MACKINAC FINANCIAL CORP /MI/
Form 10-Q
May 14, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2018

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)

MICHIGAN	38-2062816
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

130 SOUTH CEDAR STREET, MANISTIQUE, MI	49854
(Address of principal executive offices)	(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, a smaller reporting company, or an emerging growth company. See definitions of “large accelerated filer,” “accelerated filer”, “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer		Accelerated Filer
Non-accelerated Filer	(Do not check if a smaller reporting company)	Smaller reporting company
		Emerging growth company

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

Yes No

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

As of May 13, 2018, there were outstanding 6,340,560 shares of the registrant's common stock, no par value.

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MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	March 31, 2018 (Unaudited)	December 31, 2017
ASSETS		
Cash and due from banks	$ 40,411	$ 37,420
Federal funds sold	16	6
Cash and cash equivalents	40,427	37,426
Interest-bearing deposits in other financial institutions	11,391	13,374
Securities available for sale	73,402	75,397
Other securities	500	500
Federal Home Loan Bank stock	3,112	3,112
Loans:		
Commercial	579,718	572,936
Mortgage	215,804	220,708
Consumer	16,919	17,434
Total Loans	812,441	811,078
Allowance for loan losses	(5,101)	(5,079)
Net loans	807,340	805,999
Premises and equipment	16,329	16,290
Other real estate held for sale	2,526	3,558
Deferred tax asset	4,674	4,970
Deposit based intangibles	1,860	1,922
Goodwill	5,694	5,694
Other assets	16,674	17,125
TOTAL ASSETS	$ 983,929	$ 985,367
LIABILITIES AND SHAREHOLDERS’ EQUITY		
LIABILITIES:		
Deposits:		
Noninterest bearing deposits	$ 143,129	$ 148,079

NOW, money market, interest checking	260,051	280,309
Savings	63,867	61,097
CDs<$250,000	135,554	142,159
CDs>$250,000	12,738	11,055
Brokered	191,458	175,299
Total deposits	806,797	817,998
Federal funds purchased	10,000	—
Borrowings	80,002	79,552
Other liabilities	5,273	6,417
Total liabilities	902,072	903,967
SHAREHOLDERS' EQUITY:		
Common stock and additional paid in capital - No par value Authorized - 18,000,000 shares Issued and outstanding - 6,332,560 and 6,294,930 respectively	62,080	61,981
Retained earnings	20,493	19,711
Accumulated other comprehensive income (loss)		
Unrealized (losses) on available for sale securities	(495)	(71)
Minimum pension liability	(221)	(221)
Total shareholders' equity	81,857	81,400
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 983,929	$ 985,367

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended March 31,	
	2018	2017
	(Unaudited)	
INTEREST INCOME:		
Interest and fees on loans:		
Taxable	$ 10,390	$ 9,957
Tax-exempt	25	33
Interest on securities:		
Taxable	372	399
Tax-exempt	69	79
Other interest income	199	128
Total interest income	11,055	10,596
INTEREST EXPENSE:		
Deposits	1,236	959
Borrowings	510	471
Total interest expense	1,746	1,430
Net interest income	9,309	9,166
Provision for loan losses	50	150
Net interest income after provision for loan losses	9,259	9,016
OTHER INCOME:		
Deposit service fees	269	272
Income from mortgage loans sold on the secondary market	177	298
SBA/USDA loan sale gains	51	60
Net mortgage servicing (amortization) income	(8)	(8)
Other	125	154
Total other income	614	776
OTHER EXPENSE:		
Salaries and employee benefits	4,154	3,797
Occupancy	811	785
Furniture and equipment	531	481
Data processing	504	461
Advertising	195	123
Professional service fees	304	321

Loan origination expenses and deposit and card related fees	126	179
Writedowns and losses on other real estate held for sale	26	12
FDIC insurance assessment	156	157
Telephone	155	157
Transaction related expenses	189	—
Other	777	704
Total other expenses	7,928	7,177
Income before provision for income taxes	1,945	2,615
Provision for income taxes	408	889
NET INCOME	$ 1,537	$ 1,726
INCOME PER COMMON SHARE:		
Basic	$ 0.24	$ 0.28
Diluted	$ 0.24	$ 0.28

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CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Net income	$ 1,537	$ 1,726
Other comprehensive income		
Change in securities available for sale:		
Unrealized (losses) gains arising during the period	(537)	500
Tax effect	113	(170)
Net change in unrealized gains on available for sale securities	(424)	330
Total comprehensive income	$ 1,113	$ 2,056

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CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31, 2018				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (loss)	Total
Balance, beginning of period	6,294,930	$ 61,981	$ 19,711	$ (292)	$ 81,400
Net income for period	—	—	1,537	—	1,537
Other comprehensive income					
Net unrealized loss on securities available for sale	—	—	—	(424)	(424)
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	1,537	(424)	1,113
Stock compensation	—	99	—	—	99
Issuance of common stock:					
Restricted stock award vesting	37,630	—	—	—	—
Dividend on common stock	—	—	(755)	—	(755)
Balance, end of period	6,332,560	$ 62,080	$ 20,493	$ (716)	$ 81,857

	Three Months Ended March 31, 2017				
	Shares of Common Stock	Common Stock and Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, beginning of period	6,263,371	$ 61,583	$ 17,206	$ (180)	$ 78,609
Net income for period	—	—	1,726	—	1,726
Other comprehensive income					
Net unrealized gain on securities available for sale	—	—	—	330	330
Actuarial loss on defined benefit pension obligation	—	—	—	—	—
Total comprehensive income	—	—	1,726	330	2,056
Stock compensation	—	100	—	—	100
Issuance of common stock:					
Restricted stock award vesting	—	—	—	—	—
Repurchase of common stock	31,559	—	—	—	—
Dividend on common stock	—	—	(756)	—	(756)
Balance, end of period	6,294,930	$ 61,683	$ 18,176	$ 150	$ 80,009

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Three Months Ended March 31,	
	2018	2017
Cash Flows from Operating Activities:		
Net income	$ 1,537	$ 1,726
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	631	572
Provision for loan losses	50	150
Deferred tax expense, net	408	889
Gain on sale of loans sold in the secondary market	(139)	(298)
Origination of loans held for sale in the secondary market	(8,201)	(15,026)
Proceeds from sale of loans in the secondary market	8,340	15,324
Loss (Gain) on sale of other real estate held for sale	26	(4)
Writedown of other real estate held for sale	—	16
Stock compensation	99	100
Change in other assets	513	1,334
Change in other liabilities	(1,144)	(2,293)
Net cash provided by operating activities	2,120	2,490
Cash Flows from Investing Activities:		
Net increase in loans	(1,454)	(5,099)
Net decrease in interest bearing deposits in other financial institutions	1,983	599
Proceeds from maturities, sales, calls or paydowns of securities available for sale	1,336	2,776
Redemption of FHLBI stock	—	192
Capital expenditures	(548)	(536)
Proceeds from sale of other real estate	1,070	740
Net cash provided by (used in) investing activities	2,387	(1,328)
Cash Flows from Financing Activities:		
Net decrease in deposits	(11,201)	(1,692)
Net activity on line of credit	1,000	(750)
Increase (decrease) in fed funds purchased	10,000	(3,000)
Principal payments on borrowings	(550)	(550)
Dividend on common stock	(755)	(756)
Net cash used in financing activities	(1,506)	(6,748)

Net increase in cash and cash equivalents	3,001	(5,586)
Cash and cash equivalents at beginning of period	37,426	46,755
Cash and cash equivalents at end of period	$ 40,427	$ 41,169
Supplemental Cash Flow Information:		
Cash paid during the year for:		
Interest	$ 1,746	$ 1,411
Income taxes	40	—
Noncash Investing and Financing Activities:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	64	576

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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 three month period ended March 31, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. 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, 2017.

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 were unchanged by 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, the valuation of investment securities, the valuation of foreclosed real estate, deferred tax assets, mortgage servicing rights, and the assessment of goodwill for impairment.

Acquired Loans

Loans acquired with evidence of credit deterioration since inception and for which it is probable that all contractual payments will not be received are accounted for under ASC Topic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30"). These loans are recorded at fair value at the time of acquisition, with no carryover of the related allowance for loan losses. Fair value of acquired loans is determined using a discounted cash flow methodology based on assumptions about the amount and timing of principal and interest payments, principal prepayments and principal defaults and losses, and current market rates. In recording the fair values of acquired impaired loans at acquisition date, management calculates a non-accretable difference (the credit component of the purchased loans) and an accretable difference (the yield component of the purchased loans).

Over the life of the acquired loans, management continues to estimate cash flows expected to be collected. We evaluate at each balance sheet date whether it is probable that we will be unable to collect all cash flows expected at acquisition and if so, recognize a provision for loan loss in our consolidated statement of operations. For any significant increases in cash flows expected to be collected, we adjust the amount of the accretable yield recognized on a prospective basis over the pool's remaining life.

Performing acquired loans are accounted for under Financial Accounting Standards Board ("FASB") Topic 310-20, Receivables – Nonrefundable Fees and Other Costs. Performance of certain loans may be monitored and based on management's assessment of the cash flows and other facts available, portions of the accretable difference may be delayed or suspended if management deems appropriate. The Corporation's policy for determining when to discontinue accruing interest on performing acquired loans and the subsequent accounting for such loans is essentially the same as the policy for originated loans.

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Allowance for Loan Losses

The allowance for loan losses includes specific allowances related to 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.

The Corporation also has an unallocated 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 probable 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.

Stock Compensation Plans

On May 22, 2012, the Corporation'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 awards ("RSAs"), stock grants,or stock appreciation rights. The aggregate number of shares of the Corporation's common stock issuable under the plan is 575,000. At March 31, 2018 there were 250,193 shares available for issuance under this plan. Awards are made to certain other senior officers at the discretion of the Corporation's management. Compensation cost equal to the fair value of the award is recognized over the vesting period.

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 Corporation adopted the new guidance on January 1, 2018. Management's analysis included: identification of all revenue streams included in the financial statements; determination of scope exclusions to identify "in-scope" revenue streams; determination of size, timing and amount of revenue recognition for in-scope items. Key revenue streams identified include service charges on deposit accounts, and credit card income. The new guidance did not have a material impact on the Corporation's consolidated financial condition or results of operation.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). ASU 2016-01 amends current guidance by requiring companies to recognize changes in fair value for equity investments that have a readily determinable fair value through net income rather than through other comprehensive income. Under ASU 2016-01, equity investments that do not have a readily determinable fair value will either be accounted for in the same manner as equity investments that have a readily determinable fair value, with changes in fair value recognized through net income or carried at cost, adjusted for changes in observable prices based on orderly transactions for identical or similar investments issued by the same issuer and further adjusted for impairment, if applicable. ASU 2016-01 also requires a qualitative assessment of impairment indicators each reporting period. If this assessment indicates that impairment exists, companies must adjust the investment to fair value and recognize an impairment loss in net income, even if the impairment is determined to be temporary. ASU 2016-01 was effective for public companies for interim and annual periods beginning after December 15, 2017. The Corporation adopted the new guidance on January 1, 2018. As such, the Corporation reclassified $.500

million of equity securities from available-for-sale securities to other securities on its unaudited condensed consolidated balance sheet. There were no unrealized gains or losses on those securities that required reclassification from accumulated other comprehensive income to retained earnings. The Corporation's adoption of ASU 2016-01 did not have a material impact on the Corporation's consolidated financial condition or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases, which will supersede the current lease requirements in ASC 840. The ASU requires lessees to recognize an asset with the right of use and related lease liability for all leases, with a limited exception for short-term leases. Leases will be classified as either finance or operating, with the classification affecting the pattern of expense recognition in the statement of operations. Currently, leases are classified as either capital or operating, with only capital leases recognized on the balance sheet. The reporting of lease related expenses in the statements of operations and cash flows will be generally consistent with the current guidance. The new lease guidance will be effective for the Corporation's year ending December 31, 2019 and will be applied using modified retrospective transition method to the beginning of the earliest period presented. The effect of applying the new lease guidance on the financial statements has not yet been determined.

In September 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income.

ASU 2016-13 requires an entity to measure expected credit losses for financial assets over the estimated lifetime of expected credit loss and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The standard includes the following core concepts in determining the expected credit loss. The estimate must: (a) be based on an asset's amortized cost (including premiums or discounts, net deferred fees and costs, foreign exchange and fair value hedge accounting adjustments), (b) reflect losses expected over the remaining contractual life of an asset (considering the effect of voluntary prepayments), (c) consider available relevant information about the estimated collectability of cash flows (including information about past events, current conditions, and reasonable and supportable forecasts), and (d) reflect the risk of loss, even when that risk is remote.

ASU 2016-13 also amends the recording of purchased credit-deteriorated assets. Under the new guidance, an allowance will be recognized at acquisition through a gross-up approach whereby an entity will record as the initial amortized cost the sum of (a) the purchase price and (b) an estimate of credit losses as of the date of acquisition. In addition, the guidance also requires immediate recognition in earnings of any subsequent changes, both favorable and unfavorable, in expected cash flows by adjusting this allowance.

ASU 2016-13 also amends the impairment model for available-for-sale debt securities and requires entities to determine whether all or a portion of the unrealized loss on an available-for-sale debt security is a credit loss. Management may not use the length of time a security has been in an unrealized loss position as a factor in concluding

whether a credit loss exists, as is currently permitted. In addition, an entity will recognize an allowance for credit losses on available-for-sale debt securities as a contra-account to the amortized cost basis rather than as a direct reduction of the amortized cost basis of the investment, as is currently required. As a result, entities will recognize improvements to credit losses on available-for-sale debt securities immediately in earnings rather than as interest income over time under current practice.

New disclosures required by ASU 2016-13 include: (a) for financial assets measured at amortized cost, an entity will be required to disclose information about how it developed its allowance, including changes in the factors that influenced management’s estimate of expected credit losses and the reasons for those changes, (b) for financial receivables and net investments in leases measured at amortized cost, an entity will be required to further disaggregate the information it currently discloses about the credit quality of these assets by year or the asset’s origination or vintage for as many as five annual periods, and (c) for available-for-sale debt securities, an entity will be required to provide a roll-forward of the allowance for credit losses and an aging analysis for securities that are past due.

Upon adoption of ASU 2016-13, a cumulative-effect adjustment to retained earnings will be recorded as of the beginning of the first reporting period in which the guidance is effective. ASU 2016-13 is effective for public companies for interim and annual periods beginning after December 15, 2019, with early adoption permitted for annual periods beginning after December 15, 2018. The Corporation is currently evaluating the provisions of ASU 2016-13 to determine the potential impact on the Corporation's consolidated financial condition and results of operations.

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In May 2017, the FASB issued ASU 2017-09, Compensation – Stock Compensation (Topic 718). ASU 2017-09 applies to entities that change the terms or conditions of a share-based payment award to provide clarity and reduce diversity in practice as well as cost and complexity when applying the guidance in Topic 718 to the modification to the terms and conditions of a share-based payment award. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017. Implementation of the new guidance did not have any effect on its consolidated financial statements, as there were no changes in terms or conditions of the Corporation's current share-based compensation programs. Future changes, should they occur, will be accounted for in accordance with ASU 2017-09.

3.EARNINGS PER SHARE

Diluted earnings per share, which reflects the potential dilution that could occur if 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 months ended March 31, 2018 and 2017 (dollars in thousands, except per share data):

	Three Months Ended March 31,	
	2018	2017
(Numerator):		
Net income	$ 1,537	$ 1,726
(Denominator):		
Weighted average shares outstanding	6,304,203	6,270,034
Effect of dilutive stock options, and vesting of restricted stock awards	26,007	10,343
Diluted weighted average shares outstanding	6,330,210	6,280,377
Income per common share:		
Basic	$ 0.24	$ 0.28
Diluted	$ 0.24	$ 0.28

4.INVESTMENT SECURITIES

The Corporation has an investment security portfolio totaling $73.902 million, composed of $73.402 million of available for sale securities and $.500 million of equity securities. There is no unrealized gain or loss associated with the equity

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securities. The amortized cost and estimated fair value of investment securities available for sale as of March 31, 2018 and December 31, 2017 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2018				
Corporate	$ 24,289	$ 101	$ (168)	$ 24,222
US Agencies	16,898	5	(246)	16,657
US Agencies - MBS	11,893	34	(250)	11,677
Obligations of states and political subdivisions	20,948	228	(330)	20,846
Total securities available for sale	$ 74,028	$ 368	$ (994)	$ 73,402
December 31, 2017				
Corporate	$ 24,352	$ 82	$ (43)	$ 24,391
US Agencies	16,935	10	(99)	16,846
US Agencies - MBS	12,830	42	(156)	12,716
Obligations of states and political subdivisions	21,370	307	(233)	21,444
Total securities available for sale	$ 75,487	$ 441	$ (531)	$ 75,397

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 $4.637 million and $4.536 million, respectively, at March 31, 2018.

5.LOANS

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

	March 31, 2018	December 31, 2017
Commercial real estate	$ 411,526	$ 406,742
Commercial, financial, and agricultural	160,188	156,951
Commercial construction	8,004	9,243
One to four family residential real estate	204,542	209,890
Consumer	16,919	17,434
Consumer construction	11,262	10,818
Total loans	$ 812,441	$ 811,078

The Corporation completed the acquisition of Peninsula Financial Corporation ("PFC") on December 5, 2014, The First National Bank of Eagle River ("Eagle River") on April 29, 2016 and Niagara Bancorporation ("Niagara") on August 31, 2016. The PFC acquired impaired loans totaled $13.290 million, the Eagle River acquired impaired loans totaled $3.401 million, and the Niagara acquired impaired loans totaled $2.105 million. In the first three months of 2018, the Corporation had positive resolution of acquired impaired loans, which resulted in the recognition of approximately $50,000 of accretable interest. In the first three months of 2017, the Corporation had positive resolution of one PFC acquired impaired loan which resulted in the recognition of approximately $100,000 of accretable interest.

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The table below details the outstanding balances of the PFC acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 13,290	$ 53,849	$ 67,139
Nonaccretable difference	(2,234)	—	(2,234)
Expected cash flows	11,056	53,849	64,905
Accretable yield	(744)	(2,100)	(2,844)
Carrying balance at acquisition date	$ 10,312	$ 51,749	$ 62,061

The table below details the outstanding balances of the Eagle River acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 3,401	$ 80,737	$ 84,138
Nonaccretable difference	(1,172)	—	(1,172)
Expected cash flows	2,229	80,737	82,966
Accretable yield	(391)	(1,700)	(2,091)
Carrying balance at acquisition date	$ 1,838	$ 79,037	$ 80,875

The table below details the outstanding balances of the Niagara acquired portfolio and the fair value adjustments at acquisition date (dollars in thousands):

	Acquired Impaired	Acquired Non-impaired	Acquired Total
Loans acquired - contractual payments	$ 2,105	$ 30,555	$ 32,660
Nonaccretable difference	(265)	—	(265)
Expected cash flows	1,840	30,555	32,395
Accretable yield	(88)	(600)	(688)
Carrying balance at acquisition date	$ 1,752	$ 29,955	$ 31,707

The table below presents a rollforward of the accretable yield on acquired loans for the three months ended March 31, 2018 (dollars in thousands):

	PFC			Eagle River			Niagara		
	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2017	$ 149	$ —	$ 149	$ 218	$ 603	$ 821	$ 38	$ 281	$ 319
Accretion	(30)	—	(30)	—	(150)	(150)	—	(54)	(54)
Reclassification from nonaccretable difference	23	—	23	—	—	—	—	—	—
Balance, March 31, 2018	$ 142	$ —	$ 142	$ 218	$ 453	$ 671	$ 38	$ 227	$ 265

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The table below presents a rollforward of the accretable yield on acquired loans for the three months ended March 31, 2017 (dollars in thousands):

	PFC			Eagle River			Niagara		
	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total	Acquired Impaired	Acquired Non-impaired	Acquired Total
Balance, December 31, 2016	$ 282	$ 642	$ 924	$ 236	$ 1,221	$ 1,457	$ 52	$ 505	$ 557
Accretion	(100)	(175)	(275)	—	(179)	(179)	—	(72)	(72)
Reclassification from nonaccretable difference	57	—	57	—	—	—	(8)	—	(8)
Balance, March 31, 2017	$ 239	$ 467	$ 706	$ 236	$ 1,042	$ 1,278	$ 44	$ 433	$ 477

Allowance for Loan Losses

An analysis of the allowance for loan losses for the three months ended March 31, 2018 and March 31, 2017 is as follows (dollars in thousands):

	March 31, 2018	March 31, 2017
Balance, January 1	$ 5,079	$ 5,020
Recoveries on loans previously charged off	25	102
Loans charged off	(53)	(126)
Provision	50	150
Balance at end of period	$ 5,101	$ 5,146

In the first three months of 2018, net charge-offs were $28,000, compared to net charge-offs of $24,000 in the same period in 2017. In the first three months of 2018, the Corporation recorded a provision for loan loss of $50,000 compared to a $.150 million provision for loan losses in the first three months of 2017. 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 March 31, 2018 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,650	$ 576	$ 54	$ 160	$ 6	$ 10	$ 2,623	$ 5,079
Charge-offs	—	—	—	(47)	—	(6)	—	(53)
Recoveries	7	3	1	2	—	12	—	25
Provision	676	965	371	58	—	(7)	(2,013)	50
Ending balance ALLR	$ 2,333	$ 1,544	$ 426	$ 173	$ 6	$ 9	$ 610	$ 5,101
Loans:								
Ending balance	$ 411,526	$ 160,188	$ 8,004	$ 204,542	$ 11,262	$ 16,919	$ —	$ 812,441
Ending balance ALLR	(2,333)	(1,544)	(426)	(173)	(6)	(9)	(610)	(5,101)
Net loans	$ 409,193	$ 158,644	$ 7,578	$ 204,369	$ 11,256	$ 16,910	$ (610)	$ 807,340
Ending balance ALLR:								
Individually evaluated	$ 362	$ 310	$ —	$ —	$ —	$ —	$ —	$ 672
Collectively evaluated	1,971	1,234	426	173	6	9	610	4,429
Total	$ 2,333	$ 1,544	$ 426	$ 173	$ 6	$ 9	$ 610	$ 5,101
Ending balance Loans:								
Individually evaluated	$ 1,568	$ 1,307	$ 372	$ —	$ —	$ —	$ —	$ 3,247
Collectively evaluated	408,273	158,881	7,632	203,032	11,215	16,919	—	805,952
	1,685	—	—	1,510	47	—	—	3,242

Acquired with deteriorated credit quality								
Total	$ 411,526	$ 160,188	$ 8,004	$ 204,542	$ 11,262	$ 16,919	$ —	$ 812,441

Impaired loans, by definition, are individually evaluated.

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A breakdown of the allowance for loan losses and recorded balances in loans at March 31, 2017 is as follows (dollars in thousands):

	Commercial real estate	Commercial, financial and agricultural	Commercial construction	One to four family residential real estate	Consumer construction	Consumer	Unallocated	Total
Allowance for loan loss reserve:								
Beginning balance ALLR	$ 1,345	$ 614	$ 57	$ 296	$ 6	$ 90	$ 2,612	$ 5,020
Charge-offs	—	—	—	(49)	—	(77)	—	(126)
Recoveries	34	1	—	61	—	6	—	102
Provision	(19)	35	38	(43)	1	(4)	142	150
Ending balance ALLR	$ 1,360	$ 650	$ 95	$ 265	$ 7	$ 15	$ 2,754	$ 5,146
Loans:								
Ending balance	$ 397,192	$ 144,673	$ 10,618	$ 202,654	$ 12,388	$ 19,021	$ —	$ 786,546
Ending balance ALLR	(1,360)	(650)	(95)	(265)	(7)	(15)	(2,754)	(5,146)
Net loans	$ 395,832	$ 144,023	$ 10,523	$ 202,389	$ 12,381	$ 19,006	$ (2,754)	$ 781,400
Ending balance ALLR:								
Individually evaluated	$ 525	$ 394	$ 38	$ 3	$ —	$ 5	$ —	$ 965
Collectively evaluated	835	256	57	262	7	10	2,754	4,181
Total	$ 1,360	$ 650	$ 95	$ 265	$ 7	$ 15	$ 2,754	$ 5,146
Ending balance Loans:								
Individually evaluated	$ 1,564	$ 1,464	$ 382	$ 403	$ —	$ 22	$ —	$ 3,835
Collectively evaluated	392,409	143,209	8,228	202,196	12,388	18,996	—	777,426
Acquired with deteriorated	3,219	—	2,008	55	—	3	—	5,285

credit quality Total	$ 397,192	$ 144,673	$ 10,618	$ 202,654	$ 12,388	$ 19,021	$ —	$ 786,546

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, and other relevant characteristics.

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, and other relevant characteristics.

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Acceptable (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.

Acceptable Watch (44)

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. Acceptable Watch 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.

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 44 or better and any loans with a risk rating of 6 or 7 not considered impaired, 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. 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 is 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.

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Below is a breakdown of loans by risk category as of March 31, 2018 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable	(44) Acceptable Watch	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 4,004	$ 23,121	$ 160,116	$ 211,764	$ 8,514	$ 4,007	$ —	$ —	$ 411,526
Commercial, financial and agricultural	11,622	12,264	52,168	80,536	2,228	1,370	—	—	160,188
Commercial construction	—	289	2,531	1,299	642	372	—	2,871	8,004
One-to-four family residential real estate	—	1,440	2,461	5,874	1,199	2,992	—	190,576	204,542
Consumer construction	—	—	—	—	—	13	—	11,249	11,262
Consumer	—	—	—	26	4	78	—	16,811	16,919
Total loans	$ 15,626	$ 37,114	$ 217,276	$ 299,499	$ 12,587	$ 8,832	$ —	$ 221,507	$ 812,441

Below is a breakdown of loans by risk category as of December 31, 2017 (dollars in thousands):

	(1) Strong	(2) Good	(3) Average	(4) Acceptable	(44) Acceptable Watch	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 2,775	$ 23,929	$ 159,385	$ 207,921	$ 8,700	$ 4,032	$ —	$ —	$ 406,742
Commercial, financial and agricultural	11,528	8,980	53,448	77,964	3,658	1,373	—	—	156,951
Commercial construction	—	308	2,749	1,310	648	374	—	3,854	9,243
One-to-four family residential real estate	—	1,377	2,575	5,449	1,212	3,515	—	195,762	209,890
Consumer construction	—	—	—	—	—	14	—	10,804	10,818

Consumer	—	—	—	28	5	96	—	17,305	17,434
Total loans	$ 14,303	$ 34,594	$ 218,157	$ 292,672	$ 14,223	$ 9,404	$ —	$ 227,725	$ 811,078

Impaired Loans

Impaired 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.

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 loan 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.

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

	Impaired Loans with No Related Allowance	Impaired Loans with Related Allowance	Total Impaired Loans	Unpaid Principal Balance	Related Allowance for Loan Losses
March 31, 2018					
Commercial real estate	$ 1,685	$ 1,568	$ 3,253	$ 2,512	$ 362
Commercial, financial and agricultural	—	1,307	1,307	1,307	310
Commercial construction	—	372	372	372	—
One to four family residential real estate	1,510	—	1,510	2,200	—
Consumer construction	47	—	47	62	—
Consumer	—	—	—	—	—
Total	$ 3,242	$ 3,247	$ 6,489	$ 6,453	$ 672
December 31, 2017					
Commercial real estate	$ 1,511	$ 516	$ 2,027	$ 3,326	$ 168
Commercial, financial and agricultural	—	166	166	326	166
Commercial construction	—	—	—	—	—
One to four family residential real estate	1,621	—	1,621	2,315	—
Consumer construction	17	—	17	66	—
Consumer	21	—	21	21	—
Total	$ 3,170	$ 682	$ 3,852	$ 6,054	$ 334

	Individually Evaluated Impaired Loans			
	March 31, 2018		December 31, 2017	
	Average Balance for the Period	Interest Income Recognized for the Period	Average Balance for the Period	Interest Income Recognized for the Period
Commercial real estate	$ 2,919	$ 56	$ 2,784	$ 141
Commercial, financial and agricultural	817	7	246	1
Commercial construction	186	—	—	3
One to four family residential real estate	2,257	30	2,057	134
Consumer construction	64	1	37	—
Consumer	11	—	13	2
Total	$ 6,254	$ 94	$ 5,137	$ 281

A summary of past due loans at March 31, 2018 and December 31, 2017 is as follows (dollars in thousands):

	March 31, 2018				December 31, 2017			
	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	$ 664	$ —	$ 1,823	$ 2,487	$ 460	$ —	$ 866	$ 1,326
Commercial, financial and agricultural	—	—	247	247	16	—	338	354
Commercial construction	—	—	13	13	73	—	14	87
One to four family residential real estate	2,387	—	2,181	4,568	3,424	—	1,350	4,774
Consumer construction	—	—	—	—	—	—	—	—
Consumer	17	—	78	95	72	—	—	72
Total past due loans	$ 3,068	$ —	$ 4,342	$ 7,410	$ 4,045	$ —	$ 2,568	$ 6,613

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 applicable 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.

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There were no troubled debt restructurings that occurred during the three months ended March 31, 2018 or March 31, 2017.

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):

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
Loans outstanding, January 1	$ 10,037	$ 9,195
Net activity on revolving lines of credit	—	500
Repayment	(123)	(313)
Loans outstanding at end of period	$ 9,914	$ 9,382

There were no loans to related parties classified substandard as of March 31, 2018 or March 31, 2017. In addition to the outstanding balances above, there were unfunded commitments of $.605 million to related parties at March 31, 2018.

6.GOODWILL AND OTHER INTANGIBLE ASSETS

During the fourth quarter of 2014, the Corporation recorded $3.805 million of goodwill and $1.206 million of deposit based intangible assets associated with the acquisition of PFC. During 2016, the Corporation recorded $1.839 million of goodwill and $.993 million of deposit based intangible assets associated with the acquisition of Eagle River. Also in 2016, the Corporation recorded $50,000 of goodwill and $.300 million of deposit based intangible assets associated with the acquisition of Niagara.

The deposit based intangible is reported net of accumulated amortization at $1.860 million at March 31, 2018. Amortization expense in the first three months of 2018 is $62,000. Amortization expense for the next five

years is expected to be at $.250 million per year.

7.SERVICING RIGHTS

Mortgage Loans

Mortgage servicing rights ("MSRs") are recorded when loans are sold in the secondary market with servicing retained. As of March 31, 2018, the Corporation had obligations to service approximately $195.235 million of residential first mortgage loans. The valuation of MSRs 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 which management estimates at $1.737 million On a quarterly basis, management evaluates the MSRs for impairment. The key economic assumptions used in determining the fair value of the MSRs include an annual constant prepayment speed of 10.57% and a discount rate of 10.17% for March 31, 2018. In 2016, management decided to no longer regularly retain the servicing on mortgage loans sold.

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

	March 31, 2018	March 31, 2017
Balance at beginning of period	$ 1,033	$ 1,573
Amortization	(108)	(141)
Balance at end of period	$ 925	$ 1,432
Balance of loan servicing portfolio	$ 195,235	$ 215,730
Mortgage servicing rights as % of portfolio	.47%	.66%

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Commercial Loans

The Corporation periodically retains the servicing on certain commercial loans that have been sold. These loans were originated and underwritten under the SBA and USDA government guarantee programs, in which the guaranteed portion of the loan was sold to a third party with servicing retained. The balance of these sold loans with servicing retained at March 31, 2018 and March 31, 2017 was approximately $54 million and $55 million, respectively. The Corporation valued these servicing rights at $.102 million as of March 31, 2018 and at $.132 million as of March 31, 2017. This valuation was established in consideration of the discounted cash flow of net expected servicing income over the life of the loans.

8.BORROWINGS

Borrowings consist of the following at March 31, 2018 and December 31, 2017 (dollars in thousands):

	2018	2017
Federal Home Loan Bank fixed rate advances	$ 60,000	$ 60,000
Correspondent bank line of credit	1,000	—
Correspondent bank term note	18,449	18,999
USDA Rural Development note	553	553
	$ 80,002	$ 79,552

The Federal Home Loan Bank borrowings bear a weighted average rate of 1.81% and mature at vaious dates through 2022. They are collateralized at March 31, 2018 by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately $73.694 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $4.550 million and $4.536 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.112 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 March 31, 2018.

The Corporation currently has one correspondent banking borrowing relationship. The relationship consisted of a $5.0 million revolving line of credit and a term note. At March 31, 2018 the line of credit bore interest at a rate of 90-day LIBOR plus 2.75% and had an initial term that expired on April 30, 2018. The Corporation has since renewed and renegotiated this line of credit. The revised agreement includes an increase to the maximum amount to $15.0 million, bearing an interest rate of 90-day LIBOR plus 2.00%, with a floor rate of 2.00% and a ceiling of 22%. The revised line of credit expires on April 30, 2020. LIBOR at March 31, 2018 was 2.32%. The term note bears the same interest and matures on April 30, 2019 and requires quarterly principal payments of $.550 million, which began March

31, 2017. This relationship is secured by all of the outstanding mBank stock.

The USDA Rural Development borrowing bears an interest rate of 1.00% and matures in August, 2024. It is collateralized by an assignment of a demand deposit account held by the Corporation's wholly owned subsidiary, First Rural Relending, in the amount of $.553 million, and guaranteed by the Corporation.

9.DEFINED BENEFIT PENSION PLAN

The Corporation acquired the Peninsula Financial Corporation noncontributory defined benefit pension plan in 2014. Effective December 31, 2005, the plan was amended to freeze participation in the plan; therefore, no additional employees are eligible to become participants in the plan. The benefits are based on years of service and the employee's

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compensation at the time of retirement. The Plan was amended effective December 31, 2010, to freeze benefit accrual for all participants. Expected contributions to the Plan in 2018 are $64,000.

The anticipated distributions over the next five years and through December 31, 2027 are detailed in the table below (dollars in thousands):

2018	$ 133
2019	130
2020	126
2021	125
2022	131
2023-2027	796
Total	$ 1,441

At March 31, 2018, the plan's assets had a fair value of $2.191 million and the Corporation had a net unfunded liability of $1.135 million. The accumulated benefit obligation at March 31, 2018 was $3.331 million. At March 31, 2017, the plan's assets had a fair value of $2.049 million and the Corporation had a net unfunded liability of $1.138 million. The accumulated benefit obligation at March 31, 2017 was $3.187 million.

Assumptions in the actuarial valuation are:

	2018	2017
Weighted average discount rate	3.33%	3.78%
Rate of increase in future compensation levels	N/A	N/A
Expected long-term rate of return on plan assets	8.00%	8.00%

The expected long-term rate of return on plan assets reflects management's expectations of long-term average rates of return on funds invested to provide for benefits included in the projected benefit obligation. The expected return is based on the outlook for inflation, fixed income returns and equity returns, while also considering historical returns, asset allocation and investment strategy. The discount rate assumption is based on investment yields available on AA rated long-term corporate bonds.

The primary investment objective is to maximize growth of the pension plan assets to meet the projected obligations to the beneficiaries over a long period of time, and to do so in a manner that is consistent with the Corporation's risk tolerance. The intention of the plan sponsor is to invest the plan assets in mutual funds with the following asset

allocation; which was in place at both March 31, 2018 and December 31, 2017.

	Target Allocation	Actual Allocation
Equity securities	50% to 70%	60%
Fixed income securities	30% to 50%	40%

10.STOCK COMPENSATION PLANS

Restricted Stock Awards

The Corporation's restricted stock awards are service-based and awarded based on performance. Each award has a vesting period of four years. Compensation expense is recognized on a straight-line basis over the vesting period. Shares are subject to certain restrictions and risk of forfeiture by the participants.

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The Corporation has historically granted RSAs to members of the Board of Directors and management. Awards granted are set to vest equally over their award terms and are issued at no cost to the recipient. The table below summarizes each of the grant awards:

Date of Award	Units Granted	Market Value at grant date	Vesting Term
March, 2015	37,730	11.15	4 years
May, 2015	3,000	10.77	Immediate
February, 2016	35,733	9.91	4 years
February, 2017	28,427	13.39	4 years
February, 2018	18,643	16.30	4 years

On August 31, 2013, 2014, 2015 and 2016, the Corporation issued 37,125 shares of its common stock for vested RSAs, in each year. In March 2015, the Corporation issued 13,194 shares of its common stock for vested RSAs. In May 2015, the Corporation granted 3,000 shares, which were immediately vested and issued. In March 2016, the Corporation issued 22,626 shares of its common stock for vested RSAs. In the first quarter of 2017, the Corporation issued 31,559 shares of its common stock for vested RSAs. In the first quarter of 2018, the Corporation issued 37,630 shares of its common stock for vested RSAs.

A summary of changes in our nonvested shares for the period follows:

	Number Outstanding	Weighted Average Grant Date Fair Value
Nonvested balance at January 1, 2018	87,285	$ 11.78
Granted during the period	18,643	16.30
Vested during the period	(37,630)	11.94
Nonvested balance at March 31, 2018	68,298	$ 12.93

11.INCOME TAXES

The Corporation has reported deferred tax assets of $4.674 million at March 31, 2018. 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 March 31, 2018 had a net operating loss and tax credit carryforwards for tax purposes of approximately $5.9 million, and $1.7 million, respectively. Tax credit carryforwards include alternative minimum tax credits and general business credits. The Corporation evaluated the future benefits from these carryforwards as of March 31, 2018 and determined that it was "more likely than not" that they would be utilized prior to expiration. 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 and credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.404 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 will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

The Corporation recognized a federal income tax expense of approximately $.408 million for the three months ended March 31, 2018 and $.889 million for the three months ended March 31, 2017.

12.FAIR VALUE MEASUREMENTS

Fair value estimates, methods, and assumptions are set forth below for the Corporation's financial instruments. As part of the adoption of ASU 2016-01, the Corporation reviewed its calculations to determine fair values of 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.

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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.

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 March 31, 2018 and December 31, 2017 (dollars in thousands):

		March 31, 2018		December 31, 2017	
	Level in Fair Value Hierarchy	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	$ 40,427	40,427	$ 37,426	$ 37,426
Interest-bearing deposits	Level 2	11,391	11,391	13,374	13,374
Securities available for sale	Level 2	72,402	72,402	74,397	74,397
Securities available for sale	Level 3	1,000	1,000	1,000	1,000
Other securities	Level 3	500	500	500	500
Federal Home Loan Bank stock	Level 2	3,112	3,112	3,112	3,112
Net loans	Level 3	807,340	797,652	805,999	797,726
Accrued interest receivable	Level 3	2,078	2,078	2,276	2,276
Total financial assets		$ 938,250	$ 928,562	$ 938,084	$ 929,811
Financial liabilities:					
Deposits	Level 2	$ 806,797	772,589	$ 817,998	$ 788,632
Borrowings	Level 2	90,002	89,084	79,552	79,242
Accrued interest payable	Level 3	297	297	322	322
Total financial liabilities		$ 897,096	$ 861,970	$ 897,872	$ 868,196

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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 March 31, 2018, 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.

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 March 31, 2018 and December 31, 2017 were based on level 2 and level 3 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 table below shows investment securities measured at fair value on a recurring basis (dollars in thousands):

(dollars in thousands)	Balance at March 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses for Three Months Ended March 31, 2018

Assets					
Corporate	$ 24,222	$ —	$ 24,222	$ —	$ —
Equity	500	—	—	500	—
US Agencies	16,657	—	16,657	—	—
US Agencies - MBS	11,677	—	11,677	—	—
Obligations of state and political subdivisions	20,846	—	19,846	1,000	—
	$ 73,902				$ —

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(dollars in thousands)	Balance at December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Twelve months ended December 31, 2017
Assets					
Corporate	$ 24,391	$ —	$ 24,391	$ —	$ —
Equity	500	—	—	500	—
US Agencies	16,846	—	16,846	—	—
US Agencies - MBS	12,716	—	12,716	—	—
Obligations of state and political subdivisions	21,444	—	20,444	1,000	—
	$ 75,897				$ —

The Corporation had no Level 3 assets or liabilities measured at fair value on a recurring basis as of March 31, 2018, or December 31, 2017 other than as described above.

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 certain impaired 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 March 31, 2018

(dollars in thousands)	Balance at March 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total (Gains) Losses for Three Months Ended March 31, 2018
Assets					

Impaired loans	$ 6,489	$ —	$ —	$ 6,489	$ —
Other real estate owned	2,526	—	—	2,526	26
					$ 26

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2017

(dollars in thousands)	Balance at December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Twelve months ended December 31, 2017
Assets					
Impaired loans	$ 3,852	$ —	$ —	$ 3,852	$ 141
Other real estate held for sale	3,558	—	—	3,558	388
					$ 529

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).

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13.SHAREHOLDERS' EQUITY

The Corporation currently has a share repurchase program. The program is conducted under authorizations by the Board of Directors. The Corporation repurchased 14,000 shares in 2016, 102,455 shares in 2015, 13,700 shares in 2014 and 55,594 shares in 2013. The share repurchases were conducted under Board authorizations made and publically announced of $.600 million on February 27, 2013, $.600 million on December 17, 2013 and an additional $.750 million on April 28, 2015. None of these authorizations has an expiration date. As of March 31, 2018, approximately $25,000 of the total authorization was available for future purchases.

14.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.

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):

	March 31, 2018	December 31, 2017
Commitments to extend credit:		
Variable rate	$ 68,208	$ 72,187
Fixed rate	36,518	37,468
Standby letters of credit - Variable rate	7,342	7,753
Credit card commitments - Fixed rate	5,885	5,788
	$ 117,953	$ 123,196

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.

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 an 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 and Northeastern Wisconsin. The Bank's most prominent concentration in the loan portfolio relates to commercial real estate loans to

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operators of nonresidential buildings. This concentration at March 31, 2018 represents $118.458 million, or 20.19%,compared to $119.025 million, or 20.77%, of the commercial loan portfolio on December 31, 2017. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gas stations and convenience sotres, 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.

15. BUSINESS COMBINATIONS

The First National Bank of Eagle River

The Corporation completed its acquisition of The First National Bank of Eagle River ("Eagle River") in April 2016. Eagle River had three branch offices and approximately $125 million in assets as of April 29, 2016, including total loans of $84 million and total deposits of $105 million. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $12.500 million. The Corporation recorded a $.933 million core deposit intangible asset and $1.839 million of goodwill in conjunction with the acquisition. Goodwill was recorded due to the synergies and economies of scale expected from combining operations of the Corporation with Eagle River.

Niagara Bancorporation

The Corporation completed its acquisition of Niagara Bancorporation, Inc. ("Niagara") in August 2016. Niagara had four branch offices and approximately $67 million in assets as of August 31, 2016 including total loans of $33 million and total deposits of $59 million. The results of operations due to the merger have been included in the Corporation's results since the acquisition date. The merger was effected by a cash payment of $7.325 million. The corporation recorded a $.300 million core deposit intangible asset and $50,000 of goodwill in conjunction with the acquisition. Goodwill was recorded due to the synergies and economies of scale expected from combining operations of the Corporation with Niagara.

First Federal of Northern Michigan Bancorp, Inc.

On January 16, 2018, the Corporation announced the signing of a definitive agreement to acquire First Federal of Northern Michigan Bancorp, Inc in Alpena, Michigan ("FFNM"). FFNM is headquartered in Alpena, Michigan and has assets in excess of $320 million. As all necessary regulatory and shareholder approvals have been received, and we expect the consummation of this transaction will occur on May 18, 2018. The final purchase price will depend upon

the closing price of the Corporation's common stock at the time of acquisition. Shareholder's of FFNM will be issued shares of the Corporation's stock.

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MACKINAC FINANCIAL CORPORATION

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

Forward Looking Statements/Risk Factors

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.

- As a community banking organization, the Corporation's success depends upon local and regional economic conditions and the Corporation has different lending risks than larger banks.

We manage our credit exposure through careful monitoring of loan applicants and loan concentrations in particular industries and through loan approval and review procedures. We have established an evaluation process designed to determine the adequacy of our allowance for loan losses. While this evaluation process uses historical and other objective information, the classification of loans and the establishment of loan losses is estimated based on

experience, judgment and expectations regarding borrowers and economic conditions, as well as regulator judgments. We can make no assurance that our loan loss reserves will be sufficient to absorb future loan losses or prevent a material adverse effect on our business, profitability or financial condition.

· 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.

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· We may not realize the expected benefits of our anticipated acquisition of First Federal of Northern Michigan.

· 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 March 31, 2018, net deferred tax assets were approximately $4.674 million. If a 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 of breach in security.

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.

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.

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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.

The following discussion covers 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, the related notes, and other supplemental information presented elsewhere in this report. It should be noted that there may be non-GAAP disclosures presented within this discussion to further assist readers in their analysis of the financial condition of the Corporation. This discussion should also 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, 2017. Throughout this discussion and elsewhere in this report, the term "Bank" refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded first quarter 2018 net income of $1.537 million, or $.24 per share, compared to net income of $1.726 million, or $.28 per share for the first quarter of 2017. The 2018 results were impacted by expenses related to the FFNM acquisition, as well as costs incurred in connection with the consolidation of two Southeast Michigan offices for long-term efficiencies. Exclusion of these one-time costs resulted in adjusted net income for the first quarter of 2018 of $1.737 million or $.28 per share.

Weighted average shares outstanding for the three month period in 2018 totaled 6,304,203, compared to 6,270,034 shares in the same period of 2017.

The net interest margin for the first quarter of 2018 was $9.309 million, or 4.19%, compared to $9.166 million, or 4.19%, in the first quarter of 2017.

Total assets of the Corporation at March 31, 2018 were $983.929 million, down by $1.438 million, or 1.46%, from the $985.367 million in total assets reported at year-end 2017.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents increased $3.001 million during the three months of 2018, compared to 2017 year end. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale decreased $1.995 million from December 31, 2017 to March 31, 2018, with the balance on March 31, 2018 totaling $73.902 million. Investment securities are increased or decreased as appropriate as a result of managing interest rate risk and liquidity. As of March 31, 2018, investment securities with an estimated fair value of $4.536 million were pledged against borrowings at the FHLB and certain customer relationships.

Loans

Through the first three months of 2018, loan balances increased by $1.363 million from December 31, 2017 balances of $811.078 million. During the first three months of 2018, the Bank had total loan production of $44.971 million, which included $8.201 million of secondary market loan production. The increase in loan production, however, was offset by loan amortization and pay-offs of $37.512 million.

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

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risk in the loan portfolio. Management intends to continue to pursue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing. The Corporation is highly competitive in structuring loans to meet borrowing needs, while maintaining strong underwriting requirements.

Following is a summary of the loan portfolio at March 31, 2018 and December 31, 2017 (dollars in thousands):

	March 31, 2018	Percent of Total	December 31, 2017	Percent of Total
Commercial real estate	$ 411,526	50.64%	$ 406,742	50.15%
Commercial, financial, and agricultural	160,188	19.72	156,951	19.35
One to four family residential real estate	204,542	25.18	209,890	25.88
Consumer construction	11,262	1.39	10,818	1.33
Commercial construction	8,004	0.99	9,243	1.14
Consumer	16,919	2.08	17,434	2.15
Total loans	$ 812,441	100.00%	$ 811,078	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of March 31, 2018 and December 31, 2017 (dollars in thousands):

	March 31, 2018			December 31, 2017		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital
Real estate - operators of nonresidential buildings	118,458	20.43%	144.71%	119,025	20.77%	146.22%
Hospitality and tourism	75,046	12.95	91.68	75,228	13.13	92.42
Lessors of residential buildings	33,127	5.71	40.47	33,032	5.77	40.58
Gasoline stations and convenience stores	21,771	3.76	26.60	21,176	3.70	26.01
Logging	16,628	2.87	20.31	17,554	3.06	21.57
Commercial construction	8,004	1.38	9.78	9,243	1.61	11.36
Other	306,684	52.90	374.66	297,678	51.96	365.70
Total Commercial Loans	$ 579,718	100.00%		$ 572,936	100.00%	

Management recognizes that additional risks presented by concentration in certain segments of the portfolio. Management does not believe that its current portfolio composition has increased such risk related to any specific industry concentration as of March 31, 2018. The current concentration of real estate-related loans represents a broad customer base composed of a high percentage of owner-occupied developments. The company will, and has, slowed growth and origination of certain industry concentrations where internal limits have been reached.

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 March 31, 2018, our residential loan portfolio totaled $215.804 million, or 26.56%, of our total outstanding loans.

Due to the seasonal nature of many of the Corporation's commercial loan customers, our loan payment terms provide flexibility by structuring payments to coincide with our customers' business cycles. The lending staff evaluates the collectability of 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.

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Credit Quality

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

	March 31, 2018	December 31, 2017
Nonperforming Assets:		
Nonaccrual loans	$ 4,165	$ 2,388
Loans past due 90 days or more	—	—
Restructured loans on nonaccrual	177	180
Total nonperforming loans	4,342	2,568
Other real estate owned	2,526	3,558
Total nonperforming assets	$ 6,868	$ 6,126
Nonperforming loans as a % of loans	0.53%	0.32%
Nonperforming assets as a % of assets	0.70%	0.62%
Reserve for Loan Losses:		
At period end	$ 5,101	$ 5,079
As a % of outstanding loans	.63%	.64%
As a % of nonperforming loans	117.48%	197.78%
As a % of nonaccrual loans	122.47%	212.69%
Texas Ratio	6.87%	7.77%

The following ratios provide additional information relative to the Corporation's credit quality (dollars in thousands):

	At Period End	
	March 31, 2018	December 31, 2017
Total loans, at period end	$ 812,441	811,078
Average loans for the period	$ 810,688	$ 795,532
	For the Period Ended	
	Three Months Ended March 31, 2018	Twelve Months Ended December 31, 2017

Net charge-offs during the period	$ 28	566
Net charge-offs to average loans, annualized	.01%	.07%

Management seeks to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the 2017 independent review provided findings similar to management with respect to credit quality. In 2018, the Corporation will once again utilize a consultant for loan review.

As of March 31, 2018, the allowance for loan losses represented .63% of total loans. At March 31, 2018, the allowance included specific reserves in the amount of $.672 million, as compared to specific reserves of $.334 million at December 31, 2017. 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. Purchased impaired credits do not have an effect on the allowance for loan losses, in accordance with ASC 310-30.

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.

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

	Three Months Ended March 31, 2018	Year Ended December 31, 2017
Balance at beginning of period	$ 3,558	$ 4,782
Other real estate transferred from loans due to foreclosure	64	2,147
Proceeds from sale of other real estate	(1,070)	(2,983)
Writedowns on other real estate held for sale	—	(307)
Loss on other real estate held for sale	(26)	(81)
Balance at end of period	$ 2,526	$ 3,558

During the first three months of 2018, the Corporation received real estate in lieu of loan payments of $64,000. In determining the carrying value of other real estate held for sale, the Corporation generally starts with a third party appraisal of the underlying collateral and then deducts estimated selling costs to arrive at a net asset value. After the initial receipt, management periodically re-evaluates the recorded balances and records any additional reductions in the fair value as a write-down of other real estate held for sale.

Deposits

The Corporation had an decrease in deposits in the first three months of 2018. Total deposits decreased by $11.201 million, or 1.37%, in the first three months of 2018. The decrease in deposits for the first three months of 2018 is composed of a decrease in core deposits of $29.043 million and an increase in noncore deposits of $17.842 million. The decrease in core deposits is largely a result of seasonality inherent in our overall deposit portfolio. Management utilizes brokered deposits as a funding source, which provides flexibility in managing interest rate risk for fixed rate longer term loan fundings.

Management continues to monitor existing deposit products in order to stay competitive, both as to terms and pricing, which will remain important as we move through the current rate cycle to protect our margin. This focus on deposits has become especially important with changing client banking habits and demographics, as well as customer desire for more electronic and mobile based banking products and services. It is the intent of management to focus on growing core deposit levels, as the comparatively inexpensive deposits, in relation to wholesale deposit sources, will continue to prove valuable as rates continue to increase.

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

	March 31, 2018	% of Total	December 31, 2017	% of Total
Noninterest bearing	$ 143,129	17.74%	$ 148,079	18.10%
NOW, money market, checking	260,051	32.23	280,309	34.27
Savings	63,867	7.92	61,097	7.47
Certificates of Deposit <$250,000	135,554	16.80	142,159	17.38
Total core deposits	602,601	74.69	631,644	77.22
Certificates of Deposit >$250,000	12,738	1.58	11,055	1.35
Brokered CDs	191,458	23.73	175,299	21.43
Total non-core deposits	204,196	25.31	186,354	22.78
Total deposits	$ 806,797	100.00%	$ 817,998	100.00%

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At March 31, 2018, this source of funding totaled $60 million and the Corporation secured this funding by pledging loans and investments. The $60 million of

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FHLB borrowings have a weighted average maturity of 1.96 years and a weighted average interest rate of 1.81% at March 31, 2018. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending, that has an outstanding balance of $.553 million, with a fixed interest rate of 1% that matures in August 2024.

The Corporation currently has one correspondent banking borrowing relationship. The relationship consisted of a revolving line of credit and a term note. At March 31, 2018 the line of credit bore interest at a rate of LIBOR plus 2.75% and has an initial term that expired on April 30, 2018. The Corporation has since renewed and renegotiated this line of credit. The revised agreement includes an increase to the maximum amount to $15.0 million, bearing an interest rate of 90-day LIBOR plus 2.00%, with a floor rate of 2.00% and a ceiling of 22%. The revised line of credit expires on April 30, 2020. LIBOR was 2.32% at March 31, 2018. The term note had a balance of $18.449 million at March 31, 2018 and bears the same interest as the line of credit, and matures on April 30, 2019 and requires quarterly principal payments of $550,000 which began in March 31, 2017. This relationship is secured by all of the outstanding mBank stock.

Shareholders' Equity

Total shareholders' equity increased $.457 million from December 31, 2017 to March 31, 2018. Contributing to the increase in shareholders' equity was net income of $1.537 million, offset by a reduction for cash dividends on common stock of $.755 million, an increase due to stock compensation of $99,000, and a decrease in the market value of securities of $.424 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income of $1.537 million, or $.24 per share, in the first three months of 2018, compared to $1.726 million, or $.28 per share, for the first three months of 2017.

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. 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 $9.352 million, 4.21% of average earning assets, in the first three months of 2018, compared to $9.223 million, and 4.21% of average earning assets, in the first three months of 2017.

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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.

	Three Months Ended										
								2018-2017			
	Average Balances March 31,		Increase/	Average Rates March 31,		Interest March 31,		Income/ Expense	Volume	Rate	Ra Vo
rs in thousands)	2018	2017	(Decrease)	2018	2017	2018	2017	Variance	Variance	Variance	Va
(1,2,3)	$ 810,688	$ 782,477	$ 28,211	5.22%	5.19%	$ 10,426	$ 10,007	$ 419	$ 361	$ 56	$
le securities	61,212	70,954	(9,742)	2.46	2.28	372	399	(27)	(55)	32	(
xable securities	13,781	14,923	(1,142)	2.97	3.26	101	120	(19)	(9)	(11)	
al funds sold	12	2,899	(2,887)	.57	0.42	—	3	(3)	(3)	1	(
interest-earning	15,766	16,615	(849)	5.12	3.05	199	125	74	(6)	85	(
earning assets	901,459	887,868	13,591	4.99	4.87	11,098	10,654	444	288	163	(
ve for loan	(5,072)	(5,018)	(54)								
and due from	37,244	43,374	(6,130)								
Assets	16,274	15,945	329								
Real Estate	3,130	4,326	(1,196)								
assets	29,644	33,995	(4,351)								
assets	$ 982,679	$ 980,490	$ 2,189								
and money t deposits	$ 204,493	$ 221,154	$ (16,661)	.40	.33	$ 201	$ 179	$ 22	$ (13)	$ 38	$ (
st checking	67,569	67,604	(35)	.15	.15	25	25	—	—	—	
gs deposits	61,646	58,938	2,708	.07	.07	10	10	—	—	—	
icates of deposit	149,849	147,283	2,566	1.11	.85	410	309	101	5	94	
red deposits	178,840	173,166	5,674	1.34	1.02	590	437	153	14	134	
wings	90,178	70,194	19,984	2.29	2.72	510	471	39	134	(74)	(
interest-bearing ties	752,575	738,339	14,236	.94	.79	1,746	1,431	315	140	192	(
nd deposits	142,695	157,164	(14,469)								
liabilities	5,515	5,694	(179)								
holders' equity	81,894	79,293	2,601								
liabilities and holders' equity	$ 982,679	$ 980,490	$ 2,189								
pread				4.05%	4.08%						
terest n/revenue				4.21%	4.21%	$ 9,352	$ 9,223	$ 129	$ 148	$ (29)	$ 1

(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 21% tax rate.

(3) Interest income on loans includes fees.

In 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 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.

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 three months of 2018, the Corporation recorded a loan loss provision of $50,000, compared to $150,000 in the first three months of 2017. There were net charge-offs of $28,000 in the first three months of 2018, compared to net charge-offs of $24,000 for the same period in 2017. There was no provision for loan losses for acquired loans as a result of acquisition fair value adjustments.

Other Income

Other income was $.614 million in the first three months of 2018, compared to $.776 million in the same period in 2017. The decrease year over year was largely a result of decreased income from loans sold in the secondary market.

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.

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The following table details other income for the three months ended March 31, 2018 and 2017 (dollars in thousands):

	Three Months Ended March 31,		Increase/(Decrease)	
	2018	2017	Dollars	Percent
Deposit service fees	$ 269	$ 272	$ (3)	-1.10%
Income from loans sold in the secondary market	177	298	(121)	(40.60)
SBA/USDA loan sale gains	51	60	(9)	(15.00)
Net mortgage servicing (amortization) income	(8)	(8)	—	-
Other noninterest income	125	154	(29)	(18.83)
Total other income	$ 614	$ 776	$ (162)	-20.88%

Other Expense

For the first three months of 2018, the Corporation recorded other expenses of $7.928 million, compared to $7.177 million in 2017, an increase of $.751 million. This increase came in salaries and benefits as well as expenses related to the pending acquisition of FFNM. The increase in salaries and benefits and other customary operating expenses are necessary to ensure our platform infrastructure keeps pace with our growing asset base and the associated regulatory and risk management needs.

The following table details other expense for the three months ended March 31, 2018 and 2017 (dollars in thousands):

	Three Months Ended March 31,		Increase/(Decrease)	
	2018	2017	Dollars	Percentage
Salaries and employee benefits	$ 4,154	$ 3,797	$ 357	9.40%
Occupancy	811	785	26	3.31
Furniture and equipment	531	481	50	10.40
Data processing	504	461	43	9.33
Advertising	195	123	72	58.54
Professional service fees	304	321	(17)	(5.30)

Loan origination expenses and deposit and card related fees	126	179	(53)	(29.61)
Writedowns and losses on other real estate held for sale	26	12	14	116.67
FDIC insurance assessment	156	157	(1)	(0.64)
Telephone	155	157	(2)	(1.27)
Transaction related expenses	189	—	189	N/A
Other	777	704	73	10.37
Total other expense	$ 7,928	$ 7,177	$ 751	10.46%

Federal Income Taxes

The Corporation recognized a federal income tax expense for the three months ended March 31, 2018 of $.408 million, compared to $.889 million a year earlier. The majority of this decrease is a result of the reduction in corporate tax rates under the Tax Cuts and Jobs Act enacted late in 2017.

The Corporation has reported deferred tax assets of $4.674 million at March 31, 2018. 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 March 31, 2018 had a net operating loss and tax credit carryforwards for tax purposes of approximately $5.9 million and $1.7 million, respectively. Tax credit carryforwards include alternative minimum tax credits and general business credits. The Corporation evaluated the future benefits from these carryforwards as of March 31, 2018 and determined it was “more likely than not” that they would be utilized prior to expiration. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to

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expire in the year 2023. A portion of the NOL 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 $1.404 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 will continue to evaluate the future benefits from these carryforwards in order to determine if any adjustment to the deferred tax asset is warranted.

LIQUIDITY

We define liquidity 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, FHLB borrowings and brokered deposits. As a final source of liquidity, the Bank can exercise existing credit arrangements.

Current balance sheet liquidity consists of $40.427 million in cash and cash equivalents and $69.366 million of unpledged investment securities. Although current liquidity is deemed adequate, management has the ability to increase on hand liquidity by acquiring brokered CDs in order to fund any anticipated loan growth.

During the first three months of 2018, the Corporation increased cash and cash equivalents by $3.001 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. During the first three months of 2018, the Bank paid dividends to the Corporation of $2.000 million. Bank capital after the payment of this dividend remained strong and above the "well capitalized" level for regulatory purposes. The Corporation also has a line of credit with a correspondent bank that had borrowing availability at March 31, 2018 of $4.000 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 "adequately capitalized." The Corporation will continue to explore opportunities for longer term sources of liquidity and permanent equity to support projected asset growth.

Liquidity is managed by the Corporation through its Asset and Liability Committee ("ALCO"). The ALCO Committee meets regularly 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 $250,000. Noncore funding consists of certificates of deposit greater than $250,000, brokered deposits, and FHLB, Farmers' Home Administration and other borrowings. At March 31, 2018, the Bank's core deposits in relation to total funding were 75% compared to 77% at December 31, 2017. These ratios indicate that at March 31, 2018, that the Bank had slightly 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 March 31, 2018, the Bank had $53 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 it offers in order to remain competitive in its goal of increasing core deposits. The Corporation also has the ability to augment local deposit growth efforts with wholesale CD funding.

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REGULATORY CAPITAL

The Corporation is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation must meet specific capital guidelines that involve quantitative measures of the Corporation's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Corporation's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation to maintain minimum amounts and ratios (set forth in the table below) of total, Tier 1 capital and Common Equity Tier 1 Capital to risk-weighted assets and of Tier 1 capital to average assets. Management has determined that, as of March 31, 2018, the Corporation is adequately capitalized.

In order to be "well-capitalized" under the current guidelines, a depository institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; an Additional Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more.

The Corporation's and the Bank's actual capital and ratios compared to generally applicable regulatory requirements as of March 31, 2018 are as follows (dollars in thousands):

	Actual		Adequacy Purposes		Well-Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital to risk weighted assets:						
Consolidated	$ 75,411	9.4% >	$ 63,996 >	8.0% >	$ 79,996 >	10.0%
mBank	$ 93,782	11.7%>	$ 77,605 >	8.0% >	$ 97,006 >	10.0%
Tier 1 capital to risk weighted assets:						
Consolidated	$ 70,310	8.8% >	$ 47,997 >	6.0% >	$ 63,996 >	8.0%
mBank	$ 88,722	11.1%>	$ 58,204 >	6.0% >	$ 77,605 >	8.0%
Common equity Tier 1 capital to risk weighted assets						

Consolidated	$ 70,310	8.8%	> $ 35,998	> 4.5%	> $ 51,997	> 6.5%
mBank	$ 88,722	11.1%	> $ 43,653	> 4.5%	> $ 63,054	> 6.5%
Tier 1 capital to average assets:						
Consolidated	$ 70,310	7.3%	> $ 38,804	> 4.0%	> $ 48,504	> 5.0%
mBank	$ 88,722	9.2%	> $ 31,990	> 4.0%	> $ 39,988	> 5.0%

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.

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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 Corporation's 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 its fixed rate loans so it has an opportunity to reprice the loan within 12 to 36 months.

As of March 31, 2018, the Corporation had established interest rate floors on approximately $137.957 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 $60.716 million of the "floor rate" loan balances will reprice with a 25 basis point increase on the prime rate, with another $115.137 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $73.902 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal as of March 31, 2018. 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 offers deposit products with 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 managing 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 interest rate risks are inherent in the business of banking 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 regular 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.

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.

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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 is the Corporation's repricing opportunities at March 31, 2018 (dollars in thousands):

	1-90 Days	91-365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	$ 265,249	200,021	337,861	9,310	$ 812,441
Securities	10,751	2,969	41,328	18,854	73,902
Other (1)	7,360	3,555	3,357	247	14,519
Total interest-earning assets	283,360	206,545	382,546	28,411	900,862
Interest-bearing obligations:					
NOW, money market, savings and interest checking	323,918	—	—	—	323,918
Time deposits	21,187	57,420	67,913	1,772	148,292
Brokered CDs	78,035	105,921	7,502	—	191,458
Borrowings	1,000	21,727	57,113	162	80,002
Total interest-bearing obligations	424,140	185,068	132,528	1,934	743,670
Gap	$ (140,780)	$ 21,477	$ 250,018	$ 26,477	$ 157,192
Cumulative gap	$ (140,780)	$ (119,303)	$ 130,715	$ 157,192	

(1) Includes Federal Home Loan Bank Stock.

The above analysis indicates that at March 31, 2018, the Corporation had a cumulative liability sensitivity gap position of $119.303 million within the one-year time frame. The Corporation's cumulative liability sensitive gap suggests that if market interest rates were to increase in the next twelve months, the Corporation has the potential to earn less net interest income. This is because more liabilities would reprice at higher rates than assets. Conversely, if market interest rates decrease in the next twelve months, the above gap position suggests the Corporation's net interest income would increase. 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.

At December 31, 2017, the Corporation had a cumulative liability sensitivity gap position of $113.098 million within the one-year time frame.

The borrowings in the gap analysis include $60.000 million of FHLB advances that have a weighted average maturity of 1.96 years and a weighted average rate of 1.81%.

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.

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

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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 has decided to curtail its foreign exchange services for customer, however, management believes the exposure to short-term foreign exchange risk is minimal.

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.

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ITEM 4 CONTROLS AND PROCEDURES

As of March 31, 2018, 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 March 31, 2018.

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 March 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Corporation’s internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Corporation and its subsidiaries are subject to routine litigation incidental to the business of banking. Although the results of litigation and claims cannot be predicted, management believes there are no legal proceedings, the outcome of which, if determined adversely to the Corporation, would individually or in the aggregate be reasonably expected to have a material adverse effect on the Corporation's result of operations.

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, an additional $600,000 on December 17, 2013 and an additional $750,000 on April 28, 2015. None of these authorizations has an expiration date. As of March 31, 2018 there remains $25,335 to be utilized under the current authorizations. As presented below, there were no purchases during the first quarter of 2018.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

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.

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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:	May 14, 2018	By:	/s/ Paul D. Tobias PAUL D. TOBIAS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER (principal executive officer)
		By:	/s/ Jesse A. Deering JESSE A. DEERING EVP/CHIEF FINANCIAL OFFICER (principal financial and accounting officer)