CapStone Bank

October 16, 2012

Dear Shareholder:

We are pleased to report positive operating results for the quarter ended September 30, 2012. We ended the quarter with $235 million in total assets compared to $222 on September 30, 2011, an increase of $13 million or 5.8%. Loans outstanding as of September 30, 2012 were $166 million versus $144 million for the same period a year ago, an increase of $22 million or 15.5%. For the same comparative period, deposits increased to $176 million from $153 million, an increase of $23 million or 15.2%. For the first nine months of 2012, total assets increased by $18.4 million or 8.5%, loans increased by $19 million or 12.6% and deposits increased by $25 million or 16.4%.

Net income for the third quarter of 2012 was $598,147 compared to $159,302 for the same period in 2011, an increase of $438,845 or 275.5%. Net income for the first nine months of 2012 was $1.5 million compared to $1.1 million for the same nine month period in 2011, an increase of $433,517 or 39.4%. During the third quarter of 2011, a nonrecurring charge of $407,000 (net of taxes) was incurred. After adjusting for this charge, net income increased by $31,845 or 5.6% for the third quarter of 2012 and by $26,517 or 1.8% for the first nine months of 2012.

During the nine month period ended September 30, 2012, the provision for loan losses was $721,000 compared to $362,000 for the same period in 2011, an increase of $359,000 or 99.2%. The allowance for loan losses was $3.9 million or 2.35% of loans outstanding on September 30, 2012 compared to $3.4 million or 2.35% at the same time in 2011. Nonaccruing loans plus other real estate owned totaled $5 million or 2.13% of total assets on September 30, 2012 compared to $1.1 million or 0.5% at the same time in 2011.

On September 21, 2012, we announced the signing of a definitive agreement to acquire Patriot State Bank, headquartered in Fuquay-Varina, NC. The bank opened in 2006 and currently operates three full-service banking offices. As a combined company, we will have approximately $377 million in assets and $297 million in deposits. With the pending acquisition and the opening of our Cary Office in the fourth quarter of 2012, our number of full-service offices will increase to five. Two of our strategic objectives will be supported with this acquisition including the diversification of our customer base and the expansion of our branch network. Pending regulatory and shareholder approval, it is anticipated the merger will be completed by year end.

Sincerely,

Michael S. Patterson
Chairman, President and CEO

CAPSTONE BANK

Balance Sheet

(Unaudited)

	Sep 2012	Sep 2011	$ Change	% Change
Assets				
Cash and due from banks	$ 3,444,177	$ 5,912,316	$ (2,468,139)	-41.7
Fed funds sold & repos	188,037	5,009,437	(4,821,400)	-96.2
Interest bearing deposits with banks	17,556,220	17,957,218	(400,998)	-2.2
Investment Securities - Taxable	30,828,103	33,537,033	(2,708,930)	-8.1
Investment Securities - Tax-exempt	13,396,821	13,116,261	280,560	2.1
Loans, net of unearned income	165,835,535	143,546,502	22,289,033	15.5
Less: Allowance for loan losses	(3,898,053)	(3,378,718)	(519,335)	-15.4
Premises and equipment, net	200,167	221,016	(20,849)	-9.4
Accrued interest receivable	692,192	732,701	(40,509)	-5.5
Other assets	6,696,343	5,458,533	1,237,811	22.7
Total Assets	**$ 234,939,542**	**$ 222,112,299**	**$ 12,827,243**	**5.8**
Liabilities				
Non-Interest Bearing Deposits	$ 24,060,107	$ 19,957,898	$ 4,102,209	20.6
Interest bearing demand deposits	28,645,392	32,017,743	(3,372,352)	-10.5
Savings and Money Market Deposits	66,726,877	40,836,233	25,890,644	63.4
Time Deposits - Retail	25,177,400	29,530,157	(4,352,757)	-14.7
Time Deposits - Wholesale	31,731,104	30,687,248	1,043,856	3.4
Total Deposits	176,340,879	153,029,279	23,311,601	15.2
Accrued expenses and other liabilities	2,175,384	1,945,934	229,450	11.8
FHLB Advances	26,500,000	35,000,000	(8,500,000)	-24.3
Other Borrowings	109,876	3,548,797	(3,438,920)	-96.9
Total Liabilities	**205,126,139**	**193,524,009**	**11,602,130**	**6**
Equity				
Common stock	12,974,365	12,974,365	-	0
Capital surplus	11,637,823	11,607,421	30,402	0.3
Retained earnings	2,210,358	1,534,382	675,975	44.1
Accumulated other comprehensive income (loss)	1,457,851	1,372,632	85,219	6.2
Net Income	1,533,006	1,099,489	433,517	39.4
Total Equity	**29,813,403**	**28,588,290**	**1,225,113**	**4.3**
Total Liabilities & Equity	**$ 234,939,542**	**$ 222,112,299**	**$ 12,827,243**	**5.8**

CapStone Bank

Income Statement

(Unaudited)

	YTD Sep 2012	YTD Sep 2011	$ Change	% Change
Interest Income				
Interest on Loans	$ 5,870,833	$ 5,701,198	$ 169,635	3
Fees on Loans	278,251	158,674	119,577	75.4
Interest on federal funds sold	3,362	5,971	(2,609)	-43.7
Interest on deposits with banks	258,711	322,279	(63,569)	-19.7
Investment Securities - Taxable	733,687	702,023	31,664	4.5
Investment Securities - Tax-exempt	360,737	299,367	61,370	20.5
Total Interest Income	7,505,581	7,189,512	316,069	4.4
Interest Expense				
Interest bearing demand deposits	84,136	111,199	(27,062)	-24.3
Savings and Money Market Deposits	254,055	212,691	41,364	19.4
Time Deposits - Retail	195,467	304,130	(108,663)	-35.7
Time Deposits - Wholesale	169,547	159,171	10,376	6.5
Total Interest Expense on Deposits	703,206	787,192	(83,986)	-10.7
FHLB Advances	389,291	444,220	(54,929)	-12.4
Interest on other borrowings	2,779	3,195	(417)	-13
Total Interest Expense	1,095,276	1,234,608	(139,332)	-11.3
Net Interest Income	**6,410,305**	**5,954,904**	**455,401**	**7.6**
Provision for loan losses	721,000	362,000	359,000	99.2
Net In. Inc. After Prov. for Loan Losses	**5,689,305**	**5,592,904**	**96,401**	**1.7**
Non Interest Income				
Service charges and fees	72,977	55,883	17,094	30.6
Securities gains (losses), net	131,792	2,603	129,188	4963
Mortgage loan and related fees	20,342	14,702	5,640	38.4
Other noninterest income	84,954	92,348	(7,394)	-8
Total Non Interest Income	310,064	165,536	144,528	87.3
Non Interest Expense				
Salaries and employee benefits	2,225,141	2,799,730	(574,589)	-20.5
Occupancy	258,918	306,642	(47,724)	-15.6
Other noninterest expense	1,231,304	1,011,579	219,725	21.7
Total Non Interest Expense	3,715,363	4,117,951	(402,588)	-9.8
Income Before Taxes	**2,284,006**	**1,640,489**	**643,517**	**39.2**
Income taxes	751,000	541,000	210,000	38.8
Net Income	**$ 1,533,006**	**$ 1,099,489**	**$ 433,517**	**39.4**