MACKINAC FINANCIAL CORP /MI/
Form 10-Q
August 11, 2006

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

FORM 10-Q

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from __________ to __________

Commission file number: 0-20167

MACKINAC FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

MICHIGAN (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

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

Large Accelerated Filer ___ Accelerated Filer ___ Non-accelerated Filer _X_

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

As of July 31, 2006, there were outstanding 3,428,695 shares of the registrant's common stock, no par value.

MACKINAC FINANCIAL CORPORATION

INDEX

MACKINAC FINANCIAL CORPORATION
PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands)

	June 30, 2006 (Unaudited)	December 31, 2005	Ju (Una
ASSETS			
Cash and due from banks	$ 5,529	$ 4,833	$ 1
Federal funds sold	12,535	3,110	
Cash and cash equivalents	18,064	7,943	2
Interest-bearing deposits in other financial institutions	893	1,025	
Securities available for sale	33,870	34,210	3
Federal Home Loan Bank stock	4,855	4,855	
Total loans	283,110	239,771	20
Allowance for loan losses	(5,415)	(6,108)	(
Net loans	277,695	233,663	19
Premises and equipment	12,748	11,987	1
Other real estate held for sale	52	945	
Other assets	4,320	4,094	
Total assets	$352,497	$298,722	$27
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Non-interest-bearing deposits	$ 21,773	$ 19,684	$ 2
Interest-bearing deposits	262,391	212,948	18
Total deposits	284,164	232,632	20
Borrowings	37,617	36,417	3
Other liabilities	3,537	3,085	
Total liabilities	325,318	272,134	24
Shareholders' equity:			
Preferred stock - no par value:			
Authorized - 500,000 shares, no shares outstanding	--	--	
Common stock and additional paid in capital - no par value			
Authorized - 18,000,000 shares			
Issued and outstanding - 3,428,695 shares	42,567	42,412	4
Accumulated deficit	(14,772)	(15,461)	(1
Accumulated other comprehensive income (loss)	(616)	(363)	
Total shareholders' equity	27,179	26,588	2
Total liabilities and shareholders' equity	$352,497	$298,722	$27

See accompanying notes to condensed consolidated financial statements.

MACKINAC FINANCIAL CORPORATION

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

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
INTEREST INCOME:				
Interest and fees on loans:				
Taxable	$5,182	$3,201	$ 9,681	$ 6,260
Tax-exempt	192	230	385	472
Interest on securities				
Taxable	274	434	547	896
Tax-exempt	41	42	82	84
Other interest	194	110	363	293
Total interest income	5,883	4,017	11,058	8,005
INTEREST EXPENSE:				
Deposits	2,509	1,198	4,589	2,328
Borrowings	439	431	855	1,084
Total interest expense	2,948	1,629	5,444	3,412
Net interest income before provision for loan losses	2,935	2,388	5,614	4,593
Provision for loan losses	--	--	(600)	--
Net interest income after provision for loan losses	2,935	2,388	6,214	4,593
OTHER INCOME:				
Service fees	122	172	232	333
Loan and lease fees	19	4	36	6
Net security gains	--	98	--	97
Net gains on sale of loans	42	13	83	20
Other	68	83	116	98
Total other income	251	370	467	554
OTHER EXPENSE:				
Salaries and employee benefits	1,496	1,606	3,090	3,110
Occupancy	293	247	610	473
Furniture and equipment	155	138	311	297
Data processing	182	246	336	492
Accounting, legal, and consulting fees	414	228	614	546
Loan and deposit	98	250	228	543
Telephone	51	77	100	137
Advertising	107	243	177	382
Penalty on prepayment of FHLB borrowings	--	--	--	4,320
Other	225	300	552	665
Total other expense	3,021	3,335	6,018	10,965

Income (loss) before income taxes	165	(577)	663	(5,818)
Provision for (benefit of) income taxes	(25)	--	(25)	--
NET INCOME (LOSS)	$ 190	$ (577)	$ 688	$(5,818)
INCOME (LOSS) PER COMMON SHARE:				
Basic	$ .05	$ (.17)	$ .20	$ (1.70)
Diluted	$ .05	$ (.17)	$ .20	$ (1.70)

See accompanying notes to condensed consolidated financial statements.

2.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Balance, beginning of period	$27,173	$28,854	$26,588	$34,730
Stock option compensation	78	--	156	--
Net income (loss) for period	190	(577)	688	(5,818)
Change in minority interest of consolidated subsidiary	--	77	--	77
Net unrealized gain (loss) on securities available for sale	(262)	163	(253)	(472)
Total comprehensive income (loss)	6	(337)	591	(6,213)
Balance, end of period	$27,179	$28,517	$27,179	$28,517

See accompanying notes to condensed consolidated financial statements.

3.

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

	Six Months Ended June 30,	
	2006	2005

CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 688	$ (5,818)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	489	489
(Gain) on sales of securities	--	(97)
(Gain) on sales of premises, equipment, and other real estate	(57)	(4)
FHLB sock dividend	--	(101)
Stock option tax compensation	156	--
Change in other assets	(288)	1,550
Change in other liabilities	452	(768)
Net cash provided by (used in) operating activities	1,440	(4,749)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net (increase) decrease in interest-bearing deposits in other financial institutions	132	18,535
Purchase of securities available for sale	--	(16,009)
Proceeds from sales of securities available for sale	--	30,813
Proceeds from maturities, calls or paydowns of securities available for sale	70	5,666
Net (increase) in loans	(44,039)	(1,828)
Capital expenditures	(1,171)	(120)
Proceeds from sale of premises, equipment, and other real estate	957	249
Net cash provided by (used in) investing activities	(44,051)	37,306
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	51,532	(7,836)
Proceeds from issuance of debt	1,200	1,651
Principal payments on borrowings	--	(50,206)
Net cash provided by (used in) Financing activities	52,732	(56,391)
Net increase (decrease) in cash and cash equivalents	10,121	(23,834)
Cash and cash equivalents at beginning of period	7,943	44,078
Cash and cash equivalents at end of period	$ 18,064	$ 20,244
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid during the year for:	$ 5,177	$ 3,522
Interest		
Income taxes	--	--
NONCASH INVESTING AND FINANCING ACTIVITIES:		
Transfers of Foreclosures from Loans to Other Real Estate Held for Sale	7	827

See accompanying notes to condensed consolidated financial statements.

4.

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, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. The unaudited consolidated financial statements and footnotes thereto should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2005.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the period. Actual results could differ from those estimates.

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

ALLOWANCE FOR LOAN LOSSES

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

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

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

STOCK OPTION PLANS

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

The Corporation adopted SFAS No. 123 (Revised) "Share Based Payments" in the first quarter of 2006. This statement supersedes APB Opinion No. 25 "Accounting for Stock Issued to Employees" and its related implementation guidance. Under Opinion No. 25, issuing stock options to employees generally resulted in recognition of no compensation cost. This adoption resulted in the recognition of after tax compensation expense in the amount of $156,000 for the six months ended June 30, 2006. The expense recorded recognizes the current period vesting of options outstanding. The after tax compensation expense, using this same accounting treatment would have amounted to $38,000 in the first six months of 2005. The per share impact of this accounting change was negligible for 2006.

2. RECENT ACCOUNTING PRONOUNCEMENT

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

3. EARNINGS (LOSS) PER SHARE

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

The following shows the computation of basic and diluted earnings (loss) per share for the three and six months ended June 30, 2005 and 2004 (dollars in thousands, except per share data):

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

	Three Months Ended June 30,		Six Mon Jun
	2006	2005	2006
INCOME (LOSS) PER COMMON SHARE - BASIC:			
Net income (loss)	$ 190	$ (577)	$ 688
Weighted average common shares outstanding	3,428,695	3,428,695	3,428,695
Income (loss) per common share - Basic	$ 0.05	$ (0.17)	$ 0.20
INCOME (LOSS) PER COMMON SHARE - DILUTED:			
Net income (loss)	$ 190	$ (577)	$ 688
Weighted average common shares outstanding for basic loss per common share	3,428,695	3,428,695	3,428,695
Add: Dilutive effect of assumed exercise of stock options	--	--	--
Average shares and dilutive potential common shares	3,428,695	3,428,695	3,428,695
Income (loss) per common share - Diluted	$ .05	$ (.17)	$ .20

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

4. INVESTMENT SECURITIES

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

	June 30, 2006		December 31, 2005	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimate Fair Valu
US Agencies	$30,963	$30,279	$30,980	$30,354
Obligations of states and political subdivisions	3,523	3,591	3,593	3,856
Corporate securities	--	--	--	--
Total securities available for sale	$34,486	$33,870	$34,573	$34,210

The amortized cost and estimated fair value of investment securities pledged to secure FHLB borrowings and customer relationships were $28.079 million and $27.497 million, respectively, at June 30, 2006.

5. LOANS

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

	June 30, 2006	December 31, 2005	June 30, 2005
Commercial real estate	$140,918	$118,637	$104,785
Commercial, financial, and agricultural	59,581	56,686	47,534
One to four family residential real estate	48,931	44,660	43,012
Consumer	2,632	2,285	2,153
Construction	31,048	17,503	7,019
Total loans	$283,110	$239,771	$204,503

LOANS - ALLOWANCE FOR LOAN LOSSES

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

	June 30, 2006	December 31, 2005	June 30, 2005
Balance at beginning of period	$6,108	$6,966	$6,966
Recoveries on loans	40	134	101
Loans charged off	(133)	(992)	(431)
Provision	(600)	--	--
Balance at end of period	$5,415	$6,108	$6,636

5. LOANS (Continued)

In the first half of 2006, net charge off activity was minimal at $93,000, or .04% of average loans outstanding compared to net charge-offs of $330,000, or 17% of average loans, in the first half of 2005. In the first half of 2006, the Corporation reduced the allowance for loan losses by recording a negative provision amounting to $600,000. This reduction in the reserve was made in recognition of the improved credit quality existent in the loan portfolio and is discussed in more detail under "Management's Discussion and Analysis."

LOANS - IMPAIRED LOANS

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

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

	June 30, 2006 (Unaudited)	December 31, 2005	June 30, 2005 (Unaudited)
Balances, at period end			
Impaired loans with specific valuation reserve	$301	$ --	$ 6
Impaired loans with no specific valuation reserve	145	114	1,527
Total impaired loans	$446	$ 114	$1,533
Impaired loans on nonaccrual basis	$446	$ 15	$1,533
Impaired loans on accrual basis	--	99	--
Total impaired loans	$446	$ 114	$1,533
Average investment in impaired loans	$163	$1,922	$3,022
Interest income recognized during impairment	1	78	51
Interest income that would have been recognized on an accrual basis	2	134	89
Cash-basis interest income recognized	1	76	51

The average investment in impaired loans was approximately $.163 million for the six-months ended June 30, 2006, $1.922 million for the year ended December 31, 2005, and $3.022 million for the six months ended June 30, 2005, respectively. Impacting the impaired loan balances in 2005 was a sale of nonperforming assets in late December which included $1.0 millio n of nonaccrual loans.

5. LOANS (Continued)

LOANS - RELATED PARTIES

The Bank, in the ordinary course of business, grants loans to the Corporation's executive officers and directors, including their families and firms in which they are principal owners.

Activity in such loans is summarized below (dollars in thousands):

	June 30, 2006	December 31, 2005	June 30, 2005
Loans outstanding beginning of period	$ 578	$ 63	$ 63
New loans	1,222	56	52
Net activity on revolving lines of credit	271	578	416
Repayment	(857)	(119)	(115)
Decrease related to retired executive officers and directors	--	--	--
Loans outstanding end of period	$1,214	$ 578	$ 416

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

6. BORROWINGS

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

	June 30, 2006	December 31, 2005	June 30, 2005
Federal Home Loan Bank advances at rates ranging from 4.98% to 5.17% maturing in 2010 and 2011	$35,000	$35,000	$35,000
Farmers Home Administration, fixed-rate note payable, maturing August 24, 2004, interest payable at 1%	1,417	1,417	1,484
Advance outstanding on line of credit with a correspondent bank	1,200	--	--
	$37,617	$36,417	$36,484

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

The Federal Home Loan Bank borrowings are collateralized at June 30, 2006, by the following: a collateral agreement on the Corporation's one to four family residential real estate loans with a book value of approximately

$17.952 million; U.S. government agency securities with an amortized cost and estimated fair value of $27.468 million and $26.886 million, respectively; and Federal Home Loan Bank stock owned by the Bank totaling $4.855 million. Prepayment of the remaining advances is subject to the provisions and conditions of the credit policy of the Federal Home Loan Bank of Indianapolis in effect as of June 30, 2006.

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

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

6. BORROWINGS (Continued)

The U.S.D.A. Rural Development borrowing is collateralized by loans totaling $959,000 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 $611,000, and guaranteed by the Corporation.

7. STOCK OPTION PLANS

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

	June 30, 2006	December 31, 2005	June 30, 2005
Outstanding shares at beginning of year	375,417	282,999	282,999
Granted during the period	--	112,500	60,000
Expired during the period	1,500	20,082	19,042
Outstanding shares at end of period	373,917	375,417	323,957
Weighted average exercise price per share at end of period	$ 12.60	$ 14.15	$ 15.39
Shares available for grant at end of period	90,988	89,488	140,948

There were no options granted in the first six months of 2006. In the second quarter of 2005, the Corporation issued 60,000 option shares at a price of $12.00 per share.

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

Exercise Price Range	Number Outstanding	Number Exercisable	Remaining Contractual Life-Years	Weighted Average Exercise Price
$9.16	12,500	2,500	9.5	$ 9.16
$9.75	257,152	120,861	8.5	9.75
$11.50	40,000	8,000	9.3	11.50
$12.00	60,000	12,000	9.0	12.00
$156.00 - $240.00	3,545	3,545	4.8	186.75
$300.00 - $406.60	720	720	3.0	345.00
	373,917	147,626	8.6	$ 12.60

8. CAPITAL

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

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

9. COMMITMENTS, CONTINGENCIES AND CREDIT RISK

FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

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

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

	June 30, 2006	December 31, 2005	June 30, 2005
Commitments to extend credit:			
Fixed rate	$ 3,345	$ 2,118	$ 1,341
Variable rate	42,787	31,557	22,982

Standby letters of credit - Variable rate	8,939	10,493	11,299
Credit card commitments - Fixed rate	2,981	3,135	2,798
	$58,052	$47,303	$38,420

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

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

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

CONTINGENCIES

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

CONCENTRATION OF CREDIT RISK

The Bank grants commercial, residential, agricultural, and consumer loans throughout Michigan. The Bank's most prominent concentration in the loan portfolio relates to commercial loans to entities within the hospitality

9. COMMITMENTS, CONTINGENCIES AND CREDIT RISK (Continued)

and tourism industry. This concentration represents $37.754 million, or 18.83%, of the commercial loan portfolio at June 30, 2006. The remainder of the commercial loan portfolio is diversified in such categories as gaming, petroleum, forestry, and agriculture. Due to the diversity of the Bank's locations, the ability of debtors of residential and consumer loans to honor their obligations is not tied to any particular economic locality.

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 interest rate environment which increase or decrease interest rate margins;

- Changes in securities markets with respect to the market value of financial assets and the level of volatility in certain markets such as foreign exchange;

- Significant increases in competition in the banking and financial services industry resulting from industry consolidation, regulatory changes and other factors, as well as action taken by particular competitors;

- The ability of borrowers to repay loans;

- The effects on liquidity of unusual decreases in deposits;

- Changes in consumer spending, borrowing, and saving habits;

- Technological changes;

- Acquisitions and unanticipated occurrences which delay or reduce the expected benefits of acquisitions;

- Difficulties in hiring and retaining qualified management and banking personnel;

- The Corporation's ability to increase market share and control expenses;

- The effect of compliance with legislation or regulatory changes;

- The effect of changes in accounting policies and practices;

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

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

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

FINANCIAL OVERVIEW

Year-to-date consolidated net income was $.688 million through June 30, 2006, compared to a net loss of $5.818 million for the same period in 2005. Basic income per share was $.20 for the six months ended June 30, 2006, compared to a loss per share of $1.70 for the same period in 2005. The income for the three months ended June 30, 2006 amounted to $.190 million, or $.05 per share, compared to a loss of $.577 million, or $.17 per share for the same period in 2005. The 2006 six months operations include a $600,000 negative provision, recorded in the first quarter, in recognition of improved credit quality. The 2005 results include a penalty of $4.320 million on the prepayment of $48.555 million of the FHLB borrowings. Excluding the provision adjustment and the prepayment penalty, the net income in the first half of 2006 amounted to $88,000, compared to an adjusted loss of $1.498 million for the same period in 2005. The six month 2006 results also include $158,000 of stock option expense, required under the new accounting rules for stock compensation plans, as well as $240,000 of expenses incurred to pursue legal action against the Corporation's former accountants. Total assets increased $53.775 million from December 31, 2005 to June 30, 2006. The loan portfolio increased $43.339 million in the first six months of 2006, from December 31, 2005 balances of $239.771 million. Deposits totaled $284.164 million at June 30, 2006, an increase of $51.532 million from the $236.632 million at December 31, 2005.

FINANCIAL CONDITION

CASH AND CASH EQUIVALENTS

Cash and cash equivalents increased $10.121 million in 2006. See further discussion of the change in cash and cash equivalents in the Liquidity section.

INVESTMENT SECURITIES

Available-for-sale securities decreased $.340 million, or 1.00%, from December 31, 2005 to June 30, 2006, with the balance on June 30, 2006, totaling $33.870 million. The decrease during the first six months of 2006 was largely due to a decrease of $.253 million in the market value during the six month period. Investment securities are utilized in an effort to manage interest rate risk and liquidity. As of June 30, 2006, investment securities with an estimated fair value of $27.497 million were pledged.

LOANS

Through the second quarter of 2006, loan balances increased by $43.339, or 18.1%, from December 31, 2005 balances of $239.771 million. During the first six months of 2006, the Bank experienced loan production of $62.154 million. This loan production, combined with normal principal reductions of approximately $10 million and early payouts of existing loans accounted for the increases in outstanding loan balances. The Corporation has been successful in maintaining loan growth without compromising credit quality. Enhancements to the loan approval process and exception reporting further provide for a more effective management of risk in the loan portfolio. Management continues to actively manage the loan portfolio, seeking to identify and resolve problem assets at an early stage. Management believes a properly positioned loan portfolio provides the most attractive earning asset yield available to the Corporation and, with changes to the loan approval process and exception reporting, management can effectively manage the risk in the loan portfolio. As shown in the table below, all segments of the loan portfolio increased in the first six months of 2006. Management intends to continue loan growth within its markets for mortgage, consumer, and commercial loan products while concentrating on loan quality, industry concentration issues, and competitive pricing.

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

	June 30, 2006	Percent of Total	December 31, 2005	Percent of Total	June 30, 2005
Commercial real estate	$140,918	49.77%	$118,637	49.48%	$104,785
Commercial, financial, and agricultural	59,581	21.05	56,686	23.64	47,534
One to four family residential real estate	48,931	17.28	44,660	18.63	43,012
Consumer	2,632	0.93	2,285	0.95	2,153
Construction	31,048	10.97	17,503	7.30	7,019

Total loans	$283,110	100.00%	$239,771	100.00%	$204,503

LOAN CONCENTRATION

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

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

	June 30, 2006			December 31, 2005		
	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders' Equity	Outstanding Balance	Percent of Commercial Loans	Percent of Shareholders' Equity
Hospitality and tourism	$$ 37,754	18.83%	138.91%	$ 37,681	21.49%	141.72%
Real estate operators - nonresidential bldg	35,478	17.69	130.53	28,217	16.10	106.13
Real estate agents & managers	15,628	7.79	57.50	10,588	6.04	39.82
New car dealers	10,002	4.99	36.80	9,995	5.70	37.59
Petroleum	7,481	3.73	27.52	6,508	3.71	24.48
Operators of nonresidential bldgs	7,306	3.64	26.88	6,218	3.55	23.39
Gaming	6,813	3.40	25.07	7,553	4.31	28.41
Investors	6,659	3.32	24.50	--	0.00	--
Skilled nursing care facilities	6,186	3.09	22.76	6,159	3.51	23.16
Family housing construction	5,467	2.73	20.11	--	0.00	--
Other	61,725	30.79	227.11	62,404	35.59	234.71
Total Commercial Loans	$$200,499	100.00		$175,323	100.00%	

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

CREDIT QUALITY

The allowance for loan losses is maintained by management at a level considered to be adequate to cover probable losses related to specifically identified loans, as well as losses inherent in the balance of the loan portfolio. At June 30, 2006, the allowance for loan losses was 1.91% of total loans outstanding compared to 2.55% at December 31, 2005 and 3.24% at June 30, 2005.

Management analyzes the allowance for loan losses in detail on a monthly basis to determine whether the losses inherent in the portfolio are properly reserved for. Net charge-offs for the six months ended June 30, 2006 amounted to $.093 million, or 0.04% of average loans outstanding, compared to $.330 million, .17% of average loans outstanding, for the same period in 2005. The Corporation, in recognition of the continued improvement in credit quality which has occurred since 2004, reduced the reserve for loan loss by $600,000 in the first quarter of 2006. The reduction of the reserve results in a current reserve balance that is more representative of the relevant risk

inherent within the Corporation's loan portfolio. The current level of charge-offs is below historical levels and projected charge-off activity, based upon current levels of nonperforming loans, is not expected to attain historical levels. Additions or reductions to the reserve in future periods will be dependent upon a combination of future loan growth, nonperforming loan balances and charge-off activity. There were no new significant problem loans or loan downgrades identified during the first or second quarter of 2006.

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

	June 30, 2006	December 31, 2005	June 30, 2005
NONPERFORMING ASSETS:			
Nonaccrual Loans	$ 446	$ 15	$ 959
Loans past due 90 days or more	--	99	2
Restructured Loans	--	--	0
Total nonperforming loans	446	114	961
Other real estate owned	52	945	2,312
Total nonperforming assets	$ 498	$ 1,059	$ 3,273
Nonperforming loans as a % of loans	.16%	.05%	.47%
Nonperforming assets as a % of assets	.14%	.35%	1.19%
RESERVE FOR LOAN LOSSES:			
At period end	$ 5,415	$ 6,108	$ 6,636
As a % of loans	1.91%	2.55%	3.24%
As a % of nonperforming loans	1,214.13%	5,357.89%	690.53%
As a % of nonaccrual loans	1,214.13%	N/M%	691.97%

========= ========= =======

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

	June 30, 2006	December 31, 2005	June 30, 2005
Commercial, financial and agricultural loans	$1,387	$1,492	$1,206
One to four family residential real estate loans	--	17	91
Consumer loans	--	--	0
Unallocated and general reserves	4,028	4,599	5,339
Totals	$5,415	$6,108	$6,636

The following ratios assist management in the determination of the Corporation's credit quality:

	Six Months Ended June 30, 2006	Twelve Months Ended December 31, 2005	Six Ended
Allowance to total loans, at period end	1.91%	2.55%	
Average loans outstanding for the periods indicated	$262,274	$207,928	$1
Net charge-offs to average outstanding loans	.04%	.41%	
Nonperforming loans to gross loans, at period end	.16%	.05%	

Total nonperforming loans increased $332,000 since December 31, 2005. The 2006 increase resulted primarily from the nonaccrual status of one commercial credit with a current principal balance of $.301 million. Late in 2005, the Bank sold $2.1 million of nonperforming assets, which included $1.000 million of nonperforming loans.

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

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

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

	Six Months Ended June 30, 2006	Year Ended December 31, 2005	Six Months Ende June 30, 2005
Balance at beginning of period	$ 945	$ 1,730	$1,730
Other real estate transferred from loans	7	274	827
Other real estate sold/written down	(900)	(1,059)	(245)
Balance at end of period	$ 52	$ 945	$2,312

During the first six months of 2006, the Corporation received real estate in lieu of loan payments of $7,000. Other real estate is initially valued at the lower of cost or the fair value less selling costs. After the initial receipt, management periodically re-evaluates the recorded balance. Any additional reduction in the fair value results in a write-down of other real estate. Write-downs on other real estate may be recorded based on subsequent evaluations of current realizable fair values.

DEPOSITS

The Corporation had an increase in deposits in the first six months of 2006. Total deposits increased by $51.532 million, or 21.2%, in the first six months of 2006. This growth in deposits included $40.278 million of non-core deposits, mostly brokered certificates of deposit. The Corporation continues to evaluate its deposit products and pricing alternatives in an effort to fund loan growth as economically as possible.

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

	June30, 2006	December 31, 2005	June 30, 2005
Demand deposit accounts	$ 21,773	$ 19,684	$ 21,033
NOW and money market	68,107	64,566	53,387
Savings and IRAs	22,104	22,555	24,843
Certificates of Deposit			