CHEMICAL FINANCIAL CORP
Form 10-Q
November 07, 2005

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2005

[ ] 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: 000-08185

CHEMICAL FINANCIAL CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Michigan (State or Other Jurisdiction of Incorporation or Organization)	**38-2022454** (I.R.S. Employer Identification No.)
333 East Main Street **Midland, Michigan** (Address of Principal Executive Offices)	**48640** (Zip Code)

(989) 839-5350
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes X No __

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

The number of shares outstanding of the Registrant's Common Stock, $1 par value, as of October 26, 2005, was 25,079,291 shares.

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CHEMICAL FINANCIAL CORPORATION
FORM 10-Q

FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and the Corporation itself. Words such as "anticipates," "believes," "estimates," "judgment," "expects," "forecasts," "intends," "is likely," "plans," "predicts," "projects," "should," "will" and variations of such words and similar expressions are intended to identify such forward-looking statements. In addition, all statements under Part I, Item 3 concerning quantitative and qualitative disclosures about market risk are forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("risk factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. The Corporation undertakes no obligation to update, amend or clarify forward-looking statements, whether as a result of new information, future events or otherwise.

Risk factors include, but are not limited to, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking laws and regulations; changes in tax laws; changes in prices, levies and assessments; the impact of technological advances and issues; governmental and regulatory policy changes; the outcomes of pending and future litigation and contingencies; trends in customer behavior as well as their ability to repay loans; changes in the local and national economy; opportunities for acquisition and the effective completion of acquisitions and integration of acquired entities; the effective completion of bank consolidations and restructurings; and the local and global effects of the ongoing war on terrorism and other military actions, including actions in Iraq. These are representative of the risk factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Income (Unaudited)

	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
	(In thousands, except per share amounts)			
INTEREST INCOME				
Interest and fees on loans	$ 42,023	$ 38,347	$ 121,055	$ 113,306
Interest on investment securities:				
Taxable	6,950	8,066	22,459	25,218
Tax-exempt	539	511	1,551	1,602
Total interest on investment securities	7,489	8,577	24,010	26,820
Interest on federal funds sold	682	265	1,586	668
Interest on deposits with banks	226	129	741	292
TOTAL INTEREST INCOME	50,420	47,318	147,392	141,086
INTEREST EXPENSE				
Interest on deposits	11,851	7,437	31,522	22,651
Interest on other borrowings - short-term	733	158	1,526	357
Interest on Federal Home Loan Bank (FHLB) borrowings	2,690	2,570	7,553	7,694
TOTAL INTEREST EXPENSE	15,274	10,165	40,601	30,702
NET INTEREST INCOME	35,146	37,153	106,791	110,384
Provision for loan losses	1,500	701	2,960	2,108
NET INTEREST INCOME after provision for loan losses	33,646	36,452	103,831	108,276
NONINTEREST INCOME				
Service charges on deposit accounts	5,406	4,970	15,136	14,281
Trust and investment management services revenue	1,891	1,761	5,963	5,541
Other charges and fees for customer services	2,388	1,706	5,984	5,060
Mortgage banking revenue	322	960	1,292	2,820
Investment securities gains	3	9	1,174	1,259
Other	239	217	633	629
TOTAL NONINTEREST INCOME	10,249	9,623	30,182	29,590
OPERATING EXPENSES				
Salaries, wages and employee benefits	14,404	14,385	43,642	43,879
Occupancy	2,346	2,237	7,067	6,976

Equipment	2,134	2,376	6,686	6,921
Other	5,955	5,501	17,190	16,803
TOTAL OPERATING EXPENSES	24,839	24,499	74,585	74,579
INCOME BEFORE INCOME TAXES	19,056	21,576	59,428	63,287
Federal income taxes	5,451	7,280	19,104	21,006
NET INCOME	$ 13,605	$ 14,296	$ 40,324	$ 42,281
NET INCOME PER SHARE (Basic)	$ 0.54	$ 0.58	$ 1.60	$ 1.69
(Diluted)	$ 0.54	$ 0.57	$ 1.60	$ 1.68
Cash dividends per share	$ 0.265	$ 0.252	$ 0.795	$ 0.756

See accompanying notes to consolidated financial statements.

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Financial Position (In thousands, except par value)

	September 30, 2005	December 31, 2004
	(Unaudited)	
ASSETS		
Cash and demand deposits due from banks	$ 111,115	$ 106,565
Federal funds sold	76,300	34,500
Interest bearing deposits with banks	36,337	5,869
Investment securities:		
Available for sale (at estimated fair value)	654,445	716,757
Held to maturity (estimated fair value - $132,367 at 9/30/05, $177,587 at 12/31/04)	132,898	176,517
Total investment securities	787,343	893,274
Loans:		
Commercial	504,189	468,970
Real estate construction	146,973	120,900
Real estate commercial	708,152	697,779
Real estate residential	783,834	760,834
Consumer	557,256	537,102
Total loans	2,700,404	2,585,585
Less: Allowance for loan losses	34,603	34,166
Net loans	2,665,801	2,551,419
Premises and equipment	45,123	47,577
Intangible assets	72,194	74,421
Other assets	47,948	50,500
TOTAL ASSETS	$ 3,842,161	$ 3,764,125
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	$ 521,969	$ 555,287
Interest-bearing	2,386,605	2,308,186
Total deposits	2,908,574	2,863,473
Reverse repurchase agreements	10,000	-
Other borrowings - short-term	127,613	101,834
Interest payable and other liabilities	29,118	28,986
FHLB borrowings	268,959	284,996
Total liabilities	3,344,264	3,279,289
Shareholders' equity:		
Common stock, $1 par value:		

Authorized - 30,000 shares		
Issued and outstanding - 25,127 shares at 9/30/05, 25,169 shares at 12/31/04	25,127	25,169
Surplus	377,469	378,694
Retained earnings	100,598	80,266
Accumulated other comprehensive (loss)/income	(5,297)	707
Total shareholders' equity	497,897	484,836
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 3,842,161	$ 3,764,125

See accompanying notes to consolidated financial statements.

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended September 30	
	2005	**2004**
	(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 40,324	$ 42,281
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	2,960	2,108
Gains on sales of loans	(863)	(1,159)
Proceeds from loan sales	75,974	125,206
Loans originated for sale	(79,776)	(122,781)
Investment securities gains	(1,174)	(1,259)
Depreciation of fixed assets	4,564	5,025
Amortization of intangible assets	2,496	2,861
Net amortization of investment securities	3,438	7,529
Mortgage servicing rights impairment recovery	-	(793)
Net decrease in accrued interest and other assets	10,599	11,107
Net increase (decrease) in interest payable and other liabilities	547	(1,522)
Net Cash Provided by Operating Activities	59,089	68,603
CASH FLOWS FROM INVESTING ACTIVITIES:		
Securities available for sale:		
Proceeds from maturities, calls and principal reductions	169,073	160,875
Proceeds from sales	75,864	81,654
Purchases	(193,711)	(274,161)
Securities held to maturity:		
Proceeds from maturities, calls and principal reductions	83,420	73,919
Purchases	(40,418)	(38,087)
Net increase in loans	(117,759)	(135,070)
Purchases of premises and equipment	(2,110)	(3,152)
Net Cash Used in Investing Activities	(25,641)	(134,022)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in total deposits	45,101	8,067
Proceeds from reverse repurchase agreements	10,000	-
Net increase in other borrowings - short-term	25,779	8,915
Increase in FHLB borrowings	65,000	150,000
Repayments of FHLB borrowings	(81,037)	(20,182)
Cash dividends paid	(19,992)	(19,027)
Proceeds from directors' stock purchase plan	231	219
Proceeds from exercise of stock options	471	2,728

Repurchases of common stock	(2,183)	-
Net Cash Provided by Financing Activities	43,370	130,720
Net Increase in Cash and Cash Equivalents	76,818	65,301
Cash and cash equivalents at beginning of year	146,934	162,191
Cash and Cash Equivalents at End of Period	$ 223,752	$ 227,492

Supplemental disclosure of cash flow information:		
Interest paid on deposits, reverse repurchase agreements, other borrowings-short-term and FHLB borrowings	$ 39,846	$ 30,684
Federal income taxes paid	18,250	20,750
Loans transferred to other real estate and repossessed assets	5,082	6,923

See accompanying notes to consolidated financial statements.

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2005

NOTE A: BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements of Chemical Financial Corporation (the "Corporation") have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly the financial condition and results of operations of the Corporation for the periods presented. Operating results for the three and nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005. For further information, refer to the consolidated financial statements and footnotes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2004.

Certain prior year amounts have been reclassified to place them on a basis comparable with the current period's financial statements. Such reclassifications had no impact on net income or shareholders' equity.

Income Taxes

The difference between the federal statutory income tax rate and the Corporation's effective federal income tax rate primarily is a function of the proportion of the Corporation's interest income exempt from federal taxation, nondeductible interest expense and other nondeductible expenses and tax credits.

Earnings Per Share

All earnings per share amounts have been presented to conform to the requirements of Statement of Financial Accounting Standards No. 128, "Earnings Per Share." Basic earnings per share exclude any dilutive effect of stock options. Basic earnings per share for the Corporation is computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share for the Corporation is computed by dividing net income by the sum of the weighted average number of common shares outstanding and the dilutive effect of outstanding employee stock options.

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2005

Earnings Per Share (continued)

The following table summarizes the number of shares used in the numerator and denominator of the basic and diluted earnings per share computations:

	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
	(In thousands)			
Numerator for both basic and diluted earnings per share, net income	$13,605	$14,296	$40,324	$42,281
Denominator for basic earnings per share, weighted average shares outstanding	25,134	25,144	25,156	25,120
Potential effect of stock options	56	78	57	86
Denominator for diluted earnings per share	25,190	25,222	25,213	25,206

Equity

In April of 2005, the Corporation's Board of Directors authorized management to repurchase up to 500,000 shares of the Corporation's common stock. The repurchased shares are available for later reissue in connection with potential future stock dividends, the Corporation's dividend reinvestment plan, employee benefit plans and other general purposes. This authorization replaced all prior share repurchase authorizations. During the third quarter of 2005, the Corporation repurchased 14,000 shares, at an average purchase price of $31.80 per share. During the nine months ended September 30, 2005, the Corporation repurchased a total of 72,200 shares, at an average purchase price of $30.24 per share.

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2005

Comprehensive Income

The components of comprehensive income, net of related tax, for the three and nine months ended September 30, 2005 and 2004 are as follows (in thousands of dollars):

	Three Months Ended September 30		Nine Months Ended September 30	
	2005	2004	2005	2004
Net income	$ 13,605	$ 14,296	$ 40,324	$ 42,281
Net unrealized (losses) gains on securities available for sale, net of tax benefit (expense) of $1,781 and $(1,309) for the three months ended 9/30/05 and 9/30/04, respectively, and $2,822 and $3,553 for the nine months ended 9/30/05 and 9/30/04, respectively	(3,308)	2,431	(5,241)	(6,599)
Reclassification adjustment for realized net gains included in net income, net of tax expense of $1 and $3 for the three months ended 9/30/05 and 9/30/04, respectively, and $411 and $441 for the nine months ended 9/30/05 and 9/30/04, respectively	(2)	(6)	(763)	(818)
Comprehensive income	$ 10,295	$ 16,721	$ 34,320	$ 34,864

The components of accumulated other comprehensive income, net of related tax, at September 30, 2005 and December 31, 2004 are as follows (in thousands of dollars):

	September 30, 2005	December 31, 2004
Net unrealized (losses) gains on investment securities available for sale (net of related tax benefit (expense) of $2,852 at 9/30/05 and ($381) at 12/31/04	$ (5,297)	$ 707

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CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2005

Operating Segment

Under the provisions of Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," it is management's opinion that the Corporation operates in a single operating segment - commercial banking. The Corporation is a bank holding company that operates three commercial banks, a title insurance company and an insurance subsidiary, each as a separate subsidiary of the Corporation, as of September 30, 2005. The Corporation's commercial bank subsidiaries operate as community banks and offer a full range of commercial banking and fiduciary products and services to the residents and business customers in their geographical market areas. The products and services offered by the commercial bank subsidiaries are generally consistent throughout the Corporation. Each of the Corporation's commercial bank subsidiaries operates within the State of Michigan. The marketing of products and services throughout the Corporation's subsidiary banks is generally uniform, as many of the markets served by the subsidiaries overlap. The distribution of products and services is uniform throughout the Corporation's commercial bank subsidiaries and is achieved primarily through retail branch banking offices, automated teller machines and electronically accessed banking products. The commercial bank subsidiaries are state-chartered commercial banks and operate under the same banking regulations.

On October 28, 2005, the Corporation issued a press release announcing a strategic restructuring that will include the consolidation of its three commercial bank charters into a single state chartered institution. The Corporation expects the legal consolidation of the bank charters to be effective on or about December 31, 2005. This press release is discussed in more detail in Note G, included herein.

Other

The Corporation and its subsidiary banks are subject to certain legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material adverse effect on the consolidated income or financial position of the Corporation.

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2005

NOTE B: NONPERFORMING ASSETS AND ALLOWANCE FOR LOAN LOSSES

The following summarizes nonperforming assets at the dates indicated (in thousands of dollars):

	September 30, 2005	December 31, 2004
Nonperforming Assets:		
Nonaccrual loans	$ 9,913	$ 8,397
Loans 90 days or more past due and still accruing interest	10,364	1,653
Total Nonperforming Loans	20,277	10,050
Repossessed assets acquired [1]	6,511	6,799
Total Nonperforming Assets	$ 26,788	$ 16,849

[1] Includes property acquired through foreclosure and by acceptance of a deed in lieu of foreclosure, and other property held for sale.

	September 30, 2005	December 31, 2004
Nonperforming loans as a percent of total loans	0.75%	0.39%
Allowance for loan losses as a percent of total loans	1.28%	1.32%
Nonperforming assets as a percent of total assets	0.70%	0.45%
Allowance for loan losses as a percent of nonperforming loans	171%	340%

CHEMICAL FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
September 30, 2005

NOTE B: NONPERFORMING ASSETS AND ALLOWANCE FOR LOAN LOSSES (continued)

The following summarizes the changes in the allowance for loan losses (in thousands of dollars):

	Nine Months Ended September 30	
	2005	2004
Allowance for Loan Losses		
Balance as of January 1	$ 34,166	$ 33,179
Provision for loan losses	2,960	2,108
Gross loans charged off	(3,008)	(2,602)
Gross recoveries of loans previously charged off	485	944
Net loans charged off	(2,523)	(1,658)
Balance as of end of period	$ 34,603	$ 33,629
Net loans charged against the allowance to average loans (annualized)	0.13%	0.09%

The Corporation considers all nonaccrual commercial and commercial real estate loans to be impaired loans. Impaired loans as of September 30, 2005 and December 31, 2004, were $5.1 million and $4.6 million, respectively. The Corporation allocated $1.2 million and $2.5 million of the allowance for loan losses to impaired loans as of September 30, 2005 and December 31, 2004, respectively. The Corporation's average investment in impaired loans was approximately $4.7 million and $4.2 million for the nine-month periods ended September 30, 2005 and 2004, respectively.

NOTE C: INTANGIBLE ASSETS

The Corporation has four major types of intangible assets: goodwill, mortgage servicing rights, core deposits and non-compete covenants. Goodwill, core deposits and non-compete covenants arose as the result of business combinations or other acquisitions. Mortgage servicing rights arose as a result o