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SOUTHERN CONNECTICUT BANCORP INC  
Form 10QSB  
November 15, 2004

U. S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

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F O R M 10 - QSB

Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended September 30, 2004

Commission file number 0-49784

SOUTHERN CONNECTICUT BANCORP, INC.  
(Name of Small Business Issuer as Specified in Its Charter)

Connecticut  
(State or Other Jurisdiction  
of Incorporation or Organization)

06-1609692  
(I.R.S. Employer  
Identification Number)

215 Church Street  
New Haven, Connecticut 06510  
(Address of Principal Executive Offices)

(203) 782-1100  
(Issuer's Telephone Number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months, and (2) has been subject to such filing requirements for the past 90 days.  
YES  No

The number of shares of the issuer's Common Stock, par value \$.01 per share, outstanding as of October 19, 2004: 2,797,711

Transitional Small Business Disclosure Format

Yes  No

Table of Contents  
Part I  
Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets as of  
September 30, 2004 (unaudited) and December 31, 2003

Consolidated Statements of Operations  
for the three months and nine months ended September 30, 2004  
and 2003 (unaudited)

Consolidated Statements of Changes in  
Shareholders' Equity for the nine months ended  
September 30, 2004 and 2003 (unaudited)

Consolidated Statements of Cash Flows for the nine months ended  
September 30, 2004 and 2003 (unaudited)

Notes to Consolidated Financial Statements (unaudited)

Item 2. Management's Discussion and Analysis or Plan of Operation

Item 3. Controls and Procedures

Part II  
Other Information

Item 1. Legal Proceedings

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

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits and Reports on Form 8-K

Signatures

Exhibit Index

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## Item 1. Financial Statements

SOUTHERN CONNECTICUT BANCORP, INC.

CONSOLIDATED BALANCE SHEETS

September 30, 2004 (unaudited) and December 31, 2003

|   | 2004          | 2003          |
|---|---------------|---------------|
|   | -----         | -----         |
| <b>Assets</b>   |               |               |
| Cash and due from banks   | \$ 255,658    | \$ 1,147,883  |
| Federal funds sold  | 6,350,000     | 966,000       |
| Short-term investments  | 3,203,563     | 454,115       |
|   | -----         | -----         |
| Cash and cash equivalents   | 9,809,221     | 2,567,998     |
|   | -----         | -----         |
| Available for sale securities, at fair value  | 14,536,086    | 8,478,068     |
| Federal Home Loan Bank Stock  | 47,100        | 21,500        |
| Loans receivable (net of allowance for loan losses of<br>\$521,283 in 2004 and \$421,144 in 2003)                             | 50,507,560    | 40,818,718    |
| Loans held for sale, at fair value  | 1,206,348     | --            |
| Accrued interest receivable   | 270,781       | 196,545       |
| Premises and equipment, net   | 3,355,702     | 3,459,915     |
| Other assets  | 986,156       | 843,296       |
|   | -----         | -----         |
| Total assets  | \$ 80,718,954 | \$ 56,386,040 |
|   | =====         | =====         |
| <br><b>Liabilities and Shareholders' Equity</b>   |               |               |
| <b>Liabilities</b>  |               |               |
| <b>Deposits</b>   |               |               |
| Noninterest bearing deposits  | \$ 14,803,852 | \$ 13,781,286 |
| Interest bearing deposits   | 42,076,931    | 33,492,589    |
|   | -----         | -----         |
| Total deposits  | 56,880,783    | 47,273,875    |
| Repurchase agreements   | 1,563,888     | 339,752       |
| Accrued expenses and other liabilities  | 275,159       | 267,232       |
| Capital lease obligations   | 1,190,230     | 1,190,879     |
|   | -----         | -----         |
| Total liabilities   | 59,910,060    | 49,071,738    |
|   | -----         | -----         |
| Commitments and Contingencies   | --            | --            |
| <br><b>Shareholders' Equity</b>   |               |               |
| Preferred stock, no par value; 500,000 shares authorized;<br>none issued  |               |               |
| Common stock, par value \$.01; 5,000,000, shares authorized;<br>shares issued and outstanding: 2004 2,797,711; 2003 1,063,320 | 27,977        | 10,633        |
| Additional paid-in capital  | 24,085,612    | 10,704,269    |
| Accumulated deficit   | (3,097,900)   | (3,100,842)   |
| Accumulated other comprehensive loss - net unrealized<br>loss on available for sale securities                                | (206,795)     | (299,758)     |
|   | -----         | -----         |
| Total shareholders' equity  | 20,808,894    | 7,314,302     |
|   | -----         | -----         |
| Total liabilities and shareholders' equity  | \$ 80,718,954 | \$ 56,386,040 |
|   | =====         | =====         |

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See Notes to Consolidated Financial Statements

1

SOUTHERN CONNECTICUT BANCORP, INC.  
 CONSOLIDATED STATEMENTS OF OPERATIONS

For the Three Months and Nine Months Ended September 30, 2004 and 2003 (unaudited)

|   | Three Months Ended<br>September 30 |            | Nine<br>Se |
|---|------------------------------------|------------|------------|
|   | 2004                               | 2003       | 2          |
| Interest Income   | -----                              | -----      | -----      |
| Interest and fees on loans                                | \$ 871,221                         | \$ 577,882 | \$ 2,548   |
| Interest on securities                                    | 86,739                             | 66,218     | 190        |
| Interest on federal funds sold and short-term investments | 30,993                             | 6,935      | 64         |
|   | -----                              | -----      | -----      |
| Total interest income                                     | 988,953                            | 651,035    | 2,802      |
|   | -----                              | -----      | -----      |
| Interest Expense  |                                    |            |            |
| Interest on deposits                                      | 144,212                            | 91,468     | 451        |
| Interest on capital lease obligations                     | 42,843                             | 42,268     | 128        |
| Interest on repurchase agreements                         | 2,048                              | 1,117      | 5          |
|   | -----                              | -----      | -----      |
| Total interest expense                                    | 189,103                            | 134,853    | 585        |
|   | -----                              | -----      | -----      |
| Net interest income                                       | 799,850                            | 516,182    | 2,216      |
| Provision for Loan Losses                                 | 56,900                             | 57,100     | 117        |
| Net interest income after                                 |                                    |            |            |
| provision for loan losses                                 | -----                              | -----      | -----      |
|   | 742,950                            | 459,082    | 2,098      |
|   | -----                              | -----      | -----      |
| Noninterest Income:                                       |                                    |            |            |
| Service charges and fees                                  | 88,017                             | 39,383     | 233        |
| Gains and fees from sales and referrals of SBA loans      | 14,930                             | --         | 231        |
| Gains on sales of available for sale securities           | 4,856                              | --         | 3          |
| Other noninterest income                                  | 35,356                             | 32,353     | 146        |
|   | -----                              | -----      | -----      |
| Total noninterest income                                  | 143,159                            | 71,736     | 615        |
|   | -----                              | -----      | -----      |
| Noninterest Expense                                       |                                    |            |            |
| Salaries and benefits                                     | 472,050                            | 375,123    | 1,405      |
| Occupancy and equipment                                   | 123,410                            | 99,923     | 385        |

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|  |             |              |       |
|--|-------------|--------------|-------|
| Professional services                      | 109,459     | 62,519       | 289   |
| Data processing and other outside services | 70,831      | 53,617       | 209   |
| Advertising and promotional expense        | 33,949      | 27,160       | 68    |
| Forms, printing and supplies               | 17,141      | 13,012       | 61    |
| Other operating expenses                   | 112,201     | 110,689      | 292   |
|  | -----       | -----        | ----- |
| Total noninterest expenses                 | 939,041     | 742,043      | 2,711 |
|  | -----       | -----        | ----- |
| Net (loss) income                          | \$ (52,932) | \$ (211,225) | \$ 2  |
|  | =====       | =====        | ===== |
| Basic (Loss) Income per Share              | \$ (0.02)   | \$ (0.20)    | \$    |
|  | =====       | =====        | ===== |
| Diluted (Loss) Income per Share            | \$ (0.02)   | \$ (0.20)    | \$    |
|  | =====       | =====        | ===== |
| Dividends per Share                        | \$ --       | \$ --        | \$    |
|  | =====       | =====        | ===== |

See Notes to Consolidated Financial Statements.

2

SOUTHERN CONNECTICUT BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY For the Nine Months  
ended September 30, 2004 and 2003 (unaudited)

|   | Number<br>of Shares | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit |
|---|---------------------|-----------------|----------------------------------|------------------------|
|   | -----               | -----           | -----                            | -----                  |
| Balance December 31, 2002                                   | 966,667             | \$ 9,667        | \$ 10,705,382                    | \$ (2,502,915)         |
| Comprehensive Loss:   |                     |                 |                                  |                        |
| Net Loss  | --                  | --              | --                               | (623,873)              |
| Unrealized holding loss on<br>available for sale securities | --                  | --              | --                               | --                     |
| Total comprehensive loss                                    |                     |                 |                                  |                        |
|   | -----               | -----           | -----                            | -----                  |
| Balance September 30, 2003                                  | 966,667             | \$ 9,667        | \$ 10,705,382                    | \$ (3,126,788)         |
|   | =====               | =====           | =====                            | =====                  |

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|   |           |           |               |                |
|---|-----------|-----------|---------------|----------------|
| Balance December 31, 2003                                   | 1,063,320 | \$ 10,633 | \$ 10,704,269 | \$ (3,100,842) |
| Comprehensive Income:                                       |           |           |               |                |
| Net Income  | --        | --        | --            | 2,942          |
| Unrealized holding gain on<br>available for sale securities | --        | --        | --            | --             |
| Total comprehensive income                                  |           |           |               |                |
| Exercise of stock warrants                                  | 5,544     | 56        | 60,424        | --             |
| Exercise of stock options                                   | 5,847     | 58        | 45,137        |                |
| Issuance of common stock                                    | 1,723,000 | 17,230    | 13,275,782    | --             |
| Balance September 30, 2004                                  | 2,797,711 | \$ 27,977 | \$ 24,085,612 | \$ (3,097,900) |

See Notes to Consolidated Financial Statements.

3

SOUTHERN CONNECTICUT BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Nine Months Ended September 30, 2004 and 2003 (unaudited)

|   | Nine Months Ended<br>September 30, |             |
|---|------------------------------------|-------------|
|   | 2004                               | 2003        |
| Cash Flows From Operations  |                                    |             |
| Net income (loss)   | \$ 2,942                           | \$ (623,87) |
| Adjustments to reconcile net income (loss) to net<br>cash used in operating activities: |                                    |             |
| Amortization and accretion of premiums<br>and discounts on investments, net             | (459)                              | 22,21       |
| Provision for loan losses   | 117,895                            | 143,50      |
| Gain on sales of available for sale securities  | (3,912)                            | (44,40)     |
| Gains on sales of SBA loans   | (202,196)                          |             |
| Depreciation and amortization   | 210,915                            | 155,30      |
| Increase in cash surrender value of life insurance                                      | (20,251)                           | (8,63)      |
| Changes in assets and liabilities:  |                                    |             |
| Increase in deferred loan fees  | 51,640                             | 31,68       |
| Increase in accrued interest receivable   | (74,236)                           | (16,43)     |
| Increase in other assets  | (122,510)                          | (30,93)     |
| Increase in accrued expenses and other liabilities                                      | 7,927                              | 37,43       |
| Net cash used in by operating activities  | (32,245)                           | (334,14)    |
| Cash Flows From Investing Activities  |                                    |             |
| Purchases of available for sale securities  | (8,968,530)                        | (10,949,68) |

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|   |              |             |
|---|--------------|-------------|
| Principal repayments on available for sale securities     | 1,006,655    | 836,85      |
| Proceeds from maturities of available for sale securities | -            | 6,185,00    |
| Proceeds from sales of available for sale securities      | 2,001,191    | 4,357,89    |
| Purchases of Federal Home Loan Bank Stock                 | (25,600)     | (21,00)     |
| Proceeds from sales of SBA loans                          | 1,986,863    |             |
| Net increase in loans receivable                          | (12,965,905) | (16,455,16  |
| Purchases of premises and equipment                       | (106,702)    | (603,53     |
| Proceeds from sale of OREO                                | 116,414      |             |
|   | -----        | -----       |
| Net cash used in investing activities                     | (16,955,614) | (16,649,63  |
|   | -----        | -----       |
| Cash Flows From Financing Activities                      |              |             |
| Net increase in demand, savings and money market deposits | 9,803,625    | 14,328,98   |
| Net decrease in certificates of deposit                   | (196,717)    | 452,81      |
| Net increase in repurchase agreements                     | 1,224,136    | 336,41      |
| Principal payments on capital lease obligations           | (649)        | (76         |
| Net proceeds from common stock offering                   | 13,293,012   |             |
| Exercise of stock options and warrants                    | 105,675      |             |
|   | -----        | -----       |
| Net cash provided by financing activities                 | 24,229,082   | 15,117,44   |
|   | -----        | -----       |
| Net increase (decrease) in cash and cash equivalents      | 7,241,223    | (1,866,33   |
| Cash and cash equivalents                                 |              |             |
| Beginning   | 2,567,998    | 3,051,42    |
|   | -----        | -----       |
| Ending  | \$ 9,809,221 | \$ 1,185,09 |
|   | =====        | =====       |

See Notes to Consolidated Financial Statements.

4

SOUTHERN CONNECTICUT BANCORP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
For the Nine Months Ended September 30, 2004 and 2003 (unaudited)

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2004                               | 2003      |
|  | -----                              | -----     |
| Supplemental disclosures of cash flow information: |                                    |           |
| Cash paid during the period for:                   |                                    |           |
| Interest   | \$ 574,600                         | \$ 392,72 |
|  | =====                              | =====     |
| Income taxes                                       | \$ --                              | \$ --     |
|  | =====                              | =====     |

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Supplemental disclosures of noncash investing activities

|  |                      |                |
|--|----------------------|----------------|
| Transfer of Loans to OREO                | \$ 116,513<br>=====  | \$ --<br>===== |
| Transfer of Loans to loans held for sale | \$1,206,348<br>===== | \$ --<br>===== |

See Notes to Consolidated Financial Statements.

Southern Connecticut Bancorp, Inc.  
Notes to Consolidated Financial Statements  
(Unaudited)

Note 1. Nature of Operations

Southern Connecticut Bancorp, Inc. ("Bancorp"), a Connecticut corporation, is a bank holding company incorporated on November 8, 2000 for the purpose of forming, and becoming the sole shareholder of, The Bank of Southern Connecticut (the "Bank"). The Bank provides a full range of banking services to commercial and consumer customers, primarily concentrated in the New Haven County area of Connecticut, through its main office in New Haven, Connecticut and two branch offices in New Haven and Branford Connecticut. The Bank is a Small Business Administration lender, and generally sells participations in the guaranteed portion of such loans. In 2003, SCB Capital Inc. was formed as a Connecticut corporation, and in April 2004 Bancorp capitalized SCB Capital, Inc., which became a subsidiary of the Company. SCB Capital, Inc. will engage in a limited range of investment banking, advisory, and brokerage services, primarily with small to medium size business clients. On April 28, 2004, Bancorp received a temporary certificate of incorporation from the Banking Department of the State of Connecticut to open a new bank, to be named The Bank of Southeastern Connecticut, to be located in New London, Connecticut.

Note 2. Basis of Financial Statement Presentation

The consolidated balance sheet at December 31, 2003 has been derived from the audited consolidated financial statements of Bancorp at that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

The accompanying consolidated unaudited financial statements as of and for the three and nine months ended September 30, 2004 and 2003 and related notes have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Accordingly, certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the audited financial statements of Bancorp and notes thereto as of December 31, 2003.



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Certain 2003 amounts have been reclassified to conform with the 2004 presentation. Such reclassifications had no effect on the 2003 net loss.

The accompanying unaudited consolidated financial information reflects, in the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for a fair presentation of the interim periods presented. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results of operations that may be expected for all of 2004.

6

### Note 3. Available for Sale Securities

The amortized cost, gross unrealized gains, gross unrealized losses and approximate fair values of available for sale securities at September 30, 2004, and December 31, 2003 are as follows:

|                                    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
| <hr/>                              |                   |                              |                               |               |
| September 30, 2004                 |                   |                              |                               |               |
| U.S. Treasury Obligations          | \$ 5,998,497      | \$ 63                        | \$ --                         | \$ 5,998,560  |
| U.S. Government Agency Obligations | 8,193,273         | --                           | (195,815)                     | 7,997,458     |
| Mortgage Backed Securities         | 551,111           | --                           | (11,043)                      | 540,068       |
|                                    | <hr/>             |                              |                               |               |
|                                    | \$ 14,742,881     | \$ 63                        | \$ (206,858)                  | \$ 14,536,086 |
| <hr/>                              |                   |                              |                               |               |
| <hr/>                              |                   |                              |                               |               |
|                                    | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| <hr/>                              |                   |                              |                               |               |
| December 31, 2003                  |                   |                              |                               |               |
| U.S. Government Agency Obligations | \$ 7,200,948      | \$ --                        | \$ (269,550)                  | \$ 6,931,398  |
| Mortgage Backed Securities         | 1,576,878         | --                           | (30,208)                      | 1,546,670     |
|                                    | <hr/>             |                              |                               |               |
|                                    | \$ 8,777,826      | \$ --                        | \$ (299,758)                  | \$ 8,478,068  |
| <hr/>                              |                   |                              |                               |               |

At September 30, 2004, gross unrealized holding losses on available for sale securities totaled \$206,858. Of the securities with unrealized losses, there are two mortgage backed and eight U.S. Government agency securities that had unrealized losses for a period in excess of twelve months with a current unrealized loss of \$200,296. Management does not believe that any of the unrealized losses are other than temporary as they relate to debt and mortgage-backed securities issued by U. S. Government and U.S. Government sponsored agencies resulting from changes in the interest rate environment. Bancorp has the intent and ability to hold these securities to maturity if

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necessary and expects to receive all contractual principal and interest related to these investments. As a result, management believes that these unrealized losses will not have a negative impact on future earnings or a permanent effect on capital.

At December 31, 2003, gross unrealized holding losses on available for sale securities totaled \$299,758. Of the securities with unrealized losses, there are no securities that had unrealized losses for a period in excess of twelve months.

7

### Note 4. Loans Receivable

A summary of Bancorp's loan portfolio at September 30, 2004 and December 31, 2003 is as follows:

|   | September 30, 2004 | December 31, 2003 |
|---|--------------------|-------------------|
|   | -----              | -----             |
| Commercial loans secured by real estate   | \$ 30,142,357      | \$ 18,043,588     |
| Commercial loans  | 17,424,420         | 18,584,292        |
| Construction and land loans, net of undisbursed<br>portion of \$254,500 in 2004 and \$729,220 in 2003 | 1,733,179          | 1,500,891         |
| Residential mortgages   | 55,965             | 948,258           |
| Consumer home equity loans  | 1,109,523          | 1,042,717         |
| Consumer installment loans  | 699,843            | 1,204,920         |
|   | -----              | -----             |
| Total loans   | 51,165,287         | 41,324,666        |
| Net deferred loan fees  | (136,444)          | (84,804)          |
| Allowance for loan losses   | (521,283)          | (421,144)         |
|   | -----              | -----             |
| Loans receivable, net   | \$ 50,507,560      | \$ 40,818,718     |
|   | =====              | =====             |

### Note 5. Deposits

At September 30, 2004 and December 31, 2003, deposits consisted of the following:

|                              | September 30, 2004 | December 31, 2003 |
|------------------------------|--------------------|-------------------|
|                              | -----              | -----             |
| Noninterest bearing deposits | \$ 14,803,852      | \$ 13,781,286     |
|                              | -----              | -----             |

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|  |               |               |
|--|---------------|---------------|
| Interest bearing deposits              |               |               |
| Checking                               | 8,829,196     | 3,499,378     |
| Money Market                           | 19,647,823    | 17,251,327    |
| Savings                                | 3,688,086     | 2,633,341     |
|  | -----         | -----         |
| Checking, money market & savings       | 32,165,105    | 23,384,046    |
|  | -----         | -----         |
| Time Certificates under \$100,000      | 3,301,116     | 3,057,294     |
| Time Certificates of \$100,000 or more | 6,610,710     | 7,051,249     |
|  | -----         | -----         |
| Time deposits                          | 9,911,826     | 10,108,543    |
|  | -----         | -----         |
|  | 42,076,931    | 33,492,589    |
|  | -----         | -----         |
| Total deposits                         | \$ 56,880,783 | \$ 47,273,875 |
|  | =====         | =====         |

8

Note 6. Available Borrowings

During 2003 Bancorp obtained secured and unsecured lines of credit with other financial institutions with total available borrowings of \$4,400,000. There are no borrowings against these lines of credit as of September 30, 2004.

Note 7. Income (Loss) Per Share

Bancorp is required to present basic income (loss) per share and diluted income (loss) per share in its statements of operations. Basic per share amounts are computed by dividing net income (loss) by the weighted average number of common shares outstanding. Diluted per share amounts assume exercise of all potential common stock in weighted average shares outstanding, unless the effect is antidilutive. Bancorp is also required to provide a reconciliation of the numerator and denominator used in the computation of both basic and diluted (loss) income per share. The following is information about the computation of (loss) income per share for the three and nine months ended September 30, 2004 and 2003.

Income (Loss) per Share

Three Months Ended September 30,

|   |             |           |           |       |
|---|-------------|-----------|-----------|-------|
|   | 2004        |           |           |       |
|   | -----       | -----     | -----     | ----- |
|   | Net         | Weighted  | Amount    | Ne    |
|   | Loss        | Average   | Per Share | Los   |
|   | -----       | Shares    | -----     | ----- |
| Basic Loss Per Share                    |             |           |           |       |
| Income available to common shareholders | \$ (52,932) | 2,793,389 | \$ (0.02) | \$ (2 |

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### Effect of Dilutive Securities

|  |             |           |           |        |
|--|-------------|-----------|-----------|--------|
| Warrants/Stock Options outstanding                               | -           | -         | -         |        |
|  |             |           |           |        |
| <b>Diluted Loss Per Share</b>                                    |             |           |           |        |
| Income available to common shareholders plus assumed conversions | \$ (52,932) | 2,793,389 | \$ (0.02) | \$ (2) |
|  |             |           |           |        |

Nine Months Ended September 30,

| 2004   |               |                               |                     |           |
|--|---------------|-------------------------------|---------------------|-----------|
|  | Net<br>Income | Weighted<br>Average<br>Shares | Amount<br>Per Share | Ne<br>Los |
|  |               |                               |                     |           |
| <b>Basic Income (Loss) Per Share</b>                             |               |                               |                     |           |
| Income available to common shareholders                          | \$ 2,942      | 1,734,522                     | \$ 0.00             | \$ (6)    |
| <b>Effect of Dilutive Securities</b>                             |               |                               |                     |           |
| Warrants/Stock Options outstanding                               | -             | 39,008                        | -                   |           |
|  |               |                               |                     |           |
| <b>Diluted Income (Loss) Per Share</b>                           |               |                               |                     |           |
| Income available to common shareholders plus assumed conversions | \$ 2,942      | 1,773,530                     | \$ 0.00             | \$ (6)    |
|  |               |                               |                     |           |

9

For the three months and nine months ended September 30, 2003, and the three months ended September 30, 2004, common stock equivalents have been excluded from the computation of the net loss per share because the inclusion of such equivalents is antidilutive.

### Note 8. Other Comprehensive Income (Loss)

Other comprehensive income (loss), which is comprised solely of the change in unrealized gains and losses on available for sale securities, is as follows:

|  | Nine Months Ended<br>September 30, 2004 |       |    |
|--|---|-------|----|
|  | Before-Tax<br>Amount                    | Taxes |    |
|  |   |       |    |
| Unrealized holding gains arising during the period                   | \$ 96,875                               | \$ -- | \$ |
| Less: Reclassification adjustment for gains recognized in net income | --<br>(3,912)                           | --    |    |

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|   | Nine Months Ended<br>September 30, 2003 |           |      |
|---|---|-----------|------|
|   | Before-Tax<br>Amount                    | Taxes     | N    |
| Unrealized holding gains on available for sale securities, net of taxes | \$ 92,963                               | \$ --     | \$   |
| Unrealized holding losses arising during the period                     | \$ (302,259)                            | \$ 34,783 | \$ ( |
| Less: Reclassification adjustment for gains recognized in net income    | (44,505)                                | 5,122     |      |
| Unrealized holding loss on available for sale securities, net of taxes  | \$ (346,764)                            | \$ 39,905 | \$ ( |

Note 9. Stock Based Compensation

During the nine months ended September 30, 2004, Bancorp granted 26,420 stock options to employees and directors at exercise prices ranging from \$8.45 to \$9.75 per share.

Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation", encourages all entities to adopt a fair value based method of accounting for employee stock compensation plans, whereby compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. However, it also allows an entity to continue to measure compensation cost for those plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," whereby compensation cost is the excess, if any, of the quoted market price of the stock at the grant date (or other measurement date) over the amount an employee must pay to acquire the stock. Stock options issued to employees and directors under Bancorp's stock option and warrant plans have no intrinsic value at the grant date, and under Opinion No. 25 no compensation cost is recognized

10

for them. Bancorp has elected to continue with the accounting methodology in Opinion No. 25 and, as a result, has provided pro forma disclosures of net loss and earnings per share and other disclosures, as if the fair value based method of accounting had been applied.

Had compensation cost for issuance of such options and warrants been recognized based on the fair values of awards on the grant dates, in accordance with the method described in SFAS No. 123, reported net income (loss) and per share amounts for the nine and three months ended September 30, 2004 and 2003

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would have differed from the pro forma amounts as shown below:

For the nine months ended September 30, 2004 and September 30, 2003

|   | Nine Months Ended<br>September 30, 2004 | Nine Months<br>September 30, 2003 |
|---|---|-----------------------------------|
| Net income (loss) as reported   | \$ 2,942                                | \$ (623)                          |
| Deduct: total stock based employee<br>compensation expense determined under fair value based<br>method for all awards | (232,943)                               | (155,000)                         |
| <br>Pro forma net loss  | <br>\$ (230,001)                        | <br>\$ (778)                      |
| <br>Basic income (loss) per share:  |   |                                   |
| As reported   | \$ 0.00                                 | \$ (0.01)                         |
| Pro forma   | \$ (0.13)                               | \$ (0.13)                         |
| <br>Diluted income (loss) per share:  |   |                                   |
| As reported   | \$ 0.00                                 | \$ (0.01)                         |
| Pro forma   | \$ (0.13)                               | \$ (0.13)                         |

For the three months ended September 30, 2004 and September 30, 2003

|   | Three Months Ended<br>September 30, 2004 | Three Months<br>September 30, 2003 |
|---|--|------------------------------------|
| Net loss as reported  | \$ (52,932)                              | \$ (211,000)                       |
| Deduct: total stock based employee<br>compensation expense determined under fair value based<br>method for all awards | (78,281)                                 | (72,000)                           |
| <br>Pro forma net loss  | <br>\$ (131,213)                         | <br>\$ (283,000)                   |
| <br>Basic loss per share:   |  |                                    |
| As reported   | \$ (0.02)                                | \$ (0.07)                          |
| Pro forma   | \$ (0.05)                                | \$ (0.05)                          |
| <br>Diluted loss per share:   |  |                                    |
| As reported   | \$ (0.02)                                | \$ (0.07)                          |
| Pro forma   | \$ (0.05)                                | \$ (0.05)                          |

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For the three and nine months ended September 30, 2004 and 2003, common stock equivalents have been excluded from the computation of the pro forma net loss per share because the inclusion of such equivalents is antidilutive.

11

### Note 10. Bank Application and Capital Raising

During 2003, Bancorp's Board of Directors approved the establishment of a new commercial bank in New London, Connecticut. In October 2003, Bancorp submitted its final application to the State of Connecticut Department of Banking related to the establishment of the new bank to be located in the city of New London. On April 28, 2004, the State of Connecticut Department of Banking issued a temporary certificate of authority in connection with this application. An application to the Federal Deposit Insurance Corporation was filed on July 30, 2004 and has been extended on October 13, 2004 in order to allow Bancorp to provide additional information regarding the infrastructure in place to support the two banks and to revise certain proposed policies of the new bank. Subject to applicable State and Federal agency regulatory approval and the issuance of a final certificate of authority from the State of Connecticut Department of Banking, Bancorp plans to open the new bank in the first quarter of 2005.

On June 17, 2004, Bancorp completed a public offering of its common stock with net proceeds of \$13.3 million after deduction of underwriter's discount and offering expenses. Bancorp issued 1,723,000 shares of common stock in connection with this offering. On June 17, 2004, Bancorp invested approximately \$2.8 million of the public offering proceeds in The Bank of Southern Connecticut. Bancorp has also committed to capitalize the new bank with \$6 million of the proceeds raised from this public offering.

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

In the normal course of business, Bancorp is a party to financial instruments with off-balance-sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit and involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the financial statements. The contractual amounts of these instruments reflect the extent of involvement Bancorp has in particular classes of financial instruments.

The contractual amounts of commitments to extend credit represent the amounts of potential accounting loss should: the contract be fully drawn upon; the customer default; and the value of any existing collateral become worthless. Bancorp uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet and evaluates each customer's creditworthiness on a case-by-case basis. Management believes that Bancorp controls the credit risk of these financial instruments through credit approvals, credit limits, monitoring procedures and the receipt of collateral as deemed necessary.

12

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Financial instruments whose contract amounts represent credit risk are as follows at September 30, 2004 and December 31, 2003:

|                                     | September 30,<br>2004 | December 31,<br>2003 |
|-------------------------------------|-----------------------|----------------------|
|                                     | -----                 | -----                |
| Commitments to extend credit        |                       |                      |
| Future loan commitments             | \$ 6,094,880          | \$ 3,752,000         |
| Unused line of credit               | 8,411,049             | 9,065,661            |
| Undisbursed construction loans      | 254,500               | 729,220              |
| Financial standby letters of credit | 1,058,055             | 933,055              |
|                                     | -----                 | -----                |
|                                     | \$15,818,484          | \$14,479,936         |
|                                     | =====                 | =====                |

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 to extend credit generally have fixed expiration dates or other termination clauses and may require payment of a fee by the borrower. Since these commitments could expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by Bancorp upon extension of credit, is based upon management's credit evaluation of the counter party. Collateral held varies, but may include residential and commercial property, deposits and securities.

Standby letters of credit are written commitments issued by Bancorp to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Newly issued or modified guarantees that are not derivative contracts have been recorded on Bancorp's books at their fair value at inception. The liability related to guarantees recorded at September 30, 2004 and December 31, 2003 was not significant.

13

### Item 2. Management's Discussion and Analysis or Plan of Operation

#### (a) Plan of Operation

##### Southern Connecticut Bancorp

Bancorp, a Connecticut corporation, was incorporated on November 8, 2000 to serve as a bank holding company for community based commercial banks. Bancorp is a bank holding company registered in accordance with the Bank Holding Company Act of 1956, as amended (the "BHC Act") and is regulated by and subject to the supervision of the Board of Governors of the Federal Reserve System ("Federal Reserve Board"). Bancorp owns one hundred percent of the capital stock of The Bank of Southern Connecticut ("Bank"), a Connecticut chartered bank headquartered in New Haven, Connecticut. The Bank commenced operations on October 1, 2001.

Bancorp's holding company structure provides organizational flexibility for its growth plans. Bancorp may in the future decide to engage in additional businesses permitted to bank holding companies and would form a subsidiary to provide these services. For example, Bancorp could acquire additional banks, establish de novo banks and other businesses, including mortgage companies,



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leasing companies, insurance agencies and small business investment companies, without having to go through a corporate reorganization. Before Bancorp could acquire interests in other banks, establish de novo banks or expand into other businesses, it will need to obtain relevant regulatory approvals.

De novo banks in Connecticut have reached profitability on average within three to four years after the commencement of operations. Bancorp was marginally profitable in the fourth quarter of 2003, the ninth quarter of operations, as well as profitable in the first two quarters of 2004. Profitability was achieved in these periods in part due to gains on sale of participations in Small Business Loan Administration ("SBA") by the Bank. The Bank originated SBA loans during the third quarter of 2004 but did not complete sales of participations during the period. SBA guaranteed loan balances of \$1,206,348 originated during the third quarter of 2004 are classified as held-for-sale on the accompanying balance sheet of Bancorp. Bancorp experienced a loss of \$52,932 in the third quarter of 2004 in part due to the absence of such sales. The profitable results of operations in the December 2003, March 2004 and June 2004 quarters are largely attributable to fee income and gains on sale derived from referrals and sales of SBA guaranteed loan participations. Bancorp intends to continue to originate and to sell at a profit participations in SBA guaranteed loans, including those currently classified as held-for-sale, in the future.

Bancorp's plan of operation is to continue to operate the Bank and increase its market share within the City of New Haven and the surrounding areas, and possibly offer certain additional banking services, such as internet based cash management services. Bancorp has received a Temporary Certificate of Authority from the Banking Commissioner of the State of Connecticut for a second, wholly owned community based commercial bank subsidiary to serve the New London, Connecticut market, called The Bank of Southeastern Connecticut. Bancorp intends to develop both the Bank's and The Bank of Southeastern Connecticut's geographic franchises with branch offices throughout the 45 miles of coastal communities located between

14

New Haven and New London Connecticut, and from New London to the Rhode Island border with Connecticut. Bancorp has applied to the Federal Deposit Insurance Corporation (the "FDIC") to insure the deposits of the new bank subsidiary. The application with the FDIC as of September 30, 2004 has been extended to permit Bancorp to provide additional information regarding the infrastructure in place to support the two banks and to revise certain proposed policies of the new bank. Bancorp is also required to apply to the Federal Reserve for approval. The Bank of Southeastern Connecticut is expected to open in the first quarter of 2005 and be staffed, managed and operated in a manner consistent with the Bank.

### Locations

Bancorp has leased a free-standing building located at 215 Church Street, New Haven, Connecticut, located in the central business and financial district of New Haven. It has assigned this lease to The Bank of Southern Connecticut, and the Bank has assumed all rights and obligations under this lease. Both Bancorp and the Bank operate from this facility. On October 7, 2002 the Bank opened a branch office in Branford, Connecticut at West Main Street and Summit Place. On August 15, 2002 the Bank also purchased a building at 1475 Whalley Avenue in the Westville section of New Haven for a branch office site which was opened on March 24, 2003. The Bank is also evaluating locations for

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the establishment of additional branch banking offices.

The following table sets forth the location of the Bank's branch offices and other related information:

| Office<br>----- | Location<br>-----                  | Square Feet<br>----- | Status<br>----- |
|-----------------|------------------------------------|----------------------|-----------------|
| Main Office     | 215 Church Street, New Haven, CT   | 11,306               | Leased          |
| Branford Office | 445 West Main Street, Branford, CT | 3,714                | Leased          |
| Amity Office    | 1475 Whalley Avenue, New Haven, CT | 2,822                | Owned           |

Bancorp entered into a lease on January 14, 2004 with the City of New London for a former banking facility located at 15 Masonic Street, New London, Connecticut. This facility is intended to be the main office of The Bank of Southeastern Connecticut. The Bank of Southeastern Connecticut is expected to be staffed, managed and operated in a manner consistent with the Bank.

On June 23, 2004, Bancorp, through a nominee, entered into an agreement to purchase an approximately one acre improved site with two buildings in Clinton, Connecticut for the primary purpose of establishing a branch office of the Bank. The net purchase price of the property is \$495,000. The entity under which title to the property will be ultimately held is to be determined. The Bank has filed applications to the Connecticut Department of Banking and the FDIC to establish bank operations at the Clinton location for the first quarter of 2005. Due to a delay in completing the acquisition of the Clinton property, the Bank's initial application to the FDIC to establish the Clinton branch has been withdrawn pending completion of the acquisition of the property. Bancorp intends that Bancorp or the Bank will improve the facility to

15

accommodate banking services. The costs of such improvements have not been fully determined at this time.

The Bank focuses on serving the banking needs of small and mid sized businesses, professionals and their employees. The Bank's target customer has up to \$30 million in revenues, up to 100 employees, and borrowing needs between \$250,000 and \$2 million. The Bank serves the greater New Haven marketplace and has a Board of Directors and management team drawn from the communities served, each of who is recognized and respected by the New Haven business community. The Bank's focus on the commercial market makes it uniquely qualified to move deftly in responding to the needs of its clients.

The Bank does not expect to compete with large institutions for the primary banking relationships of large corporations, but it competes for the small to medium-size businesses and for the consumer business of employees of such entities. The Bank's geographic market focus also provides a unique competitive advantage by clearly identifying the Bank as the independent local bank focused on commercial lending and other commercial banking services. The Bank's focus clients operate retail, service, wholesale distribution, manufacturing and international businesses. Many of these customers use the services of the Bank because of relationships and contacts with the Bank's directors and management. We believe that the Bank is successfully winning new business because of these relationships and a combination of a fair price for our services, quick decision processes and a high-touch level of personalized

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customer service.

### Lending, Depository and Other Products

The Bank currently has a wide range of "core" bank products and services offerings which are more completely described below. Additionally, through correspondent and other relationships, the Bank helps its customers meet all of their banking needs, including obtaining services which the Bank may not offer directly.

The Bank offers core deposit products, including checking accounts, money market accounts, savings accounts, sweep accounts, NOW accounts and a variety of certificates of deposit and IRA accounts to the public. To attract deposits, the Bank is employing an aggressive marketing plan in its service area and features a broad product line and rates and services competitive with those offered in the New Haven market and the surrounding communities. The primary sources of deposits have been and are expected to be businesses and their employees located in, and residents of, New Haven and the surrounding communities. The Bank is obtaining these deposits through personal solicitation by its officers and directors, outside programs and advertisements published and / or broadcasted in the local media.

Deposits and the Bank's equity capital are the sources of funds for lending and investment activities. Repayments on loans, investment income and proceeds from the sale and maturity of investment securities will also provide additional funds for these purposes. While scheduled principal repayments on loans and investment securities are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank expects to manage the pricing of deposits to maintain a desired deposit balance. The Bank offers drive-in teller services, wire transfers and safe deposit services.

16

The Bank's loan strategy is to offer a broad range of loans to businesses and individuals in its service area, including commercial and business loans, personal loans, mortgage loans, home equity loans, and automobile loans. The Bank has received lending approval status from the SBA to enable it to make SBA guaranteed loans to both the greater New Haven business community and companies throughout the State of Connecticut. The marketing focus on small to medium-size businesses and professionals may result in an assumption of certain lending risks that are different from or greater than those which would apply to loans made to larger companies or consumers. Commercial loans generally entail certain additional risks because repayment is usually dependent on the success of the enterprise. The Bank seeks to manage the credit risk inherent in its loan portfolio through credit controls, loan diversification and personal guarantees of the principal owners of these small to medium-sized businesses. Prior to approving a loan the Bank evaluates: the credit histories of potential borrowers; the value and liquidity of available collateral; the purpose of the loan; the source and reliability of funds for repayment and other factors considered relevant in the circumstances.

Loans are made on a variable or fixed rate basis with fixed rate loans limited to five-year terms. All loans are approved by the Bank's management and the Loan Committee of the Bank's Board of Directors. At the present time, the Bank is not syndicating or securitizing loans, however the Bank originates and sells individual SBA guaranteed loan participations. The Bank at times participates in multi-bank loans for companies in its service area. Commercial

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loans and commercial real estate loans may be written for terms of up to twenty years. Loans to purchase or refinance commercial real estate are collateralized by the subject real estate. Loans to local businesses are generally supported by the personal guarantees of the principal owners and are carefully underwritten to determine appropriate collateral and covenant requirements.

Other services provided currently or to be provided include cashier's checks, money orders, travelers checks, bank by mail, lock box, direct deposit and U. S. Savings Bonds. The Bank is associated with a shared network of automated teller machines that its customers are able to use throughout Connecticut and other regions. The Bank does not currently expect to offer trust services but may offer trust services through a joint venture with a larger institution. To offer trust services in the future, the Bank would need the approval of the Connecticut Banking Commissioner and the FDIC.

### Investment Securities

Another significant activity for the Bank is maintaining an investment portfolio. Although granting a variety of loans to generate interest income and loan fees is an important aspect of the Bank's business plan, the aggregate amount of loans will be subject to maintaining a prudent loan-to-deposit ratio. The Bank's overall portfolio objective is to maximize the long-term total rate of return through active management of portfolio holdings taking into consideration estimated asset/liability and liquidity needs, tax equivalent yields and maturities. Permissible investments include debt securities such as U. S. Government securities, government sponsored agency securities, municipal bonds, domestic certificates of deposit that are insured by the FDIC, mortgage-backed securities and collateralized mortgage obligations. The Bank expects that investments in equity securities will be very limited. The Bank's current investment portfolio is limited to U. S. government and agency obligations and agency issue collateralized

17

mortgage obligations classified as available for sale. Accordingly, the principal risk associated with the Bank's current investing activities is market risk (variations in value resulting from general changes in interest rates) rather than credit risk.

### Market and Competition

There are numerous banks and other financial institutions serving the Southern Connecticut Market posing significant competition for the Bank to attract deposits and loans. The Bank also experiences competition from out-of-state financial institutions with little or no traditional bank branches in New Haven. To grow, we will have to win customers away from the customer base of existing banks and financial institutions as well as win new customers from growth in the Southern Connecticut Market. Many of such banks and financial institutions are well established and well capitalized, allowing them to provide a greater range of services than we will be able to offer in the near future.

The greater New Haven is currently served by approximately 70 offices of commercial banks, none of which is headquartered in New Haven. All of these banks are substantially larger than the Bank expects to be in the near future and are able to offer products and services which may be impracticable for the Bank to provide at this time. There are numerous banks and other financial institutions serving the communities surrounding New Haven, which also draws customers from New Haven, posing significant competition for the Bank to attract deposits and loans. The Bank also experiences competition from out-of-state

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financial institutions with little or no traditional bank branches in New Haven. Many of such banks are and financial institutions are well established and better capitalized than the Bank, allowing them to provide a greater range of services.

Intense market demands, economic pressures and significant legislative and regulatory actions have eroded traditional banking industry classifications and have increased competition among banks and other financial institutions. Market dynamics, as well as legislative and regulatory changes have resulted in a number of new competitors offering services historically offered only by commercial banks; non-bank corporations offering services traditionally offered only by banks; increased customer awareness of product and service differences among competitors; and increased merger activity.

Over the past ten years, the Connecticut banking market has been characterized by significant consolidation among financial institutions. Since January 1994, there have been 60 completed acquisitions of Connecticut based banks and thrifts. Although our competitors are currently much larger than us, we believe that the corporate service culture and operational infrastructure at large banks often does not provide the type of personalized service that many of our small to medium business and professional clients desire and that we strive to provide.

Additional legislative and regulatory changes may affect the Bank in the future; however, the nature of such changes and the effect of their implementation cannot be assessed. New rules and regulations may, among other things, revise limits on interest rates on various categories of deposits and may limit or influence interest rates on loans. Monetary and fiscal policies of the United States government and its instrumentalities, including the Federal Reserve, significantly influence the growth of loans, investments and deposits. The banking regulatory environment is

18

undergoing significant change both as it affects the banking industry directly and as it affects competition between banks and non-bank financial institutions.

The Bank of Southeastern Connecticut

On July 2, 2003, Bancorp submitted an application to the State of Connecticut, Department of Banking ("Department") for the establishment by Bancorp of a new commercial bank in New London, Connecticut. The application was subsequently temporarily withdrawn to complete additional information requested by the Department, including a three-year balance sheet and income statement forecast for the proposed new bank.

On August 7, 2003, the application, including the completed additional information, was resubmitted to the Department, and on October 2, 2003, the final application, including additional information, was submitted.

On April 28, 2004, a temporary certificate of authority was issued by the State of Connecticut Department of Banking in connection with the new bank application. Application to the Federal Insurance Deposit Corporation for deposit insurance has been extended to allow Bancorp to provide information regarding the infrastructure in place to support the two banks and to revise certain proposed policies of the new bank. Application to the Federal Reserve Bank of Boston for Bancorp to acquire the new bank will be filed in the near future after receipt of approval from the FDIC. Subject to the receipt of regulatory approvals, Bancorp expects the new bank to be operating by the end of

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the first quarter of 2005.

SCB Capital, Inc.

On November 17, 2003, SCB Capital, Inc., a wholly-owned subsidiary of Bancorp, was incorporated. SCB Capital, Inc. will engage in a limited range of investment banking and advisory services primarily to small to medium size business clients of Bancorp located in Connecticut. It is not anticipated that SCB Capital, Inc. will directly provide financing or equity in the investment banking transactions it facilitates or in which it acts as principal. SCB Capital, Inc. is in the process of applying for approval as a broker-dealer and membership with the National Association of Security Dealers. SCB Capital, Inc. has been capitalized with \$20,000 and has not commenced operations. Any additional amount to be invested in SCB Capital, Inc. will be determined by Bancorp's Board of Directors following completion of the application.

### Recent Developments

Bancorp raised \$13.3 million, net of underwriting discounts and offering expenses, in equity capital through a public offering of common stock on June 17, 2004. On June 17, 2004, Bancorp invested approximately \$2.8 million of these proceeds in the equity capital of The Bank of Southern Connecticut. Also, Bancorp has committed to investing \$6 million of the proceeds in the equity capital of The Bank of Southeastern Connecticut at the time it receives all final regulatory approvals and commences banking operations. On November 9, 2004, Bancorp committed to investing an additional \$1 million in The Bank of Southern Connecticut. The remaining balance of the public offering net proceeds will be utilized for future branch office

19

expansion and general corporate purposes. Bancorp listed its common stock on the American Stock Exchange in connection with its offering. Bancorp's common stock symbol is "SSE".

For a more detailed discussion of Bancorp's liquidity, see Liquidity on page 31 of this Form 10-QSB. Currently, other than the potential start up of a new bank in early 2005 and the establishment of new Bank branch offices (as previously discussed on pages 15 and 16 under the "Locations" heading), there are no plans involving the significant purchase or sale of property or equipment in the next twelve months. Outside of staffing the new bank located in New London and new offices of the Bank, Bancorp does not anticipate a significant change in the number of its employees.

The Board of Directors of the Bank adopted resolutions designed to strengthen and enhance the Bank's Bank Secrecy Act compliance and the Bank's Information Technology controls. The Bank appointed a new Bank Secrecy Act Officer and has amended its Bank Secrecy Act policies to strengthen compliance. Additionally, the Bank has retained an experienced outside consultant to assist it in developing and implementing Information Technology controls.

On August 11, 2004, Joseph V. Ciaburri, the Chairman and Chief Executive Officer of Bancorp, and Michael M. Ciaburri, the President and Chief Operating Officer of Bancorp, each entered into a settlement agreement with the Banking Commissioner of the State of Connecticut and each paid a civil penalty of \$2,500 in connection with three loans made by the Bank in November 2003 that resulted in a concentration of unsecured credit by the Bank exceeding 15% of the equity capital and reserves for loan and lease losses of the Bank. In particular, the Commissioner found that the two officers voted to approve the

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loans at a meeting of the loan committee of the Bank without conditioning their approval to ensure that no commitment would be issued prior to obtaining a participation commitment from another financial institution to cover the excess loans over the applicable lending limitations. The settlement agreement acknowledged the officers' claim that they were not aware that their vote to approve the loans violated the applicable Connecticut statutes. No violation was found on behalf of the Bank or Bancorp, and the Commissioner acknowledged that the officers, in conjunction with the Bank's board of directors, have implemented policies and procedures to prevent future occurrences of such actions. In January 2004, the Bank sold a participation in the loans, bringing the loans within the Bank's lending limit. The loans have fully performed at all times.

As of September 30, 2004, the Bank has 29 full-time employees. Its employees perform most routine day-to-day banking transactions for the Bank. However, the Bank has entered into a number of arrangements for banking services such as correspondent banking, data processing and armored carriers.

Overall, the Bank's plan of operation is focused on responsible growth and pricing of deposits and loans, and investment in high quality U. S. government securities to achieve a net interest margin sufficient to cover operating expenses, achieve profitable operations and maintain liquidity.

20

### (b) Management's Discussion and Analysis of Financial Condition and Results of Operations

#### Summary

Bancorp had a net loss of \$53,000 (or basic and diluted loss per share of \$0.02) for the quarter ended September 30, 2004, compared to a net loss of \$211,000 (or basic and diluted loss per share of \$0.20) for the quarter ended September 30, 2003. Bancorp had net income of \$3,000 (or basic and diluted earnings per share of \$0.00) for the nine months ended September 30, 2004, compared to a net loss of \$624,000 (or basic and diluted loss per share of \$0.59) for the nine months ended September 30, 2003. The quarterly loss reflects: i) ongoing costs of developing infrastructure to support The Bank of Southeastern Connecticut, ii) the absence of gains on the sale of SBA guaranteed loan participations, and iii) additional provisions to the allowance for loan and lease losses due to increased loan volume.

#### Financial Condition

##### Assets

Bancorp has reached total assets of \$80.7 million at September 30, 2004, an increase of \$24.3 million (43%) from \$56.4 million in assets as of December 31, 2003. Earning assets reached \$76.4 million, increasing \$25.5 million (50%) during the first nine months of 2004.

Bancorp has maintained liquidity by maintaining balances in overnight Federal funds sold and short-term investments including money market mutual funds to provide funding for higher yielding loans as they are approved and closed. As of September 30, 2004, Federal funds sold were \$6.4 million and short-term investments balances were \$3.2 million. Federal funds sold and short-term investments increased by \$5.4 million and \$2.7 million, respectively,

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during the first nine months of 2004. The increases were due to receipt of the net proceeds of the public offering of equity securities by Bancorp which were not invested in available for sale securities. In addition, Bancorp has invested \$14.5 million in U.S. Treasury, government agency and mortgage backed securities classified as available for sale.

### Investments

Available for sale securities increased \$6.1 million from December 31, 2003, reflecting the investment of approximately \$8.0 million of net proceeds received from the June 2004 public offering in U.S. Treasury and Agency securities, less amortization and sales of securities.

During the nine months ended September 30, 2004, gross unrealized losses on the available for sale securities portfolio totaled \$207,000. These losses were the result of volatility in market rates and yield curve changes and impacted the market prices in government agency bonds and mortgage-backed securities. Management does not believe these losses are other than temporary, and Bancorp has the ability to hold these securities to maturity if necessary, and has both the intent and ability to retain its investments for a period of time sufficient to allow for any anticipated recovery in fair value. As a result, management believes that these unrealized losses will not have a negative impact on future earnings and capital.

21

### Loans

The total of the net loan portfolio and loans held for sale increased \$10.9 million (27%) from \$40.8 million at December 31, 2003 to \$51.7 million at September 30, 2004. The increase in loans is due to the addition of a branch office in April 2003 and continued robust demand in the greater New Haven and Connecticut markets. The increase in the loan portfolio was funded primarily by increases in deposits and the additional capital invested in the Bank by Bancorp. The loan to deposit ratio as of September 30, 2004 was 91%. Bancorp continues to target a loan to deposit ratio in the 80% to 85% range. Given the additional capital raised by Bancorp in the second quarter of 2004, temporary excesses of this ratio above the target range have been deemed prudent by management of Bancorp. Bancorp and the Bank's Boards of Directors may elect to review Bancorp's policy regarding this risk factor.

### Critical Accounting Policy

In the ordinary course of business, Bancorp has made a number of estimates and assumptions relating to reporting results of operations and financial condition in preparing its financial statements in conformity with accounting principals generally accepted in the United States of America. Actual results could differ significantly from those estimates under different assumptions and conditions. Bancorp believes the following discussion addresses Bancorp's only critical accounting policy, which is the policy that is most important to the portrayal of Bancorp's financial condition and results and requires management's most difficult, subjective and complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain.

### Allowance for Loan Losses

The allowance for loan losses, a material estimate susceptible to



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significant change in the near-term, is established as losses are estimated to have occurred through a provision for losses charged against operations, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Management's judgment in determining the adequacy of the allowance is inherently subjective and is based on the evaluation of individual loans, pools of homogeneous loans, the known and inherent risk characteristics and size of the loan portfolios, the assessment of current economic and real estate market conditions, estimates of the current value of underlying collateral, past loan loss experience, review of regulatory authority examination reports and evaluations of specific loans and other relevant factors. Loans, including impaired loans, are charged against the allowance for loan losses when management believes that the uncollectibility of principal is confirmed. Any subsequent recoveries are credited to the allowance for loan losses when received. In connection with the determination of the allowance for loan losses, management obtains appraisals for significant properties, when considered necessary.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on

22

historical loss experience adjusted for qualitative factors. An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Based on its evaluation, management believes the allowance for loan losses of \$521,000 at September 30, 2004, which represents 1.00% of gross loans outstanding, is adequate, under prevailing economic conditions, to absorb probable losses on existing loans. At December 31, 2003, the allowance for loan losses was \$421,000 or 1.02% of gross loans outstanding.

### Analysis of Allowance for Loan Losses

The following represents the activity in the allowance for loan losses for the nine months ended September 30:

Allowance for Loan Losses as of September 30, 2004 and 2003

|                                 | 2004      | 2003      |
|---------------------------------|-----------|-----------|
|                                 | -----     | -----     |
| Balance at beginning of period  | \$421,144 | \$232,000 |
| Charge-offs                     | (28,976)  | (22,291)  |
| Recoveries                      | 11,220    | -         |
| Provision charged to operations | 117,895   | 143,500   |
|                                 | -----     | -----     |
| Balance at end of period        | \$521,283 | \$353,209 |
|                                 | =====     | =====     |

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### Non-Accrual, Past Due and Restructured Loans

The following table represents non-accruing and past due loans:

| (Thousands of dollars)                           | September 30, 2004 | December 31, 2003 |
|--|--------------------|-------------------|
| Loans delinquent over 90 days and still accruing | \$ 0               | \$ 0              |
| Non-accruing loans                               | 27,553             | 94,063            |
| Total  | \$27,553           | \$94,063          |
| % of Total Loans                                 | 0.05%              | 0.23%             |
| % of Total Assets                                | 0.03%              | 0.17%             |

### Potential Problem Loans

At September 30, 2004, the Bank had no other loans, other than those disclosed in the table above, as to which management has significant doubts as to the ability of the borrower to comply with the present repayment terms.

23

### Deposits

Deposits were \$56.9 million at September 30, 2004, an increase of \$9.6 million (20%) from \$47.3 million as of December 31, 2003. The increase in deposits was primarily in non-interest bearing checking deposits, and interest bearing money market, checking and savings deposits, offset by a \$197,000 decline in certificates of deposit balances. The increase in the total deposit portfolio reflects the continued vigorous marketing effort of the Bank. Bancorp does not have any brokered deposits.

### Other

Repurchase agreements increased \$1.2 million from December 31, 2003 to \$1.6 million as of September 30, 2004 due to increased activity in these customer accounts.

### Results of Operations

De Novo banks in Connecticut have reached profitability on average within three to four years after commencement of operations. Bancorp was initially profitable in the fourth quarter of 2003, the ninth quarter of operation. Bancorp was also profitable in both the first and second quarters of 2004. Bancorp had a loss of \$53,000 in the third quarter of 2004, due to a

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decline of approximately \$73,000 from the second quarter in SBA loan participation sale gains and continued expenses associated with the anticipated opening of The Bank of Southeastern Connecticut. Bancorp originated SBA guaranteed loans which are carried as loans held for sale during the third quarter, but did not close any loan participation sale transactions during the quarter. For the third quarter of 2003, Bancorp had a loss of \$211,000. Bancorp intends to continue originate and to sell at a profit participations in SBA guaranteed loans, including those currently classified as held-for-sale, in the future.

For the nine month period ending September 30, 2004, Bancorp had a profit of \$3,000, in comparison to a loss of \$624,000 for the nine months ending September 30, 2003.

### Average Balances, Yields and Rates

The following table presents average balance sheets (daily averages), interest income, interest expense, and the corresponding annualized rates on earning assets and rates paid on interest bearing liabilities for the nine and three months ended September 30, 2004 compared to the nine and three months ended September 30, 2003. Interest income on loans includes loan fee income which is not significant. In addition, Bancorp does not have any tax-exempt securities or loans.

24

### Distribution of Assets, Liabilities and Shareholders' Equity; Interest Rates and Interest differential

| (Dollars in thousands)               | Three months Ended<br>September 30, 2004 |  |                         | Three months Ended<br>September 30, 2003 |  |                         | Fluctuations<br>in interest<br>Income/Expense<br>Total |
|--------------------------------------|--|--|-------------------------|--|--|-------------------------|--|
|                                      | Average<br>Balance                       | Interest<br>Income/Average<br>Expense Rate | Average<br>Expense Rate | Average<br>Balance                       | Interest<br>Income/Average<br>Expense Rate | Average<br>Expense Rate |  |
| Interest earning assets              |  |  |                         |  |  |                         |  |
| Loans                                | \$ 47,834                                | \$ 871                                     | 7.22%                   | \$ 30,403                                | \$ 578                                     | 7.60%                   | \$ 293   |
| Federal funds sold                   | 7,230                                    | 24   | 1.32%                   | 2,070                                    | 5  | 0.97%                   | 19   |
| Short-term investments               | 3,167                                    | 7  | 0.88%                   | 748                                      | 2  | 1.07%                   | 5  |
| Investments                          | 15,216                                   | 87   | 2.27%                   | 9,843                                    | 66   | 2.68%                   | 21   |
| <b>Total interest earning assets</b> | <b>73,447</b>                            | <b>989</b>                                 | <b>5.34%</b>            | <b>43,064</b>                            | <b>651</b>                                 | <b>6.05%</b>            | <b>338</b>   |
| Cash and due from banks              | 622                                      |  |                         | 1,355                                    |  |                         |  |
| Premises and equipment, net          | 3,390                                    |  |                         | 3,532                                    |  |                         |  |
| Allowance for loan losses            | (474)                                    |  |                         | (297)                                    |  |                         |  |
| Other                                | 1,323                                    |  |                         | 849                                      |  |                         |  |
| <b>Total assets</b>                  | <b>\$ 78,308</b>                         |  |                         | <b>\$ 48,503</b>                         |  |                         |  |

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|   | =====     |        |        | =====     |        |        |        |
|---|-----------|--------|--------|-----------|--------|--------|--------|
| Interest bearing liabilities              |           |        |        |           |        |        |        |
| Time certificates                         | \$ 9,765  | 53     | 2.15%  | \$ 6,178  | 39     | 2.53%  | 14     |
| Savings deposits                          | 3,627     | 12     | 1.31%  | 2,122     | 5      | 0.94%  | 7      |
| Money market /<br>checking deposits       | 25,056    | 79     | 1.25%  | 20,498    | 48     | 0.94%  | 31     |
| Capital lease obligations                 | 1,190     | 43     | 14.34% | 1,191     | 42     | 14.11% | 1      |
| Repurchase agreements                     | 1,630     | 2      | 0.49%  | 1,075     | 1      | 0.37%  | 1      |
|   | -----     |        |        | -----     |        |        | -----  |
| Total interest bearing liabilities        | 41,268    | 189    | 1.82%  | 31,064    | 135    | 1.74%  | 54     |
|   | -----     |        |        | -----     |        |        | -----  |
| Non-interest bearing deposits             | 15,807    |        |        | 9,834     |        |        |        |
| Accrued expenses and<br>other liabilities | 463       |        |        | 183       |        |        |        |
| Shareholder's equity                      | 20,770    |        |        | 7,422     |        |        |        |
|   | -----     |        |        | -----     |        |        |        |
| Total liabilities and equity              | \$ 78,308 |        |        | \$ 48,503 |        |        |        |
|   | =====     |        |        | =====     |        |        |        |
| Net interest income                       |           | \$ 800 |        |           | \$ 516 |        | \$ 284 |
|   |           | =====  |        |           | =====  |        | =====  |
| Interest spread                           |           | 3.52%  |        |           | 4.31%  |        |        |
|   |           | =====  |        |           | =====  |        |        |
| Interest margin                           |           | 4.32%  |        |           | 4.79%  |        |        |
|   |           | =====  |        |           | =====  |        |        |

(1) Includes nonaccruing loans.

25

Distribution of Assets, Liabilities and Shareholders' Equity;  
Interest Rates and Interest differential

|                         | Nine months Ended<br>September 30, 2004 |  |       | Nine months Ended<br>September 30, 2003 |  |       |  |
|-------------------------|---|--|-------|---|--|-------|--|
| (Dollars in thousands)  | Average<br>Balance                      | Interest<br>Income/Average<br>Expense Rate |       | Average<br>Balance                      | Interest<br>Income/Average<br>Expense Rate |       | Fluctuations<br>in interest<br>Income/Expense<br>Total |
|                         | -----                                   |  |       | -----                                   |  |       | -----  |
| Interest earning assets |   |  |       |   |  |       |  |
| Loans                   | \$ 45,985                               | \$ 2,549                                   | 7.40% | \$ 26,202                               | \$ 1,498                                   | 7.62% | \$ 1,0   |
| Federal funds sold      | 5,176                                   | 42   | 1.08% | 2,860                                   | 23   | 1.07% |  |

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|   |           |          |        |           |          |        |      |
|---|-----------|----------|--------|-----------|----------|--------|------|
| Short-term investments                    | 2,863     | 22       | 1.03%  | 1,188     | 6        | 0.67%  |      |
| Investments                               | 10,491    | 190      | 2.42%  | 8,799     | 198      | 3.00%  |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Total interest earning assets             | 64,515    | 2,803    | 5.80%  | 39,049    | 1,725    | 5.89%  | 1,0  |
| Cash and due from banks                   | 1,001     |          |        | 1,452     |          |        |      |
| Premises and equipment, net               | 3,417     |          |        | 3,345     |          |        |      |
| Allowance for loan losses                 | (452)     |          |        | (279)     |          |        |      |
| Other                                     | 1,204     |          |        | 843       |          |        |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Total assets                              | \$ 69,685 |          |        | \$ 44,410 |          |        |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Interest bearing liabilities              |           |          |        |           |          |        |      |
| Time certificates                         | \$ 11,971 | 191      | 2.13%  | \$ 6,239  | 121      | 2.59%  |      |
| Savings deposits                          | 2,944     | 27       | 1.23%  | 1,748     | 13       | 0.99%  |      |
| Money market/<br>checking deposits        | 24,658    | 234      | 1.27%  | 17,937    | 142      | 1.06%  |      |
| Capital lease obligations                 | 1,191     | 128      | 14.36% | 1,192     | 126      | 14.09% |      |
| Repurchase agreements                     | 1,295     | 6        | 0.62%  | 703       | 3        | 0.57%  |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Total interest bearing liabilities        | 42,059    | 586      | 1.86%  | 27,819    | 405      | 1.94%  | 1    |
| <hr/>                                     |           |          |        |           |          |        |      |
| Non-interest bearing deposits             | 15,034    |          |        | 8,303     |          |        |      |
| Accrued expenses and<br>other liabilities | 372       |          |        | 425       |          |        |      |
| Shareholder's equity                      | 12,220    |          |        | 7,863     |          |        |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Total liabilities and equity              | \$ 69,685 |          |        | \$ 44,410 |          |        |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Net interest income                       |           | \$ 2,217 |        |           | \$ 1,320 |        | \$ 8 |
| <hr/>                                     |           |          |        |           |          |        |      |
| Interest spread                           |           |          | 3.94%  |           |          | 3.95%  |      |
| <hr/>                                     |           |          |        |           |          |        |      |
| Interest margin                           |           |          | 4.59%  |           |          | 4.51%  |      |
| <hr/>                                     |           |          |        |           |          |        |      |

(1) Includes nonaccruing loans.

Changes in Assets and Liabilities and Fluctuations in Interest Rates

The following tables summarize the variance in interest income and expense for the nine and three months ended September 30, 2004 and 2003 resulting in changes in assets and liabilities and fluctuations in interest rates earned and paid. The changes in interest attributable to both rate and volume have been allocated to both rate and volume on a pro rata basis.

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| (Dollars in thousands)             | Three months Ended<br>September 30, 2004 v. 2003 |                             |          |
|------------------------------------|--|-----------------------------|----------|
|                                    | Increase<br>Or<br>(Decrease)                     | Due to Change in<br>Average |          |
|                                    |  | Volume                      | Rate     |
|                                    | (Dollars in thousands)                           |                             |          |
| Interest earning assets            |  |                             |          |
| Loans                              | \$ 293   | \$ 483                      | \$ (190) |
| Federal funds sold                 | 19   | 17                          | 2        |
| Short-term investments             | 5  | 7                           | (2)      |
| Investments                        | 21   | 79                          | (58)     |
| Total interest earning assets      | 338  | 586                         | (248)    |
| Interest bearing liabilities       |  |                             |          |
| Time certificates                  | \$ 14  | \$ 48                       | \$ (34)  |
| Savings deposits                   | 7  | 4                           | 3        |
| Money market / checking deposits   | 31   | 12                          | 19       |
| Capital lease obligations          | 1  | --                          | 1        |
| Repurchase agreements              | 1  | 1                           | 0        |
| Total interest bearing liabilities | 54   | 65                          | (11)     |
| Net interest income                | \$ 284   | \$ 521                      | \$ (237) |

27

| (Dollars in thousands)  | Nine months Ended<br>September 30, 2004 v. 2003 |                             |         |
|-------------------------|---|-----------------------------|---------|
|                         | Increase<br>Or<br>(Decrease)                    | Due to Change in<br>Average |         |
|                         |   | Volume                      | Rate    |
|                         | (Dollars in thousands)                          |                             |         |
| Interest earning assets |   |                             |         |
| Loans                   | \$ 1,051  | \$ 1,124                    | \$ (73) |
| Federal funds sold      | 19  | 19                          | 0       |

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|                                    |        |         |          |
|------------------------------------|--------|---------|----------|
| Short-term investments             | 16     | 10      | 6        |
| Investments                        | (8)    | 47      | (55)     |
|                                    | -----  | -----   | -----    |
| Total interest earning assets      | 1,078  | 1,200   | (122)    |
|                                    | -----  | -----   | -----    |
| Interest bearing liabilities       |        |         |          |
| Time certificates                  | \$ 70  | \$ 107  | \$ (37)  |
| Savings deposits                   | 14     | 10      | 4        |
| Money market / checking deposits   | 92     | 60      | 32       |
| Capital lease obligations          | 2      | -       | 2        |
| Repurchase agreements              | 3      | 3       | 0        |
|                                    | -----  | -----   | -----    |
| Total interest bearing liabilities | 181    | 180     | 1        |
|                                    | -----  | -----   | -----    |
| Net interest income                | \$ 897 | \$1,020 | \$ (123) |
|                                    | =====  | =====   | =====    |

Net Interest Income

For the quarter ended September 30, 2004, net interest income was \$800,000 versus \$516,000 for the same period in 2003, a \$284,000 or a 55% increase. This was the result of a \$30.4 million increase in average earning assets in the quarter ended September 30, 2004 in comparison to the same period a year ago, including increases in average loans of \$17.4 million, short term investments and federal funds sold of \$7.6 million and Investments of \$5.4 million. Also, average interest bearing liabilities increased \$10.2 million during the quarter ended September 30, 2004 in comparison to the same period a year ago, also partially offsetting the favorable net interest income effects of the increase in average earning assets volume. The ratio of average loans to average total interest earning assets declined during the quarter ended September 30, 2004 in comparison to the quarter ended September 30, 2003, to 65.1% from 70.6%, due to the receipt of funds at the end of the second quarter of 2004 from the public offering of equity, a substantial portion of which is invested in federal funds and short term investments and available for sale investment securities. It is the intention of Bancorp that the Bank and the proposed bank to be located in New London, Connecticut, will invest the majority of these funds in loans in the future.

The yield on average interest earning assets for the three months ended September 30, 2004 was 5.34% versus 6.05% for same period in 2003. The decrease in the yield on average earning assets is due to the change in asset mix from 2003 to 2004, reflecting the larger investments in federal funds sold, short term investments and available for sale investment

securities which are at significantly lower yields than loans. The cost of average interest bearing liabilities was 1.82% for the three months ended June 30, 2004 versus 1.74% for the same period in 2003. The increase in the cost of average interest bearing liabilities was primarily the result of higher rates paid on daily rate money market and interest bearing checking accounts, offset somewhat by lower roll-over rates offered to renewing and new time deposits.

For the nine months ended September 30, 2004, net interest income was

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\$2.2 million versus \$1.3 million for the same period in 2003, a \$897,000 or 68% increase. This was the result of a \$25.5 million increase in average earning assets in the nine months ended September 30, 2004 in comparison to the same period a year ago, due primarily to increases in average loans of \$19.8 million and short term investments and federal funds of \$4.0 million. Also, average interest bearing liabilities increased \$14.2 million during the nine months ended September 30, 2004 in comparison to the same period a year ago, partially offsetting the favorable net interest income effect of the increase in average earning assets.

The yield on average interest earning assets for the nine months ended September 30, 2004 was 5.80% versus 5.89% for same period in 2003. The decrease in the yield on average earning assets is due to the change in asset mix from 2003 to 2004, reflecting the larger investments in federal funds sold, short term investments and available for sale investment securities which are at significantly lower yields than loans. The cost of average interest bearing liabilities was 1.86% for the nine months ended September 30, 2004 versus 1.94% for the same period in 2003. The decrease in the cost of average interest bearing liabilities was primarily the result of lower roll-over rates offered to renewing and new time deposits in the first six months of 2004, in comparison to those paid and offered in the same period during 2003.

### Provision for Loan Losses

The \$57,000 provision for loan losses for the three months ended September 30, 2004 reflects loan portfolio growth and seasoning. During the quarter, net recoveries of \$9,000 were recorded. The provision for loan losses for the three months ended September 30, 2003 was \$57,000, and was primarily due to the increase in the Bank's loan volume during the period.

The \$118,000 provision for loan losses for the nine months ended September 30, 2004 primarily reflects loan portfolio growth and seasoning. The provision for loan losses for the nine months ended September 30, 2003 was \$144,000, and was primarily due to the increase in the Bank's loan volume during the period. Net charge offs for the nine month period ending September 30, 2004 were \$18,000.

### Noninterest Income

The \$71,000 increase in total noninterest income for the third quarter of 2004 versus the third quarter 2003 is primarily the result of an increase in service charges and fees derived from deposits, loans and other services. During the third quarter of 2004, Bancorp did not have any gains from the sales of SBA guaranteed loan participations and referrals. Bancorp originated for sale in the secondary market \$1,206,348 of SBA guaranteed loans during the third quarter of 2004, which are reported as loans held for sale on Bancorp's Consolidated Balance Sheet.

Bancorp intends to continue to originate SBA guaranteed loans in the future and expects to continue to earn income from SBA loan participation sales and referrals.

The \$414,000 increase in total noninterest income for the first nine months of 2004 versus 2003 is primarily the result of an increase in the gains and fees from the sales and referrals of the guaranteed portion of SBA loans of \$232,000, increases in fees from deposit and loan related volume and activity and fees from other services of \$222,000, offset by a decrease in realized gains



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on the sales of available for sale securities of \$41,000.

### Noninterest Expense

Total noninterest expense was \$939,000 for the third quarter of 2004 versus \$742,000 for the same period in 2003, an increase of \$197,000 or 27%. The increase in expense is due to the growth in Bancorp's loan and deposit volume, as well as the acquisition of additional infrastructure relating to administration and compliance, requiring additional staffing and other operating expenses.

Total noninterest expense was \$2.7 million for the first nine months of 2004 versus \$2.0 million for the same period in 2003, an increase of \$709,000 or 35%. The increase in expense is due to the growth in the Bancorp's loan and deposit volume, the addition of the New Haven (Amity) office in March of 2003, costs associated with the establishment of The Bank of Southeastern Connecticut, In Organization, the acquisition of the New London facility in January 2004, as well as the acquisition of additional infrastructure relating to administration and compliance, additional staffing and other operating expenses.

Salaries and benefits for the third quarter of 2004 of \$472,000 increased by \$97,000, or 26%, from the third quarter of 2003. The increase is due to staff compensation and benefits increases in the third quarter of 2004 in comparison to the same period a year ago, primarily arising from additions to IT, lending and deposit operations staff.

Salaries and benefits for the first nine months of 2004 increased by \$348,000 or 33% due to staff increases relating to the New Haven (Amity) office and other new employees engaged due to loan and deposit volume increases and infrastructure development.

Occupancy and equipment for the third quarter of 2004 increased by \$23,000 or 24% due primarily to increases relating to depreciation of buildings, equipment and furniture of \$9,000, rent and property taxes relating to the future New London bank subsidiary facility of \$17,000, offset by net decreases in other occupancy costs.

Occupancy and equipment for the first nine months of 2004 increased by \$117,000 or 44% due primarily to increases relating to depreciation of buildings, equipment and furniture of \$51,000, rent, property taxes and other occupancy relating to the New London facility of \$39,000, maintenance of \$22,000 and property taxes of \$4,000.

Professional fees for the third quarter of 2004 increased by \$47,000 or by 75% due primarily to the engagement of consultants to assist the Bank in developing infrastructure and related policies and procedures, legal and other professional costs relating to the chartering and

operational planning of the proposed banking subsidiary to be located in New London, and other matters.

Professional fees for the first nine months of 2004 increased by \$111,000 or 63% due primarily to the engagement of consultants in the second and third quarters of 2004 to assist the Bank in developing infrastructure and related policies and procedures, and legal and other professional costs relating to the chartering of the proposed banking subsidiary to be located in New London and the investment banking subsidiary SCB Capital, Inc.

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Data processing and other outside services for the third quarter increased by \$17,000, or 32%, primarily due to increased loan and deposit volumes.

Data processing and other outside services for the first nine months of 2004 increased by \$69,000, or 49%, primarily due to increased loan and deposit volumes.

Forms, printing and supplies expense for the first nine months of 2004 increased \$19,000, or 44%, due to increased expenses related to increases in loan and deposit volume and materials related to the public offering.

Other Operating Expense for the first nine months of 2004 increased by \$41,000, or 17%, primarily due to insurance cost increases of \$31,000, filing fees in the total of \$29,000 in connection with the new proposed banking subsidiary to be located in New London, SCB Capital, Inc. and the registration of Bancorp's option plans, less net decreases in other components of Other Operating Expense.

### Off-Balance Sheet Arrangements

See Note 11 for information regarding the Bancorp's off-balance sheet arrangements.

### Liquidity

Management believes that Bancorp's short-term assets have sufficient liquidity to cover potential fluctuations in deposit accounts and loan demand and to meet other anticipated operating cash requirements.

Bancorp's liquidity position as of September 30, 2004 and December 31, 2003 consisted of liquid assets totaling \$24.3 million and \$11.0 million, respectively. This represents 30% and 20% of total assets at September 30, 2004 and December 31, 2003, respectively. The net increase in liquidity during the first nine months of 2004 is primarily due to increases in federal funds sold, short-term investments and available for sale securities principally due to receipt of the net proceeds from the public offering of equity securities by Bancorp. The following categories of assets as described in the accompanying balance sheet are considered liquid assets: cash and due from banks, federal funds sold, short-term investments, and securities available for sale. Liquidity is a measure of Bancorp's ability to generate adequate cash to meet financial obligations. The principal cash requirements of a financial institution are to cover downward fluctuations in deposits and increases in its loan portfolio.

### Capital

The following table illustrates Bancorp's regulatory capital ratios at:

September 30,  
2004

December 31,  
2003

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|   |        |        |
|---|--------|--------|
|   | -----  | -----  |
| Tier 1 (Leverage) Capital Ratio to Average assets | 29.56% | 14.17% |
| Tier 1 Capital to Risk Weighted Assets            | 33.54% | 16.37% |
| Total Capital to Risk Weighted Assets             | 34.39% | 17.28% |

The following table illustrates the Bank's regulatory capital ratios at:

|   |                       |                      |
|---|-----------------------|----------------------|
|   | September 30,<br>2004 | December 31,<br>2003 |
|   | -----                 | -----                |
| Tier 1 (Leverage) Capital Ratio to Average assets | 14.82%                | 14.16%               |
| Tier 1 Capital to Risk Weighted Assets            | 17.61%                | 16.33%               |
| Total Capital to Risk Weighted Assets             | 18.47%                | 17.24%               |

Capital adequacy is one of the most important factors used to determine the safety and soundness of individual banks and the banking system. Based on the above ratios, Bancorp is considered to be well capitalized under applicable regulations specified by the Federal Reserve. The Bank also is considered to be "well capitalized" under applicable regulations. To be considered "well capitalized" an institution must generally have a leverage capital ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10%.

### Market Risk

Market risk is defined as the sensitivity of income to fluctuations in interest rates, foreign exchange rates, equity prices, commodity prices and other market-driven rates or prices. Based upon on the nature of the Company's business, market risk is primarily limited to interest rate risk, which is the impact that changing interest rates have on current and future earnings.

Bancorp's goal is to maximize long-term profitability, while controlling its exposure to interest rate fluctuations. The first priority is to structure and price Bancorp's assets and liabilities to maintain an acceptable interest rate spread, while reducing the net effect of changes in interest rates. In order to reach an acceptable interest rate spread, Bancorp must generate loans and seek acceptable long-term investments to replace the lower yielding balances in Federal Funds sold and short-term investments. The focus also must be on maintaining a proper balance between the timing and volume of assets and liabilities re-pricing within the balance sheet. One method of achieving this balance is to originate variable rate loans for the portfolio to offset the short-term re-pricing of the liabilities. In fact, a number of the interest bearing deposit products

have no contractual maturity. Customers may withdraw funds from their accounts at any time and deposits balances may therefore run off unexpectedly due to changing market conditions.

The exposure to interest rate risk is monitored by the Asset and Liability Management Committee ("ALCO") consisting of senior management personnel and selected members of the Board of Directors of the Bank. ALCO reviews the interrelationships within the balance sheet to maximize net interest

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income within acceptable levels of risk. ALCO reports to the Board of Directors of Bancorp and the Bank on a quarterly basis regarding the status of ALCO activities and interest rate risk.

### Impact of Inflation and Changing Prices

Bancorp's financial statements have been prepared in terms of historical dollars, without considering changes in relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all of the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effect of general levels of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. Notwithstanding this fact, inflation can directly affect the value of loan collateral, in particular, real estate. Inflation, or disinflation, could significantly affect Bancorp's earnings in future periods.

### "Safe Harbor" Statement Under Private Securities Litigation Reform Act of 1995

Certain statements contained in Bancorp's public reports, including this report, and in particular in this "Management's Discussion and Analysis or Plan of Operation", may be forward looking and subject to a variety of risks and uncertainties. These factors include, but are not limited to, (1) changes in prevailing interest rates which would affect the interest earned on Bancorp's interest earning assets and the interest paid on its bearing liabilities, (2) the timing of re-pricing of Bancorp's interest earning assets and interest bearing liabilities, (3) the effect of changes in governmental monetary policy, (4) the effect of changes in regulations applicable to Bancorp and the conduct of its business, (5) the volatility of quarterly earnings, due in part to the variation in the number, dollar volume and profit realized from SBA guaranteed loan participation sales in different quarters, (6) the effect of a loss of any executive officer, key personnel, or directors, (7) changes in competition among financial service companies, including possible further encroachment of non-banks on services traditionally provided by banks and the impact of recently enacted federal legislation, (8) the ability of competitors which are larger than Bancorp to provide products and services which it is impracticable for Bancorp to provide, (9) the effect of Bancorp's opening of branches and organization of a new bank and the receipt of regulatory approval to complete both actions, (10) the effect of any decision by Bancorp to engage in any business not historically permitted to it, (11) concentration of our business in Southern Connecticut, (12) the concentration of our loan portfolio in commercial loans to small-to-medium sized businesses, which may be impacted more severely than larger businesses during periods of economic weakness and (13) lack of seasoning in our loan portfolio, which may increase the risk of future credit defaults. Other such factors may be described in other filings made by Bancorp with the SEC.

Although Bancorp believes that it offers the loan and deposit products and has the resources needed for success, future revenues and interest spreads and yields cannot be reliably predicted. These trends may cause Bancorp to adjust its operations in the future. Because of the foregoing and other factors, recent trends should not be considered reliable indicators of future financial results or stock prices.

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### Item 3. Controls and Procedures

#### (a) Evaluation of disclosure controls and procedures

Based upon an evaluation of the effectiveness of Bancorp's disclosure controls and procedures performed by Bancorp's management, with participation of Bancorp's Chief Executive Officer, its Chief Operating Officer, and its Chief Financial Officer as of the end of the period covered by this report, Bancorp's Chief Executive Officer, Chief Operating Officer and Chief Financial Officer concluded that Bancorp's disclosure controls have been effective.

As used herein, "disclosure controls and procedures" mean controls and other procedures of Bancorp that are designed to ensure that information required to be disclosed by Bancorp in the reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commissions rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by Bancorp in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to Bancorp's management, including its principal executive, and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

#### (b) Changes in Internal Controls

There have not been any significant changes in Bancorp's internal controls or in other factors that occurred during Bancorp's quarter ended September 30, 2004 that could significantly affect these controls subsequent to the evaluation referenced in paragraph (a) above.

34

## PART II Other Information

### Item 1. Legal Proceedings

Not Applicable

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

Not Applicable

### Item 3. Defaults Upon Senior Securities

Not applicable.

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

Not Applicable

### Item 5. Other Information

Not applicable.

### Item 6. Exhibits and Reports on Form 8-K

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(a) Exhibits  
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| No.<br>----- | Description<br>-----   |
|--------------|--|
| 3(i)         | Amended and Restated Certificate of Incorporation of the Issuer (incorporated by reference to Exhibit 3(i) to Issuer's Quarterly Report on Form 10-QSB dated June 30, 2002)  |
| 3(ii)        | By-Laws of the Issuer (incorporated by reference to Exhibit 3(ii) to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))   |
| 10.1         | Lease, dated as of August 17, 2000, between 215 Church Street, LLC and the Issuer (incorporated by reference to Exhibit 10.1 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))  |
| 10.2         | Letter agreement dated January 3, 2001 amending the Lease between 215 Church Street, LLC and the Issuer (incorporated by reference to Exhibit 10.2 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))                        |
| 10.3         | First Amendment to Lease dated March 30, 2001 between 215 Church Street, LLC and the Issuer (incorporated by reference to Exhibit 10.3 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))                                    |
| 35           |  |
| 10.4         | Second Amendment to Lease dated March 31, 2001 between 215 Church Street, LLC and the Issuer (incorporated by reference to Exhibit 10.4 to the Issuer's Registration Statement Form SB-2 (No. 333-59824))                                      |
| 10.5         | Assignment of Lease dated April 11, 2001 between the Issuer and The Bank of Southern Connecticut (incorporated by reference to Exhibit 10.5 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))                               |
| 10.6         | Employment Agreement dated as of January 23, 2001, between The Bank of Southern Connecticut, the Issuer and Joseph V. Ciaburri (incorporated by reference to Exhibit 10.6 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824)) |
| 10.7         | Issuer's 2001 Stock Option Plan (incorporated by reference to Exhibit 10.7 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))  |
| 10.8         | Issuer's 2001 Warrant Plan (incorporated by reference to Exhibit 10.8 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))   |
| 10.9         | Sublease dated January 1, 2001 between Michael Ciaburri, d/b/a Ciaburri Bank Strategies and The Bank of Southern Connecticut (incorporated by reference to Exhibit 10.9 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))   |
| 10.10        | Sublease dated January 1, 2001 between Laydon and Company, LLC and The   |

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- Bank of Southern Connecticut (incorporated by reference to Exhibit 10.10 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))
- 10.11 Issuer's 2001 Supplemental Warrant Plan (incorporated by reference to Exhibit 10.11 to Issuer's Annual Report on Form 10-KSB dated March 29, 2002)
- 10.12 Issuer's 2002 Stock Option Plan (incorporated by reference to Appendix B to Issuer's Definitive Proxy Statement dated April 18, 2002).
- 10.13 Employment Agreement dated as of February 12, 2003, between The Bank of Southern Connecticut and Michael M. Ciaburri. (incorporated by reference to Exhibit 10.13 to Issuer's Form 10 QSB dated May 14, 2003).
- 10.14 Amendment to Employment Agreement dated as of October 20, 2003, between The Bank of Southern Connecticut and Southern Connecticut Bancorp, Inc. and Joseph V. Ciaburri. (incorporated by reference to Exhibit 10.14 to the Issuer's Form 10-KSB dated March xx, 2004 (No. 333-59824))
- 10.15 Lease dated January 14, 2004 between The City of New London and the Issuer (incorporated by reference to Exhibit 10.17 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))
- 10.16 Lease dated August 2, 2002, between 469 West Main Street LLC and The Bank of Southern Connecticut (incorporated by reference to Exhibit 10.18 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824))
- 10.17 Underwriting Agreement between A.G. Edwards & Sons, Inc. and Keefe, Bruyette & Woods, and Southern Connecticut Bancorp dated June 16, 2004. (Incorporated by reference to Exhibit 1.1 to the Issuer's Registration Statement on Form SB-2 (No. 333-59824)).
- 36
- 10.18 Form of Stock Option Agreement for a Non-Qualified Stock Option granted under the Issuer's 2002 Stock Option Plan.
- 10.19 Form of Stock Option Agreement for an Incentive Stock Option granted under the Issuer's 2002 Stock Option Plan
- 10.20 Agreement of Sale of property and premises located in Clinton, Connecticut made June 22, 2004 between Dr. Alan Maris and James S. Brownstein, Trustee.
- 31.1 Section Rule 13(a)-14(a)/15(d)-14(a) Certification by Chairman and Chief Executive Officer.
- 31.2 Section Rule 13(a)-14(a)/15(d)-14(a) Certification by President and Chief Operating Officer.
- 31.3 Section Rule 13(a)-14(a)/15(d)-14(a) by Vice President and Chief Financial Officer.
- 32.1 Section 1350 Certification by Chairman and Chief Executive Officer.
- 32.2 Section 1350 Certification by President and Chief Operating Officer.

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32.3 Section 1350 Certification by Vice President and Chief Financial Officer.

(b) Reports on Form 8-K  
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The issuer filed reports on Form 8-K during the quarter ended September 30, 2004.

| Date of Filing<br>----- | Item Reported<br>-----   |
|-------------------------|--|
| July 20, 2004           | Results of Bancorp's operations for quarter ended June 30, 2004. |

37

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SOUTHERN CONNECTICUT BANCORP, INC.

By: /S/ Joseph V. Ciaburri  
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Name: Joseph V. Ciaburri  
Title: Chairman &  
Chief Executive Officer

Date: November 15, 2004

38

Exhibit Index  
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- 10.18 Form of Non-Qualified Stock Option Agreement under Bancorp's 2002 Stock Option Plan. (filed herewith)
- 10.19 Form of Incentive Stock Option Agreement under Bancorp's 2002 Stock Option Plan. (filed herewith)
- 10.20 Agreement of Sale of property located in Clinton, Connecticut made June 22, 2004 between Dr. Alan Maris and James S. Brownstein, Trustee. (filed herewith)
- 31.1 Rule 13(a)-14(a)/15(d)-14(a) Certification by Chairman and Chief



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- Executive Officer. (filed herewith)
- 31.2 Rule 13(a)-14(a)/15(d)-14(a) Certification by President and Chief Operating Officer. (filed herewith)
- 31.3 Rule 13(a)-14(a)/15(d)-14(a) Certification by Vice President and Chief Financial Officer. (filed herewith)
- 32.1 Section 1350 Certification by Chairman and Chief Executive Officer. (filed herewith)
- 32.2 Section 1350 Certification by President and Chief Operating Officer. (filed herewith)
- 32.3 Section 1350 Certification by Vice President and Chief Financial Officer. (filed herewith)