MACKINAC FINANCIAL CORP /MI/
Form 10-Q
August 14, 2012
Table of Contents

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 June 30, 2012

OR

o 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 (State or other jurisdiction of incorporation or organization)	**38-2062816** (I.R.S. Employer Identification No.)
130 SOUTH CEDAR STREET, MANISTIQUE, MI (Address of principal executive offices)	**49854** (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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 x No o

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

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

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

As of June 30, 2012, there were outstanding 3,419,736 shares of the registrant s common stock, no par value.

Table of Contents

MACKINAC FINANCIAL CORPORATION

INDEX

Table of Contents

MACKINAC FINANCIAL CORPORATION

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands)

	June 30, 2012 (Unaudited)	December 31, 2011	June 30, 2011 (Unaudited)
ASSETS			
Cash and due from banks	**$ 33,248**	$ 20,071	$ 22,294
Federal funds sold		13,999	12,000
Cash and cash equivalents	**33,248**	34,070	34,294
Interest-bearing deposits in other financial institutions	**10**	10	10
Securities available for sale	**39,054**	38,727	38,613
Federal Home Loan Bank stock	**3,060**	3,060	3,060
Loans:			
Commercial	**319,398**	311,215	305,752
Mortgage	**90,260**	83,106	83,194
Consumer	**9,795**	6,925	5,866
Total Loans	**419,453**	401,246	394,812
Allowance for loan losses	**(5,083)**	(5,251)	(6,155)
Net loans	**414,370**	395,995	388,657
Premises and equipment	**10,134**	9,627	9,623
Other real estate held for sale	**3,518**	3,162	4,806
Deferred Tax Asset	**10,271**	8,427	8,444
Other assets	**10,701**	5,233	4,866
TOTAL ASSETS	**$ 524,366**	$ 498,311	$ 492,373
LIABILITIES AND SHAREHOLDERS EQUITY			
LIABILITIES:			
Deposits:			
Noninterest bearing deposits	**$ 59,872**	$ 51,273	$ 49,769
NOW, money market, interest checking	**143,795**	152,563	149,448
Savings	**14,248**	14,203	16,526
CDs<$100,000	**140,018**	130,685	114,215
CDs>$100,000	**25,975**	23,229	23,102
Brokered	**41,473**	32,836	46,607
Total deposits	**425,381**	404,789	399,667

Borrowings	**35,997**	35,997	36,069
Other liabilities	**2,636**	2,262	1,853
Total liabilities	**464,014**	443,048	437,589
SHAREHOLDERS EQUITY:			
Preferred stock - No par value: Authorized 500,000 shares, Issued and outstanding - 11,000 shares	**11,000**	10,921	10,811
[redacted]			
Retained earnings	**5,131**	492	(102)
[redacted]			
[redacted]			
[redacted]			

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except per Share Data)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
	(Unaudited)		(Unaudited)	
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	**$ 5,873**	$ 5,198	**$ 11,453**	$ 10,334
Tax-exempt	**30**	37	**62**	79
Interest on securities:				
Taxable	**238**	292	**502**	574
Tax-exempt	**7**	7	**14**	14
Other interest income	**30**	30	**55**	63
Total interest income	**6,178**	5,564	**12,086**	11,064
INTEREST EXPENSE:				
Deposits	**992**	1,231	**1,975**	2,449
Borrowings	**167**	155	**329**	296
Total interest expense	**1,159**	1,386	**2,304**	2,745
Net interest income	**5,019**	4,178	**9,782**	8,319
Provision for loan losses	**150**	600	**645**	600
Net interest income after provision for loan losses	**4,869**	3,578	**9,137**	7,719
OTHER INCOME:				
Deposit service fees	**189**	219	**383**	436
Income from secondary market loans sold	**226**	120	**524**	199
SBA/USDA loan sale gains	**620**	950	**620**	1,186
Mortgage servicing income	**115**		**200**	
Other	**155**	59	**184**	104
Total other income	**1,305**	1,348	**1,911**	1,925
OTHER EXPENSE:				
Salaries and employee benefits	**2,003**	1,806	**3,978**	3,630
Occupancy	**335**	349	**680**	714
Furniture and equipment	**219**	221	**447**	415
Data processing	**258**	179	**486**	355
Professional service fees	**310**	232	**490**	385
Loan and deposit	**338**	252	**479**	431
Writedowns and losses on other real estate held for sale	**174**	(35)	**185**	432
FDIC insurance assessment	**159**	255	**318**	540
Telephone	**57**	58	**112**	109
Advertising	**98**	111	**196**	199
Other	**256**	301	**670**	578
Total other expenses	**4,207**	3,729	**8,041**	7,788

Income before provision for income taxes		**1,967**		1,197		**3,007**		1,856
Provision for (benefit of) income taxes		**(2,335)**		402		**(1,986)**		616
NET INCOME		**4,302**		795		**4,993**		1,240
Preferred dividend and accretion of discount		**161**		192		**354**		381
NET INCOME AVAILABLE TO COMMON SHAREHOLDERS	**$**	**4,141**	$	603	**$**	**4,639**	$	859
INCOME PER COMMON SHARE:								
Basic	**$**	**1.21**	$	.18	**$**	**1.36**	$	.25
Diluted	**$**	**1.17**	$	.17	**$**	**1.31**	$	.25

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS COMPREHENSIVE INCOME

(Dollars in Thousands)

(Unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2011	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Net income	**$ 4,302**	$ 795	**$ 4,993**	$ 1,240
Net change in net unrealized gains and losses on securities available for sale:				
Unrealized gains (losses) arising during the period	**139**	45	**562**	(94)
Less: reclassification adjustment for gains(losses) included in net income				
Net securities gain (loss) during the period	**139**	45	**562**	(94)
Tax effect	**(47)**	(15)	**(191)**	32
Net of tax	**92**	30	**371**	(62)
Comprehensive income	**$ 4,394**	$ 825	**$ 5,364**	$ 1,178

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY

(Dollars in Thousands)

(Unaudited)

	Three Months Ended June 31, 2012 Preferred Stock	2012 Common Shareholders Equity	2012 Total Shareholders Equity	2011 Preferred Stock	2011 Common Shareholders Equity	2011 Total Shareholders Equity
Balance, beginning of period	**$ 10,976**	**$ 45,119**	**$ 56,095**	$ 10,757	$ 43,340	$ 54,097
Net income for period		**4,302**	**4,302**		795	795
Net unrealized gain (loss) on securities available for sale		**92**	**92**		30	30
Total comprehensive income (loss)		**4,394**	**4,394**		825	825
Dividend on preferred stock		**(137)**	**(137)**		(138)	(138)
	24	**(24)**		54	(54)	

Accretion of preferred stock discount												
Balance, end of period	**$**	**11,000**	**$**	**49,352**	**$**	**60,352**	$	10,811	$	43,973	$	54,784

	Six Months Ended June 30,											
	2012						**2011**					
		Preferred Stock		**Common Shareholders Equity**		**Total Shareholders Equity**		**Preferred Stock**		**Common Shareholders Equity**		**Total Shareholders Equity**
Balance, beginning of period	**$**	**10,921**	**$**	**44,342**	**$**	**55,263**	$	10,706	$	43,176	$	53,882
Net income (loss) for period				**4,993**		**4,993**				1,240		1,240
Net unrealized gain (loss) on securities available for sale				**371**		**371**				(62)		(62)
Total comprehensive income (loss)				**5,364**		**5,364**				1,178		1,178
Dividend on preferred stock				**(275)**		**(275)**				(276)		(276)
Accretion of preferred stock discount		**79**		**(79)**				105		(105)		
Balance, end of period	**$**	**11,000**	**$**	**49,352**	**$**	**60,352**	$	10,811	$	43,973	$	54,784

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MACKINAC FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in Thousands)

(Unaudited)

	Six Months Ended June 30, 2012	2011
Cash Flows from Operating Activities:		
Net income	$ **4,993**	$ 1,240
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	**777**	749
Provision for loan losses	**645**	600
Provision (benefit of) for income taxes	**(1,986)**	616
(Gain) on sale of secondary market loans	**(198)**	(122)
Origination of secondary market loans held for sale	**(28,942)**	(11,247)
Proceeds from secondary market loans held for sale	**29,140**	11,446
(Gain) loss on sale of premises, equipment, and other real estate held for sale	**11**	(64)
Writedown of other real estate held for sale	**174**	496
Change in other assets	**(5,546)**	392
Change in other liabilities	**374**	(113)
Net cash provided by operating activities	**(558)**	3,993
Cash Flows from Investing Activities:		
Net increase in loans	**(19,755)**	(14,966)
Net increase in interest-bearing deposits in other financial institutions		703
Purchase of securities available for sale	**(6,293)**	(12,875)
Proceeds from maturities, sales, calls or paydowns of securities available for sale	**6,368**	7,843
Capital expenditures	**(1,044)**	(527)
Redemption of FHLB stock		363
Proceeds from sale of premises, equipment, and other real estate	**143**	2,429
Net cash provided by (used in) investing activities	**(20,581)**	(17,030)
Cash Flows from Financing Activities:		
Net increase in deposits	**20,592**	12,888
Dividend on preferred stock	**(275)**	(276)
Net cash provided by financing activities	**20,317**	12,612
Net increase (decrease) in cash and cash equivalents	**(822)**	(425)
Cash and cash equivalents at beginning of period	**34,070**	34,719
Cash and cash equivalents at end of period	$ **33,248**	$ 34,294
Supplemental Cash Flow Information:		
Cash paid during the year for:		
Interest	$ **2,304**	$ 2,720
Income taxes	**50**	50

Noncash Investing and Financing Activities:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	**685**	2,105
(net of adjustments made through the allowance for loan losses)		

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The unaudited condensed consolidated financial statements of Mackinac Financial Corporation (the Corporation) have been prepared in accordance with generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six-month period ended June 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. 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, 2011.

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 was not changed due to these reclassifications.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and the valuation of deferred tax assets, mortgage servicing rights and other real estate held for sale.

Allowance for Loan Losses

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

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

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

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock Option Plans

The Corporation sponsors three stock option plans. One plan was approved during 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 directors, were approved in 1997. A total of 30,000 shares (adjusted for the 1:20 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 were granted at a price equal to the market price of the stock at the date of grant. The committee determined the vesting of the options when they were granted as established under the plan. All of the option plans have expired.

2. EARNINGS PER SHARE

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

The following shows the computation of basic and diluted earnings per share for the three and six months ended June 30, 2012 and 2011 (dollars in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2011**	**2012**	**2011**
(Numerator):				
Net income	**$ 4,302**	$ 795	**$ 4,993**	$ 1,240
Preferred stock dividends and accretion of discount	**161**	192	**354**	381
Net income available to common shareholders	**$ 4,141**	$ 603	**$ 4,639**	$ 859
(Denominator):				
Weighted average shares outstanding - basic	**3,419,736**	3,419,736	**3,419,736**	3,419,736
Dilutive effect of stock options				
Dilutive effect of common stock warrants	**120,172**	90,074	**112,904**	84,831

Weighted average shares outstanding - diluted		**3,539,908**		3,509,810		**3,532,640**		3,504,567
Income per common share:								
Basic	**$**	**1.21**	$	.18	**$**	**1.36**	$	.25
Diluted	**$**	**1.17**	$	.17	**$**	**1.31**	$	.25

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities available for sale as of June 30, 2012, December 31, 2011 and June 30, 2011 are as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
June 30, 2012				
US Agencies - MBS	**$ 9,667**	**$ 412**	**$**	**$ 10,079**
US Agencies	**10,338**	**155**		**10,493**
Corporate Bonds	**12,519**	**70**	**(17)**	**12,572**
Obligations of states and political subdivisions	**5,474**	**438**	**(2)**	**5,910**
Total securities available for sale	**$ 37,998**	**$ 1,075**	**$ (19)**	**$ 39,054**
December 31, 2011				
US Agencies - MBS	$ 11,111	$ 387	$	$ 11,498
US Agencies	10,407	168		10,575
Corporate Bonds	8,314		(136)	8,178
Other asset backed	2,954		(34)	2,920
Obligations of states and political subdivisions	5,448	110	(2)	5,556
Total securities available for sale	$ 38,234	$ 665	$ (172)	$ 38,727
June 30, 2011				
US Agencies - MBS	$ 18,842	$ 660	$	$ 19,502
US Agencies	10,478	157		10,635
Corporate Bonds	5,297		(1)	5,296
Obligations of states and political subdivisions	3,163	34	(17)	3,180
Total securities available for sale	$ 37,780	$ 851	$ (18)	$ 38,613

When gross unrealized losses exist within the portfolio, the Corporation considers them temporary in nature and related to interest rate fluctuations. 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 $8.796 million and $9.242 million, respectively, at June 30, 2012.

4. LOANS

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

	June 30, 2012	December 31, 2011	June 30, 2011
Commercial real estate	**$ 211,506**	$ 199,201	$ 198,285
Commercial, financial, and agricultural	**85,099**	92,269	84,405
One to four family residential real estate	**84,665**	77,332	79,013
Construction :			
Consumer	**5,595**	5,774	4,181
Commerical	**22,793**	19,745	23,062
Consumer	**9,795**	6,925	5,866
Total loans	**$ 419,453**	$ 401,246	$ 394,812

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

An analysis of the allowance for loan losses for the six months ended June 30, 2012, the year ended December 31, 2011, and the six months ended June 30, 2011 is as follows (dollars in thousands):

	June 30, 2012	December 31, 2011	June 30, 2011
Balance at beginning of period	**$ 5,251**	$ 6,613	$ 6,613
Recoveries on loans previously charged off	**219**	138	21
Loans charged off	**(1,032)**	(3,800)	(1,079)
Provision	**645**	2,300	600
Balance at end of period	**$ 5,083**	$ 5,251	$ 6,155

In the first half of 2012, net charge off activity was $.813 million, or .20% of average loans outstanding compared to net charge-offs of $1.058 million, or .28% of average loans, in the same period in 2011. In the first half of 2012, the Corporation recorded a provision for loan loss of $.645 million compared to $.600 million in the first half of 2011. The Corporation s allowance for loan loss reserve policy calls for a measurement of the adequacy of the reserve at each quarter end. This process includes an analysis of the loan portfolio to take into account increases in loans outstanding and portfolio composition, historical loss rates, and specific reserve requirements of nonperforming loans.

A breakdown of the allowance for loan losses and recorded balances in loans at June 30, 2012 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	**$ 2,823**	**$ 1,079**	**$ 207**	**$ 1,114**	**$**	**$**	**$ 28**	**$ 5,251**
Charge-offs	**(691)**	**(24)**	**(6)**	**(296)**		**(15)**		**(1,032)**
Recoveries	**18**	**187**		**5**		**9**		**219**
Provision	**634**	**(354)**	**17**	**260**		**6**	**82**	**645**
Ending balance ALLR	**$ 2,784**	**$ 888**	**$ 218**	**$ 1,083**	**$**	**$**	**$ 110**	**$ 5,083**
Loans:								
Ending balance	**$ 211,506**	**$ 85,099**	**$ 22,793**	**$ 84,665**	**$ 5,595**	**$ 9,795**	**$**	**$ 419,453**

Ending balance ALLR	**(2,784)**	**(888)**	**(218)**	**(1,083)**			**(110)**	**(5,083)**
Net loans	**$ 208,722**	**$ 84,211**	**$ 22,575**	**$ 83,582**	**$ 5,595**	**$ 9,795**	**$ (110)**	**$ 414,370**
Ending balance ALLR:								
Individually evaluated	**1,000**	**148**	**12**	**36**				**1,196**
Collectively evaluated	**1,784**	**740**	**206**	**1,047**			**110**	**3,887**
Total	**$ 2,784**	**$ 888**	**$ 218**	**$ 1,083**	**$**	**$**	**$ 110**	**$ 5,083**
Ending balance Loans:								
Individually evaluated	**$ 22,119**	**$ 6,150**	**$ 1,534**	**$ 764**	**$ 15**	**$**	**$**	**$ 30,582**
Collectively evaluated	**189,387**	**78,949**	**21,259**	**83,901**	**5,580**	**9,795**		**388,871**
Total	**$ 211,506**	**$ 85,099**	**$ 22,793**	**$ 84,665**	**$ 5,595**	**$ 9,795**	**$**	**$ 419,453**

Impaired loans, by definition, are individually evaluated.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A breakdown of the allowance for loan losses and recorded balances in loans at December 31, 2011 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	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	6,613
Charge-offs	(2,267)	(579)	(412)	(490)		(52)		(3,800)
Recoveries	32	21	75	1		9		138
Provision	1,598	619	155	(19)		43	(96)	2,300
Ending balance ALLR	$ 2,823	$ 1,079	$ 207	$ 1,114	$	$	$ 28	$ 5,251
Loans:								
Ending balance	$ 199,201	$ 92,269	$ 19,745	$ 77,332	$ 5,774	$ 6,925	$	$ 401,246
Ending balance ALLR	(2,823)	(1,079)	(207)	(1,114)			(28)	(5,251)
Net loans	$ 196,378	$ 91,190	$ 19,538	$ 76,218	$ 5,774	$ 6,925	$ (28)	$ 395,995
Ending balance ALLR:								
Individually evaluated	$ 926	$ 160	$	$ 114	$	$	$	$ 1,200
Collectively evaluated	1,897	919	207	1,000			28	4,051
Total	$ 2,823	$ 1,079	$ 207	$ 1,114	$	$	$ 28	$ 5,251
Ending balance Loans:								
Individually evaluated	$ 13,628	$ 1,707	$	$ 1,930	$	$	$	$ 17,265
Collectively evaluated	185,573	90,562	19,745	75,402	5,774	6,925		383,981
Total	$ 199,201	$ 92,269	$ 19,745	$ 77,332	$ 5,774	$ 6,925	$	$ 401,246

A breakdown of the allowance for loan losses and recorded balances in loans at June 30, 2011 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	$ 3,460	$ 1,018	$ 389	$ 1,622	$	$	$ 124	$ 6,613
Charge-offs	(344)	(407)	(62)	(255)		(11)		(1,079)
Recoveries	14	2				5		21
Provision	(178)	541	(64)	419		6	(124)	600

Ending balance ALLR	$ 2,952	$ 1,154	$ 263	$ 1,786	$	$	$	$ 6,155
Loans:								
Ending balance	$ 198,285	$ 84,405	$ 23,062	$ 79,013	$ 4,181	$ 5,866	$	$ 394,812
Ending balance ALLR	(2,952)	(1,154)	(263)	(1,786)				(6,155)
Net loans	$ 195,333	$ 83,251	$ 22,799	$ 77,227	$ 4,181	$ 5,866	$	$ 388,657
Ending balance ALLR:								
Individually evaluated	$ 1,144	$ 361	$ 39	$ 845	$	$	$	$ 2,389
Collectively evaluated	1,808	793	224	941				3,766
Total	$ 2,952	$ 1,154	$ 263	$ 1,786	$	$	$	$ 6,155
Ending balance Loans:								
Individually evaluated	$ 16,003	$ 2,141	$ 1,395	$ 4,022	$	$ 38	$	$ 23,599
Collectively evaluated	182,282	82,264	21,667	74,991	4,181	5,828		371,213
Total	$ 198,285	$ 84,405	$ 23,062	$ 79,013	$ 4,181	$ 5,866	$	$ 394,812

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

As part of the management of the loan portfolio, risk ratings are assigned to all commercial loans. Through the loan review process, ratings are modified as believed to be appropriate to reflect changes in the credit. Our ability to manage credit risk depends in large part on our ability to properly identify and manage problem loans. To do so, we operate a credit risk rating system under which our credit management personnel assign a credit risk rating to each loan at the time of origination and review loans on a regular basis to determine each loan s credit risk rating on a scale of 1 through 8, with higher scores indicating higher risk. The credit risk rating structure used is shown below.

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

Excellent (1)

Borrower is not vulnerable to sudden economic or technological changes and is in a non-seasonal business or industry. These loans generally would be characterized by having good experienced management and a strong liquidity position with minimal leverage.

Good (2)

Borrower shows limited vulnerability to sudden economic change with modest seasonal effect. Borrower has above average financial statements and an acceptable repayment history with minimal leverage and a profitability that exceeds peers.

Average (3)

Generally, a borrower rated as average may be susceptible to unfavorable changes in the economy and somewhat affected by seasonal factors. Some product lines may be affected by technological change. Borrowers in this category exhibit stable earnings, with a satisfactory payment history.

Acceptable (4)

The loan is an otherwise acceptable credit that warrants a higher level of administration due to various underlying weaknesses. These weaknesses, however, have not and may never deteriorate to the point of a Special Mention rating or Classified status. This rating category may include new businesses not yet having established a firm performance record.

Special Mention (5)

The loan is not considered as a Classified status, however may exhibit material weaknesses that, if not corrected, may cause future problems. Borrowers in this category warrant special attention but have not yet reached the point of concern for loss. The borrower may have deteriorated to the point that they would have difficulty refinancing elsewhere. Similarly, purchasers of these businesses would not be eligible for bank financing unless they represent a significantly lessened credit risk.

Substandard (6)

The loan is Classified and exhibits 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 within this category clearly represent troubled and deteriorating credit situations requiring constant supervision and an action plan must be developed and approved by the appropriate officers to mitigate the risk.

Doubtful (7)

Loans in this category exhibit the same weaknesses used to describe the substandard credit; however, the traits are more pronounced. 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.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

General Reserves:

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

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

Commercial construction loans in the amount of $3.407 million, $3.694 million and $3.002 million for the periods ended June 30, 2012, December 31, 2011 and June 30, 2011, respectively did not receive a specific risk rating. These amounts represent loans made for land development and unimproved land purchases. Below is a breakdown of loans by risk category as of June 30, 2012 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	**$ 4,394**	**$ 16,806**	**$ 56,024**	**$ 111,719**	**$ 16,917**	**$ 5,452**	**$ 194**	**$**	**$ 211,506**
Commercial, financial and agricultural	**4,316**	**5,827**	**20,866**	**47,912**	**4,468**	**1,710**			**85,099**
Commercial construction	**205**	**849**	**5,582**	**10,892**	**766**	**1,092**		**3,407**	**22,793**
One to four family residential real estate		**1,987**	**3,774**	**5,789**		**790**		**72,325**	**84,665**
Consumer construction								**5,595**	**5,595**
Consumer			**77**	**582**				**9,136**	**9,795**
Total loans	**$ 8,915**	**$ 25,469**	**$ 86,323**	**$ 176,894**	**$ 22,151**	**$ 9,044**	**$ 194**	**$ 90,463**	**$ 419,453**

Below is a breakdown of loans by risk category as of December 31, 2011 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 3,083	$ 16,946	$ 47,154	$ 118,259	$ 5,198	$ 7,642	$ 919	$	$ 199,201
Commercial, financial and agricultural	4,416	7,875	17,738	60,498	201	1,541			92,269
Commercial construction	209	552	4,542	10,415	313	20		3,694	19,745
One-to-four family residential real estate			3,359	5,910	2,023			66,040	77,332
Consumer construction								5,774	5,774
Consumer			105	599				6,221	6,925
Total loans	$ 7,708	$ 25,373	$ 72,898	$ 195,681	$ 7,735	$ 9,203	$ 919	$ 81,729	$ 401,246

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

Below is a breakdown of loans by risk category as of June 30, 2011 (dollars in thousands):

	(1) Excellent	(2) Good	(3) Average	(4) Acceptable	(5) Sp. Mention	(6) Substandard	(7) Doubtful	Rating Unassigned	Total
Commercial real estate	$ 6,223	$ 16,963	$ 43,625	$ 115,724	$ 5,109	$ 7,934	$ 2,576	$ 131	$ 198,285
Commercial, financial and agricultural	2,821	11,501	29,121	38,223	211	2,136		392	84,405
Commercial construction	514	559	5,250	12,022	1,715			3,002	23,062
One to four family residential real estate		3,330	3,084	5,412		3,904		63,283	79,013
Consumer construction								4,181	4,181
Consumer		38	87	473		27		5,241	5,866
Total loans	$ 9,558	$ 32,391	$ 81,167	$ 171,854	$ 7,035	$ 14,001	$ 2,576	$ 76,230	$ 394,812

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 during impairment and that which would have been recognized were $.037 million and $.174 million for the six months ended June 30, 2012. For the six months ended June 30, 2011, the amounts were $.068 million and $.271 million.

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

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

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

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

	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
For the six months ended:						
June 30, 2012						
With no valuation reserve:						
Commercial real estate	**$ 535**	**$**	**$ 1,138**	**$**	**$**	**$ 23**
Commercial, financial and agricultural			**1,063**			**18**
Commercial construction	**676**		**676**			**4**
One to four family residential real estate	**543**		**874**			**24**
Consumer construction	**15**		**16**			**1**
Consumer						
With a valuation reserve:						
Commercial real estate	**$ 3,214**	**$**	**$ 3,916**	**$ 708**	**$ 37**	**$ 94**
Commercial, financial and agricultural	**278**		**459**	**84**		**8**
Commercial construction						
One to four family residential real estate	**114**		**114**	**18**		**2**
Consumer construction						
Consumer						
Total:						
Commercial real estate	**$ 3,749**	**$**	**$ 5,054**	**$ 708**	**$ 37**	**$ 117**
Commercial, financial and agricultural	**278**		**1,522**	**84**		**26**
Commercial construction	**676**		**676**			**4**
One to four family residential real estate	**657**		**988**	**18**		**26**
Consumer construction	**15**		**16**			**1**
Consumer						
Total	**$ 5,375**	**$**	**$ 8,256**	**$ 810**	**$ 37**	**$ 174**
For the Year Ended:						
December 31, 2011						
With no valuation reserve:						
Commercial real estate	$ 1,313	$	$ 2,519	$	$ 66	$ 116
Commercial, financial and agricultural	16		542		29	35

Commercial construction			176			11
One to four family residential real estate	608		1,727			99
Consumer construction			4			
Consumer			2			
With a valuation reserve:						
Commercial real estate	$ 1,049	$ 2,400	$ 807	$ 700	$ 20	$ 31
Commercial, financial and agricultural	1,095		282	173		14
Commercial construction						
One to four family residential real estate	1,389	103	1,121	150	3	56
Consumer construction	20		9	4		1
Consumer						
Total:						
Commercial real estate	$ 2,362	$ 2,400	$ 3,326	$ 700	$ 86	$ 147
Commercial, financial and agricultural	1,111		824	173	29	49
Commercial construction			176			11
One to four family residential real estate	1,997	103	2,848	150	3	155
Consumer construction	20		13	4		1
Consumer			2			
Total	$ 5,490	$ 2,503	$ 7,189	$ 1,027	$ 118	$ 363

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

	Nonaccrual Basis	Accrual Basis	Average Investment	Related Valuation Reserve	Interest Income Recognized During Impairment	Interest Income on Accrual Basis
For the Six monthes ended:						
June 30, 2011						
With no valuation reserve:						
Commercial real estate	$ 78	$ 600	$ 2,726	$	$ 67	$ 14
Commercial, financial and agricultural	48	1,098	521			2
Commercial construction			327			11
One to four family residential real estate	34		33			2
Consumer construction			7			
Consumer						
With a valuation reserve:						
Commercial real estate	$ 3,038	$	$ 2,906	$ 1,170	$	$ 87
Commercial, financial and agricultural	542		862	251		33
Commercial construction				834		
One to four family residential real estate	3,872	104	3,199		1	122
Consumer construction				27		
Consumer	27		4			
Total:						
Commercial real estate	$ 3,116	$ 600	$ 5,632	$ 1,170	$ 67	$ 101
Commercial, financial and agricultural	590	1,098	1,383	251		35
Commercial construction			327	834		11
One to four family residential real estate	3,906	104	3,232		1	124
Consumer construction			7	27		
Consumer	27		4			
Total	$ 7,639	$ 1,802	$ 10,585	$ 2,282	$ 68	$ 271

A summary of past due loans at June 30, 2012, December 31, 2011 and June 30, 2011 is as follows (dollars in thousands):

		June 30, 2012		December 31, 2011		June 30, 2011
	30-89 days Past Due	90+ days Past Due/	30-89 days Past Due	90+ days Past Due/	30-89 days Past Due	90+ days Past Due/

	(accruing)	Nonaccrual	Total	(accruing)	Nonaccrual	Total	(accruing)	Nonaccrual	Total
Commercial real estate	$	$ 3,749	$ 3,749	$ 15	$ 2,362	$ 2,377	$ 1,473	$ 3,116	$ 4,589
Commercial, financial and agricultural		278	278	137	1,111	1,248	62	590	652
Commercial construction		676	676				20		20
One to four family residential real estate	286	657	943	188	1,997	2,185	96	3,906	4,002
Consumer construction		15	15		20	20			
Consumer	14		14	14		14		27	27
Total past due loans	$ 300	$ 5,375	$ 5,675	$ 354	$ 5,490	$ 5,844	$ 1,651	$ 7,639	$ 9,290

A roll-forward of nonaccrual activity for the first six months ended June 30, 2012 (dollars in thousands):

	For the Six Months Ended June 30, 2012						
	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
NONACCRUAL							
Beginning balance	$ 2,362	$ 1,111	$	$ 1,997	$ 20	$	$ 5,490
Principal payments	(1,012)	(1,382)		(1,052)			(3,446)
Charge-offs	(463)			(293)	(5)		(761)
Advances							
Class transfers							
Transfers to OREO	(466)			(219)			(685)
Transfers to accruing							
Transfers from accruing	3,288	559	676	220			4,743
Other	40	(10)		4			34
Ending balance	$ 3,749	$ 278	$ 676	$ 657	$ 15	$	$ 5,375

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of nonaccrual activity during the year ended December 31, 2011 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer Construction	Consumer	Total
NONACCRUAL							
Beginning balance	$ 3,522	$ 760	$ 458	$ 1,129	$ 52	$	$ 5,921
Principal payments	(1,458)	(767)	(14)	(47)			(2,286)
Charge-offs	(1,950)	(557)	(62)	(601)		(27)	(3,197)
Advances							
Class transfers							
Transfers to OREO	(1,203)	(262)	(382)	(1,948)	(53)		(3,848)
Transfers to accruing	(892)						(892)
Transfers from accruing	4,301	1,938		3,273	20	27	9,559
Other	42	(1)		191	1		233
Ending balance	$ 2,362	$ 1,111	$	$ 1,997	$ 20	$	$ 5,490

A roll-forward of nonaccrual activity for the first six months ended June 30, 2011 (dollars in thousands):

[redacted]

NONACCRUAL							
Beginning balance	$ 3,522	$ 760	$ 458	$ 1,129	$ 52	$	$ 5,921
Principal payments	(938)	(155)	(14)	(445)			(1,552)
Charge-offs	(326)	(407)	(62)	(90)			(885)
Advances							
Class transfers							
Transfers to OREO	(989)		(382)	(332)	(52)		(1,755)
Transfers to accruing	(892)						(892)

Transfers from accruing	2,724	389		3,631		27	6,771
Other	15	3		13			31
Ending balance	$ 3,116	$ 590	$	$ 3,906	$	$ 27	$ 7,639

Troubled Debt Restructuring

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

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

At June 30, 2012, the Corporation had no TDRs that were not otherwise reported as a nonaccrual loan.

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A summary of troubled debt restructurings is as follows (dollars in thousands):

	June 30, 2012		**December 31, 2011**		**June 30, 2011**	
	Number of Modifications	**Recorded Investment**	**Number of Modifications**	**Recorded Investment**	**Number of Modifications**	**Recorded Investment**
Commercial real estate		$	1	$ 2,400	2	$ 600
Commercial, financial and agricultural					1	1,098
Commercial construction					1	104
One to four family residential real estate			1	103		
Consumer construction						
Consumer						
Total troubled debt restructurings		$	2	$ 2,503	4	$ 1,802

A roll-forward of troubled debt restructuring during the period ended June 30, 2012 (dollars in thousands):

	Commercial Real Estate	**Commercial, Financial and Agricultural**	**Commercial Construction**	**One to four family residential real estate**	**Consumer and Consumer Construction**	**Total**
ACCRUING						
Beginning balance	**$ 2,400**	**$**	**$**	**$ 103**	**$**	**$ 2,503**
Principal payments						
Charge-offs						
Advances						
New restructured						
Transfers to performing status				**(103)**		**(103)**
	(2,400)					**(2,400)**

Transfers to nonaccrual						
Ending balance	**$**	**$**	**$**	**$**	**$**	**$**

A roll-forward of troubled debt restructuring during the year ended December 31, 2011 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
ACCRUING						
Beginning balance	$ 4,537	$	$	$ 105	$	$ 4,642
Principal payments				(2)		(2)
Charge-offs						
Advances						
New restructured	2,400					2,400
Transfers to performing	(582)					(582)
Transfers to nonaccrual	(3,955)					(3,955)
Ending balance	$ 2,400	$	$	$ 103	$	$ 2,503

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS (Continued)

A roll-forward of troubled debt restructuring during the period ended June 30, 2011 (dollars in thousands):

	Commercial Real Estate	Commercial, Financial and Agricultural	Commercial Construction	One to four family residential real estate	Consumer and Consumer Construction	Total
ACCRUING						
Beginning balance	$ 4,537	$	$	$ 105	$	$ 4,642
Principal payments	(4)			(1)		(5)
Charge-offs						
Advances						
New restructured	600	1,098				1,698
Transfers to performing	(578)					(578)
Transfers to nonaccrual	(3,955)					(3,955)
Ending balance	$ 600	$ 1,098	$	$ 104	$	$ 1,802

Insider Loans

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

	June 30, 2012	December 31, 2011	June 30, 2011
Loans outstanding, beginning of period	**$ 8,827**	$ 9,532	$ 9,532
New loans	**936**	933	705
Net activity on revolving lines of credit	**41**	69	124

Principal payments		**(419)**		(1,707)		(1,216)
Loans outstanding, end of period	**$**	**9,385**	$	8,827	$	9,145

There were no loans to related parties classified substandard as of June 30, 2012, December 31, 2011 or June 30, 2011. In addition to the outstanding balances above, there were unfunded commitments of $.319 million to related parties at June 30, 2012.

5. MORTGAGE SERVICING RIGHTS

Mortgage servicing rights (MSRs) are recorded when loans are sold in the secondary market with servicing retained. As of June 30, 2012, the Corporation had obligations to service approximately $66 million of residential first mortgage loans. The valuation is based upon the net present value of the projected revenues over the expected life of the loans being serviced, as reduced by estimated internal costs to service these loans. The fair value of the capitalized servicing rights approximates the carrying value. The key economic assumptions used in determining the fair value of the mortgage servicing rights include an annual constant prepayment speed of 15.90 and a discount rate of 7.50% for June 30, 2012.

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

		June 30, 2012		**December 31, 2011**
Balance at beginning of period	**$**	**400**	**$**	
Additions from loans sold with servicing retained		**170**		**415**
Amortization		**(45)**		**(15)**
Fair value of MSRs at end of period	**$**	**525**	**$**	**400**

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. BORROWINGS

Borrowings consist of the following at June 30, 2012, December 31, 2011 and June 30, 2011 (dollars in thousands):

	June, 30 2012	December 31, 2011	June, 30 2011
Federal Home Loan Bank fixed rate advances at June 30, 2012 with a weighted average rate of 1.82% maturing in 2013, 2014 and 2016	**$ 35,000**	$ 35,000	$ 35,000
USDA Rural Development, fixed-rate note payable, maturing August 24, 2024, interest payable at 1%	**997**	997	1,069
	$ 35,997	$ 35,997	$ 36,069

The Federal Home Loan Bank borrowings are collateralized at June 30, 2012 by the following: a collateral agreement on the Corporation s one to four family residential real estate loans with a book value of approximately $47.028 million; mortgage related and municipal securities with an amortized cost and estimated fair value of $8.544 million and $8.992 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $3.060 million. Prepayment of the advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of June 30, 2012.

The USDA Rural Development borrowing is collateralized by loans totaling $.156 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 $.938 million, and guaranteed by the Corporation.

7. STOCK OPTION PLANS

A summary of stock option transactions for the six months ended June 30, 2012 and 2011, and the year ended December 31, 2011, is as follows:

June 30, 2012	December 31, 2011	June 30, 2011

Outstanding shares at beginning of year	**392,152**	394,072	394,072
Granted during the period			
Exercised during the period			
Expired / forfeited during the period		(1,920)	
Outstanding shares at end of period	**392,152**	392,152	394,072
Exercisable shares at end of period	**148,861**	148,861	150,781
Weighted average exercise price per share at end of period	**$ 10.27**	$ 10.27	$ 10.98
Shares available for grant at end of period			

There were no options granted in the first three months of 2012 and 2011.

Following is a summary of the options outstanding and exercisable at June 30, 2012:

Exercise Price	Number Outstanding	Exercisable	Unvested Options	Weighted Average Remaining Contractual Life-Years
$ 9.16	5,000	2,000	3,000	3.46
$ 9.75	257,152	120,861	136,291	2.46
$ 10.65	50,000	10,000	40,000	4.46
$ 11.50	40,000	8,000	32,000	3.25
$ 12.00	40,000	8,000	32,000	2.96
	392,152	148,861	243,291	2.86

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. INCOME TAXES

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of June 30, 2012 had a net operating loss and tax credit carryforwards for tax purposes of approximately $25.7 million, and $2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $15.0 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation recognized a deferred tax benefit of approximately $1.986 million for the June 30, 2012 six month period and $.616 million for the six months ended June 30, 2011. The valuation allowance at June 30, 2012 was $3.4 million. Management evaluated the deferred tax valuation allowance as of June 30, 2012 and determined that an adjustment to the valuation was warranted. The Corporation reduced the valuation allowance by $3.0 million since it was determined that it was more likely than not that these benefits would be realized. The Corporation made this determination after a thorough review of projected earnings and the composition and sustainability of those earnings over the projected tax carryover period. This analysis substantiated the ability to utilize these deferred tax assets. The Corporation will continue to evaluate the future benefits from these carryforwards and at such time as it becomes more likely than not that they would be utilized prior to expiration will recognize the additional benefits as an adjustment to the valuation allowance.

9. FAIR VALUE MEASUREMENTS

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

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

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

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

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

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

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

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.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS (Continued)

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

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

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

The following table presents information for financial instruments at June 30, 2012, December 31, 2011 and June 30, 2011(dollars in thousands):

		June 30, 2012		December 31, 2011		June 30, 2011	
	Level in Fair Value Hierarchy	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**	**Carrying Amount**	**Estimated Fair Value**
Financial assets:							
Cash and cash equivalents	Level 1	**$ 33,248**	**$ 33,248**	$ 34,070	$ 34,070	$ 34,294	$ 34,294
Interest-bearing deposits	Level 2	**10**	**10**	10	10	10	10
Securities available for sale	Level 2	**39,054**	**39,054**	38,727	38,727	38,613	38,613
Federal Home Loan Bank stock	Level 2	**3,060**	**3,060**	3,060	3,060	3,060	3,060
Net loans	Level 3	**414,370**	**411,781**	395,995	394,463	388,657	388,814
Accrued interest receivable	Level 2	**1,303**	**1,303**	1,261	1,261	1,326	1,326
Total financial assets		**$ 491,045**	**$ 488,456**	$ 473,123	$ 471,591	$ 465,960	$ 466,117
Financial liabilities:							
Deposits	Level 2	**$ 425,381**	**$ 425,149**	$ 404,789	$ 404,821	$ 399,667	$ 400,811
Borrowings	Level 2	**35,997**	**35,853**	35,997	35,634	36,069	35,663
Accrued interest payable	Level 2	**239**	**239**	202	202	258	258

Total financial liabilties	**$**	**461,617**	**$**	**461,241**	$	440,988	$	440,657	$	435,994	$	436,732

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

The following is information about the Corporation s assets and liabilities measured at fair value on a recurring basis at June 30, 2012, 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.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. FAIR VALUE MEASUREMENTS (Continued)

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

The fair value of all investment securities at June 30, 2012 and June 30, 2011 were based on level 2 inputs. There are no other assets or liabilities measured on a recurring basis at fair value. For additional information regarding investment securities, please refer to Note 3 Investment Securities.

The Corporation had no Level 3 assets or liabilities on a recurring basis as of June 30, 2012, December 31, 2011 or June 30, 2011.

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

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

Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2012

(dollars in thousands)	Balance at June 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Three Months Ended June 30, 2012	Total Losses for Six Months Ended June 30, 2012
Assets						
Impaired loans	$ 5,375	$	$	$ 5,375	$ 624	$ 1,012
Other real estate owned	3,518			3,518	174	185
					$ 798	$ 1,197

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2011

(dollars in thousands)	Balance at December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Year Ended December 31, 2011
Assets					
Impaired loans	$ 7,993	$	$	$ 7,993	$ 3,200
Other real estate owned	3,162			3,162	1,137
					$ 4,337

Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2011

(dollars in thousands)	Balance at June 30, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Losses for Three Months Ended June 30, 2011	Total Losses for Six Months Ended June 30, 2011
Assets						
Impaired loans	$ 9,441	$	$	$ 9,441	$ 449	$ 875
Other real estate owned	4,806			4,806	(35)	496
					$ 414	$ 1,371

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

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).

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. SHAREHOLDERS EQUITY

Participation in the TARP Capital Purchase Program

On April 24, 2009, the Corporation entered into and closed a Letter Agreement, including the Securities Purchase Agreement-Standard Terms (collectively, the Securities Purchase Agreement), related to the TARP Capital Purchase Program (CPP). Pursuant to the Securities Purchase Agreement, the Corporation issued and sold to the Treasury (i) 11,000 shares of the Corporation s Series A Preferred Shares, and (ii) the Warrant to purchase 379,310 shares of the Corporation s Common Shares, at an exercise price of $4.35 per share (subject to certain anti-dilution and other adjustments), for an aggregate purchase price of $11.000 million in cash. The Warrant has a ten-year term.

As a result of the CPP transaction, the Corporation is required to take certain actions, for so long as the Treasury holds any securities acquired from the Corporation pursuant to the CPP (excluding any period in which the Treasury holds only the Warrant to purchase Common Shares of the Corporation) (the CPP Period), to ensure that its executive compensation and benefit plans with respect to Senior Executive Officers (as defined in the relevant agreements) comply with Section 111(b) of Emergency Economic Stabilization Act of 2008 (EESA), as implemented by any guidance or regulations issued under Section 111(b) of EESA, and not adopt any benefit

plans with respect to, or which cover, the Corporation s Senior Executive Officers that do not comply with EESA, as amended by the American Recovery and Reinvestment Act of 2009 (the ARRA), which was passed by Congress and signed by the President on February 17, 2009. The applicable executive compensation standards generally remain in effect during the CPP Period and apply to the Corporation s Senior Executive

Officers (which for purposes of the ARRA and the CPP agreements, includes the Corporation s Chief Executive Officer, its Chief Financial Officer, and the next three most highly-compensated executive officers, even though the Corporation s senior executive officers consist of a smaller group of executives for purposes of the other compensation disclosures in the Corporation s annual proxy statement).

Amounts recorded for Preferred Stock and Warrant Common Stock were estimated based on an allocation of the total proceeds from the issuance on the relative fair values of both instruments. Fair value of the Preferred Stock was determined based on assumptions regarding the discount rate (market rate) on the Preferred Stock (estimated 12%). Fair value of the Warrant Common Stock is based on the value of the underlying Preferred Stock based on an estimate for a three year term. The allocation of the proceeds received resulted in the recording of a discount on the Preferred Stock and a premium on the Warrant Common Stock. The discount on the preferred will be accreted on an effective yield basis over a three-year term. The allocated carrying value of the Preferred Stock and Warrant Common Stock on the date of issuance (based on their relative fair values) was $10.382 million and $.618 million, respectively. Cumulative dividends on the Preferred Stock are payable at 5% annum for the first five years and at a rate of 9% per annum thereafter on the liquidation preference of $1,000 per share. The Company is prohibited from paying any dividend with respect to shares of common stock unless all accrued and unpaid dividends are paid in full on the Preferred Stock for all past dividend periods. The Preferred Stock is non-voting, other than class voting rights on matters that could adversely affect the Preferred Stock. The Preferred Stock may be redeemed at any time with regulatory approval. The Treasury may also transfer the Preferred Stock to a third party at any time. The preferred stock qualifies as Tier 1 Capital for regulatory purposes at the holding company.

The Corporation has the right to redeem the Series A Preferred Shares at any time after consulting with its primary regulator, in which case the executive compensation standards would no longer apply to the Corporation.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. 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):

	June 30, 2012	December 31, 2011	June 30, 2011
Commitments to extend credit:			
Variable rate	**$ 41,693**	$ 28,495	$ 23,727
Fixed rate	**15,452**	15,453	11,516
Standby letters of credit - Variable rate	**3,378**	3,523	2,527
Credit card commitments - Fixed rate	**3,226**	3,019	3,094
	$ 63,749	$ 50,490	$ 40,864

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 expanded discussion on the Corporation s legal proceedings, see Part II, Item 1, Legal Proceedings in this report.

C***oncentration of Credit Risk***

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank s most prominent concentration in the loan portfolio relates to commercial real estate loans to operators of nonresidential buildings. This concentration at June 30, 2012 represents $83.539 million, or 26.15%, compared to $59.587 million, or 19.49%, of the commercial loan portfolio on June 30, 2011. The remainder of the commercial loan portfolio is diversified in such categories as hospitality and tourism, real estate agents and managers, new car dealers, gaming, petroleum, forestry, agriculture and construction. Due to the diversity of the Bank s locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic sector.

Table of Contents

MACKINAC FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. RECENT DEVELOPMENTS

On March 27, 2012, the Corporation announced that it intended to conduct a $7 million rights offering (the Rights Offering) to shareholders of record as of April 6, 2012. In the Rights Offering, the Corporation distributed to its shareholders as of the record date, non-transferable subscription rights to purchase up to 1,217,391 shares of its common stock at a subscription price of $5.75 per share. The Corporation subsequently filed a prospectus with the Securities and Exchange Commission on May 31, 2012 pursuant to which the Corporation launched the Rights Offering. The Rights Offering expired on July 26, 2012 and shareholders purchased 1,217,390 shares in the Rights Offering, resulting in aggregate proceeds to the Corporation of $7.0 million. The Corporation is in the process of distributing these shares.

Commensurate with the announcement of the Rights Offering, on March 27, 2012, the Corporation entered into a Securities Purchase Agreement with Steinhardt Capital Investors, LLLP (SCI), which was subsequently amended on May 23 and 31, 2012 (as amended, the Securities Purchase Agreement). Pursuant to the Securities Purchase Agreement and contingent upon receipt of approval form the Federal Reserve, SCI agreed to purchase a number of shares of the Corporation s common stock, depending on the outcome of the Rights Offering at the same $5.75 per share price as offering to the Corporation s shareholders in the Rights Offering (the SCI Investment). SCI received approval from the Federal Reserve in August 3, 2012. Based upon the results of the Rights Offering, SCI purchased 922,788 shares of the Corporation s common stock on August 10, 2012. The proceeds to the Corporation from the Rights Offering and the SCI Investment totaled approximately $12.3 million.

The following table sets forth the Corporation s actual (see Column A) and pro forma capitalization as of December 31, 2011 after completion of the rights offering and the SCI Investment. The Corporation s pro forma capitalization gives effect to the capital raised through the completion of the rights offering and the SCI Investment.

		Actual June 30, 2012 (A)		**100% Current Shareholder Subscription Rights Exercised and Purchase of 922,788 shares (B)**
Capital Structure				
Common shareholders equity	$	49,352	$	60,958
Preferred stock		11,000		11,000
Total shareholders equity	$	60,352	$	71,958
Total capitalization	$	60,352	$	71,958
Tangible capital	$	60,299	$	71,905
Intangible assets				
Subsidiaries:				
Core deposit premium	$		$	
Other identifiable intangibles - MSRs		525		525
Total intangibles	$	525	$	525

Risk-Based Capital				
Tier 1 Capital				
Total shareholders equity	$	60,352	$	71,958
Net unrealized (gains) losses on available for sale securities		(696)		(696)
Less: disallowed deferred tax asset		(8,600)		(8,600)
Less: intangibles		(53)		(53)
Total Tier 1 Capital	$	51,003	$	62,609
Tier 2 Capital				
Allowable reserve for loan losses (limited to 1.25% of risk-weighted assets)	$	5,083	$	5,083
Qualifying long-term debt				
Total Tier 2 Capital		5,083		5,083
Total risk-based capital	$	56,086	$	67,692
Risk-weighted assets	$	439,256	$	439,256
Capital Ratios:				
Tier 1 Capital to average assets		10.16%		12.26%
Tier 1 Capital to risk-weighted assets		11.62%		14.25%
Total Capital to risk-weighted assets		12.77%		15.41%
Average Assets (4th quarter)	$	510,659	$	510,659
Total Tier 1 Average Assets (excluding Deferred Tax Asset)	$	502,006	$	502,006

Table of Contents

MACKINAC FINANCIAL CORPORATION

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 level and volatility of interest rates which may negatively affect the Corporation s interest margin;
- 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; and
- An increase in the Corporation s FDIC insurance premiums, or the collection of special assessments by the FDIC.

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

Table of Contents

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, 2011. Throughout this discussion, the term Bank refers to mBank, the principal banking subsidiary of the Corporation.

FINANCIAL OVERVIEW

The Corporation recorded a second quarter 2012 net income available to common shareholders of $4.141 million or $1.21 per share compared to net income of $.603 million, or $.18 per share for the second quarter of 2011. Operating results for the second quarter of 2012 included a valuation adjustment to the deferred tax asset of $3.000 million. Excluding the deferred tax asset, net income for the quarter was $1.141 million, or $.33 per share.

Weighted average shares outstanding totaled 3,419,736 for both periods. The common stock warrants outstanding of 379,310 shares were dilutive, at approximately $.04 per share, for the 2012 second quarter and $.05 per share for the six month period, as the market value of our stock remained above the $4.35 strike price.

The net interest margin for the second quarter of 2012 increased to $5.019 million, or 4.30%, compared to $4.178 million, of 3.79% in the second quarter of 2011. The six month margin in 2012 was $9.782 million, or 4.23% compared to $8.319 million, or 3.85%.

Total assets of the Corporation at June 30, 2012 were $524.366 million, up by $31.993 million, or 6.50% from the $492.373 million in total assets reported at June 30, 2011 and up by $26.055 million, or 5.22%, from total assets of $498.311 million at year-end 2011. The loan portfolio increased $18.207 million, or 4.54%, from December 31, 2011 balances of $401.246 million. Deposits totaled $425.381 million at June 30, 2012, an increase of $20.592 million from the $404.789 million at December 31, 2011.

FINANCIAL CONDITION

Cash and Cash Equivalents

Cash and cash equivalents decreased $.822 million during the first half of 2012. See further discussion of the change in cash and cash equivalents in the Liquidity section.

Investment Securities

Securities available for sale increased $.327 million from December 31, 2011 to June 30, 2012, with the balance on June 30, 2012, totaling $39.054 million. The Corporation purchased $6.293 million of investments during the 2012 first half mainly to replace maturities and paydowns of investments. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of June 30, 2012, investment securities with an estimated fair value of $9.242 million were pledged.

Loans

Through the first half of 2012, loan balances increased by $18.207 million, or 4.54%, from December 31, 2011 balances of $401.246 million. During the first half of 2012, the Bank had total loan production of $101 million, which included $29 million of secondary market loan production. This loan production, however, was offset by loan principal runoff, paydowns and amortization, and also SBA/USDA loan sales of $7.364 million, and nonperforming loans transferred to other real estate owned (OREO) amounting to $.685 million.

Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with a diligent loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. Management intends to continue loan growth within its

Table of Contents

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 June 30, 2012, December 31, 2011 and June 30, 2011 (dollars in thousands):

	June 30, 2012	Percent of Total	December 31, 2011	Percent of Total	June 30, 2011	Percent of Total
Commercial real estate	**$ 211,506**	**50.42%**	$ 199,201	49.64%	$ 198,285	50.22%
Commercial, financial, and agricultural	**85,099**	**20.29**	92,269	23.00	84,405	21.38
One to four family residential real estate	**84,665**	**20.19**	77,332	19.27	79,013	20.01
Construction:						
Consumer	**5,595**	**1.33**	5,774	1.44	23,062	5.84
Commercial	**22,793**	**5.43**	19,745	4.92	4,181	1.06
Consumer	**9,795**	**2.34**	6,925	1.73	5,866	1.49
Total loans	**$ 419,453**	**100.00%**	$ 401,246	100.00%	$ 394,812	100.00%

Following is a table showing the significant industry types in the commercial loan portfolio as of June 30, 2012, December 31, 2011 and June 30, 2011 (dollars in thousands):

	June 30, 2012			December 31, 2011			June 30, 2011		
	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital	Outstanding Balance	Percent of Loans	Percent of Capital
Real estate - operators of nonres bldgs	**$ 83,539**	**26.15%**	**138.42%**	$ 75,391	24.22%	135.53%	$ 59,587	19.49%	108.77%
Hospitality and tourism	**36,557**	**11.45**	**60.57**	33,306	10.70	59.87	33,467	10.94	61.09
Commercial construction	**22,793**	**7.14**	**37.77**	19,745	6.34	35.50	23,062	7.54	42.10
Lessors of nonresidential buildings	**13,358**	**4.18**	**22.13**	16,499	5.30	29.66	16,316	5.34	29.78
Real estate agents and managers	**12,860**	**4.03**	**21.31**	10,617	3.41	19.09	14,909	4.88	27.21
Other	**150,291**	**47.05**	**249.02**	155,657	50.02	279.83	158,411	51.81	289.16
Total Commercial Loans	**$ 319,398**	**100.00%**		$ 311,215	100.00%		$ 305,752	100.00%	

Management recognizes the additional risk presented by the concentration in certain segments of the portfolio. On a historical basis, the Corporation s highest concentration of credit risk was the hospitality and tourism industry. Management does not consider the current loan concentrations in hospitality and tourism to be problematic, and has no intention of further reducing loans to this industry segment. Management does not believe that its current portfolio composition has increased exposure related to any specific industry concentration as of June 30, 2012. The current concentration of real estate related loans represents a broad customer base composed of a high percentage of owner occupied developments.

Our residential real estate portfolio predominantly includes one to four family adjustable rate mortgages that have repricing terms generally from one to three years, construction loans to individuals and bridge financing loans for qualifying customers. As of June 30, 2012, our residential loan portfolio totaled $84.665 million, or 20.19% of our total outstanding loans.

The Corporation has also extended credit to governmental units, including Native American organizations. Tax-exempt loans and leases decreased from $1.991 million at the end of December 31, 2011 to $1.736 million at June 30, 2012. The Corporation has elected to reduce its tax-exempt portfolio, since it provides no current tax benefit, due to tax net operating loss carryforwards.

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

Table of Contents

Credit Quality

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the six months ended June 30, 2012 amounted to $.813 million, or .20% of average loans outstanding, compared to $1.058 million, or .28% of average loans outstanding, for the same period in 2011. The current reserve balance is representative of the relevant risk inherent within the Corporation s loan portfolio. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity.

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

	June 30, 2012	December 31, 2011	June 30, 2011
Nonperforming Assets:			
Nonaccrual Loans	**$ 5,375**	$ 5,490	$ 7,639
Loans past due 90 days or more			
Restructured loans		2,503	1,802
Total nonperforming loans	**5,375**	7,993	9,441
Other real estate owned	**3,518**	3,162	4,806
Total nonperforming assets	**$ 8,893**	$ 11,155	$ 14,247
Nonperforming loans as a % of loans	**1.28%**	1.99%	2.39%
Nonperforming assets as a % of assets	**1.70%**	2.24%	2.89%
Reserve for Loan Losses:			
At period end	**$ 5,083**	$ 5,251	$ 6,155
As a % of loans	**1.21%**	1.35%	1.56%
As a % of nonperforming loans	**94.57%**	65.69%	65.19%
As a % of nonaccrual loans	**94.57%**	95.65%	80.57%
Texas ratio*	**13.59%**	18.43%	23.38%

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

Nonperforming assets at $8.893 million have been reduced in 2012 by $2.262 million from the $11.155 million at 2011 year end. This reduction in nonperforming assets reflects management s efforts in the aggressive remediation of problem credits and disposition of OREO properties.

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

	At Period End		
	June 30, 2012	December 31, 2011	June 30, 2011
Total loans, at period end	**$ 419,453**	$ 401,246	$ 394,812

Average loans for the year	**$**	**413,467**	$	388,115	$	379,153

		Six Months Ended June 30, 2012		For the Period Ended Twelve Months Ended December 31, 2011		Six Months Ended June 30, 2011
Net charge-offs during the period	**$**	**813**	$	3,662	$	1,058
Net charge-offs to average loans		**.20%**		.94%		.28%
Net charge-offs to beginning allowance balance		**15.48%**		55.38%		16.00%

Management continues to address market issues impacting its loan customer base. In conjunction with the Corporation s senior lending staff and the bank regulatory examinations, management reviews the Corporation s loans, related collateral evaluations, and the overall lending process. The Corporation also utilizes an outside loan review consultant to perform a review of the loan portfolio. Historically, this independent review has provided findings similar to management as to the overall adequacy of the loan loss reserve and has substantiated the Corporation s loan rating system. In 2012, the Corporation will again utilize a consultant for loan review.

Table of Contents

As of June 30, 2012, the allowance for loan losses represented 1.21% of total loans. At June 30, 2012, the allowance included specific reserves in the amount of $1.196 million, as compared to $1.200 million at December 31, 2011 and $2.389 million at June 30, 2011. In management s opinion, the allowance for loan losses is adequate to cover probable losses related to specifically identified loans, as well as probable losses inherent in the balance of the loan portfolio.

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

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

	Six Months Ended June 30 2012	Year Ended December 31, 2011	Six Months Ended June 30, 2011
Balance at beginning of period	**$ 3,162**	$ 5,562	$ 5,562
Other real estate transferred from loans due to foreclosure	**685**	4,194	2,105
Other real estate sold	**(144)**	(5,457)	(2,429)
Writedowns on other real estate held for sale	**(174)**	(855)	(496)
Loss on sale of other real estate held for sale	**(11)**	(282)	64
Balance at end of period	**$ 3,518**	$ 3,162	$ 4,806

During the second quarter of 2012, the Corporation received real estate in lieu of loan payments of $.685 million. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balances and any additional reductions in the fair value result in a write-down of other real estate.

Deposits

The Corporation had an increase in deposits in the first six months of 2012. Total deposits increased by $20.592 million, or 5.09%, in the first half of 2012. The increase in deposits for the first half of 2012 is composed of an increase in noncore deposits of $11.383 million and an increase in core deposits of $9.389 million. In 2012, the rate of growth on core deposits slowed from that experienced in recent years. The Corporation, as part of an overall strategy to increase interest margins, reduced rates on some of its deposits to be more in line with competitors. This has resulted in slower core deposit growth and some migration of deposit dollars to short-term certificates of deposit. Management will continue to monitor deposit flows and adjust rates when it is deemed necessary to maintain or increase core deposits.

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

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

	June 30, 2012	% of Total	December 31, 2011	% of Total	June 30, 2011	% of Total
Noninterest bearing	**$ 59,872**	**14.07%**	$ 51,273	12.67%	$ 49,769	12.45%
NOW, money market, checking	**143,795**	**33.80**	152,563	37.69	149,448	37.40
Savings	**14,248**	**3.35**	14,203	3.51	16,526	4.13
Certificates of Deposit <$100,000	**140,018**	**32.92**	130,685	32.28	114,215	28.58
Total core deposits	**357,933**	**84.14**	348,724	86.15	329,958	82.56
Certificates of Deposit >$100,000	**25,975**	**6.11**	23,229	5.74	23,102	5.78
Brokered CDs	**41,473**	**9.75**	32,836	8.11	46,607	11.66
Total non-core deposits	**67,448**	**15.86**	56,065	13.85	69,709	17.44
Total deposits	**$ 425,381**	**100.00%**	$ 404,789	100.00%	$ 399,667	100.00%

Table of Contents

Borrowings

The Corporation also utilizes FHLB borrowings as a source of funding. At June 30, 2012, this source of funding totaled $35 million and the Corporation secured this funding by pledging loans and investments. The $35 million of FHLB borrowings has a weighted average maturity of 2.53 years and a weighted average rate of 1.82% at June 30, 2012. The Corporation also has a USDA Rural Development loan held by its wholly owned subsidiary, First Rural Relending that has a fixed interest rate of 1% and matures in August 2024.

Shareholders Equity

Total shareholders equity increased $5.089 million from December 31, 2011 to June 30, 2012. Contributing to the increase in shareholders equity was net income of $4.639 million, an increase in the market value of securities of $.371 million and the accretion of the discount on preferred stock of $.079 million.

RESULTS OF OPERATIONS

Summary

The Corporation reported net income available to common shareholders of $4.639 million, or $1.36 per share, in the first half of 2012, compared to $.859 million or $.25 per share for the first half of 2011. Fully diluted earnings per share amounted to $1.31 per share for the 2012 six-month period and $.25 per share in 2011. The warrants outstanding were more dilutive in 2012 due to the increased market value of our common stock. The first half results include a valuation adjustment to the deferred tax asset of $3 million, a provision for loan losses of $.645 million and OREO writedowns and losses of $.185 million. Operating results for the same period in 2011 include a $.600 million provision for loan losses, and $.432 million of OREO writedowns and losses.

Net Interest Income

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

Net interest margin on a fully taxable equivalent basis amounted to $5.038 million, 4.32% of average earning assets, in the second quarter of 2012, compared to $4.201 million, and 3.81% of average earning assets, in the second quarter of 2011. In the first six months of 2012, net interest margin increased to $9.821 million, 4.25% of average earning assets, compared to $8.367 million, 3.87 % of average earning assets, for the same period in 2011. Margin improvement in 2012 was primarily due to a reduction in funding costs between periods.

Table of Contents

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

	Three Months Ended										
								2012-2011			
	Average Balances June 30,		Increase/	Average Rates June 30,		Interest June 30,		Income/ Expense	Volume	Rate	Rate/ Volume
(dollars in thousands)	**2012**	**2011**	**(Decrease)**	**2012**	**2011**	**2012**	**2011**	**Variance**	**Variance**	**Variance**	**Variance**
Loans (1,2,3)	**$ 422,888**	$ 378,250	$ 44,638	**5.63%**	5.57%	**$ 5,917**	$ 5,254	$ 663	$ 618	$ 53	$ (8)
Taxable securities	**37,306**	37,248	58	**2.57**	3.14	**238**	292	(54)		(54)	
Nontaxable securities (2)	**852**	849	3	**4.72**	4.72	**11**	10	1			1
Federal funds sold	**5,363**	22,286	(16,923)	**.22**	.13	**3**	7	(4)	(5)	5	(4)
Other interest-earning assets	**3,070**	3,753	(683)	**3.54**	2.56	**27**	24	3	(4)	9	(2)
Total earning assets	**469,479**	442,386	27,093	**5.31**	5.07	**6,196**	5,587	609	609	13	(13)
Reserve for loan losses	**(5,187)**	(6,135)	948								
Cash and due from banks	**20,737**	29,608	(8,871)								
Fixed Assets	**9,933**	9,693	240								
Other Real Estate	**3,483**	4,721	(1,238)								
Other assets	**13,236**	14,208	(972)								
Total assets	**$ 511,681**	$ 494,481	$ 17,200								
NOW and money market deposits	**$ 115,500**	$ 123,819	$ (8,319)	**.36%**	.70%	**$ 102**	$ 216	$ (114)	$ (14)	$ (106)	$ 6
Interest checking	**31,042**	25,993	5,049	**.47**	1.02	**36**	66	(30)	13	(36)	(7)
Savings deposits	**13,114**	17,123	(4,009)	**.09**	.23	**3**	10	(7)	(2)	(6)	1
CDs <$100,000	**139,214**	110,175	29,039	**1.79**	1.85	**620**	508	112	134	(16)	(6)
CDs >$100,000	**24,780**	22,569	2,211	**1.74**	1.69	**107**	95	12	9	3	
Brokered deposits	**33,744**	59,861	(26,117)	**1.47**	2.24	**123**	335	(212)	(146)	(116)	50
Borrowings	**35,997**	36,069	(72)	**1.87**	1.73	**167**	156	11		12	(1)
Total interest-bearing liabilities	**393,391**	395,609	(2,218)	**1.18**	1.41	**1,158**	1,386	(228)	(6)	(265)	43
Demand deposits	**59,264**	42,009	17,255								
Other liabilities	**3,111**	2,725	386								
Shareholders equity	**55,915**	54,138	1,777								
Total liabilities and shareholders equity	**$ 511,681**	$ 494,481	$ 17,200								
Rate spread				**4.13%**	3.66%						
Net interest margin/revenue				**4.32%**	3.81%	**$ 5,038**	$ 4,201	$ 837	$ 615	$ 278	$ (56)

(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 euivalent basis, using a 34% tax rate

	Six Months Ended										
								2012-2011			
	Average Balances June 30,		Increase/	Average Rates June 30,		Interest June 30,		Income/ Expense	Volume	Rate	Rate/ Volume
(dollars in thousands)	**2012**	**2011**	**(Decrease)**	**2012**	**2011**	**2012**	**2011**	**Variance**	**Variance**	**Variance**	**Variance**
Loans (1,2,3)	**$ 413,467**	$ 379,153	$ 34,314	**5.62%**	5.56%	**$ 11,547**	$ 10,454	$ 1,093	$ 949	$ 89	$ 37
Taxable securities	**37,144**	34,773	2,371	**2.72**	3.33	**502**	574	(72)	39	(112)	(6)

Nontaxable securities (2)	**853**	852	1	**4.95**	4.97	**21**	21				
Federal funds sold	**10,044**	16,978	(6,934)	**.16**	.17	**8**	14	(6)	(6)		
Other interest-earning assets	**3,070**	3,946	(876)	**3.08**	2.56	**47**	50	(3)	(11)	9	(2)
Total earning assets	**464,578**	435,702	28,876	**5.25**	5.14	**12,125**	11,113	1,012	970	(13)	29
Reserve for loan losses	**(5,214)**	(6,410)	1,196								
Cash and due from banks	**21,477**	28,437	(6,960)								
Fixed Assets	**9,879**	9,689	190								
Other Real Estate	**3,339**	4,821	(1,482)								
Other assets	**13,487**	14,475	(988)								
Total assets	**$ 507,546**	$ 486,714	$ 20,832								
NOW and money market deposits	**$ 118,949**	$ 121,937	$ (2,988)	**.37%**	.74%	**$ 218**	$ 450	$ (232)	$ (11)	$ (228)	$ 7
Interest checking	**30,655**	24,918	5,737	**.51**	1.10	**78**	136	(58)	31	(73)	(16)
Savings deposits	**13,108**	17,430	(4,322)	**.11**	.25	**7**	22	(15)	(5)	(13)	3
CDs <$100,000	**136,815**	103,492	33,323	**1.79**	1.87	**1,218**	961	257	310	(43)	(11)
CDs >$100,000	**24,451**	22,347	2,104	**1.73**	1.71	**210**	190	20	18	1	1
Brokered deposits	**33,290**	63,102	(29,812)	**1.47**	2.21	**244**	691	(447)	(327)	(230)	110
Borrowings	**35,997**	36,069	(72)	**1.84**	1.65	**329**	296	33	(1)	33	1
Total interest-bearing liabilities	**393,265**	389,295	3,970	**1.18**	1.42	**2,304**	2,746	(442)	15	(553)	95
Demand deposits	**55,686**	40,961	14,725								
Other liabilities	**2,929**	2,453	476								
Shareholders equity	**55,666**	54,005	1,661								
Total liabilities and shareholders equity	**$ 507,546**	$ 486,714	$ 20,832								
Rate spread				**4.06%**	3.72%						
Net interest margin/revenue				**4.23%**	3.87%	**$ 9,821**	$ 8,367	$ 1,454	$ 955	$ 540	$ (66)

(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 euivalent basis, using a 34% tax rate

We are now into the third year of a low interest rate environment. The Corporation, during this period, repriced all of its brokered deposits along with the majority of its bank time deposits. This repricing of liabilities is the primary reason for the increased interest margin, on a fully taxable equivalent basis, from 3.87% in the first six months of 2011 to 4.23% in the first six months of 2012.

During this relatively low interest environment, the Corporation has also repriced a significant portion of its loan portfolio. Management has been diligent when repricing maturing or new loans in establishing interest rate floors in order to maintain our improved interest rate spread.

Table of Contents

Provision for Loan Losses

The Corporation records a provision for loan losses when it believes it is necessary to adjust the allowance for loan losses to maintain an adequate level after considering factors such as loan charge-offs and recoveries, changes in identified levels of risk in the loan portfolio, changes in the mix of loans in the portfolio, loan growth, and other economic factors. During the first half of 2012, the Corporation determined through this analysis that a $.645 million provision for loan loss was required, compared to $.600 million in the first half of 2011. Impacting the loan loss provision for the six month period in 2012 were net charge-offs of $.813 million.

Other Income

Other income decreased by $.014 million for the six months ended June 30, 2012, compared to the six months ended June 30, 2011. In the first half of 2012, revenue due to 1-4 family loans produced and sold in the secondary market, amounted to $.524 million compared to $.199 million a year ago. We expect to continue to benefit from secondary market activity in future periods. SBA/USDA loan sale gains amounted to $.620 million in the first half of 2012, compared to $1.186 million for the same period in 2011. Service fees and other noninterest income decreased slightly between periods largely because of lower NSF fees, which we believe will continue due to customers being more diligent in managing their accounts.

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

The following table details other income for the three and six months ended June 30, 2012 and 2011 (dollars in thousands):

	Three Months Ended June 30,		Increase/(Decrease)		Six Months Ended June 30,		Increase/(Decrease)	
	2012	2011	Dollars	Percent	2012	2011	Dollars	Percent
Deposit service fees	**$ 189**	$ 219	$ (30)	(13.70)%	**$ 383**	$ 436	$ (53)	(12.16)
Income from secondary market loans sold	**226**	120	106	88.33	**524**	199	325	163.32
SBA/USDA loan sale gains	**620**	950	(330)	(34.74)	**620**	1,186	(566)	(47.72)
Mortgage servicing income	**115**		115	100.00	**200**		200	100.00
Other noninterest income	**155**	59	96	162.71	**184**	104	80	76.92
Total other income	**$ 1,305**	$ 1,348	$ (43)	(3.19)%	**$ 1,911**	$ 1,925	$ (14)	(.73)

Other Expense

Other expenses increased $.253 million for the six months ended June 30, 2012, compared to the same period in 2011. The most significant increases in other expense were in salaries and benefits and professional services. During the first half of 2012, the Corporation recorded write-downs and net losses on OREO properties of $.185, compared to $.432 million for the same period in 2011. Management continually reviews all areas of other expense for cost reduction opportunities that will not impact service quality and employee morale.

Table of Contents

The following table details other expense for the three and six months ended June 30, 2012 and 2011 (dollars in thousands):

	Three Months Ended June 30,		Increase/(Decrease)		Six Months Ended June 30,		Increase/(Decrease)	
	2012	**2011**	**Dollars**	**Percentage**	**2012**	**2011**	**Dollars**	**Percentage**
Salaries and employee benefits	**$ 2,003**	$ 1,806	$ 197	10.91%	**$ 3,978**	$ 3,630	$ 348	9.59%
Occupancy	**335**	349	(14)	(4.01)	**680**	714	(34)	(4.76)
Furniture and equipment	**219**	221	(2)	(.90)	**447**	415	32	7.71
Data processing	**258**	179	79	44.13	**486**	355	131	36.90
Professional service fees	**310**	232	78	33.62	**490**	385	105	27.27
Loan and deposit	**338**	252	86	34.13	**479**	431	48	11.14
Writedowns and losses on other real estate held for sale	**174**	(35)	209	(597.14)	**185**	432	(247)	(57.18)
FDIC insurance premiums	**159**	255	(96)	(37.65)	**318**	540	(222)	(41.11)
Telephone	**57**	58	(1)	(1.72)	**112**	109	3	2.75
Advertising	**98**	111	(13)	(11.71)	**196**	199	(3)	(1.51)
Other	**256**	301	(45)	(14.95)	**670**	578	92	15.92
Total other expense	**$ 4,207**	$ 3,729	$ 478	12.82%	**$ 8,041**	$ 7,788	$ 253	3.25%

Federal Income Taxes

A valuation allowance is provided against deferred tax assets when it is more likely than not that some or all of the deferred tax asset will not be realized. The Corporation, as of June 30, 2012 had a net operating loss and tax credit carryforwards for tax purposes of approximately $25.7 million, and $2.1 million, respectively. The net operating loss carryforwards expire twenty years from the date they originated. These carryforwards, if not utilized, will begin to expire in the year 2023. A portion of the NOL, approximately $15.0 million, and all of the credit carryforwards are subject to the limitations for utilization as set forth in Section 382 of the Internal Revenue Code. The annual limitation is $1.400 million for the NOL and the equivalent value of tax credits, which is approximately $.476 million. These limitations for use were established in conjunction with the recapitalization of the Corporation in December 2004.

The Corporation recognized a deferred tax benefit of approximately $1.986 million for the June 30, 2012 six month period and $.616 million for the six months ended June 30, 2011. The valuation allowance at June 30, 2012 was $3.4 million. Management evaluated the deferred tax valuation allowance as of June 30, 2012 and determined that an adjustment to the valuation was warranted. The Corporation reduced the valuation allowance by $3.0 million since it was determined that it was more likely than not that these benefits would be realized. The Corporation made this determination after a thorough review of projected earnings and the composition and sustainability of those earnings over the projected tax carryover period. This analysis substantiated the ability to utilize these deferred tax assets. The Corporation will continue to evaluate the future benefits from these carryforwards and at such time as it becomes more likely than not that they would be utilized prior to expiration will recognize the additional benefits as an adjustment to the valuation allowance.

Table of Contents

LIQUIDITY

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

Current balance sheet liquidity consists of $33.248 million in cash and due from balances, $29.130 million of unpledged investment securities. The Corporation has also experienced significant deposit inflows during the six three months of 2012. Management anticipates reducing liquidity levels in future periods through payments of maturing brokered deposits and funding loan growth.

During the first six months of 2012, the Corporation decreased cash and cash equivalents by $.822 million. As shown on the Corporation s condensed consolidated statement of cash flows, liquidity was impacted by cash provided by investing activities, with a net increase in loans of $19.755 million. Offsetting the net decrease used by investing activities was cash provided by financing activities, primarily a net increase in deposits of $20.592 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.

It is anticipated that during the remainder of 2012, the Corporation will fund anticipated loan production by reducing current balances of liquidity.

The Corporation s primary source of liquidity on a stand-alone basis is dividends from the Bank. The Bank is currently prohibited from paying dividends because of a deficit in retained earnings. The Bank, in order to pay dividends in future periods, will need to completely eliminate the negative balance of retained earnings through future profits.

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

Core deposits are herein defined as demand deposits, NOW (negotiable order withdrawals), money markets, savings and certificates of deposit under $100,000. Noncore funding consists of certificates of deposit greater than $100,000, brokered deposits, and FHLB and Farmers Home Administration borrowings. At June 30, 2012, the Bank s core deposits in relation to total funding were 91.92% compared to 75.72% at June 30, 2011. These ratios indicated at June 30, 2012, that the Bank has decreased its reliance on noncore deposits and borrowings to fund the Bank s long-term assets, namely loans and investments. The bank believes that by maintaining adequate volumes of short-term investments and implementing competitive pricing strategies on deposits, it can ensure adequate liquidity to support future growth. The Bank also has correspondent lines of credit available to meet unanticipated short-term liquidity needs. As of June 30, 2012, the Bank had $28.375 million of unsecured lines available and additional funding sources available if secured. The bank believes that its liquidity position remains strong to meet both present and future financial obligations and commitments, events or uncertainties that have resulted or are reasonably likely to result in material changes with respect to the Bank s liquidity.

From a long-term perspective, the Corporation s operating plan for 2012 includes strategies to increase core deposits in the Corporation s local markets. New deposit products and strategic advertising is expected to aid in efforts of management in growing core deposits which will then reduce the dependency on noncore deposits. The Corporation s operating plan for 2012 calls for augmenting local deposit growth efforts with wholesale CD funding, to the extent necessary.

Table of Contents

CAPITAL AND REGULATORY

As a bank holding company, the Corporation is required to maintain certain levels of capital under government regulation. There are several measurements of regulatory capital and the Corporation is required to meet minimum requirements under each measurement. The federal banking regulators have also established capital classifications beyond the minimum requirements in order to risk-rate deposit insurance premiums and to provide trigger points for prompt corrective action in the event an institution becomes financially troubled. As of June 30, 2012, the Corporation and Bank were well capitalized. During the first half of 2012, total capitalization increased by $6.089 million.

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

		June 30, 2012		December 31, 2011		June 30, 2011
Capital Structure						
Shareholders equity	**$**	**49,352**	$	44,342	$	43,973
Preferred stock		**11,000**		10,921		10,811
Total shareholders equity	**$**	**60,352**	$	55,263	$	54,784
Total capitalization	**$**	**60,352**	$	55,263	$	54,784
Tangible capital	**$**	**60,299**	$	55,263	$	54,784
Intangible Assets						
Core deposit premium	**$**		$		$	
Other identifiable intangibles		**525**		400		
Total intangibles	**$**	**525**	$	400	$	
Regulatory capital						
Tier 1 capital:						
Shareholders equity	**$**	**60,352**	$	55,263	$	54,784
Net unrealized (gains) losses on available for sale securities		**(696)**		(325)		(550)
Less: disallowed deferred tax asset		**(8,600)**		(6,500)		(8,100)
Less: intangibles		**(53)**		(40)		
Total Tier 1 capital	**$**	**51,003**	$	48,398	$	46,134
Tier 2 Capital:						
Allowable reserve for loan losses	**$**	**5,083**	$	5,206	$	5,071
Qualifying long-term debt						
Total Tier 2 capital		**5,083**		5,206		5,071
Total capital	**$**	**56,086**	$	53,604	$	51,205
Risk-adjusted assets	**$**	**439,256**	$	416,423	$	404,593
Capital ratios:						
Tier 1 Capital to average assets		**10.16%**		10.08%		9.50%
Tier 1 Capital to risk weighted assets		**11.61%**		11.62%		11.40%
Total Capital to risk weighted assets		**12.77%**		12.87%		12.66%

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

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

	Shareholders Equity to Quarter-end Assets	**Tangible Equity to Quarter-end Assets**	**Tier 1 Capital to Average Assets**	**Tier 1 Capital to Risk-Weighted Assets**	**Total Capital to Risk-Weighted Assets**
Regulatory minumum for capital adequacy purposes	N/A	N/A	4.00%	4.00%	8.00%
Regulatory defined well capitalized guideline	N/A	N/A	5.00%	6.00%	10.00%
The Corporation:					
June 30, 2012	**11.51%**	**11.50%**	**10.16%**	**11.61%**	**12.77%**
June 30, 2011	11.13%	11.13%	9.50%	11.40%	12.66%
The Bank:					
June 30, 2012	**10.87%**	**10.86%**	**9.52%**	**10.89%**	**12.04%**
June 30, 2011	10.22%	10.22%	8.51%	10.21%	11.46%

MACKINAC FINANCIAL CORPORATION

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

INTEREST RATE RISK

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

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

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

The Corporation has established interest rate floors on approximately $182 million, or 57% of its variable rate commercial loans. These interest rate floors will result in a lag on the repricing of these variable rate loans when and if interest rates increase in future periods. Approximately $98 million of the floor rate loan balances will reprice with a 100 basis point increase on the prime rate, with another $83 million repricing in the next 100 basis point prime rate increase.

The Corporation also has $39.054 million of securities providing for scheduled monthly principal and interest payments as well as unanticipated prepayments of principal. These cash flows are then reinvested into other earning assets at current market rates. The Corporation also has federal funds sold to correspondent banks as well as other interest-bearing deposits with correspondent banks. These funds are generally repriced on a daily basis.

The Corporation has $218 million of transactional accounts, of which $60 million consists of noninterest bearing demand deposit balances. Transaction account balances have increased significantly in the last year due in part to the Corporation s focus on these low costs accounts by developing new attractive products and increased sales efforts to municipalities, schools and businesses. These transactional account balances provide additional repricing flexibility in changing interest rate environments since they have no scheduled maturities and interest rates can be reset at any time.

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

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

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

Table of Contents

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

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

The following is the Corporation s opportunities at June 30, 2012 (dollars in thousands):

	1-90 Days	91 - 365 Days	>1-5 Years	Over 5 Years	Total
Interest-earning assets:					
Loans	**$ 289,112**	**$ 9,093**	**$ 41,299**	**$ 79,949**	**$ 419,453**
Securities	**902**	**2,539**	**25,825**	**9,788**	**39,054**
Other (1)				**3,060**	**3,060**
Total interest-earning assets	**290,014**	**11,632**	**67,124**	**92,797**	**461,567**
Interest-bearing obligations:					
NOW, money market, savings, interest checking	**217,915**				**217,915**
Time deposits	**19,765**	**47,295**	**98,706**	**227**	**165,993**
Brokered CDs		**3,629**	**37,844**		**41,473**
Borrowings			**35,000**	**997**	**35,997**
Total interest-bearing obligations	**237,680**	**50,924**	**171,550**	**1,224**	**461,378**
Gap	**$ 52,334**	**$ (39,292)**	**$ (104,426)**	**$ 91,573**	**$ 189**
Cumulative gap	**$ 52,334**	**$ 13,042**	**$ (91,384)**	**$ 189**	

(1) Includes Federal Home Loan Bank Stock

The above analysis indicates that at June 30, 2012, the Corporation had a cumulative asset sensitivity gap position of $13.042 million within the one-year time frame. The Corporation s cumulative asset sensitive gap suggests that if market interest rates continue to decline in the next twelve months, the Corporation may experience a decrease in net interest income. 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, 2011, the Corporation had a cumulative liability sensitivity gap position of $69.219 million within the one-year time frame.

The borrowings in the gap analysis include $35.000 million of FHLB advances that were refinanced in late 2011. These borrowings now have a weighted average maturity of 2.8 years and a weighted average rate of 1.82%.

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

Table of Contents

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. The Corporation s interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems, and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, the Corporation assesses the existing and potential future effects of changes in interest rates on its financial condition, including capital adequacy, earnings, liquidity, and asset quality. In addition to changes in interest rates, the level of future net interest income is also dependent on a number of variables, including: the growth, composition and levels of loans, deposits, and other earning assets and interest-bearing obligations, and economic and competitive conditions; potential changes in lending, investing, and deposit strategies; customer preferences; and other factors.

FOREIGN EXCHANGE RISK

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

OFF-BALANCE-SHEET RISK

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

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

IMPACT OF INFLATION AND CHANGING PRICES

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and results of operations in historical dollars without considering the change in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Corporation s operations. Nearly all the assets and liabilities of the Corporation are financial, unlike industrial or commercial companies. As a result, the Corporation s performance is directly impacted by changes in interest rates, which are indirectly influenced by inflationary expectations. The

Corporation s ability to match the interest sensitivity of its financial assets to the interest sensitivity of its financial liabilities tends to minimize the effect of changes in interest rates on the Corporation s performance. Changes in interest rates do not necessarily move to the same extent as changes in the price of goods and services.

Table of Contents

MACKINAC FINANCIAL CORPORATION

ITEM 4 CONTROLS AND PROCEDURES

As of June 30, 2012, we carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934. Our management, which includes our principal executive officer and our principal financial officer, does not expect that our disclosure controls and procedures will prevent all errors and all fraud.

A control system, no matter how well conceived and operated, can provide only reasonable, but not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints; additionally, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Corporation have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate due to changes in conditions; also the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Our principal executive officer and principal accounting officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures, as defined, under Rule 13a-15 of the Securities Exchange Act of 1934 are effective as of June 30, 2012.

Changes in Internal Control Over Financial Reporting

There were no changes in the Corporation s internal control over financial reporting that occurred during the quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Corporation s internal control over financial reporting.

Table of Contents

MACKINAC FINANCIAL CORPORATION

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

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.

Table of Contents

SIGNATURES

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

MACKINAC FINANCIAL CORPORATION
(Registrant)

Date: August 14, 2012	By:	/s/ Paul D. Tobias PAUL D. TOBIAS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER (principal executive officer)
	By:	/s/ Ernie R. Krueger ERNIE R. KRUEGER EVP/CHIEF FINANCIAL OFFICER (principal financial and accounting officer)