

MACKINAC FINANCIAL CORP /MI/
Form 10-Q
August 14, 2014
[Table of Contents](#)

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 June 30, 2014

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: 0-20167

MACKINAC FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

MICHIGAN
(State or other jurisdiction of
incorporation or organization)

38-2062816
(I.R.S. Employer Identification No.)

130 SOUTH CEDAR STREET, MANISTIQUE, MI
(Address of principal executive offices)

49854
(Zip Code)

Registrant's telephone number, including area code: **(888) 343-8147**

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 periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large Accelerated Filer Accelerated Filer Non-accelerated Filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

As of June 30, 2014, there were outstanding 5,527,690 shares of the registrant's common stock, no par value.

Table of Contents

MACKINAC FINANCIAL CORPORATION

INDEX

	Page No.
<u>PART I.</u>	
	<u>FINANCIAL INFORMATION</u>
<u>Item 1.</u>	<u>Financial Statements</u>
	<u>Condensed Consolidated Balance Sheets - June 30, 2014 (Unaudited), December 31, 2013 and June 30, 2013 (Unaudited)</u>
	1
	<u>Condensed Consolidated Statements of Operations - Three and Six Months Ended June 30, 2014 (Unaudited) and June 30, 2013 (Unaudited)</u>
	2
	<u>Condensed Consolidated Statements of Comprehensive Income - Three and Six Months Ended June 30, 2014 (Unaudited) and June 30, 2013 (Unaudited)</u>
	3
	<u>Condensed Consolidated Statements of Changes in Shareholders' Equity - Three and Six Months Ended June 30, 2014 (Unaudited) and June 30, 2013 (Unaudited)</u>
	3
	<u>Condensed Consolidated Statements of Cash Flows - Six Months Ended June 30, 2014 (Unaudited) and June 30, 2013 (Unaudited)</u>
	4
	<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>
	5
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
	32
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	42
<u>Item 4.</u>	<u>Controls and Procedures</u>
	45
<u>PART II.</u>	
	<u>OTHER INFORMATION</u>
<u>Item 1.</u>	<u>Legal Proceedings</u>
	46
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	46
<u>Item 6.</u>	<u>Exhibits and Reports on Form 8-K</u>
	46
<u>SIGNATURES</u>	47

Table of Contents

MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATIONITEM 1. FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	June 30, 2014 (Unaudited)	December 31, 2013	June 30, 2013 (Unaudited)
ASSETS			
Cash and due from banks	\$ 20,744	\$ 18,216	\$ 26,216
Federal funds sold	2	3	3
Cash and cash equivalents	20,746	18,219	26,219
Interest-bearing deposits in other financial institutions	235	10	10
Securities available for sale	47,374	44,388	47,307
Federal Home Loan Bank stock	3,060	3,060	3,060
Loans:			
Commercial	374,565	359,368	343,561
Mortgage	113,332	110,663	98,559
Consumer	15,043	13,801	13,435
Total Loans	502,940	483,832	455,555
Allowance for loan losses	(5,097)	(4,661)	(5,177)
Net loans	497,843	479,171	450,378
Premises and equipment	9,790	10,210	10,536
Other real estate held for sale	1,947	1,884	2,481
Deferred tax asset	9,097	9,933	8,367
Other assets	5,777	5,925	5,143
TOTAL ASSETS	\$ 595,869	\$ 572,800	\$ 553,501
LIABILITIES AND SHAREHOLDERS EQUITY			
LIABILITIES:			
Deposits:			
Noninterest bearing deposits	\$ 73,732	\$ 72,936	\$ 64,736
NOW, money market, interest checking	148,242	149,123	146,203
Savings	15,658	13,039	12,229
CDs<\$100,000	143,140	140,495	134,767
CDs>\$100,000	23,151	23,159	25,091
Brokered	80,093	67,547	64,881
Total deposits	484,016	466,299	447,907

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Borrowings	42,087	37,852	35,925
Other liabilities	3,289	3,400	3,149
Total liabilities	529,392	507,551	486,981
SHAREHOLDERS EQUITY:			
Preferred stock - No par value:			
Authorized - 500,000 shares , none issued and outstanding			4,000
Common stock and additional paid in capital - No par value			
Authorized - 18,000,000 shares			
Issued and outstanding - 5,527,690 ; 5,541,390 and 5,557,859 respectively	53,703	53,621	53,934
Retained earnings	12,325	11,412	8,156
Accumulated other comprehensive income	449	216	430
Total shareholders equity	66,477	65,249	66,520
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	\$ 595,869	\$ 572,800	\$ 553,501

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
	(Unaudited)		(Unaudited)	
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	\$ 6,373	\$ 6,014	\$ 12,654	\$ 11,903
Tax-exempt		28	23	55
Interest on securities:				
Taxable	244	241	481	481
Tax-exempt	14	6	27	13
Other interest income	32	32	80	63
Total interest income	6,663	6,321	13,265	12,515
INTEREST EXPENSE:				
Deposits	800	886	1,622	1,763
Borrowings	204	166	391	327
Total interest expense	1,004	1,052	2,013	2,090
Net interest income	5,659	5,269	11,252	10,425
Provision for loan losses	191	100	374	475
Net interest income after provision for loan losses	5,468	5,169	10,878	9,950
OTHER INCOME:				
Deposit service fees	192	175	349	337
Income from loans sold on the secondary market	139	279	242	578
SBA/USDA loan sale gains	166	554	548	663
Mortgage servicing income	89	182	102	285
Other	64	61	100	146
Total other income	650	1,251	1,341	2,009
OTHER EXPENSE:				
Salaries and employee benefits	2,523	2,375	5,064	4,681
Occupancy	546	363	1,084	745
Furniture and equipment	303	255	622	525
Data processing	288	268	574	533
Advertising	123	111	230	215
Professional service fees	276	320	607	545
Loan and deposit	83	45	162	118
Writedowns and losses on other real estate held for sale	14	87	14	89
FDIC insurance assessment	90	95	175	200
Telephone	82	63	164	145
Other	570	541	1,309	1,038
Total other expenses	4,898	4,523	10,005	8,834

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Income before provision for income taxes	1,220	1,897	2,214	3,125
Provision for income taxes	414	637	748	1,052
NET INCOME	806	1,260	1,466	2,073
Preferred dividend and accretion of discount		63		200
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	\$ 806	\$ 1,197	\$ 1,466	\$ 1,873
INCOME PER COMMON SHARE:				
Basic	\$.15	\$.22	\$.27	\$.34
Diluted	\$.14	\$.22	\$.26	\$.34

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013
Net income	\$ 806	\$ 1,260	\$ 1,466	\$ 2,073
Net change in net unrealized gains and losses on securities available for sale:				
Unrealized gains (losses) arising during the period	150	(832)	345	(763)
Less: reclassification adjustment for gains included in net income		15		15
Net securities gain (loss) during the period	150	(817)	345	(748)
Tax effect	(45)	277	(112)	254
Other comprehensive income (loss)	105	(540)	233	(494)
Total comprehensive income	\$ 911	\$ 720	\$ 1,699	\$ 1,579

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in Thousands)

(Unaudited)

	Three Months Ended			Three Months Ended		
	Preferred Stock	June 30, 2014 Common Shareholders Equity	Total Shareholders Equity	Preferred Stock	June 30, 2013 Common Shareholders Equity	Total Shareholders Equity
Balance, beginning of period	\$	\$ 65,730	\$ 65,730	\$ 11,000	\$ 62,039	\$ 73,039
Net income for period		806	806		1,260	1,260
Net unrealized gain (loss) on securities available for sale		105	105		(540)	(540)
Total comprehensive income		911	911		720	720
Stock compensation		113	113		75	75
Dividend on common stock		(277)	(277)		(222)	(222)
Repurchase of common stock					(29)	(29)
Redemption of Preferred Series A stock				(7,000)		(7,000)

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Dividend on preferred stock						(63)	(63)
Balance, end of period	\$	\$ 66,477	\$ 66,477	\$ 4,000	\$	62,520	\$ 66,520

		Six Months Ended June 30, 2014			Six Months Ended June 30, 2013		
	Preferred Stock	Common Shareholders Equity	Total Shareholders Equity	Preferred Stock	Common Shareholders Equity	Total Shareholders Equity	
Balance, beginning of period	\$	\$ 65,249	\$ 65,249	\$ 11,000	\$ 61,448	\$ 72,448	
Net income for period		1,466	1,466		2,073	2,073	
Net unrealized gain (loss) on securities available for sale		233	233		(494)	(494)	
Total comprehensive income		1,699	1,699		1,579	1,579	
Stock compensation		225	225		183	183	
Dividend on common stock		(553)	(553)		(444)	(444)	
Repurchase of common stock		(143)	(143)		(46)	(46)	
Redemption of Preferred Series A stock				(7,000)		(7,000)	
Dividend on preferred stock					(200)	(200)	
Balance, end of period	\$	\$ 66,477	\$ 66,477	\$ 4,000	\$ 62,520	\$ 66,520	

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Six Months Ended June 30,	
	2014	2013
<u>Cash Flows from Operating Activities:</u>		
Net income	\$ 1,466	\$ 2,073
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	751	840
Provision for loan losses	374	475
Deferred income taxes, net	748	1,052
Gain on sales/calls of securities		(15)
(Gain) on sale of loans sold to secondary market	(191)	(458)
Origination of loans held for sale in the secondary market	(11,170)	(32,597)
Proceeds from sale of loans in the secondary market	11,361	33,055
Loss (gain) on sale of premises, equipment, and other real estate held for sale	41	(25)
Writedown of other real estate held for sale	2	114
Stock compensation	225	183
Change in other assets	149	72
Change in other liabilities	(111)	99
Net cash provided by operating activities	3,645	4,868
<u>Cash Flows from Investing Activities:</u>		
Net increase in loans	(19,354)	(7,600)
Net increase in deposits held at other banks	(225)	
Purchase of securities available for sale	(3,243)	(4,974)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	504	476
Capital expenditures	(798)	(501)
Proceeds from sale of premises, equipment, and other real estate	742	1,329
Net cash (used in) investing activities	(22,374)	(11,270)
<u>Cash Flows from Financing Activities:</u>		
Net increase in deposits	17,717	13,350
Net increase in borrowings	4,235	
Repurchase of common stock	(143)	(46)
Dividend on common stock	(553)	(444)
Redemption of Preferred Series A		(7,000)
Dividend on preferred stock		(200)
Net cash provided by financing activities	21,256	5,660
Net increase (decrease) in cash and cash equivalents	2,527	(742)
Cash and cash equivalents at beginning of period	18,219	26,961
Cash and cash equivalents at end of period	\$ 20,746	\$ 26,219

Supplemental Cash Flow Information:

Cash paid during the year for:

Interest	\$	2,009	\$	1,651
Income taxes		25		99

Noncash Investing and Financing Activities:

Transfers of Foreclosures from Loans to Other Real Estate Held for Sale (net of adjustments made through the allowance for loan losses)		282		687
--	--	-----	--	-----

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Basis of Presentation

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the Corporation) have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six-month period ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013.

In order to properly reflect some categories of other income and other expenses, reclassifications of expense and income items have been made to prior period numbers. The net other income and other expenses was not changed due to these reclassifications.

The preparation of 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 financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of deferred tax assets, mortgage servicing rights and other real estate held for sale.

Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to commercial loans, when they have been judged to be impaired. A loan is impaired when, based on current information, it is probable that the Corporation will not collect all amounts due in accordance with the contractual terms of the loan agreement. These specific allowances are based on discounted cash flows of expected future payments using the loan's initial effective interest rate or the fair value of the collateral if the loan is collateral dependent.

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

The Corporation continues to maintain a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for possible loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation's past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectability of the principal is unlikely. In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additions to the allowance for loan losses based on their judgments of collectability.

In management's opinion, the allowance for loan losses is adequate to cover probable losses relating to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio as of the balance sheet date.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Stock Compensation Plans

On May 22, 2012, the Company's shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants may be awarded incentive stock options, non-statutory stock options, shares of restricted stock units (RSUs), or stock appreciation rights. The aggregate number of shares of the Company's common stock issuable under the plan is 575,000, which included 392,152 option shares outstanding at that time. Awards are made at the discretion of management. Compensation cost equal to the fair value of the award is recognized over the vesting period.

The Corporation, in August 2012 and March 2014, granted Restricted Stock Units (RSUs) to members of the Board of Directors and Management. In August 2012, 148,500 RSUs were granted at a market value of \$7.91 and will vest equally over a four year term. In exchange for the grant of these RSUs various previously issued stock option awards were surrendered. In March 2014, 52,774 RSUs were granted at a market value of \$12.95, also vesting equally over a four year term. The RSUs were awarded at no cost to the employee. Compensation cost to be recognized over the four year vesting periods, is \$1.175 million and \$.683 million, respectively. On August 31, 2013, the Corporation issued 37,125 shares of its common stock for vested RSUs. As of June 30, 2014, RSUs totaling 164,149 were unvested and unrecognized compensation expense was \$1.270 million.

2. **RECENT ACCOUNTING PRONOUNCEMENTS**

In May 2014, the Financial Accounting Standards Board (FASB) issued guidance on the recognition of revenue from contracts with customers. Revenue recognition will depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance also requires disclosures regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The guidance permits two methods of adoption: retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. The guidance is effective January 1, 2017 and early adoption is not permitted. The company is currently evaluating the impact of the new guidance and the method of adoption in the consolidated financial results.

3. **EARNINGS PER SHARE**

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Diluted earnings per share, which reflects the potential dilution that could occur if outstanding stock options were exercised and stock awards were fully vested and resulted in the issuance of common stock that then shared in our earnings, is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents, after giving effect for dilutive shares issued.

The following shows the computation of basic and diluted earnings per share for the three and six months ended June 30, 2014 and 2013 (dollars in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
(Numerator):				
Net income	\$ 806	\$ 1,260	\$ 1,466	\$ 2,073
Preferred stock dividends and accretion of discount		63		200
Net income available to common shareholders	\$ 806	\$ 1,197	\$ 1,466	\$ 1,873
(Denominator):				
Weighted average shares outstanding - basic	5,527,690	5,556,133	5,529,290	5,557,842
Effect of dilutive stock options and vesting of restricted stock units	90,001		55,642	
Weighted average shares outstanding - diluted	5,617,691	5,556,133	5,584,932	5,557,842
Income per common share:				
Basic	\$.15	\$.22	\$.27	\$.34
Diluted	\$.14	\$.22	\$.26	\$.34

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2014, December 31, 2013 and June 30, 2013 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<u>June 30, 2014</u>				
US Agencies - MBS	\$ 6,598	\$ 253	\$	\$ 6,851
US Agencies	17,755	91	(258)	17,588
Corporate Bonds	15,691	189		15,880
Obligations of states and political subdivisions	6,441	400	(2)	6,839
Other	216			216
Total securities available for sale	\$ 46,701	\$ 933	\$ (260)	\$ 47,374
<u>December 31, 2013</u>				
US Agencies - MBS	\$ 7,078	\$ 281	\$	\$ 7,359
US Agencies	15,227		(372)	14,855
Corporate Bonds	15,862	218	(1)	16,079
Obligations of states and political subdivisions	5,893	202		6,095
Total securities available for sale	\$ 44,060	\$ 701	\$ (373)	\$ 44,388
<u>June 30, 2013</u>				
US Agencies - MBS	\$ 7,491	\$ 354	\$	\$ 7,845
US Agencies	15,172	74	(341)	14,905
Corporate Bonds	18,557	161	(45)	18,673
Obligations of states and political subdivisions	5,435	450	(1)	5,884
Total securities available for sale	\$ 46,655	\$ 1,039	\$ (387)	\$ 47,307

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

The Corporation has evaluated gross unrealized losses that exist within the portfolio and considers them temporary in nature. The Corporation has both the ability and the intent to hold the investment securities until their respective maturities and therefore does not anticipate the realization of the temporary losses.

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were \$4.378 million and \$4.530 million, respectively, at June 30, 2014.

5. LOANS

The composition of loans is as follows (dollars in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Commercial real estate	\$ 274,500	\$ 268,809	\$ 243,363
Commercial, financial, and agricultural	89,515	79,655	84,145
One to four family residential real estate	105,868	103,768	94,254
Construction :			
Consumer	7,464	6,895	4,305
Commerical	10,550	10,904	16,053
Consumer	15,043	13,801	13,435
Total loans	\$ 502,940	\$ 483,832	\$ 455,555

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

An analysis of the allowance for loan losses for the six months ended June 30, 2014, the year ended December 31, 2013, and the six months ended June 30, 2013 is as follows (dollars in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Balance at beginning of period	\$ 4,661	\$ 5,218	\$ 5,218
Loans charged off	(115)	(2,432)	(616)
Recoveries on loans previously charged off	177	200	100
Provision	374	1,675	475
Balance at end of period	\$ 5,097	\$ 4,661	\$ 5,177

In the first half of 2014, net recoveries were \$62,000, compared to net charge-offs of \$.516 million, or .23% of average loans, in the same period in 2013. In the first half of 2014, the Corporation recorded a provision for loan loss of \$.374 million compared to \$.475 million in the first half of 2013. The Corporation's allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

A breakdown of the allowance for loan losses and recorded balances in loans at June 30, 2014 is as follows (dollars in thousands):

Three Months Ended June 30, 2014	Commercial,			One to four			Consumer	Unallocated	Total
	Commercial	financial and agricultural	Commercial construction	Commercial real estate	family residential construction	Consumer			
Allowance for loan loss reserve:	real estate	agricultural	construction	real estate	construction	Consumer	Unallocated	Total	
Beginning balance ALLR	\$ 1,756	\$ 1,572	\$ 41	\$ 391	\$ 16	\$ 114	\$ 993	\$ 4,883	
Charge-offs		(3)		(13)		(17)		(33)	
Recoveries	20	15	3	8		10		56	
Provision	(146)	85	(4)	(41)	(1)	4	294	191	
Ending balance ALLR	\$ 1,630	\$ 1,669	\$ 40	\$ 345	\$ 15	\$ 111	\$ 1,287	\$ 5,097	

Six Months Ended
June 30, 2014
Allowance for loan loss
reserve:

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Beginning balance ALLR	\$ 1,849	\$ 1,378	\$ 80	\$ 516	\$ 25	\$ 148	\$ 665	\$ 4,661
Charge-offs	(1)	(65)		(16)		(33)		(115)
Recoveries	74	59	6	14		24		177
Provision	(292)	297	(46)	(169)	(10)	(28)	622	374
Ending balance ALLR	\$ 1,630	\$ 1,669	\$ 40	\$ 345	\$ 15	\$ 111	\$ 1,287	\$ 5,097

At June 30,2014

Loans:

Ending balance	\$ 274,500	\$ 89,515	\$ 10,550	\$ 105,868	\$ 7,464	\$ 15,043	\$	\$ 502,940
Ending balance ALLR	(1,630)	(1,669)	(40)	(345)	(15)	(111)	(1,287)	(5,097)
Net loans	\$ 272,870	\$ 87,846	\$ 10,510	\$ 105,523	\$ 7,449	\$ 14,932	\$ (1,287)	\$ 497,843

Ending balance ALLR:

Individually evaluated	\$ 189	\$ 1,110	\$	\$ 118	\$	\$ 21	\$	\$ 1,438
Collectively evaluated	1,441	559	40	227	15	90	1,287	3,659
Total	\$ 1,630	\$ 1,669	\$ 40	\$ 345	\$ 15	\$ 111	\$ 1,287	\$ 5,097

Ending balance Loans:

Individually evaluated	\$ 609	\$ 1,744	\$	\$ 622	\$	\$ 64	\$	\$ 3,039
Collectively evaluated	273,891	87,771	10,550	105,246	7,464	14,979		499,901
Total	\$ 274,500	\$ 89,515	\$ 10,550	\$ 105,868	\$ 7,464	\$ 15,043	\$	\$ 502,940

Impaired loans, by definition, are individually evaluated.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2013 is as follows (dollars in thousands):

Allowance for loan loss reserve:	Commercial	Commercial, financial and	Commercial	One to four	Consumer	Consumer	Unallocated	Total
	real estate	agricultural	construction	family residential	construction			
Beginning balance ALLR	\$ 3,267	\$ 692	\$ 125	\$ 980	\$	\$	\$ 154	5,218
Charge-offs	(1,539)	(632)		(141)		(120)		(2,432)
Recoveries	92	56	2	26	2	22		200
Provision	29	1,262	(47)	(349)	23	246	511	1,675
Ending balance ALLR	\$ 1,849	\$ 1,378	\$ 80	\$ 516	\$ 25	\$ 148	\$ 665	\$ 4,661

Loans:

Ending balance	\$ 268,809	\$ 79,655	\$ 10,904	\$ 103,768	\$ 6,895	\$ 13,801	\$	\$ 483,832
Ending balance ALLR	(1,849)	(1,378)	(80)	(516)	(25)	(148)	(665)	(4,661)
Net loans	\$ 266,960	\$ 78,277	\$ 10,824	\$ 103,252	\$ 6,870	\$ 13,653	\$ (665)	\$ 479,171

Ending balance ALLR:

Individually evaluated	\$ 99	\$ 891	\$	\$ 103	\$	\$ 18	\$	\$ 1,111
Collectively evaluated	1,750	487	80	413	25	130	665	3,550
Total	\$ 1,849	\$ 1,378	\$ 80	\$ 516	\$ 25	\$ 148	\$ 665	\$ 4,661

Ending balance Loans:

Individually evaluated	\$ 649	\$ 1,830	\$	\$ 385	\$	\$ 42	\$	\$ 2,906
Collectively evaluated	268,160	77,825	10,904	103,383	6,895	13,759		480,926
Total	\$ 268,809	\$ 79,655	\$ 10,904	\$ 103,768	\$ 6,895	\$ 13,801	\$	\$ 483,832

A breakdown of the allowance for loan losses and recorded balances in loans at June 30, 2013 is as follows (dollars in thousands):

Three Months Ended June 30, 2013	Commercial	Commercial, financial and	Commercial	One to four	Consumer	Consumer	Unallocated	Total
	real estate	agricultural	construction	family residential	construction			
Allowance for loan loss reserve:								
Beginning balance ALLR	\$ 2,964	\$ 847	\$ 118	\$ 990	\$	\$ 13	\$ 105	\$ 5,037
Charge-offs	(21)	(4)		(6)		(5)		(36)
Recoveries	29	30	1	6		10		76
Provision	(311)	217	(22)	(113)		(5)	334	100
Ending balance ALLR	\$ 2,661	\$ 1,090	\$ 97	\$ 877	\$	\$ 13	\$ 439	\$ 5,177

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Six Months Ended

June 30, 2013

Allowance for loan loss
reserve:

Beginning balance ALLR	\$	3,267	\$	692	\$	125	\$	980	\$		\$	154	\$	5,218
Charge-offs		(456)		(76)				(13)				(71)		(616)
Recoveries		41		33		2		11				13		100
Provision		(191)		441		(30)		(101)				71		285
Ending balance ALLR	\$	2,661	\$	1,090	\$	97	\$	877	\$		\$	13	\$	439

At June 30, 2013

Loans:

Ending balance	\$	243,363	\$	84,145	\$	16,053	\$	94,254	\$	4,305	\$	13,435	\$	455,555
Ending balance ALLR		(2,661)		(1,090)		(97)		(877)				(13)		(439)
Net loans	\$	240,702	\$	83,055	\$	15,956	\$	93,377	\$	4,305	\$	13,422	\$	450,378

Ending balance ALLR:

Individually evaluated	\$	1,396	\$	643	\$	8	\$	148	\$		\$	13	\$	2,208
Collectively evaluated		1,265		447		89		729						439
Total	\$	2,661	\$	1,090	\$	97	\$	877	\$		\$	13	\$	439

Ending balance Loans:

Individually evaluated	\$	14,499	\$	6,668	\$	917	\$	640	\$		\$	22	\$	22,746
Collectively evaluated		228,864		77,477		15,136		93,614		4,305		13,413		432,809
Total	\$	243,363	\$	84,145	\$	16,053	\$	94,254	\$	4,305	\$	13,435	\$	455,555

Impaired loans, by definition, are individually evaluated.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans.

To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan's credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

In the context of the credit risk rating structure, the term Classified is defined as a problem loan which may or may not be in a nonaccrual status, dependent upon current payment status and collectability.

Strong (1)

Borrower is not vulnerable to sudden economic or technological changes. They have strong balance sheets and are within an industry that is very typical for our markets or type of lending culture. Borrowers also have strong financial and cash flow performance and excellent collateral (low loan to value or readily available to liquidate collateral) in conjunction with an impeccable repayment history.

Good (2)

Borrower shows limited vulnerability to sudden economic change. These borrowers have above average financial and cash flow performance and a very good repayment history. The balance sheet of the company is also very good as compared to peer and the company is in an industry that is familiar to our markets or our type of lending. The collateral securing the deal is also very good in terms of its type, loan to value, etc.

Average (3)

Borrower is typically a well-seasoned business, however may be susceptible to unfavorable changes in the economy, and could be somewhat affected by seasonal factors. The borrowers within this category exhibit financial and cash flow performance that appear average to slightly above average when compared to peer standards and they show an adequate payment history. Collateral securing this type of credit is good, exhibiting above average loan to values, etc.

Acceptable/Acceptable Watch (4)

A borrower within this category exhibits financial and cash flow performance that appear adequate and satisfactory when compared to peer standards and they show a satisfactory payment history. The collateral securing the request is within supervisory limits and overall is acceptable. Borrowers rated acceptable could also be newer businesses that are typically susceptible to unfavorable changes in the economy, and more than likely could be affected by seasonal factors.

Special Mention (5)

The borrower may have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Examples of this type of credit include a start-up company fully based on projections, a documentation issue that needs to be corrected or a general market condition that the borrower is working through to get corrected.

Substandard (6)

Substandard loans are classified assets exhibiting a number of well-defined weaknesses that jeopardize normal repayment. The assets are no longer adequately protected due to declining net worth, lack of earning capacity, or insufficient collateral offering the distinct possibility of the loss of a portion of the loan principal. Loans classified as substandard clearly represent troubled and deteriorating credit situations requiring constant supervision.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

Doubtful (7)

Loans in this category exhibit the same, if not more pronounced weaknesses used to describe the substandard credit. Loans are frozen with collection improbable. Such loans are not yet rated as Charge-off because certain actions may yet occur which would salvage the loan.

Charge-off/Loss (8)

Loans in this category are largely uncollectible and should be charged against the loan loss reserve immediately.

General Reserves:

For loans with a credit risk rating of 5 or better and any loans with a risk rating of 6 or 7 with no specific reserve, reserves are established based on the type of loan collateral, if any, and the assigned credit risk rating. Determination of the allowance is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on pools of homogenous loans based on historical loss experience, and consideration of current environmental factors and economic trends, all of which may be susceptible to significant change.

Using a historical average loss by loan type as a base, each loan graded as higher risk is assigned a specific percentage. Within the commercial loan portfolio, the historical loss rates are used for specific industries such as hospitality, gaming, petroleum, and forestry. The residential real estate and consumer loan portfolios are assigned a loss percentage as a homogenous group. If, however, on an individual loan the projected loss based on collateral value and payment histories are in excess of the computed allowance, the allocation is increased for the higher anticipated loss. These computations provide the basis for the allowance for loan losses as recorded by the Corporation.

Commercial construction loans in the amount of \$3.153 million, \$2.951 million and \$3.394 million for the periods ended June 30, 2014, December 31, 2013 and June 30, 2013, respectively did not receive a specific risk rating. These amounts represent loans made for land development and unimproved land purchases. Below is a breakdown of loans by risk category as of June 30, 2014 (dollars in thousands):

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	\$ 15	\$ 25,065	\$ 121,108	\$ 126,593	\$	\$ 1,719	\$	\$	\$ 274,500
Commercial, financial and agricultural	2,107	4,418	31,875	46,320		4,795			89,515
Commercial construction		460	2,919	3,616		402		3,153	10,550
One to four family residential real estate		2,329	1,303	4,344				97,892	105,868
Consumer construction								7,464	7,464
Consumer			20	39				14,984	15,043
Total loans	\$ 2,122	\$ 32,272	\$ 157,225	\$ 180,912	\$	\$ 6,916	\$	\$ 123,493	\$ 502,940

Below is a breakdown of loans by risk category as of December 31, 2013 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	\$ 1,502	\$ 23,310	\$ 116,702	\$ 125,010	\$	\$ 2,285	\$	\$	\$ 268,809
Commercial, financial and agricultural	3,741	4,348	27,455	39,070		5,041			79,655
Commercial construction	30	479	2,702	4,340		402		2,951	10,904
One-to-four family residential real estate	251	3,074	1,275	4,482		710		93,976	103,768
Consumer construction								6,895	6,895
Consumer	10		37	43		30		13,681	13,801
Total loans	\$ 5,534	\$ 31,211	\$ 148,171	\$ 172,945	\$	\$ 8,468	\$	\$ 117,503	\$ 483,832

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

Below is a breakdown of loans by risk category as of June 30, 2013 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable/ Acceptable Watch	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	\$ 2,294	\$ 22,319	\$ 86,404	\$ 111,180	\$ 16,446	\$ 4,531	\$ 189		\$ 243,363
Commercial, financial and agricultural	4,997	5,253	21,780	46,214	4,176	1,725			84,145
Commercial construction		723	5,119	5,660	755	402		3,394	16,053
One to four family residential real estate		1,954	2,465	4,565				85,270	94,254
Consumer construction								4,305	4,305
Consumer		109	36	470				12,820	13,435
Total loans	\$ 7,291	\$ 30,358	\$ 115,804	\$ 168,089	\$ 21,377	\$ 6,658	\$ 189	\$ 105,789	\$ 455,555

Impaired Loans

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal. There was no interest income recorded during impairment for the three and six months ended June 30, 2014. Interest income that would have been recognized during these periods was \$.029 million and \$.053 million, respectively. For the three and six months ended June 30, 2013, the amounts that would have been recognized were \$.059 million and \$.117 million, respectively.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loans basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

The following is a summary of impaired loans and their effect on interest income (dollars in thousands):

June 30, 2014	Nonaccrual Basis	Accrual Basis	QTD	YTD	Related Valuation Reserve	Three Months Ended	Six Months Ended
			Average Investment	Average Investment		Interest Income Recognized During Impairment Accrual Basis	Interest Income Recognized During Impairment Accrual Basis
<i>With no valuation reserve:</i>							
Commercial real estate	\$ 278	\$	\$ 279	\$ 304	\$	\$ 4	\$ 8
Commercial, financial and agricultural	82		97	140		2	4
Commercial construction							
One to four family residential real estate	37		38	97			3
Consumer construction							
Consumer			3	6			
<i>With a valuation reserve:</i>							
Commercial real estate	\$ 176	\$	\$ 176	\$ 176	\$ 104	\$ 3	\$ 7
Commercial, financial and agricultural	1,726		1,157	918	1,110	13	20
Commercial construction							
One to four family residential real estate	346		279	299	100	7	11
Consumer construction							
Consumer	7		7	8	1		
<i>Total:</i>							
Commercial real estate	\$ 454	\$	\$ 455	\$ 480	\$ 104	\$ 7	\$ 15
Commercial, financial and agricultural	1,808		1,254	1,058	1,110	15	24
Commercial construction							
One to four family residential real estate	383		317	396	100	7	14
Consumer construction							
Consumer	7		10	14	1		
Total	\$ 2,652	\$	\$ 2,036	\$ 1,948	\$ 1,315	\$ 29	\$ 53

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

For the Year Ended: December 31, 2013	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
<i>With no valuation reserve:</i>						
Commercial real estate	\$ 513	\$	\$ 3,045	\$	\$	\$ 153
Commercial, financial and agricultural	59		505			13
Commercial construction			626			3
One to four family residential real estate	361		625			16
Consumer construction						
Consumer			2			
<i>With a valuation reserve:</i>						
Commercial real estate	\$ 59	\$	\$ 71	\$ 14	\$	\$ 5
Commercial, financial and agricultural	752		834	265		18
Commercial construction						
One to four family residential real estate	250		261	78		20
Consumer construction						
Consumer	30		30	13		
<i>Total:</i>						
Commercial real estate	\$ 572	\$	\$ 3,116	\$ 14	\$	\$ 158
Commercial, financial and agricultural	811		1,339	265		31
Commercial construction			626			3
One to four family residential real estate	611		886	78		36
Consumer construction						
Consumer	30		32	13		
Total	\$ 2,024	\$	\$ 5,999	\$ 370	\$	\$ 228

5. LOANS (Continued)

June 30, 2013	Nonaccrual Basis	Accrual Basis	QTD	YTD	Related Valuation Reserve	Three Months Ended	Six Months Ended	Interest Income on Accrual Basis
			Average Investment	Average Investment		Interest Income Recognized During Impairment	Interest Income Recognized During Impairment	
<i>With no valuation reserve:</i>								
Commercial real estate	\$ 728	\$	\$ 733	\$ 797	\$	\$	\$ 14	\$ 26

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Commercial, financial and agricultural	176	206	248		3	6
Commercial construction			275			3
One to four family residential real estate	94	133	165		3	5
Consumer construction						
Consumer	9	2	1			
<i>With a valuation reserve:</i>						
Commercial real estate	\$ 2,329	\$ 2,308	\$ 2,298	\$ 1,240	\$ 30	\$ 60
Commercial, financial and agricultural	341	267	199	106	4	6
Commercial construction						
One to four family residential real estate	306	303	289	126	5	11
Consumer construction						
Consumer						
<i>Total:</i>						
Commercial real estate	\$ 3,057	\$ 3,041	\$ 3,095	\$ 1,240	\$ 44	\$ 86
Commercial, financial and agricultural	517	473	447	106	7	12
Commercial construction			275			3
One to four family residential real estate	400	436	454	126	8	16
Consumer construction						
Consumer	9	2	1			
Total	\$ 3,983	\$ 3,952	\$ 4,272	\$ 1,472	\$ 59	\$ 117

A summary of past due loans at June 30, 2014, December 31, 2013 and June 30, 2013 is as follows (dollars in thousands):

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

	June 30, 2014			December 31, 2013			June 30, 2013		
	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total	30-89 days Past Due (accruing)	90+ days Past Due/ Nonaccrual	Total
Commercial real estate	\$ 602	\$ 454	\$ 1,056	\$	\$ 572	\$ 572	\$ 146	\$ 3,057	\$ 3,203
Commercial, financial and agricultural	5	1,808	1,813	4	811	815	92	517	609
Commercial construction				20		20			
One to four family residential real estate	141	383	524	201	611	812	100	400	500
Consumer construction									
Consumer	57	7	64	14	30	44	18	9	27
Total past due loans	\$ 805	\$ 2,652	\$ 3,457	\$ 239	\$ 2,024	\$ 2,263	\$ 356	\$ 3,983	\$ 4,339

5. LOANS (Continued)

A roll-forward of nonperforming loan activity for the three months ended June 30, 2014 (dollars in thousands):

NONACCRUAL	For the Three Months Ended June 30, 2014						
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
Beginning balance	\$ 455	\$ 730	\$	\$ 299	\$	\$ 7	\$ 1,491
Principal payments	(3)	(63)		(14)			(80)
Charge-offs						(6)	(6)
Advances							
Class transfers							
Transfers to OREO							
Transfers to accruing							
Transfers from accruing		1,139		89		6	1,234
Other	2	2		9			13

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Ending balance \$ 454 \$ 1,808 \$ \$ 383 \$ \$ 7 \$ 2,652

A roll-forward of nonperforming loan activity for the three months ended June 30, 2013 (dollars in thousands):

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NONACCRUAL	For the Three Months Ended June 30, 2013						Total
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	
Beginning balance	\$ 2,963	\$ 424	\$	\$ 446	\$	\$	\$ 3,833
Principal payments	(31)	(66)		(16)			(113)
Charge-offs				(6)		(4)	(10)
Advances							
Class transfers							
Transfers to OREO				(38)			(38)
Transfers to accruing							
Transfers from accruing	126	179		14		13	332
Other	(1)	(20)					(21)
Ending balance	\$ 3,057	\$ 517	\$	\$ 400	\$	\$ 9	\$ 3,983

A roll-forward of nonperforming loan activity for the first six months ended June 30, 2014 (dollars in thousands):

NONACCRUAL	For the Six Months Ended June 30, 2014						Total
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	
Beginning balance	\$ 572	\$ 811	\$	\$ 611	\$	\$ 30	\$ 2,024
Principal payments	(102)	(81)		(22)		(4)	(209)
Charge-offs		(53)		(3)		(25)	(81)
Advances							
Class transfers							
Transfers to OREO	(26)			(256)			(282)
Transfers to accruing		(10)		(127)			(137)
Transfers from accruing		1,139		171		6	1,316
Other	10	2		9			21
Ending balance	\$ 454	\$ 1,808	\$	\$ 383	\$	\$ 7	\$ 2,652

5. LOANS (Continued)

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

A roll-forward of nonperforming loan activity for the first six months ended June 30, 2013 (dollars in thousands):

NONACCRUAL	For the Six Months Ended June 30, 2013						Total
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	
Beginning balance	\$ 3,071	\$ 436	\$ 675	\$ 505	\$	\$	\$ 4,687
Principal payments	(148)	(68)	(100)	(65)			(381)
Charge-offs	(329)	(72)		(13)		(4)	(418)
Advances							
Class transfers							
Transfers to OREO			(580)	(107)			(687)
Transfers to accruing							
Transfers from accruing	443	241		76		13	773
Other	20	(20)	5	4			9
Ending balance	\$ 3,057	\$ 517	\$	\$ 400	\$	\$ 9	\$ 3,983

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

A roll-forward of nonperforming loan activity during the year ended December 31, 2013 (dollars in thousands):

Beginning balance	\$	3,071	\$	436	\$	675	\$	505	\$		\$	4,687
Principal payments		(1,478)		(319)		(100)		(88)		(2)		(1,987)
Advances												
Transfers to OREO		(208)		(37)		(580)		(107)				(932)
Transfers from accruing		443		1,346				434		36		2,259

Troubled Debt Restructuring

Troubled debt restructurings (TDR) are determined on a loan-by-loan basis. Generally restructurings are related to interest rate reductions, loan term extensions and short term payment forbearance as means to maximize collectability of troubled credits. If a portion of the TDR loan is uncollectible (including forgiveness of principal), the uncollectible amount will be charged off against the allowance at the time of the restructuring. In general, a borrower must make at least six consecutive timely payments before the Corporation would consider a return of a restructured loan to accruing status in accordance with FDIC guidelines regarding restoration of credits to accrual status.

The Corporation has, in accordance with generally accepted accounting principles and per recently enacted accounting standard updates, evaluated all loan modifications to determine the fair value impact of the underlying asset. The carrying amount of the loan is compared to the expected payments to be received, discounted at the loan's original rate, or for collateral dependent loans, to the fair value of the collateral.

5. LOANS (Continued)

A summary of troubled debt restructurings for the periods indicated is as follows (dollars in thousands):

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

	June 30, 2014		December 31, 2013		June 30, 2013	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
Commercial real estate		\$		\$		\$
Commercial, financial and agricultural			1	528		
Commercial construction						
One to four family residential real estate	1	89				
Consumer construction						
Consumer						
Total troubled debt restructurings	1	\$ 89	1	\$ 528		\$

A roll-forward of troubled debt restructuring during the three months ended June 30, 2014 (dollars in thousands):

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

ACCRUING										
Beginning balance	\$	1,009	\$	1,186	\$	858	\$	187	\$	3,240
Principal payments		(2)								(2)
Charge-offs										
Advances										
New restructured										
Transferred out of TDR										
Transfers to nonaccrual								(89)		(89)
Ending Balance	\$	1,007	\$	1,186	\$	858	\$	98	\$	3,149
NONACCRUAL										
Beginning balance	\$		\$	508	\$		\$		\$	508
Principal payments										
Charge-offs										
Advances										
New restructured										
Transfers to foreclosed properties										
Transfers from accruing								89		89
Ending Balance	\$		\$	508	\$		\$	89	\$	597
TOTALS										
Beginning balance	\$	1,009	\$	1,694	\$	858	\$	187	\$	3,748
Principal payments		(2)								(2)
Charge-offs										
Advances										
New restructured										
Transfers out of TDRs										
Transfers to nonaccrual								(89)		(89)
Transfers to foreclosed properties										
Transfers from accruing								89		89
Ending Balance	\$	1,007	\$	1,694	\$	858	\$	187	\$	3,746

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

A roll-forward of troubled debt restructuring during the three months ended June 30, 2013 (dollars in thousands):

ACCRUING										
Beginning balance	\$	3,588	\$	2,174	\$	858	\$	100	\$	6,720
Principal payments		(25)								(25)
Charge-offs										
Advances										
New restructured										
Transferred out of TDRs										
Transfers to nonaccrual										
Ending Balance	\$	3,563	\$	2,174	\$	858	\$	100	\$	6,695
NONACCRUAL										
Beginning balance	\$	2,169	\$		\$		\$	106	\$	2,275
Principal payments										
Charge-offs										
Advances										
New restructured										
Transfers to foreclosed properties										
Transfers from accruing										
Ending Balance	\$	2,169	\$		\$		\$	106	\$	2,275
TOTALS										
Beginning balance	\$	5,757	\$	2,174	\$	858	\$	206	\$	8,995
Principal payments		(25)								(25)
Charge-offs										
Advances										
New restructured										
Transfers out of TDRs										
Transfers to nonaccrual										
Transfers to foreclosed properties										

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Transfers from accruing

Ending Balance	\$	5,732	\$	2,174	\$	858	\$	206	\$	8,970
----------------	----	-------	----	-------	----	-----	----	-----	----	-------

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. LOANS (Continued)

A roll-forward of troubled debt restructuring during the six months ended June 30, 2014 (dollars in thousands):

ACCRUING	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
Beginning balance	\$ 3,520	\$ 1,186	\$ 858	\$ 99		\$ 5,663
Principal payments	(2,513)			(3)		(2,516)
Charge-offs						
Advances						
New restructured						
Transferred out of TDRs						
Transfers from accruing				91		91
Transfers to nonaccruing				(89)		(89)
Ending Balance	\$ 1,007	\$ 1,186	\$ 858	\$ 98		\$ 3,149
NONACCRUAL						
Beginning balance	\$	\$ 523	\$	\$ 91		\$ 614
Principal payments		(15)				(15)
Charge-offs						
Advances						
New restructured						
Transfers to accruing				(91)		(91)
Transfers from accruing				89		89
Ending Balance	\$	\$ 508	\$	\$ 89		\$ 597
TOTALS						
Beginning balance	\$ 3,520	\$ 1,709	\$ 858	\$ 190		\$ 6,277
Principal payments	(2,513)	(15)		(3)		(2,531)
Charge-offs						
Advances						
New restructured						
Transfers out of TDR						
Transfers to nonaccrual				(89)		(89)

Transfers to accruing					89	89
Transfer from accruing						
Ending Balance	\$	1,007	\$	1,694	\$	858
					187	\$
						3,746

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

A roll-forward of troubled debt restructuring during the six months ended June 30, 2013 (dollars in thousands):

ACCRUING	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
Beginning balance	\$ 3,611	\$ 1,221	\$ 858	\$ 102	\$	\$ 5,792
Principal payments	(48)			(2)		(50)
Charge-offs						
Advances						
New restructured		953				953
Transferred out of TDRs						
Transfers to nonaccrual						
Ending Balance	\$ 3,563	\$ 2,174	\$ 858	\$ 100	\$	\$ 6,695
NONACCRUAL						
Beginning balance	\$ 2,162	\$	\$	\$ 102	\$	\$ 2,264
Principal payments						
Charge-offs						
Advances						
New restructured	7			4		11
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	\$ 2,169	\$	\$	\$ 106	\$	\$ 2,275
TOTALS						
Beginning balance	\$ 5,773	\$ 1,221	\$ 858	\$ 204	\$	\$ 8,056
Principal payments	(48)			(2)		(50)
Charge-offs						
Advances						
New restructured	7	953		4		964
Transfers out of TDRs						
Transfers to nonaccrual						
Transfers to foreclosed properties						

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Transfers from accruing

Ending Balance	\$	5,732	\$	2,174	\$	858	\$	206	\$	8,970
----------------	----	-------	----	-------	----	-----	----	-----	----	-------

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

5. **LOANS** (Continued)

A roll-forward of troubled debt restructuring during the year ended December 31, 2013 (dollars in thousands):

ACCRUING	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
Beginning balance	\$ 3,611	\$ 1,221	\$ 858	\$ 102	\$	\$ 5,792
Principal payments	(91)	(460)		(3)		(554)
Charge-offs						
Advances						
New restructured		953				953
Transferred out of TDR						
Transfers to nonaccrual		(528)				(528)
Ending Balance	\$ 3,520	\$ 1,186	\$ 858	\$ 99	\$	\$ 5,663
NONACCRUAL						
Beginning balance	\$ 2,162	\$	\$	\$ 102	\$	\$ 2,264
Principal payments	(1,376)	(5)		(15)		(1,396)
Charge-offs	(793)					(793)
Advances						
New restructured	7	528		4		539
Transfers to foreclosed properties						
Transfers from accruing						
Ending Balance	\$	\$ 523	\$	\$ 91	\$	\$ 614
TOTALS						
Beginning balance	\$ 5,773	\$ 1,221	\$ 858	\$ 204	\$	\$ 8,056
Principal payments	(1,467)	(465)		(18)		(1,950)
Charge-offs	(793)					(793)
Advances						
New restructured	7	1,481		4		1,492
Transfers out of TDRs						
Transfers to nonaccrual		(528)				(528)
Transfers to foreclosed properties						

Transfers from accruing

Ending Balance	\$	3,520	\$	1,709	\$	858	\$	190	\$	6,277
----------------	----	-------	----	-------	----	-----	----	-----	----	-------

Insider Loans

The Bank, in the ordinary course of business, grants loans to the Corporation's executive officers and directors, including their families and firms in which they are principal owners. Activity in such loans is summarized below (dollars in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Loans outstanding, beginning of period	\$ 9,043	\$ 11,297	\$ 11,297
New loans		496	496
Net activity on revolving lines of credit	1,178	(266)	(25)
Principal payments	(1,523)	(2,484)	(1,298)
Loans outstanding, end of period	\$ 8,698	\$ 9,043	\$ 10,470

There were no loans to related parties classified substandard as of June 30, 2014, December 31, 2013 or June 30, 2013. In addition to the outstanding balances above, there were unfunded commitments of \$.575 million to related parties at June 30, 2014.

6. MORTGAGE SERVICING RIGHTS

Mortgage servicing rights (MSRs) are recorded when loans are sold in the secondary market with servicing retained. As of June 30, 2014, the Corporation had obligations to service approximately \$138 million of residential

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

first mortgage loans. The valuation is based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans. The fair value of the capitalized servicing rights approximates the carrying value. The key economic assumptions used in determining the fair value of the mortgage servicing rights include an annual constant prepayment speed of 10.13% and a discount rate of 8.16% for June 30, 2014.

The following summarizes mortgage servicing rights capitalized and amortized, along with the aggregate activity in related valuation allowances (dollars in thousands):

	Six Months Ended June 30, 2014	Year Ended December 31, 2013	Six Months Ended June 30, 2013
Balance at beginning of period	\$ 1,129	\$ 638	\$ 638
Additions from loans sold with servicing retained	75	675	225
Amortization	(143)	(184)	(80)
Balance at end of period	\$ 1,061	\$ 1,129	\$ 783

7. BORROWINGS

Borrowings consist of the following at June 30, 2014, December 31, 2013 and June 30, 2013 (dollars in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Federal Home Loan Bank fixed rate advances at June 30, 2014 with a weighted average rate of 1.82% maturing in 2014, 2016 and 2018	\$ 35,000	\$ 35,000	\$ 35,000
Correspondent bank line of credit - holding company	500	2,000	
Bank line of credit - wholly-owned asset based lending subsidiary	2,835		
Correspondent bank term note, current floor rate of 4%, maturing March 22, 2017	2,900		
	852	852	925

USDA Rural Development, fixed-rate note payable, maturing
August 24, 2024, interest payable at 1%

\$	42,087	\$	37,852	\$	35,925
----	---------------	----	--------	----	--------

The Federal Home Loan Bank borrowings are collateralized at June 30, 2014 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately \$44.140 million; mortgage related and municipal securities with an amortized cost and estimated fair value of \$4.378 million and \$4.530 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling \$3.060 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of June 30, 2014.

The USDA Rural Development borrowing is collateralized by loans totaling \$.125 million originated and held by the Corporation's wholly owned subsidiary, First Rural Relending, and an assignment of a demand deposit account in the amount of \$.798 million, and guaranteed by the Corporation.

The Corporation currently has two banking borrowing relationships. The first relationship consists of a line of credit and a term note. The line of credit bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on March 22, 2015. The term note bears the same interest and matures on March 22, 2017. The second borrowing relationship consists of a \$10 million revolving line of credit, which can be increased to \$25 million upon request, used to support asset based lending activities at a wholly-owned subsidiary that currently bears interest at 90-day LIBOR plus 2.75% and has an initial term that expires on September 10, 2016.

8. STOCK COMPENSATION PLANS

On May 22, 2012, the Company's shareholders approved the Mackinac Financial Corporation 2012 Incentive Compensation Plan, under which current and prospective employees, non-employee directors and consultants

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

may be awarded incentive stock options, non-statutory stock options, shares of restricted stock units (RSUs), or stock appreciation rights. The aggregate number of shares of the Company's common stock issuable under the plan is 575,000, which included 392,152 option shares outstanding at that time.

The Corporation, in August 2012 and March 2014, granted Restricted Stock Units (RSUs) to members of the Board of Directors and Management. In August 2012, 148,500 RSUs were granted at a market value of \$7.91 and will vest equally over a four year term. In exchange for the grant of the August 2012 RSUs, various previously issued stock option awards were surrendered. In March 2014, 52,774 RSUs were granted at a market value of \$12.95, also vesting equally over a four year term. The RSUs were awarded at no cost to the employee. Compensation cost to be recognized over the four-year vesting periods, is \$1.175 million and \$.683 million, respectively. On August 31, 2013, the Corporation issued 37,125 shares of its common stock for vested RSUs. As of June 30, 2014, RSUs totaling 164,149 were unvested and unrecognized compensation expense was \$1.270 million.

A summary of stock option transactions for the six months ended June 30, 2014 and 2013, and the year ended December 31, 2013, is as follows:

	June 30, 2014	December 31, 2013	June 30, 2013
Outstanding shares at beginning of year	237,152	242,152	242,152
Granted during the period			
Exercised during the period			
Expired / forfeited during the period		(5,000)	
Outstanding shares at end of period	237,152	237,152	242,152
Exercisable shares at end of period	124,861	124,861	126,361
Weighted average exercise price per share at end of period	\$ 9.80	\$ 9.80	\$ 9.88
Shares available for grant at end of period			

There were no options granted in the first six months of 2014 and 2013.

Following is a summary of the options outstanding and exercisable at June 30, 2014:

Exercise Price	Outstanding	Number Exercisable	Unvested Options	Weighted Average Remaining Contractual Life-Years
\$ 9.75	217,152	120,861	96,291	.48
\$ 10.65	10,000	2,000	8,000	1.04
\$ 12.00	10,000	2,000	8,000	2.46
	237,152	124,861	112,291	.59

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. STOCK COMPENSATION PLANS (Continued)

Options issued since the Corporation's recapitalization in December of 2004 call for 20% immediate vesting upon issue and subsequent vesting to occur over a two to five year period, based upon the market value appreciation of the underlying Corporation's stock. Compensation related to these options was expensed based upon the vesting period without consideration given to market value appreciation. There are no future compensation expenses related to existing option programs.

9. INCOME TAXES

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of June 30, 2014 had a net operating loss and tax credit carryforwards for tax purposes of approximately \$17.2 million, and \$2.4 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately \$10.3 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is \$1.400 million for the NOL and the equivalent value of tax credits, which is approximately \$.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation has reported deferred tax assets of \$9.097 million at June 30, 2014, which is net of a valuation allowance of \$.760 million. Management evaluated the deferred tax valuation allowance as of June 30, 2014 and determined that no adjustment to the valuation was warranted. The remaining valuation allowance pertains to the existing tax credit carryovers, which will only be utilized after all net operating loss carryforwards. Since a portion of these tax credits may expire before that occurs, a valuation allowance for these has been established. The Corporation will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

10. FAIR VALUE MEASUREMENTS

Fair value estimates, methods, and assumptions are set forth below for the Corporation's financial instruments:

Cash, cash equivalents, and interest-bearing deposits - The carrying values approximate the fair values for these assets.

Securities - Fair values are based on quoted market prices where available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Federal Home Loan Bank stock Federal Home Loan Bank stock is carried at cost, which is its redeemable value and approximates its fair value, since the market for this stock is limited.

Loans - Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, residential mortgage, and other consumer. The fair value of loans is calculated by discounting scheduled cash flows using discount rates reflecting the credit and interest rate risk inherent in the loan.

The methodology in determining fair value of nonaccrual loans is to average them into the blended interest rate at 0% interest. This has the effect of decreasing the carrying amount below the risk-free rate amount and, therefore, discounts the estimated fair value.

Impaired loans are measured at the estimated fair value of the expected future cash flows at the loan's effective interest rate or the fair value of the collateral for loans which are collateral dependent. Therefore, the carrying values of impaired loans approximate the estimated fair values for these assets.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUE MEASUREMENTS (Continued)

Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and savings, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows applying interest rates currently being offered on similar time deposits.

Borrowings - Rates currently available for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt. The fair value of borrowed funds due on demand is the amount payable at the reporting date.

Accrued interest - The carrying amount of accrued interest approximates fair value.

Off-balance-sheet instruments - The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements, the current interest rates, and the present creditworthiness of the counterparties. Since the differences in the current fees and those reflected to the off-balance-sheet instruments at year-end are immaterial, no amounts for fair value are presented.

The following table presents information for financial instruments at June 30, 2014, December 31, 2013 and June 30, 2013 (dollars in thousands):

	Level in Fair Value Hierarchy	June 30, 2014		December 31, 2013		June 30, 2013	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:							
Cash and cash equivalents	Level 1	\$ 20,746	\$ 20,746	\$ 18,219	\$ 18,219	\$ 26,219	\$ 26,219
Interest-bearing deposits	Level 2	235	235	10	10	10	10
Securities available for sale	Level 2	47,374	47,374	44,388	44,388	47,307	47,307
Federal Home Loan Bank stock	Level 2	3,060	3,060	3,060	3,060	3,060	3,060
Net loans	Level 2	497,843	499,609	479,171	479,538	450,378	444,638
Accrued interest receivable	Level 3	1,485	1,485	1,351	1,351	1,636	1,636

Total financial assets		\$	570,743	\$	572,509	\$	546,199	\$	546,566	\$	528,610	\$	522,870
Financial liabilities:													
Deposits	Level 2	\$	484,016	\$	485,230	\$	466,299	\$	465,431	\$	447,907	\$	446,438
Borrowings	Level 2		42,087		42,699		37,852		37,487		35,925		35,621
Accrued interest payable	Level 3		186		186		182		182		229		229
Total financial liabilities		\$	526,289	\$	528,115	\$	504,333	\$	503,100	\$	484,061	\$	482,288

Limitations - Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include premises and equipment, other assets, and other liabilities. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The following is information about the Corporation's assets and liabilities measured at fair value on a recurring basis at June 30, 2014, and the valuation techniques used by the Corporation to determine those fair values.

Level 1: In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUE MEASUREMENTS (Continued)

Level 2: Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3: Level 3 inputs are unobservable inputs, including inputs available in situations where there is little, if any, market activity for the related asset or liability.

The fair value of all investment securities at June 30, 2014 and June 30, 2013 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to Note 4 Investment Securities.

The Corporation had no Level 3 assets or liabilities on a recurring basis as of June 30, 2014, December 31, 2013 or June 30, 2013.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Corporation's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

The Corporation also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets include loans and other real estate owned. The Corporation has estimated the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections.

Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2014

Balance at	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Total Losses for Three Months Ended	Total Losses for Six Months Ended
------------	--	---	---------------------------------------	--	--------------------------------------

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

(dollars in thousands)	June 30, 2014	(Level 1)	(Level 2)	(Level 3)	June 30, 2014	June 30, 2014
Assets						
Impaired loans	\$ 2,652	\$	\$	2,652	\$ 22	\$ 430
Other real estate owned	1,947			1,947	14	14
					\$ 36	\$ 444

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2013

(dollars in thousands)	Balance at December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Year Ended December 31, 2013
Assets					
Impaired loans	\$ 2,024	\$	\$	2,024	\$ 2,075
Other real estate owned	1,884			1,884	265
					\$ 2,340

Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2013

(dollars in thousands)	Balance at June 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Three Months Ended June 30, 2013	Total Losses for Six Months Ended June 30, 2013
Assets						
Impaired loans	\$ 3,983	\$	\$	3,983	\$ 10	\$ 418
Other real estate owned	2,481			2,481	87	89
					\$ 97	\$ 507

The Corporation had no investments subject to fair value measurement on a nonrecurring basis.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUE MEASUREMENTS (Continued)

Impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Corporation estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

11. SHAREHOLDERS' EQUITY

In August 2012 the Corporation consummated the previously announced \$7.000 million rights offering and the investment by Steinhardt Capital Investors, LLLP (SCI) by issuing 2,140,123 shares of common stock for net proceeds of \$11.506 million. Also, in August 2012, the Corporation exited the TARP Capital Purchase Program (CPP) when the Corporation's 11,000 Series A Preferred Shares, issued in April, 2009 to the U.S. Treasury, were publically offered and sold. The Corporation repurchased the 379,310 of Common Stock Warrants issued to the U.S. Treasury under the CPP in December, 2012 for \$1.3 million. During 2013, the Corporation redeemed all of the outstanding Series A Preferred Shares.

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The Corporation repurchased 55,594 shares in 2013 and 13,700 shares in the first quarter of 2014. The share repurchases were conducted under Board authorizations made and publically announced of \$600,000 on February 27, 2013 and an additional \$600,000 on December 17, 2013. Neither of these authorizations has an expiration date.

12. COMMITMENTS, CONTINGENCIES AND CREDIT RISK

Financial Instruments With Off-Balance-Sheet Risk

The Corporation is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

The Corporation's exposure to credit loss, in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit, is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. These commitments are as follows (dollars in thousands):

	June 30, 2014		December 31, 2013		June 30, 2013
Commitments to extend credit:					
Variable rate	\$ 54,048	\$	36,039	\$	37,462
Fixed rate	18,604		15,070		19,873
Standby letters of credit - Variable rate	5,742		5,077		3,805
Credit card commitments - Fixed rate	3,234		3,152		3,113
	\$ 81,628	\$	59,338	\$	64,253

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. COMMITMENTS, CONTINGENCIES AND CREDIT RISK (Continued)

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The commitments are structured to allow for 100% collateralization on all standby letters of credit.

Credit card commitments are commitments on credit cards issued by the Corporation's subsidiary and serviced by other companies. These commitments are unsecured.

Legal Proceedings and Contingencies

In the normal course of business, the Corporation is involved in various legal proceedings. For expanded discussion on the Corporation's legal proceedings, see Part II, Item 1, "Legal Proceedings" in this report.

Concentration of Credit Risk

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank's most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at June 30, 2014 represents \$103.598 million, or 27.66%, compared to \$95.510 million, or 27.80%, of the commercial loan portfolio on June 30, 2013. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank's locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

13. SUBSEQUENT EVENT

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

On July 18, 2014, the Corporation announced the signing of a definitive agreement to acquire Peninsula Financial Corporation (Peninsula) for \$13.285 million. The purchase price of Peninsula contemplates a special dividend to Peninsula shareholders prior to the consummation that would reduce the acquired equity to \$10.5 million. Peninsula is headquartered in Marquette County, Michigan and is the parent of Peninsula Bank with June 30 assets of approximately \$132 million and six banking offices. The consummation of this transaction is expected to occur late in the third or early in the fourth quarter of 2014.

Table of Contents

Forward Looking Statements/Risk Factors

FORWARD LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Corporation intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and is including this statement for purposes of these safe harbor provisions. Forward-looking statements which are based on certain assumptions and describe future plans, strategies, or expectations of the Corporation, are generally identifiable by use of the words "believe", "expect", "intend", "anticipate", "estimate", "project", or similar expressions. The Corporation's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could cause actual results to differ from the results in forward-looking statements include, but are not limited to:

RISK FACTORS

Risks Related to our Lending and Credit Activities

- *Our business may be adversely affected by conditions in the financial markets and economic conditions generally, as our borrowers' ability to repay loans and the value of the collateral securing our loans decline.*
- *Weakness in the markets for residential or commercial real estate, including the secondary residential mortgage loan markets, could reduce our net income and profitability.*
- *Our allowance for loan losses may be insufficient.*

Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of our control, may require an increase in our allowance for loan losses.

Risks Related to Our Operations

- *We are subject to interest rate risk.*

Our earnings and cash flows are largely dependent upon our net interest income, which is the difference between interest income on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. There are many factors which influence interest rates that are beyond our control, including but not limited to general economic conditions and governmental policy, in particular, the policies of the FRB.

- *Changes in our accounting policies or in accounting standards could materially affect how we report our financial results and condition.*
- *Our controls and procedures may fail or be circumvented.*
- *Impairment of deferred income tax assets could require charges to earnings, which could result in an adverse impact on our results of operations.*

In assessing the realizability of deferred income tax assets, management considers whether it is more likely than not that some allowance requires management to evaluate all available evidence, both negative and positive. Positive evidence necessary to overcome the negative evidence includes whether future taxable income in sufficient amounts and character within the carry back and carry forward periods is available under the tax law, including the use of tax planning strategies. When negative evidence (e.g. cumulative losses in recent years, history of operating loss or tax credit carry forwards expiring unused) exists, more positive evidence than negative evidence will be necessary. At June 30, 2014, net deferred tax assets are approximately \$9.1 million. If an additional valuation allowance becomes necessary with respect to such balance, it could have a material adverse effect on our business, results of operations and financial condition.

- *Our information systems may experience an interruption or breach in security.*

Table of Contents

Risks Related to Legal and Regulatory Compliance

- *We operate in a highly regulated environment, which could increase our cost structure or have other negative impacts on our operations.*
- *The full impact of the recently enacted Dodd-Frank Act is currently unknown given that many of the details and substance of the new laws will be implemented through agency rulemaking.*

Among the many requirements if the Dodd-Frank Act for new banking regulations is a requirement for new capital regulations to be adopted within 15 months. These regulations must be at least as stringent as, and may call for higher levels of capital than, current regulations.

Strategic Risks

- *Maintaining or increasing our market share may depend on lowering prices and market acceptance of new products and services.*
- *Future growth or operating results may require us to raise additional capital but that capital may not be available.*

Reputation Risks

- *Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of our computer system or otherwise, could severely harm our business.*

Liquidity Risks

- *We could experience an unexpected inability to obtain needed liquidity.*

The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets and its access to alternative sources of funds. We seek to ensure our funding needs are met by maintaining an appropriate level of liquidity through asset/liability management.

Risks Related to an Investment in Our Common Stock

- *Limited trading activity for shares of our common stock may contribute to price volatility.*
- *Our securities are not an insured deposit.*
- *You may not receive dividends on your investment in common stock.*

Our ability to pay dividends is dependent upon our receipt of dividends from the Bank, which is subject to regulatory restrictions. Such restrictions, which govern state-chartered banks, generally limit the payment of dividends on bank stock to the bank's undivided profits after all payments of all necessary expenses, provided that the bank's surplus equals or exceeds its capital.

These risks and uncertainties should be considered in evaluating forward-looking statements. Further information concerning the Corporation and its business, including additional factors that could materially affect the Corporation's financial results, is included in the Corporation's filings with the Securities and Exchange Commission. All forward-looking statements contained in this report are based upon information presently available and the Corporation assumes no obligation to update any forward-looking statements.

Table of Contents

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. This discussion should be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation's Annual Report and Form 10-K for the year-ended December 31, 2013. Throughout this discussion, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded a second quarter 2014 income of \$.806 million or \$.15 per share compared to net income available to common shareholders of \$1.197 million, or \$.22 per share for the second quarter of 2013. Operating results for the first six months of 2014 totaled \$1.466 million or \$.27 per share, compared to \$1.873 million, or \$.34 per share, for the same period in 2013.

Weighted average shares totaled 5,529,290 shares for the six month period in 2014 and 5,527,690 shares in the 2014 second quarter compared to 5,557,842 shares for the six month period in 2013 and 5,556,133 shares in the 2013 second quarter of 2013.

The net interest margin for the second quarter of 2014 increased to \$5.659 million, or 4.18%, compared to \$5.269 million, or 4.16% in the second quarter of 2013. The six month margin in 2014 was \$11.252 million, or 4.21% compared to \$10.425 million, or 4.17%.

Total assets of the Corporation at June 30, 2014 were \$595.869 million, up by \$42.368 million, or 7.65% from the \$553.501 million in total assets reported at June 30, 2013 and up by \$23.069 million, or 4.03%, from total assets of \$572.800 million at year-end 2013. The loan portfolio increased \$19.108 million, or 3.95%, from December 31, 2013 balances of \$483.832 million. Deposits totaled \$484.016 million at June 30, 2014, an increase of \$17.717 million from the \$466.299 million at December 31, 2013.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased \$2.527 million during the first half of 2014. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased \$2.986 million from December 31, 2013 to June 30, 2014, with the balance on June 30, 2014, totaling \$47.374 million. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of June 30, 2014, investment securities with an estimated fair value of \$4.605 million were pledged.

Loans

Through the first half of 2014, loan balances increased by \$19.108 million, or 3.95%, from December 31, 2013 balances of \$483.832 million. During the first half of 2014, the Bank had total loan production of \$86 million, which included \$11 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization, and also SBA/USDA loan sales of \$4.724 million, and nonperforming loans transferred to other real estate owned (OREO) amounting to \$.282 million.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Table of Contents

Following is a summary of the loan portfolio at June 30, 2014, December 31, 2013 and June 30, 2013 (dollars in thousands):

	June 30, 2014	Percent of Total	December 31, 2013	Percent of Total	June 30, 2013	Percent of Total
Commercial real estate	\$ 274,500	54.58%	\$ 268,809	55.56%	\$ 243,363	53.42%
Commercial, financial, and agricultural	89,515	17.80	79,655	16.46	84,145	18.47
One to four family residential real estate	105,868	21.05	103,768	21.45	94,254	20.69
Construction:						
Consumer	7,464	1.48	6,895	1.43	4,305	.95
Commercial	10,550	2.10	10,904	2.25	16,053	3.52
Consumer	15,043	2.99	13,801	2.85	13,435	2.95
Total loans	\$ 502,940	100.00%	\$ 483,832	100.00%	\$ 455,555	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of June 30, 2014, December 31, 2013 and June 30, 2013 (dollars in thousands):

	June 30, 2014			December 31, 2013			June 30, 2013		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital
Real estate - operators of nonres bldgs	\$ 103,598	27.66%	155.84%	\$ 100,333	27.92%	153.77%	\$ 95,510	27.80%	143.58%
Hospitality and tourism	42,111	11.24	63.35	45,360	12.62	106.90	42,833	12.47	64.39
Lessors of residential buildings	14,912	3.98	22.43	14,191	3.95	21.75	13,377	3.89	20.11
Gasoline and convenience stores	11,881	3.17	17.87	11,534	3.21	17.68	11,038	3.21	16.59
Real estate agents and managers	11,388	3.04	17.13	10,922	3.04	16.74	9,472	2.76	14.24
Commercial construction	10,550	2.82	15.87	10,904	3.03	16.46	16,053	4.67	24.13
Other	180,125	48.09	270.96	166,124	46.23	41.90	155,278	45.20	233.43
Total Commercial Loans	\$ 374,565	100.00%		\$ 359,368	100.00%		\$ 343,561	100.00%	

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. On a historical basis, the Corporation's highest concentration of credit risk was the hospitality and tourism industry. Management does not consider the current loan concentrations in hospitality and tourism to be problematic, and has no intention of further reducing loans to this industry segment. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of June 30, 2014. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

Our residential real estate portfolio predominantly includes one to four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of June 30, 2014, our residential

loan portfolio totaled \$105.868 million, or 21.05% of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases increased from \$1.526 million at the end of December 31, 2013 to \$2.113 million at June 30, 2014.

Due to the seasonal nature of many of the Corporation's commercial loan customers, loan payment terms provide flexibility by structuring payments to coincide with the customer's business cycle. The lending staff evaluates the collectability of the past due loans based on documented collateral values and payment history. The Corporation discontinues the accrual of interest on loans when, in the opinion of management, there is an indication that the borrower may be unable to meet the payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Table of Contents**Credit Quality**

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net recoveries for the six months ended June 30, 2014 amounted to \$62,000, compared to net charge-offs of \$.516 million, or .23% of average loans outstanding, for the same period in 2013. The current reserve balance is representative of the relevant risk inherent within the Corporation's loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

The table below shows period end balances of nonperforming assets (dollars in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Nonperforming Assets:			
Nonaccrual Loans	\$ 2,055	\$ 1,410	\$ 3,983
Loans past due 90 days or more			
Restructured loans	597	614	
Total nonperforming loans	2,652	2,024	3,983
Other real estate owned	1,947	1,884	2,481
Total nonperforming assets	\$ 4,599	\$ 3,908	\$ 6,464
Nonperforming loans as a % of loans	.53%	.42%	.87%
Nonperforming assets as a % of assets	.77%	.68%	1.17%
Reserve for Loan Losses:			
At period end	\$ 5,097	\$ 4,661	\$ 5,177
As a % of loans	1.01%	.96%	1.14%
As a % of nonperforming loans	192.19%	230.29%	129.98%
As a % of nonaccrual loans	248.03%	330.57%	129.98%
Texas ratio*	6.43%	5.59%	9.02%

*calculated by taking total nonperforming assets divided by total equity plus reserve for loan losses

Nonperforming assets at \$4.599 million were reduced by \$1.865 million from one year ago and increased \$.691 million from the \$3.908 million at 2013 year end. The current low level of nonperforming assets is also representative of the overall quality of the Corporation's loan portfolio.

The following ratios provide additional information relative to the Corporation's credit quality:

	June 30, 2014	At Period End December 31, 2013	At Period End June 30, 2013
Total loans, at period end	\$ 502,940	\$ 483,832	\$ 455,555
Average loans for the year	\$ 489,656	\$ 462,500	\$ 453,023

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

	For the Period Ended		For the Period Ended
	Six Months Ended June 30, 2014	Twelve Months Ended December 31, 2013	Six Months Ended June 30, 2013
Net charge-offs (recoveries) during the period	\$ (62)	\$ 2,232	\$ 516
Net charge-offs to average loans	N/M%	.48%	.23%
Net charge-offs to beginning allowance balance	N/M%	42.78%	9.89%

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and the bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan review consultant to perform a review of the loan portfolio. Historically, this independent review has provided findings similar to management as to the overall adequacy of the loan loss reserve and has substantiated the Corporation's loan rating system. In 2014, the Corporation will again utilize a consultant for loan review.

Table of Contents

As of June 30, 2014, the allowance for loan losses represented 1.01% of total loans. At June 30, 2014, the allowance included specific reserves in the amount of \$1.438 million, as compared to \$1.111 million at December 31, 2013 and \$2.208 million at June 30, 2013. In management's opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

As part of the process of resolving problem credits, the Corporation may acquire ownership of collateral which secured such credits. The Corporation carries this collateral in other real estate on the balance sheet.

The following table represents the activity in other real estate for the periods indicated (dollars in thousands):

	Six Months Ended June 30 2014	Year Ended December 31, 2013	Six Months Ended June 30 2013
Balance at beginning of period	\$ 1,884	\$ 3,212	\$ 3,212
Other real estate transferred from loans due to foreclosure	282	932	687
Other real estate sold	(205)	(1,996)	(1,329)
Writedowns on other real estate held for sale	(2)	(231)	(114)
Gain (loss) on sale of other real estate held for sale	(12)	(33)	25
Balance at end of period	\$ 1,947	\$ 1,884	\$ 2,481

During the first half of 2014, the Corporation received real estate in lieu of loan payments of \$.282 million. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balances and any additional reductions in the fair value result in a write-down of other real estate.

Deposits

The Corporation had an increase in deposits in the first six months of 2014. Total deposits increased by \$17.717 million, or 3.80%, in the first half of 2014. The increase in deposits for the first half of 2014 is composed of an increase in noncore deposits of \$12.538 million and an increase in core deposits of \$5.179 million. In recent years, the Corporation has strategically emphasized the growth of core deposits. This strategic initiative is supported with an individual incentive plan, along with the introduction of several new deposit products and competitive deposit pricing. The core deposit balances increased primarily in transactional account deposits, our lowest cost of funds. Most recently, we have experienced some declines in core deposits. A portion of these decreases can be attributed to individual customer deposit reductions due to various business related needs. In an effort to stem some runoff from core deposit CDs, management recently increased some offering rates on CD products.

Management continues to monitor existing deposit products in order to stay competitive as to both terms and pricing. It is the intent of management to be aggressive in its markets to grow core deposits with an emphasis placed on transactional deposits.

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

The following table represents detail of deposits at the end of the periods indicated (dollars in thousands):

	June 30, 2014	% of Total	December 31, 2013	% of Total	June 30, 2013	% of Total
Noninterest bearing NOW, money market, checking	\$ 73,732	15.23%	\$ 72,936	15.64%	\$ 64,736	14.45%
Savings	148,242	30.63	149,123	31.98	146,203	32.64
Certificates of Deposit <\$100,000	15,658	3.24	13,039	2.80	12,229	2.73
Total core deposits	380,772	78.67	375,593	80.55	357,935	79.91
Certificates of Deposit >\$100,000	23,151	4.78	23,159	4.96	25,091	5.60
Brokered CDs	80,093	16.55	67,547	14.49	64,881	14.49
Total non-core deposits	103,244	21.33	90,706	19.45	89,972	20.09
Total deposits	\$ 484,016	100.00%	\$ 466,299	100.00%	\$ 447,907	100.00%

Table of Contents

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At June 30, 2014, this source of funding totaled \$35 million and the Corporation secured this funding by pledging loans and investments. The \$35 million of FHLB borrowings has a weighted average maturity of 1.96 years and a weighted average rate of 1.79% at June 30, 2014. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending that has an outstanding balance of \$.852 million, with a fixed interest rate of 1% that matures in August 2024.

In addition to the above, the Corporation currently has two banking borrowing relationships. The first relationship consists of a line of credit and a term note. The line of credit bears interest at 90-day LIBOR plus 2.75%, with a floor rate of 4.00% and has an initial term that expires on March 22, 2015. The term note bears the same interest and matures on March 22, 2017. The second borrowing relationship consists of a \$10 million revolving line of credit, which can be increased to \$25 million upon request, used to support asset based lending activities at a wholly-owned subsidiary that currently bears interest at 90-day LIBOR plus 2.75% and has an initial term that expires on September 10, 2016.

Shareholders Equity

Total shareholders equity increased \$1.228 million from December 31, 2013 to June 30, 2014. Contributing to the increase in shareholders equity was net income available to common shareholders of \$1.466 million, a reduction for dividends on common stock of \$.553 million, increases due to stock compensation of \$.225 million, an increase in the market value of securities of \$.233 million and a decrease due to the repurchase of common stock of \$.143 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income available to common shareholders of \$1.466 million, or \$.27 per share, in the first half of 2014, compared to \$1.873 million or \$.34 per share for the first half of 2013. The first half results include a provision for loan losses of \$.374 million. Operating results for the same period in 2013 include a provision for loan losses of \$.475 million.

Net Interest Income

Net interest income is the Corporation's primary source of core earnings. Net interest income represents the difference between the average yield earned on interest earning assets and the average rate paid on interest bearing obligations. The net interest income is impacted by economic and competitive factors that influence rates, loan demand, and the availability of funding.

Net interest margin on a fully taxable equivalent basis amounted to \$5.661 million, 4.18% of average earning assets, in the second quarter of 2014, compared to \$5.287 million, and 4.17% of average earning assets, in the second quarter of 2013. In the first six months of 2014, net interest margin increased to \$11.277 million, 4.22% of average earning assets, compared to \$10.460 million, 4.19 % of average earning assets, for the same period in 2013.

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Table of Contents

The following table presents the amount of interest income from average interest-earning assets and the yields earned on those assets, as well as the interest expense on average interest-bearing obligations and the rates paid on those obligations. All average balances are daily average balances.

(dollars in thousands)	Three Months Ended						2014-2013				
	Average Balances			Average Rates		Interest		Income/ Expense Variance	Volume Variance	Rate Variance	Rate/ Volume Variance
	June 30, 2014	June 30, 2013	Increase/ (Decrease)	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013				
Loans (1,2,3)	\$ 492,922	\$ 456,937	\$ 35,985	5.18%	5.32%	\$ 6,370	\$ 6,056	\$ 314	\$ 477	\$ (151)	\$ (12)
Taxable securities	45,515	47,456	(1,941)	2.15	2.04	244	241	3	(10)	13	(3)
Nontaxable securities (2)	1,828	835	993	3.73	4.80	17	10	7	12	(2)	(3)
Federal funds sold	3	3									
Other interest-earning assets	3,160	3,070	90	4.32	4.18	34	32	2	1	1	
Total earning assets	543,428	508,301	35,127	4.92	5.00	6,665	6,339	326	480	(139)	(15)
Reserve for loan losses	(4,960)	(5,180)	220								
Cash and due from banks	16,272	17,927	(1,655)								
Fixed Assets	9,883	10,635	(752)								
Other Real Estate	2,112	3,175	(1,063)								
Other assets	14,415	13,597	818								
Total assets	\$ 581,150	\$ 548,455	\$ 32,695								
NOW and money market deposits	\$ 96,397	\$ 116,362	\$ (19,965)	.22%	.25%	\$ 54	\$ 72	\$ (18)	\$ (12)	\$ (7)	\$ 1
Interest checking	47,288	36,761	10,527	.24	.32	28	29	(1)	8	(7)	(2)
Savings deposits	15,151	13,085	2,066	.11	.09	4	3	1			1
CDs <\$100,000	145,494	130,957	14,537	1.19	1.60	433	524	(91)	58	(134)	(15)
CDs >\$100,000	23,229	24,610	(1,381)	1.26	1.66	73	102	(29)	(6)	(25)	2
Brokered deposits	72,781	53,449	19,332	1.15	1.17	208	156	52	56	(3)	(1)
Borrowings	43,043	40,656	2,387	1.90	1.64	204	166	38	10	27	1
Total interest-bearing liabilities	443,383	415,880	27,503	.91	1.01	1,004	1,052	(48)	114	(149)	(13)
Demand deposits	69,380	64,556	4,824								
Other liabilities	2,834	536	2,298								
Shareholders equity	65,553	67,483	(1,930)								
Total liabilities and shareholders equity	\$ 581,150	\$ 548,455	\$ 32,695								
Rate spread				4.01%	3.99%						
Net interest margin/revenue				4.18%	4.17%	\$ 5,661	\$ 5,287	\$ 374	\$ 366	\$ 10	\$ (2)

(dollars in thousands)	Six Months Ended						2014-2013				
	Average Balances			Average Rates		Interest		Income/ Expense Variance	Volume Variance	Rate Variance	Rate/ Volume Variance
	June 30, 2014	June 30, 2013	Increase/ (Decrease)	June 30, 2014	June 30, 2013	June 30, 2014	June 30, 2013				
Loans (1,2,3)	\$ 489,656	\$ 453,023	\$ 36,633	5.22%	5.41%	\$ 12,687	\$ 11,986	\$ 701	\$ 969	\$ (248)	\$ (20)
Taxable securities	44,392	47,082	(2,690)	2.19	2.06	481	481		(27)	29	(2)
Nontaxable securities (2)	1,668	839	829	4.96	4.81	41	20	21	20	1	
Federal funds sold	3	3									
Other interest-earning assets	3,115	3,070	45	5.24	4.14	81	63	18	1	17	
Total earning assets	538,834	504,017	34,817	4.97	5.02	13,290	12,550	740	963	(201)	(22)
Reserve for loan losses	(4,907)	(5,153)	246								
Cash and due from banks	20,038	18,243	1,795								

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Fixed Assets	10,085	10,634	(549)											
Other Real Estate	2,085	3,234	(1,149)											
Other assets	14,799	13,912	887											
Total assets	\$ 580,934	\$ 544,887	\$ 36,047											
NOW and money market deposits	\$ 106,565	\$ 120,797	\$ (14,232)	.22%	.25%	\$ 114	\$ 150	\$ (36)	\$ (18)	\$ (21)	\$ 3			
Interest checking	40,228	36,418	3,810	.22	.32	44	57	(13)	6	(17)	(2)			
Savings deposits	14,365	13,279	1,086	.10	.11	7	7		1	(1)				
CDs <\$100,000	148,390	131,297	17,093	1.21	1.62	892	1,057	(165)	138	(268)	(35)			
CDs >\$100,000	23,217	24,620	(1,403)	1.33	1.66	153	203	(50)	(12)	(41)	3			
Brokered deposits	70,183	45,621	24,562	1.18	1.28	412	289	123	156	(21)	(12)			
Borrowings	40,937	38,679	2,258	1.93	1.70	391	327	64	19	42	3			
Total interest-bearing liabilities	443,885	410,711	33,174	0.91	1.03	2,013	2,090	(77)	290	(327)	(40)			
Demand deposits	68,875	62,475	6,400											
Other liabilities	2,666	1,854	812											
Shareholders equity	65,508	69,847	(4,339)											
Total liabilities and shareholders equity	\$ 580,934	\$ 544,887	\$ 36,047											
Rate spread				4.06%	3.99%									
Net interest margin/revenue				4.22%	4.19%	\$ 11,277	\$ 10,460	\$ 817	\$ 673	\$ 126	\$ 18			

- (1) For purposes of these computations, nonaccruing loans are included in the daily average loan amounts outstanding.
- (2) The amount of interest income on loans and nontaxable securities has been adjusted to a tax equivalent basis, using a 34% tax rate
- (3) Interest income on loans includes fees

In the past several years of a low interest rate environment, the Corporation repriced all of its brokered deposits along with the majority of its bank time deposits. This repricing of liabilities is the primary reason for the increased interest margin, on a fully taxable equivalent basis in recent reported periods.

During this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread. The Corporation is anticipating some margin pressure in future periods as we continue to see extremely competitive pricing on new and renewable loans.

Table of Contents**Provision for Loan Losses**

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first half of 2014, the Corporation determined through this analysis that a \$.374 million provision for loan loss was required, compared to \$.475 million in the first half of 2013. There were net recoveries of \$62,000 in the first half of 2014, compared to net charge-offs of \$.516 million for the same period in 2013.

Other Income

Other income, at \$1.341 million in the first half of 2014, decreased \$.668 million from the first half of 2013 level of \$2.009 million. Other income decreased primarily as a result of a reduced level of fees and gains on the sale of loans from secondary market mortgage lending of \$.336 million from prior year period.

Management continues to evaluate deposit products and services for ways to better serve its customer base and also enhance service fee income through a broad array of products that price services based on income contribution and cost attributes.

The following table details other income for the three and six months ended June 30, 2014 and 2013 (dollars in thousands):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Increase/(Decrease) Dollars	Percent	2014	2013	Increase/(Decrease) Dollars	Percent
Deposit service fees	\$ 192	\$ 175	\$ 17	9.71%	\$ 349	\$ 337	\$ 12	3.56%
Income from secondary market loans sold	139	279	(140)	(50.18)	242	578	(336)	(58.13)
SBA/USDA loan sale gains	166	554	(388)	(70.04)	548	663	(115)	(17.35)
Mortgage servicing income	89	182	(93)	(51.10)	102	285	(183)	(64.21)
Other noninterest income	64	61	3	4.92	100	146	(46)	(31.51)
Total other income	\$ 650	\$ 1,251	\$ (601)	(48.04)%	\$ 1,341	\$ 2,009	\$ (668)	(33.25)%

Other Expense

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

For the first half of 2014, the Corporation recorded other expense of \$10.005 million compared to \$8.834 million in 2013, an increase of \$1.171 million. The largest increase from the first half of 2013 was in salaries and benefits, largely reflective of the compensation packages for the staff up of our asset based lending subsidiary formed in the third quarter of 2013. We also had increased occupancy costs between periods due primarily to our new Marquette branch office, which we moved into late in 2013. We incurred some additional legal costs as well in the first half of 2014 for the exploration of acquisitions.

The following table details other expense for the three and six months ended June 30, 2014 and 2013 (dollars in thousands):

Table of Contents

	Three Months Ended June 30,				Six Months Ended June 30,			
	2014	2013	Increase/(Decrease)		2014	2013	Increase/(Decrease)	
			Dollars	Percentage			Dollars	Percentage
Salaries and employee benefits	\$ 2,523	\$ 2,375	\$ 148	6.23%	\$ 5,064	\$ 4,681	\$ 383	8.18%
Occupancy	546	363	183	50.41	1,084	745	339	45.50
Furniture and equipment	303	255	48	18.82	622	525	97	18.48
Data processing	288	268	20	7.46	574	533	41	7.69
Advertising	123	111	12	10.81	230	215	15	6.98
Professional service fees	276	320	(44)	(13.75)	607	545	62	11.38
Loan and deposit	83	45	38	84.44	162	118	44	37.29
Writedowns and losses on other real estate held for sale	14	87	(73)	(83.91)	14	89	(75)	(84.27)
FDIC insurance premiums	90	95	(5)	(5.26)	175	200	(25)	(12.50)
Telephone	82	63	19	30.16	164	145	19	13.10
Other	570	541	29	5.36	1,309	1,038	271	26.11
Total other expense	\$ 4,898	\$ 4,523	\$ 375	8.29%	\$ 10,005	\$ 8,834	\$ 1,171	13.26%

Federal Income Taxes

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of June 30, 2014 had a net operating loss and tax credit carryforwards for tax purposes of approximately \$17.2 million, and \$2.4 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately \$10.3 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is \$1.400 million for the NOL and the equivalent value of tax credits, which is approximately \$.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation has reported deferred tax assets of \$9.097 million at June 30, 2014, which is net of a valuation allowance of \$.760 million. Management evaluated the deferred tax valuation allowance as of June 30, 2014 and determined that no adjustment to the valuation was warranted. The remaining valuation allowance pertains to the existing tax credit carryovers, which will only be utilized after all net operating loss carryforwards. Since a portion of these tax credits may expire before that occurs, a valuation allowance for these has been established. The Corporation will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

Table of Contents

LIQUIDITY

Liquidity is defined as the ability to generate cash at a reasonable cost to fulfill lending commitments and support asset growth, while satisfying the withdrawal demands of customers and make payments on existing borrowing commitments. The Bank's principal sources of liquidity are core deposits and loan and investment payments and prepayments. Providing a secondary source of liquidity is the available for sale investment portfolio. As a final source of liquidity, the Bank can exercise existing credit arrangements.

Current balance sheet liquidity consists of \$20.746 million in cash and due from balances, negligible fed funds sold, \$42.769 million of unpledged investment securities. Although current liquidity is deemed adequate, management will increase on hand liquidity in the near term by issuing brokered CDs in order to fund anticipated loan growth.

During the first six months of 2014, the Corporation increased cash and cash equivalents by \$2.527 million. As shown on the Corporation's condensed consolidated statement of cash flows, liquidity was impacted by cash used in investing activities, with a net increase in loans of \$19.354 million. Offsetting the net decrease used by investing activities was cash provided by financing activities, primarily a net increase in deposits of \$17.717 million. The management of bank liquidity for funding of loans and deposit maturities and withdrawals includes monitoring projected loan fundings and scheduled prepayments and deposit maturities within a 30 day period, a 30- to 90- day period and from 90 days until the end of the year. This funding forecast model is completed weekly.

The Corporation's primary source of liquidity on a stand-alone basis is dividends from the Bank. The Corporation also has a line of credit with a correspondent bank with current availability of \$2.500 million. The Corporation's current plan for dividends from the Bank are dependent upon the profitability of the Bank, growth of assets at the Bank and the level of capital needed to stay well capitalized.

Liquidity is managed by the Corporation through its Asset and Liability Committee (ALCO). The ALCO Committee meets monthly to discuss asset and liability management in order to address liquidity and funding needs to provide a process to seek the best alternatives for investments of assets, funding costs, and risk management. The liquidity position of the Bank is managed daily, thus enabling the Bank to adapt its position according to market fluctuations. Core deposits are important in maintaining a strong liquidity position as they represent a stable and relatively low cost source of funds. The Bank's liquidity is best illustrated by the mix in the Bank's core and noncore funding dependence ratio, which explains the degree of reliance on noncore liabilities to fund long-term assets.

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under \$100,000. Noncore funding consists of certificates of deposit greater than \$100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At June 30, 2014, the Bank's core deposits in relation to total funding were 72.38% compared to 73.98% at June 30, 2013. These ratios indicated at June 30, 2014, that the Bank has increased its reliance on noncore deposits and borrowings to fund the Bank's long-term assets, namely loans and investments. The bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of June 30, 2014, the Bank had \$28.375 million of unsecured lines available and additional funding sources available if secured. The bank believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank's liquidity.

From a long-term perspective, the Corporation's strategy is to increase core deposits in the Corporation's local markets. Management continually evaluates deposit products offered in order to remain competitive in its goal of increasing core deposits. The Corporation will and has the ability to augment local deposit growth efforts with wholesale CD funding.

CAPITAL AND REGULATORY

As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of June 30, 2014, the Corporation and Bank were well capitalized. During the first six months of 2014, total capitalization increased by \$1.228 million.

Table of Contents

The following table details sources of capital for the periods indicated (dollars in thousands):

	June 30, 2014	December 31, 2013	June 30, 2013
Capital Structure			
Shareholders' equity	\$ 66,477	\$ 65,249	\$ 62,520
Preferred stock			4,000
Total shareholders' equity	\$ 66,477	\$ 65,249	\$ 66,520
Total capitalization	\$ 66,477	\$ 65,249	\$ 66,520
Tangible capital	\$ 66,477	\$ 65,249	\$ 66,520
Intangible Assets			
Core deposit premium	\$	\$	\$
Other identifiable intangibles	1,061	1,129	830
Total intangibles	\$ 1,061	\$ 1,129	\$ 830
Regulatory capital			
Tier 1 capital:			
Shareholders' equity	\$ 66,477	\$ 65,249	\$ 66,520
Net unrealized (gains) losses on available for sale securities	(449)	(216)	(430)
Less: disallowed deferred tax asset	(5,500)	(7,000)	(6,500)
Less: intangibles	(106)	(113)	(83)
Total Tier 1 capital	\$ 60,422	\$ 57,920	\$ 59,507
Tier 2 Capital:			
Allowable reserve for loan losses	\$ 5,097	\$ 4,661	\$ 5,177
Qualifying long-term debt			
Total Tier 2 capital	5,097	4,661	5,177
Total capital	\$ 65,519	\$ 62,581	\$ 64,684
Risk-adjusted assets	\$ 508,874	\$ 489,407	\$ 467,090
Capital ratios:			
Tier 1 Capital to average assets	10.50%	10.31%	11.01%
Tier 1 Capital to risk weighted assets	11.87%	11.83%	12.74%
Total Capital to risk weighted assets	12.88%	12.79%	13.85%

Regulatory capital is not the same as shareholders' equity reported in the accompanying condensed consolidated financial statements. Certain assets cannot be considered assets for regulatory purposes, such as acquisition intangibles and noncurrent deferred tax benefits.

Presented below is a summary of the capital position in comparison to generally applicable regulatory requirements:

	Shareholders Equity to Quarter-end	Tangible Equity to Quarter-end	Tier 1 Capital to Average	Tier 1 Capital to Risk-Weighted	Total Capital to Risk-Weighted
--	--	--------------------------------------	---------------------------------	---------------------------------------	--------------------------------------

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

	Assets	Assets	Assets	Assets	Assets
Regulatory minimum for capital adequacy purposes	N/A	N/A	4.00%	4.00%	8.00%
Regulatory defined well capitalized guideline	N/A	N/A	5.00%	6.00%	10.00%
The Corporation:					
June 30, 2014	11.16%	11.16%	10.50%	11.87%	12.88%
June 30, 2013	12.02%	12.02%	11.01%	12.74%	13.85%
The Bank:					
June 30, 2014	11.20%	11.20%	10.50%	11.90%	12.88%
June 30, 2013	11.18%	11.18%	10.15%	11.74%	12.84%

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

In general, the Corporation attempts to manage interest rate risk by investing in a variety of assets which afford it an opportunity to reprice assets and increase interest income at a rate equal to or greater than the interest expense associated with repricing liabilities.

Interest rate risk is the exposure of the Corporation to adverse movements in interest rates. The Corporation derives its income primarily from the excess of interest collected on its interest-earning assets over the interest paid on its interest-bearing obligations. The rates of interest the Corporation earns on its assets and owes on its obligations generally are established contractually for a period of time. Since market interest rates change over time, the Corporation is exposed to lower profitability if it cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excess levels of interest rate risk could pose a significant threat to the Corporation's earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to the Corporation's safety and soundness.

Loans are the most significant earning asset. Management offers commercial and real estate loans priced at interest rates which fluctuate with various indices such as the prime rate or rates paid on various government issued securities. In addition, the Corporation prices the majority of fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

The Corporation has established interest rate floors on approximately \$143.787 million of its variable rate commercial loans. These interest rate floors will result in a lag on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately \$98.781 million of the floor rate loan balances will reprice with a 100 basis point increase on the prime rate, with another \$40.915 million repricing in the next 100 basis point prime rate increase.

The Corporation also has \$47.374 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation has \$237.632 million of transactional accounts, of which \$73.732 million consists of noninterest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the Corporation's focus on these low cost accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

Other deposit products have a variety of terms ranging from deposits whose interest rates can change on a weekly basis to certificates of deposit with repricing terms of up to five years. Longer term deposits generally include penalty provisions for early withdrawal.

Beyond general efforts to shorten the loan pricing periods and extend deposit maturities, management can manage interest rate risk by the maturity periods of securities purchased, selling securities available for sale, and borrowing funds with targeted maturity periods, among other strategies. Also, the rate of interest rate changes can impact the actions taken since the rate environment affects borrowers and depositors differently.

Exposure to interest rate risk is reviewed on a regular basis. Interest rate risk is the potential of economic losses due to future interest rate changes. These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect of interest rate changes on net interest income and to structure the composition of the balance sheet to minimize interest rate risk and at the same time maximize income. Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. Tools used by management include maturity and repricing analysis and interest rate sensitivity analysis. The Bank has monthly asset/liability meetings with an outside consultant to review its current position and strategize about future opportunities on risks relative to pricing and positioning of assets and liabilities.

Table of Contents

The difference between repricing assets and liabilities for a specific period is referred to as the gap. An excess of repricable assets over liabilities is referred to as a positive gap. An excess of repricable liabilities over assets is referred to as a negative gap. The cumulative gap is the summation of the gap for all periods to the end of the period for which the cumulative gap is being measured.

Assets and liabilities scheduled to reprice are reported in the following time frames. Those instruments with a variable interest rate tied to an index and considered immediately repricable are reported in the 1- to 90-day time frame. The estimates of principal amortization and prepayments are assigned to the following time frames.

The following are the Corporation's repricing opportunities at June 30, 2014 (dollars in thousands):

	1-90 Days	91 - 365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	\$ 221,607	\$ 101,993	\$ 178,085	\$ 1,255	\$ 502,940
Securities	3,306	3,080	28,131	12,857	47,374
Other (1)	237			3,060	3,297
Total interest-earning assets	225,150	105,073	206,216	17,172	553,611
Interest-bearing obligations:					
NOW, money market, savings, interest checking	163,900				163,900
Time deposits	31,246	62,427	72,468	150	166,291
Brokered CDs	17,728	10,877	51,488		80,093
Borrowings	500	10,000	30,735	852	42,087
Total interest-bearing obligations	213,374	83,304	154,691	1,002	452,371
Gap	\$ 11,776	\$ 21,769	\$ 51,525	\$ 16,170	\$ 101,240
Cumulative gap	\$ 11,776	\$ 33,545	\$ 85,070	\$ 101,240	

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at June 30, 2014, the Corporation had a cumulative asset sensitivity gap position of \$33.545 million within the one-year time frame. The Corporation's cumulative asset sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn more net interest income. Since more assets would reprice at higher rates than liabilities. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation's net interest income would decrease. A limitation of the traditional gap analysis is that it does not consider the timing or magnitude of non-contractual repricing or expected prepayments. In addition, the gap analysis treats savings, NOW, and money market accounts as repricing within 90 days, while experience suggests that these categories of deposits are actually comparatively resistant to rate sensitivity.

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

At December 31, 2013, the Corporation had a cumulative liability sensitivity gap position of \$24.272 million within the one-year time frame.

The borrowings in the gap analysis include \$35.000 million of FHLB advances that have a weighted average maturity of 1.96 years and a weighted average rate of 1.79%.

The Corporation's primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk and foreign exchange risk. The Corporation has no market risk sensitive instruments held for trading purposes. The Corporation has limited agricultural-related loan assets and therefore has minimal significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates are assumed to be insignificant.

Table of Contents

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation's interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

FOREIGN EXCHANGE RISK

In addition to managing interest rate risk, management also actively manages risk associated with foreign exchange. The Corporation provides foreign exchange services, makes loans to, and accepts deposits from, Canadian customers primarily at its banking offices in Sault Ste. Marie, Michigan. To protect against foreign exchange risk, the Corporation monitors the volume of Canadian deposits it takes in and then invests these Canadian funds in Canadian commercial loans and securities. Management believes the exposure to short-term foreign exchange risk is minimal and at an acceptable level for the Corporation.

OFF-BALANCE-SHEET RISK

Derivative financial instruments include futures, forwards, interest rate swaps, option contracts and other financial instruments with similar characteristics. The Corporation currently does not enter into futures, forwards, swaps, or options. However, the Corporation is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and involve to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the condensed consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions.

Commitments to extend credit and standby letters of credit are not recorded as an asset or liability by the Corporation until the instrument is exercised.

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in

the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation's operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation's performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The Corporation's ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation's performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

Table of Contents

Item 4. Controls and Procedures

As of June 30, 2014, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934 are effective as of June 30, 2014.

Changes in Internal Control Over Financial Reporting

There were no changes in the Corporation's internal control over financial reporting that occurred during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

Table of ContentsPART II. OTHER INFORMATION**Item 1. Legal Proceedings**

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The Corporation currently has a share repurchase program. The program is conducted under authorizations from time to time by the Board of Directors. The shares reported in the table below are covered by Board authorizations made and publically announced for \$600,000 on February 27, 2013 and an additional \$600,000 on December 17, 2013. Neither of these authorizations has an expiration date.

Issuer purchase of Equity Securities

Period of purchases (1)	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of a publically announced plan or program	Maximum dollars yet to be used for stock purchases
January 1, 2014 to January 31, 2014	9,200	\$ 10.19	9,200	\$ 595,874
February 1, 2014 to February 28, 2014	4,500	\$ 11.00	4,500	546,368
March 1, 2014 to March 31, 2014		\$		546,368
Total First Quarter 2014	13,700	\$ 10.50	13,700	

(1) Monthly information is provided for the Corporation's fiscal months during the first quarter of 2014. There were no purchases made during the second quarter of 2014.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Edgar Filing: MACKINAC FINANCIAL CORP /MI/ - Form 10-Q

Exhibit 31.1	Rule 13a-14(a) Certification of Chief Executive Officer.
Exhibit 31.2	Rule 13a-14(a) Certification of Chief Financial Officer.
Exhibit 32.1	Section 1350 Certification of Chief Executive Officer.
Exhibit 32.2	Section 1350 Certification of Chief Financial Officer.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Extension Schema Document.
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document.
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MACKINAC FINANCIAL CORPORATION
(Registrant)

Date: August 14, 2014

By: /s/ Paul D. Tobias
PAUL D. TOBIAS,
CHAIRMAN AND CHIEF EXECUTIVE
OFFICER
(principal executive officer)

By: /s/ Ernie R. Krueger
ERNIE R. KRUEGER
EVP/CHIEF FINANCIAL OFFICER
(principal financial and accounting officer)