TREATY OAK BANCORP INC
Form 10QSB
August 13, 2007

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, DC 20549**

# FORM 10-QSB

| | |
|---|---|
| **x** | **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 OF THE SECURITIES EXCHANGE ACT OF 1934** |

**For the quarterly period ended June 30, 2007**

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

**Commission File Number: 333-112325**

# Treaty Oak Bancorp, Inc.

(Exact name of registrant as specified in its charter)

**Texas**
(State or other jurisdiction of
corporation or organization)

**20-0413144**
(I.R.S. Employer Identification Number)

**101 Westlake Drive, Austin, Texas**
(Address of Principal Executive Offices)

**78746**
(Zip Code)

**(512) 617-3600**
(Registrant s telephone number, including area code)

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

**Yes x** **No o**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

**Yes o** **No x**

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the close of business on August 9, 2007.

| | |
|---|---|
| $0.01 Par Value Common Stock | 2,902,393 shares |

Transitional Small Business Disclosure Format (Check one): **Yes o** **No x**

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**QUARTERLY REPORT ON FORM 10-QSB**

**FOR THE PERIOD ENDED JUNE 30, 2007**

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This Form 10-QSB contains forward-looking statements consisting of estimates with respect to the financial condition, results of operations, and other business of Treaty Oak Bancorp, Inc., that are subject to various factors which could cause actual results to differ materially from those estimates. Factors that could influence the estimates include changes in the national, regional, and local market conditions, legislative and regulatory conditions, and an adverse interest rate environment.

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**Treaty Oak Bancorp, Inc.**

**Consolidated Balance Sheets (unaudited)**

**June 30, 2007 and September 30, 2006**

**(Dollars In Thousands, Except Par Value and Share Amounts)**

| | **June 30, 2007** | **September 30, 2006(1)** |
|---|---|---|
| ASSETS | | |
| Cash and cash items | $ 332 | $ 267 |
| Due from banks | 2,962 | 2,312 |
| Federal funds sold | 21,443 | 23,775 |
| Total cash and cash equivalents | 24,737 | 26,354 |
| | | |
| Securities available for sale | 11 | 16 |
| Securities held to maturity, fair value of $1,450 and $2,001, respectively | 1,451 | 2,006 |
| Investment in Federal Home Loan Bank stock, at cost | 224 | 224 |
| Investment in Independent Banker s Financial Corporation stock, at cost | 102 | 102 |
| Loans, net | 78,001 | 59,620 |
| Premises and equipment, net | 5,627 | 5,593 |
| Note receivable from affiliate | | 2,821 |
| Accrued interest receivable | 529 | 484 |
| Due from affiliates | | 192 |
| Goodwill and other intangibles, net | 1,199 | 1,205 |
| Other assets | 1,297 | 474 |
| Total assets | $ 113,178 | $ 99,091 |
| | | |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| | | |
| Deposits: | | |
| Noninterest-bearing demand | $ 27,134 | $ 28,091 |
| NOW, money market and savings | 35,893 | 32,401 |
| Time deposits | 31,765 | 20,526 |
| Total deposits | 94,792 | 81,018 |
| | | |
| Accounts payable and accrued expenses | 342 | 352 |
| Accrued interest payable | 284 | 160 |
| Property mortgage | 2,619 | 2,667 |
| Notes payable | | 2,483 |
| Minority interest - PGI Equity Partners, LP | | 1,106 |
| Other liabilities | 23 | 33 |
| Total liabilities | 98,060 | 87,819 |
| | | |
| Shareholders equity: | | |
| Preferred stock, $0.01 par value; 1,000,000 shares authorized; none issued | | |
| Common stock, $0.01 par value; 20,000,000 shares authorized; 2,908,396 and 2,640,226, respectively, issued | 29 | 26 |
| Paid-in capital | 18,651 | 14,989 |
| Accumulated deficit | (3,512 ) | (3,693 ) |
| Less shares held in treasury, at cost (6,003 shares) | (50 ) | (50 ) |
| Total shareholders equity | 15,118 | 11,272 |
| Total liabilities and shareholders equity | $ 113,178 | $ 99,091 |

See Notes to Consolidated Financial Statements (unaudited)

(1) Derived from Audited Consolidated Financial Statements

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**Treaty Oak Bancorp, Inc.**

**Consolidated Statements of Operations (unaudited)**

**Three Months and Nine Months Ended June 30, 2007 and 2006**

**(Dollars In Thousands, Except Share and Per Share Amounts)**

| | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Nine Months Ended June 30, 2007 | Nine Months Ended June 30, 2006 |
|---|---|---|---|---|
| Interest income: | | | | |
| Loans, including fees | $ 1,738 | $ 1,104 | $ 4,882 | $ 2,887 |
| Taxable securities | 18 | 22 | 49 | 76 |
| Interest on deposits with other banks | | 34 | | 91 |
| Federal funds sold | 136 | 73 | 444 | 181 |
| Total interest income | 1,892 | 1,233 | 5,375 | 3,235 |
| | | | | |
| Interest expense: | | | | |
| Deposits | 644 | 252 | 1,753 | 643 |
| Other borrowings | 42 | 41 | 149 | 124 |
| Total interest expense | 686 | 293 | 1,902 | 767 |
| | | | | |
| Net interest income | 1,206 | 940 | 3,473 | 2,468 |
| | | | | |
| Provision for loan losses | 75 | 90 | 220 | 180 |
| Net interest income after provision for loan losses | 1,131 | 850 | 3,253 | 2,288 |
| | | | | |
| Noninterest income: | | | | |
| Service charges on deposit accounts | 57 | 31 | 129 | 69 |
| Other noninterest income | 47 | 113 | 180 | 316 |
| Total noninterest income | 104 | 144 | 309 | 385 |
| | | | | |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 691 | 420 | 1,832 | 1,253 |
| Occupancy and equipment expenses | 84 | 109 | 297 | 331 |
| Accounting and other professional fees | 76 | 63 | 178 | 255 |
| Other noninterest expense | 367 | 268 | 1,074 | 750 |
| Total noninterest expense | 1,218 | 860 | 3,381 | 2,589 |
| | | | | |
| Net income | $ 17 | $ 134 | $ 181 | $ 84 |
| | | | | |
| Earnings per common share - basic | $ 0.01 | $ 0.05 | $ 0.07 | $ 0.03 |
| Earnings per common share - diluted | $ 0.01 | $ 0.05 | $ 0.06 | $ 0.03 |
| | | | | |
| Weighted average shares outstanding - basic | 2,783,192 | 2,630,018 | 2,726,174 | 2,629,548 |
| Weighted average shares outstanding - diluted | 3,043,770 | 2,631,074 | 2,927,716 | 2,631,702 |

See Notes to Consolidated Financial Statements (unaudited)

**Treaty Oak Bancorp, Inc.**

**Consolidated Statement of Shareholders Equity (unaudited)**

**Nine Months Ended June 30, 2007**

**(Dollars In Thousands, Except Share Amounts)**

| | Common Stock Shares | Amount | Additional Paid-In Capital | Accumulated Deficit | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| Balances at October 1, 2006 | 2,640,226 | $ 26 | $ 14,989 | $ (3,693) | $ (50) | $ 11,272 |
| Shares issued from Treaty Oak Holdings merger | 1,094,163 | 11 | 9,082 | | | 9,093 |
| Shares retired from Treaty Oak Holdings merger | (1,000,000) | (10) | (8,300) | | | (8,310) |
| Warrants and options from Treaty Oak Holdings merger | | | 932 | | | 932 |
| Shares issued through the exercise of common stock warrants | 171,606 | 2 | 1,714 | | | 1,716 |
| Non-cash stock based compensation | 2,401 | | 234 | | | 234 |
| Net income | | | | 181 | | 181 |
| Balances at June 30, 2007 | 2,908,396 | $ 29 | $ 18,651 | $ (3,512) | $ (50) | $ 15,118 |

See Notes to Consolidated Financial Statements (unaudited)

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**Treaty Oak Bancorp, Inc.**

**Consolidated Statements of Cash Flows (unaudited)**

**Nine Months Ended June 30, 2007 and 2006**

**(Dollars In Thousands)**

| | Nine Months Ended June 30, 2007 | Nine Months Ended June 30, 2006 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 181 | $ 84 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Provision for loan losses | 220 | 180 |
| Non-cash stock based compensation | 234 | |
| Depreciation and amortization | 275 | 264 |
| Other | (7) | 15 |
| Changes in other operating assets and liabilities: | | |
| Accrued interest receivable | (2) | (5) |
| Other assets | (760) | (177) |
| Accrued interest payable | 123 | 5 |
| Other liabilities | (100) | 156 |
| **Net cash provided by operating activities** | 164 | 522 |
| | | |
| Cash flows from investing activities: | | |
| Proceeds from maturities and principal repayments on securities - available for sale | 5 | 12 |
| Proceeds from maturities and principal repayments on securities - held to maturity | 1,998 | 1,496 |
| Purchases of securities - held to maturity | (1,443) | |
| Acquistion of interest in PGI Equity Partners, LP | | (80) |
| Purchases of correspondent bank stock | | (7) |
| Net increase in loans | (18,534) | (17,340) |
| Cash received from the acquistion of Treaty Oak Holdings, Inc. | 515 | |
| (Advances to) repayments from affiliates | 192 | (468) |
| Collection of notes receivable from affiliates | 2,821 | |
| Purchases of premises and equipment | (294) | (58) |
| **Net cash used in investing activities** | (14,740) | (16,445) |
| | | |
| Cash flows from financing activities: | | |
| Net increase in deposits | 13,774 | 13,175 |
| Payments of principal on mortgage | (48) | (45) |
| Payments of principal on notes payable | (2,483) | (12) |
| Proceeds from exercise of warrants | 1,716 | 11 |
| **Net cash provided by financing activities** | 12,959 | 13,129 |
| | | |
| Net decrease in cash and cash equivalents | (1,617) | (2,794) |
| Cash and cash equivalents at beginning of period | 26,354 | 13,107 |
| Cash and cash equivalents at end of period | $ 24,737 | $ 10,313 |

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**Treaty Oak Bancorp, Inc.**

**Consolidated Statements of Cash Flows (unaudited)**

**Nine Months Ended June 30, 2007 and 2006**

**(Dollars In Thousands)**

| | Nine Months Ended June 30, 2007 | Nine Months Ended June 30, 2006 |
|---|---|---|
| Supplemental disclosures of cash flow information: | | |
| Non-cash investing and financing information: | | |
| Cash interest received | $ 5,330 | $ 3,230 |
| Cash interest paid | $ 1,778 | $ 762 |
| | | |
| Acquisition of Treaty Oak Holdings, Inc. | | |
| Assets acquired, excluding cash acquired | $ 1,280 | |
| Liabilities assumed | (80 ) | |
| Issuance of common stock | (9,093 ) | |
| Retirement of comon stock | 8,310 | |
| Issuance of warrants and assumption of options | (932 ) | |
| Net cash acquired | $ (515 ) | |

See Notes to Consolidated Financial Statements (unaudited)

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**Note 1. Basis of Presentation**

Treaty Oak Bancorp, Inc. (the Company ) is a bank holding company incorporated on November 18, 2003, and organized December 8, 2003 for the purpose of holding the common stock of Treaty Oak Bank (formerly Texline State Bank, the Bank ). The Company, through Treaty Oak Bank, provides a full range of commercial and consumer banking services to individuals and businesses in the commercial sector in Austin, Texas, and in the agriculture, cattle and commercial sectors in the community of Texline, Texas.

On November 15, 2006, the Company completed its acquisition of Treaty Oak Holdings, Inc. ( TOHI ) pursuant to the Agreement and Plan of Merger, dated October 3, 2006 (the Merger Agreement ). The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the merger, TOHI operated as a bank holding company and significant shareholder of the Company, but otherwise had no active operations. As a result of the merger, the Company now owns TOHI s subsidiary companies, Treaty Oak Financial Holdings, Inc. ( TOFHI ) and PGI Capital, Inc. These entities have been consolidated in the Company s financial statements since the merger on November 15, 2006. TOFHI is an inactive corporate entity with assets of cash and a note receivable. PGI Capital, Inc. is the general partner of PGI Equity Partners, LP, the entity which owns the Company s corporate headquarters.

The Company acquired a 47.5% interest in PGI Equity Partners, LP (the Partnership ) on December 31, 2004. The Partnership owns and operates the building in which the Company offices. On February 23, 2006, the Company acquired additional 2.5% Class A and 1.25% Class B interests in the Partnership from the sole remaining minority shareholder, bringing the Company s total ownership interest in the Partnership to 51.25% at September 30, 2006. TOHI owned 43.25% of the limited partnership interests, while PGI Capital, Inc. owned the remaining 0.5% limited partnership interest. Thus, following the Company s merger with TOHI on November 15, 2006, the Company now owns 100.0% of the limited partnership interests in the Partnership as well as the 5.0% general partnership interest held by PGI Capital, Inc., the Partnership s general partner. The Partnership has been consolidated in the Company s financial statements since December 31, 2004. TOHI and PGI Capital, Inc. s interests have been accounted for as minority interests until the merger on November 15, 2006.

The consolidated financial statements include the accounts of Treaty Oak Bancorp, Inc., its wholly owned subsidiary Treaty Oak Bank, and PGI Equity Partners, LP. The consolidated financial statements also include the accounts of PGI Capital, Inc. and TOFHI subsequent to the merger on November 15, 2006.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-QSB and, therefore, do not include all of the disclosures and notes required by accounting principles generally accepted in the United States of America. In the opinion of management, all material adjustments (which are of a normal recurring nature) considered necessary for a fair presentation have been made. The results for the interim period are not necessarily indicative of the results to be expected for the entire year or any other interim period.

New Accounting Pronouncements

The Company adopted Financial Accounting Standards Board Statement No. 123R, Share-Based Payment , ( Statement 123R ) on October 1, 2006. Under Statement 123R, the cost of employee services received in exchange for an award of equity instruments is based on the grant-date fair value of the award (with limited exceptions). That cost is recognized over the period during which an employee is required to provide service in exchange for the award the requisite service period (usually the vesting period).

Prior to October 1, 2006, the Company accounted for stock-based compensation to employees using the intrinsic value method. Accordingly, compensation costs for employee stock options were measured as the excess, if any, of the fair value of the Company s common stock at date of grant over the exercise price.

The Company accounts for stock-based compensation to non-employees at fair value.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). Fin 48 clarifies the accounting and reporting for income taxes recognized in accordance with SFAS No. 109,

Accounting for Income Taxes. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. The Company is currently evaluating the impact of FIN 48. The Company will adopt this Interpretation in the first quarter of fiscal 2008.

In September 2006, the SEC issued Staff Accounting Bulletin ( SAB ) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses the views of the SEC staff regarding the process of quantifying financial statement misstatements. SEC registrants are expected to reflect the effects of initially applying the guidance in SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment should be made to the opening balance of retained earnings for that year. The Company adopted SAB 108 on October 1, 2006. The adoption did not have any impact on the financial statements.

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 transacts. 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 will adopt this standard in the first quarter of fiscal 2008. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operations and 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 to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt this standard in the first quarter of fiscal 2008. The Company is currently evaluating the impact of SFAS No. 159 on its consolidated financial position, results of operations and cash flows.

**Note 2. Merger with Organizing Shareholder**

On November 15, 2006, the Company completed the acquisition of TOHI pursuant to the Agreement and Plan of Merger, dated October 3, 2006. TOHI was one of the five organizing shareholders of the Company and operated as a bank holding company and significant shareholder of the Company, but otherwise had no active operations. The primary purpose of the merger was to achieve certain operational efficiencies for the Company and its affiliates. The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the consummation of the merger, TOHI held approximately 38% of the issued and outstanding shares of the Company s common stock. Pursuant to the Merger Agreement, (1) each issued and outstanding share of TOHI s common stock, par value $0.01 per share was converted into the right to receive 0.8121 shares of the Company s common stock, par value $0.01 per share, and (2) each issued and outstanding share of TOHI s preferred stock, par value $10.00 per share, was converted into the right to receive 1.2034 shares of the Company s common stock.

TOHI had issued options to acquire shares of common stock to various individuals, 40,000 of which were outstanding as of the date of the merger. These options were assumed by the Company and, pursuant to the conversion ratio, now represent options to acquire 32,484 shares of the Company s common stock. The options were fully vested at the merger date. Also, at the closing of the merger, certain TOHI warrantholders were issued new warrants to acquire, in the aggregate, 450,000 shares of the Company s common stock. The warrants were fully vested when issued. The Company granted the TOHI shareholders certain limited registration rights pursuant to a Registration Rights Agreement executed at the closing of the merger. Pursuant to the Registration Rights Agreement these former TOHI shareholders can request that the Company register their shares of the Company s common stock

on a Registration Statement on Form S-3 if such form is available for use by the Company, but only once during any 12-month period. The former TOHI warrantholders were also granted similar S-3 registration rights.

The TOHI shareholders contributed certain assets and liabilities to the Company in connection with the merger. As of November 15, 2006, the assets and liabilities contributed by TOHI were as follows (in thousands):

| | **As of November 15, 2006** |
|---|---|
| Cash | $ 441 |
| Subscriptions receivable | 72 |
| Notes receivable | 100 |
| Accrued interest receivable | 5 |
| Investment in PGI Equity Partnership, LP | 875 |
| Investment in PGI Capital, Inc. (1) | 54 |
| Investment in Treaty Oak Financial Holdings, Inc. (2) | 248 |
| | 1,795 |
| Accrued expenses | (80 ) |
| Net assets contributed by TOHI | $ 1,715 |

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(1) PGI Capital, Inc. s assets were comprised of $31,000 in cash and $224,000 of general and limited partnership interests in PGI Equity Partners LP. PGI Capital, Inc. liabilities included a note payable to the Bank of $200,000 plus accrued interest of $1,000.

(2) Treaty Oak Financial Holdings assets were comprised of $43,000 in cash, a $166,500 note receivable and related accrued interest of $38,000.

The Company and TOHI were deemed to be under common control. A majority of the directors of the Company also served on TOHI s board of directors and were shareholders of both entities. TOHI also owned 1,000,000 shares of the Company s common stock, representing approximately 38% of the Company shares then outstanding. Because the Company and TOHI were deemed to be under common control, purchase accounting was not applied to the merger. Instead the net assets contributed by TOHI were recorded at their predecessor basis. The 1,000,000 shares of Company common stock owned by TOHI were cancelled by the Company and recorded as a reduction of its common stock accounts (par value and paid in capital) at their fair market value, as determined by an independent appraisal, of $8.31 per share, or $8,310,000 in the aggregate. The 1,094,163 new shares of Company stock issued to the TOHI shareholders were also recorded at the fair market value price of $8.31 per share, or $9,093,000 in the aggregate. The warrants issued by the Company in exchange for the TOHI warrants and the TOHI options assumed by the Company were valued and recorded at their fair value using a Black-Scholes pricing model. The net effect of the contribution of assets and the capital stock transactions was a $1,715,000 increase to the Company s equity and a 94,163 net increase in the number of Company shares issued. Although the net assets contributed by TOHI to the Company were not adjusted to their fair value, the assets were evaluated for collectibility and/or impairment according to generally accepted accounting principles prior to the merger and adjusted accordingly by TOHI prior to the merger.

**Note 3. Earnings (Loss) Per Share**

Basic earnings per share is computed by dividing net earnings by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding plus the number of additional common shares that would have been outstanding if dilutive common shares had been issued. For the three months ended June 30, 2007, all potentially dilutive securities were

dilutive. The 902,079 of potentially dilutive securities included 418,950 of options to purchase common stock issued under the Company s Stock Incentive Plan, 645 options to purchase stock issued outside of the Plan, stock options to purchase 32,484 shares of the Company s common stock at an exercise price of $6.16 that were assumed in conjunction with the merger with TOHI and warrants to purchase 450,000 of the Company s common stock at an exercise price of the greater of $6.67 per share or the book value of the Company as defined by the warrant agreements. For the nine months ended June 30, 2007, all potentially dilutive securities except for 500 options to purchase common stock with an exercise price of $10.26 and 6,400 options to purchase common stock with an exercise price of $10.95, were dilutive. For the nine months ended June 30, 2007, the 895,179 of potentially dilutive securities included 412,050 options to purchase common stock issued under the Company s Stock Incentive Plan, 645 options to purchase stock issued outside of the Plan, stock options to purchase 32,484 shares of the Company s common stock at an exercise price of $6.16 that were assumed in conjunction with the merger with TOHI and warrants to purchase 450,000 of the Company s common stock at an exercise price of the greater of $6.67 per share or the book value of the Company as defined by the warrant agreements.

For the three and nine months ended June 30, 2006, all potentially dilutive securities, except for stock options to purchase 179,500 and 145,500 shares, respectively, of the Company s common stock at $8.33 per shares, were anti-dilutive.

During the three months ended June 30, 2007, 168,265 of the Company s warrants to purchase common stock at $10.00 per share which were issued in connection with the Company s initial public offering, were exercised. The remaining 140,000 of warrants 140,000 expired on June 30, 2007.

## Note 4. Securities

Securities consisted of the following (in thousands):

| | As of June 30, 2007 | | As of September 30, 2006 | |
|---|---|---|---|---|
| | **Amortized Cost** | **Fair Value** | **Amortized Cost** | **Fair Value** |
| Securities Available for Sale: | | | | |
| U.S. Government Agencies | $ 9 | $ 9 | $ 14 | $ 14 |
| Other mortgage backed securities | 2 | 2 | 2 | 2 |
| Total Securities Available for Sale | $ 11 | $ 11 | $ 16 | $ 16 |
| Securities Held to Maturity: | | | | |
| U.S. Government Agencies | $ 1,446 | $ 1,446 | $ 2,000 | $ 1,996 |
| Other mortgage backed securities | 5 | 4 | 6 | 5 |
| Total Securities Held to Maturity | $ 1,451 | $ 1,450 | $ 2,006 | $ 2,001 |

At June 30, 2007, $512,000 of the Company s securities were pledged to Texline Independent School District, $700,000 to the City of Texline and $250,000 to the State of Texas.

## Note 5. Loans and Allowance for Loan Losses

The Company grants real estate, commercial and agribusiness loans to customers primarily in the Austin and Northwest Texas markets. Loans at June 30, 2007, and September 30, 2006 were as follows (in thousands):

| | As of June 30, 2007 | As of September 30, 2006 |
|---|---|---|
| | | |
| Agriculture | $ 2,758 | $ 2,989 |
| Commercial | 28,451 | 19,068 |
| Commercial real estate | 18,129 | 18,582 |
| Residential real estate | 9,079 | 8,221 |
| Construction real estate | 13,940 | 4,329 |
| Consumer and other | 6,361 | 6,981 |
| Gross Loans | 78,718 | 60,170 |
| Less: allowance for loan losses | (717) | (550) |
| | | |
| Net Loans | $ 78,001 | $ 59,620 |

Activity in the allowance for loan losses for the three months and nine months ended June 30, 2007, was as follows (in thousands):

| | Three Months Ended June 30, 2007 | 2006 | Nine Months Ended June 30, 2007 | 2006 |
|---|---|---|---|---|
| Balance at beginning of period | $ 646 | $ 358 | $ 550 | $ 277 |
| Provision for loan losses | 75 | 90 | 220 | 180 |
| Loans charged off | (7) | (12) | (58) | (22) |
| Recoveries on loans previously charged off | 3 | 1 | 5 | 2 |
| | | | | |
| Balance at end of period | $ 717 | $ 437 | $ 717 | $ 437 |

At June 30, 2007 and September 30, 2006, the Bank had approximately $95,000 and $123,000, respectively, in nonperforming loans and non accrual loans. At June 30, 2007 and September 30, 2006 the Bank had approximately $800 and $5,000 in repossessed assets, respectively, and approximately $76,000 and $41,000, respectively, in other real estate owned.

## Note 6. Premises and Equipment

Premises and equipment at June 30, 2007, and September 30, 2006, were as follows (in thousands):

| | As of June 30, 2007 | As of September 30, 2006 |
|---|---|---|
| | | |
| Land | $ 959 | $ 959 |
| Building and leasehold improvements | 4,614 | 4,568 |
| Furniture, fixtures and equipment | 1,025 | 778 |
| | 6,598 | 6,305 |
| Less accumulated depreciation and amortization | (971) | (712) |
| Total | $ 5,627 | $ 5,593 |

Depreciation and amortization expense for the nine months ended June 30, 2007 and 2006 was approximately $260,000 and $257,000, respectively.

## Note 7. Deposits

Time deposits of $100,000 or more totaled $16,713,000 and $8,989,000 at June 30, 2007 and September 30, 2006, respectively. At June 30, 2007 and September 30, 2006, the scheduled maturities of time deposits were as follows (in thousands):

| Years Ending September 30, | As of June 30, 2007 | As of September 30, 2006 |
|---|---|---|
| 2007 | $ 15,927 | $ 20,197 |
| 2008 | 15,076 | 329 |
| 2009 | 762 | |
| | $ 31,765 | $ 20,526 |

## Note 8. Goodwill and Other Intangibles

In conjunction with the acquisition of Texline State Bank, the Company recorded goodwill of $1,161,000 and core deposit intangibles of $70,000. Goodwill is periodically, but at least annually, reviewed to determine whether a decline in value exists which requires a charge to earnings and a reduction to the goodwill reflected on the statement of financial condition of the Company.

Core deposit intangibles are amortized on a straight-line basis over seven years. The following table reflects the net carrying amount of core deposit intangibles at June 30, 2007 and September 30, 2006 (in thousands):

| | As of June 30, 2007 | As of September 30, 2006 |
|---|---|---|
| Gross core deposit intangibles | $ 70 | $ 70 |
| Less: accumulated amortization | (32) | (26) |
| Net core deposit intangibles | $ 38 | $ 44 |

**Note 9. Stock Based Compensation and 2004 Stock Incentive Plan**

The Company adopted Financial Accounting Standards Board Statement No. 123R, Share-Based Payment , ( Statement 123R ) on October 1, 2006. Under Statement 123R, the cost of employee services received in exchange for an award of equity instruments is based on the grant-date fair value of the award (with limited exceptions). That cost is recognized over the period during which an employee is required to provide service in exchange for the award the requisite service period (usually the vesting period). The Company adopted Statement 123R using the modified prospective application, which was required for public companies. Under the modified prospective application, Statement 123R applies to new awards and to awards modified, repurchased, or cancelled after October 1, 2006. Additionally, compensation cost for the portion of awards for which the requisite service had not been

rendered that are outstanding as of October 1, 2006 will be recognized as the requisite service is rendered subsequent to October 1, 2006.

Prior to October 1, 2006, the Company accounted for stock-based compensation to employees using the intrinsic value method. Accordingly, compensation costs for employee stock options was measured as the excess, if any, of the fair value of the Company s common stock at date of grant over the exercise price.

The Company accounts for stock-based compensation to non-employees at fair value.

On January 19, 2004, the Company and its shareholders approved the Company s 2004 Stock Incentive Plan (the Plan ). The Plan authorizes incentive stock option grants, non-statutory stock option grants, direct stock issuances, stock appreciation rights, salary investment option grants, and director fee option grants. Eligible participants are employees, non-employee board members, and independent consultants or advisors. The Company initially reserved 500,000 shares of common stock under the Plan, and the share reserve increases on the 1st business day in January each year (beginning in 2005) by an amount equal to 2% of the number of outstanding shares of the Company on the last business day in December of the preceding year, subject to a maximum annual increase of 100,000 shares. No person may receive stock option grants, stock issuances, or stock appreciation rights for more than 100,000 shares in the aggregate in any calendar year under the Plan. Option awards are generally granted with an exercise price equal to the market price of the Company s stock at the date of the grant; have 10-year contractual terms and vest based on three years of continuous service. Share awards generally vest over four years.

The following table illustrates the stock compensation expense recognized during the three and nine months ended June 30, 2007:

| | **Three Months Ended June 30, 2007** | | **Nine Months Ended June 30, 2007** | |
|---|---|---|---|---|
| Stock options for employees and directors | $ | 57 | $ | 164 |
| Stock options for services provided | 11 | | 20 | |
| Restricted stock grants | 24 | | 50 | |
| | $ | 92 | $ | 234 |

For the three months and nine months ended June 30, 2006, the expense related to stock option compensation included in the determination of net income was less than that which would have been recognized if the fair value method had been applied. The Company s net income and earnings per share would have been adjusted to the proforma amounts indicated below for the three months and nine months ended June 30, 2006, assuming the Company had expensed the fair value of the options (in thousands, except per share amounts):

| | **Three Months Ended June 30, 2006** | | **Nine Months Ended June 30, 2006** | | |
|---|---|---|---|---|---|
| | | | | | |
| Net income as reported | $ | 134 | $ | 84 | |
| Net income (loss) pro forma | $ | 95 | $ | (28 | ) |
| | | | | | |
| Income per share as reported | | | | | |
| Basic | $ | 0.05 | $ | 0.03 | |
| Diluted | $ | 0.05 | $ | 0.03 | |
| | | | | | |
| Income (loss) per share pro forma | | | | | |
| Basic | $ | 0.04 | $ | (0.01 | ) |
| Diluted | $ | 0.04 | $ | (0.01 | ) |

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The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. The Black-Scholes option pricing model requires the input of highly subjective assumptions. The Company continues to assess the assumptions and methodologies used to calculate the estimated fair value of the stock-based compensation. Circumstances may change and additional data may become available over time, which could result in changes to these assumptions and methodologies. The risk-free rate for periods within the expected life of the options is based on the U.S. Treasury yield in effect at the time of the grant. The expected life of the options is estimated based on the vesting life and contractual life of the options. Volatility in the Black-Scholes model is based on historical volatility for comparable publicly-traded banks and the Company s historical stock prices since inception.

The fair value of restricted common stock granted under the Plan is estimated using the most recently traded market price of the Company s common stock at the time of the grant.

The weighted average fair value of the options granted during the three months ended June 30, 2007 and 2006, has been estimated using the Black-Scholes option pricing model with the following assumptions:

| | | **Three Months Ended June 30, 2007** | | **Three Months Ended June 30, 2006** | |
|---|---|---|---|---|---|
| Dividend yield | | 0 | % | 0 | % |
| Risk-free interest rate | | 4.96 | % | 4.73 | % |
| Expected volatility | | 5.0 | % | 22.0 | % |
| Expected life in years | | 6.85 Years | | 6.85 Years | |

As of June 30, 2007, there were outstanding options under the Company s Stock Incentive Plan to purchase an aggregate of 418,950 shares of the Company s common stock. Each option has an exercise price of between $8.00 and $10.95 per share and may be exercised in three equal annual installments for each year of service measured from the grant date.

The table below presents the summary of stock option and restricted stock activity for the Plan during the nine months ended June 30, 2007.

| | **Nine Months Ended June 30, 2007** | | | | | |
|---|---|---|---|---|---|---|
| | **Restricted Stock** | | | **Options** | | |
| | **Shares** | **Weighted Average Remaining Contractual Term in Years** | **Shares** | **Weighted Average Exercise Price** | **Weighted Average Remaining Contractual Term in Years** | **Aggregate Intrinsic Value** |
| Outstanding, beginning of the period | | | 301,350 | $ 8.38 | | |
| Granted | 54,207 | | 120,650 | 8.98 | | |
| Forfeited/expired | | | (3,050 ) | 8.40 | | |
| Outstanding, end of the period | 52,407 | 3.5 | 418,950 | $ 8.62 | 8.2 | $ 985,902 |
| | | | | | | |
| Exercisable at the end of the period | 2,401 | | 198,067 | $ 8.41 | 7.2 | $ 506,249 |

A summary of shares of our common stock subject to our nonvested shares and options as of June 30, 2007 and changes during the nine months ended June 30, 2007 is presented below:

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| | Nine Months Ended June 30, 2007 | | | |
|---|---|---|---|---|
| | Restricted Stock | | Options | |
| | Shares | Weighted Average Grant Date Fair Value | Shares | Weighted Average Grant Date Fair Value |
| Nonvested, beginning of the period | | $ | 180,400 | $ 1.84 |
| Granted | 52,407 | 8.26 | 120,650 | 2.48 |
| Vested | (2,401 ) | (8.73 ) | (77,117 ) | 1.79 |
| Forfeited/expired | | | (3,050 ) | 1.83 |
| Nonvested, end of the period | 50,006 | $ 8.24 | 220,883 | $ 2.21 |

As of June 30, 2007, there was $713,925 of total unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 2.8 years. No options were exercised during the three months and nine months ended June 30, 2007.

**Note 10. Other Related Party Transactions**

**Transactions with Former Organizing Shareholder**

On August 30, 2006, TOHI, the Company s largest shareholder at that time, repurchased shares of its stock owned by certain principals of our formerly affiliated services firms, including the Company s former CEO Terry W. Hamann. Concurrent with this stock redemption, those formerly affiliated firms relocated from the headquarters building. At that time, Mr. Hamann resigned his remaining positions with the Company including all committee assignments and his seat on the board of directors of both the Company and the Bank. Mr. Hamann had previously resigned his role as Chairman, CEO and President of the Company in February 2006.

**Other Transactions**

On October 11, 2005, the Company made a $355,000 loan to TOHI with monthly interest payments due on the first of each month beginning November 1, 2005. The purpose of the loan was to enable TOHI to pay off certain obligations, and to provide sufficient liquidity to TOHI until the proposed merger with the Company was completed. On April 26, 2006, the obligation was renewed and increased to $373,000 at the then current prime rate. The loan was renewed and increased to $400,000 on September 1, 2006. The principal balance ($396,000 as of September 30, 2006), along with any accrued interest, was due and payable in full on November 1, 2006. On November 15, 2006, in connection with the merger of TOHI and the Company, the loan was paid in full.

On August 24, 2006, the Company made a $2,425,000 loan to TOHI with monthly interest payments at the current prime rate (8.25% at September 30, 2006) due on the 24th day of each month. The purpose of the loan was to enable TOHI to redeem shares of common and preferred stock from certain of its shareholders. The loan was due and payable on February 24, 2007 but was paid-off in full on November 15, 2006 in connection with the Company s acquisition of TOHI.

**Note 11.** **Financial Instruments with Off-Balance Sheet Risk**

In the normal course of business, the Company is a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers, through the use of commitments to extend credit. Those instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the consolidated balance sheet. The contract or notional amounts of those instruments reflect the extent of the Company s involvement in particular classes of financial instruments.

The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as they do for on-balance sheet instruments.

The following table summarizes the Company s off-balance sheet financial instruments as of June 30, 2007 and September 30, 2006 (in thousands):

| | As of June 30, 2007 | As of September 30, 2006 |
|---|---|---|
| Commitments to extend credit | $ 22,537 | $ 21,277 |
| Standby letters of credit | 14 | 1,935 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer s creditworthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Company upon extension of credit is based on management s credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties.

Standby letters of credit are written conditional commitments used by the Company to guarantee the performance of a customer to a third party. The Company s policies generally require that letter of credit arrangements contain security and debt covenants similar to those contained in loan arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount shown in the table above. If the commitment is funded, the Company would be entitled to seek recovery from the customer. As of June 30, 2007, no amounts have been recorded as liabilities for the Company s potential obligations under these guarantees.

**Note 12.** **Dividend Restrictions and Regulatory Matters**

Banks and bank holding companies are subject to regulatory capital requirements administered by state and federal banking regulatory agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors. Failure to meet capital requirements can initiate regulatory action. As of June 30, 2007, management believes the Bank is in compliance with all regulatory capital requirements to which it is subject.

The following table sets forth the bank only actual capital levels in addition to the requirements under prompt corrective action regulations (in thousands):

| | Actual Amount | Ratio | | For Capital Adequacy Purposes Amount | Ratio | | To Be Well Capitalized Under Prompt Corrective Action Provisions Amount | Ratio | |
|---|---|---|---|---|---|---|---|---|---|
| As of June 30, 2007 | | | | | | | | | |
| Tier 1 capital (to average assets) | $ 8,878 | 9.49 | % | $ 3,742 | 4 | % | $ 4,678 | 5 | % |
| Tier 1 capital (to risk-weighted assets) | 8,878 | 10.18 | % | 3,490 | 4 | % | 5,234 | 6 | % |
| Total Capital (to risk-weighted assets) | 9,595 | 11.00 | % | 6,979 | 8 | % | 8,724 | 10 | % |

| | Actual | | | For Capital Adequacy Purposes | | | To Be Well Capitalized Under Prompt Corrective Action Provisions | | |
|---|---|---|---|---|---|---|---|---|---|
| As of September 30, 2006 | | | | | | | | | |
| Tier 1 capital (to average assets) | $ 8,213 | 11.07 | % | $ 2,967 | 4 | % | $ 3,709 | 5 | % |
| Tier 1 capital (to risk-weighted assets) | 8,213 | 11.39 | % | 2,885 | 4 | % | 4,328 | 6 | % |
| Total Capital (to risk-weighted assets) | 8,763 | 12.15 | % | 5,771 | 8 | % | 7,213 | 10 | % |

As of June 30, 2007 and September 30, 2006, the Bank met the level of capital required to be categorized as well capitalized under prompt corrective action regulations. Management is not aware of any conditions subsequent to June 30, 2007 that would change the Bank s capital category.

The Bank is a state chartered banking association and is subject to regulation, supervision and examination by the Texas Department of Banking and the Federal Deposit Insurance Corporation (FDIC). In addition, upon making certain determinations with respect to the condition of any insured bank, the FDIC may begin proceedings to terminate a bank s federal deposit insurance.

Certain restrictions exist regarding the ability of the Bank to pay cash dividends. Regulatory approval is required in order to pay dividends until such time as the accumulated deficit is eliminated and certain other conditions are met. Further, the Company has been notified by its banking regulators that no approval will be received in the first three years of operations.

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

**Introduction**

We are a bank holding company headquartered in Austin, Texas. We operate a state chartered bank, Treaty Oak Bank (the Bank ) in Austin, Texas with a branch in Texline, Texas. We began operations in Austin, Texas on September 10, 2004. Given its greater growth potential, we are focusing the majority of our efforts on growing a community-oriented bank out of our headquarters in Austin, Texas. In the course of preparing our consolidated financial statements, we use certain estimates with respect to loans, intangibles, the allowance for loan losses and other estimates necessary for financial reporting. We have made no significant changes to the types of estimates and the manner in which they are determined since the filing of our annual report on Form 10-KSB, except as otherwise noted within this discussion and analysis.

**Recent Developments**

In connection with the Company s initial public offering on May 7, 2004, we issued approximately 315,000 of warrants to purchase registered common stock at an exercise price of $10 per share, with an expiration date of June 30, 2007. A total of approximately 175,000 warrants were exercised prior to the expiration date resulting in a total increase in the Company s capital of $1,750,000 as of June 30, 2007. The unexercised warrants expired as of June 30, 2007. The capital from the warrants will be used to support the continued growth of the Bank.

On July 17, 2007, the Company s branch in Marble Falls, Texas opened for business. The primary focus of our Marble Falls branch is on medium and small commercial businesses, real estate lending (including interim construction and commercial real estate loans) and agricultural lending. The Company expects to open its newest branch in the Barton Creek area of southwest Austin in January 2008. The primary focus of the Barton Creek branch will be to expand the community bank operations of our Austin headquarters.

On November 15, 2006, the Company completed the acquisition of Treaty Oak Holdings, Inc. ( TOHI ) pursuant to the Agreement and Plan of Merger, dated October 3, 2006. TOHI was one of the five organizing shareholders of the Company and operated as a bank holding company and significant shareholder, but otherwise had no active operations. The merger was approved by the Company s Board of Directors and also by the Company s shareholders at a Special Meeting of Shareholders held on October 24, 2006. Prior to the consummation of the merger, TOHI held approximately 38% of the issued and outstanding shares of our common stock.

The primary purpose of this merger was to achieve certain operational efficiencies for the Company and its affiliates. The following factors were important to both the Company and TOHI Board s decisions to approve the merger and recommend approval to their respective shareholders:

(i) The merger would simplify the bookkeeping, financial reporting, and corporate record keeping for the Treaty Oak affiliated entities;

(ii) The merger would reduce the accounting and other costs for the various Treaty Oak entities, including the costs associated with the filing of multiple tax returns and regulatory reports;

(iii) The merger would eliminate the need to treat TOHI as a separate bank holding company and make the various banking regulatory filings;

(iv) The Company and TOHI Boards of Directors believed that it was beneficial for the Company and TOHI shareholders to have all of the shareholders associated with the Treaty Oak affiliated entities invested in one organization (*i.e.*, the Company) rather than multiple organizations;

(v) As part of the exchange, the Company would receive net assets from TOHI, including cash and limited partnership interests in PGI Equity Partners, LP, the entity that owns Treaty Oak Bank s

headquarters at 101 Westlake Drive, Austin, Texas, which would increase the liquidity and financial strength of the Company;

(vi) The merger was anticipated to be accretive to the Company s tangible book value per share outstanding;

(vii) Net operating losses incurred by TOHI may be available to offset future earnings of the Company; and

(viii) The TOHI Board believed that the exchange of the TOHI shares for the Company shares in connection with the merger would improve the liquidity of such shares since the Company is a public reporting company.

The Company and TOHI were deemed to be under common control. A majority of the directors of the Company also served on TOHI s board of directors and were shareholders of both entities. TOHI also owned 1,000,000 shares of the Company s common stock, representing approximately 38% of the Company shares then outstanding. Because the Company and TOHI were deemed to be under common control, purchase accounting was not applied to the merger. Instead the net assets contributed by TOHI were recorded at their predecessor cost. The 1,000,000 shares of Company common stock owned by TOHI were cancelled by the Company and recorded as a reduction of its common stock accounts (par value and paid in capital) at their fair market value, as determined by an independent appraisal, of $8.31 per share, or $8,310,000 in the aggregate. The 1,094,163 new shares of Company stock issued to the TOHI shareholders were also recorded at the fair market value price of $8.31 per share, or $9,093,000 in the aggregate. The warrants issued by the Company in exchange for the TOHI warrants and the TOHI options assumed by the Company were valued and recorded at their fair value using a Black-Scholes pricing model. The net effect of the contribution of assets and the capital stock transactions was a $1,715,000 increase to the Company s equity and a 94,163 net increase in the number of Company shares issued. Although the net assets contributed by TOHI to the Company were not adjusted to their fair value, the assets were evaluated for collectibility and/or impairment according to generally accepted accounting principles prior to the merger and adjusted accordingly by TOHI prior to the merger.

**Results of Operations**

***General***

The following discussion analyzes the results of the Company for the three months and nine months ended June 30, 2007, and June 30, 2006.

***Net Income General***

The Company s fiscal year ends on September 30. Net income for the three months ended June 30, 2007, was $17,000, compared to net income of $134,000 for the three months ended June 30, 2006. Despite an increase in the net income of the Company s primary subsidiary, the Bank, the Company s net income decreased for the three months ended June 30, 2007 as compared to the three months ended June 30, 2006, due to the recognition of non-cash based stock compensation to directors and employees, increased directors fees and decreased earnings by PGI Equity Partners, LP as a result of reduced sublease income. The Bank s increased net income was a result of asset growth and increased net interest margin offset by an increase in personnel and related expenses to support the growth of the Company and the start-up costs associated with the Company s new branch in Marble Falls, Texas, which opened in July 2007.

For the nine months ended June 30, 2007 the Company had net income of $134,000 compared to net income of $84,000 for the nine months ended June 30, 2006. Again, the improvement in operations is attributable to the increase in net interest income, as the Company grew its earnings assets at a faster pace and at a greater yield than its interest bearing liabilities, and the elimination of expenses associated with the start-up of operations in Austin, Texas. The increase in net income was offset, in part, by increased personnel expense and by the recognition of non-cash based stock compensation to directors and employees.

Our profitability depends primarily on net interest income, which is defined as the difference between total interest earned on interest earning assets (investments and loans) and total interest paid on interest bearing liabilities (deposits, borrowed funds) and non-interest income. The Company s net income is affected by its provision for loan losses, as well as other income and other expenses. The provision for loan losses reflects the amount considered to be adequate to cover probable credit losses in the loan portfolio. Non-interest income or other income consists of service charges on deposits, gain on sale of loans, and other operating income. Other expenses include salaries and employee benefits, occupancy expenses, data processing expenses, marketing, supplies, and other operating expenses.

Net interest income is affected by changes in the volume and mix of interest earning assets, the level of interest rates earned on those assets, the volume and mix of interest bearing liabilities, and the level of interest rates paid on those interest bearing liabilities. The provision for loan losses is dependent upon changes in the loan portfolio and management s assessment of the collectibility of the loan portfolio, as well as economic and market conditions. Other income and other expenses are impacted by growth of operations and growth in the number of accounts through both acquisitions and core banking business growth. Growth in operations affects other expenses as a result of additional employees, branch facilities, and promotional marketing expense. Growth in the number of accounts affects other income including service fees, as well as other expenses such as computer services, supplies, postage, telecommunications, and other miscellaneous expenses.

***Net Interest Income***

For the three months ended June 30, 2007, our net interest income was $1,206,000 compared to $940,000 for three months ended June 30, 2006. For the nine months ended June 30, 2007, our net interest income was $3,473,000 compared to $2,468,000 for the nine months ended June 30, 2006.

For the comparative three month periods of June 30, 2007, and June 30, 2006, the average rate on interest-bearing liabilities increased 121 basis points, from 3.30% to 4.51%, while the average rate on interest bearing assets increased 69 basis points from 7.87% to 8.56% during the same period. For the comparative nine month periods of June 30, 2007, and June 30, 2006, the average rate on interest-bearing liabilities increased 130 basis points, from 3.17% to 4.47%, while the average rate on interest bearing assets increased 81 basis points from 7.71% to 8.52% during the same period. The increase in the average rate on interest-bearing assets and liabilities was due to a general increase in interest rates during the period. Interest rates on deposits increased at a faster rate than assets as a result of increased competition for deposits and the Company s increased use of wholesale funding sources.

The following tables present, for the periods indicated, the total dollar amount of interest income from average interest earning assets, and the resultant yields, as well as the interest expense on average interest bearing liabilities, and the resultant costs, expressed both in dollars and rates. Yields are reflected on an annualized basis (in thousands except for yields).

| | **Three Months Ended June 30, 2007** | | | **Three Months Ended June 30, 2006** | | |
|---|---|---|---|---|---|---|
| | **Average Balance** | **Interest (2)** | **Yield/ Rate** | **Average Balance** | **Interest (2)** | **Yield/ Rate** |
| Interest Earning Assets: | | | | | | |
| Loans (1) | $ 75,429 | $ 1,738 | 9.22 % | $ 50,780 | $ 1,104 | 8.70 % |
| Taxable investment securities | 1,461 | 18 | 4.93 % | 2,856 | 22 | 3.08 % |
| Federal funds sold | 11,196 | 136 | 4.86 % | 6,030 | 73 | 4.84 % |
| Interest bearing deposits with other banks | | | 0.00 % | 2,681 | 31 | 4.63 % |
| Federal Home Loan Bank Stock | 326 | | 0.00 % | 324 | 3 | 3.70 % |
| Total interest earning assets | 88,412 | 1,892 | 8.56 % | 62,671 | 1,233 | 7.87 % |
| Non-interest earning assets | 11,154 | | | 9,633 | | |
| Total assets | $ 99,566 | | | $ 72,304 | | |
| Interest Bearing Liabilities: | | | | | | |
| Deposits: | | | | | | |
| NOW and money market deposits | $ 26,527 | $ 245 | 3.69 % | $ 18,118 | $ 105 | 2.32 % |
| Savings deposits | 525 | 2 | 1.45 % | 424 | 1 | 0.94 % |
| Time deposits | 30,955 | 397 | 5.13 % | 14,296 | 146 | 4.09 % |
| Short-term borrowings | 167 | 4 | 8.47 % | 4 | | 0.00 % |
| Property mortgage and long term borrowings | 2,625 | 39 | 5.99 % | 2,687 | 41 | 6.10 % |
| Total interest bearing liabilities | 60,799 | 686 | 4.51 % | 35,529 | 293 | 3.30 % |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Demand deposits non-interest bearing | 24,036 | | | | 24,937 | | | |
| Other non-interest bearing liabilities | 640 | | | | 707 | | | |
| Shareholders equity | 14,091 | | | | 11,131 | | | |
| Total liabilities and shareholders equity | $ 99,566 | | | | $ 72,304 | | | |
| | | | | | | | | |
| Net interest income | | $ 1,206 | | | | $ 940 | | |
| | | | | | | | | |
| Interest rate spread (3) | | | 4.05 | % | | | 4.57 | % |
| Net interest margin (4) | | | 5.46 | % | | | 6.00 | % |

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| | **Nine Months Ended June 30, 2007** | | | **Nine Months Ended June 30, 2006** | | |
|---|---|---|---|---|---|---|
| | **Average Balance** | **Interest (2)** | **Yield/ Rate** | **Average Balance** | **Interest (2)** | **Yield/ Rate** |
| Interest Earning Assets: | | | | | | |
| Loans (1) | $ 70,636 | $ 4,882 | 9.22 % | $ 44,334 | $ 2,887 | 8.68 % |
| Taxable investment securities | 1,528 | 49 | 4.28 % | 3,463 | 76 | 2.93 % |
| Federal funds sold | 11,583 | 444 | 5.11 % | 5,006 | 181 | 4.82 % |
| Interest bearing deposits with other banks | | | 0.00 % | 2,815 | 83 | 3.93 % |
| Federal Home Loan Bank Stock | 326 | | 0.00 % | 320 | 7 | 3.34 % |
| Total interest earning assets | 84,073 | 5,375 | 8.52 % | 55,938 | 3,235 | 7.71 % |
| Non-interest earning assets | 11,163 | | | 18,173 | | |
| Total assets | $ 95,236 | | | $ 74,111 | | |
| | | | | | | |
| Interest Bearing Liabilities: | | | | | | |
| Deposits: | | | | | | |
| NOW and money market deposits | $ 28,420 | $ 784 | 3.68 % | $ 15,557 | $ 289 | 2.48 % |
| Savings deposits | 527 | 6 | 1.46 % | 448 | 2 | 0.60 % |
| Time deposits | 24,778 | 963 | 5.18 % | 123503 | 372 | 3.67 % |
| Short-term borrowings | 574 | 29 | 6.74 % | 46 | | 0.00 % |
| Property mortgage and long term borrowings | 2,441 | 119 | 6.51 % | 2,702 | 104 | 5.13 % |
| | | | | | | |
| Total interest bearing liabilities | 56,740 | 1,902 | 4.47 % | 32,256 | 767 | 3.17 % |
| Demand deposits non-interest bearing | 24,616 | | | 21,055 | | |
| Other non-interest bearing liabilities | 577 | | | 10,628 | | |
| Shareholders equity | 13,303 | | | 10,173 | | |
| Total liabilities and shareholders equity | $ 95,236 | | | $ 74,111 | | |
| | | | | | | |
| Net interest income | | $ 3,473 | | | $ 2,468 | |
| | | | | | | |
| Interest rate spread (3) | | | 4.05 % | | | 4.54 % |
| Net interest margin (4) | | | 5.51 % | | | 5.88 % |

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(1) Non-accrual loans are included in average loans.

(2) Interest income includes loan fees of $73,000 and $178,000, for the three and nine months ended June 30, 2007, respectively and $38,000 and $94,000 for the three and nine months ended June 30, 2006.

(3) Interest rate spread represents the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities.

(4) Net interest margin represents annualized net interest income as a percentage of average interest earning assets.

***Volume, Mix and Rate Analysis of Net Interest Income***

The following table presents the extent to which changes in volume, changes in interest rates, and changes in the interest rates times the changes in volume of interest earning assets and interest bearing liabilities affected the Bank s interest income and interest expense during the period indicated. Information is provided on changes in each category due to (1) changes attributable to changes in volume (change in volume times the prior period interest rate), (2) changes attributable to changes in interest rate (changes in rate times the prior period volume), and (3) changes attributable to changes in rate/volume (changes in interest rate times changes in volume). Changes attributable to the combined impact of volume and rate have been allocated proportionally to the changes due to volume and the changes due to rate (in thousands):

| | Three Months Ended June 30, 2007 Compared to Three Months Ended June 30, 2006 | | |
|---|---|---|---|
| | Change Due to Volume | Change Due to Rate | Total Change |
| Interest Earning Assets: | | | |
| Loans | $ 568 | $ 66 | $ 634 |
| Taxable investment securities | (17) | 13 | (4) |
| Federal funds sold | 63 | | 63 |
| Interest bearing deposits with other banks | (32) | 1 | (31) |
| Increase in interest income | $ 582 | $ 80 | $ 662 |
| | | | |
| Interest Bearing Liabilities: | | | |
| NOW and money market deposit accounts | $ 78 | $ 62 | $ 140 |
| Savings deposits | 1 | 1 | 2 |
| Time deposits | 214 | 37 | 251 |
| Short-term borrowings | 3 | 1 | 4 |
| Long term borrowings | (1) | (1) | (2) |
| Increase in interest expense | 295 | 100 | 395 |
| Increase (decrease) in net interest income | $ 287 | $ (20) | $ 267 |

| | Nine Months Ended June 30, 2007 Compared to Nine Months Ended June 30, 2006 | | |
|---|---|---|---|
| | Change Due to Volume | Change Due to Rate | Total Change |
| Interest Earning Assets: | | | |
| Loans | $ 1,212 | $ 119 | $ 1,331 |
| Taxable investment securities | (41) | 23 | (18) |
| Federal funds sold | 168 | 7 | 175 |
| Interest bearing deposits with other banks | (59) | 4 | (55) |
| Increase in interest income | $ 1,280 | $ 153 | $ 1,433 |
| | | | |
| Interest Bearing Liabilities: | | | |
| NOW and money market deposit accounts | $ 237 | $ 93 | $ 330 |
| Savings deposits | 1 | 2 | 3 |
| Time deposits | 292 | 102 | 394 |
| Short-term borrowings | 18 | 2 | 20 |
| Long term borrowings | (8) | 19 | 11 |
| Increase in interest expense | 540 | 218 | 758 |
| Increase (decrease) in net interest income | $ 740 | $ (65) | $ 675 |

***Provision for Loan Losses***

The provision for loan losses is an expense determined by management as the amount necessary to increase the allowance for loan losses after net charge-offs have been deducted to a level that, in management s best estimate, is necessary to absorb probable losses in the loan portfolio. The amount of the provision is based on management s review of the loan portfolio and consideration of such factors as historical loss experience, general prevailing economic conditions, changes in the size and composition of the loan portfolio and specific borrower considerations, including the ability of the borrower to repay the loan and the estimated value of the underlying collateral. The provision is calculated monthly and a charge or credit to expense is made, as required, to adjust the allowance to the calculated level.

For the three months ended June 30, 2007, the Bank made $75,000 in provisions for loan losses, compared to $90,000 for the three months ended June 30, 2006. For the three months ended June 30, 2007, the Bank charged off $7,000 in commercial and consumer loans and had recoveries of loans previously charged-off of $3,000 for net charge-offs of $4,000. For the three months ended June 30, 2006, the Bank charged off $12,000 in commercial and consumer loans and had recoveries of loans previously charged-off of $1,000 for net charge-offs of $11,000. The factors combined increased the Allowance for Loan Losses to $717,000 or 0.91% of the portfolio at June 30, 2007 as compared to 0.91% at September 30, 2006. This amount represents management s estimate of probable losses inherent in the portfolio. For the nine months ended June 30, 2007 and June 30, 2006, the provision for loan losses was $220,000 and $180,000, respectively. For the nine months ended June 30, 2007, the Bank charged-off $58,000 in commercial and consumer loans and had recoveries of loans previously charged-off of 5,000 for a net charge-off of $53,000. For the nine months ended June 30, 2006, the Bank charged-off $22,000 in commercial and consumer loans and had recoveries of loans previously charged-off of $2,000 for a net charge-off of $20,000.

***Other Income***

For the three months ended June 30, 2007, other income decreased $40,000 from $144,000 during the three months ended June 30, 2006, to $104,000. The majority of the decrease was related to the decrease in sublease income in PGI Equity Partners, LP. For the nine months ended June 30, 2007, other income decreased $76,000 from $385,000 during the nine months ended June 30, 2006 to $309,000. The decrease also was due to the decrease in sublease income.

***Non-Interest Expenses***

For the three months ended June 30, 2007, salaries and employee benefits were $691,000 compared to $420,000 for the three months ended June 30, 2006. The increase in salaries and employee benefits was due to the Bank s continued growth and new branch openings and the corresponding addition of new employees. Stock based compensation recognized for the three months ended June 30, 2007 totaled $92,000. Occupancy and equipment expenses for the three months ended June 30, 2007 decreased from $109,000 for the three months ended June 30, 2006 to $84,000. Professional fees paid for accounting and legal services, including regulatory filings and audit services, totaled $76,000 and $63,000, respectively, for the three months ended June 30, 2007 and 2006. The increase was due to an increase in expense for professional tax and consulting fees. Other expenses increased from $268,000 for the three months ended June 30, 2006, to $367,000 for the three months ended June 30, 2007. This increase in other expenses was also a result of the growth of the Bank and the increase in employees and the start-up expenses for the opening of the branch in Marble Falls.

***Income Taxes***

No federal tax benefit has been recorded for the three and nine months ended June 30, 2007, based upon net operating losses incurred and carried forward in previous years. Because of the Company s limited operating history, the federal tax benefit of the cumulative losses has been fully reserved against. The Company has now achieved profitability for the previous six quarters and therefore, the Company continues to evaluate whether the trend of profitable operations supports the recording of federal tax benefits in a subsequent quarter. However, due to the uncertainties in the current interest rate environment, the start-up costs associated with the Company s branch expansion and the costs necessary to implement Sarbanes-Oxley Section 404 compliance in the next fiscal year, the

Company believes a valuation allowance is warranted and will continue to monitor and evaluate the need for a valuation allowance.

**Financial Condition**

***Loan Portfolio***

Net loans increased $18,381,000 (30.8%) to $78,001,000 from $59,620,000 between June 30, 2007 and September 30, 2006. The concentration within the portfolio has shifted over time from the previous concentration of agricultural loans to real estate and commercial loans.

***Loan Portfolio Mix***

The following tables set forth the composition of the loan portfolio (in thousands):

| | As of June 30, 2007 | | As of September 30, 2006 | |
|---|---|---|---|---|
| Agriculture | $ 2,758 | | $ 2,989 | |
| Commercial | 28,451 | | 19,068 | |
| Commercial real estate | 18,129 | | 18,582 | |
| Residential real estate | 9,079 | | 8,221 | |
| Construction real estate | 13,940 | | 4,329 | |
| Consumer and other | 6,361 | | 6,981 | |
| Gross Loans | 78,718 | | 60,170 | |
| Less: allowance for loan losses | (717 | ) | (550 | ) |
| Net Loans | $ 78,001 | | $ 59,620 | |

Loan concentrations are considered to exist when there are amounts loaned to a multiple number of borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions.

For the three month and nine month periods ended June 30, 2007, the majority of new loan growth came from the Austin market reflecting a broader, more diverse mix of industries and borrowers.

Management may renew loans at maturity when requested by a customer whose financial strength appears to support such a renewal or when such a renewal appears to be in the best interest of the Bank. The Bank requires payment of accrued interest in such instances and may adjust the rate of interest, require a principal reduction, or modify other terms of the loan at the time of renewal.

***Loan Maturities***

The following table presents the contractual maturity ranges for agricultural, commercial, real estate and consumer loans outstanding at June 30, 2007, and at September 30, 2006, and also presents for each maturity range the portion of loans that have fixed interest rates or interest rates that fluctuate over the life of the loan in accordance with changes in the interest rate environment as represented by the base rate (in thousands):

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| June 30, 2007 | Due in One Year or Less Fixed Rate | Floating Rate | Due after One Year Through Five Years Fixed Rate | Floating Rate | Due after Five Years Fixed Rate | Floating Rate | Total |
|---|---|---|---|---|---|---|---|
| Agricultural | $ 33 | $ 1,687 | $ | $ 551 | $ | $ 487 | $ 2,758 |
| Real estate residential | 1,470 | 2,205 | 1,888 | 2,312 | 1,204 | | 9,079 |
| Real estate commercial | 201 | 7,841 | 284 | 8,819 | | 984 | 18,129 |
| Real estate construction | 1,001 | 5,039 | 181 | 6,251 | | 1,468 | 13,940 |
| Commercial | 2,302 | 14,813 | 1,114 | 10,216 | | 6 | 28,451 |
| Consumer and other | 421 | 4,510 | 757 | 634 | 18 | 21 | 6,361 |
| **Total** | $ 5,428 | $ 36,095 | $ 4,224 | $ 28,783 | $ 1,222 | $ 2,966 | $ 78,718 |

| September 30, 2006 | Due in One Year or Less Fixed Rate | Floating Rate | Due after One Year Through Five Years Fixed Rate | Floating Rate | Due after Five Years Fixed Rate | Floating Rate | Total |
|---|---|---|---|---|---|---|---|
| Agricultural | $ 6 | $ 2,137 | $ | $ 342 | $ | $ 504 | $ 2,989 |
| Real estate residential | 163 | 2,635 | 1,976 | 1,914 | 1,533 | | 8,221 |
| Real estate commercial | 323 | 3,335 | 258 | 9,928 | | 4,738 | 18,582 |
| Real estate construction | 1,049 | 202 | 1,013 | 2,065 | | | 4,329 |
| Commercial | 173 | 12,118 | 1,589 | 5,050 | 27 | 111 | 19,068 |
| Consumer and other | 559 | 5,166 | 652 | 550 | 31 | 23 | 6,981 |
| **Total** | $ 2,273 | $ 25,593 | $ 5,488 | $ 19,849 | $ 1,591 | $ 5,376 | $ 60,170 |

As of June 30, 2007, 52.7% of the loan portfolio, or $41,523,000, matures within one year or less and $67,844,000 of the loan portfolio, or 86.2%, are variable rate loans. At September 30, 2006, 46.3% of the loan portfolio or $27,866,000, matured within one year or less and $57,818,000 of these loans, or 84.5%, were variable rate loans.

***Investment Securities***

The primary purposes of the investment portfolio are to provide a source of earnings for liquidity management purposes, to provide collateral to pledge against public deposits, and to control interest rate risk. In managing the portfolio, the Bank seeks to attain the objectives of safety of principal, liquidity, diversification, and maximized return on investment.

The following tables set forth the amortized cost and fair value of the Bank s securities portfolio by accounting classification category and by type of security as indicated (in thousands) as of June 30, 2007 and September 30, 2006:

| | As of June 30, 2007 Amortized Cost | Fair Value | As of September 30, 2006 Amortized Cost | Fair Value |
|---|---|---|---|---|
| Securities Available for Sale: | | | | |
| U.S. Government Agencies | $ 9 | $ 9 | $ 14 | $ 14 |
| Other mortgage backed securities | 2 | 2 | 2 | 2 |
| Total Securities Available for Sale | $ 11 | $ 11 | $ 16 | $ 16 |
| | | | | |
| Securities Held to Maturity: | | | | |
| U.S. Government Agencies | $ 1,446 | $ 1,446 | $ 2,000 | $ 1,996 |
| Other mortgage backed securities | 5 | 4 | 6 | 5 |
| | | | | |
| Total Securities Held to Maturity | $ 1,451 | $ 1,450 | $ 2,006 | $ 2,001 |

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U.S. Treasury securities and securities of U.S. Government agencies generally consist of fixed rate securities with maturities of three months to five years. Other mortgage backed securities consists of fixed rate mortgage pass-through securities with a maturity of five to fifteen years.

***Asset Quality***

The following table sets forth the amount of non-performing loans and non-performing assets as of June 30, 2007, and September 30, 2006 (in thousands except for percentages):

| | As of June 30, 2007 | | | As of September 30, 2006 | | |
|---|---|---|---|---|---|---|
| Non-accruing loans | $ | 95 | | $ | 123 | |
| Loans 90 days or more past due, still accruing interest | | | | | | |
| | | | | | | |
| Total non-performing loans | 95 | | | 123 | | |
| Other real estate owned | 76 | | | 41 | | |
| Other repossessed assets | 1 | | | 5 | | |
| | | | | | | |
| Total non-performing assets | $ | 172 | | $ | 169 | |
| | | | | | | |
| Total non-performing loans to total loans | 0.22 | | % | 0.20 | | % |
| Allowance for loan losses to non-performing loans | 417 | | % | 447 | | % |
| Total non-performing assets to total assets | 0.15 | | % | 0.17 | | % |

***Non-performing Loans***

Non-performing loans include (1) loans accounted for on a non-accrual basis, (2) accruing loans contractually past due 90 days or more as to interest and principal, and (3) troubled debt restructurings. Management reviews the loan portfolio for problem loans on an ongoing basis.

During the ordinary course of business, management becomes aware of borrowers that may not be able to meet the contractual requirements of loan agreements. Such loans are placed under close supervision with consideration given to placing the loan on a non-accrual status, increasing the allowance for loan losses, and (if appropriate) partial or full charge-off. After a loan is placed on non-accrual status, any current year interest previously accrued but not yet collected is reversed against current income. When payments are received on non-accrual loans, such payments are applied to principal and not taken into income. Loans are not placed back on accrual status unless all back interest and principal payments are made. If interest on non-accrual loans had been accrued, such income would have amounted to approximately $1,400 for the three months ended June 30, 2007 and $2,600 for the three months ended June 30, 2006. This amount was not included in interest income during this period.

Under Federal and Texas law, any loan 90 or more days past due is required to be placed on non-accrual basis unless specifically identified mitigating circumstances exist. Our policy is to place loans 90 days past due on non-accrual status. An exception is made when management believes the loan is fully secured and in process of collection. Non-accrual loans are further classified as impaired when underlying collateral is not sufficient to cover the loan balance and it is probable that we will not fully collect all principal and interest. As of June 30, 2007 and September 30, 2006, we had $95,000 and $123,000 in non-accrual loans, respectively. There were no loans contractually past due over 90 days which continued to accrue interest on June 30, 2007 and September 30, 2006, based upon specific information available at that time to management. In compliance with these statutes, we have developed pro forma financial statements assuming that no loans will continue to accrue interest if they become 90 days past due, and instead transfer all such loans to non-accruing status.

A troubled debt restructuring is a restructured loan upon which interest accrues at a below market rate or upon which certain principal has been forgiven so as to aid the borrower in the final repayment of the loan, with any interest previously accrued, but not yet collected, being reversed against current income. Interest is accrued based upon the new loan terms. There were no troubled debt restructurings outstanding as of June 30, 2007 and September 30, 2006.

Non-performing assets also consist of other repossessed assets and other real estate owned ( OREO ). OREO represents properties acquired through foreclosure or other proceedings and is recorded at the lower of cost or fair market value less the estimated cost of disposal. OREO is evaluated regularly to ensure that the recorded amount is supported by its current fair market value. Valuation allowances to reduce the carrying amount to fair market value less estimated costs of disposal are recorded as necessary. Revenues and expenses from the operations of OREO and changes in the valuation are included in other income and other expenses on the income statement. As of June 30, 2007, and September 30, 2006, we had $76,000 and $41,000, respectively, in other real estate owned. The property consists of three single family dwellings located in Texline and Dalhart, Texas. Repossessed assets totaled $1,000 and $5,000, respectively, at June 30, 2007 and September 30, 2006.

***Sources of Funds***

*General*

Deposits, short-term and long-term borrowings, loan and investment security repayments and prepayments, proceeds from the sale of securities, and cash flows generated from operations are the primary sources of our funds for lending, investing, and other general purposes. Loan repayments are a relatively predictable source of funds except during periods of significant interest rate declines, while deposit flows tend to fluctuate with prevailing interests rates, money markets conditions, general economic conditions, and competition.

*Deposits*

We offer a variety of deposit accounts with a range of interest rates and terms. Core deposits consist of checking accounts (non-interest bearing), NOW accounts, money market accounts, savings accounts, and non-public certificates of deposit. These deposits, along with public fund deposits and short-term borrowings, are used to support our asset base. Deposits are obtained predominantly from the geographic trade areas surrounding our office locations. We rely primarily on customer service and long-standing relationships with customers to attract and retain deposits; however, market interest rates and rates offered by competing financial institutions significantly affect our ability to attract and retain deposits. As the competition for deposits has increased, we have continued to expand and diversify the Bank s funding sources. For the three months and nine months ended June 30, 2007, we have increased institutional deposits to ensure adequate funding of our loan growth.

The following table sets forth the maturities of time deposits $100,000 and over as of June 30, 2007, and September 30, 2006 (in thousands):

| | As of June 30, 2007 | | As of September 30, 2006 | |
|---|---|---|---|---|
| Time deposits $100,000 and over: | | | | |
| Maturing within three months | $ | 9,822 | $ | 1,949 |
| After three months but within six months | 2,281 | | 3,982 | |
| After six months but within 12 months | 3,198 | | 3,058 | |
| After 12 months | 1,412 | | | |
| | | | | |
| Total time deposits $100,000 and over | $ | 16,713 | $ | 8,989 |

*Return on Equity and Assets*

The following table sets forth certain information regarding the Company s return on equity and assets for the periods indicated:

| | For the Three Months Ended June 30, 2007 | | June 30, 2006 | | For the Nine Months Ended June 30, 2007 | | June 30, 2006 | |
|---|---|---|---|---|---|---|---|---|
| Return on assets | 0.06 | % | 0.18 | % | 0.21 | % | 0.11 | % |
| Return on equity | 0.45 | % | 1.20 | % | 1.60 | % | 0.75 | % |
| Dividend payout ratio | 0 | % | 0 | % | 0 | % | 0 | % |
| Equity to assets ratio | 13.36 | % | 15.02 | % | 13.36 | % | 15.02 | % |

**Capital Resources**

In connection with the Company s initial public offering on May 7, 2004, we issued approximately 315,000 of warrants to purchase registered common stock at an exercise price of $10 per share, with an expiration date of June 30, 2007. A total of approximately 175,000 warrants were exercised prior to the expiration date resulting in an increase in the Company s capital of $1,750,000. During the three months ended June 30, 2007, 168,265 warrants were exercised, thereby increasing the Company s capital by $1,682,650. The unexercised warrants expired as of June 30, 2007. The capital from the warrants will be used to support the continued growth of the Bank.

The risk-based capital regulations established and administered by the banking regulatory agencies discussed previously are applicable to the Bank. Risk-based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks, to account for off-balance sheet exposure, and to minimize disincentives for holding liquid assets. Under the regulations, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk weighted assets and off-balance sheet items. Under the prompt corrective action regulations, to be adequately capitalized a bank must maintain minimum ratios of total capital to risk-weighted assets of 8.00%, Tier 1 capital to risk-weighted assets of 4.00%, and Tier 1 capital to total assets of 4.00%. Failure to meet these capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank s financial statements.

As of June 30, 2007 and as of September 30, 2006, the most recent notifications from the federal Banking regulators categorized the Bank as well-capitalized. A well-capitalized institution must maintain a minimum ratio of total capital to risk-weighted assets of at least 10.00%, a minimum ratio of Tier 1 capital to risk weighted assets of at least

6.00%, and a minimum ratio of Tier 1 capital to total assets of at least 5.00% and must not be subject to any written order, agreement, or directive requiring it to meet or maintain a specific capital level. There are no conditions or events since that notification that the Bank s management believes have changed the capital classification.

The Bank was in full compliance with all applicable capital adequacy requirements as of June 30, 2007 and September 30, 2006. The required and actual amounts and ratios for the Bank as of June 30, 2007 and September 30, 2006, are presented below:

| | Actual Amount | Ratio | | For Capital Adequacy Purposes Amount | Ratio | | To Be Well Capitalized Under Prompt Corrective Action Provisions Amount | Ratio | |
|---|---|---|---|---|---|---|---|---|---|
| As of June 30, 2007 | | | | | | | | | |
| Tier 1 capital (to average assets) | $ 8,878 | 9.49 | % | $ 3,742 | 4 | % | $ 4,678 | 5 | % |
| Tier 1 capital (to risk-weighted assets) | 8,878 | 10.18 | % | 3,490 | 4 | % | 5,234 | 6 | % |
| Total Capital (to risk-weighted assets) | 9,595 | 11.00 | % | 6,979 | 8 | % | 8,724 | 10 | % |

| | Actual | | | For Capital Adequacy Purposes | | | To Be Well Capitalized Under Prompt Corrective Action Provisions | | |
|---|---|---|---|---|---|---|---|---|---|
| As of September 30, 2006 | | | | | | | | | |
| Tier 1 capital (to average assets) | $ 8,213 | 11.07 | % | $ 2,967 | 4 | % | $ 3,709 | 5 | % |
| Tier 1 capital (to risk-weighted assets) | 8,213 | 11.39 | % | 2,885 | 4 | % | 4,328 | 6 | % |
| Total Capital (to risk-weighted assets) | 8,763 | 12.15 | % | 5,771 | 8 | % | 7,213 | 10 | % |

**Item 3.** ***Controls and Procedures***

With the participation of management, the Company s chief executive officer and chief financial officer reviewed and evaluated the Company s disclosure controls and procedures as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (the Exchange Act ), as of the end of the period covered by this report. Based on this evaluation, the chief executive officer and chief financial officer concluded that the disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported to the Company s management within the time periods specified in the Securities and Exchange Commission s rules and forms.

There have been no significant changes in the Company s internal controls for financial reporting or in other factors that could significantly affect these controls, including any significant deficiencies or material weaknesses of internal controls that would require corrective action. In connection with the new rules, the Company is currently in the process of further reviewing and documenting its disclosure controls and procedures, including its internal accounting controls, and may from time to time make changes aimed at enhancing their effectiveness and ensuring that the Company s systems evolve with its business.

**PART II.** **Other Information**

**Item 1.** ***Legal Proceedings***

None

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

On May 7, 2004, the Securities and Exchange Commission declared our Registration Statement on Form SB-2 (File No. 333-112325) related to our initial public offering effective. In addition, on October 22, 2004, we filed a Form SB-2MEF under Rule 462 registering additional shares of common stock and warrants to purchase our common stock under our public offering. We registered a total of 1,944,000 shares of our common stock, of which 324,000 shares are issuable under registered common stock warrants. We accepted subscriptions for 1,589,602 shares of our common stock under the offering and have received net offering proceeds (after deducting offering expenses) of approximately $11.9 million.

From the offering proceeds, we paid our organizing shareholder and affiliate, Treaty Oak Holdings, Inc. ( TOHI ) for reimbursement of expenses and advances on our behalf in connection with our offering and repayment of the amount due under a convertible promissory note. TOHI owned approximately 39% of our common stock, but was acquired by us in a transaction that closed on November 15, 2006. We contributed to the capital of the Bank and paid operating expenses including repayment of certain costs previously paid by TOHI. We also repaid principal and interest under unsecured promissory notes issued in connection with the purchase price of the Bank, and have paid ongoing operating expenses. These payments are summarized in the table below:

| | **As of June 30, 2007** |
|---|---|
| Gross proceeds from sale of shares | $ 13,276,271 |
| Gross proceeds from exercise of warrants | 1,522,600 |
| Amounts receivable as of December 31, 2004 | |
| Repayment of offering and start-up costs under Expense Reimbursement Agreement to Treaty Oak Holdings, Inc., including offering costs of $500,000 and pre-opening expenses of $275,000 | (775,000) |
| Repayment of note payable to Treaty Oak Holdings, Inc., including accrued interest of approximately $7,000 | (507,302) |
| Repayment of notes payable for the acquisition of Texline State Bank including accrued interest of approximately $29,000 | (1,015,332) |
| Contribution to the capital of the Bank | (7,500,000) |
| Payments to directors and officers (bonuses and directors fees) | (202,368) |
| Payments to officers (salary and benefits) | (337,108) |
| Other payments to affiliates for services | (149,057) |
| Limited partnership investment in affiliated limited partnership | (1,030,000) |
| Loan to affiliated company | (46,037) |
| Repurchase of shares issued | (50,005) |
| Payment of additional operating expenses (estimated) | (1,030,200) |
| Remaining net proceeds | $ 2,156,462 |

In connection with the Company s initial registered public offering on May 7, 2004, we issued warrants to purchase approximately 315,000 shares common stock at an exercise price of $10 per share, with an expiration date of June 30, 2007. A total of approximately 175,000 warrants were exercised prior to the expiration date resulting in a total increase in the Company s capital of $1,750,000. Of the total warrants exercised, $1,522,600 of the proceeds

had been received in cash by June 30, 2007. The unexercised warrants expired as of June 30, 2007. The capital from the warrants will be used to support the continued growth of the Bank.

**Item 3.** ***Defaults Upon Senior Securities***

**None.**

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

None.

**Item 5.** ***Other Information***

None.

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

| Exhibit Number | **Exhibit Title** |
|---|---|
| 2.1(1) | Agreement and Plan of Merger, dated October 3, 2006, between Treaty Oak Holdings, Inc. and the Company |
| 3.1(2) | Amended and Restated Articles of Incorporation |
| 3.2(3) | By-laws |
| 4.1(3) | Specimen Common Stock Certificate, $.01 par value per share |
| 4.2(3) | See Exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and By-laws defining rights of holders of Common Stock |
| 31.1 | Certification of Chief Executive Officer required by Rule 13a-14(a)/15d-14(a) under the Exchange Act** |
| 31.2 | Certification of Chief Financial Officer required by Rule 13a-14(a)/15d-14(a) under the Exchange Act** |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002** |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002** |

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(1) Incorporated by reference to the Company s Current Report on Form 8-K filed October 10, 2006.

(2) Incorporated by reference to the Company s Registration Statement on Form S-8 filed October 22, 2004.

(3) Incorporated by reference to the same numbered exhibit to the Company s Registration Statement on Form SB-2.

** Filed herewith.

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**SIGNATURES**

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

**TREATY OAK BANCORP, INC.**

| | | |
|---|---|---|
| Dated: August 13, 2007 | By: | /s/ Jeffrey L. Nash<br>Jeffrey L. Nash, President and Chief Executive Officer |
| | By: | /s/ Coralie S. Pledger<br>Coralie S. Pledger, Chief Financial Officer |