BLACKHAWK BANCORP INC
Form 10KSB
March 31, 2003

U. S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-KSB

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2002
OR
[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ________ to ________

Commission file number 0-18599

BLACKHAWK BANCORP, INC.
(Name of small business issuer in its charter)

WISCONSIN	39-1659424
(State of Incorporation)	(IRS Employer ID No.)

400 Broad Street, Beloit, Wisconsin 53511
(Address of principal executive offices)
Issuer's Telephone Number (608) 364-8911

Securities Registered Under Section 12(b) of the Exchange Act:
NONE

Securities Registered Under Section 12(g) of the Exchange Act:
COMMON STOCK, $ .01 PAR VALUE

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 .

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

State issuer's revenues for its most recent fiscal year. $22,194,763

As of March 14, 2003, 2,517,131 shares of common stock were outstanding and the aggregate market value (based on the bid price at March 14, 2003) of the shares held by non-affiliates (excludes shares reported or beneficially owned by directors and officers - does not constitute an admission to affiliate status) was approximately $17,126,000.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Blackhawk Bancorp, Inc.' s definitive proxy statement for its Annual Meeting of Stockholders, to be held on May 21, 2003, are incorporated by reference into Part III hereof.

Transitional Small Business Disclosure Format (check one): Yes [ ] No [X]

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BLACKHAWK BANCORP, INC.

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

GENERAL. Blackhawk Bancorp, Inc. (the "Company") was incorporated under the laws of the state of Wisconsin in November 1989. The Company owns and operates a subsidiary financial institution, Blackhawk State Bank ("Bank") headquartered in Beloit, Wisconsin and owns 100% of the common securities of Blackhawk Statutory Trust I, which was formed in December 2002 for the purpose of issuing Trust Preferred Securities.

The Bank is a Wisconsin-chartered commercial bank operating nine free-standing branches, three of which are in Beloit, Wisconsin and six are located in the following cities in Illinois: Belvidere (2), Oregon (1), Rochelle (1), Rockford (1) and Roscoe (1). The Bank has three wholly-owned subsidiaries: Nevahawk

Investment, Inc. ("Nevahawk"), an investment subsidiary located in Las Vegas, Nevada; RSL, Inc. ("RSL"), which in turn owns Midland Acceptance Corporation ("MAC"), both of which are substantially inactive; and First Financial Services, Inc. ("FFSI"), whose primary activity is ownership of one of the bank's facilities.

Through its nine locations the Bank provides various consumer banking, business banking and related financial services. Consumer banking services to individuals include demand, savings and time deposits. Consumer lending services include installment loans, mortgage loans, overdraft protection, personal lines of credit and credit cards. The bank also provides trust and investment services through a separate department of the bank and also through a third party marketing agreement with a full service brokerage company.

Business banking services, which are provided to small business, commercial and governmental organizations include commercial and commercial real estate lending, deposits, cash management and letters of credit.

The bank's primary source of revenue is net interest income and fees earned on its loans, and investments. Other non-interest income consists of fees from the sale and servicing of mortgage loans, service charges on deposits, trust services fees and income from retail non-deposit investment sales.

RECENT DEVELOPMENTS. On March 17, 2003 Blackhawk Bancorp, Inc. announced the signing of a definitive agreement to acquire DunC Corp. and its subsidiary, First Bank, bc, for $7.2 million, or $1,518 per share in a cash transaction. The agreement provides for limited adjustments in price based on the performance of DunC Corp. The acquisition is expected to be complete in the third quarter of 2003 and is subject to shareholder and regulatory approval. First Bank, bc, with assets of approximately $75 million and over 40 employees, is headquartered in Capron, Illinois. It has four full service locations in Illinois including Capron, Belvidere, Rockford and Machesney Park. First Bank, bc offers a full range of retail, commercial and real estate banking services. After completion of this merger, Blackhawk will rank second in deposit balances in the fast growing Boone County of Illinois. It also picks up a full-service facility in the rapidly developing Rte. 173 and Forest Hills Rd. area of Machesney Park, IL. Proxy statements will be sent to DunC Corp. shareholders for approval of the proposed transaction. Shareholders of Blackhawk Bancorp, Inc. will not be required to vote on the transaction.

LENDING ACTIVITIES. A significant amount of the loans in the Bank's loan portfolio are secured by residential or commercial real estate. Substantially all of the real estate securing the mortgage loans is located within thirty minutes driving distance of the Bank's offices Commercial loans are either collateralized by assets other than real estate or are unsecured. Interest rates on commercial loans are generally tied to an index adjustable monthly and therefore are more rate-sensitive than mortgage loans. Consumer and installment loans are generally secured by automobiles, boats, or second liens on real estate. A substantial percentage of automobile and boat loans in the portfolio were purchased from area dealers. The Bank also offers credit cards and home equity lines of credit. The Analysis of Loan Portfolio, located in Table 2 of Item 7, shows the changes in the types of loans from 2000 through 2002.

INVESTMENT ACTIVITIES. The Bank and its subsidiary, Nevahawk, maintain investment portfolios, which are managed to provide liquidity for lending or deposit withdrawals, control interest rate risk and enhance the earnings of the company. The investments held by the Bank and Nevahawk consist primarily of U.S. government and agency securities, mutual funds, corporate bonds, mortgage-backed securities, collateralized mortgage obligations and municipal bonds or repurchase agreements backed by similar securities.

DEPOSIT ACTIVITIES. Deposits are divided between interest bearing and non-

interest bearing. Non-interest bearing deposits consist of checking accounts of individuals, businesses and governmental organizations. The interest-bearing deposits include savings accounts, money market deposit accounts, certificates of deposit, individual retirement accounts and NOW accounts. The aggregate balance of time deposits with balances in excess of $0.1 million was $28.9 million at December 31, 2002. The Bank attracts deposits by offering competitive rates and fees and providing high quality customer service.

WEALTH MANAGEMENT SERVICES The Bank provides wealth management services, including acting as trustee for living and testamentary trusts, and as an agent, custodian, guardian, conservator, personal representative or administrator for individuals or their estates. The Bank also provides full-service brokerage services through a relationship with a third-party provider, Raymond James Securities, Inc.

COMPETITION. Active competition exists for all services offered by the Company with other state banks, national banks, credit unions, savings and loans, finance companies, personal loan companies, brokerage and mutual fund companies, mortgage bankers, insurance agencies, and other financial institutions in the Company's markets. The principal competitive factors in the banking and financial services industry are quality of services to customers, ease of access to services, and pricing of services, including interest rates paid on deposits, interest rates charged on loans, and fees charged for fiduciary and other services. To compete in this environment, the Company offers competitive rates and fees, convenient hours and locations, and high quality services, including internet banking and a unique courier service.

EMPLOYMENT. As of December 31, 2002, the Company and the Bank had 154 employees, of which 125 were employed on a full-time basis. The Company provides a variety of benefit plans to its employees, including health insurance, long-term disability insurance, group term life insurance, flexible spending accounts, profit sharing, 401k, and stock options. Management considers its relations with employees to be good.

REGULATORY FILINGS WITH SECURITIES AND EXCHANGE COMMISSION. Copies of our Annual Reports on Form 10-KSB, Quarterly reports on Form 10-QSB, Current Reports on Form 8-K, and amendments to those reports are available free of charge at the SEC's website at http://www.sec.gov and/or from the company.

SUPERVISION AND REGULATION. The Company and the Bank are extensively regulated under federal and state law. Any descriptions of statutory and regulatory provisions contained in the following discussion are qualified in their entirety by reference to the particular statutory and regulatory provisions. Any change in applicable law or regulations may have a material effect on the Company.

THE COMPANY.

On March 27, 1990, the Company received approval from the Federal Reserve Board (the "FRB") under the Bank Holding Company Act of 1956, as amended (the "BHC Act"), to become a registered bank holding company by acquiring all of the capital stock of the Bank. As a result, since consummation of the bank holding company reorganization on May 16, 1990, the Company's activities have been subject to limitations imposed under the BHC Act. Transactions between the Company and the Bank and their affiliates are also subject to certain restrictions. As a registered bank holding company, the Company is subject to various filing requirements of the FRB and is also subject to examination by the FRB.

FRB approval must be obtained before a bank holding company acquires all or substantially all of the assets of a bank or savings association or merges or consolidates with another bank holding company or savings and loan holding company. Wisconsin has also adopted legislation that allows bank holding

companies from other states to acquire banks in Wisconsin, and allows Wisconsin bank holding companies to acquire banks in other states.

GRAMM-LEACH-BLILEY ACT. The laws and regulations to which the Company is subject are constantly under review by Congress, regulatory agencies and state legislatures. On November 12, 1999, then President Clinton signed important legislation passed by Congress to overturn Depression-era restrictions on affiliations by banking organizations. This comprehensive legislation, referred to as the Gramm-Leach-Bliley Act (the "Act"), eliminates certain barriers to and restrictions on affiliations between banks and securities firms, insurance companies and other financial service organizations. The Act provides for a new type of "financial holding company" structure, under which affiliations among these entities may occur, subject to the regulation of the Federal Reserve Board and regulation of affiliates by the functional regulators, including the Securities and Exchange Commission and state insurance regulators. In addition, the Act permits certain non-banking financial and financially related activities to be conducted by operating subsidiaries of a national bank. Under the Act, a bank holding company may become certified as a financial holding company by filing a notice with the Federal Reserve Board, together with a certification that the bank holding company meets certain criteria, including capital, management and Community Reinvestment Act requirements. The Act contains a number of provisions allocating regulatory authority among the Federal Reserve Board, other banking regulators, the Securities and Exchange Commission and state insurance regulators. In addition, the Act imposes strict new limits on the transfer and use by financial institutions of nonpublic, personal information about their customers.

Other important provisions of the Act permit merchant banking activities, venture capital activities, and insurance underwriting, to be conducted by a subsidiary of a financial holding company. It also allows municipal securities underwriting activities to be conducted directly by a national bank or by its subsidiary. Under the Act, a financial holding company may engage in a broad list of "financial activities," and any non-financial activity that the Federal Reserve Board determines is "complementary" to a financial activity and poses no substantial risk to the safety and soundness of the depository institution or the financial system. The Company has not elected to become a financial holding company.

On June 1, 2000, the federal bank regulatory agencies issued final regulations implementing the Act's consumer privacy protections. Among other things, the new privacy regulations give customers the right to "opt out" of having their nonpublic, personal information shared by a financial institution with nonaffiliated third parties, bars financial institutions from disclosing customer account numbers or other such access codes to nonaffiliated third parties for direct marketing purposes and requires annual disclosure by financial institutions of their policies and procedures for protecting customers' nonpublic, personal information. Full compliance with the new privacy regulations was mandatory as of July 1, 2001.

USA PATRIOT ACT OF 2001. On October 26, 2001, President Bush signed into law the USA Patriot Act of 2001. The requirements of the Act were scheduled to go into effect on October 26, 2002, pending issuance of final rules. This comprehensive legislation provides that U.S. depository institutions are prohibited from providing correspondent banking services to foreign shell banks. It also requires that upon request of the appropriate federal banking agency the Bank must produce records relating to its anti-money laundering compliance or its customers within 120 hours of the request. The Act allows the Bank to share information relating to money laundering or suspected terrorists with the Financial Crimes Enforcement Network (FinCEN) and other financial institutions. In addition, the Act requires the institution to establish anti-money laundering programs and perform due diligence on private banking and correspondent accounts. The Act allows the Treasury to issue regulations on the maintenance

of "concentration accounts" and to prohibit an institution's customers from anonymously directing funds into or through such accounts. The Federal Reserve Board and other regulators are required to consider the effectiveness of a bank holding company or its financial institution in combating money laundering when ruling on applications.

Section 326 of the USA Patriot Act of 2001 requires the Bank to develop an extensive Customer Identification Program and obtain certain information prior to opening or adding a signatory to an account. The Bank must adopt risk-based procedures for verifying the elements of customer information and must develop procedures for determining whether the customer appears on any list of known or suspected terrorists or terrorist organizations provided to the institution by any federal government agency. The Bank must provide the customer prior notice of the requirements of the Act, and must retain all records used to verify the customer's identity for a period of five years after the account is closed.

SARBANES-OXLEY ACT OF 2002. On July 30, President Bush signed the Sarbanes-Oxley Act of 2002 (the "Act"). This legislation impacts corporate governance of public companies, affecting their officers and directors, their audit committees, their relationships with their accountants and the audit function itself. Certain provisions of the Act became effective on July 30, 2002. Other provisions will become effective as the SEC adopts appropriate rules.

The Act implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from corporate wrongdoing. The Act includes the creation of an independent accounting oversight board to oversee the audit of public companies and their auditors, provisions restricting non-audit services performed by independent accountants for public companies and additional corporate governance and responsibility provisions.

The Act requires audit committees to have in place procedures to receive and address complaints regarding accounting, internal control and auditing issues and provides protection for corporate whistleblowers. The Company has adopted a policy providing employees with the opportunity to confidentially report their concerns directly to members of the Bank's Audit Committee or the Bank's Internal Auditor and has communicated its policy to all employees.

CAPITAL ADEQUACY. The FRB has adopted capital guidelines as to both minimum levels of core capital and risk-based capital. The minimum core capital requirement ranges from 3% to 5% of total assets depending upon the regulator's determination of the holding company's strength. The guidelines assign risk weightings to assets and off-balance sheet items, and have minimum risk-based capital ratios. All bank holding companies are required to have total consolidated capital of 8% of risk-weighted assets. Core capital consists principally of shareholders' equity less intangibles, while qualifying total capital consists of core capital plus certain debt instruments and a portion of the allowance for loan losses. Table 12 of Item 7 of this report, reflects various regulatory measures of capital as of December 31, 2002. The Company's core and risk-based capital ratios, as shown in the table are well above the minimum levels.

Under Wisconsin law, a bank holding company is deemed to be engaged in the banking business and is subject to supervision and examination by the Wisconsin Department of Financial Institutions (the "WDFI"). The WDFI is also empowered to issue orders to a bank holding company to remedy any condition or policy, which, in the opinion of the WDFI, endangers the safety of deposits of any subsidiary state bank or trust company. In the event of non-compliance with such an order, the WDFI has the power to direct the operations of the state bank or trust company and to restrict dividends paid to the bank holding company.

THE BANK.

Wisconsin-chartered banks, including the Bank, are regulated and supervised by the WDFI. Each Wisconsin chartered bank is periodically examined by the WDFI or its primary federal regulator. The approval of the WDFI is required to establish or close branches, merge with other banks and undertake many other activities.

Any Wisconsin bank that does not operate in accordance with the regulations, policies and directives of the WDFI may be subject to sanctions for noncompliance. The WDFI may, under certain circumstances, suspend or remove directors, officers or employees who have violated the law, conducted the Bank's business in a manner which is unsafe, unsound or contrary to the depositors' interests or been negligent in the performance of their duties.

Wisconsin state banks are authorized to accept deposits (including demand, savings and time deposits and certificates of deposit). Banks may make a wide variety of loans (including mortgage loans, loans to corporations and other commercial loans and other personal consumer loans). Other federal and state regulations with respect to banks include required reserves, limitations as to the nature and amount, by type and borrower, of lending, regulatory approval of mergers and consolidations, issuance and retirement by a bank of its own securities, and other aspects of banking operations.

PAYMENT OF DIVIDENDS. A Wisconsin bank may only pay dividends on its capital stock if such payment would not impair the bank's capital stock and surplus account (as defined under Wisconsin law). Federal and state regulations limit dividends paid by the Bank to the Company to net income of the Bank. The Bank paid dividends to the Company of $1.5 million, $1.5 million and $1.3 million for the years ended December 31, 2002, 2001 and 2000, respectively. During 2001 the Bank received a waiver from state banking regulators to pay dividends to the Company in excess of current net income.

FEDERAL DEPOSIT INSURANCE CORPORATION. The Bank's deposit accounts are insured by the FDIC. FDIC insurance, at the present time, generally insures up to a maximum of $0.1 million for each insured depositor. The FDIC imposes an annual assessment on deposits. Effective January 1, 1993, premiums are assessed on the basis of a risk rating assigned by the FDIC. Since that time the Bank's premium has been at the lowest available rate. Beginning in 1997, financial institutions insured by the FDIC were required to contribute to the Financing Corporation bond refinancing. This is expected to occur through the year 2003. Beginning January 1, 2000, the Bank's Bank Insurance Fund ("BIF") and Saving Association Insurance Fund ("SAIF") deposits were assessed at the same rate.

The FDIC issues regulations, conducts periodic examinations, requires the filing of reports and generally supervises the operations of its insured banks. The approval of the FDIC is required prior to any merger or consolidation, or the establishment or relocation of any branch office. This supervision and regulation is intended primarily for the protection of depositors.

As a FDIC-insured bank, the Bank is subject to certain FDIC requirements designed to maintain the safety and soundness of individual banks and the banking system. The FDIC, based upon appraisals during examinations, may revalue assets of an insured institution and require establishment of specific reserves in amounts equal to the difference between such revaluation and the book value of the assets. In addition, the FDIC has adopted regulations regarding capital adequacy requirements similar to those of the FRB.

OTHER ASPECTS OF FEDERAL AND STATE LAW. The Bank is also subject to federal and state statutory and regulatory provisions covering, among other things, security procedures, currency reporting, insider and affiliated party transactions, management interlocks, community reinvestment, truth-in-lending, electronic funds transfers, truth-in-savings, privacy, and equal credit opportunity.

Proposals for new legislation or rule making affecting the financial services industry are continuously being advanced and considered at both the national and state levels. Proposals are primarily focused upon restructuring and strengthening regulation and supervision to reduce the risks to which assets of banks and savings institutions are exposed.

Although further changes in the regulatory framework may be enacted, specific provisions and their ultimate effect upon the business of the Bank and the Company cannot be reliably anticipated.

GOVERNMENTAL MONETARY POLICIES AND ECONOMIC CONDITIONS. The earnings of the Bank and the Company are affected not only by general economic conditions but also by the policies of various governmental regulatory authorities. In particular, the FRB influences general economic conditions and interest rates through the regulation of money and credit conditions. It does so primarily through open-market operations in U.S. Government Securities, varying the discount rate on member and nonmember bank borrowings, and setting reserve requirements against bank deposits. FRB monetary policies have had a significant effect on the operating results of banks in the past and are likely to continue to have such an effect in the future. The general effect, if any, of such policies upon the future business and earnings of the Bank cannot be accurately predicted. In addition, losses sustained by the federal insurance funds and regulatory costs incurred in connection with failed or failing insured depository institutions continue to be assessed to those within the industry. As such, future earnings will be adversely affected by regulations enacted to cover these losses and costs.

EXECUTIVE OFFICERS

NAME AND AGE	PRINCIPAL OCCUPATION
R. Richard Bastian, III, 56	President and Chief Executive Officer of the Company since February 2002 and of the Bank since May 2001. Previously, President of the Bank of Kenosha from January 1999 to January 2001 and Executive Vice President and Director of the Clean Air Action Corporation from August 1994 to January 2001.
Todd J. James, 39	Executive Vice President and Chief Financial Officer of the Company and the Bank since February 2003. Senior Vice President and Chief Financial Officer from February 2002 to February 2003. Previously Senior Vice President, Amcore Investment Group N.A. from October 1999 to February 2002 and Vice President Amcore Financial, Inc. from October 1998 to October 1999. Previously, Vice President, Amcore Bank N.A.
Judith A. Gard, 62	Senior Vice President, Manager Consumer Banking for the Bank since October 2001. Previously, Vice President, Private Banking Manager for Firstar Bank from February 1999 to October 2001 and Senior Vice President, Home Equity Unit Manager for Bank One from 1996 to 1998.
Todd L. Larson, 43	Senior Vice President, Business Banking for the Bank since January 2003. Previously Vice President, Business Banking for the Bank from

	November 1999 to January 2003, and Vice President of Stillman BancCorp, N.A. from November 1998 to November 1999. Previously Vice President, Commercial Lending, Belvidere Bank.
Terri Burdick, 39	Senior Vice President, Human Resources of the Bank since February 2003. Vice President, Human Resources of the Bank from October 2001 to February 2003. Employee Benefits Manager for The Swiss Colony, Inc. from September 1999 to October 2001. Previously, Corporate Benefits Manager for Regal Beloit Corporation.
James A. Sylvester, 56	Vice President, Senior Mortgage Lender of the Bank since August 2001. Previously Business Development Director for RSM McGladrey, Inc. from January through June 2001 and owner/operator of Jimmy's Frozen Custard from 1996 through 2000.
Peggy Holt, 45	Vice President, Quality Control & Process Improvement of the Bank since January 2003. Previously Organizational Effectiveness Consultant of the Bank from January 2002 until December 2002. Prior thereto, Senior Consultant, Leadership Development and Senior Vice President, Organizational Development Bank One Corporation.
Victoria A. Damron, 53	Vice President of Marketing for the Bank since August 2002. Previously owner Damron Communications.

ITEM 2. DESCRIPTION OF PROPERTY

On December 31, 2002, the Company had nine locations, of which one was leased. All of these offices are considered by management to be well maintained and adequate for the purpose intended. See the Note 5 to the Consolidated Financial Statements and Table 14 included under Item 7 of this document for further information on properties.

ITEM 3. LEGAL PROCEEDINGS

Management believes that no litigation is threatened or pending in which the Company faces potential loss or exposure which will materially affect the Company's financial position or results of operation, other than noted below. Since the Company's banking subsidiary acts as a depository of funds, trustee or escrow agent, it is named as defendant in lawsuits involving claims to the ownership of funds in particular accounts. This and other litigation is incidental to the Company's business.

On August 18, 2000 the Bank filed a lawsuit in Waukesha County, Wisconsin, against Fiserv, Inc., a former data processing services provider, for breach of contract. The bank was seeking to recover damages sustained due to a processing error in which $0.5 million was improperly charged to the Bank's check clearing account at the Federal Home Loan Bank of Chicago. On February 14, 2003 a jury delivered a verdict that Fiserv, Inc. did not breach its contract with the bank. Fiserv, Inc. has filed a counterclaim seeking a $0.4 million reimbursement of legal fees. The court has not made a final ruling on the case or any counter claims that have been or may be filed by Fiserv,

Inc. Although the ultimate disposition of any counterclaims can not be predicted with any certainty, the Company believes that the case will not have a material adverse effect on the Company's consolidated financial position, though it could have a material adverse effect on the Company's consolidated results of operations in a given year.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of 2002.

PART II

ITEM 5. MARKET FOR COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

At December 31, 2002 the company has approximately 900 holders of record of its common stock. The Company's stock is publicly traded on the Over the Counter Market under the symbol BKHB. The following table sets forth the stock price and dividend information for each quarter during the years ended December 31, 2002 and 2001. Stock price information represents high and low bid quotations and as such reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

	For the Quarter Ended							
	12/31/02	09/30/02	06/30/02	03/31/02	12/31/01	09/30/01	06/30/01	03/31/01
Stock Price								
High	$ 9.50	$ 9.50	$ 9.70	$ 9.65	$ 9.50	$ 10.62	$ 10.30	$ 10.38
Low	8.25	8.55	9.35	9.10	8.50	8.80	8.38	8.00
Dividends	0.09	0.09	0.09	0.09	0.09	0.09	0.12	0.12

For disclosures required under the company's equity compensation plans see Notes 1 and 10 to the Company's Consolidated Financial Statements attached as Exhibit 99 of this Form 10-KSB.

A Wisconsin bank may only pay dividends on its capital stock if such payment would not impair the bank's capital stock and surplus account (as defined under Wisconsin law). Federal and state regulations limit dividends paid by the Bank to the Company to net income of the Bank. Thus, the ability of the Company to pay dividends will be impacted by the profitability of the Bank. The Bank paid dividends to the Company of $1.5 million, $1.5 million and $1.3 million for the years ended December 31, 2002, 2001 and 2000, respectively. During 2001 the Bank received a waiver from state banking regulators to pay dividends to the Company in excess of current net income.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OF OPERATION

The purpose of Management's discussion and analysis is to provide relevant information regarding the Registrant's financial condition and its results of operations. This discussion focuses on the significant factors which affected the Company's earnings in 2002, with comparisons to 2001 and 2000, where applicable.

FACTORS INFLUENCING FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 with respect to the

financial condition, results of operations, plans, objectives, future performance and business of Blackhawk Bancorp, Inc. Statements that are not historical facts, including statements about beliefs and expectations, are forward-looking statements. These statements are based upon beliefs and assumptions of Blackhawk's management and on information currently available to such management. The use of the words "believe", "expect", "anticipate", "plan", "estimate", "may", "will" or similar expressions are forward-looking statements. Forward-looking statements speak only as of the date they are made, and Blackhawk undertakes no obligation to update publicly any of them in light of new information or future events.

Contemplated, projected, forecasted or estimated results in such forward-looking statements involve certain inherent risks and uncertainties. A number of factors - many of which are beyond the ability of the company to control or predict - could cause actual results to differ materially from those described in the forward-looking statements. Factors which could cause such a variance to occur include, but are not limited to: heightened competition; adverse state and federal regulation; failure to obtain new or retain existing customers; ability to attract and retain key executives and personnel; changes in interest rates; unanticipated changes in industry trends; unanticipated changes in credit quality and risk factors, including general economic conditions; success in gaining regulatory approvals when required; changes in the Federal Reserve Board monetary policies; unexpected outcomes of new and existing litigation in which Blackhawk or its subsidiaries, officers, directors or employees is named defendants; technological changes; changes in accounting principles generally accepted in the United States; changes in assumptions or conditions affecting the application of critical accounting policies; and the inability of third party vendors to perform critical services for the company or its customers.

CRITICAL ACCOUNTING POLICIES

The financial condition and results of operations for Blackhawk Bancorp, Inc. presented in the Consolidated Financial Statements, accompanying notes to the Consolidated Financial Statements, selected financial data appearing elsewhere within this report, and management's discussion and analysis are, to a large extent, dependent upon the Company's accounting policies. The selection and application of these accounting policies involve judgements, estimates and uncertainties that are susceptible to change.

Presented below are discussions of those accounting policies that management believes are the most important (Critical Accounting Policies) to the portrayal and understanding of the Company's financial condition and results of operations. These Critical Accounting Policies require management's most difficult, subjective and complex judgements about matters that are inherently uncertain. In the event that different assumptions or conditions were to prevail, and depending upon the severity of such changes, the possibility of materially different financial condition or results of operations is a reasonable likelihood. See also Note 1 of the Notes to Consolidated Financial Statements.

LOANS

Loans are the Company's largest income earning asset category. Loans are recorded at the amount advanced to the borrower plus certain costs incurred by the Bank to originate the loan, less certain origination fees that are collected from the borrower. The carrying amount of loans is reduced as principal payments are made. Payments made by the borrower are allocated between interest income and principal payment based upon the outstanding principal amount, the contractual rate of interest and other contractual terms. The carrying amount is further adjusted to reflect amortization of

the origination costs net of origination fees. These items are amortized over the expected life of the loan.

The accrual of interest income is generally discontinued (Non-Accrual Status) when management believes that collection of principal and/or interest is doubtful or when payment becomes 90 days past due. Payments received from the borrower after a loan is placed on Non-Accrual Status are applied to reduce the principal balance of the loan until such time that collectibility of remaining principal and interest is no longer doubtful. Unpaid interest that has previously been recorded as income is reversed against interest income when a loan is placed on Non-Accrual Status. The outstanding loan balance is written-off against the allowance for loan losses when management determines that probability of collection of principal will not occur. See also the discussion of Allowance for Loan Losses that follows.

Those judgements and assumptions that are most critical to the application of this accounting policy are the initial and on-going credit-worthiness of the borrower, the amount and timing of future cash flows of the borrower that are available for repayment of the loan, the sufficiency of underlying collateral and the enforceability of third-party guarantees. These judgements and assumptions are dependent upon or can be influenced by a variety of factors including the breadth and depth of experience of lending officers, credit administration and loan review staff that periodically review the status of the loan, changing economic and industry conditions, changes in the financial condition of the borrower and changes in the value and availability of the underlying collateral and guarantees.

If different assumptions or conditions were to prevail, the amount and timing of interest income and loan losses, due to the inability to collect all of the remaining principal balance that is due from a borrower, could be materially different. These factors are most pronounced during economic downturns. See also Table 2 and Note 4 of the Notes to Consolidated Financial Statements.

ALLOWANCE FOR LOAN LOSSES

Management periodically reviews the loan portfolio in order to establish an estimated allowance for loan losses (Allowance) that are probable as of the respective reporting date. Additions to the Allowance are charged against earnings for the period as a provision for loan losses (Provision). Actual loan losses are charged against (reduce) the Allowance when management believes that the collection of principal will not occur. Unpaid interest for loans that are placed on Non-Accrual Status is reversed against the interest income previously recognized. Subsequent recoveries of amounts previously charged to the Allowance, if any, are credited to (increase) the Allowance.

The Allowance is regularly reviewed by management to determine whether or not the amount is considered adequate to absorb probable losses. If not, an additional Provision is made to increase the Allowance. This evaluation includes specific loss estimates on certain individually reviewed loans, statistical loss estimates for loan groups or pools that are based on historical loss experience and general loss estimates that are based upon the size, quality, and concentration characteristics of the various loan portfolios, adverse situations that may affect a borrower's ability to repay, and current economic and industry conditions.

In addition to the judgements and assumptions noted in the preceding discussion of Loans, those most critical to the application of this accounting policy are the frequency and subjectivity of loan reviews and risk gradings, emerging or changing trends that might not be fully captured

in the historical loss experience, and charges against the Allowance for actual losses that are greater than previously estimated. While the Company strives to reflect all known risk factors in its evaluation of the adequacy of the Allowance, estimation or judgement errors may occur.

If different assumptions or conditions were to prevail, the Allowance may not be adequate to absorb the new estimate of probable losses. If so, an additional Provision may be necessary and the amount could be material. See also Table 2 and Note 4 of the Notes to Consolidated Financial Statements.

RESULTS OF OPERATIONS

OVERVIEW

The Company reported net income of $1.2 million for the year ended December 31, 2002. This compares to $0.9 million for the year ended 2001 and a net loss of $0.3 million in 2000. This represents an increase of $0.4 million or 43.06% when comparing 2002 to 2001, and an increase of $1.1 million when comparing 2001 to 2000.

Diluted earnings per share for 2002 were $0.50 compared to $0.36 in 2001 and ($0.12) in 2000. This represents an increase of $0.14 per share or 38.89% when comparing 2002 to 2001, and an increase of $0.48 per share when comparing 2001 to 2000. The percentage increase in diluted earnings per share is less than the percentage increase in net income due to a 4.86% increase in the weighted average common shares outstanding, resulting from the issuance of shares for stock options exercised.

The company's return on average equity for 2002 was 4.92% versus 3.65% in 2001 and (1.19%) in 2000. The company's return on average assets for 2002 was 0.38% compared to 0.27% in 2001 and (0.09%) in 2000.

Both the Company and the Bank continue to exceed the minimum capital requirements established by regulators for banks and bank holding companies. In addition, the Bank continues to be "well capitalized" as defined by regulatory guidelines. See Note 15 to the Consolidated Financial Statements attached as Exhibit 99 of this form 10-KSB.

The 2002 results include the write-off of a $0.3 million receivable related to a claim against a former data processing provider. On August 18, 2000 the bank filed a breach of contract lawsuit to recover $0.5 million that was charged to its check clearing account in error. In the fourth quarter of 2000, $0.3 million of the original claim was written off and the remaining amount was written off in the fourth quarter of 2002. On February 14, 2003 a Waukesha County, Wisconsin jury delivered a verdict that the data processor did not breach its contract with the bank. The after tax charge to income in the fourth quarter of 2002 was $0.2 million.

During the third quarter of 2002 the bank closed its Wal Mart in-store branch. The 2002 results include an after tax charge of $40.0 thousand due to the abandonment of leasehold improvements.

In 2002 the bank changed its vacation policy to eliminate the vesting of vacation on December 31 for the following year. Instead, vacation will be earned and used in the same calendar year. This change resulted in a $0.1 million decrease in salary and benefits expense.

Pursuant to SFAS No. 142, an accounting standard effective January 1, 2002, amortization of goodwill, which resulted from purchase accounting adjustments from previous acquisitions, was discontinued. Goodwill amortization for 2001 and 2000 was $0.2 million or $0.08 per share. No transition or impairment charge was required for 2002.

NET INTEREST INCOME

Net interest income, which is the sum of interest and certain fees generated by earning assets minus interest paid on deposits and other funding sources, is the primary source of the company's earnings. All discussions of interest income amounts and rates are on a tax-equivalent basis, which accounts for income earned on loans and securities that are not fully subject to income taxes as if they were fully subject to income taxes. As shown in Item 7, Table 1 of this report, net interest income increased by $0.4 million, or 3.96%, to $11.2 million for the year ended December 31, 2002, compared to $10.8 million for the comparable period in 2001. The net interest margin, which is the tax equivalent net interest income divided by average interest earning assets was 3.77% in 2002, 3.66% in 2001 and 3.48% in 2000. The increase in Net Interest Margin between 2002 and 2001 is primarily due to the impact of lower market rates paid on deposit accounts not being fully offset as earning assets re-priced more slowly in 2002. If this trend continues into 2003 the Bank may see a lower Net Interest Margin as assets re-price with less incremental benefit from lower interest costs on deposit accounts. Net interest income and the net interest margin are expected to continue to be pressured from the shifts in the asset mix from loans to investment securities. The increase in Net Interest Margin between 2001 and 2000 is primarily due to Bank growth, a mix shift in deposit accounts to more transaction accounts and the effects of the lower interest rate environment on time deposits.

For the year ended December 31, 2002, total tax equivalent interest income decreased by $3.2 million or 13.96%, to $19.6 million compared to $22.8 million for the year ended December 31, 2001. The decrease in interest income is due to a 115 basis point decrease in the yield on average earning assets to 6.58% for 2002, compared to 7.73% for the same period in 2001. The decrease in the yield on average earning assets for 2002 compared to 2001 is partially offset by a $2.8 million increase in average earning assets. For the year ended December 31, 2001, total tax equivalent interest income increased by $0.5 million, or 2.34%, to $22.8 million compared to $22.3 million for the same period in 2000. The increase in interest income was due to bank growth offset by the impact of lower interest rates as the yield on earning assets decreased from 7.96% for 2000 to 7.73% in 2001.

The decrease in the yield on average earning assets reflects a shift in the asset mix from loans to investment securities and short-term investments for the year ended December 31, 2002 compared to the same period in 2001. The decrease in the yield on average earning assets also reflects the lower interest rate environment during 2002 compared to 2001, which resulted from the Federal Reserve Bank's lowering of managed rates by 375 basis points during 2001 and another 50 basis points in November of 2002. If managed rates continue to decrease or even remain at current levels, interest income and the average rate on earning assets are expected to continue to decline as more assets re-price.

Interest and fees on loans decreased 20.61% to $14.7 million for the year ended December 31, 2002 compared to $18.5 million for the same period of 2001. This decrease was the result of a $25.3 million or 11.38% decrease in average loans outstanding and an 87 basis point decrease in yield on the portfolio. The decrease in average loans outstanding for the year ended December 31, 2002 is largely attributable to the refinancing activity in the residential real estate market. The remaining decrease is the result of economic conditions and lower loan demand in the company's primary markets. The lower overall portfolio yield on average loans reflects the overall lower interest rate environment and competitive pricing pressure for quality credit customers and the Federal Reserve Bank's lowering of managed rates by 375 basis points during 2001 and another 50 basis points in

November of 2002. Interest and fees on loans increased 5.03% to $18.5 million for the year ended December 31, 2001 compared to $17.6 million in 2000. This increase was the result of an $18.2 million or 8.90% increase in average loans outstanding offset by a 31 basis point decrease in yield on the portfolio.

Interest income on taxable securities increased by $0.4 million or 13.76% in 2002 to $3.5 million compared to $3.1 million for 2001. Average balances of taxable investment securities increased 39.59% to $71.9 million for 2002 compared to $51.5 million for the same period in the prior year. However, the yield on average taxable investment securities decreased 110 basis points to 4.86% for 2002 compared to 5.96% for 2001. Interest income on tax exempt securities increased $0.1 million or 11.86% to $1.3 million compared to $1.2 million in 2001. This is the result of a $2.1 million increase in the average balance of tax exempt investment securities to $20.1 million for 2002 compared to $18.0 for 2001. The yield on tax exempt securities was 6.43% in 2002 and 6.42% in 2001.

Interest income on taxable securities decreased by $0.7 million or 17.48% in 2001 to $3.1 million compared to $3.7 million for the same period in 2000. Average balances of taxable investment securities decreased 11.79% to $51.5 million for 2001 compared to $58.4 million for the same period in the prior year. Also, the average yield decreased .42% to 5.96% for 2001 compared to 6.38% for 2000. Average tax exempt securities increased to $18.0 million in 2001 compared to $15.1 for the same period in 2000, while their average tax equivalent yield increased from 5.33% for 2000 to 6.42% for 2001.

Interest from fed funds sold and repurchase agreements increased to $0.1 million for the year ended December 31, 2002, compared to $49.0 thousand during the same period in 2001. The increase in interest on fed funds sold and repurchase agreements is due to increased average balances. Funds from the reduction in the loan portfolio were held in short-term investments before being used to purchase longer-term investment securities. The Company invested a portion of these funds in short-term reverse repurchase agreements backed by U.S. Government guaranteed securities.

Total interest expense decreased by $3.6 million, or 30.12%, to $8.4 million for 2002 compared to $12.0 million for the same period in 2001. For 2001 total interest expense decreased by $0.5 million, or 4.36%, to $12.0 million compared to $12.5 million for the same period in 2000. The decrease in total interest expense is the result of the aforementioned lower interest rate environment coupled with favorable shifts in the company's funding mix.

While interest paid on deposits decreased $2.9 million, or 32.51% to $5.9 million during 2002 compared to $8.8 million for the same period in 2001, average total interest bearing deposits increased $0.9 million over the year. Year to date interest paid on deposits in 2001 decreased $0.6 million, or 5.92% to $8.8 million compared to $9.3 million for the same period in 2000 while average total interest bearing deposits increased by $5.2 million. In addition to the impact of the overall lower interest rate environment the company's funding cost was reduced due to favorable shifts in the funding mix. For 2002 the average balance of time deposits decreased $6.0 million, or 4.65%, to $122.6 million compared to $128.6 million for the same period in 2001. The decrease in the average balance of time deposits was offset with increases in the average balances of checking accounts, interest-bearing checking accounts and savings accounts of $4.0 million, $4.3 million and $2.6 million, respectively.

Interest on short-term borrowings decreased $0.2 million to $0.3 million in 2002 compared to $0.5 million in 2001. This decrease is the result of the

lower managed interest rate environment in 2002 previously discussed which offset the 33.97% increase in average balances outstanding.

Interest on short-term borrowings decreased $1.5 million to $0.5 million in 2001 compared to $1.9 million for the same period in 2000. This decrease is the net result of the decreasing interest rate environment as mentioned earlier, and the refinancing of short-term FHLBC advances to long-term.

Interest expense on other borrowings decreased $0.6 million to $2.2 million compared to $2.8 million in 2001. The decrease is primarily the result of the maturity of $6.8 million of Federal Home Loan Bank term advances in January 2002.

PROVISIONS FOR LOAN LOSSES

The provision for loan losses (provision) is an amount added to the allowance for loan losses (allowance) to provide for the known and estimated amount of loans that will not be collected. Actual loan losses are charged against (reduce) the allowance when management believes that the collection of principal will not occur. Subsequent recoveries of amounts previously charged to the allowance, if any, are credited to (increase) the allowance. Management determines the appropriate provision based upon a number of criteria, including a detailed evaluation of certain credits, historical performance, economic conditions and overall quality of the loan portfolio.

The provision for loan losses of $1.0 million for 2002 represents a $0.2 million or 17.84% decrease compared to $1.2 million for 2001. In 2002, the provision includes $0.5 million to cover a loss on one commercial relationship that was also charged off against the allowance in 2002. The provision of $1.2 million in 2001 includes an increased amount based on management's assessment of the portfolio and economic conditions in the bank's primary markets, even though it represents a $1.0 million or 45.93% decrease compared to 2000. The decrease from 2000 is due to the 2000 provision including $1.9 million related to one commercial real estate loan. This loan was subsequently charged off in 2001. In 2002, Blackhawk had net charge-offs of $1.3 million (total charge-offs of $1.4 million less recoveries of $0.1 million). In 2001, the Bank had net charge-offs of $2.7 million (total charge-offs of $2.8 million less recoveries of $0.1 million), compared to 2000, when it had net charge-offs of $0.4 million (total charge-offs of $0.4 million less recoveries of $0.0 million). Net charge-offs to average loans were 0.67% in 2002, 1.22% in 2001 and 0.18% in 2000. The allowance for loan losses as a percent of loans was 1.10% at December 31, 2002 compared to 1.14% at December 31, 2001 and to 1.76% at December 31, 2000.

NONINTEREST INCOME

Noninterest income increased 6.37% to $3.0 million in 2002 from $2.8 million in 2001. The majority of this increase was from net security gains as they increased $0.2 million or 143.18% to $0.3 million for 2002 compared to $0.1 million in 2001. Service charges on deposit accounts increased $0.1 million or 4.77% to $1.6 million and primarily reflect higher volumes of demand deposits in 2002. The gain on sale of loans decreased $0.1 million and is the result of turn-over in the company's mortgage banking management and origination staff. Management believes that these changes in staff have resulted in better quality control and risk management in the company's mortgage banking activities. In 2002, $33.8 million of mortgages were sold to the secondary market at an average gain of 1.34% compared to an average gain of 1.75% on the $32.2 million of mortgage loans sold to the secondary market in 2001. Approximately 75% of the loan volume sold to the secondary market was from refinance activity. The level of market interest

rates and the volume of higher rate mortgage loans that are eligible for refinancing will impact the Bank's level of gains reported in future periods. Brokerage and annuity commissions increased $33.0 thousand or 26.83% to $0.2 million. On September 30, 2002 Blackhawk State Bank purchased $5.0 million in Bank Owned Life Insurance (BOLI) assets. The BOLI, which insures the lives of key employees, was purchased to help offset the cost of increasing employee benefits. Thus the cash value of life insurance increase is $0.1 million or 181.78% for the year ended December 31, 2002. These increases were offset by a $63.0 thousand loss from abandonment of leasehold improvements related to the closing of the Bank's Wal-Mart in-store branch in October 2002 and the $0.1 million write down of an OREO property based on a change in the estimate of its net realizable value.

Noninterest income for 2001 increased $0.4 million, or 18.49% to $2.8 million compared to $2.4 million in 2000. The increase included a net increase of $0.2 million, or 93.23% in revenues from the sale and servicing of mortgage loans and an increase of $0.1 million in gain on sale of securities. The increase in revenues from the sale and servicing of mortgage loans was driven by the high level of refinancing activity that occurred in 2001 compared to 2000 due to the lower interest rate environment in 2001. The interest rate environment and economic uncertainty had the opposite effect on brokerage and annuity commission income, which decreased 46.05% from $0.2 million in 2000 to $0.1 million in 2001. Deposit service charges increased $0.2 million, or 17.04% from $1.3 million in 2000 to $1.5 million in 2001. The increase in deposit service charges was achieved as a result of increased focus on gathering transaction accounts and a restructuring of account fees.

NONINTEREST EXPENSE

Noninterest expense increased 3.69% to $11.3 million in 2002 from $10.9 million in 2001, including a $0.3 million charge to write off the balance of a receivable related to the Bank's breach of contract claim against a former data processor. On February 14, 2003 a Waukesha County, Wisconsin jury delivered a verdict that the data processor did not breach its contract.

Total salary and benefits increased $0.2 million or 3.72% in 2002 compared to 2001. Salaries and employee benefits for 2002 were reduced by $0.1 million as a result of the Company's change in vacation policy. The Company changed its vacation policy to eliminate the vesting of vacation on December 31 for the following year. Instead vacation will be earned and used in the same year. Excluding the favorable impact from the change in vacation policy, salary and benefits increased 6.51%. This increase reflects the costs associated with attracting several key members of the management team that have joined the organization in the second half of 2001 and throughout 2002. These key managers include the chief executive officer R. Richard Bastian, III, chief financial officer Todd J. James and other officers listed in Part I Item 1 of this filing.

Equipment expense increased $0.1 million or 17.34% to $0.9 million in 2002 from $0.8 million in 2001. The increase is primarily due to higher depreciation expense on computer equipment and systems in 2002. Professional fees, while down $0.1 million or 11.16% compared to 2001 are still higher than normal, primarily due to the on-going lawsuit, against Fiserv, Inc. Amortization of intangibles decreased by $0.2 million as a result of FASB 142 which was adopted by the Company on January 1, 2002 and eliminated the amortization of goodwill resulting from prior acquisitions accounted for under the purchase method of accounting. Goodwill is subject to an annual impairment test. No impairment charge was required for the year. Other expense includes $0.1 million of charges to accrue severance

payments for former executives. In addition, the company realized a $0.1 million credit against other expenses due to an adjustment related to stale reconciling items.

Noninterest expense increased 5.98% to $10.9 million for the year ended December 31, 2001 from $10.3 million for the year ended December 31, 2000. Salary and benefits increased $0.3 million or 6.94% from $4.9 million for the year ended December 31, 2000 to $5.2 million for the year ended December 31, 2001. The Bank also incurred a significant level of legal fees related to its lawsuit against a former check processor to recover funds improperly charged to the Bank's correspondent bank account during 1998. Total professional fees increased $0.3 million or 73.30% to $0.6 million in 2001 from $0.4 million in 2000. Loan expenses increased 193.02% or $0.2 million from $0.1 million in 2000 to $0.3 million in 2001 and reflect the increased costs of working through a higher level of problem credits in 2001.

Management monitors two ratios related to other operating income and expense: (1) Net other operating expense as a percentage of average assets, and (2) Standard efficiency ratio. Net other operating expense to average assets increased slightly to 2.56% in 2002 from 2.52% in 2001 compared to 2.57% in 2000. The increase from 2001 to 2002 reflected management's commitment to invest resources to create long-term shareholder value, including the recruitment of a number of key managers and upgrading desktop computers and operating systems. The standard efficiency ratio (non-interest expense divided by net interest income plus other non-interest income) decreased to 81.61% in 2002, compared to 82.04% in 2001 and 86.23% in 2000. For 2002, the standard efficiency ratio reflects the Company's ability to grow net interest income and other operating income in excess of the growth in operating expenses.

INCOME TAXES

The effective income tax rate for the Company in 2002 was 19.53%. The effective income tax rate was 25.32% in 2001 and (54.50%) in 2000. The resulting effective rate for 2000 was not reflective of the Company's effective tax rate under normal operating results, but was reflective of the pre-tax loss for the year and the net effect of non-deductible and non-taxable income and expenses upon that relatively smaller taxable base. Thus we are comparing effective income tax rates from 2002 and 2001. The primary reasons for the decline in the effective income tax rate from 2001 to 2002 were the increased holdings of tax-exempt municipal securities, the decrease in non-deductible amortization of intangibles and the Bank's purchase of $5.0 million of BOLI, on which the earnings are tax exempt. Income generated at Nevahawk is not subject to state income taxes while certain U.S. government agency investments qualify for state tax exemption for the Bank within Illinois.

BALANCE SHEET ANALYSIS

OVERVIEW

Total assets as of December 31, 2002 increased $22.1 million or 6.69% to $352.4 million compared to $330.3 million as of December 31, 2001. Total average assets for the year increased $3.2 million or 1.00% to $322.4 million compared to $319.2 million in 2001. December 31 total assets included short-term year-end deposits from one commercial customer of $18.6 million in 2002 and $14.4 million in 2001. Excluding those deposits total assets increased 5.67% year over year.

SECURITIES

Available-for-sale securities increased $41.3 million, to $83.9 million, as of December 31, 2002 from $42.6 million as of December 31, 2001. During 2002 the Bank experienced loan run-off of $23.2 million and deposit growth of $9.3 million, excluding the short-term year end deposits of $18.6 million and $14.4 million at December 31, 2002 and 2001, respectively. The funds provided from loans and deposits as well as the Bank's excess liquidity at December 31, 2001 were invested in investment securities.

FEDERAL HOME LOAN BANK OF CHICAGO STOCK

The Bank's investment in stock of the Federal Home Loan Bank of Chicago increased from $2.4 million at December 31, 2001 to $4.5 million at December 31, 2002. The increase is due to the purchase of $2.0 million in additional stock and stock dividends received. The additional stock was purchased as the returns on the FHLB stock are expected to be at least as high as debt securities allowed by the bank's investment policy without price risk.

LOANS

Net loans decreased 10.92% during 2002 to $186.3 million at December 31, 2002 from $209.1 million at December 31, 2001. The composition of and changes to the Bank's loan portfolio are detailed in Table 2 of Item 7 of this report. The decrease occurred across all categories of loans and reflects low loan demand due to economic weakness in the bank's primary markets. In addition, the historically low interest rate environment has created a significant amount of refinancing of loans in the bank's one to four family mortgage portfolio. The company's focus on relationship banking has resulted in the subsidiary bank not pursuing certain "transactions" that may have resulted in increased loan balances, but offered no opportunity to form other relationships with the client. Management expects continued weak loan demand and competition for quality credits.

NON-PERFORMING LOANS

Non-performing loans include loans that have been placed in non-accrual status, are determined by management to be impaired because full collection of principal and interest is doubtful, and loans which are past-due ninety days or more as to interest and/or principal payments. For additional discussion of the Bank's non-performing loans see table 2 of Part I Item 7 of this filing and footnote 4 to the Consolidated Financial Statements.

ASSET QUALITY

The allowance for loan losses was $2.1 million or 1.10% of total loans at December 31, 2002 compared to $2.4 million or 1.14% of total loans at December 31, 2001. As of December 31, 2002, non-performing loans and performing loans classified as impaired totaled $3.0 million compared to $4.3 million at December 31, 2001. The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance for loan losses is adequate to cover probable credit losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. In accordance with FASB Statements 5 and 114, the allowance is provided for losses that have been incurred as of the balance sheet date. The allowance is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. Management reviews a calculation of the allowance for loan losses on a quarterly basis. While management

uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. Table 2 of item 7 of this filing contains an allocation of the allowance for loan losses by category. At December 31, 2002, $1.4 million or 67.91% of the allowance is allocated to real estate mortgage loans. Approximately $0.9 million of this allocation is due to historic loss experience and the remaining amount is due to economic factors and an increase in the number of commercial real estate loans added to the bank's internal watch list. The decrease in the allocation to consumer loans is the result of a change in the handling of loans to customers in bankruptcy. During the fourth quarter of 2002 approximately $0.1 million of consumer loans were charged off, despite the existence of collateral. Future payments on these loans will be credited to the allowance account as recoveries.

POTENTIAL PROBLEM LOANS

The bank uses an internal asset classification system as a means of identifying and reporting problem and potential problem loans. All commercial and commercial real loans are graded on a scale of 1 to 7, with 1 being the best credit grade. Loans graded 5, 6, or 7 are classified as "watch", "substandard" and "doubtful", respectively. An asset is classified as substandard if it is inadequately protected by the current net worth and paying capacity of the obligor, or the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Once an asset is considered uncollectible and viewed as non-bankable it is charged off as a loss against the allowance account. Assets that do not currently expose the company to sufficient risk to warrant classification in one of the aforementioned categories, but possess weakness that may or may not be within the control of the customer are deemed to be watch loans. The classified loans are reviewed monthly by the directors' loan committee, which must approve all additions and deletions from the classified list.

In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require the bank to make additions to the allowance for loan losses based on their judgments of collectibility based on information available to them at the time of their examination. The policy of the Company is to place a loan on non-accrual status if: (a) payment in full of interest and principal is not expected, or (b) principal or interest has been in default for a period of 90 days or more, unless the obligation is both in the process of collection and well secured. Well secured is defined as collateral with sufficient market value to repay principal and all accrued interest. A debt is in the process of collection if collection of the debt is proceeding in due course either through legal action, including judgement enforcement procedures, or in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to current status.

At December 31, 2002 the allowance for loan losses to total non-performing and impaired loans equaled 69.21% compared to 55.76% at December 31, 2001. While the total nonperforming and impaired loans decreased by $1.3 million there was a considerable shift in the make-up of non-performing loans. As a result of increased collection efforts total residential real estate loans either on non-accrual or past due 90 days and still accruing was reduced by $0.8 million to $1.8 million compared to $2.5 million at

December 31, 2001. The reduction in non-performing residential real estate loans was offset by an increase in nonperforming commercial and industrial loans of $0.3 million to $0.5 million at December 31, 2002 compared to $0.2 million at December 31, 2001.

DEPOSITS

Total deposits at December 31, 2002 were $263.1 million as compared to $249.6 million at December 31, 2001. Excluding short-term deposits of $18.6 million and $14.4 million made on the final business day of 2002 and 2001, respectively, deposits increased 3.95%. During 2002, the Bank generated more transaction accounts. The average balance of non-interest-bearing checking accounts increased $4.0 million or 15.18% to $30.3 million for the year ended December 31, 2002, the average balance of interest bearing checking accounts increased $4.3 million or 15.09% to $32.7 million and the average balance of savings deposits increased $2.6 million or 5.10% to $53.7 million. These favorable mix shifts to lower cost of funds deposits offset a decrease of $6.0 million or 4.65% in average time deposits from $128.6 million for the year ended December 31, 2001 to $122.6 million in the current year.

SHORT-TERM BORROWINGS

Total short term borrowings increased $7.4 million or 121.03% to $13.5 million compared to $6.1 million at December 31, 2001. This increase is primarily due to an increase in repurchase agreements with business and governmental organizations. The bank's customers use repurchase agreements to invest excess liquidity on a daily basis. During 2002 the Company's $5.7 million term loan was refinanced as a line of credit. However, upon issuance of the trust preferred securities described below, the line of credit was reduced to $0.1 million.

LONG-TERM BORROWINGS

Long-term borrowings decreased $9.5 million to $38.9 million at December 31, 2002 compared to $48.4 million at December 31, 2001. The bank's primary source for long-term borrowings has been, and is expected to continue to be, the Federal Home Loan Bank of Chicago ("FHLB"). Early in 2002, the Bank paid off $6.8 million in FHLB advances. In the fourth quarter of 2002, $3.0 million was borrowed from the FHLB to fund investment purchases. As mentioned above the Company's $5.7 million term bank loan was refinanced as a line of credit.

COMPANY OBLIGATED MANDATORILY REDEEMABLE PREFERRED SECURITIES OF SUBSIDIARY TRUST HOLDING SOLELY SUBORDINATED DEBENTURES

In December of 2002 the Company capitalized Blackhawk Statutory Trust I for the purpose of issuing $7.0 million in trust preferred capital securities. The Company capitalized the trust and then issued $7.2 million of subordinated debentures to the trust, which in turn issued $7.0 million of capital securities to an outside investor. Management believes that this is an advantageous method of funding the Company's growth strategies. The subordinated debentures do not contain restrictions or covenants typically found in bank financing arrangements. Also, while it qualifies as tier I capital, with certain limitations, it does not dilute the ownership of the existing shareholders. The capital provided was initially used to reduce outstanding bank debt, however, bank debt financing will likely increase to prior levels upon the closing of the pending acquisition of DunC Corp. See footnote 9 to the Consolidated Financial Statements for further discussion of Company Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust Holding Solely Subordinated Debentures.

ASSET/LIABILITY MANAGEMENT

Asset/liability management is the process of identifying, measuring and managing the risk to the Company's earnings and capital resulting from the movements in interest rates. It is the Company's objective to protect earnings and capital while achieving liquidity, profitability and strategic goals.

The Company focuses its measure of interest rate risk on the effect a shift in interest rates would have on earnings rather than on the amount of assets and/or liabilities subject to re-pricing in a given time period. Since not all assets or liabilities move at the same rate and at the same time, a determination must be made as to how each interest earning asset and each interest bearing liability adjusts with each change in the base rate. The Company develops, evaluates and amends its assumptions on an ongoing basis and analyzes its earnings exposure quarterly.

In addition to the effect on earnings, a quarterly evaluation is made to determine the change in the economic value of equity with various changes in interest rates. This determination indicates how much the value of the assets and the value of the liabilities change with a specified change in interest rates. The net difference between the economic values of the assets and liabilities results in an economic value of equity.

LIQUIDITY

Liquidity, as it relates to the subsidiary bank, is a measure of its ability to fund loans and withdrawals of deposits in a cost-effective manner. The Bank's principal sources of funds are deposits, scheduled amortization and prepayment of loan principal, amortization, prepayment and maturity of investment securities, short-term borrowings and income from operations. Additional sources include purchasing fed funds, sale of securities, sale of loans, borrowing from both the Federal Reserve Bank and Federal Home Loan Bank, and dividends paid by Nevahawk, a wholly owned subsidiary of the Bank.

The liquidity needs of the Company generally consist of payment of dividends to its shareholders, payments of principal and interest on borrowed funds and subordinated debentures, and a limited amount of expenses. The sources of funds to provide this liquidity are issuance of capital stock and dividends from its subsidiary bank. Certain restrictions are imposed upon the Bank, which could limit its ability to pay dividends if it did not have net earnings or adequate capital in the future. The Company maintains adequate liquidity to pay its expenses.

The following table summarizes The Company's significant contractual obligations and other potential funding needs at December 31, 2002 (in thousands):

Time Deposits	Long-term debt(1)	Operating