

FIRST STATE BANK MISSION STATEMENT

The mission of First State Bank of Livingston, Texas, is to provide professional high-quality commercial banking services to businesses and individuals within its trade area.

Such services will be performed within the framework of maintaining a safe and sound banking institution, with the realization that to carry out its mission the bank must preserve its ability to operate in a consistently profitable manner.

Within the scope of safe banking practices, the bank recognizes its responsibility as one of the leading financial institutions in its service area to actively promote and participate in investments which will lead to the creation of economic opportunities for the businesses and individuals it serves.

The bank recognizes that one of its greatest resources is its staff of competent employees. It is committed to provide them fair and adequate compensation and benefits, technical and professional training, and the opportunity to work and advance within the bank throughout their employment careers.

The bank also recognizes its responsibility to its owners, the stockholders, to earn an adequate and fair return on their investment.

At all times the bank will operate in a strictly legal, moral and ethical manner and will insist upon this same commitment from its directors, management, and employees.

The bank will make continuous effort to maintain a friendly and courteous relationship among its employees and with its customers.

In descending order of priority the bank will manage its operations to achieve:

1. Safety
2. Profitability
3. Growth

HISTORY

First State Bank of Livingston is an early-chartered bank of the Texas state banking system. It was originally organized in 1910 as Guaranty State Bank and was renamed with its present name in 1925.

The bank's present location at the corner of Polk Street and Jackson Avenue in Livingston is its third location.

During the intervening years First State Bank has functioned as an important part of the business and cultural scene of Livingston and Polk County.

The growth of the bank, both in assets and in its physical plant, has mirrored the growth of its East Texas trade area. The bank has played a key role in the transition of its trade area from a rural retail sales, agricultural, and timber-based economy to the present subregional trade center, retaining its traditional bases, but also adding petroleum production, some diversified manufacturing, retirement living and recreation.

In 1995 First State Bank opened its first branch in Shepherd, Texas, about 15 miles south of the main bank location.

Also in 1995 the bank became a State Member Bank of the Federal Reserve System, resulting in a change in the bank's primary federal regulator from the Federal Deposit Insurance Corporation to the Federal Reserve Bank.

In July, 1998, the second branch was opened on U. S. Highway 190 West on the fast-growing western side of the City of Livingston.

In February, 1999, the bank's third branch was opened in the community of Onalaska, adjacent to Lake Livingston about 14 miles west of Livingston.

In September, 2002, the Onalaska branch opened its newly-constructed building in Onalaska.

DEFINITION, DEMOGRAPHICS AND ECONOMIC FACTORS OF THE BANK'S MARKET AREA

DEFINITION

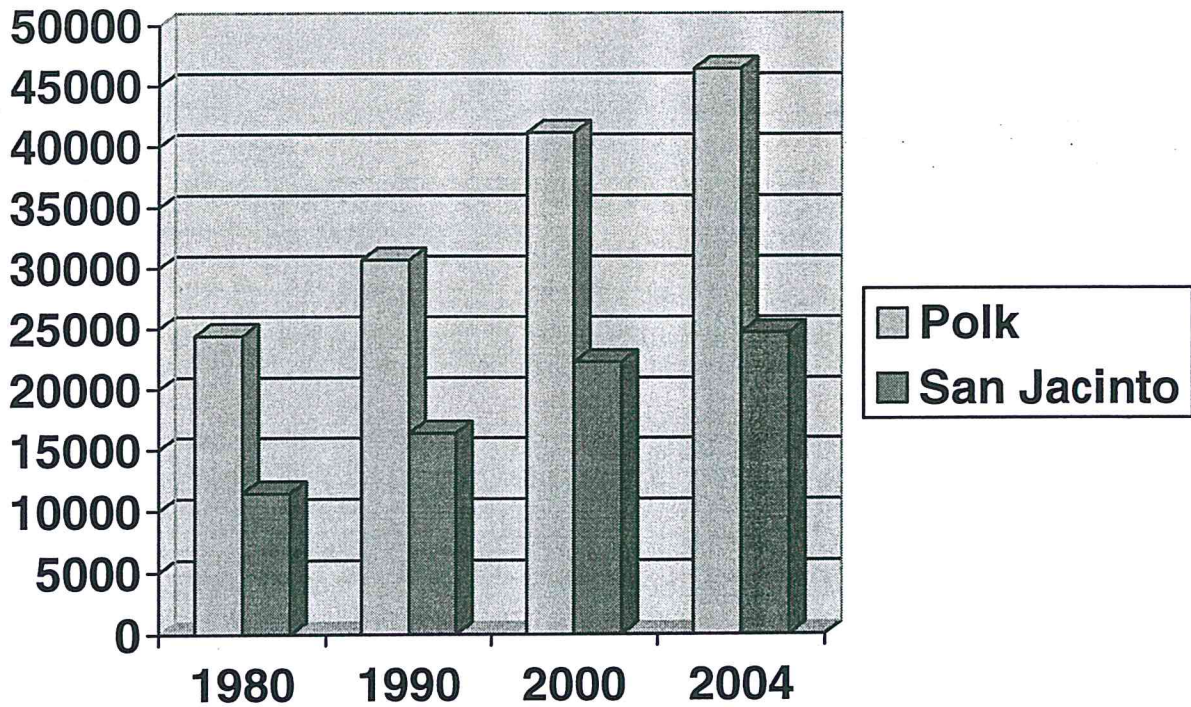
First State Bank's primary market area has been historically considered to be the Polk County area. Since the opening of the Shepherd branch it is now considered to be Polk and San Jacinto Counties.

The surrounding marginal areas of Tyler, Hardin, Liberty, Walker and Trinity counties are within the bank's service area and contribute some customer relationships both in loans and deposit accounts but for purposes of analysis are not statistically important.

DEMOGRAPHIC AND ECONOMIC FACTORS

The two counties comprising the primary market area, Polk and San Jacinto, had a 2004 estimated population of 46,397 and 24,678 respectively, for a total of 71,075.

Both counties experienced healthy growth over the 2000-2004 period, with a census growth of 12.80% for Polk County and 10.92% for San Jacinto.



Historically the bank's service area has been greatly influenced by its single largest industry, wood products.

Timber growth, logging, pulpwood production, sawmilling and other manufactured wood products are important contributors to the local economy.

Oil and gas drilling continues at a greater than normal rate and has led to some substantial discoveries.

Construction of the 91,000 acre Lake Livingston project by the Trinity River Authority and the development of a great many Lake Livingston-related and other rural subdivisions has led to recreational and retirement living becoming another important economic factor in the bank's service area.

A pro-active effort in developing other local employment has had reasonable success over the last ten years. An interested group of local civic and business leaders, including several officers of the bank, have been successful in promoting the location of the following major employers in the Livingston area:

- The Texas Department of Criminal Justice Terrell Unit, employing approximately 900.
- VF Factory Outlet, employing approximately 100.
- Wal-Mart Super Center, employing approximately 500.
- American Railcar Goodrich Plant, employing approximately 100.
- Memorial Medical Systems \$24 million hospital complex employing approximately 140 which has recently announced a \$25 to \$30 million expansion to be completed in 2006 or early 2007.
- CVS Drug Stores has entered the Livingston market with a new building.
- Lowe's Home Center opened in 2004, employing approximately 125.
- IAH detention center opened in 2006 and employs approximately 150.
- Postel Industries is going to open operations using the old Cooper-Cameron building and they are expecting to employ approximately 30 to 40.
- Construction is in progress on a Tractor Supply. This is replacing an old tire store that sat in an area prone to flooding. The site is being built up with dirt so it sits above the flood plain. This will now be a high value commercial site in Livingston.
- Construction on a New Hampton Inn is complete and they are open for business.
- Another Hotel, Executive Inn, in Shepherd has just finished construction and is open for business. We did the financing on this project.
- Agr-Tex (SunCoast Bedding), another loan customer, opened up in Shepherd in 2005. They took an old site used for refurbishing mobile homes. The site was an eye sore for

the town. Now it is a state of the art wood shavings packaging plant that employees approximately 10 to 15.

COMPETITIVE ENVIRONMENT IN THE BANK'S MARKET AREA

First State Bank operates in a competitive environment within its market area. It competes with another bank of almost equal size, one smaller bank, and a branch of a statewide Federal Savings and Loan.

After many years of First State Bank's being the largest financial institution in the market area, the 1999 merger of its two largest local competitors, First National Bank and The Bank of Livingston, moved it into second place in the market. Subsequently a pattern of the merged First National Bank's losing some deposits and total assets and First State Bank's growth has resulted in First State Bank once again becoming the largest bank in the market area. Growth trends for both banks appear to be similar after the merger runoff.

Statistically the competition is as follows: (as of 12/31/05)

	First State Bank	First National Bank	Peoples State Bank
Assets (\$mil)	228	219	63
Deposits (\$mil)	199	183	58
Branches	3	2	3
Earnings (\$thousands)			
(12 Mos Ending 12/31/05)	3,205	3,249	376
Total Capital (\$mil)	27	35	4

Information is not available on the Livingston branch of Guaranty FSB but it is not considered to be a material factor in the competitive environment.

The bank also competes for deposits with two New York Stock Exchange brokerage houses and the brokerage and insurance subsidiary of First National Bank which maintain local offices and sell a significant amount of investment products, including mutual funds and annuities.

STRENGTHS AND WEAKNESSES OF THE BANK

STRENGTHS

Reputation:

First State Bank enjoys an excellent reputation within its business community. Its large customer base is the result of decades of satisfied customers who have referred others to the bank. Its Board of Directors includes many business, civic and community leaders of the Livingston and Polk County area.

Relative Size:

The size of First State Bank, small enough for personal attention to its customers and large enough to provide a broad range of banking services is viewed as a strength.

Service Area:

The Polk County - San Jacinto County service area of the bank is viewed as a good area in which to do business. The bank's service area, as has been noted, is growing rapidly. Deep East Texas is considered by many to be a desirable area in which to live because of its rural life style coupled with ready access to the large cities of the Gulf Coast.

Loyal Customers:

First State Bank's many years in its service area has resulted in a large core group of loyal customers. It is believed that these customers enjoy doing business with the bank, have established personal relationships with many of the bank's officers and employees, and truly feel a strong tie to our banking institution.

The bank recognizes the importance of these relationships and emphasizes the value of maintaining the loyalty and trust of its customers in its employee training and customer service activities.

Competent and Professional Staff:

Management of First State Bank endeavors to maintain a high level of employee and officer competence. Most of the bank officers are professional bankers with many years' experience. In most cases the experience has been at First State Bank.

Six of the bank officers hold university degrees in banking, accounting, management, real estate or related fields. In addition, one officer is a Certified Public Accountant and two have attended graduate schools of banking. One officer is certificated as an American Institute of Banking instructor in the areas of bank management, accounting and financial statement analysis. One officer is a graduate of the American Bankers Association National Compliance School and has been recognized as a Certified Bank Compliance Officer by the Bank Administration Institute.

The bank frequently sends officers and employees to specific seminars and training schools and periodically holds in-bank training sessions on various topics relating to bank operations or lending functions.

In September 2005, after Hurricane Rita devastated the area, this Bank was open for business the first business day after the storm. We were the only bank in the area to be opened on time that first day. This is a direct result of a dedicated and competent group of officers and employees.

Technological Abilities:

First State Bank clearly leads the local market in the area of technical competence. The bank was first in its marketplace with interactive telephone banking and its debit card product. It was also first in its market with statement imaging.

In 1999 First State Bank became the first bank in its business territory to implement an Internet web page. In 2000 this product was expanded to encompass full transactional Internet banking, making First State Bank the first bank in its market with Internet banking. Since this time all other area banks have now started offering this service.

Automated Teller Machines (ATMs) are viewed as an important means of customer account access. The bank presently maintains five ATMs, three of which are drive-up units, much preferred from a standpoint of convenience and safety.

Physical Plant:

The bank owns a well-maintained, attractive and functional headquarters building in downtown Livingston, and attractive branch locations in Shepherd, West Livingston, and Onalaska.

As far as space and design are concerned the main bank facilities, which were extensively remodeled in 2002, are more than adequate for present and forecast growth over the next ten years. If more space is needed in the main bank, the present multistory building is designed for the addition of two more floors. In 2006 there are plans to remove the old out of date escalators and replace them with a stationary staircase. One of two elevators will be reworked to accommodate the anticipated additional traffic.

The Shepherd and West Livingston branches are viewed as being adequate. The Onalaska branch is new and has more than adequate space.

Parking for customers and bank personnel is adequate at present.

Capital, Asset Quality and Earnings

With 12/31/05 primary capital of 12.22%, compared with the Texas Department of Banking's minimum capital requirement of 6.00%, First State Bank is well capitalized. It also meets the FDIC guidelines as a well capitalized bank for the purpose of determining FDIC insurance premiums.

With its relatively low loan:deposit ratio and large portfolio of well-selected investments, management views the bank as being very safe from the standpoint of asset quality. This positioning is also borne out by the bank's high Tier I Risk Based Capital Ratio of 26.45%.

WEAKNESSES

Location of Main Bank

The design, size, functionality and adequate land of the main bank facility have been noted as a strength. However, the actual geographic location of the main bank is perceived as being somewhat of a weakness. Since the building of the U. S. Highway 59 bypass several years ago, the major retail shopping area of Livingston has moved to the bypass.

Also because of the bypass the most important traffic artery of the city has reoriented itself from the former north-south "main street", Washington Avenue, to Church Street, which is also U. S. Highway 190, and runs east-west.

Although the downtown section of Livingston has not completely died, and, in fact, seems to be making something of a comeback, the area west of downtown at the intersection of U. S. 59 bypass and U. S. 190 has clearly become the most important trade area of the city.

The bank's present location at 112 W. Polk St. is clearly tied to the older downtown Livingston area. Both of its bank competitors and the savings and loan office have locations on Church Street, and one of the banks has a west side branch location which is also located on Hwy 190 West, an extension of Church Street.

Although banking is not really an impulse business, it is to some extent a convenience business and management feels that although the situation of location is not critical at this time we are somewhat less conveniently located than the competition. This weakness is likely to become more important as time progresses. This locational weakness is being dealt with by the location of convenient branches.

It should be noted that our largest competitor, First National Bank, is making a major move. They will be moving their home office location out of downtown Livingston to the west side of town right across the street from our West Side Branch. They will be closing their west side branch and making their current downtown location into a branch. We will monitor this closely to determine if this has a positive or negative effect on us. The general feeling is that this will probably not change anything over the long term. Both banks will still have locations in the same general areas and offer basically the same bank services.

Low Loan Demand

As is previously discussed, First State Bank is situated in a market that does not include a great deal of manufacturing industry. The local retail environment is to a large extent made up of out-of-town-based retailers who bring their own financing into the local market.

The large segment of the population made up of retirees and vacation-orientated families are to a large extent savers rather than borrowers. Many of these customers have retirement income and important savings and other investments.

Also, a large segment of the community is made up of low-moderate income families who have difficulty qualifying for sizable loans because of repayment problems brought about by low income levels.

Although some employment has been added and is expected to increase in the future, a realistic assessment of the bank's business community indicates that we must expect our business to be characterized by a scarcity of qualifying loans.

Non-Bank Competition

As has been the case for banks nationwide, recent years have produced many competitors that are not banks that compete for funds and loans that, traditionally, would have been part of banks' usual business.

In First State Bank's service area there are two nationwide investment firms that maintain offices for the purpose of selling investments. A large bank competitor in the Livingston market has entered the alternative investment market and is actively promoting annuities and brokerage services. These firms' products typically include stocks, bonds, annuities, IRA funds, and mutual funds. These offices also offer brokered certificates of deposit with out of territory commercial banks. All of these products constitute competition for the bank for investors' funds.

Although not maintaining offices locally, all of the other investment firms that sell in the national marketplace maintain offices in the Houston area and continually solicit investment funds from local customers.

In the area of loans, there is also significant non-bank competition.

Probably the greatest non-bank competition is in the area of automobile financing. All of the local automobile dealerships have an affiliation with the captive finance companies owned by the automobile manufacturers. GMAC, Ford Motor Credit, and Chrysler Credit are all represented and do a great many loans.

There are also a number of mortgage companies and insurance companies offering their services in the local market for real-estate financing.

The large commercial finance companies, such as Associates, CIT, General Electric Credit, and Borg-Warner, all do business locally, particularly in the area of heavy equipment financing and dealer inventory financing.

PLANS AND GOALS

ASSET SIZE

First State Bank ended the year 2005 with total assets of \$228 million. The bank has some substantial growth during the 4th quarter of 2005. Much of this is attributed to Insurance claims and FEMA money from Hurricane Rita, therefore this spike in deposits could subside as our depositors spend this money repairing hurricane damage. The bank has shown consistent real asset growth over the past five year period, as will be shown in the attached historic record section.

It is assumed that the bank will experience real asset growth at the rate of 3% compounded annually.

After the 1999 loss of its position as the area's largest financial institution because of the merger of two large competitors, First State Bank regained this position during 2002. An important goal is to maintain this leadership position in total bank assets.

Detailed year-by-year projections of asset levels will be found in the accompanying Five Year Projected Plan section of this report.

EARNINGS

For the year 2005 First State Bank had net earnings of \$3,205,000. These earnings produced a return on average equity of 12.31%.

Projected return on equity through 2010 is approximately 10.32%.

Detailed year-by-year projections of the bank's anticipated earnings will be found in the accompanying Five Year Projected Plan section of this report.

CAPITAL

As of December 31, 2005, the bank's capital : asset ratio was 12.22%. The bank is considered well-capitalized from a regulatory standpoint and for the purpose of computation of FDIC deposit insurance premiums.

Applying the adjustments to the asset base necessary to compute risk-based capital ratios, the bank had a "Tier I" risk-based capital ratio as of December 31, 2005, of 26.45%

As a state-chartered bank, First State Bank is required to maintain a primary capital : asset ratio of at least 6%. Regulatory risk-based capital guidelines require a Tier I ratio of at least 8%.

For the last five years, even with a healthy growth of assets, the bank has been able to maintain or even increase its capital ratios through good earnings and a conservative dividend payout philosophy.

The bank plans to earn, and manage dividend payments to the parent holding company, so that primary capital does not fall below 7% and to manage asset types so that Tier I risk-based capital does not fall below 12%.

DIVIDENDS

The bank's sole stockholder and recipient of dividends is its parent holding company, East Texas Bancshares, Inc.

During 1999 East Texas Bancshares, Inc., and its two subsidiary banks successfully concluded a multi-year plan to retire the holding company's two senior securities, the Class A and Class B preferred stock, leaving the holding company with only common equity. This was an important goal for the banks and the holding company as the preferred carrying costs were post-tax and were somewhat burdensome in regard to the required dividends necessary from the banks to cover this carrying cost.

The bank plans for dividends to continue to be paid at a rate that will maintain a primary capital:asset ratio exceeding 11%. This payout will provide adequately for the expenses of the holding company and allow the continuation, and possible increase, of the current dividend to the holding company's common stock.

Likewise, the portion of earnings retained by the bank should, according to the plan, allow capital to be accumulated to fund the anticipated growth of the bank in line with the plan for assets and earnings.

FACILITIES

The bank's primary headquarters facility is deemed to be adequate for the bank's needs over the planning period. An extensive upgrade and remodeling of the headquarters building was completed in 2002.

The West Livingston branch is a first-rate facility and is more than adequate for any anticipated growth over the planning period. This is the only location that we do not offer safe deposit boxes. We are strongly considering offering safe deposit box services at this location sometime in the near future.

The Shepherd branch is adequate for projected growth in this area. A special problem of the Shepherd branch is security. The branch has been the subject of two armed robberies. Security has been upgraded in this facility and now includes: 1. exploding dye/irritant gas packets to be included in the money drawers. 2. bars on all outside windows and across the glass front of the building. 3. a bullet-resistant electronically operated entrance door admitting only known customers or those showing proper identification.

A modern newly-constructed building was completed for the Onalaska branch in 2002.

TECHNOLOGY

The bank has invested heavily in technology in the past including converting to the IBM AS-400 computer format, a telephone voice response customer inquiry system, a new state of the art time and weather information system, six state-of-the-art ATMs, statement imaging and PC-based teller machines.

Netteller Internet Banking was initiated early in 2000. The Netteller system has since been upgraded to allow on-line bill paying.

In 2002 a conversion from the obsolescent Liberty operating system to the state-of-the art Jack Henry CIF 20/20 was completed.

Cash Management, an on-line system for businesses, allowing in-office origination of ACH and wire transactions was added in 2004.

In 2005 a module was added to our computer banking program to allow business accounts to access their account information real-time, transfer funds, and initiate wire transfers from their places of business.

Statement and item imaging was changed in 2005 to a system offered by Jack Henry, Inc.

A fraud detection software "Yellow Hammer" was purchased from Jack Henry in 2005 and implemented in 2006.

Major technology investments anticipated over the planning period are:

- Document imaging, storage and retrieval, which will enable the scanning, electronic filing and quick retrieval of information now stored on paper in conventional filing cabinets.

HUMAN ASSETS

The bank recognizes the need for training, increased job responsibility, and communication among officers and employees that is necessary for succession because of retirement, or other voluntary or involuntary termination of employment. Additional supervisory and regular employees may also be required to increase staffing because of anticipated growth or addition of branches.

Ben R. Ogletree, Jr., was serving as Chairman, President and Chief Executive Officer. Mr. Ogletree vacated the office of President in 2005 and, retained the Chairman and Chief Executive Officer's position, at the same time phasing down his hours and job responsibility.

Executive Vice President / Controller, Robert Sebaugh assumed the office and responsibilities of President.

Senior Vice President, Tony Taylor assumed the office and responsibilities of Controller, previously held by Robert Sebaugh.

Vice President, Joe Puckett replaced Tony Taylor as Senior Commercial Loan Officer.

West Branch Manager, Debra Ward replaced Joe Puckett. Her assistant Shirley Johnson replaced her as Branch Manager.

The above changes were challenging, but all seem to be working well. All officers involved in the changes worked hard and continue to work hard in making sure the transitions are smooth. No major changes are anticipated in the near future.

The bank recognizes the need for continued professional education and training.

From time to time in-bank schools and seminars are held to accomplish officer and employee training.

The bank also plans to utilize various out-of-bank professional training sessions, such as schools and seminars to further the education and professional skills of its officers and employees.

Growth Rate 3%

Strategic Plan
First State Bank of Livingston
Balance Sheet

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Assets										
Cash & Due From Banks	7,197	8,011	8,109	6,765	7,961	6,070	6,750	6,750	7,000	7,000
Due From Banks - Int Bearing	2,362	892	-	-	6,248	3,493	4,000	4,000	4,000	4,000
Securities	69,129	73,634	84,220	88,344	87,514	96,916	101,467	100,763	100,023	99,653
Fed Funds	14,835	9,803	825	4,850	17,415	8,501	4,000	4,000	4,000	4,000
Loans	61,174	62,200	69,982	74,804	78,330	77,960	80,299	82,707	85,188	87,743
Government Guaranteed Loans	43,022	42,193	38,002	30,724	23,785	22,153	25,000	30,000	35,000	40,000
Allowance for Loan Losses	(803)	(831)	(880)	(928)	(999)	(999)	(900)	(900)	(900)	(900)
Premises & Fixed Assets	3,545	4,538	4,221	4,276	4,194	4,204	4,400	4,375	4,350	4,325
Other Assets	2,792	2,341	2,250	2,302	3,125	2,704	2,925	2,950	2,925	2,950
Total Assets	203,253	202,781	206,729	211,137	227,573	221,002	227,941	234,645	241,586	248,771
Liabilities										
Deposits:										
Non-Interest Bearing	38,771	31,182	31,685	37,188	45,155	43,247	44,544	45,880	47,256	48,673
Interest Bearing	142,426	148,631	150,293	147,499	153,538	147,153	151,567	156,114	160,797	165,620
Other Liabilities	2,368	1,553	1,567	1,553	1,686	1,634	1,650	1,660	1,670	1,680
Total Liabilities	183,565	181,366	183,545	186,240	200,379	192,034	197,761	203,654	209,723	215,973
Equity Capital										
Common Stock	2,200	2,200	2,200	2,200	2,200	2,200	2,200	2,200	2,200	2,200
Surplus	3,800	3,800	3,800	3,800	3,800	3,800	3,800	3,800	3,800	3,800
Undivided Profits	11,946	13,688	15,415	17,184	18,897	21,194	23,432	24,180	24,991	25,863
Net Income	2,667	2,927	2,969	3,513	3,205	3,166	3,148	3,211	3,272	3,335
Dividends	(925)	(1,200)	(1,200)	(1,800)	(908)	(1,392)	(2,400)	(2,400)	(2,400)	(2,400)
Total Equity Capital	19,688	21,415	23,184	24,897	27,194	28,968	30,180	30,991	31,863	32,798
Total Liabilities & Capital	203,253	202,781	206,729	211,137	227,573	221,002	227,941	234,645	241,586	248,771
Number of Employees	70	69	71	73	73	74	75	76	76	76
Capital / Assets	9.69%	10.56%	11.21%	11.79%	11.95%	13.11%	13.24%	13.21%	13.19%	13.18%
Return on Average Equity	13.55%	14.24%	13.31%	14.61%	12.31%	11.27%	10.64%	10.50%	10.41%	10.32%
Return on Average Assets	1.31%	1.44%	1.45%	1.68%	1.46%	1.41%	1.40%	1.39%	1.37%	1.36%

Strategic Plan
First State Bank of Livingston
Income Statements

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Net Interest Income	6,859	7,269	7,568	8,216	8,355	8,494	8,749	9,011	9,281	9,559
Non-Interest Income:										
Deposit Service Charges	1,409	1,507	1,611	1,686	1,534	1,620	1,701	1,786	1,875	1,969
Other Non-Interest Income	388	613	386	437	547	514	525	530	535	540
Total Non-Interest Income	1,797	2,120	1,997	2,123	2,081	2,134	2,226	2,316	2,410	2,509
Non-Interest Expense:										
Personnel Expense	2,537	2,740	2,879	3,099	3,381	3,391	3,661	3,839	4,026	4,222
Occupancy Expense	730	797	306	308	358	379	390	402	414	426
Other Operating Expenses	1,913	2,035	2,627	2,592	2,720	2,884	2,971	3,060	3,152	3,247
Total Non-Interest Expenses	5,180	5,572	5,812	5,999	6,459	6,654	7,022	7,301	7,592	7,895
Gain (Loss) on Securities	3	-	-	-	-	-	-	-	-	-
Provision for Loan Losses	220	205	195	120	170	240	240	240	240	240
Net Income Before Taxes	3,259	3,612	3,558	4,220	3,807	3,734	3,713	3,786	3,859	3,933
Federal Income Taxes	592	685	589	707	602	568	565	575	587	598
Net Income	2,667	2,927	2,969	3,513	3,205	3,166	3,148	3,211	3,272	3,335