TREATY OAK BANCORP INC
Form 10QSB
February 14, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-QSB

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

For the quarterly period ended December 31, 2007

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

Commission File Number: 333-112325

Treaty Oak Bancorp, Inc.

(Exact name of registrant as specified in its charter)

Texas

(State or other jurisdiction of

corporation or organization)

20-0413144

(I.R.S. Employer Identification Number)

101 Westlake Drive, Austin, Texas

(Address of Principal Executive Offices)

78746

(Zip Code)

(512) 617-3600

(Registrant s telephone number, including area code)

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

Yes x No.o

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

Yes o No.x

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the close of business on February 14, 2008.

$0.01 Par Value Common Stock	2,969,739 shares

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

QUARTERLY REPORT ON FORM 10-QSB

FOR THE PERIOD ENDED DECEMBER 31, 2007

TABLE OF CONTENTS

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

Treaty Oak Bancorp, Inc.

Consolidated Balance Sheets (unaudited)

December 31, 2007 and September 30, 2007

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

ASSETS	**December 31, 2007**	**September 30, 2007 (1)**
Cash and cash items	$ 337	$ 435
Due from banks	5,079	2,670
Federal funds sold	14,190	19,224
Total cash and cash equivalents	19,606	22,329
Securities available for sale	6	7
Securities held to maturity, fair value of $1,214 and $354, respectively	1,209	354
Investment in Federal Home Loan Bank stock, at cost	242	224
Investment in Independent Banker s Financial Corporation stock, at cost	102	102
Due from time deposits	1,198	198
Loans, net	85,071	83,333
Premises and equipment, net	6,229	6,044
Accrued interest receivable	637	686
Goodwill and other intangibles, net	1,193	1,195
Other assets	692	814
Total assets	$ 116,185	$ 115,286
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits:		
Noninterest-bearing demand	$ 21,743	$ 30,158
NOW, money market and savings	46,492	36,371
Time deposits	29,613	30,188
Total deposits	97,848	96,717
Accounts payable and accrued expenses	305	413
Accrued interest payable	269	214
Notes payable	2,588	2,604
Other liabilities	31	28
Total liabilities	101,041	99,976
Shareholders equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; none issued		
Common stock, $0.01 par value; 20,000,000 shares authorized; 2,980,948 and 2,962,484, respectively, issued	30	30
Paid-in capital	18,873	18,758
Accumulated deficit	(3,654)	(3,428)
Less shares held in treasury, at cost (11,209 and 6,003 shares, respectively)	(105)	(50)
Total shareholders equity	15,144	15,310
Total liabilities and shareholders equity	$ 116,185	$ 115,286

See Notes to Consolidated Financial Statements (unaudited)

(1) Derived from Audited Consolidated Financial Statement

Treaty Oak Bancorp, Inc.

Consolidated Statements of Operations (unaudited)

Three Months Ended December 31, 2007 and 2006

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

	Three Months Ended December 31, 2007		Three Months Ended December 31, 2006	
Interest income:				
Loans, including fees	$	1,816	$	1,545
Taxable securities		33		14
Interest on deposits with other banks		30		
Federal funds sold		182		226
Total interest income		2,061		1,785
Interest expense:				
Deposits		722		565
Other borrowings		39		67
Total interest expense		761		632
Net interest income		1,300		1,153
Provision for loan losses		86		75
Net interest income after provision for loan losses		1,214		1,078
Noninterest income:				
Service charges on deposit accounts		68		33
Other noninterest income		39		72
Total noninterest income		107		105
Noninterest expense:				
Salaries and employee benefits		762		526
Occupancy and equipment expenses		151		112
Accounting and other professional fees		196		55
Other noninterest expense		438		354
Total noninterest expense		1,547		1,047
Net income (loss)	$	(226)	$	136
Earnings (loss) per common share - basic	$	(0.08)	$	0.05
Earnings (loss) per common share - diluted	$	(0.08)	$	0.05
Weighted average shares outstanding - basic		2,964,470		2,682,664
Weighted average shares outstanding - diluted		2,964,470		2,778,017

See Notes to Consolidated Financial Statements (unaudited)

Treaty Oak Bancorp, Inc.

Consolidated Statement of Shareholders Equity (unaudited)

Three Months Ended December 31, 2007

(Dollars In Thousands, Except Share Amounts)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Treasury Stock	Total
Balances at October 1, 2007	2,962,484	30	18,758	(3,428)	(50)	15,310
Shares issued through the exercise of common stock options	5,000		41			41
Shares issued through the exercise of common stock warrants	140		1			1
Purchase of treasury shares (5,206)					(55)	(55)
Non-cash stock based compensation	13,324		73			73
Net loss				(226)		(226)
Balances at December 31, 2007	2,980,948	$ 30	$ 18,873	$ (3,654)	$ (105)	$ 15,144

See Notes to Consolidated Financial Statements (unaudited)

5

Treaty Oak Bancorp, Inc.

Consolidated Statements of Cash Flows (unaudited)

Three Months Ended December 31, 2007 and 2006

(Dollars In Thousands)

	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006
Cash flows from operating activities:		
Net income (loss)	$ (226)	$ 136
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	86	75
Non-cash stock based compensation	73	50
Depreciation and amortization	112	90
Other		(7)
Changes in other operating assets and liabilities:		
Accrued interest receivable	49	(57)
Other assets	122	(124)
Accrued interest payable	55	24
Other liabilities	(105)	(158)
Net cash provided by operating activities	166	29
Cash flows from investing activities:		
Proceeds from maturities and principal repayments on securities - available for sale	1	1
Proceeds from maturities and principal repayments on securities - held to maturity	250	2,000
Purchases of securities - held to maturity	(1,106)	(1,340)
Purchases of time deposits	(1,000)	
Net increase in loans	(1,824)	(8,748)
Cash received from the acquistion of Treaty Oak Holdings, Inc.		515
Advances to affiliates		192
Collection of notes receivable from affiliates		2,821
Purchases of premises and equipment	(294)	(38)
Purchases of correspondent bank stock	(18)	
Net cash used in investing activities	(3,991)	(4,597)
Cash flows from financing activities:		
Net increase (decrease) in deposits	1,131	(2,612)
Payments of principal on mortgage	(16)	(15)
Payments of principal on notes payable		(2,483)
Purchases of treasury shares	(55)	
Proceeds from exercise of warrants	1	18
Proceeds from exercise of options	41	
Net cash provided by (used in) financing activities	1,102	(5,092)
Net decrease in cash and cash equivalents	(2,723)	(9,660)
Cash and cash equivalents at beginning of period	22,329	26,354
Cash and cash equivalents at end of period	$ 19,606	$ 16,694

See Notes to Consolidated Financial Statements (unaudited)

Treaty Oak Bancorp, Inc.

Consolidated Statements of Cash Flows (unaudited)

Three Months Ended December 31, 2007 and 2006

(Dollars In Thousands)

	Three Months Ended December 31, 2007		Three Months Ended December 31, 2006	
Supplemental disclosures of cash flow information:				
Non-cash investing and financing information:				
Cash interest received	$	2,110	$	1,685
Cash interest paid	$	706	$	606
Acquisition of Treaty Oak Holdings, Inc.				
Assets acquired, excluding cash acquired			$	1,280
Liabilities assumed				(80)
Issuance of common stock				(9,093)
Retirement of comon stock				8,310
Issuance of warrants and assumption of options				(932)
Net cash acquired			$	(515)

See Notes to Consolidated Financial Statements (unaudited)

Note 1. Basis of Presentation

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

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

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

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

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

New Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. FIN 48 also provides guidance on the accounting for and disclosure of unrecognized tax benefits, interest and penalties. The Company adopted FIN 48 on October 1, 2007. The adoption did not have any impact on the financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 addresses the views of the SEC staff regarding the process of quantifying financial statement misstatements. SEC registrants are expected to reflect the effects of initially applying the guidance in SAB 108 in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment should be made to the opening balance of retained earnings for that year. The Company adopted SAB 108 on October 1, 2007 and the adoption did not have any impact on the financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. It clarifies that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts. This Statement does not require any new fair value measurements, but rather, it provides enhanced guidance to other pronouncements that require or permit assets or liabilities to be measured at fair value. This Statement is effective for fiscal years beginning after November 15, 2007, with earlier adoption permitted. The Company will adopt this standard in the first quarter of fiscal 2009. The Company does not expect that the adoption of this Statement will have a material impact on its financial position, results of operation and cash flows.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities . This Statement permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company will adopt this standard in the first quarter of fiscal 2009. The Company is currently evaluating the impact of SFAS No. 159 on its consolidated financial position, results of operations and cash flows.

Note 2. Merger with Organizing Shareholder

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

TOHI had issued options to acquire shares of common stock to various individuals, 40,000 of which were outstanding as of the date of the merger. These options were assumed by the Company and, pursuant to the conversion ratio, now represent options to acquire 32,484 shares of the Company s common stock. The options were fully vested at the merger date. Also, at the closing of the merger, certain TOHI warrantholders were issued new warrants to acquire, in the aggregate, 450,000 shares of the Company s common stock. The warrants were fully vested when issued. The Company granted the TOHI shareholders certain limited registration rights pursuant to a Registration Rights Agreement executed at the closing of the merger. Pursuant to the Registration Rights Agreement these former TOHI shareholders can request that the Company register their shares of the Company s common stock on a Registration Statement on Form S-3 if such form is available for use by the Company, but only once during any 12-month period. The former TOHI warrantholders were also granted similar S-3 registration rights.

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

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

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

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

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

Note 3. Earnings (Loss) Per Share

Basic earnings (loss) per share is computed by dividing net earnings (loss) by the weighted-average number of common shares outstanding for the period. Diluted earnings per share is computed using the weighted-average number of common shares outstanding plus the number of additional common shares that would have been outstanding if dilutive common shares had been issued. For the three months ended December 31, 2007, there were 1,023,291 potentially dilutive securities outstanding, however, due to the net loss, all potentially dilutive securities were all anti-dilutive.

For the three months ended December 31, 2006, all potentially dilutive securities were anti-dilutive except for stock options to purchase 15,500 shares of the Company s common stock at an exercise price of $8.00, stock options to purchase 32,484 shares of the Company s common stock at an exercise price of $6.16 that were assumed in conjunction with the merger with TOHI and warrants to purchase 450,000 of the Company s common stock at an exercise price of the greater of $6.67 per share or the book value of the Company as defined by the warrant agreements.

Note 4. Securities

Securities consisted of the following (in thousands):

	As of December 31, 2007 Amortized Cost	As of December 31, 2007 Fair Value	As of September 30, 2007 Amortized Cost	As of September 30, 2007 Fair Value
Securities Available for Sale:				
U.S. Government Agencies	$ 4	$ 4	$ 5	$ 5
Other mortgage backed securities	2	2	2	2
Total Securities Available for Sale	$ 6	$ 6	$ 7	$ 7
Securities Held to Maturity:				
U.S. Treasury securities	$ 1,205	$ 1,210	$ 349	$ 350
Other mortgage backed securities	4	4	5	4
Total Securities Held to Maturity	$ 1,209	$ 1,214	$ 354	$ 354

At December 31, 2007, $513,000 of the Company s securities at fair value were pledged to Texline Independent School District, and $707,000 to the City of Texline.

Note 5. Loans and Allowance for Loan Losses

The Company grants real estate, commercial and agribusiness loans to customers primarily in the Austin and Northwest Texas markets. Loans at December 31, 2007, and September 30, 2007 were as follows (in thousands):

	As of December 31, 2007	As of September 30, 2007
Agriculture	$ 3,730	$ 3,932
Commercial	29,537	29,502
Commercial real estate	21,404	21,015
Residential real estate	9,681	9,061
Construction real estate	13,448	14,108
Consumer and other	8,114	6,504
Gross Loans	85,914	84,122
Less: allowance for loan losses	(843)	(789)
Net Loans	$ 85,071	$ 83,333

Activity in the allowance for loan losses for the three months and six months ended December 31, 2007, was as follows (in thousands):

	Three Months Ended December 31,			
	2007		2006	
Balance at beginning of period	$	789	$	550
Provision for loan losses		86		75
Loans charged off		(33)		(51)
Recoveries on loans previously charged off		1		1
Balance at end of period	$	843	$	575

At December 31, 2007 and September 30, 2007, the Bank had approximately $629,000 and $204,000, respectively, in nonperforming loans and non accrual loans. At December 31, 2007 and September 30, 2007 the Bank had no repossessed assets, and $50,000 in other real estate owned.

Note 6. Premises and Equipment

Premises and equipment at December 31, 2007, and September 30, 2007, were as follows (in thousands):

	As of December 31, 2007		As of September 30, 2007	
Land	$	959	$	959
Building and leasehold improvements		5,086		4,929
Furniture, fixtures and equipment		1,371		1,233
		7,416		7,121
Less accumulated depreciation and amortization		(1,187)		(1,077)
Total	$	6,229	$	6,044

Depreciation and amortization expense for the three months ending December 31, 2007 and 2006 was $110,000 and $86,000, respectively.

Note 7. Deposits

Time deposits of $100,000 or more totaled $12,599,000 and $13,470,000 at December 31, 2007 and September 30, 2007, respectively. At December 31, 2007 and September 30, 2007, the scheduled maturities of time deposits were as follows (in thousands):

Years Ending September 30,	As of December 31, 2007		As of September 30, 2007	
2008	$	27,955	$	29,889

2009	1,488	299
2010	170	
	$ 29,613	$ 30,188

12

Note 8. Goodwill and Other Intangibles

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

Core deposit intangibles are amortized on a straight-line basis over seven years. The following table reflects the net carrying amount of core deposit intangibles at December 31, 2007 and September 30, 2007 (in thousands):

	As of December 31, 2007	As of September 30, 2007
Gross core deposit intangibles	$ 70	$ 70
Less: accumulated amortization	(38)	(36)
Net core deposit intangibles	$ 32	$ 34

Note 9. Stock Based Compensation and 2004 Stock Incentive Plan

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

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

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

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

The following table illustrates the stock compensation expense recognized during the three months ended December 31, 2007 and 2006.

	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006
Stock options for directors and employees	$ 46	$ 44
Restricted stock for employees	27	6
	$ 73	$ 50

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

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

The weighted average fair value of the options granted during the three months ended December 31, 2007 and 2006, has been estimated using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended December 31, 2007	Three Months Ended December 31, 2006
Dividend yield	0%	0%
Risk-free interest rate	3.34 - 4.14%	4.70 - 4.75%
Expected volatility	5.24%	3.35%
Expected life in years	4.0 Years	6.85 Years

As of December 31, 2007, there were outstanding options under the Company s Stock Incentive Plan to purchase an aggregate of 540,162 shares of the Company s common stock. Each option has an exercise price of between $8.00 and $10.95 per share and may be exercised in three equal annual installments for each year of service measured from the grant date. During the three months ended December 31, 2007, the Company granted stock options to purchase an aggregate of 110,862 shares of its common stock with an exercise prices ranging from $10.35 to $10.50 per share to ten (10) officers and directors and 1,000 shares with an exercise price of $10.00 per share to an employee.

On November 20, 2007, the Company awarded 13,324 shares of common stock to six (6) officers. The stock vests in four equal installments upon completion of each year of service over the four-year period of service measured from the date of the award. On November 20, 2007 and December 20, 2007, four (4) officers surrendered 5,206 vested shares of common stock to satisfy federal income tax withholding requirements.

During the three months ended December 31, 2006, the Company granted stock options to purchase an aggregate of 71,750 shares of its common stock with an exercise prices ranging from $8.00 to $9.00 per share to fifteen (15) officers and directors. The options may be exercised in three equal annual installments for each year of service measured from the grant date. Included in the option grants for the three months ended December 31, 2006 was an award to Jeffrey L. Nash, in connection with the execution of his employment agreement with the Company, of 15,000 options to purchase shares of stock at an exercise price of $8.00 per share.

On November 20, 2006, the Company awarded 38,006 shares of common stock to six (6) officers. The stock vests in four equal installments upon completion of each year of service over the four-year period of service measured from the date of the award.

The table below presents the summary of stock option and restricted stock activity for the Plan during the three months ended December 31, 2007.

	Three Months Ended December 31, 2007					
	Restricted Stock		Options			
	Shares	Weighted Average Remaining Contractual Term in Years	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding, beginning of the period	49,507		433,300	$ 8.74		
Granted	13,324		111,862	10.36		
Exercised			(5,000)	(8.33)		
Forfeited/expired/surrendered	(5,206)					
Outstanding, end of the period	57,625	3.0	540,162	$ 9.08	8.2	$ 600,738
Exercisable at the end of the period	5,972		247,350	$ 8.47	7.1	$ 402,959

A summary of shares of our common stock subject to our nonvested shares and options as of December 31, 2007 and changes during the three months ended December 31, 2007 is presented below:

	Three Months Ended December 31, 2007			
	Restricted Stock		Options	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested, beginning of the period	47,106	$ 8.25	229,117	$ 1.70
Granted	13,324	10.00	111,862	1.36
Vested	(8,777)	(8.00)	(48,167)	(1.79)
Forfeited/expired				
Nonvested, end of the period	51,653	$ 8.75	292,812	$ 1.57

As of December 31, 2007, there was $812,432 of total unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a

weighted-average period of 2.77 years. Options totaling 5,000 with an exercise price of $8.33 per share were exercised during the three months ended December 31, 2007.

Note 10. Stock Warrants

As of December 31, 2007, the Company has 450,000 warrants to purchase the Company s common stock outstanding. The warrants are fully vested, have an exercise price of the greater of the Company s book value per share of common stock at the exercise date or $6.67 per share and expire on August 11, 2011.

Note 11. Other Related Party Transactions

The Company had no amounts due from affiliates at December 31, 2007 and September 30, 2007.

On October 11, 2005, the Company made a $355,000 loan to TOHI with monthly interest payments due on the first of each month beginning November 1, 2005. The purpose of the loan was to enable TOHI to pay off certain obligations, and to provide sufficient liquidity to TOHI until the proposed merger with the Company was completed. On April 26, 2006, the obligation was renewed and increased to $373,000 at the then current prime rate. The loan was renewed and increased to $400,000 on September 1, 2006. The principal balance ($396,000 as of September 30, 2007), along with any accrued interest, was due and payable in full on November 1, 2006. On November 15, 2006, in connection with the merger of TOHI and the Company, the loan was paid in full.

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

Note 12. Financial Instruments with Off-Balance Sheet Risk

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

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

The following table summarizes the Company s off-balance sheet financial instruments as of December 31, 2007 and September 30, 2007 (in thousands):

	As of December 31, 2007	As of September 30, 2007
Commitments to extend credit	$ 18,303	$ 20,786
Standby letters of credit	4,418	2,251

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

Standby letters of credit are written conditional commitments used by the Company to guarantee the performance of a customer to a third party. The Company s policies generally require that letter of credit arrangements contain security and debt covenants similar to those contained in loan arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount shown in the table above. If the commitment is funded, the Company would be entitled to seek recovery from the customer. As of December 31, 2007, no amounts have been recorded as liabilities for the Company s potential obligations under these guarantees.

Note 13. Commitments and Contingencies

The following table presents a summary of non-cancelable future operating lease commitments as of December 31, 2007 (in thousands):

Years Ending September 30,	As of December 31, 2007
2008	$ 112
2009	165
2010	174
2011	175
2012	178
Thereafter	1,669
	$ 2,473

Note 14. Dividend Restrictions and Regulatory Matters

Banks and bank holding companies are subject to regulatory capital requirements administered by state and federal banking regulatory agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings and other factors. Failure to meet capital requirements can initiate regulatory action. As of December 31, 2007, management believes the Bank is in compliance with all regulatory capital requirements to which it is subject.

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

	Actual Amount	Actual Ratio	For Capital Adequacy Purposes Amount	For Capital Adequacy Purposes Ratio	To Be Well Capitalized Under Prompt Corrective Action Provisions Amount	To Be Well Capitalized Under Prompt Corrective Action Provisions Ratio
As of December 31, 2007						
Tier 1 capital (to average assets)	$ 9,223	8.56%	$ 4,308	4%	$ 5,385	5%
Tier 1 capital (to risk-weighted assets)	9,223	9.51%	3,878	4%	5,816	6%
Total Capital (to risk-weighted assets)	10,066	10.38%	7,755	8%	9,694	10%

	Actual Amount	Actual Ratio	For Capital Adequacy Purposes Amount	For Capital Adequacy Purposes Ratio	To Be Well Capitalized Under Prompt Corrective Action Provisions Amount	To Be Well Capitalized Under Prompt Corrective Action Provisions Ratio
As of September 30, 2007						
Tier 1 capital (to average assets)	$ 9,079	8.78%	$ 4,243	4%	$ 5,303	5%
Tier 1 capital (to risk-weighted assets)	9,079	9.76%	3,726	4%	5,589	6%
Total Capital (to risk-weighted assets)	9,868	10.61%	7,451	8%	9,314	10%

As of December 31, 2007 and September 30, 2007, the Bank met the level of capital required to be categorized as well capitalized under prompt corrective action regulations. Management is not aware of any conditions subsequent to December 31, 2007 that would change the Bank s capital category.

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

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

Note 15. Subsequent Event

On November 13, 2007 the Company s Board of Directors approved a plan to deregister its common stock under the Securities Exchange Act of 1934, as amended, and, therefore, terminate its obligations to file reports with the Securities and Exchange Commission. This going private transaction would be accomplished through an amendment (the Amendment) to the Company s Articles of Incorporation, which would (1) authorize 2,500,000 shares of a new Series A Preferred Stock and (2) effect a reclassification of all shares of common stock held by record shareholders owning less than 2,500 shares of our common stock into shares of Series A Preferred Stock on a one-for-one basis (the

Reclassification). Shares of common stock held by record shareholders owning 2,500 or more shares will remain outstanding and will be unaffected by the Reclassification.

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

Introduction

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

Recent Developments

On January 7, 2008, the Bank opened its newest branch at 2800 Barton Creek Boulevard, Austin, Texas, in the affluent Barton Creek Estates community in southwest Austin.

On November 13, 2007our Board of Directors approved a plan to deregister our common stock under the Securities Exchange Act of 1934, as amended, and, therefore, terminate our obligations to file reports with the Securities and Exchange Commission. This going private transaction would be accomplished through an amendment (the Amendment) to the Company s Articles of Incorporation, which would (1) authorize 2,500,000 shares of a new Series A Preferred Stock and (2) effect a reclassification of all shares of common stock held by record shareholders owning less than 2,500 shares of our common stock into shares of Series A Preferred Stock on a one-for-one basis (the Reclassification). Shares of common stock held by record shareholders owning 2,500 or more shares will remain outstanding and will be unaffected by the Reclassification.

The Amendment and Reclassification are subject to approval by the holders of two-thirds (2/3) of the outstanding shares of our common stock. Shareholders will be asked to approve the Amendment and Reclassification at our 2008 annual shareholders meeting to be held on February 25, 2008.

If the Amendment is approved by our shareholders and, after completion of the Reclassification, we have fewer than 300 shareholders of record of common stock, we intend to terminate the registration of our common stock under the Securities Exchange Act of 1934, as amended, and become a non-reporting company. If that occurs, we will no longer file periodic reports with the Securities and Exchange Commission, including annual reports on Form 10-KSB and quarterly reports on Form 10-QSB.

Those shareholders receiving shares of Series A Preferred Stock in the Reclassification will have the option to sell those shares to us at any time during the 30 day period following the Reclassification at a cash price equal to $11.00 per share (the Put Price).

Our Board of Directors received a fairness opinion from its financial advisor, Fowler Valuation Services, LC, that the Put Price to be paid following the Reclassification is fair, from a financial perspective, to all of our shareholders.

Results of Operations

General

The following discussion analyzes the results of the Company for the three months ended December 31, 2007, and December 31, 2006.

Net Income-General

The Company s fiscal year ends on September 30. Net loss for the three months ended December 31, 2007, was $226,000, compared to net income of $136,000 for the quarter ended December 31, 2006. The decrease was primarily due to reduced earnings generated at the Bank as a result of the start-up costs in the Marble Falls and Barton Creek branches and the decreased net interest margin as a result of recent interest rate reductions by the Federal Reserve Bank. The decrease in earnings was also a result of professional fees and expenses related to the Reclassification and continuing costs related to being a public company, including financial reporting and compliance.

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

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

Net Interest Income

For the three months ended December 31, 2007, our net interest income was $1,300,000 compared to $1,153,000 for three months ended December 31, 2006. Net interest income for the quarters ended December 31, 2007 and 2006 was reduced by the amortization of direct loan origination costs of approximately $16,200 and $13,400, respectively.

For the comparative three month periods of December 31, 2006 and December 31, 2007, the average rate on interest-bearing liabilities decreased 16 basis points, from 4.38% to 4.22%, while the average rate on interest bearing assets decreased 9 basis points from 8.24% to 8.15% during the same period. The average yield on loans decreased 42 basis points during the period due to the decline in the prime rate and the corresponding impact on the variable rate loans in the portfolio. The decrease in loans was offset, in part, by increased yields on investments with longer maturities. The decrease in the average rate on interest-bearing liabilities was due to the overall decline in interest rates during the period and the maturity and repricing of higher-yielding time deposits. This decrease was partially offset by higher rates on promotional money market products offered by our new branches. Deposit rates do not always decline as quickly as asset rates in a falling rate environment due to the maturities of certain deposit products and the general competition in the market for deposits.

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

	Three Months Ended December 31, 2007			Three Months Ended December 31, 2006		
	Average Balance	**Interest (2)**	**Yield/ Rate**	**Average Balance**	**Interest (2)**	**Yield/ Rate**
Interest Earning Assets:						
Loans (1)	$ 82,417	$ 1,816	8.81%	$ 66,980	$ 1,545	9.23%
Taxable investment securities	1,125	15	5.33%	1,711	14	3.27%
Federal funds sold	15,154	182	4.80%	17,581	226	5.14%
Interest bearing deposits with other Banks	2,112	30	5.68%			0.00%
Federal Home Loan Bank Stock	336	18	21.44%	326		0.00%
Total interest earning assets	101,144	2,061	8.15%	86,598	1,785	8.24%
Non-interest earning assets	12,449			10,301		
Total assets	$ 113,593			$ 96,899		
Interest Bearing Liabilities:						
Deposits:						
NOW and money market deposits	$ 38,930	$ 388	3.99%	$ 33,417	$ 296	3.54%
Savings deposits	631	2	1.27%	510	2	1.57%
Time deposits	29,909	332	4.44%	19,884	267	5.37%
Short-term borrowings			0.00%	1,213	26	8.58%
Property mortgage and long term borrowings	2,593	39	6.02%	2,685	41	6.11%
Total interest bearing liabilities	72,063	761	4.22%	57,709	632	4.38%
Demand deposits non-interest bearing	25,619			26,411		
Other non-interest bearing liabilities	649			537		
Shareholders equity	15,262			12,242		
Total liabilities and shareholders equity	$ 113,593			$ 96,899		
Net interest income		$ 1,300			$ 1,153	
Interest rate spread (3)			3.93%			3.86%
Net interest margin (4)			5.14%			5.33%

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

(2) Interest income includes loan fees of $83,000, for the three months ended December 31, 2007 and $49,000 for the three months ended December 31, 2006.

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

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

Volume, Mix and Rate Analysis of Net Interest Income

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

	Three Months Ended December 31, 2007 Compared to Three Months Ended December 31, 2006		
	Change Due to Volume	**Change Due to Rate**	**Total Change**
Interest Earning Assets:			
Loans	$ 1,361	$ (1,090)	$ 271
Taxable investment securities	(31)	32	1
Federal funds sold	(117)	73	(44)
Interest bearing deposits with other Banks	30		30
FHLB/TIB stock	2	16	18
Increase in interest income	$ 1,245	$ (969)	$ 276
Interest Bearing Liabilities:			
NOW and money market deposit accounts	$ 220	$ (128)	$ 92
Savings deposits	2	(2)	
Time deposits	445	(380)	65
Short-term borrowings	(26)		(26)
Long term borrowings	(6)	4	(2)
Increase (decrease) in interest expense	635	(506)	129
Increase (decrease) in net interest income	$ 610	$ (463)	$ 147

Provision for Loan Losses

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

For the three months ended December 31, 2007, the Bank made $86,000 in provisions for loan losses, compared to $75,000 for the three months ended December 31, 2006. For the three months ended December 31, 2007, the Bank charged off $33,000 in commercial and consumer loans and had recoveries of loans previously charged-off of $1,000 for net recoveries of $32,000. For the three months ended December 31, 2006, the Bank charged off $51,000 in commercial and consumer loans and had zero recoveries of loans previously charged-off for net charge-offs of

$1,000, for net charge-offs of $50,000. The factors combined increased the Allowance for Loan Losses to $843,000 or 0.98% of the portfolio at December 31, 2007. This amount represents management s estimate of probable losses inherent in the portfolio.

Other Income

For the three months ended December 31, 2007, other income increased $2,000 from $105,000 during the three months ended December 31, 2006, to $107,000. Service charges and other income increased by $35,000 but were offset by a decrease of $33,000 in sublease income in PGI Equity Partners, LP, which is the real estate investment company that owns and manages the property where the Company s offices are located.

Non-Interest Expenses

For the three months ended December 31, 2007, salaries and employee benefits were $762,000 compared to $526,000 for the three months ended December 31, 2006. Stock based compensation recognized for the three months ended December 31, 2007 totaled $73,000 as compared to $50,000 for the three months ended December 31, 2006. Occupancy and equipment expenses for the three months ended December 31, 2007 increased from $112,000 for the three months ended December 31, 2006 to $151,000. The increase in salaries and employee benefits and occupancy and equipment expenses was due to the Bank s continued growth and the corresponding addition of new employees at the new branches in Marble Falls and Barton Creek. The increase in stock based compensation was due to the issuance of stock options and restricted stock under the Company s Stock Incentive Plan. Professional fees paid for accounting and legal services, including regulatory filings and audit services, totaled $196,000 and $55,000, respectively, for the three months ended December 31, 2007 and 2006. The increase was due to expenses related to the Reclassification and the increased costs of being a public company, including additional financial reporting and compliance. Other expenses increased from $354,000 for the three months ended December 31, 2006, to $438,000 for the three months ended December 31, 2007. Other expenses primarily consist of data processing and software maintenance costs, marketing and advertising, business development expenses, and other operating costs. This increase in other expenses was also a result of the growth of the Bank and the increase in employees at all locations.

Income Taxes

No federal tax expense has been recorded for the three months ended December 31, 2007 based upon net operating losses incurred and carried forward from prior years. Although we were profitable for the fiscal years ended September 30, 2007 and 2006, we have fully reserved against the deferred tax benefit accumulated through September 30, 2007, based upon our projected financial results for the fiscal year ending September 30, 2008 and other factors including our limited operating history.

Financial Condition

Loan Portfolio

Net loans increased $1,738,000 (2.1%) to $85,071,000 from $83,333,000 between September 30, 2007 and December 31, 2007. The concentration within the portfolio has shifted over time from the previous concentration of agricultural loans to real estate and commercial loans.

Loan Portfolio Mix

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

	As of December 31, 2007	As of September30, 2007
Agriculture	$ 3,730	$ 3,932
Commercial	29,633	29,502
Commercial real estate	21,198	21,015
Residential real estate	9,972	9,061
Construction real estate	13,447	14,108
Consumer and other	7,934	6,504
Gross Loans	85,914	84,122
Less: allowance for loan losses	(843)	(789)
Net Loans	$ 85,071	$ 83,333

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

For the three month period ended December 31, 2007, the majority of new loan growth came from the Austin and Marble Falls markets reflecting a broader, more diverse mix of industries and borrowers.

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

Loan Maturities

The following table presents the contractual maturity ranges for agricultural, commercial, real estate and consumer loans outstanding at December 31, 2007, and at September 30, 2007, and also presents for each maturity range the portion of loans that have fixed interest rates or interest rates that fluctuate over the life of the loan in accordance with changes in the interest rate environment as represented by the base rate (in thousands):

	Due in One Year or Less		Due after One Year Through Five Years		Due after Five Years		
December 31, 2007	**Fixed Rate**	**Floating Rate**	**Fixed Rate**	**Floating Rate**	**Fixed Rate**	**Floating Rate**	**Total**
Agricultural	$ 23	$ 2,645	$	$ 578	$	$ 484	$ 3,730
Commercial	376	18,671	1,318	9,075		193	29,633
Commercial real estate	230	8,121	707	12,140			21,198
Residential real estate	1,808	2,954	2,562	2,024	624		9,972
Construction real estate	788	4,717	168	5,742	129	1,903	13,447
Consumer and other	472	5,779	360	1,299	24		7,934
Total	$ 3,697	$ 42,887	$ 5,115	$ 30,858	$ 777	$ 2,580	$ 85,914

	Due in One Year or Less		Due after One Year Through Five Years		Due after Five Years		
September 30, 2007	**Fixed Rate**	**Floating Rate**	**Fixed Rate**	**Floating Rate**	**Fixed Rate**	**Floating Rate**	**Total**
Agricultural	$ 38	$ 2,731	$	$ 676	$	$ 487	$ 3,932
Commercial	2,106	18,477	1,026	7,772		121	29,502
Commercial real estate	230	9,771	732	10,282			21,015
Residential real estate	1,542	2,354	1,959	2,542	664		9,061
Consumer and other	825	3,915	174	7,418		1,776	14,108
Consumer and other	480	4,368	566	1,900			6,504
Total	$ 5,221	$ 41,616	$ 4,457	$ 29,780	$ 664	$ 2,384	$ 84,122

As of December 31, 2007, 54.2% of the loan portfolio, or $46,584,000, matures or re-prices within one year or less and $76,325,000 of the loan portfolio, or 88.8%, were variable rate loans. At September 30, 2007, 55.7% of the loan portfolio or $46,837,000, matured or re-priced within one year or less and $73,780,000 of these loans, or 87.7%, were variable rate loans.

24

Investment Securities

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

The following tables set forth the amortized cost and fair value of the Bank s securities portfolio by accounting classification category and by type of security as indicated (in thousands) as of December 31, 2007 and September 30, 2007:

	As of December 31, 2007		As of September 30, 2007	
	Amortized Cost	**Fair Value**	**Amortized Cost**	**Fair Value**
Securities Available for Sale:				
U.S. Government Agencies	$ 4	$ 4	$ 5	$ 5
Other mortgage backed securities	2	2	2	2
Total Securities Available for Sale	$ 6	$ 6	$ 7	$ 7
Securities Held to Maturity:				
U.S. Treasury Securities	$ 1,205	$ 1,210	$ 349	$ 350
Other mortgage backed securities	4	4	5	4
Total Securities Held to Maturity	$ 1,209	$ 1,214	$ 354	$ 354

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

Asset Quality

The following table sets forth the amount of non-performing loans and non-performing assets as of December 31, 2007, and September 30, 2007 (in thousands except for percentages):

	As of December 31, 2007	**As of September 30, 2007**
Non-accruing loans	$ 629	$ 204
Loans 90 days or more past due, still accruing interest		
Total non-performing loans	629	204
Other real estate owned	50	50

Other repossessed assets		
Total non-performing assets	$ 679	$ 254
Total non-performing loans to total loans	0.73%	0.30%
Allowance for loan losses to non-performing loans	134%	311%
Total non-performing assets to total assets	0.58%	0.22%

Non-performing Loans

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

During the ordinary course of business, management becomes aware of borrowers that may not be able to meet the contractual requirements of loan agreements. Such loans are placed under close supervision with consideration given to placing the loan on a non-accrual status, increasing the allowance for loan losses, and (if appropriate) partial or full charge-off. After a loan is placed on non-accrual status, any current year interest previously accrued but not yet collected is reversed against current income. When payments are received on non-accrual loans, such payments are applied to principal and not taken into income. Loans are not placed back on accrual status unless all back interest and principal payments are made. If interest on non-accrual loans had been accrued, such income would have amounted to approximately $4,000 for the three months ended December 31, 2007 and $2,200 for the three months ended December 31, 2006. This amount was not included in interest income during this period.

Under Federal and Texas law, any loan 90 or more days past due is required to be placed on non-accrual basis unless specifically identified mitigating circumstances exist. Our policy is to place loans 90 days past due on non-accrual status. An exception is made when management believes the loan is fully secured and in process of collection. Non-accrual loans are further classified as impaired when underlying collateral is not sufficient to cover the loan balance and it is probable that we will not fully collect all principal and interest. As of December 31, 2007 and September 30, 2007, we had $629,000 and $204,000 in non-accrual loans respectively. There were no loans contractually past due over 90 days which continued to accrue interest on December 31, 2007 and September 30, 2007, based upon specific information available at that time to management. In compliance with these statutes we have developed pro forma financial statements assuming that no loans will continue to accrue interest if they become 90 days past due, and instead transfer all such loans to non-accruing status.

A troubled debt restructuring is a restructured loan upon which interest accrues at a below market rate or upon which certain principal has been forgiven so as to aid the borrower in the final repayment of the loan, with any interest previously accrued, but not yet collected, being reversed against current income. Interest is accrued based upon the new loan terms. There were no troubled debt restructurings outstanding as of December 31, 2007 and September 30, 2007.

Non-performing assets also consist of other repossessed assets and other real estate owned (OREO). OREO represents properties acquired through foreclosure or other proceedings and is recorded at the lower of cost or fair market value less the estimated cost of disposal. OREO is evaluated regularly to ensure that the recorded amount is supported by its current fair market value. Valuation allowances to reduce the carrying amount to fair market value less estimated costs of disposal are recorded as necessary. Revenues and expenses from the operations of OREO and changes in the valuation are included in other income and other expenses on the income statement. As of December 31, 2007, and September 30, 2007, we had $50,000 in other real estate owned. The property consists of two single family dwellings located in Texline and Clayton, New Mexico. There were no repossessed assets at December 31, 2007 and September 30, 2007.

Sources of Funds

General

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

Deposits

We offer a variety of deposit accounts with a range of interest rates and terms. Core deposits consist of checking accounts (non-interest bearing), NOW accounts, savings accounts, and non-public certificates of deposit. These deposits, along with public fund deposits and short-term borrowings, are used to support our asset base. Deposits are obtained predominantly from the geographic trade areas surrounding our office locations. We rely primarily on customer service and long-standing relationships with customers to attract and retain deposits; however, market interest rates and rates offered by competing financial institutions significantly affect our ability to attract and retain deposits. As the competition for deposits has increased, we have continued to expand and diversify the Bank s funding sources. For the three months ended December 31, 2007, we have utilized institutional deposits to ensure adequate funding of our loan growth.

The following table sets forth the maturities of time deposits $100,000 and over as of December 31, 2007, and September 30, 2007 (in thousands):

	As of December 31, 2007	As of September 30, 2007
Time deposits $100,000 and over:		
Maturing within three months	$ 3,619	$ 2,898
After three months but within six months	3,663	2,814
After six months but within 12 months	5,117	7,453
After 12 months	200	305
Total time deposits $100,000 and over	$ 12,599	$ 13,470

Return on Equity and Assets

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

	For the Three Months Ended	
	December 31, 2007	December 31, 2006
Return on assets	(0.19)%	0.03%
Return on equity	(1.49)%	0.21%
Dividend payout ratio	0%	0%
Equity to assets ratio	13.03%	15.36%

The following table presents a summary of non-cancelable future operating lease commitments as of December 31, 2007 (in thousands):

Years Ending September 30,	As of December 31, 2007

2008	$	112
2009		165
2010		174
2011		175
2012		178
Thereafter		1,669
	$	2,473

Capital Resources

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

As of December 31, 2007 and as of September 30, 2007, the most recent notifications from the federal Banking regulators categorized the Bank as well-capitalized. A well-capitalized institution must maintain a minimum ratio of total capital to risk-weighted assets of at least 10.00%, a minimum ratio of Tier 1 capital to risk weighted assets of at least 6.00%, and a minimum ratio of Tier 1 capital to total assets of at least 5.00% and must not be subject to any written order, agreement, or directive requiring it to meet or maintain a specific capital level. There are no conditions or events since that notification that the Bank s management believes have changed the capital classification.

The Bank was in full compliance with all applicable capital adequacy requirements as of December 31, 2007 and September 30, 2007. The required and actual amounts and ratios for the Bank as of December 31, 2007 and September 30, 2007, are presented below:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2007						
Tier 1 capital (to average assets)	$ 9,223	8.56%	$ 4,308	4%	$ 5,385	5%
Tier 1 capital (to risk-weighted assets)	9,223	9.51%	3,878	4%	5,816	6%
Total Capital (to risk-weighted assets)	10,066	10.38%	7,755	8%	9,694	10%

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2007						
Tier 1 capital (to average assets)	$ 9,079	8.78%	$ 4,243	4%	$ 5,303	5%
Tier 1 capital (to risk-weighted assets)	9,079	9.76%	3,726	4%	5,589	6%
Total Capital (to risk-weighted assets)	9,868	10.61%	7,451	8%	9,314	10%

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

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

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

PART II. Other Information

Item 1. *Legal Proceedings*

None

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

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

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

		As of December 31, 2007
Gross proceeds from sale of shares	$	13,276,271
Gross proceeds from exercise of warrants		
Amounts receivable as of December 31, 2004		
Repayment of offering and start-up costs under Expense Reimbursement Agreement to Treaty Oak Holdings, Inc., including offering costs of $500,000 and pre-opening expenses of $275,000		(775,000)
Repayment of note payable to Treaty Oak Holdings, Inc., including accrued interest of approximately $7,000		(507,302)
Repayment of notes payable for the acquisition of Texline State Bank including accrued interest of approximately $29,000		(1,015,332)
Contribution to the capital of the Bank		(7,500,000)
Payments to directors and officers (bonuses and directors fees)		(212,968)
Payments to officers (salary and benefits)		(386,108)
Other payments to affiliates for services		(149,057)
Limited partnership investment in affiliated limited partnership		(1,030,000)
Loan to affiliated company		(46,037)
Repurchase of shares issued		(105,005)
Expenses related to proposed reclassification transaction		(120,000)
Payment of additional operating expenses (estimated)		(1,068,281)
Remaining net proceeds	$	361,181

In connection with the Company s acquisition of TOHI, we issued 1,094,163 shares of the Company s common stock to the TOHI shareholders. We also issued warrants to acquire, in the aggregate, 450,000 shares of the

Company s common stock with an exercise price of the lesser of the Company s book value or $6.67 to various TOHI warrantholders. We issued the stock and warrants under an exemption from registration under Section 4(2) of the Securities Act of 1933. The Company granted the TOHI shareholders certain limited registration rights pursuant to a Registration Rights Agreement executed at the closing of the merger. Pursuant to the Registration Rights Agreement these former TOHI shareholders can request that the Company register their shares of the Company s stock on a Registration Statement on Form S-3 if such form is available for use by the Company, but only once during any 12-month period. The former TOHI warrantholders were also granted similar S-3 registration rights.

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

None.

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

On November 13, 2007 our Board of Directors approved a plan to deregister our common stock under the Securities Exchange Act of 1934, as amended, and, therefore, terminate our obligations to file reports with the Securities and Exchange Commission. This going private transaction would be accomplished through an amendment (the Amendment) to the Company s Articles of Incorporation, which would (1) authorize 2,500,000 shares of a new Series A Preferred Stock and (2) effect a reclassification of all shares of common stock held by record shareholders owning less than 2,500 shares of our common stock into shares of Series A Preferred Stock on a one-for-one basis (the Reclassification). Shares of common stock held by record shareholders owning 2,500 or more shares will remain outstanding and will be unaffected by the Reclassification.

The Amendment and Reclassification are subject to approval by the holders of two-thirds (2/3) of the outstanding shares of our common stock. Shareholders will be asked to approve the Amendment and Reclassification at our 2008 annual shareholders meeting to be held on February 25, 2008.

If the Amendment is approved by our shareholders and, after completion of the Reclassification, we have fewer than 300 shareholders of record of common stock, we intend to terminate the registration of our common stock under the Securities Exchange Act of 1934, as amended, and become a non-reporting company. If that occurs, we will no longer file periodic reports with the Securities and Exchange Commission, including annual reports on Form 10-KSB and quarterly reports on Form 10-QSB.

Those shareholders receiving shares of Series A Preferred Stock in the Reclassification will have the option to sell those shares to us at any time during the 30 day period following the Reclassification at a cash price equal to $11.00 per share (the Put Price).

Our Board of Directors received a fairness opinion from its financial advisor, Fowler Valuation Services, LC, that the Put Price to be paid following the Reclassification is fair, from a financial perspective, to all of our shareholders.

Item 5. ***Other Information***

None.

Item 6. ***Exhibits***

The following exhibits are filed herewith or are incorporated by reference to exhibits previously filed with the SEC.

Exhibit Number	Exhibit Title
2.1(1)	Agreement and Plan of Merger, dated October 3, 2006, between Treaty Oak Holdings, Inc. and the Company
3.1(2)	Amended and Restated Articles of Incorporation
3.2(3)	By-laws
4.1(3)	Specimen Common Stock Certificate, $.01 par value per share
4.2(3)	See Exhibits 3.1 and 3.2 for provisions of the Articles of Incorporation and By-laws defining rights of holders of Common Stock
10.1(3)	Amended and Restated Building Lease between PGI Equity Partners, L.P. and Treaty Oak Bank
10.2(3)	Form of Promotional Shares Lock-In Agreement
10.3(2)*	Treaty Oak Bancorp, Inc. 2004 Stock Incentive Plan (amended and restated as of May 20, 2004)
10.4(3)*	Form of Indemnification Agreement between Treaty Oak Bancorp, Inc. and its directors and officers, and those of the Bank
10.5(4)*	Employment Agreement, dated September 27, 2006, between Treaty Oak Bancorp, Inc. and Jeffrey L. Nash
10.6(5)	Form of Warrant
10.7(5)	Form of Registration Rights Agreement with former shareholders of Treaty Oak Holdings, Inc.
10.8(5)	Form of Registration Rights Agreement with former warrantholders of Treaty Oak Holdings, Inc.
10.9(6)	Promissory Note of PGI Equity Partners, L.P. dated March 15, 2005 payable to Prudential Mortgage Capital Company, LLC
31.1**	Certification of Chief Executive Officer required by Rule 13a-14(a)/15d-14(a) under the Exchange Act**
31.2**	Certification of Chief Financial Officer required by Rule 13a-14(a)/15d-14(a) under the Exchange Act**
32.1**	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002**
32.2**	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of Sarbanes-Oxley Act of 2002**

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* Indicates management contract or compensatory plan or arrangement.
(1) Incorporated by reference to the Company s Current Report on Form 8-K filed October 10, 2006.
(2) Incorporated by reference to the Company s Registration Statement on Form S-8 filed October 22, 2004.
(3) Incorporated by reference to the same numbered exhibit to the Company s Registration Statement on Form SB-2.
(4) Incorporated by reference to the Company s Current Report on Form 8-K filed November 1, 2006.
(5) Incorporated by reference to the Company s same numbered exhibit to the Form 10-KSB filed December 29, 2006.
(6) Incorporated by reference to the Company s same numbered exhibit to the Form 10-KSB filed December 31, 2007.

** Filed herewith.

SIGNATURES

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

TREATY OAK BANCORP, INC.

Dated: February 14, 2008

By: /s/ Jeffrey L. Nash
Jeffrey L. Nash, President and Chief Executive Officer

By: /s/ Coralie S. Pledger
Coralie S. Pledger, Chief Financial Officer