MACKINAC FINANCIAL CORP /MI/
Form 10-Q
November 14, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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 X No ___

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

Large Accelerated Filer ___ Accelerated Filer ___ Non-accelerated Filer X

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

Yes ___ No X

As of October 31, 2006, there were outstanding 3,428,695 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)

	September 30, 2006	December 31, 2005	Se
	(Unaudited)		(
ASSETS			
Cash and due from banks	$ 5,537	$ 4,833	
Federal funds sold	11,949	3,110	
Cash and cash equivalents	17,486	7,943	
Interest-bearing deposits in other financial institutions	889	1,025	
Securities available for sale	36,129	34,210	
Federal Home Loan Bank stock	4,152	4,855	
Total loans	292,614	239,771	
Allowance for loan losses	(5,316)	(6,108)	
Net loans	287,298	233,663	
Premises and equipment	12,643	11,987	
Other real estate held for sale	26	945	
Other assets	4,568	4,094	
Total assets	$363,191	$298,722	
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Non-interest-bearing deposits	$ 22,826	$ 19,684	
Interest-bearing deposits	270,668	212,948	
Total deposits	293,494	232,632	
Borrowings	38,307	36,417	
Other liabilities	3,164	3,085	
Total liabilities	334,965	272,134	
Shareholders' equity:			
Preferred stock - no par value:			
Authorized - 500,000 shares, no shares outstanding	--	--	
Common stock and additional paid in capital - no par value			
Authorized - 18,000,000 shares Issued and outstanding - 3,428,695 shares	42,646	42,412	
Accumulated deficit	(14,083)	(15,461)	
Accumulated other comprehensive income (loss)	(337)	(363)	
Total shareholders' equity	28,226	26,588	
Total liabilities and shareholders' equity	$363,191	$298,722	

See accompanying notes to condensed consolidated financial statements.

MACKINAC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in Thousands, Except per Share Data)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	$5,635	$3,547	$15,316	$ 9,807
Tax-exempt	189	222	575	694
Interest on securities				
Taxable	306	282	852	1,178
Tax-exempt	5	42	87	126
Other interest	268	177	631	470
Total interest income	6,403	4,270	17,461	12,275
INTEREST EXPENSE:				
Deposits	2,951	1,338	7,540	3,666
Borrowings	500	425	1,355	1,509
Total interest expense	3,451	1,763	8,895	5,175
Net interest income before provision for loan losses	2,952	2,507	8,566	7,100
Provision for loan losses	--	--	(600)	--
Net interest income after provision for loan losses	2,952	2,507	9,166	7,100
OTHER INCOME:				
Service fees	133	137	365	470
Loan and lease fees	23	5	59	11
Net security gains	(1)	(1)	(1)	96
Net gains on sale of loans	66	17	149	37
Other	19	96	135	194
Total other income	240	254	707	808
OTHER EXPENSE:				
Salaries and employee benefits	1,487	1,555	4,577	4,665
Occupancy	333	275	943	748
Furniture and equipment	159	133	470	430
Data processing	176	234	512	726
Accounting, legal, and consulting fees	341	204	955	750
Loan and deposit	78	153	305	696
Telephone	55	66	155	203
Advertising	70	314	247	696
Penalty on prepayment of FHLB borrowings	--	--	--	4,320
Other	303	345	856	1,010
Total other expense	3,002	3,279	9,020	14,244
Income (loss) before income taxes	190	(518)	853	(6,336)
Provision for (benefit of) income taxes	(500)	--	(525)	--

NET INCOME (LOSS)	$ 690	$ (518)	$ 1,378	$(6,336)
INCOME (LOSS) PER COMMON SHARE:				
Basic	$ .20	$ (.15)	$ .40	$ (1.85)
Diluted	$ .20	$ (.15)	$ .40	$ (1.85)

See accompanying notes to condensed consolidated financial statements.

2.

MACKINAC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in Thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30	
	2006	2005	2006	200
Balance, beginning of period	$27,179	$28,517	$26,588	$34,7
Stock option compensation	78	--	234	
Net income (loss) for period	690	(518)	1,378	(6,3
Change in minority interest of consolidated subsidiary	--	--	--	
Net unrealized gain (loss) on securities available for sale	279	(99)	26	(5
Total comprehensive income (loss)	1,047	(617)	1,638	(6,8
Balance, end of period	$28,226	$27,900	$28,226	$27,9

See accompanying notes to condensed consolidated financial statements.

3.

MACKINAC FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands)
(Unaudited)

	Nine Months En September 30	
	2006	20

CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 1,378	$ (6
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	762	
(Gain) on sales of securities	--	
(Gain) on sales of premises, equipment, and other real estate	(60)	
FHLB stock dividend	--	
Stock option compensation	234	
Change in other assets	(568)	1
Change in other liabilities	79	(1
Net cash provided by (used in) operating activities	1,825	(5
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net (increase) decrease in interest-bearing deposits in other financial institutions	136	17
Purchase of securities available for sale	(5,000)	(16
Proceeds from sales of securities available for sale	--	30
Proceeds from maturities, calls or paydowns of securities available for sale	3,079	6
FHLB repurchase of stock	703	
Net (increase) in loans	(53,658)	(15
Capital expenditures	(1,307)	(1
Proceeds from sale of premises, equipment, and other real estate	1,013	
Purchase of minority interest in subsidiary of bank	--	
Net cash provided by (used in) investing activities	(55,034)	22
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	60,862	(2
Proceeds from issuance of debt	1,959	1
Principal payments on borrowings	(69)	(50
Net cash provided by (used in) financing activities	62,752	(51
Net increase (decrease) in cash and cash equivalents	9,543	(33
Cash and cash equivalents at beginning of period	7,943	44
Cash and cash equivalents at end of period	$ 17,486	$ 10
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest	$ 8,764	$ 5
Income taxes	--	
NONCASH INVESTING AND FINANCING ACTIVITIES:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	23	

See accompanying notes to condensed consolidated financial statements.

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the "Corporation") have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the nine month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. 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, 2005.

The preparation of financial statements in conformity with generally accepted accounting principles 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 period. Actual results could differ from those estimates.

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 not changed due to these classifications.

ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses includes specific allowances related to commercial loans, which 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 continues to maintain a general allowance for loan losses for loans not considered impaired. The allowance for loan losses is maintained at a level which management believes is adequate to provide for possible loan losses. Management periodically evaluates the adequacy of the allowance using the Corporation's past loan loss experience, known and inherent risks in the portfolio, composition of the portfolio, current economic conditions, and other factors. The allowance does not include the effects of expected losses related to future events or future changes in economic conditions. This evaluation is inherently subjective since it requires material estimates that may be susceptible to significant change. Loans are charged against the allowance for loan losses when management believes the collectibility 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 collectibility.

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 OPTION PLANS

The Corporation sponsors three stock option plans. One plan was approved in 2000 and applies to officers, employees, and nonemployee directors. This plan was amended as a part of the December 2004 stock offering and recapitalization. The amendment, approved by shareholders, increased the shares available under this plan by 428,587 shares from the original 25,000 (adjusted for the 1:20 reverse stock split), to a total authorized share balance of 453,587. The other two plans, one for officers and employees and the other for nonemployee

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

directors, were approved in 1997. A total of 30,000 shares (adjusted for the 1:20 reverse stock split), were made available for grant under these plans. Options under all of the plans are granted at the discretion of a committee of the Corporation's Board of Directors. Options to purchase shares of the Corporation's stock are granted at a price equal to the market price of the stock at the date of grant. The committee determines the vesting of the options when they are granted as established under the plan.

The Corporation adopted SFAS No. 123 (Revised) "Share Based Payments" in the first quarter of 2006. This statement supersedes APB Opinion No. 25 "Accounting for Stock Issued to Employees" and its related implementation guidance. Under Opinion No. 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This adoption resulted in the recognition of after tax compensation expense in the amount of $234,000 for the nine months ended September 30, 2006. The expense recorded recognizes the current period vesting of options outstanding. The after tax compensation expense, using this same accounting treatment would have amounted to $81,000 in the first nine months of 2005. The per share impact of this accounting change was approximately $.02 per share in each quarter and $.07 per share for the nine months ended September 30, 2006.

2. RECENT ACCOUNTING PRONOUNCEMENT

The Corporation adopted SFAS No. 123 (revised) "Share Based Payments" in the first quarter of 2006. The Corporation does not expect a material impact on the results of operations for 2006 as a result of this change, with $78,000 reported as expense in the third quarter.

3. EARNINGS (LOSS) PER SHARE

Earnings (loss) per share are based upon the weighted average number of shares outstanding.

The following shows the computation of basic and diluted earnings (loss) per share for the three and nine months ended September 30, 2006 and 2005 (dollars in thousands, except per share data):

Additional shares issued as a result of option exercises would not be dilutive in either period.

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Mon Septem 2006
Income (loss) per common share-Basic:			
Net income (loss)	$ 690	$ (518)	$ 1,378
Weighted average common shares outstanding	3,428,695	3,428,695	3,428,695
Income (loss) per common share-Basic	$ .20	$ (.15)	$ .40
Income (loss) per common share-Diluted:			
Net income (loss)	$ 690	$ (518)	$ 1,378
Weighted average common shares outstanding for basic loss per common share	3,428,695	3,428,695	3,428,695
Add: Dilutive effect of assumed exercise of stock options	--	--	--
Average shares and dilutive potential common shares	3,428,695	3,428,695	3,428,695
Income (loss) per common share-Diluted	$ .20	$ (.15)	$ .40

6.

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

4. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of September 30, 2006, December 31, 2005 and September 30, 2005 are as follows (dollars in thousands):

	September 30, 2006		December 31, 2005		September 30, 200	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value	Amortized Cost	Estima Fair Va
US Agencies	$35,954	$35,536	$30,980	$30,354	$31,990	$31,5
Obligations of states and political subdivisions	512	593	3,593	3,856	3,594	3,9
Total securities available for sale	$36,466	$36,129	$34,573	$34,210	$35,584	$35,5

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $26.939

million and $26.577 million, respectively, at September 30, 2006.

5. LOANS

The composition of loans at September 30, 2006, December 31, 2005 and September 30, 2005 is as follows (dollars in thousands):

	September 30, 2006	December 31, 2005	September 30, 2005
Commercial real estate	$146,838	$118,637	$123,429
Commercial, financial, and agricultural	58,548	56,686	36,297
One to four family residential real estate	51,341	44,660	42,490
Consumer	2,792	2,285	2,108
Construction	33,095	17,503	14,138
Total loans	$292,614	$239,771	$218,462

LOANS - ALLOWANCE FOR LOAN LOSSES

An analysis of the allowance for loan losses for the nine months ended September 30, 2006, the year ended December 31, 2005, and the nine months ended September 30, 2005 is as follows: (dollars in thousands):

	September 30, 2006	December 31, 2005	September 30, 2005
Balance at beginning of period	$6,108	$6,966	$6,966
Recoveries on loans	59	134	107
Loans charged off	(251)	(992)	(484)
Provision	(600)	--	--
Balance at end of period	$5,316	$6,108	$6,589

In the first nine months of 2006, net charge off activity was minimal at $192,000, or .07% of average loans outstanding compared to net charge-offs of $377,000, or .19% of average loans, in the same period in 2005. In the first quarter of 2006, the Corporation reduced the allowance for loan losses by recording a negative provision amounting to $600,000. This reduction in the reserve was made in recognition of the improved credit quality existent in the loan portfolio and is discussed in more detail under "Management's Discussion and Analysis."

5. LOANS (Continued)

LOANS - IMPAIRED LOANS

Nonperforming loans are those which are contractually past due 90 days or more as to interest or principal payments, on nonaccrual status, or loans, the terms of which have been renegotiated to provide a reduction or deferral on interest or principal. The interest income recorded and that which would have been recorded had nonaccrual and renegotiated loans been current, or not troubled was not material to the consolidated financial statements for the nine months ended September 30, 2006 and 2005.

Information regarding impaired loans as of September 30, 2006, December 31, 2005 and September 30, 2005 is as follows (dollars in thousands):

	September 30, 2006 (Unaudited)	December 31, 2005	September 30, 2005 (Unaudited)	Sep 30
Balances, at period end				
Impaired loans with specific valuation reserve	$1,803	$ --	$1,071	
Impaired loans with no specific valuation reserve	262	114	886	
Total impaired loans	$2,065	$ 114	$1,957	
Impaired loans on nonaccrual basis	$2,065	$ 15	$1,957	
Impaired loans on accrual basis	--	99	--	
Total impaired loans	$2,065	$ 114	$1,957	
Average investment in impaired loans	$ 713	$1,922	$2,374	
Interest income recognized during impairment	4	78	76	
Interest income that would have been recognized on an accrual basis	56	134	132	
Cash-basis interest income recognized	3	76	76	

The average investment in impaired loans was approximately $.713 million for the nine months ended September 30, 2006, $1.922 million for the year ended December 31, 2005, and $2.374 million for the nine months ended September 30, 2005, respectively. Impacting the impaired loan balances in 2005 was a sale of nonperforming assets in late December which included $1.0 million of nonaccrual loans.

LOANS - RELATED PARTIES

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):

	September 30, 2006	December 31, 2005	September 30, 2005

Loans outstanding beginning of period	$ 578	$ 63	$ 63
New loans	1,647	56	52
Net activity on revolving lines of credit	271	578	514
Repayment	(865)	(119)	(115)
Loans outstanding end of period	$1,631	$ 578	$ 514

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. LOANS (Continued)

There were no loans to related-parties classified substandard at September 30, 2006, December 31, 2005 or September 30, 2005, respectively. In addition to the outstanding balances above, there were no unused commitments to related parties at September 30, 2006.

6. BORROWINGS

Borrowings consist of the following at September 30, 2006, December 31, 2005 and September 30, 2005 (dollars in thousands):

	September 30, 2006	December 2005
Federal Home Loan Bank advances at rates ranging from 4.98% to 5.53% maturing in 2010 and 2011	$35,000	$35,00
Farmers Home Administration, fixed-rate note payable, maturing August 24, 2004, interest payable at 1%	1,348	1,41
Advance outstanding on line of credit with a correspondent bank, interest payable at the prime rate, 8.25% as of September 30, 2006	1,959	-
	$38,307	$36,41

In the first quarter of 2005, the Corporation prepaid $48.555 million of the Federal Home Loan Bank ("FHLB") borrowings and incurred a prepayment penalty of $4.320 million. This early payoff of FHLB borrowings reduced interest rate risk and better positions the Corporation for future match funding of loan growth.

The Federal Home Loan Bank borrowings are collateralized at September 30, 2006, by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately $19.361 million; U.S. government agency securities with an amortized cost and estimated fair value of $26.328 million and $25.966 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $4.152 million. Prepayment of the remaining advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of September 30, 2006.

In the second quarter of 2006, the Corporation established a $6 million line of credit with a correspondent bank. This line of credit, which is priced at the prime rate, will be utilized by the Corporation to infuse capital into the Bank in order to support the regulatory required 8% Tier 1 capital.

The U.S.D.A. Rural Development borrowing is collateralized by loans totaling $1.036 million originated and held by the Corporation's wholly owned subsidiary, First Rural Relending, and an assignment of a demand deposit account in the amount of $.460 million, and guaranteed by the Corporation.

MACKINAC FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. STOCK OPTION PLANS

A summary of stock option transactions for the nine months ended September 30, 2006 and 2005, and the year ended December 31, 2005, is as follows: (Historical stock option information has been adjusted for the 1:20 reverse stock split which occurred in December 2004).

	September 30, 2006	December 31, 2005	Septe
Outstanding shares at beginning of year	375,417	282,999	2
Granted during the period	--	112,500	1
Expired during the period	1,500	20,082	
Outstanding shares at end of period	373,917	375,417	3
Weighted average exercise price per share at end of period	$ 12.60	$ 14.15	$
Shares available for grant at end of period	90,988	89,488	1

There were no options granted in the first nine months of 2006. In the first nine months of 2005, the Corporation issued 60,000 option shares at a price of $12.00 per share and 40,000 option shares priced at $11.50 per share.

Following is a summary of the options outstanding and exercisable at September 30, 2006:

Exercise Price Range	Number Outstanding	Number Exercisable	Weighted Average Remaining Contractual Life-Years	Weighted Average Exercise Price

$9.16	12,500	2,500	9.25	$ 9.16
$9.75	257,152	120,861	8.21	9.75
$11.50	40,000	8,000	9.00	11.50
$12.00	60,000	12,000	8.71	12.00
$156.00 - $240.00	3,545	3,545	4.51	186.75
$300.00 - $406.60	720	720	2.79	345.00
	373,917	147,626	8.36	$ 12.60

8. CAPITAL

On December 16, 2004, the Corporation consummated a recapitalization through the issuance of $30 million of common stock in a private placement. The net proceeds of this offering amounted to $26.2 million. This recapitalization provided the funding to enable the Corporation to recapitalize the Bank with a $15.5 million capital infusion. This capital infusion provided the Bank with enough capital to be deemed a "well capitalized" institution by regulatory standards.

9. 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):

	September 30, 2006	December 31, 2005	September 30, 2005
Commitments to extend credit:			
Fixed rate	$ 4,628	$ 2,118	$ 1,709
Variable rate	44,142	31,557	27,827
Standby letters of credit - Variable rate	6,422	10,493	10,933
Credit card commitments - Fixed rate	2,488	3,135	3,145

	$57,680	$47,303	$43,614
	=======	=======	=======

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.

CONTINGENCIES

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

CONCENTRATION OF CREDIT RISK

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank's most prominent concentration in the loan portfolio relates to commercial loans to entities within the hospitality and tourism industry. This concentration represents $37.287 million, or 15.17%, of the commercial loan portfolio at September 30, 2006. The remainder of the commercial loan portfolio is diversified in such categories as real estate related, car dealers, gaming, and petroleum. 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 locality.

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

FORWARD-LOOKING STATEMENTS

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

- The highly regulated environment in which the Corporation operates could adversely affect its ability to carry out its strategic plan due to restrictions on new products, funding opportunities, or new market entrances;
- General economic conditions, either nationally or in the state(s) in which the Corporation does business;
- Legislation or regulatory changes which affect the business in which the Corporation is engaged;
- Changes in the interest rate environment which increase or decrease interest rate margins;
- Changes in securities markets with respect to the market value of financial assets and the level of volatility in certain markets such as foreign exchange;
- Significant increases in competition in the banking and financial services industry resulting from industry consolidation, regulatory changes, and other factors, as well as action taken by particular competitors;
- The ability of borrowers to repay loans;
- The effects on liquidity of unusual decreases in deposits;
- Changes in consumer spending, borrowing, and saving habits;
- Technological changes;
- Acquisitions and unanticipated occurrences which delay or reduce the expected benefits of acquisitions;
- Difficulties in hiring and retaining qualified management and banking personnel;
- The Corporation's ability to increase market share and control expenses;
- The effect of compliance with legislation or regulatory changes;
- The effect of changes in accounting policies and practices;

- The costs and effects of existing and future litigation and of adverse outcomes in such litigation.

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 will cover results of operations, asset quality, financial position, liquidity, interest rate sensitivity, and capital resources for the periods indicated. The information included in this discussion is intended to assist readers in their analysis of, and should be read in conjunction with, the consolidated financial statements and related notes and other supplemental information presented elsewhere in this report. This discussion should be read in conjunction with the consolidated financial statements and footnotes contained in the Corporation's Annual Report and Form 10-K for the year-ended December 31, 2005. Throughout this discussion, the term "Bank" refers to mBank, formerly known as North Country Bank and Trust, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

Year-to-date consolidated net income was $1.378 million through September 30, 2006, or $.40 per share, compared to a loss of $6.336 million, $1.85 per share, for the same period in 2005. The income for the three months ended September 30, 2006 amounted to $.690 million, or $.20 per share, compared to a loss of $.518 million, or $.15 per share for the same period in 2005. The 2006 nine months operations include a $600,000 negative provision, recorded in the first quarter, in recognition of improved credit quality and a $500,000 deferred tax benefit recorded in the third quarter. The deferred tax benefit was recorded in accordance with generally accepted accounting principles for recognition of a portion of the benefits to be derived from NOL carry-forwards. The 2005 results include a penalty of $4.320 million on the prepayment of $48.555 million of the FHLB borrowings. Excluding the provision and deferred tax adjustment in 2006 and the prepayment penalty recorded in 2005, the net income in the first nine months of 2006 amounted to $278,000, compared to an adjusted loss of $2.016 million for the same period in 2005. The nine month 2006 results also include $234,000 of stock option expense, required under the new accounting rules for stock compensation plans, as well as $400,000 of expenses incurred to pursue legal action against the Corporation's former accountants. The costs associated with the pursuit of this legal action have surpassed our earlier estimates but management and the Corporation's Board of Directors believe the case has merit and is in the best interests of shareholders. Legal expenses for this action are projected to be $250,000 in the fourth quarter which will carry the case through trial. Total assets increased $64.469 million from December 31, 2005 to September 30, 2006. The loan portfolio increased $52.843 million in the first nine months of 2006, from December 31, 2005 balances of $239.771 million. Deposits totaled $293.494 million at September 30, 2006, an increase of $60.862 million from the $232.632 million at December 31, 2005.

FINANCIAL CONDITION

CASH AND CASH EQUIVALENTS

Cash and cash equivalents increased $9.543 million in 2006. See further discussion of the change in cash and cash equivalents in the Liquidity section.

INVESTMENT SECURITIES

Available-for-sale securities increased $1.919 million, or 5.61%, from December 31, 2005 to September 30, 2006, with the balance on September 30, 2006, totaling $36.129 million. The increase in securities was primarily due to the combination of an early prepayment of $2.960 million of municipal obligations and the purchase of a $5.0 million US Agency security. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of September 30, 2006, investment securities with an estimated fair value of $27 million were pledged.

LOANS

Through the third quarter of 2006, loan balances increased by $52.843, or 22.04%, from December 31, 2005 balances of $239.771 million. During the first nine months of 2006, the Bank experienced loan production of $84 million. This loan production, combined with normal principal reductions of approximately $16 million and $15 million of early payouts of existing loans accounted for the increases in outstanding loan balances. The Corporation has been successful in maintaining loan growth without compromising credit quality. Enhancements to the loan approval process and exception reporting further provide for a more effective management of risk in the loan portfolio. Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with changes to the loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. As shown in the table below, all segments of the loan portfolio increased in the first nine months of 2006. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

Following is a summary of the loan portfolio at September 30, 2006, December 31, 2005 and September 30, 2005 (dollars in thousands):

	September 30, 2006	Percent of Total	December 31, 2005	Percent of Total
Commercial real estate	$146,838	50.18%	$118,637	49.48%
Commercial, financial, and agricultural	58,548	20.01	56,686	23.64
One to four family residential real estate	51,341	17.55	44,660	18.63
Consumer	2,792	.95	2,285	.95

Construction	33,095	11.31	17,503	7.30
Total loans	$292,614	100.00%	$239,771	100.00%

LOAN CONCENTRATION

Management recognizes that loan concentration within specific industries does increase the risk associated within the Corporation's loan portfolio. Historically, the Corporation had significant concentrations of its loan portfolio composed of hospitality and tourism loans. Management's intent is to monitor loan concentrations and to limit exposure to any one segment of the economy.

Following is a table showing the significant industry types in the commercial loan portfolio as of September 30, 2006, December 31, 2005 and September 30, 2005 (dollars in thousands):

	September 30, 2006			December 31, 2005		
	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders' Equity	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders' Equity
Hospitality and tourism	$ 37,287	18.15%	132.10%	$ 37,681	21.49%	141.72%
Real estate operators - nonresidential bldg	35,965	17.51	127.42	28,217	16.10	106.13
Real estate agents & managers	19,744	9.61	69.95	10,588	6.04	39.82
New car dealers	10,049	4.89	35.60	9,995	5.70	37.59
Family housing construction	7,215	3.51	25.56	2,184	1.25	8.21
Operators of nonresidential bldgs	7,035	3.43	24.92	6,218	3.55	23.39
Investors	6,658	3.24	23.59	191	.10	.72
Gaming	6,459	3.15	22.88	7,553	4.31	28.41
Petroleum	6,258	3.05	22.17	6,508	3.71	24.48
Skilled nursing care facilities	5,932	2.89	21.02	5,370	3.06	20.20
Other	62,784	30.57	222.43	60,818	34.69	228.74
Total Commercial Loans	$205,386	100.00%		$175,323	100.00%	

Management has made considerable progress in reducing concentrations of hospitality and tourism loans, which reduced exposure to this economic segment and lowered overall loan portfolio risk. Management expects further reductions in concentrations of hospitality and tourism loans through a combination of new loans in other industries and paydowns and maturities of current portfolio loans in this sector.

CREDIT QUALITY

The allowance for loan losses is maintained by management at a level considered to be adequate to cover probable losses related to specifically identified loans, as well as losses inherent in the balance of the loan portfolio. At September 30, 2006, the allowance for loan losses was 1.82% of total loans outstanding compared to 2.55% at December 31, 2005 and 3.02% at September 30, 2005.

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the nine months ended September 30, 2006 amounted to $.192 million, or .07% of average loans outstanding, compared to $.377 million, ..19% of average loans outstanding, for the same period in 2005. The Corporation, in recognition of the continued improvement in credit quality which has occurred since 2004, reduced the reserve for loan loss by $600,000 in the first quarter of 2006. The reduction of the reserve results in a current reserve balance that is more representative of the relevant risk inherent within the Corporation's loan portfolio. The current level of charge-offs is below historical levels and

projected charge-off activity, based upon current levels of nonperforming loans, is not expected to attain historical levels. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity. There were no new significant problem loans or loan downgrades identified during the first or second quarter of 2006. In the third quarter of 2006, one large commercial credit was put into nonaccrual which accounted for the majority of the increase in nonperforming loans. This commercial credit is secured primarily by real estate and no material loss is anticipated.

The table below shows period end balances of non-performing assets (dollars in thousands):

	September 30, 2006	December 31, 2005	September 30, 2005
NONPERFORMING ASSETS:			
Nonaccrual Loans	$ 2,065	$ 15	$1,957
Loans past due 90 days or more	--	99	--
Restructured Loans	--	--	0
Total nonperforming loans	2,065	114	1,957
Other real estate owned	26	945	1,948
Total nonperforming assets	$ 2,091	$ 1,059	$3,905
Nonperforming loans as a % of loans	.71%	.05%	.09%
Nonperforming assets as a % of assets	.58%	.35%	1.39%
RESERVE FOR LOAN LOSSES:			
At period end	$ 5,316	$ 6,108	$6,589

As a % of loans	1.82%	2.55%	3.02%
As a % of nonperforming loans	257.43%	5,357.89%	336.69%
As a % of nonaccrual loans	257.43%	N/M%	N/M%

Following is the allocation of the allowance for loan losses as of September 30, 2006, December 31, 2005 and September 30, 2005 (dollars in thousands):

	September 30, 2006	December 31, 2005	September 30, 2005
Commercial, financial and agricultural loans	$1,431	$1,492	$1,716
One to four family residential real estate loans	29	17	80
Consumer loans	--	--	--
Unallocated and general reserves	3,856	4,599	4,793
Totals	$5,316	$6,108	$6,589

The following ratios assist management in the determination of the Corporation's credit quality (dollars in thousands):

	Nine Months Ended September 30, 2006	Twelve Months Ended December 31, 2005	Nine Month Ended September 3 2005
Allowance to total loans, at period end	1.82%	2.55%	3.02%
Average loans outstanding for the periods indicated	$271,351	$207,928	$202,381
Net charge-offs to average outstanding loans	.07%	.41%	.19%
Nonperforming loans to gross loans, at period end	.71%	.05%	1.79%

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MACKINAC FINANCIAL CORPORATION
ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Total nonperforming loans increased $1.951 million since December 31, 2005. The 2006 increase resulted primarily from the nonaccrual status of one commercial credit with a current principal balance of $1.693 million. Late in 2005, the Bank sold $2.1 million of nonperforming assets, which included $1.000 million of nonperforming loans.

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation's senior lending staff and the bank regulatory examinations, management reviews the Corporation's loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes a loan review consultant to perform a review of the loan portfolio. The opinion of this consultant upon completion of the independent review provided findings similar to management on the overall adequacy of the reserve. The Corporation has engaged this same consultant for loan review during 2006.

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, which is grouped with other assets on the condensed consolidated balance sheet.

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

	Nine Months Ended September 30, 2006	Year Ended December 31, 2005	Nine Months Ended September 30, 2005
Balance at beginning of period	$ 945	$ 1,730	$1,730
Other real estate transferred from loans	23	274	556
Other real estate sold/written down	(942)	(1,059)	(338)
Balance at end of period	$ 26	$ 945	$1,948

During the first nine months of 2006, the Corporation received real estate in lieu of loan payments of $23,000. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balance. Any additional reduction in the fair value results in a write-down of other real estate. Write-downs on other real estate may be recorded based on subsequent evaluations of current realizable fair values.

DEPOSITS

The Corporation had an increase in deposits in the first nine months of 2006. Total deposits increased by $60.862 million, or 26.2%, in the first nine months of 2006. This growth in deposits included $41.508 million of non-core deposits, mostly brokered certificates of deposit. The Corporation continues to evaluate its deposit products and pricing alternatives in an effort to fund loan growth as economically as possible.

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

	September 30,	December 31,	September 30,

	2006	2005	2005
Demand deposit accounts	$ 22,826	$ 19,684	$ 19,690
NOW and money market	73,797	64,566	61,093
Savings and IRAs	22,576	22,555	23,670
Certificates of Deposit			