HARRIS PREFERRED CAPITAL CORP
Form 10-Q
November 14, 2007

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United States
Securities And Exchange Commission
Washington, D.C. 20549

Form 10-Q

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

For the quarterly period ended September 30, 2007

Commission file number 1-13805

Harris Preferred Capital Corporation
(Exact name of registrant as specified in its charter)

Maryland	**# 36-4183096**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Indentification No.)
111 West Monroe Street, Chicago, Illinois	**60603**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code:
(312) 461-2121

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
73/8% Noncumulative Exchangeable Preferred Stock, Series A, par value $1.00 per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 þ No o

Indicate by check mark whether this registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

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

Yes o No þ

The number of shares of Common Stock, $1.00 par value, outstanding on November 13, 2007 was 1,000. No common equity is held by nonaffiliates.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED BALANCE SHEETS

	September 30, 2007 (unaudited)	December 31, 2006 (audited) (in thousands)	September 30, 2006 (unaudited)
Assets			
Cash on deposit with Harris N.A	$ 5,201	$ 5,284	$ 1,026
Securities purchased from Harris N.A. under agreement to resell	9,421	9,854	12,083
Notes receivable from Harris N.A.	5,531	6,512	6,722
Securities available-for-sale:			
Mortgage-backed	379,555	404,075	396,917
U.S. Treasury	89,936	59,948	64,926
Other assets	1,597	1,667	1,646
Total assets	$ 491,241	$ 487,340	$ 483,320
Liabilities			
Accrued expenses	$ 75	$ 120	$ 51
Preferred dividends payable	4,609	4,611	
Total liabilities	$ 4,684	$ 4,731	$ 51
Commitments and contingencies			
Stockholders Equity			
73/8% Noncumulative Exchangeable Preferred Stock, Series A ($1 par value); liquidation value of $250,000,000 and 20,000,000 shares authorized, 10,000,000 shares issued and outstanding	$ 250,000	$ 250,000	$ 250,000
Common stock ($1 par value); 1,000 shares authorized, issued and outstanding	1	1	1
Additional paid-in capital	240,733	240,733	240,733
Earnings in excess of (less than) distributions	2,324	(71)	1,673
Accumulated other comprehensive loss net unrealized losses on available-for-sale securities	(6,501)	(8,054)	(9,138)
Total stockholders equity	486,557	482,609	483,269
Total liabilities and stockholders equity	$ 491,241	$ 487,340	$ 483,320

The accompanying notes are an integral part of these consolidated financial statements.

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HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVEV INCOME (Unaudited)

	Quarter Ended September 30, 2007	Quarter Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
	(in thousands, except per share data)			
Interest income:				
Securities purchased from Harris N.A. under agreement to resell	$ 1,002	$ 1,090	$ 2,860	$ 3,360
Notes receivable from Harris N.A.	89	111	278	360
Securities available-for-sale:				
Mortgage-backed	4,549	4,118	13,671	11,809
U.S. Treasury	75	104	223	307
Total interest income	5,715	5,423	17,032	15,836
Operating expenses:				
Loan servicing fees paid to Harris N.A.	5	5	14	17
Advisory fees	36	32	103	93
General and administrative	54	59	181	223
Total operating expenses	95	96	298	333
Net income	5,620	5,327	16,734	15,503
Preferred dividends	4,609	4,609	13,827	13,828
Net income available to common stockholder	$ 1,011	$ 718	$ 2,907	$ 1,675
Basic and diluted earnings per common share	$ 1,011.00	$ 718.00	$ 2,907.00	$ 1,675.00
Net income	$ 5,620	$ 5,327	$ 16,734	$ 15,503
Other comprehensive income net unrealized gains on available-for-sale securities	4,209	7,912	1,553	1,848
Comprehensive income	$ 9,829	$ 13,239	$ 18,287	$ 17,351

The accompanying notes are an integral part of these consolidated financial statements.

HARRIS PREFERRED CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
(Unaudited)

	Nine Months Ended September 30, 2007	2006
	(in thousands, except per share data)	
Balance at January 1	$ 482,609	$ 479,746
Net income	16,734	15,503
Other comprehensive income	1,553	1,848
Dividends (common stock $511.85 per share)	(512)	
Dividends (preferred stock $0.4609 per share)	(13,827)	(13,828)
Balance at September 30	$ 486,557	$ 483,269

The accompanying notes are an integral part of these consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
	(in thousands)	
Operating Activities:		
Net Income	$ 16,734	$ 15,503
Adjustments to reconcile net income to net cash provided by operating activities:		
Decrease (increase) in other assets	70	(185)
Net decrease in accrued expenses and other liabilities	(47)	(79)
Net cash provided by operating activities	16,757	15,239
Investing Activities:		
Decrease in securities purchased from Harris N.A. under agreement to resell	433	8,417
Repayments of notes receivable from Harris N.A.	981	1,962
Purchases of securities available-for-sale	(258,795)	(333,447)
Proceeds from maturities of securities available-for-sale	254,880	321,983
Net cash used in investing activities	(2,501)	(1,085)
Financing Activities:		
Cash dividends paid on common stock	(512)	
Cash dividends paid on preferred stock	(13,827)	(13,828)
Net cash used in financing activities	(14,339)	(13,828)
Net (decrease) increase in cash on deposit with Harris N.A.	(83)	326
Cash on deposit with Harris N.A. at beginning of period	5,284	700
Cash on deposit with Harris N.A. at end of period	$ 5,201	$ 1,026

The accompanying notes are an integral part of these consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

Harris Preferred Capital Corporation (the Company) is a Maryland corporation whose principal business objective is to acquire, hold, finance and manage qualifying real estate investment trust (REIT) assets (the Mortgage Assets), consisting of a limited recourse note or notes (the Notes) issued by Harris N.A. (the Bank) secured by real estate mortgage assets (the Securing Mortgage Loans) and other obligations secured by real property, as well as certain other qualifying REIT assets, primarily U.S. treasury securities and securities collateralized with real estate mortgages. The Company holds its assets through a Maryland real estate investment trust subsidiary, Harris Preferred Capital Trust. Harris Capital Holdings, Inc., owns 100% of the Company s common stock. The Bank owns all common stock outstanding issued by Harris Capital Holdings, Inc.

The accompanying consolidated financial statements have been prepared by management from the books and records of the Company. These statements reflect all adjustments and disclosures which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented and should be read in conjunction with the notes to consolidated financial statements included in the Company s 2006 Form 10-K. Certain reclassifications were made to conform prior years financial statements to the current year s presentation. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

2. Commitments and Contingencies

Legal proceedings in which the Company is a defendant may arise in the normal course of business. There is no pending litigation against the Company.

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

Forward-Looking Information

The statements contained in this Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company s expectation, intentions, beliefs or strategies regarding the future. Forward-looking statements include the Company s statements regarding tax treatment as a real estate investment trust, liquidity, provision for loan losses, capital resources and investment activities. In addition, in those and other portions of this document, the words anticipate, believe, estimate, expect, intend and other similar expressions, as they re the Company or the Company s management, are intended to identify forward-looking statements. Such statements reflect the current views of the Company with respect to future events and are subject to certain risks, uncertainties and assumptions. It is important to note that the Company s actual results could differ materially from those described herein as anticipated, believed, estimated or expected. Among the factors that could cause the results to differ materially are the risks discussed in Item 1A. Risk Factors in the Company s 2006 Form 10-K and in the Risk Factors section included in the Company s Registration Statement on Form S-11 (File No. 333-40257), with respect to the Preferred Shares declared effective by the Securities and Exchange Commission on February 5, 1998. The Company assumes no obligation to update any such forward-looking statement.

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Results of Operations

Third Quarter 2007 Compared with Third Quarter 2006

The Company s net income for the third quarter of 2007 was $5.6 million, a 6% increase from the third quarter 2006 net income of $5.3 million. Earnings increased primarily because of increased interest income on earning assets.

Interest income on securities purchased under agreement to resell for the third quarter of 2007 was $1.0 million on an average balance of $80.8 million, with an annualized yield of 4.96%. During the same period in 2006, the interest income on securities purchased under agreement to resell was $1.1 million, on an average balance of $97.9 million, with an annualized yield of 4.45%. The decrease in income was attributable to lower balances, partially offset by higher yields. Third quarter 2007 interest income on the Notes totaled $89 thousand and yielded 6.4% on $5.6 million of average principal outstanding for the quarter compared to $111 thousand and a 6.4% yield on $6.9 million average principal outstanding for the third quarter of 2006. The decrease in income was attributable to a reduction in the Notes balance because of principal paydowns by customers in the Securing Mortgage Loans. Interest income on securities available-for-sale for the current quarter was $4.6 million resulting in a yield of 4.7% on an average balance of $393 million, compared to $4.2 million with a yield of 4.4% on an average balance of $382 million for the same period a year ago. The increase in interest income is primarily attributable to the portfolio of mortgage-backed securities generating a higher yield in the current quarter.

There were no Company borrowings during third quarter 2007 or 2006.

Third quarter 2007 operating expenses totaled $95 thousand, compared to $96 thousand in the third quarter of 2006. Loan servicing expenses totaled $5 thousand for the third quarter in 2007 and 2006. Advisory fees for the third quarter 2007 were $36 thousand compared to $32 thousand a year earlier. General and administrative expenses totaled $54 thousand, a decrease of $5 thousand from the same period in 2006 due to lower processing costs.

At September 30, 2007 and 2006, there were no Securing Mortgage Loans on nonaccrual status.

The Company classifies all securities as available-for-sale. The Company has no intent to sell specific securities, and the Company has the ability to hold all securities to maturity. Available-for-sale securities are reported at fair value with unrealized gains and losses included as a separate component of stockholders equity. At September 30, 2007, net unrealized losses on available-for-sale securities were $6.5 million compared to $9.1 million of unrealized losses on September 30, 2006 and $8.1 million of unrealized losses at December 31, 2006. The unrealized loss positions at September 30, 2007 and 2006 and December 31, 2006 were attributable to changes in interest rates and not to lowered credit quality of individual securities; therefore management believes these unrealized losses are temporary.

In making a determination of temporary vs. other-than-temporary impairment of an investment, a major consideration of management is whether the Company will be able to collect all amounts due according to the contractual terms of the investment. Such a determination involves estimation of the outcome of future events as well as knowledge and experience about past and current events. Factors considered include the following: whether the fair value is significantly below cost and the decline is attributable to specific adverse conditions in an industry or geographic area; the period of time the decline in fair value has existed; if an outside rating agency has downgraded the investment; if dividends have been reduced or eliminated; if scheduled interest payments have not been made and finally, whether the financial condition of the issuer has deteriorated. In addition, it may be necessary for the Company to demonstrate its ability and intent to hold a debt security to maturity.

Nine Months Ended September 30, 2007 compared with September 30, 2006

The Company s net income for the nine months ended September 30, 2007 was $16.7 million. This represented a $1.2 million increase or 8% from 2006 earnings for the nine month period. Earnings increased primarily because of an increase in interest income on earning assets.

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Interest income on securities purchased under agreement to resell for the nine months ended September 30, 2007 was $2.9 million, on an average balance of $78 million, with an average rate of 4.9%. During the same period in 2006, the interest income on securities purchased under agreement to resell was $3.4 million on an average balance of $99 million, with an average rate of 4.5%. The decrease in interest income was attributable to lower balances, partially offset by higher yields. Interest income on the Notes for the nine months ended September 30, 2007 totaled $278 thousand, yielding 6.4% on $5.8 million of average principal outstanding compared to $360 thousand of income yielding 6.4% on $7.5 million of average principal outstanding for the same period in 2006. The decrease in income was attributable to a reduction in the Notes balance because of customer payoffs on the Securing Mortgage Loans. The average outstanding balance of the Securing Mortgage Loans was $7 million for the nine months ended September 30, 2007 and $9 million for the same period in 2006. There were no Company borrowings during either period. Interest income on securities available-for-sale for the nine months ended September 30, 2007 was $13.9 million resulting in a yield of 4.6% on an average balance of $399 million, compared to $12.1 million resulting in a yield of 4.4% on an average balance of $371 million a year ago. The increase in interest income from available-for-sale securities is primarily attributable to growth in the portfolio of mortgage-backed securities.

Operating expense for the nine months ended September 30, 2007 totaled $298 thousand, a decrease of $35 thousand from a year ago. Loan servicing expenses for the nine months ended September 30, 2007 totaled $14 thousand, a decrease of $3 thousand or 18% from 2006. This decrease is attributable to the reduction in the principal balance of the Notes because servicing costs vary directly with these balances. Advisory fees for the nine months ended September 30, 2007 were $103 thousand compared to $93 thousand a year ago. The increase is due to increased costs with the day-to-day operations of the Company. General and administrative expenses totaled $181 thousand, a decrease of $42 thousand or 19% from the same period in 2006 as a result of reduced costs for printing, insurance and processing costs.

On October 1, 2007, the Company paid a cash dividend of $0.46094 per share on outstanding Preferred Shares to the stockholders of record on September 15, 2007 as declared on August 29, 2007. On September 30, 2006, the Company paid a cash dividend of $0.46094 per share on outstanding Preferred Shares to the stockholders of record on September 15, 2006, as declared on August 30, 2006. On September 12, 2007, the Company paid a cash dividend of $512 thousand declared on August 29, 2007 on the outstanding common shares to the stockholder of record on September 1, 2007. The Company made the election under Internal Revenue Code Section 858(a) to treat this distribution as having been made during 2006.

Liquidity Risk Management

The objective of liquidity management is to ensure the availability of sufficient cash flows to meet all of the Company s financial commitments. In managing liquidity, the Company takes into account various legal limitations placed on a REIT.

The Company s principal asset management requirements are to maintain the current earning asset portfolio size through the acquisition of additional Notes or other qualifying assets in order to pay dividends to its stockholders after satisfying obligations to creditors. The acquisition of additional Notes or other qualifying assets is funded with the proceeds obtained as a result of repayment of principal balances of individual Securing Mortgage Loans or maturities or sales of securities. The payment of dividends on the Preferred Shares is made from legally available funds, arising from operating activities of the Company. The Company s cash flows from operating activities principally consist of the collection of interest on the Notes, mortgage-backed securities and other earning assets. The Company does not have and does not anticipate having any material capital expenditures.

In order to remain qualified as a REIT, the Company must distribute annually at least 90% of its adjusted REIT ordinary taxable income, as provided for under the Internal Revenue Code, to its common and preferred stockholders. The Company currently expects to distribute dividends annually equal to 90% or more of its adjusted REIT ordinary taxable income.

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The Company anticipates that cash and cash equivalents on hand and the cash flow from the Notes and mortgage-backed treasury securities will provide adequate liquidity for its operating, investing and financing needs including the capacity to continue preferred dividend payments on an uninterrupted basis.

As presented in the accompanying Consolidated Statements of Cash Flows, the primary source of funds in addition to $16.8 million provided from operations during the nine months ended September 30, 2007, was $255 million provided from the maturities of securities available-for-sale. In the prior period ended September 30, 2006, the primary sources of funds other than $15.2 million from operations were $322 million provided from the maturities of securities available-for-sale and $8.4 million resulting from a decrease in securities purchased under agreement to resell. The primary uses of funds for the nine months ended September 30, 2007 were $259 million for purchases of securities available-for-sale and $13.8 million in preferred stock dividends paid and $512 thousand in common stock dividends paid. In the prior period ended September 30, 2006, the primary uses of funds were $333 million for purchases of securities available-for-sale and $13.8 million in preferred stock dividends paid.

Market Risk Management

The Company s market risk is composed primarily of interest rate risk. There have been no material changes in market risk or the manner in which the Company manages market risk since December 31, 2006.

Accounting Pronouncements

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements, in September 2006. The Statement provides guidance for using fair value to measure assets and liabilities. It clarifies the methods for measuring fair value, establishes a fair value hierarchy and requires expanded disclosure. SFAS 157 applies when other standards require or permit assets or liabilities to be measured at fair value and is effective for fiscal years beginning after November 15, 2007. The Company is in the process of assessing the impact of adopting this Statement on its financial position and results of operations.

The FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115, in February 2007. The Statement permits entities to choose to measure certain eligible items at fair value at specified election dates. Although most of the provisions are elective, the amendment to SFAS 115 applies to all entities with available-for-sale and trading securities. SFAS 159 is effective as of the beginning of the fiscal year that begins after November 15, 2007. The Company is in the process of assessing the impact of adopting this Statement on its financial position and results of operations.

Other Matters