present.

The total investment portfolio increased by 4% or \$20.0 million from December 31, 2006, to \$560.9 million at March 31, 2007. The increase was driven by an increase of \$25.2 million or 10% in available-for-sale securities and \$1.0 million or 6% in other equity securities, offset by a decline of \$6.1 million or 2% in held-to-maturity securities. The aggregate of federal funds sold and interest-bearing deposits with banks increased by \$24.4 million during the first three months of 2007, reaching \$76.3 million at March 31, 2007.

Table 3 Analysis of Deposits

The following table presents the trends in the composition of deposits at the dates indicated:

| (In thousands) | March 31, 2007 | % | December 31, 2006 | % |
|-----------------------------------|----------------|-----|----------------------|-----|
| Noninterest-bearing deposits | \$ 449,604 | 20% | \$ 394,662 | 20% |
| Interest-bearing deposits: | | | | |
| Demand | 241,148 | 11 | 233,841 | 12 |
| Money market savings | 588,704 | 26 | 518,146 | 26 |
| Regular savings | 164,293 | 7 | 160,035 | 8 |
| Time deposits less than \$100,000 | 472,799 | 21 | 406,910 | 20 |
| Time deposits \$100,000 or more | 357,774 | 15 | 280,629 | 14 |

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| | | | | |
|------------------------|-------------|------|-------------|------|
| Total interest-bearing | 1,824,718 | 80 | 1,599,561 | 80 |
| Total deposits | \$2,274,322 | 100% | \$1,994,223 | 100% |

Total deposits were \$2.3 billion at March 31, 2007, increasing \$280.1 million or 14% from December 31, 2006. During the first three months of 2007, growth rates of 16% were achieved for time deposits of less than \$100,000 (up \$65.9 million), 27% for time deposits of \$100,000 or more (up \$77.1 million), 14% for money market deposits (up \$70.6 million.), 14% for non-interest bearing demand deposits (up \$54.9 million), 3% for interest-bearing demand deposits (up \$7.3 million) and 3% for interest-bearing regular savings (up \$4.3 million). These increases were mainly the result of the Potomac Bank acquisition. Excluding the Potomac acquisition, deposits increased 4% compared to December 31, 2006, due primarily to increases in time and money market deposits.

Total borrowings were \$368.9 million at March 31, 2007, which represented an increase of \$17.4 million or 5% from December 31, 2006. This increase was mainly due to an increase of \$15.3 million, or 15%, in customer repurchase agreements resulting from the acquisition of Potomac during the first quarter of 2007.

Table of Contents**Market Risk and Interest Rate Sensitivity****Overview**

The Company's net income is largely dependent on its net interest income. Net interest income is susceptible to interest rate risk to the degree that interest-bearing liabilities mature or reprice on a different basis than interest-earning assets. When interest-bearing liabilities mature or reprice more quickly than interest-earning assets in a given period, a significant increase in market rates of interest could adversely affect net interest income. Similarly, when interest-earning assets mature or reprice more quickly than interest-bearing liabilities, falling interest rates could result in a decrease in net interest income. Net interest income is also affected by changes in the portion of interest-earning assets that are funded by interest-bearing liabilities rather than by other sources of funds, such as noninterest-bearing deposits and stockholders' equity.

The Company's Board of Directors has established a comprehensive interest rate risk management policy, which is administered by Management's Asset Liability Management Committee (ALCO). The policy establishes limits of risk, which are quantitative measures of the percentage change in net interest income (a measure of net interest income at risk) and the fair value of equity capital (a measure of economic value of equity (EVE) at risk) resulting from a hypothetical change in U.S. Treasury interest rates for maturities from one day to thirty years. The Company measures the potential adverse impacts that changing interest rates may have on its short-term earnings, long-term value, and liquidity by employing simulation analysis through the use of computer modeling. The simulation model captures optionality factors such as call features and interest rate caps and floors imbedded in investment and loan portfolio contracts. As with any method of gauging interest rate risk, there are certain shortcomings inherent in the interest rate modeling methodology used by the Company. When interest rates change, actual movements in different categories of interest-earning assets and interest-bearing liabilities, loan prepayments, and withdrawals of time and other deposits, may deviate significantly from assumptions used in the model. Finally, the methodology does not measure or reflect the impact that higher rates may have on adjustable-rate loan customers' ability to service their debts, or the impact of rate changes on demand for loan, lease, and deposit products.

The Company prepares a current base case and eight alternative simulations, at least once a quarter, and reports the analysis to the Board of Directors. In addition, more frequent forecasts are produced when interest rates are particularly uncertain or when other business conditions so dictate.

If a measure of risk produced by the alternative simulations of the entire balance sheet violates policy guidelines, ALCO is required to develop a plan to restore the measure of risk to a level that complies with policy limits within two quarters.

The Company's interest rate risk management goals are (1) to increase net interest income at a growth rate consistent with the growth rate of total assets and, (2) to minimize fluctuations in net interest margin as a percentage of earning assets. Management attempts to achieve these goals by balancing, within policy limits, the volume of floating-rate liabilities with a similar volume of floating-rate assets; by keeping the average maturity of fixed-rate asset and liability contracts reasonably matched; by maintaining a pool of administered core deposits; and by adjusting pricing rates to market conditions on a continuing basis.

The balance sheet is subject to quarterly testing for eight alternative interest rate shock possibilities to indicate the inherent interest rate risk. Average interest rates are shocked by +/- 100, 200, 300, and 400 basis points (bp), although the Company may elect not to use particular scenarios that it determines are impractical in a current rate environment. It is management's goal to structure the balance sheet so that net interest earnings at risk over a twelve-month period and the economic value of equity at risk do not exceed policy guidelines at the various interest rate shock levels.

The Company augments its quarterly interest rate shock analysis with alternative external interest rate scenarios on a monthly basis. These alternative interest rate scenarios may include non-parallel rate ramps and non-parallel yield curve twists.

Analysis

Measures of net interest income at risk produced by simulation analysis are indicators of an institution's short-term performance in alternative rate environments. These measures are typically based upon a relatively brief period, usually one year. They do not necessarily indicate the long-term prospects or economic value of the institution.

Table of Contents**ESTIMATED CHANGES IN NET INTEREST INCOME****CHANGE IN**

| INTEREST RATES: | + 400 bp | + 300 bp | + 200 bp | + 100 bp | - 100 bp | - 200 bp | -300 bp | -400 bp |
|------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|----------------|----------------|
| POLICY LIMIT | -25% | -20% | -17.5% | -12.5% | -12.5% | -17.5% | -20% | -25% |
| March 2007 | -8.59 | -6.31 | -4.12 | -1.27 | 0.71 | -0.67 | -2.89 | -5.82 |
| December 2006 | -13.67 | -10.94 | -7.68 | -3.12 | 0.37 | -2.27 | -5.37 | -9.87 |

The Net Interest Income at Risk position decreased since the 4th quarter of 2006 in all rate scenarios. All of the above measures of net interest income at risk remained well within prescribed policy limits. Although assumed to be unlikely, our largest exposure is at the +400bp level, with a measure of -8.59%. This is also well within our prescribed policy limit of 25%.

The measures of equity value at risk indicate the ongoing economic value of the Company by considering the effects of changes in interest rates on all of the Company's cash flows, and discounting the cash flows to estimate the present value of assets and liabilities. The difference between these discounted values of the assets and liabilities is the economic value of equity, which, in theory, approximates the fair value of the Company's net assets.

ESTIMATED CHANGES IN ECONOMIC VALUE OF EQUITY (EVE)**CHANGE IN**

| INTEREST RATES: | + 400 bp | + 300 bp | + 200 bp | + 100 bp | - 100 bp | -200 bp | -300 bp | -400 bp |
|------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|----------------|----------------|----------------|
| POLICY LIMIT | -40% | -30% | -22.5% | -10.0% | -12.5% | -22.5% | -30% | -40% |
| March 2007 | -14.05 | -9.66 | -4.49 | -0.24 | -2.46 | -8.23 | -15.31 | -22.57 |
| December 2006 | -17.78 | -13.07 | -7.18 | -1.67 | -6.09 | -14.95 | -24.51 | -35.53 |

Measures of the economic value of equity (EVE) at risk position decreased over year-end 2006 in all rising rate shock bands as well as all falling rate bands. The risk position improved substantially due to additional core deposits from the PBOV acquisition in February. Although assumed to be unlikely, our largest exposure is at the -400bp level, with a measure of -22.57%. This is also well within our prescribed policy limit of 40%.

Liquidity

Liquidity is measured using an approach designed to take into account loan and lease payments, maturities, calls and pay-downs of securities, earnings, balance sheet growth, mortgage banking activities, investment portfolio liquidity, and other factors. Through this approach, implemented by the funds management subcommittee of ALCO under formal policy guidelines, the Company's liquidity position is measured weekly, looking forward at thirty-day intervals out to 180 days. The measurement is based upon the asset-liability management model's projection of a funds sold or purchased position, along with ratios and trends developed to measure dependence on purchased funds and core growth. Resulting projections as of March 31, 2007 showed short-term investments exceeding short-term borrowings over the subsequent 180 days by \$93.1 million, which increased from an excess of \$72.5 million at December 31, 2006. This excess of liquidity over projected requirements for funds indicates that the Company can increase its loans and other earning assets without incurring additional borrowing.

The Company also has external sources of funds, which can be drawn upon when required. The main source of external liquidity is a line of credit for \$782.7 million from the Federal Home Loan Bank of Atlanta, of which \$585.1 million was available based on pledged collateral with \$219.2 million outstanding at March 31, 2007. Other external sources of liquidity available to the Company in the form of lines of credit granted by the Federal Reserve, correspondent banks and other institutions totaled \$153.1 million at March 31, 2007, against which there were no outstanding. Based upon its liquidity analysis, including external sources of liquidity available, management believes the liquidity position is appropriate at March 31, 2007.

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The following is a schedule of significant commitments at March 31, 2007:

| | (In thousands) |
|---|-------------------|
| Commitments to extend credit: | |
| Unused lines of credit (home equity and business) | \$ 423,797 |
| Other commitments to extend credit | 170,114 |
| Standby letters of credit | 44,853 |
| | \$ 638,764 |

Capital Management

The Company recorded a total risk-based capital ratio of 11.50% at March 31, 2007, compared to 13.62% at December 31, 2006; a tier 1 risk-based capital ratio of 10.54%, compared to 12.64%; and a capital leverage ratio of 9.16%, compared to 9.81%. Capital adequacy, as measured by these ratios, was well above regulatory requirements. Management believes the level of capital at March 31, 2006, is appropriate.

Stockholders' equity for March 31, 2007, totaled \$275.3 million, representing an increase of \$37.5 million or 16% from \$237.8 million at December 31, 2006.

Internal capital generation (net income less dividends) added \$3.9 million to total stockholders' equity during the first three months of 2007. When internally formed capital is annualized and expressed as a percentage of average total stockholders' equity, the resulting rate was 6% compared to 9% reported for the full-year 2006.

External capital formation (equity created through the issuance of stock under the employee stock purchase plan, stock option plan and for the acquisition of Potomac Bank) totaled \$33.3 million during the three month period ended March 31, 2007.

Dividends for the first three months of the year were \$0.23 per share in 2007, compared to \$0.22 per share in 2006, for respective dividend payout ratios (dividends declared per share to diluted net income per share) of 47% versus 39% for the first three months of 2006.

B. RESULTS OF OPERATIONS — THREE MONTHS ENDED MARCH 31, 2007 AND MARCH 31, 2006

Net income for the first three months of the year decreased \$0.8 million or 10% to \$7.5 million in 2007 from \$8.3 million in 2006, representing annualized returns on average equity of 11.96% in 2007 and 15.26% in 2006, respectively. Diluted earnings per share (EPS) for the first three months of the year were \$0.49 in 2007, compared to \$0.56 in 2006.

Net interest income grew by \$0.8 million, or 4%, to \$24.0 million for the first three months of 2007, while total noninterest income grew by \$1.1 million, or 11% for the period. However, this growth was more than offset by a \$3.3 million, or 16%, increase in noninterest expenses.

The increase in net interest income was the result of continued growth in the loan portfolio and higher loan yields which were largely offset by increased rates on interest-bearing deposits and an increased use of time deposits, as noninterest bearing deposits continued to decrease. These factors produced a net interest margin decrease of 28 basis points to 4.07% for the three months ended March 31, 2007, from 4.35% for the same period of 2006, and the net interest spread decreasing by 39 basis points.

Table of ContentsTable 4 - Consolidated Average Balances, Yields and Rates
(Dollars in thousands and tax equivalent)

| | For the three months ended March 31, | | | | | |
|--|--------------------------------------|-----------------|-------------------------------------|--------------------|-----------------|-------------------------------------|
| | 2007 | | | 2006 | | |
| | Average Balance | Interest (1) | Annualized Average Yield/Rate | Average Balance | Interest (1) | Annualized Average Yield/Rate |
| Assets | | | | | | |
| Total loans and leases (2) | \$ 1,926,614 | \$ 34,769 | 7.30% | \$ 1,728,377 | \$ 29,008 | 6.79% |
| Total securities | 551,566 | 7,883 | 5.86 | 555,061 | 7,489 | 5.51 |
| Other earning assets | 40,617 | 527 | 5.26 | 11,227 | 122 | 4.41 |
| TOTAL EARNING ASSETS | | | | | | |
| | 2,518,797 | 43,179 | 6.95% | 2,294,665 | 36,619 | 6.46% |
| Nonearning assets | 226,416 | | | 190,022 | | |
| Total assets | \$ 2,745,213 | | | \$ 2,484,687 | | |
| Liabilities and Stockholders Equity | | | | | | |
| Interest-bearing demand deposits | \$ 231,152 | 189 | 0.33% | \$ 236,570 | 165 | 0.28% |
| Money market savings deposits | 547,135 | 4,974 | 3.69 | 371,686 | 2,349 | 2.56 |
| Regular savings deposits | 163,037 | 156 | 0.39 | 199,281 | 215 | 0.44 |
| Time deposits | 749,131 | 8,469 | 4.58 | 573,462 | 4,945 | 3.50 |
| Total interest-bearing deposits | 1,690,455 | 13,788 | 3.31 | 1,380,999 | 7,674 | 2.25 |
| Short-term borrowings | 316,929 | 3,481 | 4.45 | 403,422 | 3,749 | 3.74 |
| Long-term borrowings | 40,939 | 610 | 5.97 | 37,109 | 577 | 6.22 |
| Total interest-bearing liabilities | 2,048,323 | 17,879 | 3.54 | 1,821,530 | 12,000 | 2.66 |
| Noninterest-bearing demand deposits | 408,954 | | | 418,214 | | |
| Other noninterest-bearing liabilities | 32,155 | | | 23,344 | | |
| Stockholders equity | 255,781 | | | 221,599 | | |
| Total liabilities and stockholders equity | \$ 2,745,213 | | | \$ 2,484,687 | | |
| Net interest income and spread | | \$ 25,300 | 3.41% | | \$ 24,619 | 3.80% |

| | | | |
|---|---------|-------|---------|
| Less: tax equivalent adjustment | 1,285 | | 1,442 |
| Net interest income | 24,015 | | 23,177 |
| Net interest margin (3) | | 4.07% | 4.35% |
| Ratio of average earning assets to Average interest-bearing liabilities | 122.97% | | 125.97% |

(1) Interest income includes the effects of taxable-equivalent adjustments (reduced by the nondeductible portion of interest expense) using the appropriate federal income tax rate of 35.00% and, where applicable, the marginal state income tax rate of 7.00% (or a combined marginal federal and state rate of 39.55%), to increase tax-exempt interest income to a taxable-equivalent basis. The net taxable-equivalent adjustment amounts utilized in the above table to compute yields were \$1.3 million and \$1.4 million for the three months ended March 31, 2007 and 2006, respectively.

- (2) Non-accrual loans are included in the average balances.
- (3) Net interest margin = annualized net interest income on a tax-equivalent basis divided by total interest-earning assets.

Net Interest Income

Net interest income for the first three months of the year was \$24.0 million in 2007, an increase of 4% from \$23.2 million in 2006, due primarily to an 11% increase in average loans and leases and a 51 basis point increase in tax-equivalent yield on loans when compared to the first three months of 2006. Non-GAAP tax-equivalent net interest income, which takes into account the benefit of tax advantaged investment securities, increased by 3%, to \$25.3 million in 2007 from \$24.6 million in 2006. The effects of changes in average balances, yields and rates are presented in Table 5.

For the first three months, total interest income increased by \$6.7 million or 19% in 2007, compared to 2006. On a non-GAAP tax-equivalent basis, interest income increased by 18%. Average earning assets increased by 10% versus the prior period to \$2.5 billion from \$2.3 billion; while the average yield earned on those assets increased by 49 basis points to 6.95%. Comparing the first three months of 2007 versus the same period in 2006, average total loans and leases grew by 11% to \$1.9 billion (76% of average earning assets, versus 75% a year ago), while recording a 51 basis point increase in average yield to 7.30%. Average commercial loans and leases increased by 27% (due to increases in all categories of commercial loans and leases); average consumer loans increased by 4% (attributable primarily to home equity loan growth); and residential real estate loans decreased by 5% (reflecting decreases in both mortgage and construction lending).

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Over the same period, average total securities decreased by 1% to \$551.6 million (22% of average earning assets, versus 24% a year ago), while the average yield earned on those assets increased by 35 basis points to 5.86%.

Interest expense for the first three months of the year increased by \$5.9 million or 49% in 2007 compared to 2006. Average total interest-bearing liabilities increased by 12% over the prior year period, while the average rate paid on these funds increased by 88 basis points to 3.54%. As shown in Table 4, all categories of interest-bearing liabilities, except regular savings deposits, showed increases in the average rate as market interest rates continued to rise.

Table 5 Effect of Volume and Rate Changes on Net Interest Income

| <i>(In thousands and tax equivalent)</i> | Increase Or (Decrease) | 2007 vs. 2006 Due to Change In Average:* | | Increase Or (Decrease) | 2006 vs. 2005 Due to Change In Average:* | |
|--|------------------------------|--|----------|------------------------------|--|----------|
| | | Volume | Rate | | Volume | Rate |
| Interest income from earning assets: | | | | | | |
| Loans and leases | \$ 5,761 | \$ 3,481 | \$ 2,280 | \$ 7,800 | \$ 4,161 | \$ 3,639 |
| Securities | 394 | (51) | 445 | (1,142) | (1,173) | 31 |
| Other earning assets | 405 | 377 | 28 | 65 | 9 | 56 |
| Total interest income | 6,560 | 3,807 | 2,753 | 6,723 | 2,997 | 3,726 |
| Interest expense on funding of earning assets: | | | | | | |
| Interest-bearing demand deposits | 24 | (4) | 28 | 18 | (1) | 19 |
| Regular savings deposits | (59) | (36) | (23) | 35 | (18) | 53 |
| Money market savings deposits | 2,625 | 1,357 | 1,268 | 1,267 | (11) | 1,278 |
| Time deposits | 3,524 | 1,755 | 1,769 | 2,166 | 725 | 1,441 |
| Total borrowings | (235) | (893) | 658 | 1,527 | 778 | 749 |
| Total interest expense | 5,879 | 2,179 | 3,700 | 5,013 | 1,473 | 3,540 |
| Net interest income | \$ 681 | \$ 1,628 | \$ (947) | \$ 1,710 | \$ 1,524 | \$ 186 |

* Where volume and rate have a combined effect that cannot be separately identified with either, the variance is allocated to volume and rate based on the relative size of the variance that can be separately identified with each.

Credit Risk Management

The Company's loan and lease portfolio (the credit portfolio) is subject to varying degrees of credit risk. Credit risk is mitigated through portfolio diversification, limiting exposure to any single customer, industry or collateral type. The Company maintains an allowance for loan and lease losses (the allowance) to absorb possible losses in the loan and lease portfolio. The allowance is based on careful, continuous review and evaluation of the loan and lease portfolio, along with ongoing, quarterly assessments of the probable losses inherent in that portfolio. The allowance represents an estimation made pursuant to Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, or SFAS No. 114, Accounting by Creditors for Impairment of a Loan. The adequacy of the allowance is determined through careful and continuous evaluation of the credit portfolio, and involves consideration of a number of factors, as outlined below, to establish a prudent level. Determination of the allowance is inherently subjective and requires significant estimates, including estimated losses on pools of homogeneous loans and leases based on historical loss experience and consideration of current economic trends, which may be susceptible to significant change. Loans and leases deemed uncollectible are charged against the allowance, while recoveries are credited to the allowance. Management adjusts the level of the allowance through the provision for loan and lease losses, which is recorded as a current period operating expense. The Company's systematic methodology for assessing the appropriateness of the allowance includes: (1) the formula allowance reflecting historical losses, as adjusted, by credit category, and (2) the specific allowance for risk-rated credits on an individual or portfolio basis.

The formula allowance, which is based upon historical loss factors, as adjusted, establishes allowances for the major loan and lease categories based upon adjusted historical loss experience over the prior eight quarters, weighted so that losses in the most recent quarters have the greatest effect. The factors used to adjust the historical loss experience address various risk characteristics of the Company's loan and lease portfolio including: (1) trends in delinquencies and other non-performing loans, (2) changes in the risk profile related to large loans in the portfolio, (3) changes in the

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categories of loans comprising the loan portfolio, (4) concentrations of loans to specific industry segments, (5) changes in economic conditions on both a local and national level, (6) changes in the Company's credit administration and loan and lease portfolio management processes, and (7) quality of the Company's credit risk identification processes.

The specific allowance is used to allocate an allowance for internally risk rated commercial loans where significant conditions or circumstances indicate that a loss may be imminent. Analysis resulting in specific allowances, including those on loans identified for evaluation of impairment, includes consideration of the borrower's overall financial condition, resources and payment record, support available from financial guarantors and the sufficiency of collateral. These factors are combined to estimate the probability and severity of inherent losses. Then a specific allowance is established based on the Company's calculation of the potential loss imbedded in the individual loan. Allowances are also established by application of credit risk factors to other internally risk rated loans, individual consumer and residential loans and commercial leases having reached nonaccrual or 90-day past due status. Each risk rating category is assigned a credit risk factor based on management's estimate of the associated risk, complexity, and size of the individual loans within the category. Additional allowances may also be established in special circumstances involving a particular group of credits or portfolio within a risk category when management becomes aware that losses incurred may exceed those determined by application of the risk factor alone.

The amount of the allowance is reviewed monthly by the Senior Loan Committee, and reviewed and approved quarterly by the Board of Directors.

The provision for loan and lease losses totaled \$.8 million for the first three months of 2007 compared to \$1.0 million in the same period of 2006. The Company experienced net recoveries during the first three months of 2007 of \$3 thousand compared to net charge-offs of \$189 thousand for the first three months of 2006.

Management believes that the allowance is adequate. However, its determination requires significant judgment, and estimates of probable losses inherent in the credit portfolio can vary significantly from the amounts actually observed. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the credits comprising the portfolio and changes in the financial condition of borrowers, such as may result from changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, and independent consultants engaged by Sandy Spring Bank, periodically review the credit portfolio and the allowance. Such review may result in additional provisions based on these third-party judgments of information available at the time of each examination. During the first three months of 2007, there were no changes in estimation methods or assumptions that affected the allowance methodology. The allowance for loan and lease losses was 1.09% of total loans and leases at March 31, 2007 and 1.08% at December 31, 2006. The allowance increased during the first three months of 2007 by \$2.7 million, to \$22.2 million at March 31, 2007, from \$19.5 million at December 31, 2006. The increase in the allowance during the first three months of 2007 was due to the increased provision for loan and lease losses mentioned above which was due primarily to growth in the size of the loan portfolio and the addition of a \$1.9 million allowance associated with the acquisition of Potomac Bank.

Nonperforming loans and leases increased by \$3.4 million to \$7.1 million at March 31, 2007 from \$3.7 million at December 31, 2006, while nonperforming assets increased by \$3.2 million for the same period to \$7.1 million at March 31, 2007. Expressed as a percentage of total assets, nonperforming assets increased to 0.24% at March 31, 2007 from 0.15% at December 31, 2006. The allowance for loan and lease losses represented 314% of nonperforming loans and leases at March 31, 2007, compared to coverage of 498% at December 31, 2006. The increase in loans and leases 90 days past due was mainly the result of two loans in the amount of \$2.7 million. Both these loans have more than adequate collateral. No losses are expected in either of these two loans. Significant variation in this coverage ratio may occur from period to period because the amount of nonperforming loans and leases depends largely on the condition of a small number of individual credits and borrowers relative to the total loan and lease portfolio. Other real estate owned was \$0 at March 31, 2007 and \$0.2 million at December 31, 2006. The balance of impaired loans and leases was \$1.4 million at March 31, 2007, with specific reserves against those loans of \$332,000, compared to \$0.3 million at December 31, 2006, with specific reserves of \$118,000.

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Table 6 Analysis of Credit Risk

(Dollars in thousands)

Activity in the allowance for credit losses is shown below:

| | Three Months Ended March 31, 2007 | Twelve Months Ended December 31, 2006 |
|---|---|--|
| Balance, January 1 | \$ 19,492 | \$ 16,886 |
| Allowance acquired from acquisition | 1,858 | 0 |
| Provision for loan and lease losses | 839 | 2,795 |
| Loan charge-offs: | | |
| Residential real estate | 0 | 0 |
| Commercial loans and leases | (11) | (230) |
| Consumer | (15) | (85) |
| Total charge-offs | (26) | (315) |
| Loan recoveries: | | |
| Residential real estate | 0 | 0 |
| Commercial loans and leases | 3 | 89 |
| Consumer | 20 | 37 |
| Total recoveries | 23 | 126 |
| Net recoveries (charge-offs) | (3) | (189) |
| Balance, period end | \$ 22,186 | \$ 19,492 |
| Net recoveries (charge-offs) to average loans and leases (annual basis) | 0.00% | 0.01% |
| Allowance to total loans and leases | 1.09% | 1.08% |

The following table presents nonperforming assets at the dates indicated:

| | March 31, 2007 | December 31, 2006 |
|---------------------------------------|-------------------|----------------------|
| Non-accrual loans and leases | \$ 1,982 | \$ 1,910 |
| Loans and leases 90 days past due | 5,084 | 1,823 |
| Total nonperforming loans and leases* | 7,066 | 3,733 |
| Other real estate owned, net | 0 | 182 |
| Total nonperforming assets | \$ 7,066 | \$ 3,915 |
| Nonperforming assets to total assets | 0.24% | 0.15% |

* Those performing credits considered

potential problem credits (which the Company classifies as substandard), as defined and identified by management, amounted to approximately \$7.8 million at March 31, 2007, compared to \$10.1 million at December 31, 2006. These are credits where known information about the borrowers possible credit problems causes management to have doubts as to their ability to comply with the present repayment terms. This could result in their reclassification as nonperforming credits in the future, but most are well collateralized and are not believed to present significant risk of loss. Loans classified for regulatory purposes not included in either non-performing

or potential problem loans consist only of other loans especially mentioned and do not, in management's opinion, represent or result from trends or uncertainties reasonably expected to materially impact future operating results, liquidity or capital resources, or represent material credits where known information about the borrowers possible credit problems causes management to have doubts as to the borrowers ability to comply with the loan repayment terms.

Noninterest Income and Expenses

Total noninterest income was \$10.9 million for the three month period ended March 31, 2007, an 11% or \$1.0 million increase from the same period of 2006. The increase in noninterest income for the first three months of 2007 was due primarily to an increase of \$0.6 million or 28% in insurance agency commissions as the result of the acquisition of Neff & Associates in January, 2006 and higher premiums from existing commercial property and casualty lines and service charges on deposit accounts increased \$0.5 million or 25%. In addition, fees on sales of investment products increased

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\$0.1 million or 11% due to increased sales volumes and trust and investment management fees increased \$0.2 million or 8% due mainly to growth in assets under management. Gains on sales of mortgage loans decreased \$0.1 million or 18% due to market conditions and other income decreased \$0.3 million or 23%.

Total noninterest expenses were \$23.6 million for the three month period ended March 31, 2007, a 16% or \$3.3 million increase from the same period in 2006. The Company incurs additional costs in order to enter new markets, provide new services, and support the growth of the Company. Management controls its operating expenses, however, with the goal of maximizing profitability over time. Salaries and employee benefits increased \$1.0 million or 8% during the first three months of 2007 due in part to the acquisition of Potomac Bank in February 2007, as well as growth in the number of full-time equivalent employees. Marketing expenses increased by \$0.2 million or 55% as part of the Company's plan to increase brand recognition and to grow market share, while outside data services grew by \$0.1 million or 19%. Occupancy and equipment expenses increased \$0.3 million or 14% due to growth in the branch network and the acquisition of Potomac Bank. Average full-time equivalent employees increased to 681 during the first three months of 2007, from 624 during the like period in 2006, a 9% increase. The ratio of net income per average full-time-equivalent employee after completion of the first three months of the year was \$11,000 in 2007 and \$13,000 in 2006. Other noninterest expenses increased \$1.3 million or 51% primarily due to \$.6 million in merger costs incurred due to the acquisition of Potomac Bank during the first quarter of 2007.

Income Taxes

The effective tax rate decreased to 27.9% for the three month period ended March 31, 2007, from 28.8% for the prior year period. This decrease was primarily due to the acquisition in February 2007 of Potomac Bank which is not subject to state income taxes.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

See Financial Condition Market Risk and Interest Rate Sensitivity in Management's Discussion and Analysis of Financial Condition and Results of Operations, above, which is incorporated herein by reference. Management has determined that no additional disclosures are necessary to assess changes in information about market risk that have occurred since December 31, 2006.

Item 4. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated as of the last day of the period covered by this report, the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rule 13a-15 under the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. There were no significant changes in the Company's internal controls over financial reporting (as defined in Rule 13a-15 under the Securities Act of 1934) during the quarter ended March 31, 2007, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION**Item 1A. RISK FACTORS**

There have been no material changes in the risk factors as disclosed in the 2006 Annual Report on Form 10-K.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

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The following table provides information on the Company's purchases of its common stock during the three months ended March 31, 2007.

Issuer Purchases of Equity Securities (1)

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number that May Yet Be Purchased Under the Plans or Programs (2)(3) |
|---------------|---|---|--|--|
| January 2007 | 0 | NA | 0 | 661,634 |
| February 2007 | 0 | NA | 0 | 661,634 |
| March 2007 | 0 | NA | 0 | 661,634 |

(1) Includes purchases of the Company's stock made by or on behalf of the Company or any affiliated purchasers of the Company as defined in Securities and Exchange Commission Rule 10b-18.

(2) On March 28, 2007, the Company's board of directors approved a continuation of the stock repurchase program that permits the repurchase of up to 5%, or approximately 786,000 shares,

of its
outstanding
common stock.
The current
program
continued a
similar plan that
expired on
March 31, 2007.
Repurchases
under the
program may be
made on the
open market and
in privately
negotiated
transactions
from time to
time until
March 31, 2009,
or earlier
termination of
the program by
the Board. The
repurchases are
made in
connection with
shares expected
to be issued
under the
Company's
various benefit
plans, as well as
for other
corporate
purposes. At
March 31, 2007,
a total of
661,634 shares
remained under
the plan.

- (3) Indicates the
number of
shares
remaining under
the plan at the
end of the
indicated
month.

Item 6. EXHIBITS

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Exhibit 31(a) and (b)
Exhibit 32 (a) and (b)

Rule 13a-14(a) / 15d-14(a) Certifications
18 U.S.C. Section 1350 Certifications
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SIGNATURES

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

SANDY SPRING BANCORP, INC.
(Registrant)

By: /S/ HUNTER R. HOLLAR

Hunter R. Hollar
President and Chief Executive Officer

Date: May 7, 2007

By: /S/ PHILIP J. MANTUA

Philip J. Mantua
Executive Vice President and Chief Financial
Officer

Date: May 7, 2007