### **CAPSTONE BANK**

January 18, 2013

Dear Shareholder:

I am pleased to report 2012 was a very good year for CapStone Bank. We experienced good growth in both assets and earnings. Total assets for the year ended December 31, 2012 were \$239 million, compared to \$217 million on December 31, 2011, an increase of \$22 million or 10.1%. Loans, during the same period, grew from \$147 million to \$172 million, an increase of \$25 million or 16.8%. Deposit growth for the year was also very positive, with total deposits increasing by \$24 million or 15.9%. During the same period, non-interest bearing deposits grew by \$8 million or 41%.

Net income for the year ended 2012 was \$1.9 million compared to \$676,000 in 2011, an increase of \$1.2 million or 186%. The growth in earnings was fueled primarily by an increase in net interest income of \$696,000 and a reduction in the provision for loan losses of \$1.6 million. Pre-tax, pre-provision income for 2012 was \$3.7 million compared to \$3.3 million in 2011, an increase of 12.1%. Return on average assets improved from 0.33% in 2011 to 0.83% in 2012 and return on average stockholders' equity for the same period improved from 2.43% to 6.58%. Total equity for the year grew from \$28 million to \$30 million and book value per share grew from \$10.80 to \$11.59, an increase of 7.3%.

Nonperforming assets (nonaccrual loans, troubled debt restructures and other real estate) showed significant improvement decreasing from \$7.2 million in 2011 to \$4.9 million at year-end 2012. This equates to 2.05% of total assets at year end 2012 compared to 3.36% at year end 2011. During 2012, we charged off \$1.2 million in loans and provided \$771,000 in the provision for loan losses. At year end 2012, we reported \$3.7 million in the allowance for loan losses, representing 2.16% of outstanding loans.

All necessary approvals to complete our merger with Patriot State Bank have been received and we will close the transaction on January 31, 2013. We are excited about the combination of our two banks and feel it will be a catalyst in our quest to enhance shareholder value. The combined bank will have approximately \$377 million in total assets, \$295 million in deposits, and will have offices in Raleigh, Cary, Fuquay-Varina and Clinton.

Our new full service office located in Cary's Regency Park will open in early February. We are excited to be converting our existing loan production office into this full service office. We have assembled a dynamic team of experienced bankers to serve this market and have high expectations for their success.

We are guardedly optimistic about the outlook for the economy in 2013. Although there are some positive signs with respect to the recovery of the housing market, until Congress deals with the nation's fiscal problems, we do not believe there will be any significant growth in the overall economy or meaningful decline in the unemployment rate. Regardless, we are confident with our exceptional team of bankers, CapStone remains poised to continue building a high-performing community bank focused on providing unparalleled service and value-driven products for our customers, growth opportunities for our team members and superior returns for our shareholders.

Thank you for your continued support of CapStone and I encourage you to contact me with any questions.

Sincerely,

Michael S. Patterson

Chairman, President and CEO

# **CAPSTONE BANK**

#### **Balance Sheet**

(Unaudited)

	Dec 2012	Dec 2011	\$ Change	% Change
Assets				
Cash and due from banks	\$ 4,249,728	\$ 2,293,449	\$ 1,956,279	85.3
Fed funds sold & repos	355,917	204,073	151,844	74.4
Interest bearing deposits with banks	18,054,221	18,154,218	(99,998)	-0.6
Investment Securities - Taxable	27,665,119	32,266,062	(4,600,942)	-14.3
Investment Securities - Tax-exempt	13,380,077	13,502,268	(122,191)	-0.9
Loans, net of unearned income	172,028,525	147,313,970	24,714,556	16.8
Less: Allowance for loan losses	(3,708,547)	(4,183,406)	474,859	11.4
Premises and equipment, net	248,617	206,196	42,421	20.6
Accrued interest receivable	639,774	716,356	(76,582)	-10.7
Other assets	6,102,642	6,095,259	7,383	0.1
Total Assets	\$ 239,016,073	\$ 216,568,445	\$ 22,447,628	10.4
Liabilities				
Non-Interest Bearing Deposits	\$ 28,645,425	\$ 20,240,943	\$ 8,404,482	41.5
Interest bearing demand deposits	31,007,974	25,657,869	5,350,105	20.9
Savings and Money Market Deposits	64,042,231	49,224,941	14,817,291	30.1
Time Deposits - Retail	23,458,441	25,967,124	(2,508,683)	-9.7
Time Deposits - Wholesale	28,358,836	30,371,636	(2,012,800)	-6.6
Total Deposits	175,512,908	151,462,513	24,050,395	15.9
Accrued expenses and other liabilities	2,258,819	1,872,425	386,394	20.6
FHLB Advances	30,500,000	31,750,000	(1,250,000)	-3.9
Other Borrowings	680,685	3,448,741	(2,768,056)	-80.3
Total Liabilities	208,952,412	188,533,679	20,418,733	10.8
Equity				
Common stock	12,974,365	12,974,365	-	0
Capital surplus	11,640,591	11,622,823	17,768	0.2
Retained earnings	2,210,358	1,534,382	675,975	44.1
Accumulated other comprehensive income (loss)	1,305,009	1,227,220	77,789	6.3
Net Income	1,933,339	675,975	1,257,363	186
Total Equity	30,063,661	28,034,766	2,028,895	7.2
Total Liabilities & Equity	\$ 239,016,073	\$ 216,568,445	\$ 22,447,628	10.4

## **CAPSTONE BANK**

#### **Income Statement**

(Unaudited)

	Dec 2012	Dec 2011	\$ Change	% Change
Interest Income				
Interest on Loans	\$ 7,912,179	\$ 7,553,157	\$ 359,022	4.8
Fees on Loans	376,636	218,081	158,555	72.7
Interest on federal funds sold	4,783	7,597	(2,814)	-37
Interest on deposits with banks	346,455	411,802	(65,347)	-15.9
Investment Securities - Taxable	945,278	967,095	(21,817)	-2.3
Investment Securities - Tax-exempt	479,825	419,238	60,588	14.5
Total Interest Income	10,065,156	9,576,970	488,186	5.1
Interest Expense				
Interest bearing demand deposits	107,919	142,954	(35,035)	-24.5
Savings and Money Market Deposits	323,984	284,592	39,393	13.8
Time Deposits - Retail	252,307	382,639	(130,332)	-34.1
Time Deposits - Wholesale	223,485	211,343	12,142	5.7
Total Interest Expense on Deposits	907,695	1,021,528	(113,833)	-11.1
FHLB Advances	491,365	584,214	(92,849)	-15.9
Interest on other borrowings	4,177	4,890	(713)	-14.6
Total Interest Expense	1,403,237	1,610,632	(207,396)	-12.9
Net Interest Income	8,661,919	7,966,337	695,582	8.7
Provision for loan losses	771,000	2,379,000	(1,608,000)	-67.6
Net In. Inc. After Prov. for Loan Losses	7,890,919	5,587,337	2,303,582	41.2
Non Interest Income				
Service charges and fees	99,998	74,323	25,674	34.5
Securities gains (losses), net	139,609	120,594	19,015	15.8
Mortgage loan and related fees	20,342	14,702	5,640	38.4
Other noninterest income	113,625	118,966	(5,341)	-4.5
Total Non Interest Income	373,573	328,585	44,988	13.7
Non Interest Expense				
Salaries and employee benefits	3,002,514	3,211,940	(209,425)	-6.5
Occupancy	352,312	396,179	(43,866)	-11.1
Other noninterest expense	1,933,327	1,427,829	505,498	35.4
Total Non Interest Expense	5,288,154	5,035,947	252,207	5
Income Before Taxes	2,976,339	879,975	2,096,363	238.2
Income taxes	1,043,000	204,000	839,000	411.3
Net Income	\$ 1,933,339	\$ 675,975	\$ 1,257,363	186