



Lake Shore Bancorp, Inc.



Our Season

2012 Annual Report

About the Cover

Living in an area in which all four seasons are present provides one with a keen awareness of the ever-revitalizing process of nature. Autumn leaves, winter snows, apple blossoms and fruit of the vine are all a unique part of living in Chautauqua and Erie Counties. Our cover is a reminder to enjoy the beauty of each season, as well as the progression from one season to another. Our successful branch expansions throughout Chautauqua and Erie Counties are a testament to Lake Shore Savings ability to recognize and seize the opportunities presented by the changing landscape that each season has to offer.



Lake Shore Bancorp, Inc.

Corporate Profile

Lake Shore Bancorp, Inc. is the parent company of Lake Shore Savings Bank, originally chartered as a savings and loan association in New York State in 1891. Lake Shore Savings Bank is a community-oriented bank dedicated to serving the financial needs of consumers and businesses in Western New York. In April 2006, the Bank converted into the federal mutual holding company structure. As part of that process, Lake Shore Bancorp, Inc. conducted an initial public offering and became a public company. Total assets as of December 31, 2012 were \$482.4 million.

In 2012, Lake Shore Savings Bank celebrated more than 121 years of service to the community since opening its first branch in Dunkirk, New York. The Bank opened its 2nd branch office in Fredonia, New York in 1987, and will open its 11th branch office in Snyder, New York during the second quarter of 2013. The Bank's 11 full service branches and 18 ATMs are located throughout Chautauqua and Erie counties. The Bank maintains its corporate headquarters in Dunkirk, New York.

Lake Shore Savings Bank serves customers' financial needs at every stage of life – from the first savings account, to home mortgages, to small business loans, to retirement accounts. The Bank specializes in high-quality, personal customer service. Its primary business is in residential mortgages and commercial real estate loans to small business customers.

Lake Shore Savings Bank supports its markets through a Community Reinvestment Fund. This program makes money available to area clubs, sports teams, civic groups, schools, charitable organizations and other non-profit groups. After all, we're dedicated to "Putting People First" throughout the communities we serve.



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To Our Shareholders



Daniel P. Reininga
President and
Chief Executive Officer
Lake Shore Bancorp, Inc.

Lake Shore Savings Bank continues to deliver high quality customer service and to build financial strength as a locally-operated community savings bank in Western New York. In 2012 we welcomed new customers, cultivated new lending relationships, invested in efficient technology upgrades and navigated regulatory changes in a year of intense strategic focus. Our success in maintaining best-in-class asset quality, while also growing commercial loans and core deposits beyond our budgeted goals, positions us well to execute the strategic plan we have developed for 2013 and beyond.

2012: Delivering Solid Results in a Strategic Year of Change

2012 marked a year of very solid financial performance for our organization. In 2012 we earned net income of \$3.6 million, or \$0.64 per diluted share, which was consistent with the record earnings we had in 2011, despite the confines of low interest rates and a weak economic environment during 2012. Furthermore, our efforts to manage non-interest expenses resulted in an efficiency ratio of 69.16%, which beat our expectations. We are very pleased with our ability to deliver solid and stable earnings, which enabled the Bank to build capital in this uncertain regulatory environment.

Our efforts in 2012 to build scale in our commercial lending portfolio allowed us to realize meaningful growth with originations of \$22.2 million, once again exceeding our targeted goal. Over the past year we have communicated a clear focus on growing this portfolio, which offers higher yields and shorter loan terms than our traditional lending focus, residential mortgages. Our lenders and community business partners responded enthusiastically which helped to drive our progress toward meeting this growth initiative. We are very proud of our success in reaching this strategic goal of diversifying our balance sheet and managing interest rate risk in a prolonged low-rate environment.

As part of our strategy to diversify the Company's loan portfolio, we've aimed to attract and secure business banking customers who can potentially provide low-cost core deposits as part of their borrower relationships. Importantly, we grew core deposits, which increased \$20.1 million, or 12.6%, from the end of 2011 to December 31, 2012.

Fortunately, while interest rates continue to pressure margins, our superior asset quality continues to improve and to bolster our financial position. From December 31, 2011 to December 31, 2012, non-performing loans as a percentage of total net loans fell 13 basis points to 0.89% - well below the overall industry average, as well as the average for our peers. Credit losses as a percentage of average loans was only 8 basis points in 2012, while our provision for loan losses was increased in order to ensure the loan loss allowance appropriately supports new, conservatively underwritten commercial real estate loan growth.

Banking in Today's Economic and Regulatory Environment

Our solid 2012 results are particularly satisfying in light of continued and new challenges experienced by the banking industry during the year. The slow economic recovery continues to stifle loan growth for all banks, but particularly for smaller banks in slower growth markets. Competition for quality credits remains high, and many banks have lowered pricing to gain volume. Our commercial loan growth success in 2012 demonstrates that a proven commitment to outstanding service can effectively win over customers of larger banks, even those offering lower rates. We are very proud of our commitment to selling with service; we have not and will not stray from conservative, common sense pricing.

Implementation of the Dodd-Frank Act continues in a choppy and inconsistent manner and has created a burdensome regulatory environment for community savings banks. As a result of Dodd-Frank, we have operated under dual regulatory oversight, with the Office of the Comptroller of the Currency overseeing Lake Shore Savings Bank and the Federal Reserve Board overseeing our savings and loan holding companies, Lake Shore, MHC and Lake Shore Bancorp, Inc. We have implemented procedures and measurement tools to ensure sound enterprise risk management practices and enhance compliance with new regulations under the Dodd-Frank Act.

More important to our investors, than our current regulatory structure, was the 2012 implementation of an interim final regulation by the Federal Reserve Board under which a mutual holding company (MHC) is no longer able to waive the receipt of dividends without the prior approval of a majority of the eligible votes of the MHC's members - our depositors. This policy change has considerable implications for our ability to pay a meaningful dividend to public shareholders and to appropriately plan for the capital we generate from earnings.

This change in regulation led to the Board's decision in January 2013 to hold a special meeting of our MHC members on February 26, 2013 to seek authorization for the MHC to waive its rights to receive dividends. As announced on February 28, 2013, our MHC members approved the proposal and the proposal was filed with the Federal Reserve Board for their non-objection. On March 25, 2013, Lake Shore, MHC received the non-objection of the Federal Reserve Board to waive its right to receive dividends paid by the Company during the twelve months ending February 26, 2014. With more than 3.6 million MHC shares outstanding, it's apparent why your Board considered this a vitally important issue to address. Without a dividend waiver, the MHC would receive an



annual payment in excess of \$1 million, assuming an annual dividend of \$0.28 per share. We continue to believe that reinvesting this capital in growing our business offers a stronger outcome for Lake Shore Savings Bank and for our shareholders. We will continue to communicate our concerns to the Federal Reserve Board regarding this interim regulation and we hope that the Federal Reserve Board will make revisions which will eliminate the requirement for an annual vote of the MHC members to waive dividends at the MHC level, as it is costly and inefficient.

2013: Strategically Positioned for a Season of Growth

Since 2007 the banking industry has operated in a "winter" of sorts, adapting to remain strong against a chilling recession, low interest rates and regulatory changes which have been at times both rapid and frozen, due to delays in issuance of final rulings. With little assurance as to when a "thaw" will come, Lake Shore has consistently focused on those things within our control: lending within our communities, enhancing our customers' access to mobile banking, and ensuring the most efficient delivery of services across all of our platforms. This resolute focus on our customers and our communities is our foundational strength, and it is the grounding force behind our strategic plan for growth in 2013 and beyond.

We constantly assess how we can best serve our customers in the future, and the answer grows clearer and louder each year: efficient electronic services. To date, we have been very successful with our conservative approach to expanding our branch network, opening up new markets for customers to receive the trademark service for which we're known. In fact, we'll open our 11th branch in Snyder, New York in the second quarter of 2013, bringing a superior level of personal service to local families and businesses in yet another Western New York community. We are now working to extend that same level of convenience and service to our customers through enhanced electronic services. We are investing appropriately today, knowing it will make both our customers' banking transactions and our Company's operations more efficient tomorrow.

To this end, we have developed a five-year plan which outlines how we'll put in place cost effective and efficient digital services to meet our customer's technology needs, to focus on attracting new customers, and to improve the Company's operational efficiency. We are very excited to be complementing our "bricks" with new cost-effective "clicks."

We believe that in order to serve our customers best, we must first ensure our internal efficiency. We are currently in the process of negotiating our core systems vendor contract, and the enhanced savings resulting from the negotiation process will be invested in operational system enhancements in order to enhance our customer-facing services as well as, allowing for faster credit decisions and easier access to customer information.

As we move through 2013, a key priority will be to implement a web-based ACH product for our business banking customers, as well as researching ways to improve electronic banking for this segment of our customer base. During 2013, we will be researching cost-efficient mobile banking solutions to enhance customer service. Building off the momentum of our recently re-designed

website, we are excited to announce the implementation of an improved electronic mortgage application system during 2013 for our retail customers which will provide an even higher level of personal service for our new and loyal customers.

Additionally, as we mentioned above, recent economic conditions have underscored the importance of maintaining a strong balance sheet in 2013 and beyond. We remain committed to adding well-collateralized, adjustable-rate commercial loans to help us manage interest rate risk. Customers seeking commercial loans in amounts less than \$2 million have been very receptive to our approach, and our strategic plan focuses on extending both our credit and our trademark service to these "sweet spot" customers, at acceptable yields, in the future.

Conclusion

We are proud of our solid financial performance in 2012, and as always very proud of the exceptional service our employees provide our customers. We enter 2013 fully committed to executing on our strategic plan and continuing to build value for our shareholders, while working within the confines of the current economic and regulatory environment. Our strategic growth plans could not be realized without the tremendous support of our entire Lake Shore Savings team, and we look forward to 2013 with a renewed energy and passion for "Putting People First." This passion is exemplified by the tremendous leadership of our Board of Directors, which will undergo some changes in 2013.

On behalf of the Board of Directors, I would like to thank our outgoing Chairman, Michael Brunecz, for his 20 years of service as Chairman and 29 years as a director. I would also like to thank James Foley for his 30 years of service as a director. Both Mike and Jim have reached the mandatory retirement age and will be stepping down from the board on May 22, 2013. During their tenure, and under their leadership and guidance, the Company has grown from approximately \$60 million in total assets with one branch office to \$482 million in total assets with 11 branch locations throughout Chautauqua and Erie counties. Both Mike and Jim have been respected members of our board and have made significant contributions to the Company. We wish them both well on their retirement.

I am pleased to introduce our incoming Chairman, Gary Winger, on the following page, and we look forward to working together to continue with the Company's track record of success in growth and earnings. Regardless of the many operational challenges facing the banking industry, our entire team is enthusiastic about our prospects for 2013, and beyond, and I look forward to updating you on our progress throughout the year. As always, your Board, management team and all of Lake Shore's employees greatly appreciate your continued support.

Sincerely,

Daniel P. Reininga
President and Chief Executive Officer



Lake Shore Savings Board of Directors

[back row, standing left to right] **Sharon E. Brautigam:** Partner, Brautigam & Brautigam, LLP, **Kevin M. Sanvidge:** former Executive Vice President of Administration and Supply Chain at Cliffstar Corporation, **Tracy S. Bennett:** former Vice President of Administration, SUNY Fredonia, **Reginald S. Corsi:** former Executive Vice President and Chief Operations Officer of Lake Shore Bancorp, Inc., **Daniel P. Reininga:** President and Chief Executive Officer, **Susan C. Ballard:** Sales Manager at Essex Homes of Western New York, Inc., and **James P. Foley:** DDS.

(front row, seated left to right) **Michael E. Brunecz:** Chairman of the Board and President of Office Concepts, Inc., **Gary W. Winger:** Vice Chairman of the Board and Principal of Compass Consulting, Inc., **Nancy L. Yocum:** CPA and former partner of Brumfield & Associates, and **David C. Mancuso:** former President and Chief Executive Officer of Lake Shore Bancorp, Inc.

Our Appreciation for Their Dedicated Service

Lake Shore's success as a mission-driven community institution is truly attributable to the superb and active leadership of our Board of Directors. Our Chairman, Mr. Michael E. Brunecz, who has dedicated considerable amounts of time, energy and effort into guiding the growth of our institution has reached the mandatory retirement age and will be leaving the Board on May 22, 2013.

The effectiveness of our Board has been greatly influenced by the superior leadership of Mr. Brunecz, who has served as our Chairman since 1993. He has chaired our Board and the Bank through the most tumultuous economic period of our lifetimes. His visionary guidance and steadfast commitment to our mission of service has been instrumental to the growth of our Company and prosperity of our customers.

We are also sincerely appreciative of the significant contributions of Dr. James P. Foley, a respected member of our Board since 1983. Dr. Foley's operational leadership and depth of knowledge of community bank lending will be truly missed upon his retirement from our Board on May 22, 2013, as a result of reaching the mandatory retirement age.

Our Board of Directors and shareholders, our management and employees and the communities we serve, all wish Mr. Brunecz and Dr. Foley a healthy, fulfilling and well-deserved retirement and thank them for their tremendous service to Lake Shore Bancorp and to Lake Shore Savings Bank.



Michael E. Brunecz



Dr. James P. Foley



Welcome

We are excited to welcome our incoming Chairman, Gary W. Winger, who has served on our Board since 1997. As Vice Chairman since 2010, he has truly exemplified Lake Shore Savings Bank's mission of "Putting People First." His contributions to our strategic planning process are rooted in his many years of working in higher education administration and financial governance. Mr. Winger was previously the Dean of Administration and Chief Financial Officer for Jamestown Community College, as well as the Chief Development Officer and Executive Director of the Jamestown Community College Foundation. Mr. Winger is currently a principal of Compass Consulting, Inc., a firm that provides consulting services in the area of higher education. During his tenure on the Board of Directors, Mr. Winger has served as the Chairman of the Compensation Committee and as a member of the ALCO, Governance and Audit Committees.

We look forward to a prosperous and dynamic 2013 and beyond under Mr. Winger's very capable leadership.

Selected Financial Data

Our selected consolidated financial and other data is set forth below, which is derived in part from, and should be read in conjunction with, our audited consolidated financial statements and notes thereto, beginning on page F-1 of our 2012 Annual Report on Form 10-K.

As of December 31,

	2012	2011	2010	2009	2008
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(Dollars in thousands)

Selected Financial Condition Data:

Total assets	\$ 482,387	\$ 488,597	\$ 479,047	\$ 425,656	\$ 407,833
Loans, net	272,933	275,068	263,031	259,174	240,463
Securities available for sale	159,368	164,165	153,924	118,381	112,863
Federal Home Loan Bank stock	1,852	2,219	2,401	2,535	2,890
Total cash and cash equivalents	19,765	23,704	33,514	22,064	29,038
Total deposits	378,543	379,798	375,785	318,414	293,248
Short-term borrowings	11,200	6,910	5,000	6,850	5,500
Long-term debt	14,400	27,230	34,160	36,150	46,460
Total stockholders' equity	66,985	63,947	55,210	55,446	54,228
Allowance for loan losses	1,806	1,366	953	1,564	1,476
Non-performing loans	2,420	2,798	2,341	1,677	1,651
Non-performing assets	3,000	3,113	2,645	1,999	1,699

For the year ended December 31,

	2012	2011	2010	2009	2008
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(Dollars in thousands, except per share data)

Selected Operating Data:

Interest income	\$ 19,650	\$ 20,765	\$ 19,926	\$ 19,693	\$ 19,983
Interest expense	4,603	5,636	6,316	7,929	8,778
Net interest income	15,047	15,129	13,610	11,764	11,205
Provision for loan losses	656	415	2,115	265	391
Net interest income after provision for loan losses	14,391	14,714	11,495	11,499	10,814
Total non-interest income	2,030	1,666	3,454	2,415	600
Total non-interest expense	11,811	11,307	11,533	11,035	9,602
Income before income taxes	4,610	5,073	3,416	2,879	1,812
Income taxes	984	1,393	373	718	342
Net income	\$ 3,626	\$ 3,680	\$ 3,043	\$ 2,161	\$ 1,470
Basic and diluted earnings per common share	\$ 0.64	\$ 0.65	\$ 0.53	\$ 0.37	\$ 0.24
Dividends declared per share	\$ 0.25	\$ 0.28	\$ 0.24	\$ 0.20	\$ 0.19



Selected Financial Ratios and Other Data

As of December 31,

	2012	2011	2010	2009	2008
Performance Ratios:					
Return on average assets	0.74%	0.76%	0.67%	0.52%	0.39%
Return on average equity	5.47%	6.15%	5.32%	3.93%	2.76%
Dividend payout ratio ⁽¹⁾	39.06%	43.08%	45.28%	54.05%	79.17%
Interest rate spread ⁽²⁾	3.07%	3.14%	2.98%	2.70%	2.75%
Net interest margin ⁽³⁾	3.26%	3.34%	3.21%	3.03%	3.19%
Efficiency ratio ⁽⁴⁾	69.16%	67.32%	67.59%	77.83%	81.34%
Non-interest expense to average total assets	2.40%	2.34%	2.54%	2.65%	2.53%
Average interest-earning assets to average interest-bearing liabilities	119.69%	116.58%	115.39%	116.16%	117.53%
Capital Ratios:					
Total risk-based capital to risk weighted assets ⁽⁵⁾	23.77%	21.81%	20.44%	20.33%	21.78%
Tier 1 risk-based capital to risk weighted assets ⁽⁵⁾	23.04%	21.27%	20.05%	19.95%	21.35%
Tangible capital to tangible assets ⁽⁵⁾	12.14%	11.18%	10.28%	10.85%	11.20%
Tier 1 leverage (core) capital to adjustable tangible assets ⁽⁵⁾	12.14%	11.18%	10.28%	10.85%	11.20%
Equity to total assets	13.89%	13.09%	11.52%	13.03%	13.30%
Asset Quality Ratios:					
Non-performing loans as a percent of total net loans	0.89%	1.02%	0.89%	0.65%	0.69%
Non-performing assets as a percent of total assets	0.62%	0.64%	0.55%	0.47%	0.42%
Allowance for loan losses as a percent of total net loans	0.66%	0.50%	0.36%	0.60%	0.61%
Allowance for loan losses as a percent of non-performing loans	74.63%	48.82%	40.71%	93.26%	89.40%
Other Data:					
Number of full service offices	10	10	10	9	9

(1) Represents dividends declared per share as a percent of earnings per share.

(2) Represents the difference between the weighted-average yield on interest-earning assets and the weighted-average cost of interest-bearing liabilities for the year.

(3) Represents the net interest income as a percent of average interest-earning assets for the year.

(4) Represents non-interest expense divided by the sum of net interest income and non-interest income.

(5) Represents the capital ratios of Lake Shore Savings Bank since Lake Shore Bancorp, Inc., as a savings and loan holding company, is not currently subject to formula-based requirements at the holding company level.

Cautionary Statement

The statements contained herein that are not purely historical are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, which statements generally can be identified by the use of forward-looking terminology, such as "may," "will," "expect," "estimate," "anticipate," "believe," "target," "plan," "project" or "continue" or the negatives thereof or other variations thereon or similar terminology, and are made on the basis of management's current plans and analyses of our business and the industry in which we operate as a whole. These factors in some cases have affected, and in the future could affect, our financial performance and could cause actual results to differ materially from those expressed in or implied by such forward-looking statements. Information on factors that could affect the Company's business and results are discussed in the Company's periodic reports filed with the Securities and Exchange Commission including the Company's annual report on Form 10-K for 2012. We do not undertake to publicly update or revise our forward-looking statements even if experience or future changes make it clear that any projected results expressed or implied therein will not be realized.

Welcoming Our Newest Branch



A new season begins, as winter thaws and the spring of 2013 arrives, bringing with it the continued and successful expansion of Lake Shore Savings throughout Erie County. Uniquely positioned to service the Snyder-Williamsville area, our newest branch shows great promise in being a welcome addition to the community.

4950 Main Street
Snyder, NY 14226
Phone: 716-898-2101
Fax: 716-839-1404

Branch Locations

CHAUTAUQUA COUNTY BRANCH LOCATIONS



128 East Fourth Street
Dunkirk, New York 14048
Phone: 716-366-4070
Fax: 716-366-2965



30 East Main Street
Fredonia, New York 14063
Phone: 716-673-9555
Fax: 716-679-0696



115 East Fourth Street
Jamestown, New York 14701
Phone: 716-664-1103
Fax: 716-664-1183



1 Green Avenue, WE
Lakewood, New York 14701
Phone: 716-483-3400
Fax: 716-483-3468



106 East Main Street
Westfield, New York 14787
Phone: 716-326-4414
Fax: 716-326-4422

ERIE COUNTY BRANCH LOCATIONS



570 Dick Road
Depew, New York 14043
Phone: 716-898-2022
Fax: 716-684-5069



5751 Transit Road
East Amherst, New York 14051
Phone: 716-688-6114
Fax: 716-688-5941



59 Main Street
Hamburg, New York 14075
Phone: 716-646-9480
Fax: 716-646-9481



3438 Delaware Avenue
Kenmore, New York 14217
Phone: 716-898-2010
Fax: 716-874-2057



3111 Union Road
Orchard Park, New York 14127
Phone: 716-674-2066
Fax: 716-674-4347



LS Lake Shore Bancorp, Inc.

CORPORATE HEADQUARTERS

31 East Fourth Street
Dunkirk, NY 14048
Phone: 716-366-4070
Fax: 716-366-3010
www.lakeshoresavings.com

Lake Shore Savings Bank Officers

Daniel P. Reininga
President and Chief Executive Officer

Rachel A. Foley
Chief Financial Officer and Treasurer

Janinne Fiegl Dugan
Vice President, Human Resource Officer

Nicole May
Compliance Officer

Steven Schiavone
Controller

Beverly J. Sutton
Internal Auditor

Lori F. Danforth
Corporate Secretary

Louis P. DiPalma
Vice President

George H. Gardner
Vice President

John P. Huber
Vice President

Nancy L. LaTulip
Vice President

Beverly J. Mulkin
Vice President

Sonia N. Ortolano
Vice President

David P. Warren
Vice President

Charles D. Brooks
Assistant Vice President

Theresa M. Campanella
Assistant Vice President

Adam J. Dimitri
Assistant Vice President

Gabriele J. Maddalena
Assistant Vice President

Nancy L. March
Assistant Vice President

Sally A. Pyne
Assistant Vice President

Barbara M. Fancher
Assistant Vice President

Shareholder Information

Annual Shareholders Meeting

May 22, 2013
8:30 a.m.
Clarion Hotel
The Lighthouse Room
30 Lake Shore Drive East
Dunkirk, NY 14048

Stock Listing

The NASDAQ Global Market
under the symbol LSBK

Special Counsel

Luse Gorman Pomerenk & Schick, PC
5335 Wisconsin Avenue, NW
Suite 780
Washington, DC 20015

Independent Auditors

ParenteBeard LLC
20 Stanwix Street
Suite 800
Pittsburgh, PA 15222

Transfer Agent and Registrar

Registrar and Transfer Company
10 Commerce Drive
Cranford, NJ 07016
800-368-5948



Lake Shore Bancorp, Inc.

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