SHORE BANCSHARES INC
Form 10-Q
May 10, 2007

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

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2007

OR

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

For the transition period from ________ to ________

Commission file number 0-22345

SHORE BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

Maryland (State or Other Jurisdiction of Incorporation or Organization)	52-1974638 (I.R.S. Employer Identification No.)
18 East Dover Street, Easton, Maryland (Address of Principal Executive Offices)	21601 (Zip Code)

(410) 822-1400
Registrant's Telephone Number, Including Area Code

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

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

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,378,639 shares of common stock as of April 25, 2007.

INDEX

	Page
Part I.Financial Information	2
Item 1. Financial Statements	2
Condensed Consolidated Balance Sheets - March 31, 2007 (unaudited) and December 31, 2006	2
Condensed Consolidated Statements of Income - For the three-month periods ended March 31, 2007 and 2006 (unaudited)	3
Condensed Consolidated Statements of Changes in Stockholders' Equity - For the three months ended March 31, 2007 and 2006 (unaudited)	4
Condensed Consolidated Statements of Cash Flows - For the three months ended March 31, 2007 and 2006 (unaudited)	5
Notes to Condensed Consolidated Financial Statements (unaudited)	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 3. Quantitative and Qualitative Disclosures about Market Risk	16
Item 4. Controls and Procedures	16
Part II. Other Information	17
Item 1A. Risk Factors	17
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	17
Item 6. Exhibits	17
Signatures	18
Exhibit Index	19

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements.

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

	March 31, 2007 (unaudited)	December 31, 2006
ASSETS:		
Cash and due from banks	$ 16,334	$ 26,511
Interest bearing deposits with other banks	29,423	33,540
Federal funds sold	51,394	19,622
Investment securities:		
Held-to-maturity, at amortized cost (fair value of $13,927 and $13,938 , respectively)	13,962	13,971
Available for sale, at fair value	115,595	116,275
Loans, less allowance for credit losses ($6,506 and $6,300, respectively)	690,960	693,419
Insurance premiums receivable	838	574
Premises and equipment, net	15,897	15,973
Accrued interest receivable on loans and investment securities	5,083	4,892
Investment in unconsolidated subsidiary	937	937
Goodwill	11,939	11,939
Other intangible assets	1,486	1,569
Deferred income taxes	2,002	2,092
Other real estate owned	398	398
Other assets	4,102	3,937
TOTAL ASSETS	$ 960,350	$ 945,649
LIABILITIES:		
Deposits:		
Noninterest bearing demand	$ 103,780	$ 109,962
NOW and Super NOW	115,440	112,549
Certificates of deposit $100,000 or more	160,083	153,731
Other time and savings	399,056	397,940
Total Deposits	778,359	774,182
Accrued interest payable	2,419	2,243
Short term borrowings	32,815	28,525
Income taxes payable	1,974	-
Long term debt	27,000	25,000
Other liabilities	4,401	4,372
TOTAL LIABILITIES	846,968	834,322
STOCKHOLDERS' EQUITY:		
Common stock, par value $.01; authorized 35,000,000 shares; issued and outstanding:		
March 31, 2007 8,374,794		
December 31, 2006 8,383,395	84	84
Additional paid in capital	29,462	29,687

Retained earnings		84,341		82,279
Accumulated other comprehensive loss		(505)		(723)
TOTAL STOCKHOLDERS' EQUITY		113,382		111,327
TOTAL LIABILITIES & STOCKHOLDERS' EQUITY	$	960,350	$	945,649

See accompanying notes to Condensed Consolidated Financial Statements.

2

SHORE BANCSHARES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(Dollars in thousands, except per share amounts)

	Three months ended March 31,	
	2007	2006
INTEREST INCOME		
Loans, including fees	$ 13,624	$ 11,455
Interest and dividends on investment securities:		
Taxable	1,284	1,020
Tax-exempt	124	143
Other interest income	858	447
Total interest income	15,890	13,065
INTEREST EXPENSE		
Certificates of deposit, $100,000 or more	1,926	1,080
Other deposits	3,442	2,238
Interest on short-term borrowings	246	264
Interest on long-term debt	371	69
Total interest expense	5,985	3,651
NET INTEREST INCOME	9,905	9,414
PROVISION FOR CREDIT LOSSES	242	311
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	9,663	9,103
NONINTEREST INCOME		
Service charges on deposit accounts	689	744
Insurance agency commissions	2,039	2,331
Other noninterest income	920	631
Total noninterest income	3,648	3,706
NONINTEREST EXPENSE		
Salaries and employee benefits	4,933	4,468
Premises and equipment expense	832	732
Other noninterest expense	2,126	1,891
Total noninterest expense	7,891	7,091
INCOME BEFORE INCOME TAXES	5,420	5,718
Federal and state income tax expense	2,017	2,167
NET INCOME	$ 3,403	$ 3,551
Basic earnings per common share	$ .41	$ .43
Diluted earnings per common share	$ .41	$ .43
Dividends declared per common share	$ .16	$ .14

Per share data has been adjusted to give retroactive effect of a 3 for 2 stock split in the form of a stock dividend declared on May 4, 2006.

See accompanying notes to Condensed Consolidated Financial Statements.

SHORE BANCSHARES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Unaudited)
For the Three Month Periods Ended March 31, 2007 and 2006
(Dollars in thousands, except per share amounts)

	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated other Comprehensive Loss	Total Stockholders' Equity
Balances, January 1, 2007	$ 84	$ 29,687	$ 82,279	$ (723)	$ 111,327
Comprehensive income:					
Net income	-	-	3,403	-	3,403
Other comprehensive gain, net of tax:					
Unrealized loss on available for sale securities, net of reclassification adjustment of $0	-	-	-	218	218
Total comprehensive income					3,621
Shares issued	-	24	-	-	24
Stock-based compensation expense	-	12	-	-	12
Stock repurchased and retired	-	(261)	-	-	(261)
Cash dividends paid $0.16 per share	-	-	(1,341)	-	(1,341)
Balances, March 31, 2007	$ 84	$ 29,462	$ 84,341	$ (505)	$ 113,382
Balances, January 1, 2006	$ 55	$ 29,014	$ 73,642	$ (1,263)	$ 101,448
Comprehensive income:					
Net income	-	-	3,551	-	3,551
Other comprehensive loss, net of tax:					
Unrealized loss on available for sale securities, net of reclassification adjustment of $0	-	-	-	(104)	(104)
Total comprehensive income					3,447
Shares issued	1	385	-	-	386
Stock-based compensation expense	-	12	-	-	12

Cash dividends paid $0.14 per share		-		-		(1,168)		-	(1,168)
Balances, March 31, 2006	$	56	$	29,411	$	76,025	$	(1,367)	$ 104,125

Per share data has been adjusted to give retroactive effect of a 3 for 2 stock split in the form of a stock dividend declared on May 4, 2006.

See accompanying notes to Condensed Consolidated Financial Statements.

4

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

	For the Three Months Ended March 31, 2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	$ 3,403	$ 3,551
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	376	348
Stock based compensation expense	12	12
Discount accretion on debt securities	(33)	(27)
Provision for credit losses	242	311
Net changes in:		
Insurance premiums receivable	(265)	585
Accrued interest receivable	(191)	(212)
Other assets	(213)	(388)
Accrued interest payable	176	176
Accrued expenses	2,003	733
Net cash provided by operating activities	5,510	5,089
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from maturities and principal payments of securities available for sale	6,003	748
Purchase of securities available for sale	(4,939)	(3,148)
Proceeds from maturities and principal payments of securities held to maturity	3	229
Purchase of securities held to maturity	-	(203)
Net decrease (increase) in loans	2,218	(14,580)
Purchase of premises and equipment	(207)	(625)
Proceeds from sale of other real estate owned	-	255
Net cash provided by (used in) investing activities	3,078	(17,324)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net decrease in demand, NOW, money market and savings deposits	(6,882)	(9,855)
Net increase in certificates of deposit	11,059	13,620
Net increase (decrease) in short term borrowings	4,291	(8,567)
Net increase in long-term borrowings	2,000	5,000
Proceeds from issuance of common stock	24	386
Stock repurchased and retired	(261)	-
Dividends paid	(1,341)	(1,168)
Net cash provided by (used in) financing activities	8,890	(584)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	17,478	(12,819)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	79,673	67,459
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 97,151	$ 54,640
Supplemental cash flows information:		

Interest paid	$	5,808	$	3,474
Income taxes paid	$	35	$	768
Transfers from loans to other real estate	$	-	$	255

See accompanying notes to Condensed Consolidated Financial Statements

Shore Bancshares, Inc.
Notes to Condensed Consolidated Financial Statements
For the Three Months Ended March 31, 2007 and 2006
(Unaudited)

Note 1 - Basis of Presentation

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

Note 2 - Earnings Per Share

Basic earnings per share is derived by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. The diluted earnings per share calculation is derived by dividing net income by the weighted average number of shares outstanding during the period, adjusted for the dilutive effect of outstanding options and warrants. Information relating to the calculation of earnings per share is summarized as follows:

	Three Months Ended March 31,	
	2007	2006
	(in thousands, except per share data)	
Net Income	$ 3,403	$ 3,551
Weighted Average Shares Outstanding - Basic	8,382	8,345
Dilutive securities	14	36
Weighted Average Shares Outstanding - Dilutive	8,396	8,381
Earnings per common share - Basic	$ 0.41	$ 0.43
Earnings per common share - Dilutive	$ 0.41	$ 0.43

There were no antidilutive stock options excluded from the calculation of earnings per share for the three months ended March 31, 2007 and 2006.

Note 3 - Significant Accounting Policy

Under the provisions of Statements of Financial Accounting Standards (SFAS) Nos. 114 and 118, "Accounting by Creditors for Impairment of a Loan," a loan is considered impaired if it is probable that the Company will not collect

all principal and interest payments according to the loan's contracted terms. The impairment of a loan is measured at the present value of expected future cash flows using the loan's effective interest rate, or at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Interest income generally is not recognized on specific impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are applied as a reduction of the loans principal balance. Interest income on other nonaccrual loans is recognized only to the extent of interest payments received.

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

(Dollars in thousands)	March 31, 2007	December 31, 2006
Impaired loans with valuation allowance	$ 3,797	$ 7,658
Impaired loans with no valuation allowance	177	-
Total impaired loans	$ 3,974	$ 7,658
Allowance for credit losses applicable to impaired loans	$ 880	$ 883
Allowance for credit losses applicable to other than impaired loans	5,626	5,417
Total allowance for credit losses	$ 6,506	$ 6,300
Interest income on impaired loans recorded on the cash basis	$ 133	$ -

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

Note 4 - Commitments

In the normal course of business, to meet the financial needs of its customers, the Company's bank subsidiaries are parties to financial instruments with off-balance sheet risk. These financial instruments include commitments to extend credit and standby letters of credit. At March 31, 2007, total commitments to extend credit were approximately $223,237,000. Outstanding letters of credit were approximately $23,974,000 at March 31, 2007.

Note 5 - Stock-Based Compensation

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

During each of the three-month periods ended March 31, 2007 and 2006, the Company recognized pre-tax stock-based compensation expense of $12,000. Such expense includes compensation expense for stock-based compensation awards granted prior to, but not yet vested as of, January 1, 2006, and all awards granted subsequent to January 1, 2006, based on the grant-date fair value. The Company recognized compensation expense for stock option awards on a straight-line basis over the requisite service period of the award. The total of unrecognized compensation cost related to nonvested share-based compensation arrangements was $1,325 as of March 31, 2007. The cost will be recognized during the second quarter of 2007, at which time all outstanding stock option awards will be fully vested.

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

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

The weighted average fair value of options granted was $5.91 per share in 2006. No options were granted during the quarter ended March 31, 2007.

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

The following is a summary of changes in shares under option for all plans for the three-month period ended March 31, 2007:

	Number of Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at beginning of year	37,515	$ 15.82	
Granted	-	-	
Exercised	(1,535)	17.92	
Expired/Cancelled	(16)	18.47	
Outstanding at end of period	35,964	15.73	$ 468,206
Exercisable at the end of period	30,469	$ 16.19	$ 312,515

The following summarizes information about options outstanding at March 31, 2007:

Options Outstanding		Options Outstanding and Exercisable	
Exercise Price	Number	Number	Weighted Average Remaining Contract Life
$21.33	5,075	5,075	1.80
14.00	4,005	4,005	2.80
13.17	17,945	12,450	4.17
18.47	8,939	8,939	1.08
	35,964	30,469	

The total intrinsic value of stock options exercised during the three-month periods ended March 31, 2007 and 2006 was approximately $15,000 and $507,000, respectively. Cash received upon exercise of options during the three-month periods ended March 31, 2007 and 2006 was approximately $24,000 and $186,000, respectively.

8

Note 6 - Segment Reporting

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

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

Selected financial information by line of business for the three months ended March 31 is included in the following table:

(In thousands)	Community banking	Insurance products and services	Parent Company(a)	Intersegment Transactions	Consolidated Total
2007					
Net Interest income	$ 9,893	$ 10	$ 2	$ -	$ 9,905
Provision for credit losses	242	-	-	-	242
Net interest income after provision	9,651	10	2	-	9,663
Noninterest income	1,610	2,095	1,314	(1,371)	3,648
Noninterest expense	6,376	1,519	1,367	(1,371)	7,891
Income before taxes	4,885	586	(51)	-	5,420
Income tax expense	1,818	218	(19)	-	2,017
Net income	$ 3,067	$ 368	$ (32)	$ -	$ 3,403
Intersegment revenue(expense)	$ (1,170)	$ (92)	$ 1,262	$ -	$ -
Average assets	$ 935,332	$ 9,911	$ 3,612	$ -	$ 948,855
2006					
Net Interest income	$ 9,413	$ -	$ 1	$ -	$ 9,414
Provision for credit losses	311	-	-	-	311
Net interest income after provision	9,102	-	1	-	9,103
Noninterest income	1,353	2,369	1,099	(1,115)	3,706
Noninterest expense	5,620	1,493	1,093	(1,115)	7,091
Income before taxes	4,835	876	7	-	5,718
Income tax expense	1,805	359	3	-	2,167
Net income	$ 3,030	$ 517	$ 4	$ -	$ 3,551
Intersegment revenue(expense)	$ (985)	$ (74)	$ 1,059	$ -	$ -
Average assets	$ 838,922	$ 10,143	$ 3,784	$ -	$ 852,849

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

Note 7 - New Accounting Pronouncements

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

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

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

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

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

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

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

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

Forward-Looking Information

Portions of this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including statements that include the words "anticipate", "estimate", "should", "expect", "believe", "intend", and similar expressions, are expressions ab our confidence, policies, and strategies, the adequacy of capital levels, and liquidity and are not guarantees of future performance. Such forward-looking statements involve certain risks and uncertainties, including economic conditions, competition in the geographic and business areas in which we operate, inflation, fluctuations in interest rates, legislation, and governmental regulation. These risks and uncertainties are described in detail in the section of the periodic reports that Shore Bancshares, Inc. files with the Securities and Exchange Commission entitled "Risk Factors" (see Item 1A of Part II of this report). Actual results may differ materially from such forward-looking statements, and we assume no obligation to update forward-looking statements at any time except as required by law.

Introduction

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

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

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

Critical Accounting Policies

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

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

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

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

OVERVIEW

Net income for the first quarter of 2007 was $3,403,000, or diluted earnings per share of $.41, compared to $3,551,000, or diluted earnings per share of $.43, for the first quarter of 2006.

Annualized return on average assets was 1.43% for the three months ended March 31, 2007, compared to 1.67% for the same period in 2006. Annualized return on average stockholders' equity was 12.1% for the three-month period ended March 31, 2007, compared to 13.7% for the same period in 2006.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income for the three-month period ended March 31, 2007 was $9,905,000, representing an increase of $491,000 or 5.2% when compared to the same period last year. An increased volume of loans is the reason for the increase. Despite an increase in the yields of all categories of earning assets, the net interest margin declined from 4.80% for the first quarter of 2006 to 4.47% for the first quarter of 2007 as a result of the increased cost of funds. The rate paid for interest bearing deposits increased 97 basis points from 2.23% for the first quarter of 2006 to 3.20% for the same period of 2007. The market for deposits remains extremely competitive thus far in 2007 and higher rates is a primary factor in attracting customer deposits. Total interest income increased by $2,825,000 for the three-month period ended March 31, 2007 when compared to the same period last year.

Total interest expense increased $2,334,000 for the three-month period ended March 31, 2007 when compared to the same period last year. An increase in the rate paid for interest bearing deposits is the primary reason for the increased expense. Rates paid for certificates of deposit and short-term borrowings increased as a result of higher short-term interest rates and increased competition for deposits. The average balance of interest bearing deposits increased by $75,696,000 for the three months ended March 31, 2007 when compared to the same period in 2006. The overall rate paid for interest bearing deposits increased 97 basis points to 3.20% as a result of higher rates paid for all deposits. For the three months ended March 31, 2007, the average balance of certificates of deposits, including those $100,000 or

more, increased by $48,432,000 when compared to the same period last year, and the average rate paid for those certificates of deposit increased 94 basis points to 4.84%. Other certificates of deposit increased $36,647,000 when compared to the same period last year, and the average rate paid for those deposits increased 90 basis points to 4.43%. Comparing the first three months of 2007 to the same period in 2006, interest bearing demand deposits increased by approximately $3,197,000 and money management and savings deposits declined by $12,581,000.

Loans comprised 78.1% and 79.5% of total average earning assets at March 31, 2007 and 2006, respectively.

Analysis of Interest Rates and Interest Differentials.

The following table presents the distribution of the average consolidated balance sheets, interest income/expense, and annualized yields earned and rates paid through March 31, 2007 and 2006:

	March 31, 2007			March 31, 2006		
(Dollars in thousands)	Average Balance	Income Expense	Yield Rate	Average Balance	Income Expense	Yield Rate
Earning Assets						
Investment securities	$ 130,007	$ 1,476	4.54%	$ 121,854	$ 1,234	4.05%
Loans	698,735	13,641	7.81%	629,172	11,466	7.29%
Interest bearing deposits	26,678	338	5.07%	15,748	171	4.35%
Federal funds sold	38,819	520	5.35%	24,927	276	4.43%
Total earning assets	894,239	15,975	7.15%	791,701	13,147	6.64%
Noninterest earning assets	54,616			61,148		
Total Assets	$ 948,855			$ 852,849		
Interest bearing liabilities						
Interest bearing deposits	$ 670,831	5,368	3.20%	$ 595,135	3,318	2.23%
Short term borrowing	27,180	246	3.62%	33,518	264	3.16%
Long term debt	27,000	371	5.50%	5,722	69	4.84%
Total interest bearing liabilities	725,011	5,985	3.30%	634,375	3,651	2.30%
Noninterest bearing liabilities	111,212			114,787		
Stockholders' equity	112,632			103,687		
Total liabilities and stockholders' equity	$ 948,855			$ 852,849		
Net interest spread		$ 9,990	3.85%		$ 9,496	4.34%
Net interest margin			4.47%			4.80%

(1) All amounts are reported on a tax equivalent basis computed using the statutory federal income tax rate exclusive of the alternative minimum tax rate of 35% and nondeductible interest expense.

(2) Average loan balances include nonaccrual loans.

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

Noninterest Income

Noninterest income for the first quarter of 2007 declined $58,000 to $3,648,000 when compared to the first quarter of 2006. During the first quarter of 2007, income from service charges on deposit accounts declined $55,000 and insurance agency commissions declined $292,000. The decline in service charges is attributable primarily to a

customer overdraft privilege program and the decrease in insurance agency commissions is attributable to contingency income from insurance companies, which varies from year to year depending on a number of factors outside of our control. We earned an unusually large amount of contingency income in 2006. Other noninterest income increased $289,000 relating to growth of our secondary market mortgage program operating as Wye Mortgage Group and growth in revenue from our trust department operating as Wye Trust Services.

Noninterest Expense

Noninterest expense for the first quarter of 2007 increased $800,000 when compared to the first quarter of 2006. The increase is primarily the result of increased salaries and benefits costs of $465,000. Increases in salary and benefit are the result of higher incentive compensation cost and increased staffing for expansion of the Wye Mortgage Group, two new bank branches opened since the first quarter of 2006, and the additional cost associated with segregating the CEO positions at Shore Bancshares, Inc. and Talbot Bank, our largest bank subsidiary, and the associated hiring of a new CEO for Talbot Bank in the third quarter of 2006. Other operating cost increases totaling $335,000 were related to our overall growth.

Income Taxes

The effective tax rate for the three months ended March 31, 2007 was 37.2%, compared to 37.9% for the same period last year. Management believes that there have been no changes in tax laws or to our tax structure that are likely to have a future material impact on our effective tax rate.

ANALYSIS OF FINANCIAL CONDITION

Loans

Loans, net of unearned income, totaled $697,466,000 at March 31, 2007, a decrease of $2,253,000 since December 31, 2006. Average loans, net of unearned income, increased by $69,563,000 or 11.1% for the three months ended March 31, 2007 when compared to the same period last of year.

Allowance for Credit Losses

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

The provision for credit losses for the three-month periods ended March 31, 2007 and 2006 was $242,000 and $311,000, respectively. The decline in the provision for the first quarter of 2007 when compared to the same period last year reflects the current quality of the loan portfolio as well as a lack of growth during the period. Management believes that we continue to maintain strong underwriting guidelines. In addition, Management believes that the local economy, including the local real estate economy, remains stable and that, as a result, collateral values remain stable. Our historical charge-off ratios remain lower than those of similarly sized institutions according to the most recent Bank Holding Company Performance Report prepared by the Federal Reserve Board. Net charge-offs were $36,000 for the three-month period ended March 31, 2007, compared to $130,000 for the same period last year. The allowance for credit losses as a percentage of average loans was .93% at March 31, 2007, compared to .86% at March 31, 2006. Loans past due 90 days and still accruing at March 31, 2007 remained relatively stable, totaling $662,000 compared to $641,000 at December 31, 2006. One loan totaling $4,500,000, which was on nonaccrual at December 31, 2006, was paid in full during the first quarter of 2007. The Company did not incur any principal loss on the loan. Based on Management’s quarterly evaluation of the adequacy of the allowance for credit losses, it believes that the allowance for credit losses and the related provision are adequate at March 31, 2007.

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

(Dollars in thousands)	Three Months Ended March 31, 2007	2006
Allowance balance - beginning of period	$ 6,300	$ 5,236
Charge-offs:		
Commercial and other	16	1
Real estate	-	107
Consumer	79	68
Totals	95	176
Recoveries:		
Commercial	32	-
Real estate	-	29
Consumer	27	17
Totals	59	46
Net charge-offs	36	130
Provision for credit losses	242	311
Allowance balance-end of period	$ 6,506	$ 5,417
Average loans outstanding during period	$ 698,735	$ 629,172
Net charge-offs (annualized) as a percentage of average loans outstanding during period	.02%	.08%
Allowance for credit losses at period end as a percentage of average loans	.93%	.86%

Because our loans are predominately secured by real estate, weaknesses in the local real estate market may have a material adverse effect on collateral values and the performance of our loan portfolio. We have a concentration of commercial real estate loans. Commercial real estate loans, excluding construction and land development loans, at March 31, 2007 were approximately $220,589,000 or 31.6% of total loans, compared to $223,743,000 or 32.0% of total loans at December 31, 2006. Construction and land development loans at March 31, 2007 were $149,826,000 or 21.5% of total outstanding loans, compared to $153,715,000 or 22.2% of total loans at December 31, 2006. We do not engage in foreign lending activities.

Nonperforming Assets

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

	March 31, 2007	December 31, 2006
Nonperforming Assets:		
Nonaccrual loans	$ 3,974	$ 7,658
Other real estate owned	398	398
	4,372	8,056
Past due loans still accruing	662	641
Total nonperforming and past due loans	$ 5,034	$ 8,697

Investment Securities

Investment securities totaled $129,557,000 at March 31, 2007, compared to $130,246,000 at December 31, 2006. Reinvestment rates on bonds purchased during the first three months of 2007 were much higher that the yields on bonds that matured during this period. The average balance of investment securities was $130,007,000 for the three months ended March 31, 2007, compared to $121,854,000 for the same period in 2006. The tax equivalent yields on investment securities were 4.54% and 4.05% for the three month periods ended March 31, 2007 and 2006, respectively.

Deposits

Total deposits at March 31, 2007 were $778,359,000, compared to $774,182,000 at December 31, 2006. Certificates of deposit of $100,000 or more increased by $6,352,000 during the first three months of 2007, NOW and SuperNOW increased $2,891,000 and noninterest bearing demand declined by $6,182,000 since December 31, 2006. Other time and savings deposits have increased by $1,116,000.

Borrowed Funds

Short-term borrowings at March 31, 2007 and December 31, 2006 were $32,815,000 and $28,524,000, respectively. Short-term borrowings consisted of securities sold under agreements to repurchase and short-term borrowings from a correspondent bank or the Federal Home Loan Bank.

Long Term Debt

At March 31, 2007, we had advances from the Federal Home Loan Bank totaling $27,000,000. Maturities of outstanding advances are as follows:

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

Liquidity and Capital Resources

We derive liquidity through increased customer deposits, maturities in the investment portfolio, loan repayments and income from earning assets. To the extent that deposits are not adequate to fund customer loan demand, liquidity needs can be met in the short-term funds markets through arrangements with correspondent banks. Talbot Bank and Centreville National Bank are also members of the Federal Home Loan Bank of Atlanta and Felton Bank is a member of the Federal Home Loan