

UNITY BANCORP INC /NJ/
Form 10-Q
August 11, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

OR

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

FOR THE TRANSITION PERIOD FROM TO .

Commission file number 1-12431

Unity Bancorp, Inc.

(Exact Name of Registrant as Specified in Its Charter)

New Jersey
(State or Other Jurisdiction
of Incorporation or Organization)

64 Old Highway 22, Clinton, NJ
(Address of Principal Executive Offices)

22-3282551
(I.R.S. Employer
Identification No.)

08809
(Zip Code)

Registrant's Telephone Number, Including Area Code **(908) 730-7630**

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, as amended, 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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2) Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act Yes No

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The number of shares outstanding of each of the registrant's classes of common equity stock, as of August 1, 2006 common stock, no par value:
6,578,843 shares outstanding

| | Page # |
|----------------------|---|
| <u>PART I</u> : | <u>CONSOLIDATED FINANCIAL INFORMATION</u> |
| <u>ITEM 1</u> : | <u>Consolidated Financial Statements (unaudited)</u> |
| | <u>Consolidated Balance Sheets at June 30, 2006, 2005 and December 31, 2005</u> 3 |
| | <u>Consolidated Statements of Income for the three and six months ended June 30, 2006 and 2005</u> 4 |
| | <u>Consolidated Statements of Changes in Shareholders' Equity for the six months ended June 30, 2006 and 2005</u> 5 |
| | <u>Consolidated Statements of Cash Flows for the six months ended June 30, 2006 and 2005</u> 6 |
| | <u>Notes to the Consolidated Financial Statements</u> 7 |
| <u>ITEM 2</u> : | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 10 |
| <u>ITEM 3</u> : | <u>Quantitative and Qualitative Disclosures about Market Risk</u> 27 |
| <u>ITEM 4</u> : | <u>Controls and Procedures</u> 27 |
| <u>PART II</u> : | <u>OTHER INFORMATION</u> 27 |
| <u>ITEM 1</u> | <u>Legal Proceedings</u> 27 |
| <u>ITEM 1A</u> | <u>Risk Factors</u> 27 |
| <u>ITEM 2</u> | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> 27 |
| <u>ITEM 3</u> | <u>Defaults upon Senior Securities</u> 27 |
| <u>ITEM 4</u> | <u>Submission of Matters to a Vote of Security Holders</u> 28 |
| <u>ITEM 5</u> | <u>Other Information</u> 28 |
| <u>ITEM 6</u> | <u>Exhibits</u> 28 |
| <u>SIGNATURES</u> | 29 |
| <u>Exhibit Index</u> | 30 |

Part 1.-Consolidated Financial Information

Item 1.-Consolidated Financial Statements (unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets

| (In thousands) | (unaudited) 06/30/06 | 12/31/05 | (unaudited) 06/30/05 |
|--|-------------------------|------------|-------------------------|
| Assets | | | |
| Cash and due from banks | \$ 13,709 | \$ 11,945 | \$ 11,284 |
| Federal funds sold and interest bearing deposits | 42,631 | 26,814 | 23,336 |
| Securities: | | | |
| Available for sale | 68,104 | 65,583 | 78,139 |
| Held to maturity (market value of \$39,700, \$40,212 and \$35,650, respectively) | 40,875 | 40,748 | 35,635 |
| Total securities | 108,979 | 106,331 | 113,774 |
| Loans: | | | |
| SBA held for sale | 24,384 | 14,001 | 13,880 |
| SBA held to maturity | 59,111 | 64,660 | 57,315 |
| Commercial | 297,826 | 260,581 | 229,860 |
| Residential mortgage | 55,966 | 62,039 | 63,775 |
| Consumer | 47,335 | 47,286 | 46,096 |
| Total loans | 484,622 | 448,567 | 410,926 |
| Less: Allowance for loan losses | 7,257 | 6,892 | 6,239 |
| Net loans | 477,365 | 441,675 | 404,687 |
| Premises and equipment, net | 10,954 | 10,593 | 10,208 |
| Bank owned life insurance | 5,279 | 5,185 | 5,093 |
| Accrued interest receivable | 3,460 | 3,167 | 2,747 |
| Loan servicing asset | 2,424 | 2,438 | 2,177 |
| Goodwill and other intangibles | 1,611 | 1,618 | |
| Other assets | 4,458 | 4,406 | 4,201 |
| Total assets | \$ 670,870 | \$ 614,172 | \$ 577,507 |
| Liabilities and Shareholders Equity | | | |
| Liabilities: | | | |
| Deposits | | | |
| Non-interest bearing demand deposits | \$ 81,721 | \$ 79,547 | \$ 79,830 |
| Interest bearing checking | 116,497 | 139,076 | 147,315 |
| Savings deposits | 187,841 | 141,935 | 149,348 |
| Time deposits, under \$100,000 | 124,652 | 108,353 | 72,655 |
| Time deposits, \$100,000 and over | 65,665 | 52,949 | 28,126 |
| Total deposits | 576,376 | 521,860 | 477,274 |
| Borrowed funds | 40,000 | 40,000 | 50,000 |
| Subordinated debentures | 9,279 | 9,279 | 9,279 |
| Accrued interest payable | 313 | 274 | 249 |
| Accrued expense and other liabilities | 1,456 | 1,830 | 2,294 |
| Total liabilities | \$ 627,424 | \$ 573,243 | \$ 539,096 |
| Commitments and contingencies | | | |
| Shareholders equity | | | |
| Common stock, no par value, 12,500 shares authorized | 43,866 | 38,423 | 37,988 |
| Treasury stock (23 shares) | (242) | (242) | (242) |
| Retained earnings | 1,555 | 3,897 | 1,155 |
| Accumulated other comprehensive loss | (1,733) | (1,149) | (490) |
| Total Shareholders Equity | 43,446 | 40,929 | 38,411 |
| Total Liabilities and Shareholders Equity | \$ 670,870 | \$ 614,172 | \$ 577,507 |
| Issued common shares | 6,602 | 6,559 | 6,435 |
| Outstanding common shares | 6,579 | 6,536 | 6,412 |

See Accompanying Notes to the Consolidated Financial Statements

Unity Bancorp

Consolidated Statements of Income

(unaudited)

| (In thousands, except per share amounts) | For the three months ended June 30, | | For the six months ended June 30, | |
|---|--|-----------------|--------------------------------------|-----------------|
| | 2006 | 2005 | 2006 | 2005 |
| Interest income: | | | | |
| Fed funds sold and interest on deposits | \$ 354 | \$ 117 | \$ 561 | \$ 179 |
| Securities: | | | | |
| Available for sale | 709 | 809 | 1,417 | 1,605 |
| Held to maturity | 467 | 348 | 943 | 622 |
| Total securities | 1,176 | 1,157 | 2,360 | 2,227 |
| Loans: | | | | |
| SBA loans | 2,179 | 1,448 | 4,332 | 2,807 |
| Commercial loans | 5,368 | 3,764 | 10,260 | 7,402 |
| Residential mortgage loans | 788 | 805 | 1,608 | 1,607 |
| Consumer loans | 779 | 652 | 1,523 | 1,244 |
| Total loan interest income | 9,114 | 6,669 | 17,723 | 13,060 |
| Total interest income | 10,644 | 7,943 | 20,644 | 15,466 |
| Interest expense: | | | | |
| Interest bearing demand deposits | 653 | 635 | 1,347 | 1,246 |
| Savings deposits | 1,704 | 781 | 2,896 | 1,241 |
| Time deposits | 1,671 | 764 | 3,170 | 1,527 |
| Borrowed funds and subordinated debentures | 583 | 498 | 1,145 | 922 |
| Total interest expense | 4,611 | 2,678 | 8,558 | 4,936 |
| Net interest income | 6,033 | 5,265 | 12,086 | 10,530 |
| Provision for loan losses | 250 | 350 | 550 | 650 |
| Net interest income after provision for loan losses | 5,783 | 4,915 | 11,536 | 9,880 |
| Non-interest Income: | | | | |
| Service charges on deposit accounts | 409 | 439 | 842 | 869 |
| Service and loan fee income | 406 | 630 | 801 | 1,166 |
| Gain on sales of SBA loans, net | 558 | 741 | 1,258 | 1,201 |
| Gain on sales of mortgage loans | 110 | 54 | 172 | 146 |
| Gain on sales of other loans | | | 82 | |
| Net security gains | | 24 | | 77 |
| Bank owned life insurance | 47 | 46 | 94 | 93 |
| Other income | 117 | 261 | 400 | 434 |
| Total non-interest income | 1,647 | 2,195 | 3,649 | 3,986 |
| Non-interest expense: | | | | |
| Compensation and benefits | 2,664 | 2,314 | 5,389 | 4,711 |
| Occupancy | 646 | 501 | 1,294 | 1,094 |
| Processing and communications | 553 | 489 | 1,080 | 955 |
| Furniture and equipment | 381 | 327 | 774 | 656 |
| Professional services | 151 | 194 | 283 | 303 |
| Loan servicing costs | 55 | 169 | 156 | 346 |
| Advertising | 148 | 187 | 318 | 372 |
| Deposit insurance | 16 | 15 | 33 | 30 |
| Other expenses | 387 | 446 | 930 | 823 |
| Total non-interest expense | 5,001 | 4,642 | 10,257 | 9,290 |
| Net income before provision for income taxes | 2,429 | 2,468 | 4,928 | 4,576 |
| Provision for income taxes | 792 | 941 | 1,634 | 1,739 |
| Net income | \$ 1,637 | \$ 1,527 | \$ 3,294 | \$ 2,837 |
| Net income per common share - Basic | \$ 0.25 | \$ 0.24 | \$ 0.50 | \$ 0.44 |
| Net income per common share - Diluted | 0.24 | 0.23 | 0.48 | 0.42 |
| Weighted average shares outstanding Basic | 6,574 | 6,414 | 6,565 | 6,399 |

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| | | | | | |
|-------------------------------------|---------|--------------|-------|--------------|-------|
| Weighted average shares outstanding | Diluted | 6,905 | 6,744 | 6,901 | 6,744 |
|-------------------------------------|---------|--------------|-------|--------------|-------|

See Accompanying Notes to the Unaudited Consolidated Financial Statements

4

Unity Bancorp, Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2006 and 2005

(unaudited)

| (In thousands) | Outstanding Shares | Common Stock | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|--|--------------------|--------------|----------------|-------------------|--------------------------------------|----------------------------|
| Balance, December 31, 2004 | 6,370 | \$ 34,025 | \$ | \$ 2,327 | \$ (484) | \$ 35,868 |
| Comprehensive income: | | | | | | |
| Net Income | | | | 2,837 | | 2,837 |
| Unrealized holding gain on securities arising during the period, net of tax of \$26 | | | | | 41 | |
| Less: reclassification adjustment for gains included in net income, net of tax of \$30 | | | | | 47 | |
| Net unrealized holding loss on securities arising during the period, net of tax benefit of \$4 | | | | | (6) | (6) |
| Total comprehensive income | | | | | | 2,831 |
| Cash dividends declared on common stock of \$.09 per share | | | | (524) | | (524) |
| 5% Stock Dividend, including cash-in-lieu of fractional shares | | 3,481 | | (3,485) | | (4) |
| Treasury stock purchased | (23) | | (242) | | | (242) |
| Stock options exercised | 65 | 482 | | | | 482 |
| Balance, June 30, 2005 | 6,412 | \$ 37,988 | \$ (242) | \$ 1,155 | \$ (490) | \$ 38,411 |

| (In thousands) | Outstanding Shares | Common Stock | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total Shareholders' Equity |
|--|--------------------|--------------|----------------|-------------------|--------------------------------------|----------------------------|
| Balance, December 31, 2005 | 6,536 | 38,423 | \$ (242) | \$ 3,897 | \$ (1,149) | \$ 40,929 |
| Comprehensive income: | | | | | | |
| Net Income | | | | 3,294 | | 3,294 |
| Unrealized holding loss on securities arising during the period, net of tax benefit of \$358 | | | | | (584) | |
| Net unrealized holding loss on securities arising during the period, net of tax benefit of \$358 | | | | | (584) | (584) |
| Total comprehensive income | | | | | | 2,710 |
| Cash dividends declared on common stock of \$.10 per share | | | | (644) | | (644) |
| 5% Stock Dividend, including cash-in-lieu of fractional shares | | 4,987 | | (4,992) | | (5) |
| Stock options exercised | 43 | 456 | | | | 456 |
| Balance, June 30, 2006 | 6,579 | \$ 43,866 | \$ (242) | \$ 1,555 | \$ (1,733) | \$ 43,446 |

See Accompanying Notes to the Unaudited Consolidated Financial Statements.

5

Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(unaudited)

| (In thousands) | For the six months ended June 30, | |
|---|-----------------------------------|-----------|
| | 2006 | 2005 |
| Operating activities: | | |
| Net income | \$ 3,294 | \$ 2,837 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Provision for loan losses | 550 | 650 |
| Depreciation and amortization | 778 | 715 |
| Net gain on sale of securities | | (77) |
| Gain on sale of SBA loans held for sale | (1,258) | (1,201) |
| Gain on sale of mortgage loans | (172) | (146) |
| Gain on sale of other loans | (82) | |
| Origination of SBA loans held for sale | (18,514) | (21,144) |
| Proceeds from the sale of SBA loans | 18,455 | 16,039 |
| Net change in other assets and liabilities | (498) | 704 |
| Net cash provided by (used in) operating activities | 2,553 | (1,623) |
| Investing activities: | | |
| Purchases of securities held to maturity | (4,360) | (15,676) |
| Purchases of securities available for sale | (7,808) | (7,074) |
| Maturities and principal payments on securities held to maturity | 4,182 | 3,575 |
| Maturities and principal payments on securities available for sale | 4,309 | 5,785 |
| Proceeds from sale of securities available for sale | | 1,175 |
| Proceeds from the sale of other real estate owned | 239 | 345 |
| Net increase in loans | (34,935) | (31,355) |
| Purchases of premises and equipment | (855) | (1,978) |
| Net cash used in investing activities | (39,228) | (45,203) |
| Financing activities: | | |
| Net increase in deposits | 54,516 | 43,376 |
| Proceeds from new borrowings | | 20,000 |
| Repayments of borrowings | | (5,000) |
| Proceeds from the issuance of common stock | 370 | 375 |
| Purchase of treasury stock | | (242) |
| Dividends paid | (630) | (469) |
| Net cash provided by financing activities | 54,256 | 58,040 |
| Increase in cash and cash equivalents | 17,581 | 11,214 |
| Cash and cash equivalents at beginning of year | 38,759 | 23,406 |
| Cash and cash equivalents at end of period | \$ 56,340 | \$ 34,620 |
| Supplemental disclosures: | | |
| Cash: | | |
| Interest paid | \$ 8,519 | \$ 4,863 |
| Income taxes paid | 2,462 | 831 |
| Non-Cash investing activities | | |
| Transfer of loan to Other Real Estate Owned | 61 | |

See Accompanying Notes to the Consolidated Financial Statements.

Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

June 30, 2006

NOTE 1. Summary of Significant Accounting Policies

The accompanying consolidated financial statements include the accounts of Unity Bancorp, Inc. (the Parent Company) and its wholly-owned subsidiary, Unity Bank (the Bank , or when consolidated with the Parent Company, the Company), and reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair presentation of interim results. Unity Investment Services, Inc. a wholly-owned subsidiary of the Bank, is used to hold part of the Bank's investment portfolio. Unity Participation Company, Inc. a wholly-owned subsidiary of the Bank is used to hold part of the Bank's loan portfolio. All significant inter-company balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior year amounts to conform to the current year presentation. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the statements of financial condition and revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions in the market. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission (SEC). The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, we and us and our refer to Unity Bancorp, Inc. and its consolidated subsidiary, Unity Bank, depending on the context. Interim financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto for the year ended December 31, 2005, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

Stock Based Compensation

The Company has incentive and non-qualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. The period during which the option is vested is generally 3 years, but no option may be exercised after 10 years from the date of the grant. The exercise price of each option is the market price on the date of grant. As of June 30, 2006, 1,379,154 shares have been reserved for issuance upon the exercise of options, 743,421 option grants are outstanding, 370,146 option grants have been exercised, forfeited or expired leaving 265,587 shares available for grant.

In addition, restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. Restricted stock awards granted during the six months ended June 30, 2006 and 2005, totaled 8,253 shares and 0 shares, respectively. The fair market value per share for these grants was \$14.12. These shares vest over a period of 4 years and are recognized as compensation to the employees over the vesting period. Compensation expense related to the restricted stock awards totaled \$41 thousand and \$10 thousand for the six months ended June 30, 2006 and 2005, respectively. For the quarters-ended, June 30, 2006 and 2005, compensation expense related to restricted stock totaled \$22 thousand and \$6 thousand respectively. As of June 30, 2006, 110,250 shares of restricted stock were reserved for issuance, of which 35,196 shares are outstanding and 75,054 shares are available for grant.

As of January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (Statement 123R) using the modified prospective application. Statement 123R requires public companies to recognize compensation expense related to stock-based compensation awards over the period during which an employee is required to provide service for the award. The provisions apply to all awards granted after the required effective date including existing awards not vested, modified, repurchased or canceled. Prior to January 1, 2006, the Company applied Accounting Principles Board Opinion 25 and related Interpretations in accounting for its Option Plans. No stock-based compensation cost was reflected in net income, as all options granted under those plans had an exercise price equal to the market value of their underlying common stock on the date of grant.

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The following table represents the impact of the adoption of SFAS 123R on the Company's financial statements for the quarter ended June 30, 2006.

| | Under SFAS 123 R | Under APB 25 | Difference |
|--|------------------------|-----------------|------------|
| Net income before provision for income taxes | \$ 2,429 | \$ 2,436 | \$ 7 |
| Net income | \$ 1,637 | \$ 1,642 | \$ 5 |
| Net income per common share - Basic | \$ 0.25 | \$ 0.25 | \$ 0.0 |
| Net income per common share - Diluted | \$ 0.24 | \$ 0.24 | \$ 0.0 |

The following table represents the impact of the adoption of SFAS 123R on the Company's financial statements for the six months ended June 30, 2006.

| | Under SFAS 123 R | Under APB 25 | Difference |
|--|------------------------|-----------------|------------|
| Net income before provision for income taxes | \$ 4,928 | \$ 4,940 | \$ 12 |
| Net income | \$ 3,294 | \$ 3,300 | \$ 6 |
| Net income per common share - Basic | \$ 0.50 | \$ 0.50 | \$ 0.0 |
| Net income per common share - Diluted | \$ 0.48 | \$ 0.48 | \$ 0.0 |

The following table illustrates the effect on net income and earnings per share for the three and six month periods ended June 30, 2005 if the Company had applied the fair value recognition provisions of FASB Statement No. 123, Accounting for Stock-Based Compensation as amended, to stock based compensation.

Proforma

| (In thousands, except per share data) | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|--|-------------------------------------|-----------------------------------|
| Net income to common shareholders as reported: | | |
| As reported | 1,527 | 2,837 |
| Pro forma | 1,511 | 2,805 |
| Income per share: | | |
| Basic as reported | 0.24 | 0.44 |
| Basic Pro forma | 0.24 | 0.44 |
| Diluted as reported | 0.23 | 0.42 |
| Diluted Pro forma | 0.22 | 0.42 |

During the six months ended June 30, 2006 and 2005, the Company granted 15,750 options at an exercise price of \$13.33 per share and 5,513 options at an exercise price of \$10.89 per share, respectively. The Company used the Black Scholes option-pricing model to calculate the \$2.98 and \$2.44 fair value of these options. The fair value of the options granted during each period were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

- Expected life of 4.19 years
- Expected volatility of 23.5 percent
- Risk free interest rate of 3.99 percent
- Dividend yield of 1.36 percent

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Transactions under the Company's stock options plans during the six months ended June 30, 2006 are summarized as follows:

| | Number of Shares | Exercise Price per Share | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in years) | Aggregate Intrinsic Value |
|----------------------------------|------------------|--------------------------|---------------------------------|--|---------------------------|
| Outstanding at December 31, 2005 | 754,131 | \$2.31 - 12.64 | \$ 5.81 | | |
| Options Granted | 15,750 | 13.33 | 13.33 | | |
| Options Exercised | (23,310) | 2.98 - 9.77 | 5.89 | | |
| Options Expired | (3,150) | 9.77 - 11.88 | 11.53 | | |
| Outstanding at June 30, 2006 | 743,421 | \$2.31 - 13.33 | \$ 5.94 | 5.76 | \$ 6,550,132 |
| Exercisable at June 30, 2006 | 722,148 | \$2.31 - 12.64 | \$ 6.11 | 5.59 | \$ 6,239,182 |

As of June 30, 2006, there was approximately \$52 thousand of unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted-average period of 2.0 years.

The following table summarizes information about stock options outstanding at June 30, 2006:

| Range of Exercise Prices | Options Outstanding | | | Options Exercisable | |
|--------------------------|---------------------|--|---------------------------------|---------------------|---------------------------------|
| | Shares Outstanding | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Shares Exercisable | Weighted Average Exercise Price |
| \$0.00-\$4.00 | 332,493 | 4.9 years | \$ 3.29 | 332,493 | \$ 3.29 |
| \$4.01-\$8.00 | 181,104 | 6.1 years | 5.58 | 181,104 | 5.58 |
| \$8.01 - \$12.00 | 208,551 | 6.5 years | 9.75 | 204,869 | 9.73 |
| \$12.01 - \$16.00 | 21,273 | 9.1 years | 13.15 | 3,682 | 12.64 |
| | 743,421 | 5.8 years | \$ 5.94 | 722,148 | \$ 6.11 |

The total intrinsic value of the stock options exercised during the six months ended June 30, 2006 and 2005 was \$203 thousand and \$267 thousand, respectively. The total intrinsic value of the stock options exercised during the quarters ended June 30, 2006 and 2005 was \$85 thousand and \$106 thousand, respectively.

On June 30, 2006, the Company paid a 5 percent stock distribution to all shareholders of record as of June 16, 2006 and accordingly, all share amounts have been restated to include the effect of the distribution.

NOTE 2. Litigation

From time to time, the Company is subject to legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of the operation of the Company.

NOTE 3. Earnings per share

The following is a reconciliation of the calculation of basic and diluted earnings per share. Basic net income per common share is calculated by dividing net income to common shareholders by the weighted average common shares outstanding during the reporting period. Diluted net income per common share is computed similarly to that of basic net income per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options, were issued during the reporting period utilizing the Treasury stock method.

| (In thousands, except per share data) | Three Months ended June 30, | | Six Months ended June 30, | | |
|--|-----------------------------|----------|---------------------------|----------|---|
| | 2006 | 2005 | 2006 | 2005 | |
| Net Income to common shareholders | \$ 1,637 | \$ 1,527 | \$ 3,294 | \$ 2,837 | |
| Basic weighted-average common shares outstanding | 6,574 | 6,414 | 6,565 | 6,399 | |
| Plus: Common stock equivalents | 331 | 330 | 336 | 345 | |
| Diluted weighted average common shares outstanding | 6,905 | 6,744 | 6,901 | 6,744 | |
| Net Income per Common share: | | | | | |
| Basic | \$ 0.25 | \$ 0.24 | \$ 0.50 | \$ 0.44 | |
| Diluted | 0.24 | 0.23 | 0.48 | 0.42 | |
| Return on average assets | 1.03 | % 1.13 | % 1.05 | % 1.08 | % |
| Return on average common equity | 15.39 | % 16.50 | % 15.82 | % 15.62 | % |
| Efficiency ratio* | 65.12 | % 62.43 | % 65.19 | % 64.34 | % |

* Non-interest expense divided by net interest income plus non-interest income less securities gains

NOTE 4. Recent accounting pronouncements

In March 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 156, Accounting for Servicing of Financial Assets. SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, establishes, among other things, the accounting for all separately recognized servicing assets and servicing liabilities. SFAS No. 156 amends Statement 140 to require that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. This Statement permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value. An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. Under this Statement, an entity can elect subsequent fair value measurement to account for its separately recognized servicing assets and servicing liabilities. By electing that option, an entity may simplify its accounting because this Statement permits income statement recognition of the potential offsetting changes in fair value of those servicing assets and servicing liabilities and derivative instruments in the same accounting period. The Statement is effective in the first fiscal year beginning after September 15, 2006 with earlier adoption permitted. The Company does not expect the adoption of Statement No. 156 to have a material impact on its financial statements.

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes . The Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109 Accounting for Income Taxes . This Interpretation presents a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation is effective for fiscal years beginning after December 15, 2006. The Company does not expect the adoption of Interpretation No. 48 to have a material impact on its financial statements.

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

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2005 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as believe , expect , anticipate , should , planned , estimated and potential . Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc. s interest rate spread or other income anticipated from operations and investments.

Overview

Unity Bancorp, Inc. (the Parent Company) is incorporated in New Jersey and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the Bank or, when consolidated with the Parent Company, the Company) was granted a charter by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through 14 branch offices located in Hunterdon, Somerset, Middlesex, Union and Warren counties in New Jersey and a loan production office in Long Island, New York. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, Small Business Administration and other commercial credits. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank's investment portfolio. Unity Participation Company, Inc., a wholly-owned subsidiary of the Bank is used for holding and administering certain loan participations.

Unity (NJ) Statutory Trust I is a statutory Business Trust and wholly-owned subsidiary of Unity Bancorp, Inc. On September 26, 2002, the trust issued \$9.0 million of capital securities to investors. These floating rate securities are treated as subordinated debentures on the financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes. In accordance with Financial Accounting Interpretation No. 46, Consolidation of Variable Interest Entities, as revised December 2003, the Company does not consolidate the accounts and related activity of Unity (NJ) Statutory Trust I.

Effective July 24, the Parent Company formed Unity (NJ) Statutory Trust II as a wholly owned subsidiary. The Trust issued \$10 million of trust preferred securities to investors. The floating rate securities are treated as subordinated debentures on the Company's financial statements, and bear interest at 159 basis points above the three month Libor rate. The securities were initially priced at 7.05%, and the rate resets quarterly. In accordance with Financial Accounting Interpretation No. 46, Consolidation of Variable Interest Entities, as revised December 2003, the Company does not consolidate the accounts and related activity of Unity (NJ) Statutory Trust II.

Earnings Summary

Net income for the three months ended June 30, 2006 was \$1.6 million, an increase of \$110 thousand or 7.2 percent, compared to net income of \$1.5 million for the same period in 2005. This was the result of increased net interest income and a lower provision for loan losses, offset in part by lower non-interest income and higher operating expenses.

Quarterly performance highlights include:

- Earnings per basic share increased to \$0.25 for the second quarter of 2006 compared to \$0.24 for the same period in 2005.
- Earnings per diluted share increased to \$0.24 for the second quarter of 2006 compared to \$0.23 for the same period a year ago.
- Return on average assets equaled 1.03 percent and 1.13 percent for each of the quarters ended June 30, 2006 and 2005, respectively.
- Return on average common equity equaled 15.39 percent and 16.50 percent for the quarters ended June 30, 2006 and 2005, respectively.
- The efficiency ratio equaled 65.12 percent for the second quarter of 2006 compared to 62.43 percent for the same period a year ago.

Net income for the six months ended June 30, 2006 was \$3.3 million, an increase of \$457 thousand or 16.1 percent, compared to net income of \$2.8 million for the same period in 2005. This was the result of increased net interest income and a lower provision for loan losses, offset in part by lower non-interest income and higher operating expenses.

Year to date performance highlights include:

- Earnings per basic share increased to \$0.50 for the six months ended June 30, 2006 compared to \$0.44 for the same period in 2005.

- Earnings per diluted share increased to \$0.48 for the six months ended June 30, 2006 compared to \$0.42 for the same period a year ago.
- Return on average assets equaled 1.05 percent and 1.08 percent for each of the six month periods ended June 30, 2006 and 2005, respectively.
- Return on average common equity equaled 15.82 percent and 15.62 percent for the six months ended June 30, 2006 and 2005, respectively.
- The efficiency ratio equaled 65.19 percent for the six months ended June 30, 2006 compared to 64.34 percent for the same period a year ago.

11

During the first six months of 2006, financial institutions continued to be pressured by a flat yield curve as the Federal Reserve Board raised short term rates four more times. Since this rate cycle began in June 2004, the Federal Reserve raised short-term interest rates seventeen times for a total of 425 basis points. This has resulted in the Federal Funds rate increasing from 1.00 percent to 5.25 percent while the Prime-lending rate increased from 4.00 percent to 8.25 percent. Despite this challenging interest rate environment, the Company was able to grow net interest income due to strong growth in interest earning assets. However, the flat yield curve and the competitive pricing of deposits in the New Jersey market place may put further pressure on the net interest margin in 2006.

Net interest income, our largest component of operating income, increased \$768 thousand or 14.6 percent to \$6.0 million for the three months ended June 30, 2006 compared to the same period in 2005. This increase was the result of a \$94 million increase in average earning assets partially offset by a reduced net interest margin and spread. Net interest margin (net interest income as a percentage of average interest earning assets) decreased 13 basis points to 3.99 percent for the current quarter compared to 4.12 percent for the same period a year ago. Over the same period, net interest spread (the difference between the rate earned on average interest-earning assets and the rate paid on average interest-bearing liabilities) decreased 22 basis points to 3.46 percent from 3.68 percent a year ago. For the six months ended June 30, 2006, net interest income was \$12.1 million, an increase of \$1.6 million or 14.8 percent, compared to \$10.5 million during the same period a year ago. The net interest margin decreased 17 basis points to 4.05 percent for the six months ended June 30, 2006 compared to the same period a year ago.

Non-interest income decreased \$548 thousand or 25 percent to \$1.6 million for the three months ended June 30, 2006 compared to \$2.2 million for the three months ended June 30, 2005. This decrease was due primarily to decreased service and loan fee income, gains on the sale of Small Business Administration (SBA) loans and commercial loan referral fees, partially offset by increased gains on Mortgage loan sales. For the six months ended June 30, 2006, non-interest income was \$3.7 million, a decrease of \$337 thousand or 8.5 percent compared to \$4.0 million during the same period a year ago. This decrease was due primarily to decreased service and loan fee income, service charges on deposits and other income, partially offset by increased gains on Mortgage loan sales, SBA loan sales and other loan sales.

Non-interest expense was \$5.0 million for the three months ended June 30, 2006, an increase of \$359 thousand or 7.7 percent compared to \$4.6 million for the same period a year ago. For the six-month period ended June 30, 2006, non-interest expense increased \$967 thousand or 10.4 percent to \$10.3 million compared to the six-month period ended June 30, 2005. The increase in both periods was due primarily to increased compensation and benefits, occupancy, furniture and equipment and processing and communications, partially offset by lower loan servicing, professional services and advertising expenses.

For the quarter ended June 30, 2006, the provision for income taxes was \$792 thousand compared to \$941 thousand for the same period a year ago. The provision for income taxes decreased \$105 thousand to \$1.6 million at June 30, 2006 compared to the same period a year ago. The current 2006 tax provision represents an effective tax rate of approximately 33.2 percent as compared to 38 percent for the prior year. The lower effective tax rate for 2006 is related to a higher proportion of revenue being generated at a subsidiary with a lower effective tax rate. Management anticipates an effective rate of approximately 33 percent for the remainder of 2006.

Net Interest Income

Tax-equivalent interest income totaled \$10.7 million for the three months ended June 30, 2006, an increase of \$2.7 million or 33.9 percent, compared to \$8.0 million a year ago. Of the \$2.7 million increase in interest income, \$1.7 million is due to an increase in the volume of interest-earning assets, while \$955 thousand is attributable to an increase in the yield on interest-earning assets. The average volume of interest-earning assets increased \$94.0 million to \$606.6 million at June 30, 2006 compared to \$512.6 million at June 30, 2005. This was due to an \$86.4 million increase in average total loans plus a \$13.3 million increase in average federal funds sold and interest bearing deposits, offset in part by a \$5.7 million decrease in average total securities. The impact of the higher interest rate environment in the second quarter of 2006 was evident in the rates earned on variable rate instruments such as SBA loans, commercial loans and consumer home equity lines of credit, as well as federal funds sold and interest bearing deposits. Key interest rate increases during the quarter included:

- The average interest rate earned on federal funds sold and interest bearing deposits increased 192 basis points to 4.73 percent for the three months ended June 30, 2006 compared to 2.81 percent for the same period a year ago.
- The average interest rate earned on SBA loans equaled 10.41 percent during the quarter, an increase of 196 basis points over the comparable quarter in 2005, due to the quarterly re-pricing of these loans with changes in the Prime rate.
- The average interest rate earned on Consumer loans increased 81 basis points to 6.69 percent for the three months ended June 30, 2006 compared to 5.88 percent for the same period a year ago due to the re-pricing of Prime based

home equity products.

12

- The average interest rate earned on Commercial loans was 7.50 percent for the quarter, an increase of 51 basis points over the comparable quarter in 2005.

The higher interest rate environment also increased interest expense and the cost of funds. Total interest expense was \$4.6 million for the three months ended June 30, 2006, an increase of \$1.9 million or 72.2 percent, compared to \$2.7 million for the same period a year ago. Of the \$1.9 million increase in interest expense, \$976 thousand is related to an increase in average interest-bearing liabilities while \$957 thousand is due to an increase in the cost of funds. Quarter over quarter, average interest-bearing liabilities increased \$93.8 million as average interest-bearing deposits increased \$88.5 million and borrowed funds and subordinated debentures increased \$5.2 million. Total interest-bearing deposits were \$467.7 million on average, an increase of \$88.5 million or 23.3 percent compared to \$379.2 million from the same period a year ago. The increase in average interest-bearing deposits was as a result of increases in the savings and time deposit categories, partially offset by a decline in interest-bearing checking accounts. Average borrowed funds and subordinated debentures increased \$5.2 million to \$49.3 million as of June 30, 2006 due to the addition of a \$10 million FHLB advance at 3.70 percent during the second quarter of 2005. The rate paid on interest bearing liabilities increased 104 basis points to 3.58 percent for the three months ended June 30, 2006 from 2.54 percent in the same period in 2005. The cost of interest-bearing deposits increased 114 basis points to 3.45 percent as the rates paid on all deposit products increased while the cost of borrowed funds and subordinated debentures increased 21 basis points to 4.75 percent.

Tax-equivalent net interest income increased \$768 thousand to \$6.05 million for the quarter ended June 30, 2006 compared to \$5.28 million for the same period a year ago. Net interest margin constricted 13 basis points to 3.99 percent compared to 4.12 percent for the same period a year ago. The tighter net interest margin was primarily the result of the higher cost of deposits to fund loan growth. The net interest spread was 3.46 percent for the three months ended June 30, 2006 compared to 3.68 percent for the same period a year ago.

Tax-equivalent interest income totaled \$20.7 million for the six months ended June 30, 2006, an increase of \$5.2 million or 33.4 percent, compared to \$15.5 million a year ago. Of the \$5.2 million increase in interest income, \$3.5 million is due to an increase in the volume of earning assets, while \$1.6 million is attributable to an increase in the yield on interest-earning assets. The average volume of interest-earning assets increased \$97.6 million to \$597.6 million at June 30, 2006 compared to \$500.0 million at June 30, 2005. This was due to an \$85.5 million increase in average total loans plus an \$11.2 million increase in average federal funds sold and interest bearing deposits partially offset by a \$774 thousand decrease in average total securities. Key interest rate increases during the six months ended June 30, 2006 included:

- The average interest rate earned on federal funds sold and interest bearing deposits increased 190 basis points to 4.57 percent for the six months ended June 30, 2006 compared to 2.67 percent for the same period a year ago.
- The average interest rate earned on SBA loans equaled 10.22 percent for the six months ended June 30, 2006, an increase of 181 basis points over the comparable period in 2005, due to the quarterly re-pricing of these loans with changes in the Prime rate.
- The average interest rate earned on Consumer loans increased 82 basis points to 6.59 percent for the six months ended June 30, 2006 compared to 5.77 percent for the same period a year ago due to the re-pricing of Prime based home equity products.
- The average interest rate earned on Commercial loans was 7.41 percent for the six months ended June 30, 2006, an increase of 44 basis points over the comparable period in 2005.

Total interest expense was \$8.6 million for the six months ended June 30, 2006, an increase of \$3.6 million or 73.4 percent, compared to \$4.9 million for the same period a year ago. Of the \$3.6 million increase in interest expense, \$1.8 million is related to an increase in average interest-bearing liabilities while \$1.8 million is due to an increase in the cost of funds. Comparing the six-month periods ended June 30, 2006 and 2005, average interest bearing liabilities increased \$95.5 million in the current year as average interest bearing deposits increased \$88.3 million and borrowed funds and subordinated debentures increased \$7.2 million. Total interest-bearing deposits were \$458.3 million on average, an increase of \$88.3 million or 23.9 percent compared to \$370.0 million from the same period a year ago. The increase in average interest-bearing deposits was a result of increases in the savings and time deposit categories, partially offset by a decline in interest-bearing checking accounts. Average borrowed funds increased \$7.2 million to \$49.3 million as of June 30, 2006 due to the addition of a \$10 million FHLB advance at 3.70 percent during the second quarter of 2005. The rate paid on interest bearing liabilities increased 98 basis points to 3.40 percent for the six months ended June 30, 2006 from 2.42 percent in the same period in 2005. The cost of interest bearing deposits increased 107 basis points to 3.26 percent as the rates paid on all deposit products increased. It is expected that the cost of deposits will continue to rise due to competitive pricing in the New Jersey marketplace. The cost of borrowed funds and subordinated debentures increased 27 basis points to 4.69 percent for the six months ended June 30, 2006 compared to 2005.

Tax-equivalent net interest income increased \$1.6 million to \$12.1 million for the six months ended June 30, 2006 compared to \$10.5 million for the same period a year ago. Net interest margin contracted 17 basis points to 4.05 percent compared to 4.22 percent for the same period a year ago. The tighter net interest margin was primarily the result of the high cost of deposits in the New Jersey market place. The net interest spread was 3.55 percent for the six months ended June 30, 2006 compared to 3.81 percent for the same period a year ago.

14

Unity Bancorp, Inc.

Consolidated Average Balance Sheets with resultant Interest and Rates

(unaudited)
(Tax-equivalent basis, dollars in thousands)

| | Three Months Ended June 30, 2006 | | | June 30, 2005 | | |
|---|-------------------------------------|--------------|----------------|---------------|-----------------|----------------|
| | Balance | Interest | Rate/ Yield | Balance | Interest | Rate/ Yield |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-bearing deposits with banks | \$ 30,005 | \$ 354 | 4.73 % | \$ 16,716 | \$ 117 | 2.81 % |
| Securities: | | | | | | |
| Available for sale | 62,831 | 722 | 4.60 | 77,646 | 822 | 4.23 |
| Held to maturity | 38,283 | 467 | 4.88 | 29,124 | 348 | 4.78 |
| Total securities | 101,114 | 1,189 | 4.70 | 106,770 | 1,170 | 4.38 |
| Loans, net of unearned discount: | | | | | | |
| SBA loans | 83,708 | 2,179 | 10.41 | 68,511 | 1,448 | 8.45 |
| Commercial | 286,943 | 5,368 | 7.50 | 215,985 | 3,764 | 6.99 |
| Residential mortgages | 58,135 | 788 | 5.42 | 60,136 | 805 | 5.35 |
| Consumer | 46,690 | 779 | 6.69 | 44,493 | 652 | 5.88 |
| Total loans | 475,476 | 9,114 | 7.68 | 389,125 | 6,669 | 6.87 |
| Total interest-earning assets | 606,595 | 10,657 | 7.04 | 512,611 | 7,956 | 6.22 |
| Noninterest-earning assets: | | | | | | |
| Cash and due from banks | 12,535 | | | 13,590 | | |
| Allowance for loan losses | (7,478) | | | (6,085) | | |
| Other assets | 28,355 | | | 20,263 | | |
| Total noninterest-earning assets | 33,412 | | | 27,768 | | |
| Total Assets | \$ 640,007 | | | \$ 540,379 | | |
| Liabilities and Shareholders Equity | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing checking | \$ 116,303 | 653 | 2.25 | \$ 156,186 | 635 | 1.63 |
| Savings deposits | 184,168 | 1,704 | 3.71 | 119,325 | 781 | 2.63 |
| Time deposits | 167,245 | 1,671 | 4.01 | 103,674 | 764 | 2.96 |
| Total interest-bearing deposits | 467,716 | 4,028 | 3.45 | 379,185 | 2,180 | 2.31 |
| Borrowed funds and subordinated debentures | | | | | | |
| | 49,279 | 583 | 4.75 | 44,033 | 498 | 4.54 |
| Total interest-bearing liabilities | 516,995 | 4,611 | 3.58 | 423,218 | 2,678 | 2.54 |
| Noninterest-bearing liabilities: | | | | | | |
| Demand deposits | 78,764 | | | 77,744 | | |
| Other liabilities | 1,589 | | | 2,292 | | |
| Total noninterest-bearing liabilities | 80,353 | | | 80,036 | | |
| Shareholders equity | 42,659 | | | 37,125 | | |
| Total Liabilities and Shareholders Equity | \$ 640,007 | | | \$ 540,379 | | |
| Net interest spread | | 6,046 | 3.46 % | | 5,278 | 3.68 % |
| Tax-equivalent basis adjustment | | (13) | | | (13) | |
| Net interest income | | 6,033 | | | \$ 5,265 | |
| Net interest margin | | | 3.99 % | | | 4.12 % |

Unity Bancorp, Inc.

Consolidated Average Balance Sheets with resultant Interest and Rates

(unaudited)

(Tax-equivalent basis, dollars in thousands)

| | Six months ended June 30, 2006 | | | June 30, 2005 | | |
|---|-----------------------------------|-----------|----------------|---------------|-----------|----------------|
| | Balance | Interest | Rate/ Yield | Balance | Interest | Rate/ Yield |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Federal funds sold and interest-bearing deposits with banks | \$ 24,778 | \$ 561 | 4.57 % | \$ 13,541 | \$ 179 | 2.67 % |
| Securities: | | | | | | |
| Available for sale | 63,816 | 1,443 | 4.52 | 77,288 | 1,631 | 4.22 |
| Held to maturity | 38,784 | 943 | 4.86 | 24,538 | 622 | 5.07 |
| Total securities | 102,600 | 2,386 | 4.65 | 101,826 | 2,253 | 4.43 |
| Loans, net of unearned discount: | | | | | | |
| SBA loans | 84,813 | 4,332 | 10.22 | 66,748 | 2,807 | 8.41 |
| Commercial | 279,176 | 10,260 | 7.41 | 214,174 | 7,402 | 6.97 |
| Residential mortgages | 59,622 | 1,608 | 5.39 | 60,248 | 1,607 | 5.33 |
| Consumer | 46,596 | 1,523 | 6.59 | 43,493 | 1,244 | 5.77 |
| Total loans | 470,207 | 17,723 | 7.58 | 384,663 | 13,060 | 6.83 |
| Total interest-earning assets | 597,585 | 20,670 | 6.95 | 500,030 | 15,492 | 6.23 |
| Noninterest-earning assets: | | | | | | |
| Cash and due from banks | 12,119 | | | 12,177 | | |
| Allowance for loan losses | (7,317) | | | (6,066) | | |
| Other assets | 27,605 | | | 23,081 | | |
| Total noninterest-earning assets | 32,407 | | | 29,192 | | |
| Total Assets | \$ 629,992 | | | \$ 529,222 | | |
| Liabilities and Shareholders Equity | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Interest-bearing checking | \$ 122,194 | 1,347 | 2.22 | \$ 158,575 | 1,246 | 1.58 |
| Savings deposits | 171,185 | 2,896 | 3.41 | 105,387 | 1,241 | 2.37 |
| Time deposits | 164,902 | 3,170 | 3.88 | 106,011 | 1,527 | 2.90 |
| Total interest-bearing deposits | 458,281 | 7,413 | 3.26 | 369,973 | 4,014 | 2.19 |
| Borrowed funds and subordinated debentures | 49,279 | 1,145 | 4.69 | 42,097 | 922 | 4.42 |
| Total interest-bearing liabilities | 507,560 | 8,558 | 3.40 | 412,070 | 4,936 | 2.42 |
| Noninterest-bearing liabilities: | | | | | | |
| Demand deposits | 78,473 | | | 78,295 | | |
| Other liabilities | 1,961 | | | 2,135 | | |
| Total noninterest-bearing liabilities | 80,434 | | | 80,430 | | |
| Shareholders equity | 41,998 | | | 36,722 | | |
| Total Liabilities and Shareholders Equity | \$ 629,992 | | | \$ 529,222 | | |
| Net interest spread | | 12,112 | 3.55 % | | 10,556 | 3.81 % |
| Tax-equivalent basis adjustment | | (26) | | | (26) | |
| Net interest income | | \$ 12,086 | | | \$ 10,530 | |
| Net interest margin | | | 4.05 % | | | 4.22 % |

The rate volume table below presents an analysis of the impact on interest income and expense resulting from changes in average volume and rates over the periods presented. Changes that are not due to volume or rate variances have been allocated proportionally to both, based on their relative absolute values. Amounts have been computed on a full tax-equivalent basis, assuming a federal income tax rate of 34.0 percent.

Rate Volume Table

| | Amount of Increase (Decrease) Three months ended June 30, 2006 versus June 30, 2005 | | | Six months ended June 30, 2006 versus June 30, 2005 | | |
|---|---|--------|---------------|--|-----------|-----------------|
| | Due to change in: | | | Due to change in: | | |
| | Volume | Rate | Total | Volume | Rate | Total |
| Interest Income | | | | | | |
| SBA | \$ 357 | \$ 374 | \$ 731 | \$ 850 | \$ 675 | \$ 1,525 |
| Commercial | 1,312 | 292 | 1,604 | 2,366 | 492 | 2,858 |
| Residential mortgage | (28) | 11 | (17) | (17) | 18 | 1 |
| Consumer | 33 | 94 | 127 | 93 | 186 | 279 |
| Total Loans | 1,674 | 771 | 2,445 | 3,292 | 1,371 | 4,663 |
| Available for sale securities | | | | | | |
| Available for sale securities | (167) | 67 | (100) | (298) | 110 | (188) |
| Held to maturity securities | 112 | 7 | 119 | 348 | (27) | 321 |
| Federal funds sold and interest-bearing deposits | | | | | | |
| Federal funds sold and interest-bearing deposits | 127 | 110 | 237 | 205 | 177 | 382 |
| Total interest-earning assets | \$ 1,746 | \$ 955 | \$ 2,701 | \$ 3,547 | \$ 1,631 | \$ 5,178 |
| Interest Expense | | | | | | |
| Interest-bearing checking | \$ (187) | \$ 205 | \$ 18 | \$ (327) | \$ 428 | \$ 101 |
| Savings deposits | 527 | 396 | 923 | 971 | 684 | 1,655 |
| Time deposits | 575 | 332 | 907 | 1,022 | 621 | 1,643 |
| Total interest-bearing deposits | 915 | 933 | 1,848 | 1,666 | 1,733 | 3,399 |
| Borrowings | 61 | 24 | 85 | 164 | 59 | 223 |
| Total interest-bearing liabilities | 976 | 957 | 1,933 | 1,830 | 1,792 | 3,622 |
| Tax equivalent net interest income | \$ 770 | (2) | 768 | \$ 1,717 | \$ (161) | 1,556 |
| Tax equivalent adjustment | | | 0 | | | 0 |
| Increase in net interest income | | | \$ 768 | | | \$ 1,556 |

Provision for Loan Losses

The provision for loan losses was \$250 thousand for the three months ended June 30, 2006, a decrease of \$100 thousand, compared to \$350 thousand for the same period a year ago. The decrease from a year ago was primarily due to lower levels of non-performing loans during the second quarter of 2006 compared to the comparable quarter a year ago. For the six months ended June 30, 2006, the provision for loan losses was \$550 thousand, a decrease of \$100 thousand, compared to \$650 thousand for the same period a year ago. The decrease from a year ago was primarily due to the lower levels of non-performing loans and lower levels of net charge-offs during the six months ended June 30, 2006 compared to a year ago. The provision is based on management's assessment of the adequacy of the allowance for loan losses, described under the caption Financial Condition-Allowance for Loan Losses. The current provision is considered appropriate under management's assessment of the adequacy of the allowance for loan losses.

Non-Interest Income

Non-interest income consists of deposit service charges, loan and servicing fees, net gains on sales of securities and loans, bank owned life insurance and other income. Non-interest income was \$1.6 million for the three months ended June 30, 2006, a decrease of \$548 thousand compared with the same period in 2005. For the six months ended June 30, 2006, non-interest income decreased \$337 thousand compared to the same period in 2005. The components of non-interest income are as follows:

| (In thousands) | Three months ended June 30, | | | Six months ended June 30, | | |
|-------------------------------|-----------------------------|----------|----------------|---------------------------|----------|----------------|
| | 2006 | 2005 | Percent Change | 2006 | 2005 | Percent Change |
| Deposit service charges | \$ 409 | \$ 439 | (6.8)% | \$ 842 | \$ 869 | (3.1)% |
| Loan and servicing fees | 406 | 630 | (35.6) | 801 | 1,166 | (31.3) |
| Gains on SBA loan sales, net | 558 | 741 | (24.7) | 1,258 | 1,201 | 4.7 |
| Gains on mortgage loan sales | 110 | 54 | 103.7 | 172 | 146 | 17.8 |
| Gains on sales of other loans | | | | 82 | | NM |
| Net security gains | | 24 | NM | | 77 | NM |
| Bank owned life insurance | 47 | 46 | | 94 | 93 | |
| Other income | 117 | 261 | (55.2) | 400 | 434 | (7.8) |
| Total non-interest income | \$ 1,647 | \$ 2,195 | (25.0)% | \$ 3,649 | \$ 3,986 | (8.5)% |

NM = Not meaningful

Service charges on deposit accounts decreased \$30 thousand or 6.8 percent for the three months ended June 30, 2006 and decreased \$27 thousand or 3.1 percent for the six months ended June 30, 2006 when compared to the same period a year ago. These decreases were a result of lower levels of overdraft fees.

Service and loan fee income decreased \$224 thousand or 35.6 percent for the three months ended June 30, 2006 and decreased \$365 thousand or 31.3 percent for the six months ended June 30, 2006 when compared to the same period a year ago. The decrease in loan and servicing fees during these periods was the result of lower levels of loan prepayment fees and reduced servicing fee rates on our serviced SBA portfolio. Average serviced SBA loans totaled \$145.9 million and \$143.7 million for the six months ended June 30, 2006 and 2005, respectively. The average net servicing rate on SBA loans totaled .81 percent compared to 0.99 percent for the six months ended June 30, 2006 and 2005, respectively.

Net gains on SBA loan sales decreased \$183 thousand or 24.7 percent for the quarter, compared to the same period a year ago, as a result of a lower sales volume. SBA loan sales totaled \$7.6 million for the three months ended June 30, 2006, compared to \$9.3 million for the three months ended June 30, 2005. For the six months ended June 30, 2006, net gains on SBA loan sales increased \$57 thousand or 4.7 percent, compared to the same period a year ago, as a result of a higher sales volume, partially offset by increased commission expenses allocated to the loans. SBA loan sales totaled \$17.2 million for the six months ended June 30, 2006, compared to \$14.8 million a year ago.

Net gains on mortgage loan sales increased \$56 thousand for the three months ended June 30, 2006 and increased \$26 thousand for the six months ended June 30, 2006 as a result of a higher origination and sales volume. Mortgage loan sales totaled \$6.8 million and \$11.2 million for the three and six month periods ended June 30, 2006.

There were no net gains on the sale of other loans during the quarter ended June 30, 2006. During the six month period, \$5.0 million of commercial hotel/motel loans were sold and a net gain of \$82 thousand was realized.

There were no security gains realized during the three months ended and six months ended June 30, 2006, compared to \$24 thousand and \$77 thousand for the same periods a year ago.

Bank owned life insurance income totaled \$47 thousand for the three months ended June 30, 2006 and \$94 thousand for the six months ended June 30, 2006.

Other non-interest income decreased \$143 thousand for the three months ended June 30, 2006 and decreased \$33 thousand for the six months ended June 30, 2006, compared with the same period a year ago. The decrease was primarily due to a reduction in commercial loan referral fees.

Non-Interest Expense

Total non-interest expense increased \$359 thousand or 7.7 percent to \$5.0 million for the three months ended June 30, 2006 and increased \$967 thousand or 10.4 percent for the six months ended June 30, 2006 compared to a year ago. The components of non-interest expense are as follows:

| (In thousands) | Three months ended June 30, | | | Six months ended June 30, | | | |
|-------------------------------|-----------------------------|----------|----------------|---------------------------|----------|----------------|---|
| | 2006 | 2005 | Percent Change | 2006 | 2005 | Percent Change | |
| Compensation and benefits | \$ 2,664 | \$ 2,314 | 15.1 | % \$ 5,389 | \$ 4,711 | 14.4 | % |
| Occupancy | 646 | 501 | 28.9 | 1,294 | 1,094 | 18.3 | |
| Processing and communications | 553 | 489 | 13.1 | 1,080 | 955 | 13.1 | |
| Furniture and equipment | 381 | 327 | 16.5 | 774 | 656 | 18.0 | |
| Professional services | 151 | 194 | (22.2) | 283 | 303 | (6.6) | |
| Loan servicing costs | 55 | 169 | (67.5) | 156 | 346 | (54.9) | |
| Advertising | 148 | 187 | (20.9) | 318 | 372 | (14.5) | |
| Deposit insurance | 16 | 15 | 6.7 | 33 | 30 | 10.0 | |
| Other expenses | 387 | 446 | (13.2) | 930 | 823 | 13.0 | |
| Total non-interest expense | \$ 5,001 | \$ 4,642 | 7.7 | % \$ 10,257 | \$ 9,290 | 10.4 | % |

Compensation and benefits expense, the largest component of non-interest expense, increased \$350 thousand, or 15.1 percent, for the three months ended June 30, 2006 and increased \$678 thousand or 14.4 percent for the six month period ended June 30, 2006 compared to the same periods a year ago. The increase in compensation and benefits was a result of increased head count, merit increases and higher benefits costs. Total full time equivalent employees amounted to 191 at June 30, 2006, compared to 178 at June 30, 2005.

Occupancy expense increased \$145 thousand or 28.9 percent, for the three months ended June 30, 2006 compared to the same period a year ago, and increased \$200 thousand or 18.3 percent for the six months ended June 30, 2006 compared to the same period a year ago. The increase during each period was due to higher rental expense, property taxes, utilities, landscaping and repairs and maintenance expense on the existing branch network and the addition of the Phillipsburg branch in the fourth quarter of 2005.

Processing and communications expense increased \$64 thousand, or 13.1 percent, for the three months ended June 30, 2006 compared to the same period a year ago, and increased \$125 thousand or 13.1 percent for the six months ended June 30, 2006 compared to the same period a year ago. The increased processing and communications expenses reflect increased transaction volume due to the increase in loans and deposits.

Furniture and equipment expense increased \$54 thousand, or 16.5 percent, for the three months ended June 30, 2006, compared to the same period a year ago and increased \$118 thousand or 18.0 percent for the six months ended June 30, 2006 compared to a year ago. These increases in furniture and equipment were primarily related to increased network maintenance costs, security monitoring and increased depreciation expenses derived from the expansion and refurbishment of the branch network.

Professional services decreased \$43 thousand, or 22.2 percent, for the three months ended June 30, 2006 compared to the same period a year ago, due to reduced consulting, audit and loan review fees. Professional services decreased \$20 thousand or 6.6 percent for the six months ended June 30, 2006 compared to the same period a year ago due primarily to lower consulting expenses partially offset by higher legal fees.

Loan servicing costs decreased \$114 thousand, or 67.5 percent for the three months ended June 30, 2006 compared to the same period a year ago, and decreased \$190 thousand or 54.9 percent for the six months ended June 30, 2006 compared to the same period a year ago. The reduction in expenses during these periods was due to a lower level of nonperforming loans and the collection of expenses on delinquent loans.

Advertising expense decreased \$39 thousand or 20.9 percent for the three months ended June 30, 2006 and decreased \$54 thousand or 14.5 percent for the six months ended June 30, 2006 compared to the same periods a year ago. The decrease was due to decreased marketing expenses related to new business generation.

Deposit insurance expense remained relatively flat for the three month and six-month periods ended June 30, 2006 compared to the prior year periods.

Other operating expenses decreased \$59 thousand or 13.2 percent for the quarter ended June 30, 2006 compared to the prior year, primarily due to lower insurance premium expenses. For the six-month period ended June 30, 2006, other operating expenses increased \$107 thousand primarily due to the establishment of a reserve for loan commitments.

Income Tax Expense

For the quarter ended June 30, 2006, the provision for income taxes was \$792 thousand compared to \$941 thousand for the same period a year ago. The provision for income taxes decreased \$105 thousand to \$1.6 million for the six months ended June 30, 2006 compared to the same period a year ago. The current 2006 tax provision represents an effective tax rate of approximately 33.2 percent as compared to 38 percent for the prior year. The lower effective tax rate for 2006 is related to a higher proportion of revenue being generated at a subsidiary with a lower effective tax rate. Management anticipates an effective rate of approximately 33 percent for the remainder of 2006.

Financial Condition at June 30, 2006

Total assets at June 30, 2006 were \$670.9 million compared to \$577.5 million a year ago and \$614.2 million at year-end 2005. Compared to year-end 2005, total assets increased due primarily to the investment of liquidity from savings and time deposit growth into loans and federal funds sold and interest bearing deposits.

Securities

The Company's investment securities portfolio is maintained for asset-liability management purposes, as an additional source of liquidity, and as an additional source of earnings. The securities portfolio consists of available for sale (AFS) and held to maturity (HTM) investments. AFS securities are investments carried at fair value that may be sold in response to changing market and interest rate conditions or for other business purposes. HTM securities, which are carried at amortized cost, are investments for which there is the positive intent and ability to hold to maturity. Management determines the appropriate security classification of AFS or HTM at the time of purchase. The portfolio is comprised of U.S. Treasury securities, obligations of the U.S. Government and government sponsored agencies, collateralized mortgage obligations and corporate and equity securities. Approximately 86 percent of the total investment portfolio has a fixed rate of interest.

AFS securities totaled \$68.1 million at June 30, 2006, an increase of \$2.5 million from year-end 2005. This increase was the result of \$7.8 million in purchases partially offset by \$4.3 million in maturities and principal payments received and \$942 thousand depreciation in the market value of the portfolio. The yield on the AFS securities portfolio was 4.52 percent for the six months ended June 30, 2006, compared to 4.22 percent a year ago. The weighted average life of the AFS portfolio was 5.36 years and the effective duration of the portfolio was 3.77 years at June 30, 2006 compared to 4.89 years and 3.55 years at December 31, 2005.

HTM securities totaled \$40.9 million at June 30, 2006, an increase of \$127 thousand compared to \$40.7 million at December 31, 2005. This increase was the result of \$4.4 million in purchases and \$4.2 million in maturities and principal payments received. The yield on HTM securities was 4.86 percent for the six months ended June 30, 2006 compared to 5.07 percent for the same period a year ago. As of June 30, 2006 and December 31, 2005, the market value of HTM securities was \$39.7 million and \$40.2 million, respectively. The weighted average life of the HTM portfolio was 4.99 years and the effective duration of the portfolio was 3.58 years at June 30, 2006 compared to 4.21 years and 3.09 years at December 31, 2005.

Securities with a carrying value of \$45.5 million and \$45.4 million at June 30, 2006 and December 31, 2005, respectively, were pledged to secure government deposits, other borrowings and for other purposes required or permitted by law. At June 30, 2006, the Company pledged \$2.0 million for governmental deposits as required.

Loan Portfolio

The loan portfolio, which represents the Company's largest asset group, is a significant source of both interest and fee income. The portfolio consists of commercial, Small Business Administration (SBA), residential mortgage and consumer loans. Elements of the loan portfolio are subject to differing levels of credit and interest rate risk.

Total loans at June 30, 2006 increased \$36.1 million or 8.0 percent to \$484.6 million compared to \$448.6 million at year-end 2005 due to commercial loan growth. The loan portfolio concentration consisted of 61 percent commercial, 17 percent SBA, 12 percent residential mortgages and 10 percent consumer loans at June 30, 2006.

Commercial loans are generally made in the Company's market place for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. These loans amounted to \$297.8 million at June 30, 2006 and increased \$37.2 million compared to \$260.6 million at year-end 2005. The yield on commercial loans was 7.41 percent for the six months ended June 30, 2006 compared to 6.97 percent for the same period a year ago.

SBA loans, which provide guarantees of up to 85 percent of the principal balance from the SBA, are generally sold in the secondary market with the non-guaranteed portion held in the portfolio as a loan held for investment. SBA loans held for investment amounted to \$59.1 million at June 30, 2006, a decrease of \$5.5 million from year-end 2005. SBA loans held for sale, carried at the lower of aggregate cost or market, amounted to \$24.4 million at June 30, 2006, an increase of \$10.4 million from year-end 2005. The yield on SBA loans, which are generally floating and adjust quarterly to the Prime rate was 10.22 percent for the six months ended June 30, 2006 compared to 8.41 percent for the same period a year ago.

Residential mortgage loans consist of loans secured by residential properties. These loans decreased \$6.1 million to \$56.0 million at June 30, 2006 as a result of pay-downs in the portfolio. The Company did not originate a significant amount of residential mortgage loans held for investment during the six month period. The yield on residential mortgages was 5.39 percent for the six months ended June 30, 2006 compared to 5.33 percent for the same period a year ago.

Consumer loans consist of home equity loans and loans for the purpose of financing the purchase of consumer goods, home improvements, and other personal needs, and are generally secured by the personal property being purchased. These loans amounted to \$47.3 million at June 30, 2006 and December 31, 2005. The yield on consumer loans was 6.59 percent for the six months ended June 30, 2006, compared to 5.77 percent for the same period a year ago.

The increase in yields throughout the loan portfolio reflects the higher interest rate environment at June 30, 2006 compared to June 30, 2005 due to the Federal Reserve raising interest rates 225 basis points since June 30, 2005.

Asset Quality

Inherent in the lending function is the possibility a customer may not perform in accordance with the contractual terms of the loan. A borrower's inability to pay its obligations according to the contractual terms can create the risk of past due loans and ultimately credit losses, especially on collateral deficient loans.

Non-performing loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the collectibility of principal and interest according to the contractual terms is in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans past due 90 days and still accruing interest are not included in non-performing loans.

Credit risk is minimized by loan diversification and adhering to credit administration policies and procedures. Due diligence on loans begins upon the origination of a loan with a borrower. Documentation, including a borrower's credit history, materials establishing the value and liquidity of potential collateral, the purpose of the loan, the source of funds for repayment of the loan, and other factors are analyzed before a loan is submitted for approval. The loan portfolio is then subject to ongoing internal reviews for credit quality. In addition, an outside firm is used to conduct independent credit reviews.

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The following table sets forth information concerning non-accrual loans and non-performing assets at each of the periods indicated:

| (In thousands) | June 30, 2006 | Dec. 31, 2005 | June 30, 2005 |
|--|---------------|---------------|---------------|
| Non-performing loans: | | | |
| SBA | \$ 1,792 | \$ 1,391 | \$ 2,849 |
| Commercial | 432 | 1,250 | 1,389 |
| Residential mortgage | 158 | 1,510 | 472 |
| Consumer | 170 | 210 | 67 |
| Total non-performing loans | 2,552 | 4,361 | 4,777 |
| OREO | | 178 | |
| Total Non-Performing Assets | \$ 2,552 | \$ 4,539 | \$ 4,777 |
| Past Due 90 days or more and still accruing interest | | | |
| SBA | \$ | \$ | \$ |
| Commercial | | | |
| Residential mortgage | | | |
| Consumer | | | |
| Total accruing loans 90 days or more past due | \$ | \$ | \$ |
| Non-Performing assets to total assets | 0.38 | % 0.74 | % 0.83 |
| Non-Performing assets to loans and OREO | 0.53 | % 1.01 | % 1.16 |
| Allowance for loans losses as a percentage of non-performing loans | 284.37 | % 158.04 | % 130.60 |
| Allowance for loan losses to total loans | 1.50 | % 1.54 | % 1.52 |

Non-performing assets amounted to \$2.6 million at June 30, 2006, a decrease of \$2.0 million from year-end 2005, primarily due to the sale of collateral on a \$1.5 million non-performing residential mortgage loan during the quarter ended June 30, 2006. OREO decreased \$178 thousand due to the sale of these assets during the quarter ended June 30, 2006. There were no loans past due 90 days or more at June 30, 2006 and December 31, 2005. Included in non-performing assets at June 30, 2006 are approximately \$820 thousand of loans guaranteed by the SBA.

Potential problem loans are those where information about possible credit problems of borrowers causes management to have doubts as to the ability of such borrowers to comply with loan repayment terms. These loans are not included in non-performing loans as they continue to perform. There were \$543 thousand in potential problem loans at June 30, 2006, compared to \$280 thousand in potential problem loans at December 31, 2005.

Allowance for Loan Losses

The allowance for loan losses totaled \$7.3 million, \$6.9 million, and \$6.2 million at June 30, 2006, December 31, 2005, and June 30, 2005, respectively with resulting allowance to total loan ratios of 1.50 percent, 1.54 percent and 1.52 percent respectively. Net charge offs amounted to \$113 thousand for the three months ended June 30, 2006, compared to \$53 thousand for the three months ended June 30, 2005. For the six months ended June 30, 2006, net charge offs totaled \$185 thousand compared to \$267 thousand in the prior year.

The following is a reconciliation summary of the allowance for loan losses for the three and six months ended June 30, 2006 and 2005:

Allowance for Loan Loss Activity

| (In thousands) | Three months ended June 30, | | Six Months ended June 30, | | |
|--|-----------------------------|----------|---------------------------|---------|---|
| | 2006 | 2005 | 2006 | 2005 | |
| Balance, beginning of period | \$ 7,120 | \$ 5,942 | \$ 6,892 | 5,856 | |
| Provision charged to expense | 250 | 350 | 550 | 650 | |
| Charge-offs: | | | | | |
| SBA | 66 | 112 | 112 | 219 | |
| Commercial | 48 | 30 | 52 | 195 | |
| Residential mortgage | | | | 24 | |
| Consumer | 14 | 4 | 49 | 12 | |
| Total Charge-offs | 128 | 146 | 213 | 450 | |
| Recoveries: | | | | | |
| SBA | | 30 | | 74 | |
| Commercial | 2 | 7 | 13 | 52 | |
| Residential mortgage | | | | | |
| Consumer | 13 | 56 | 15 | 57 | |
| Total recoveries | 15 | 93 | 28 | 183 | |
| Total net charge-offs | 113 | 53 | 185 | 267 | |
| Balance, end of period | \$ 7,257 | \$ 6,239 | \$ 7,257 | 6,239 | |
| Selected loan quality ratios: | | | | | |
| Net charge offs to average loans (annualized) | 0.10 | % 0.05 | % 0.08 | % 0.14 | % |
| Allowance for loan losses to total loans at period end | 1.50 | % 1.52 | % 1.50 | % 1.52 | % |
| Allowance for loan losses to non-performing loans | 284.4 | % 130.6 | % 284.4 | % 130.6 | % |

Deposits

Deposits, which include non-interest and interest bearing demand deposits and interest-bearing savings and time deposits, are the primary source of the Company's funds. The Company offers a variety of products designed to attract and retain customers, with primary focus on building and expanding relationships. For the first six months of 2006 the Company realized continued growth in deposits. This growth was achieved through emphasis on customer service, competitive rate structures and selective marketing. The Company attempts to establish a comprehensive relationship with business borrowers, seeking deposits as well as lending relationships.

Total deposits increased \$54.5 million to \$576.4 million at June 30, 2006 from \$521.9 million at December 31, 2005. The increase in deposits was primarily the result of a \$45.9 million increase in savings deposits, a \$29.0 million increase in time deposits and a \$2.2 million increase in demand deposits, partially offset by a \$22.6 million decrease in interest bearing demand deposits. This resulted in a shift in our deposit concentration from 27 percent interest bearing demand and 27 percent savings accounts at December 31, 2005 to 20 percent interest bearing demand and 33 percent savings deposits at June 30, 2006. This reallocation was directly related to promotion of the Company's new variable rate savings product and the transfer of balances from interest bearing demand accounts into the higher cost savings product. The concentration of time deposits increased to 33 percent at June 30, 2006 compared to 31 percent at year-end 2005 due to the Company's new variable rate CD product.

Included in deposits at June 30, 2006 are \$35.7 million of Government deposits, as compared to \$43.6 million at December 31, 2005. These deposits are generally short in duration and are very sensitive to price competition. The Company believes the current portfolio of these deposits is appropriate.

Borrowed Funds and Subordinated Debentures

Borrowed funds and subordinated debentures totaled \$49.3 million at June 30, 2006 and December 31, 2005. As of June 30, 2006, the Company was a party to the following borrowed funds and subordinated debenture transactions:

- A \$10 million repurchase agreement with a term of 5 years, expiring on March 11, 2009 and a rate of 2.78 percent. The borrowing may be called, by the counterparty if the 3-month LIBOR rate is greater than or equal to 7 percent on March 11, 2005 or on any quarterly payment date thereafter.
- A \$10 million FHLB repo-advance with a term of 10 years, expiring on December 15, 2014 and a fixed rate of 2.95 percent. The borrowing is convertible by the FHLB on December 15, 2006 and quarterly thereafter with 4 business days notice into replacement funding for the same or lesser principal amount based on any advance then offered by the FHLB at then current market rates.
- A \$10 million FHLB repo-advance with a term of 10 years, expiring on April 27, 2015 and a fixed rate of 3.70 percent. The borrowing is convertible by the FHLB on April 27, 2008 and quarterly thereafter with 4 business days notice into replacement funding for the same or lesser principal amount based on any advance then offered by the FHLB at then current market rates.
- A \$10.0 million advance from the Federal Home Loan Bank (FHLB). The 4.92 percent borrowing from the FHLB matures in 2010 and is callable by the FHLB at any time.
- \$9.3 million in subordinated debentures issued on September 26, 2002 with a floating rate of 3-month Libor plus 340 basis points. At June 30, 2006, the rate equaled 8.86 percent. The subordinated debentures mature on September 26, 2032, but are redeemable in whole or in part by the issuer prior to maturity, but after September 26, 2007.

Subsequent to quarter end, the Company issued \$10 million in subordinated debentures with a floating rate of 159 basis points over the three month Libor rate. The debentures were initially priced at 7.05%, and mature on June 30, 2036, but are callable after five years at the option of the Company.

Interest Rate Sensitivity

The principal objectives of the asset and liability management function are to establish prudent risk management guidelines, evaluate and control the level of interest rate risk in balance sheet accounts, determine the level of appropriate risk given the business focus, operating environment, capital, and liquidity requirements, and actively manage risk within the Board approved guidelines. The Company seeks to reduce the vulnerability of the operations to changes in interest rates, and actions in this regard are taken under the guidance of the Asset/Liability Management Committee (ALCO) of the Board of Directors. The ALCO reviews the maturities and repricing of loans, investments, deposits and borrowings, cash flow needs, current market conditions, and interest rate levels.

The Company utilizes Modified Duration of Equity and Economic Value of Portfolio Equity (EVPE) models to measure the impact of longer-term asset and liability mismatches beyond two years. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVPE analysis is also used to dynamically model the present value of asset and liability cash flows, with rate shocks of 200 basis points. The economic value of equity is likely to be different as interest rates change. Like the simulation model, results falling outside prescribed ranges require action by the ALCO. The Company's variance in the economic value of equity, as a percentage of assets with rate shocks of 200 basis points at June 30, 2006, is a decline of 2.29 percent in a rising rate environment and an increase of 1.31 percent in a falling rate environment. Both variances are within the board-approved guidelines of +/- 3.00 percent. At December 31, 2005 the economic value of equity with rate shocks of 200 basis points was a decline of 1.66 percent in a rising rate environment and a decline of 0.18 percent in a falling rate environment.

Operating, Investing, and Financing Cash

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Cash and cash equivalents amounted to \$56.3 million at June 30, 2006, an increase of \$17.6 million from December 31, 2005. Net cash provided by operating activities for the six months ended June 30, 2006, amounted to \$2.6 million, primarily due to proceeds from the sales of SBA and commercial loans and net income from operations, offset by originations of loans held for sale. Net cash used in investing activities amounted to \$39.2 million for the six months ended June 30, 2006, primarily due to loan originations, security purchases and investments in premises and equipment, partially offset by proceeds from the maturities and sales of securities available for sale. Net cash provided by financing activities, amounted to \$54.3 million for the six months ended June 30, 2006, attributable to increased deposits and proceeds from the exercise of stock options, partially offset by the payment of dividends.

24

Liquidity

The Company's liquidity is a measure of its ability to fund loans, withdrawals or maturities of deposits and other cash outflows in a cost-effective manner.

Parent Company

At June 30, 2006, the Parent Company had \$455 thousand in cash compared to \$933 thousand at December 31, 2005. The decrease in cash at the parent company was due to the payment of operating expenses and cash dividends. Expenses at the Parent Company are minimal and management believes that the Parent Company has adequate liquidity to fund its obligations.

Consolidated Bank

Liquidity is a measure of the ability to fund loans, withdrawals or maturities of deposits and other cash outflows in a cost-effective manner. The principal sources of funds are deposits, scheduled amortization and repayments of loan principal, sales and maturities of investment securities and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition.

At June 30, 2006, \$42.9 million was available for additional borrowings from the FHLB of New York. Pledging additional collateral in the form of 1-4 family residential mortgages or investment securities can increase the line with the FHLB. The maximum borrowing line available if additional collateral was pledged as of June 30, 2006 amounted to approximately \$66.2 million. An additional source of liquidity is Federal Funds sold, which were \$42.6 million at June 30, 2006.

As of June 30, 2006, deposits included \$35.7 million of Government deposits, as compared to \$43.6 million at December 31, 2005. These deposits are generally short in duration, and are sensitive to price competition. The Company believes the current portfolio of these deposits to be appropriate. Included in the portfolio are \$30.7 million of deposits from four municipalities. The withdrawal of these deposits, in whole or in part would not create a liquidity shortfall for the Company.

At June 30, 2006, the Bank had approximately \$153 million of loan commitments, which will generally either expire or be funded within one year. The Company believes it has the necessary liquidity to honor all commitments. Many of these commitments will expire and never be funded. In addition, approximately \$26.6 million of these commitments are for SBA loans, which may be sold into the secondary market.

Regulatory Capital

A significant measure of the strength of a financial institution is its capital base. Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for common stock and qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, certain qualifying long-term debt, preferred stock and hybrid instruments which do not qualify for tier 1 capital. Minimum capital levels are regulated by risk-based capital adequacy guidelines, which require a bank to maintain certain capital as a percent of assets, and certain off-balance sheet items adjusted for predefined credit risk factors (risk-adjusted assets). A bank is required to maintain, at a minimum, tier 1 capital as a percentage of risk-adjusted assets of 4.0 percent and combined tier 1 and tier 2 capital as a percentage of risk-adjusted assets of 8.0 percent.

In addition to the risk-based guidelines, regulators require that a bank which meets the regulator's highest performance and operation standards maintain a minimum leverage ratio (tier 1 capital as a percentage of tangible assets) of 4 percent. For those banks with higher levels of risk or that are experiencing or anticipating significant growth, the minimum leverage ratio will be proportionately increased. Minimum leverage ratios for each bank are evaluated through the ongoing regulatory examination process.

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The Company's capital amounts and ratios are presented in the following table.

| (In thousands) | Actual Amount | Ratio | For Capital Adequacy Purposes Amount | Ratio | To Be Well Capitalized Under Prompt Corrective Action Provisions Amount | Ratio |
|--------------------------------|---------------|-------|--------------------------------------|-------|---|---------|
| As of June 30, 2006 | | | | | | |
| Leverage Ratio | | | ≥ | | ≥ | |
| | 52,543 | 8.22 | % 25,581 | 4.00 | % 31,976 | 5.00 % |
| Tier I risk-based ratio | | | ≥ | | ≥ | |
| | 52,543 | 9.69 | % 21,689 | 4.00 | % 32,534 | 6.00 % |
| Total risk-based ratio | | | ≥ | | ≥ | |
| | 59,327 | 10.94 | % 43,378 | 8.00 | % 54,223 | 10.00 % |
| As of December 31, 2005 | | | | | | |
| Leverage Ratio | | | ≥ | | ≥ | |
| | 49,462 | 8.27 | % 23,935 | 4.00 | % 29,919 | 5.00 % |
| Tier I risk-based ratio | | | ≥ | | ≥ | |
| | 49,462 | 9.98 | % 19,827 | 4.00 | % 29,741 | 6.00 % |
| Total risk-based ratio | | | ≥ | | ≥ | |
| | 55,667 | 11.23 | % 39,655 | 8.00 | % 49,569 | 10.00 % |

The Bank's capital amounts and ratios are presented in the following table.

| (In thousands) | Actual Amount | Ratio | For Capital Adequacy Purposes Amount | Ratio | To Be Well Capitalized Under Prompt Corrective Action Provisions Amount | Ratio |
|--------------------------------|---------------|-------|--------------------------------------|-------|---|---------|
| As of June 30, 2006 | | | | | | |
| Leverage Ratio | | | ≥ | | ≥ | |
| | 45,819 | 7.22 | % 25,387 | 4.00 | % 31,734 | 5.00 % |
| Tier I risk-based ratio | | | ≥ | | ≥ | |
| | 45,819 | 8.44 | % 21,717 | 4.00 | % 32,576 | 6.00 % |
| Total risk-based ratio | | | ≥ | | ≥ | |
| | 58,611 | 10.80 | % 43,435 | 8.00 | % 54,293 | 10.00 % |
| As of December 31, 2005 | | | | | | |
| Leverage Ratio | | | ≥ | | ≥ | |
| | 42,260 | 7.01 | % 24,124 | 4.00 | % 30,155 | 5.00 % |
| Tier I risk-based ratio | | | ≥ | | ≥ | |
| | 42,260 | 8.51 | % 19,855 | 4.00 | % 29,783 | 6.00 % |
| Total risk-based ratio | | | ≥ | | ≥ | |
| | 54,473 | 10.97 | % 39,711 | 8.00 | % 49,638 | 10.00 % |

Shareholders' Equity

Shareholders' equity increased \$2.5 million, or 6.1 percent, to \$43.4 million at June 30, 2006 compared to \$40.9 million at December 31, 2005. This increase was the result of \$3.3 million in net income and \$456 thousand in proceeds from stock options exercised, partially offset by \$644 thousand in cash dividends declared during the six months ended June 30, 2006 and \$584 thousand of depreciation in the market value of the securities available for sale portfolio.

On April 27, 2006, the Company announced a 5 percent stock distribution payable on June 30, 2006 to all shareholders of record as of June 16, 2006 and accordingly, all share amounts have been restated to include the effect of the distribution.

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On October 21, 2002, the Company authorized the repurchase of up to 10% of its outstanding common stock. The amount and timing of purchases would be dependent upon a number of factors, including the price and availability of the Company's shares, general market conditions and competing alternate uses of funds. There were no shares repurchased during the six months ended June 30, 2006. As of June 30, 2006 the Company had repurchased a total of 142 thousand shares of which 119 thousand shares have been retired, leaving 483 thousand shares remaining to be repurchased under the plan.

Impact of Inflation and Changing Prices

The financial statements and notes thereto, presented elsewhere herein, have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. The impact of inflation is reflected in the increased cost of the operations. Unlike most industrial companies, nearly all the Company's assets and liabilities are monetary. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

26

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

During 2006, there have been no significant changes in the Company's assessment of market risk as reported in Item 6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2005. (See Interest Rate Sensitivity in Management's Discussion and Analysis Herein.)

ITEM 4. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures as of June 30, 2006. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective for recording, processing, summarizing and reporting the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms. Such evaluation did not identify any change in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2006 has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION**Item 1. Legal Proceedings**

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of the operation of the Company.

Item 1.A. Risk Factors

There have been no significant changes in the Company's assessment of the risk factors associated with the Company's securities in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

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

(a) and (b) none

(c)

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------------|----------------------------------|------------------------------|--|--|
| April 1, 2005 through April 30, 2005 | 0 | 0 | 118,650 | 506,100 |
| May 1, 2005 through May 31, 2005 | 23,020 | \$ 10.51 | 141,670 | 483,080 |
| June 1, 2005 through June 30, 2005 | 0 | 0 | 141,670 | 483,080 |
| July 1, 2005 through June 30, 2006 | 0 | 0 | 141,670 | 483,080 |
| Total | 23,020 | \$ 10.51 | 141,670 | 483,080 |

Item 3. Defaults Upon Senior Securities-None

27

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

(a) Election of Directors

The following Directors were elected to a three-year term at the Company's 2006 Annual Meeting held on April 27, 2006, expiring at the Company's Annual Meeting in 2009:

| | Shares For | % | Shares Withheld | % | % |
|-------------------|------------|------|-----------------|-----|---|
| Frank Ali | 5,299,588 | 93.1 | % 390,702 | 6.9 | % |
| Dr. Mark S. Brody | 5,592,315 | 98.3 | % 97,975 | 1.7 | % |
| Charles S. Loring | 5,383,833 | 94.6 | % 306,457 | 5.4 | % |

Item 5. Other Information - None

Item 6. Exhibits

(a) Exhibits

- Exhibit 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
- Exhibit 32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

UNITY BANCORP, INC.

Dated: August 11, 2006

By: */s/* Alan J. Bedner, Jr.

ALAN J. BEDNER, JR

Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

QUARTERLY REPORT ON FORM 10-Q

| EXHIBIT NO. | DESCRIPTION |
|--------------------|---|
| 31.1 | Exhibit 31.1-Certification of James A. Hughes. Required by Rule 13a-14(a) or Rule 15d-14(a) and section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Exhibit 31.2-Certification of Alan J. Bedner, Jr. Required by Rule 13a-14(a) or Rule 15d-14(a) and section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Exhibit 32.1-Certification of James A. Hughes and Alan J. Bedner, Jr, required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350. |

30
