

NORTHEAST BANCORP /ME/  
Form 10-Q  
February 13, 2015  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**

**For the quarterly period ended December 31, 2014**

**Commission File Number: 1-14588**

**Northeast Bancorp**

(Exact name of registrant as specified in its charter)

**Maine**  
(State or other jurisdiction of incorporation or organization)

**01-0425066**  
(I.R.S. Employer Identification No.)

**500 Canal Street, Lewiston, Maine**  
(Address of Principal executive offices)

**04240**  
(Zip Code)

**(207) 786-3245**

Registrant's telephone number, including area code

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of January 31, 2015 the registrant had outstanding 8,957,474 shares of voting common stock, \$1.00 par value per share and 880,963 shares of non-voting common stock, \$1.00 par value per share.

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## PART 1- FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(Dollars in thousands, except share data)

|   | <b>December 31, 2014</b> |         | <b>June 30, 2014</b> |         |
|---|--------------------------|---------|----------------------|---------|
| <b>Assets</b>   |                          |         |                      |         |
| Cash and due from banks   | \$                       | 2,626   | \$                   | 3,372   |
| Short-term investments  |                          | 80,643  |                      | 78,887  |
| Total cash and cash equivalents   |                          | 83,269  |                      | 82,259  |
| Available-for-sale securities, at fair value  |                          | 107,841 |                      | 113,881 |
| Loans held for sale   |                          | 5,154   |                      | 11,945  |
| Loans   |                          | 575,335 |                      | 516,416 |
| Less: Allowance for loan losses   |                          | 1,664   |                      | 1,367   |
| Loans, net  |                          | 573,671 |                      | 515,049 |
| Premises and equipment, net   |                          | 8,494   |                      | 9,135   |
| Real estate owned and other repossessed collateral, net   |                          | 2,058   |                      | 1,991   |
| Federal Home Loan Bank stock, at cost   |                          | 4,102   |                      | 4,102   |
| Intangible assets, net  |                          | 2,467   |                      | 2,798   |
| Bank owned life insurance   |                          | 15,055  |                      | 14,836  |
| Other assets  |                          | 7,924   |                      | 5,935   |
| Total assets  | \$                       | 810,035 | \$                   | 761,931 |
| <b>Liabilities and Stockholders Equity</b>  |                          |         |                      |         |
| <b>Liabilities</b>  |                          |         |                      |         |
| <b>Deposits:</b>  |                          |         |                      |         |
| Demand  | \$                       | 51,920  | \$                   | 50,140  |
| Savings and interest checking   |                          | 95,373  |                      | 98,340  |
| Money market  |                          | 144,523 |                      | 83,901  |
| Time  |                          | 339,904 |                      | 341,948 |
| Total deposits  |                          | 631,720 |                      | 574,329 |
| Federal Home Loan Bank advances   |                          | 35,244  |                      | 42,824  |
| Wholesale repurchase agreements   |                          | 10,117  |                      | 10,199  |
| Short-term borrowings   |                          | 2,775   |                      | 2,984   |
| Junior subordinated debentures issued to affiliated trusts  |                          | 8,530   |                      | 8,440   |
| Capital lease obligation  |                          | 1,464   |                      | 1,558   |
| Other liabilities   |                          | 9,262   |                      | 9,531   |
| Total liabilities   |                          | 699,112 |                      | 649,865 |
| <b>Commitments and contingencies</b>  |                          |         |                      |         |
| <b>Stockholders equity</b>  |                          |         |                      |         |
| Preferred stock, \$1.00 par value, 1,000,000 shares authorized; no shares issued and outstanding at December 31, 2014 and June 30, 2014 |                          |         |                      |         |

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|   |            |            |
|---|------------|------------|
| Voting common stock, \$1.00 par value, 25,000,000 shares authorized; 8,965,424 and 9,260,331 shares issued and outstanding at December 31, 2014 and June 30, 2014, respectively | 8,965      | 9,260      |
| Non-voting common stock, \$1.00 par value, 3,000,000 shares authorized; 880,963 shares issued and outstanding at December 31, 2014 and June 30, 2014                            | 881        | 881        |
| Additional paid-in capital  | 87,404     | 90,914     |
| Retained earnings   | 15,314     | 12,294     |
| Accumulated other comprehensive loss  | (1,641)    | (1,283)    |
| Total stockholders' equity  | 110,923    | 112,066    |
| Total liabilities and stockholders' equity  | \$ 810,035 | \$ 761,931 |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*

Table of Contents**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF INCOME**

(Unaudited)

(Dollars in thousands, except share and per share data)

|   | Three Months Ended December 31, |           | Six Months Ended December 31, |           |
|---|---------------------------------|-----------|-------------------------------|-----------|
|   | 2014                            | 2013      | 2014                          | 2013      |
| <b>Interest and dividend income:</b>  |                                 |           |                               |           |
| Interest on loans   | \$ 10,948                       | \$ 10,282 | \$ 21,870                     | \$ 18,739 |
| Interest on available-for-sale securities   | 232                             | 262       | 475                           | 544       |
| Other interest and dividend income  | 79                              | 96        | 146                           | 147       |
| Total interest and dividend income  | 11,259                          | 10,640    | 22,491                        | 19,430    |
| <b>Interest expense:</b>  |                                 |           |                               |           |
| Deposits  | 1,281                           | 979       | 2,410                         | 2,026     |
| Federal Home Loan Bank advances   | 265                             | 327       | 588                           | 651       |
| Wholesale repurchase agreements   | 73                              | 98        | 145                           | 192       |
| Short-term borrowings   | 7                               | 6         | 16                            | 11        |
| Junior subordinated debentures issued to affiliated trusts                        | 188                             | 192       | 394                           | 385       |
| Obligation under capital lease agreements   | 19                              | 21        | 38                            | 43        |
| Total interest expense  | 1,833                           | 1,623     | 3,591                         | 3,308     |
| Net interest and dividend income before provision for loan losses                 | 9,426                           | 9,017     | 18,900                        | 16,122    |
| Provision for loan losses   | 113                             | 151       | 433                           | 227       |
| Net interest and dividend income after provision for loan losses                  | 9,313                           | 8,866     | 18,467                        | 15,895    |
| <b>Noninterest income:</b>  |                                 |           |                               |           |
| Fees for other services to customers  | 392                             | 421       | 786                           | 861       |
| Gain on sales of loans held for sale  | 447                             | 341       | 1,029                         | 880       |
| Gain on sales of portfolio loans  | 445                             | 13        | 525                           | 230       |
| (Loss) gain recognized on real estate owned and other repossessed collateral, net | (31)                            | (77)      | (54)                          | (115)     |
| Bank-owned life insurance income  | 110                             | 116       | 219                           | 234       |
| Other noninterest income  | 7                               | 21        | 19                            | 34        |
| Total noninterest income  | 1,370                           | 835       | 2,524                         | 2,124     |
| <b>Noninterest expense:</b>   |                                 |           |                               |           |
| Salaries and employee benefits  | 4,737                           | 4,253     | 9,270                         | 8,865     |
| Occupancy and equipment expense   | 1,181                           | 1,311     | 2,384                         | 2,601     |
| Professional fees   | 458                             | 281       | 766                           | 657       |
| Data processing fees  | 347                             | 277       | 692                           | 554       |
| Marketing expense   | 80                              | 103       | 148                           | 139       |
| Loan acquisition and collection expense   | 413                             | 290       | 687                           | 763       |
| FDIC insurance premiums   | 110                             | 117       | 234                           | 227       |
| Intangible asset amortization   | 166                             | 210       | 331                           | 420       |
| Legal settlement recovery   |                                 |           |                               | (250)     |
| Other noninterest expense   | 718                             | 772       | 1,437                         | 1,490     |
| Total noninterest expense   | 8,210                           | 7,614     | 15,949                        | 15,466    |
| Income from continuing operations before income tax expense                       | 2,473                           | 2,087     | 5,042                         | 2,553     |
| Income tax expense  | 893                             | 676       | 1,818                         | 832       |

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|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Net income from continuing operations          | 1,580      | 1,411      | 3,224      | 1,721      |
| (Loss) income from discontinued operations     |            |            |            |            |
| before tax (benefit) expense                   |            | (27)       |            | (12)       |
| Income tax (benefit) expense                   |            | (9)        |            | (4)        |
| Net (loss) income from discontinued operations |            | (18)       |            | (8)        |
| Net income                                     | \$ 1,580   | \$ 1,393   | \$ 3,224   | \$ 1,713   |
| Weighted-average shares outstanding:           |            |            |            |            |
| Basic  | 10,132,349 | 10,432,833 | 10,155,598 | 10,436,673 |
| Diluted  | 10,132,349 | 10,432,833 | 10,155,598 | 10,436,673 |
| Earnings per common share:                     |            |            |            |            |
| Basic:   |            |            |            |            |
| Income from continuing operations              | \$ 0.16    | \$ 0.13    | \$ 0.32    | \$ 0.16    |
| Income from discontinued operations            |            |            |            |            |
| Net Income                                     | \$ 0.16    | \$ 0.13    | \$ 0.32    | \$ 0.16    |
| Diluted:                                       |            |            |            |            |
| Income from continuing operations              | \$ 0.16    | \$ 0.13    | \$ 0.32    | \$ 0.16    |
| Income from discontinued operations            |            |            |            |            |
| Net income                                     | \$ 0.16    | \$ 0.13    | \$ 0.32    | \$ 0.16    |
| Cash dividends declared per common share       | \$ 0.01    | \$ 0.09    | \$ 0.02    | \$ 0.18    |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*

Table of Contents**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

(Dollars in thousands)

|   | Three Months Ended December 31, |          | Six Months Ended December 31, |          |
|---|---------------------------------|----------|-------------------------------|----------|
|   | 2014                            | 2013     | 2014                          | 2013     |
| Net income  | \$ 1,580                        | \$ 1,393 | \$ 3,224                      | \$ 1,713 |
| Other comprehensive income (loss), before tax:                            |                                 |          |                               |          |
| Available-for-sale securities:  |                                 |          |                               |          |
| Change in net unrealized gain or loss on available-for-sale securities    | 538                             | (647)    | 263                           | (130)    |
| Reclassification adjustment for net gains included in net income          |                                 |          |                               |          |
| Total available-for-sale securities                                       | 538                             | (647)    | 263                           | (130)    |
| Derivatives and hedging activities:                                       |                                 |          |                               |          |
| Change in accumulated loss on effective cash flow hedges                  | (500)                           | 565      | (770)                         | 584      |
| Reclassification adjustments for net gains included in net income         | (24)                            | (17)     | (34)                          | (36)     |
| Total derivatives and hedging activities                                  | (524)                           | 548      | (804)                         | 548      |
| Total other comprehensive income (loss), before tax                       | 14                              | (99)     | (541)                         | 418      |
| Income tax expense (benefit) related to other comprehensive (loss) income | 4                               | (34)     | (183)                         | 142      |
| Other comprehensive income (loss), net of tax                             | 10                              | (65)     | (358)                         | 276      |
| Comprehensive income  | \$ 1,590                        | \$ 1,328 | \$ 2,866                      | \$ 1,989 |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*



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(Unaudited)

(Dollars in thousands, except share and per share data)

|   | Preferred Stock | Voting Common Stock | Non-voting Common Stock | Additional | Retained         | Accumulated Other Comprehensive | Total                 |
|---|-----------------|---------------------|-------------------------|------------|------------------|---------------------------------|-----------------------|
|   | Shares          | Amount              | Shares                  | Amount     | Capital          | Loss                            | Stockholders' Equity  |
| Balance at June 30, 2013                      |                 | \$ 9,565,680        | \$ 9,566                | 880,963    | \$ 881 \$ 92,745 | \$ 12,524                       | \$ (1,914) \$ 113,802 |
| Net income                                    |                 |                     |                         |            |                  | 1,713                           | 1,713                 |
| Other comprehensive income, net of tax        |                 |                     |                         |            |                  | 276                             | 276                   |
| Dividends on common stock at \$0.18 per share |                 |                     |                         |            |                  | (1,879)                         | (1,879)               |
| Stock-based compensation                      |                 |                     |                         |            | 471              |                                 | 471                   |
| Forfeiture of restricted common stock         |                 | (14,149)            | (14)                    |            | 14               |                                 |                       |
| Balance at December 31, 2013                  |                 | \$ 9,551,531        | \$ 9,552                | 880,963    | \$ 881 \$ 93,230 | \$ 12,358                       | \$ (1,638) \$ 114,383 |
| Balance at June 30, 2014                      |                 | \$ 9,260,331        | \$ 9,260                | 880,963    | \$ 881 \$ 90,914 | \$ 12,294                       | \$ (1,283) \$ 112,066 |
| Net income                                    |                 |                     |                         |            |                  | 3,224                           | 3,224                 |
| Other comprehensive income, net of tax        |                 |                     |                         |            |                  | (358)                           | (358)                 |
| Common stock repurchased                      |                 | (448,686)           | (449)                   |            | (3,653)          |                                 | (4,102)               |
| Dividends on common stock at \$0.02 per share |                 |                     |                         |            |                  | (204)                           | (204)                 |
| Stock-based compensation                      |                 |                     |                         |            | 297              |                                 | 297                   |
| Issuance of restricted common stock           |                 | 168,000             | 168                     |            | (168)            |                                 |                       |
| Forfeiture of restricted common stock         |                 | (14,221)            | (14)                    |            | 14               |                                 |                       |
| Balance at December 31, 2014                  |                 | \$ 8,965,424        | \$ 8,965                | 880,963    | \$ 881 \$ 87,404 | \$ 15,314                       | \$ (1,641) \$ 110,923 |

The accompanying notes are an integral part of these unaudited consolidated financial statements.

Table of Contents**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

(Dollars in thousands)

|  | <b>Six Months Ended December 31,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2014</b>                          | <b>2013</b> |
| <b>Operating activities:</b>   |                                      |             |
| Net income   | \$ 3,224                             | \$ 1,713    |
| Adjustments to reconcile net income to net cash provided by (used in) by operating activities: |                                      |             |
| Provision for loan losses  | 433                                  | 227         |
| Loss on sale and impairment of real estate owned and other repossessed collateral, net         | 54                                   | 115         |
| Accretion of fair value adjustments on loans, net  | (6,117)                              | (4,099)     |
| Accretion of fair value adjustments on deposits, net   | (120)                                | (415)       |
| Accretion of fair value adjustments on borrowings, net   | (72)                                 | (132)       |
| Originations of loans held for sale  | (49,444)                             | (44,651)    |
| Net proceeds from sales of loans held for sale   | 57,264                               | 47,299      |
| Gain on sales of loans held for sale   | (1,029)                              | (880)       |
| Gain on sales of portfolio loans   | (525)                                | (230)       |
| Amortization of intangible assets  | 331                                  | 420         |
| Bank-owned life insurance income, net  | (219)                                | (234)       |
| Depreciation of premises and equipment   | 847                                  | 1,035       |
| Loss (gain) on sale of premises and equipment  | 28                                   | (1)         |
| Net gain on sale of available-for-sale securities  |                                      |             |
| Stock-based compensation   | 297                                  | 471         |
| Amortization of securities, net  | 519                                  | 668         |
| Changes in other assets and liabilities:   |                                      |             |
| Other assets   | (1,693)                              | (6,568)     |
| Other liabilities  | (1,071)                              | 3,290       |
| Net cash provided (used in) by operating activities  | 2,707                                | (1,972)     |
| <b>Investing activities:</b>   |                                      |             |
| Proceeds from sales of available-for-sale securities   |                                      |             |
| Purchases of available-for-sale securities   |                                      | (12,083)    |
| Proceeds from maturities and principal payments on available-for-sale securities               | 5,786                                | 18,165      |
| Loan purchases   | (39,667)                             | (29,967)    |
| Proceeds from sales of portfolio loans   | 3,665                                | 216         |
| Loan originations and principal collections, net   | (16,778)                             | (34,000)    |
| Purchases of premises and equipment  | (234)                                | (594)       |
| Proceeds from sales of premises and equipment  |                                      | 11          |
| Proceeds from sales of real estate owned and other repossessed collateral                      | 129                                  | 528         |
| Net cash used in investing activities  | (47,099)                             | (57,724)    |
| <b>Financing activities:</b>   |                                      |             |
| Net increase in deposits   | 57,511                               | 52,314      |
| Net (decrease) increase in short-term borrowings   | (209)                                | 1,843       |
| Repurchase of common stock   | (4,102)                              |             |
| Dividends paid on common stock   | (204)                                | (1,879)     |
| Proceeds from FHLB advances  |                                      | 15,000      |
| Repayments of FHLB advances  | (7,500)                              |             |
| Repayment of wholesale repurchase agreements   |                                      | (10,000)    |

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|  |           |           |
|--|-----------|-----------|
| Repayment of capital lease obligation                                      | (94)      | (89)      |
| Net cash provided by financing activities                                  | 45,402    | 57,189    |
| Net decrease in cash and cash equivalents                                  | 1,010     | (2,507)   |
| Cash and cash equivalents, beginning of period                             | 82,259    | 65,934    |
| Cash and cash equivalents, end of period                                   | \$ 83,269 | \$ 63,427 |
| Supplemental schedule of noncash investing and financing activities:       |           |           |
| Transfers from loans to real estate owned and other repossessed collateral | \$ 241    | \$ 1,727  |
| Transfers from real estate owned and other repossessed collateral to loans | 2         |           |

*The accompanying notes are an integral part of these unaudited consolidated financial statements.*

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**NORTHEAST BANCORP AND SUBSIDIARY**

**Notes to Unaudited Consolidated Financial Statements**

**December 31, 2014**

**1. Basis of Presentation**

The accompanying unaudited condensed and consolidated interim financial statements include the accounts of Northeast Bancorp ( Northeast ) or the Company ) and its wholly-owned subsidiary, Northeast Bank (the Bank ).

These financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting principally of normal recurring accruals) considered necessary for a fair presentation of the Company s financial position, results of operations, and cash flows for the interim periods presented. These financial statements and notes should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended June 30, 2014 ( Fiscal 2014 ) included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission.

**2. Recent Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board ( FASB ) issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)* ( ASU 2014-09 ). ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. ASU 2014-09 is effective January 1, 2017 and is not expected to have a significant impact on the Company s financial statements.

In June 2014, the FASB issued ASU 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures* ( ASU 2014-11 ). ASU 2014-11 requires that repurchase-to-maturity transactions be accounted for as secured borrowings consistent with the accounting for other repurchase agreements. In addition, ASU 2014-11 requires separate accounting for repurchase financings, which entails the transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty. ASU 2014-11 requires entities to disclose certain information about transfers accounted for as sales in transactions that are economically similar to repurchase agreements. In addition, ASU 2014-11 requires disclosures related to collateral, remaining contractual tenor and of the potential risks associated with repurchase agreements, securities lending transactions and repurchase-to-maturity transactions. ASU 2014-11 is effective January 1, 2015 and is not expected to have a significant impact on the Company s financial statements.

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In August 2014, the FASB issued ASU 2014-14, *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure* ( ASU 2014-14 ). ASU 2014-14 affects creditors that hold government-guaranteed mortgage loans, including those guaranteed by the Federal Housing Administration (FHA) of the U.S. Department of Housing and Urban Development (HUD), and the U.S. Department of Veterans Affairs (VA). The update requires that, upon foreclosure, a guaranteed mortgage loan be derecognized and a separate other receivable be recognized when specific criteria are met. ASU 2014-14 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2014. The adoption of this guidance is not expected to have a significant impact on the Company's financial statements.

Table of Contents**3. Securities Available-for-Sale**

The following presents a summary of the amortized cost, gross unrealized holding gains and losses, and fair value of securities available for sale.

|                                   | Amortized<br>Cost | December 31, 2014         |                            | Fair<br>Value |
|-----------------------------------|-------------------|---------------------------|----------------------------|---------------|
|                                   |                   | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses |               |
| (Dollars in thousands)            |                   |                           |                            |               |
| U.S. Government agency securities | \$ 48,302         | \$ 43                     | \$ (28)                    | \$ 48,317     |
| Agency mortgage-backed securities | 60,553            | 4                         | (1,033)                    | 59,524        |
|                                   | \$ 108,855        | \$ 47                     | \$ (1,061)                 | \$ 107,841    |

|                                   | Amortized<br>Cost | June 30, 2014             |                            | Fair<br>Value |
|-----------------------------------|-------------------|---------------------------|----------------------------|---------------|
|                                   |                   | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses |               |
| (Dollars in thousands)            |                   |                           |                            |               |
| U.S. Government agency securities | \$ 48,415         | \$ 31                     | \$ (28)                    | \$ 48,418     |
| Agency mortgage-backed securities | 66,744            | 3                         | (1,284)                    | 65,463        |
|                                   | \$ 115,159        | \$ 34                     | \$ (1,312)                 | \$ 113,881    |

When securities are sold, the adjusted cost of the specific security sold is used to compute the gain or loss on sale. There were no securities sold during the three and six months ended December 31, 2014 or 2013. At December 31, 2014, investment securities with a fair value of approximately \$34.7 million were pledged as collateral to secure outstanding borrowings.

The following summarizes the Company's gross unrealized losses and fair values aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

|                                   | Less than 12 Months |                      | December 31, 2014<br>More than 12 Months |                      | Fair<br>Value | Total<br>Unrealized<br>Losses |
|-----------------------------------|---------------------|----------------------|--|----------------------|---------------|-------------------------------|
|                                   | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value                            | Unrealized<br>Losses |               |                               |
| (Dollars in thousands)            |                     |                      |  |                      |               |                               |
| U.S. Government agency securities | \$ 27,086           | \$ (28)              | \$                                       | \$                   | \$ 27,086     | \$ (28)                       |
| Agency mortgage-backed securities | 2,188               | (8)                  | 54,970                                   | (1,025)              | 57,158        | (1,033)                       |
|                                   | \$ 29,274           | \$ (36)              | \$ 54,970                                | \$ (1,025)           | \$ 84,244     | \$ (1,061)                    |

|                                   | Less than 12 Months |                      | June 30, 2014<br>More than 12 Months |                      | Fair<br>Value | Total<br>Unrealized<br>Losses |
|-----------------------------------|---------------------|----------------------|--------------------------------------|----------------------|---------------|-------------------------------|
|                                   | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value                        | Unrealized<br>Losses |               |                               |
| (Dollars in thousands)            |                     |                      |                                      |                      |               |                               |
| U.S. Government agency securities | \$ 24,141           | \$ (28)              | \$                                   | \$                   | \$ 24,141     | \$ (28)                       |

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|                                   |    |        |    |        |         |        |         |         |    |        |    |         |
|-----------------------------------|----|--------|----|--------|---------|--------|---------|---------|----|--------|----|---------|
| Agency mortgage-backed securities |    |        |    | 62,734 | (1,284) | 62,734 | (1,284) |         |    |        |    |         |
|                                   | \$ | 24,141 | \$ | (28)   | \$      | 62,734 | \$      | (1,284) | \$ | 86,875 | \$ | (1,312) |

There were no other-than-temporary impairment losses on securities during the three and six months ended December 31, 2014 or 2013.

At December 31, 2014, the Company had twenty securities in a continuous loss position for greater than twelve months. At December 31, 2014, all of the Company's available-for-sale securities were issued or guaranteed by either government agencies or government-sponsored enterprises. The decline in fair value of the Company's available-for-sale securities at December 31, 2014 is attributable to changes in interest rates.

Management of the Company, in addition to considering current trends and economic conditions that may affect the quality of individual securities within the Company's investment portfolio, also considers the Company's ability and intent to hold such securities to maturity or recovery of cost. Management does not believe any of the Company's available-for-sale securities are other-than-temporarily impaired at December 31, 2014.

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The amortized cost and fair values of available-for-sale debt securities by contractual maturity are shown below as of December 31, 2014. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | <b>Amortized<br/>Cost</b> |    | <b>Fair<br/>Value</b> |
|--|---------------------------|----|-----------------------|
|  | (Dollars in thousands)    |    |                       |
| Due within one year                    | \$ 9,035                  | \$ | 9,039                 |
| Due after one year through five years  | 39,267                    |    | 39,278                |
| Due after five years through ten years | 30,053                    |    | 29,718                |
| Due after ten years                    | 30,500                    |    | 29,806                |
|  | \$ 108,855                | \$ | 107,841               |



Table of Contents**4. Loans, Allowance for Loan Losses and Credit Quality**

Loans are carried at the principal amounts outstanding, or amortized acquired fair value in the case of acquired loans, adjusted by partial charge-offs and net of deferred loan costs or fees. Loan fees and certain direct origination costs are deferred and amortized into interest income over the expected term of the loan using the level-yield method. When a loan is paid off, the unamortized portion is recognized in interest income. Interest income is accrued based upon the daily principal amount outstanding except for loans on nonaccrual status.

Loans purchased by the Company are accounted for under ASC 310-30, *Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality* (ASC 310-30). At acquisition, the effective interest rate is determined based on the discount rate that equates the present value of the Company's estimate of cash flows with the purchase price of the loan. Prepayments are not assumed in determining a purchased loan's effective interest rate and income accretion. The application of ASC 310-30 limits the yield that may be accreted on the purchased loan, or the accretable yield, to the excess of the Company's estimate, at acquisition, of the expected undiscounted principal, interest, and other cash flows over the Company's initial investment in the loan. The excess of contractually required payments receivable over the cash flows expected to be collected on the loan represents the purchased loan's nonaccretable difference. Subsequent improvements in expected cash flows of loans with nonaccretable differences result in a prospective increase to the loan's effective yield through a reclassification of some, or all, of the nonaccretable difference to accretable yield. The effect of subsequent credit-related declines in expected cash flows of purchased loans are recorded through a specific allocation in the allowance for loan losses.

Loans are generally placed on nonaccrual status when they are past due 90 days as to either principal or interest, or when in management's judgment the collectability of interest or principal of the loan has been significantly impaired. Loans accounted for under ASC 310-30 are placed on nonaccrual when it is not possible to reach a reasonable expectation of the timing and amount of cash flows to be collected on the loan. When a loan has been placed on nonaccrual status, previously accrued and uncollected interest is reversed against interest on loans. Interest on nonaccrual loans is accounted for on a cash-basis or using the cost-recovery method when collectability is doubtful. A loan is returned to accrual status when collectability of principal is reasonably assured and the loan has performed for a reasonable period of time.

In cases where a borrower experiences financial difficulties and the Company makes certain concessionary modifications to contractual terms, the loan is classified as a troubled debt restructuring (TDR), and therefore by definition is an impaired loan. Concessionary modifications may include adjustments to interest rates, extensions of maturity, and other actions intended to minimize economic loss and avoid foreclosure or repossession of collateral. For loans accounted for under ASC 310-30, the Company evaluates whether it has granted a concession by comparing the restructured debt terms to the expected cash flows at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition. As a result, if an ASC 310-30 loan is modified to be consistent with, or better than, the Company's expectations at acquisition, the loan would not qualify as a TDR. Nonaccrual loans that are restructured generally remain on nonaccrual status for a minimum period of six months to demonstrate that the borrower can meet the restructured terms. If the restructured loan is on accrual status prior to being modified, it is reviewed to determine if the modified loan should remain on accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan is classified as a nonaccrual loan. With limited exceptions, loans classified as TDRs remain classified as such until the loan is paid off.

The composition of the Company's loan portfolio is as follows on the dates indicated.

|                        | December 31, 2014 |       |            | June 30, 2014 |       |  |
|------------------------|-------------------|-------|------------|---------------|-------|--|
| Originated             | Purchased         | Total | Originated | Purchased     | Total |  |
| (Dollars in thousands) |                   |       |            |               |       |  |

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|                         |    |         |    |         |    |         |    |         |    |         |    |         |
|-------------------------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|
| Residential real estate | \$ | 112,272 | \$ | 2,211   | \$ | 114,483 | \$ | 116,972 | \$ | 3,687   | \$ | 120,659 |
| Home equity             |    | 25,534  |    |         |    | 25,534  |    | 27,975  |    |         |    | 27,975  |
| Commercial real estate  |    | 125,567 |    | 217,914 |    | 343,481 |    | 116,617 |    | 199,481 |    | 316,098 |
| Commercial business     |    | 82,672  |    | 267     |    | 82,939  |    | 41,518  |    | 282     |    | 41,800  |
| Consumer                |    | 8,898   |    |         |    | 8,898   |    | 9,884   |    |         |    | 9,884   |
| Total loans             | \$ | 354,943 | \$ | 220,392 | \$ | 575,335 | \$ | 312,966 | \$ | 203,450 | \$ | 516,416 |

Related Party Loans

The Bank's authority to extend credit to their respective directors and executive officers, as well as to entities controlled by such persons, is currently governed by the requirements of the Sarbanes-Oxley Act of 2002 and Regulation O of the Board of Governors of the Federal Reserve System. Among other things, these provisions require that extensions of credit to insiders (1) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features; and (2) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the Bank's capital. In addition, the extensions of credit to insiders must be approved by each Bank's Board of Directors.

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Total loans and advances, to directors, executive officers and their affiliates were \$416 thousand at December 31, 2014. All loans were performing at December 31, 2014.

Allowance for Loan Losses and Impaired Loans

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. For residential and consumer loans, a charge-off is recorded no later than the point at which a loan is 180 days past due if the loan balance exceeds the fair value of the collateral, less costs to sell. For commercial loans, a charge-off is recorded on a case-by-case basis when all or a portion of the loan is deemed to be uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses consists of general, specific, and unallocated reserves and reflects management's estimate of probable loan losses inherent in the loan portfolio at the balance sheet date. Management uses a consistent and systematic process and methodology to evaluate the appropriateness of the allowance for loan losses on a quarterly basis. The calculation of the allowance for loan losses is segregated by portfolio segments, which include: commercial real estate, commercial business, consumer, residential real estate, and purchased loans. Risk characteristics relevant to each portfolio segment are as follows:

**Residential real estate:** All loans in this segment are collateralized by residential real estate and repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, particularly unemployment rates and housing prices, has a significant effect on the credit quality in this segment. For purposes of the Company's allowance for loan loss calculation, home equity loans and lines of credit are included in residential real estate.

**Commercial real estate:** Loans in this segment are primarily income-producing properties. For owner-occupied properties, the cash flows are derived from an operating business, and the underlying cash flows may be adversely affected by deterioration in the financial condition of the operating business. The underlying cash flows generated by non-owner occupied properties may be adversely affected by increased vacancy rates. Management periodically obtains rent rolls, with which it monitors the cash flows of these loans. Adverse developments in either of these areas will have an adverse effect on the credit quality of this segment. For purposes of the allowance for loan losses, this segment also includes construction loans.

**Commercial business:** Loans in this segment are made to businesses and are generally secured by the assets of the business. Repayment is expected from the cash flows of the business. Weakness in national or regional economic conditions, and a corresponding weakness in consumer or business spending, will have an adverse effect on the credit quality of this segment.

**Consumer:** Loans in this segment are generally secured, and repayment is dependent on the credit quality of the individual borrower. Repayment of consumer loans is generally based on the earnings of individual borrowers, which may be adversely impacted by regional labor market conditions.

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Purchased: Loans in this segment are typically secured by commercial real estate, multi-family residential real estate, or business assets and have been acquired by the Bank's Loan Acquisition and Servicing Group ( LASG ). Loans acquired by the LASG are, with limited exceptions, performing loans at the date of purchase. Loans in this segment acquired with specific material credit deterioration since origination are identified as purchased credit-impaired. Repayment of loans in this segment is largely dependent on cash flow from the successful operation of the property, in the case of non-owner occupied property, or operating business, in the case of owner-occupied property. Loan performance may be adversely affected by factors affecting the general economy or conditions specific to the real estate market, such as geographic location or property type. Loans in this segment are evaluated for impairment under ASC 310-30. The Company reviews expected cash flows from purchased loans on a quarterly basis. The effect of a decline in expected cash flows subsequent to the acquisition of the loan is recognized through a specific allocation in the allowance for loan losses.

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by loan segment. The Company does not weight periods used in that analysis to determine the average loss rate in each portfolio segment. This historical loss factor is adjusted for the following qualitative factors:

- Levels and trends in delinquencies and nonperforming loans
  
- Trends in the volume and nature of loans
  
- Trends in credit terms and policies, including underwriting standards, procedures and practices, and the experience and ability of lending management and staff
  
- Trends in portfolio concentration
  
- National and local economic trends and conditions
  
- Effects of changes or trends in internal risk ratings
  
- Other effects resulting from trends in the valuation of underlying collateral

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There were no significant changes in the Company's policies or methodology pertaining to the general component of the allowance for loan losses during the three and six months ended December 31, 2014 or 2013.

The allocated component of the allowance for loan losses relates to loans that are classified as impaired. Impairment is measured on a loan-by-loan basis for commercial business and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan. Large groups of smaller-balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment based on the group's historical loss experience adjusted for qualitative factors. Accordingly, the Company does not separately identify individual consumer and residential loans for individual impairment and disclosure. However, all TDRs are individually reviewed for impairment.

For all portfolio segments, except loans accounted for under ASC 310-30, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. For the purchased loan segment, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to realize cash flows as estimated at acquisition. For loans accounted for under ASC 310-30 for which cash flows can reasonably be estimated, loan impairment is measured based on the decrease in expected cash flows from those estimated at acquisition, excluding changes due to changes in interest rate indices and other non-credit related factors, discounted at the loan's effective rate assumed at acquisition. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting the scheduled principal and interest payments when due.

The following table sets forth activity in the Company's allowance for loan losses.

|                   | Three Months Ended December 31, 2014 |                           |                        |          |           |             |          | Total |
|-------------------|--------------------------------------|---------------------------|------------------------|----------|-----------|-------------|----------|-------|
|                   | Residential<br>Real Estate           | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Purchased | Unallocated |          |       |
| Beginning balance | \$ 783                               | \$ 340                    | \$ 49                  | \$ 51    | \$ 271    | \$ 45       | \$ 1,539 |       |
| Provision         | 2                                    | (53)                      | 5                      | 8        | 142       | 9           | 113      |       |
| Recoveries        | 11                                   | 1                         |                        | 3        |           |             | 15       |       |
| Charge-offs       |                                      |                           |                        | (3)      |           |             | (3)      |       |
| Ending balance    | \$ 796                               | \$ 288                    | \$ 54                  | \$ 59    | \$ 413    | \$ 54       | \$ 1,664 |       |

|                   | Three Months Ended December 31, 2013 |                           |                        |          |           |             |          | Total |
|-------------------|--------------------------------------|---------------------------|------------------------|----------|-----------|-------------|----------|-------|
|                   | Residential<br>Real Estate           | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Purchased | Unallocated |          |       |
| Beginning balance | \$ 695                               | \$ 163                    | \$ 50                  | \$ 148   | \$ 101    | \$ 67       | \$ 1,224 |       |
| Provision         | (33)                                 | 158                       | 2                      | (24)     | 106       | (58)        | 151      |       |
| Recoveries        |                                      |                           |                        | 12       |           |             | 12       |       |
| Charge-offs       | (13)                                 |                           |                        | (24)     |           |             | (37)     |       |

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|                |    |     |    |     |    |    |    |     |    |     |    |   |    |       |
|----------------|----|-----|----|-----|----|----|----|-----|----|-----|----|---|----|-------|
| Ending balance | \$ | 649 | \$ | 321 | \$ | 52 | \$ | 112 | \$ | 207 | \$ | 9 | \$ | 1,350 |
|----------------|----|-----|----|-----|----|----|----|-----|----|-----|----|---|----|-------|

|                   |    |       |    |      |    |    |    |      |    |     |    |    |    |       |
|-------------------|----|-------|----|------|----|----|----|------|----|-----|----|----|----|-------|
| Beginning balance | \$ | 580   | \$ | 358  | \$ | 48 | \$ | 79   | \$ | 267 | \$ | 35 | \$ | 1,367 |
| Provision         |    | 360   |    | (71) |    | 6  |    | (27) |    | 146 |    | 19 |    | 433   |
| Recoveries        |    | 16    |    | 1    |    |    |    | 13   |    |     |    |    |    | 30    |
| Charge-offs       |    | (160) |    |      |    |    |    | (6)  |    |     |    |    |    | (166) |
| Ending balance    | \$ | 796   | \$ | 288  | \$ | 54 | \$ | 59   | \$ | 413 | \$ | 54 | \$ | 1,664 |

Six Months Ended December 31, 2013

|                   | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Purchased | Unallocated | Total    |
|-------------------|----------------------------|---------------------------|------------------------|----------|-----------|-------------|----------|
|                   | (Dollars in thousands)     |                           |                        |          |           |             |          |
| Beginning balance | \$ 594                     | \$ 173                    | \$ 70                  | \$ 189   | \$ 76     | \$ 41       | \$ 1,143 |
| Provision         | 82                         | 148                       | (24)                   | (78)     | 131       | (32)        | 227      |
| Recoveries        | 6                          |                           | 6                      | 31       |           |             | 43       |
| Charge-offs       | (33)                       |                           |                        | (30)     |           |             | (63)     |
| Ending balance    | \$ 649                     | \$ 321                    | \$ 52                  | \$ 112   | \$ 207    | \$ 9        | \$ 1,350 |

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The following table sets forth information regarding the allowance for loan losses by portfolio segment and impairment methodology.

|                            | December 31, 2014          |                           |                        |          |            |             |                        | Total      |
|----------------------------|----------------------------|---------------------------|------------------------|----------|------------|-------------|------------------------|------------|
|                            | Residential<br>Real Estate | Commercial<br>Real Estate | Commercial<br>Business | Consumer | Purchased  | Unallocated | (Dollars in thousands) |            |
| Allowance for loan losses: |                            |                           |                        |          |            |             |                        |            |
| Individually evaluated     | \$ 367                     | \$ 21                     | \$                     | \$ 17    | \$ 374     | \$          | \$                     | \$ 779     |
| Collectively evaluated     | 429                        | 267                       | 54                     | 42       |            | 54          |                        | 846        |
| ASC 310-30                 |                            |                           |                        |          | 39         |             |                        | 39         |
| Total                      | \$ 796                     | \$ 288                    | \$ 54                  | \$ 59    | \$ 413     | \$ 54       | \$                     | \$ 1,664   |
| Loans:                     |                            |                           |                        |          |            |             |                        |            |
| Individually evaluated     | \$ 3,426                   | \$ 2,567                  | \$                     | \$ 605   | \$ 10,117  | \$          | \$                     | \$ 16,715  |
| Collectively evaluated     | 134,380                    | 123,000                   | 82,672                 | 8,293    |            |             |                        | 348,345    |
| ASC 310-30                 |                            |                           |                        |          | 210,275    |             |                        | 210,275    |
| Total                      | \$ 137,806                 | \$ 125,567                | \$ 82,672              | \$ 8,898 | \$ 220,392 | \$          | \$                     | \$ 575,335 |

|                            |            |            |           |          |            |       |    |            |
|----------------------------|------------|------------|-----------|----------|------------|-------|----|------------|
| Allowance for loan losses: |            |            |           |          |            |       |    |            |
| Individually evaluated     | \$ 190     | \$ 84      | \$        | \$ 6     | \$ 166     | \$    | \$ | \$ 446     |
| Collectively evaluated     | 390        | 274        | 48        | 73       |            | 35    |    | 820        |
| ASC 310-30                 |            |            |           |          | 101        |       |    | 101        |
| Total                      | \$ 580     | \$ 358     | \$ 48     | \$ 79    | \$ 267     | \$ 35 | \$ | \$ 1,367   |
| Loans:                     |            |            |           |          |            |       |    |            |
| Individually evaluated     | \$ 2,314   | \$ 2,549   | \$        | \$ 240   | \$ 4,747   | \$    | \$ | \$ 9,850   |
| Collectively evaluated     | 142,633    | 114,068    | 41,518    | 9,644    |            |       |    | 307,863    |
| ASC 310-30                 |            |            |           |          | 198,703    |       |    | 198,703    |
| Total                      | \$ 144,947 | \$ 116,617 | \$ 41,518 | \$ 9,884 | \$ 203,450 | \$    | \$ | \$ 516,416 |

The following table sets forth information regarding impaired loans. Loans accounted for under ASC 310-30 that have performed based on cash flow and accretable yield expectations determined at date of acquisition are not considered impaired assets and have been excluded from the tables below.

December 31, 2014  
Unpaid

June 30, 2014  
Unpaid

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|   | Recorded<br>Investment | Principal<br>Balance | Related<br>Allowance | Recorded<br>Investment | Principal<br>Balance | Related<br>Allowance |
|---|------------------------|----------------------|----------------------|------------------------|----------------------|----------------------|
|   | (Dollars in thousands) |                      |                      |                        |                      |                      |
| Impaired loans without a valuation allowance: |                        |                      |                      |                        |                      |                      |
| Originated:                                   |                        |                      |                      |                        |                      |                      |
| Residential real estate                       | \$ 1,372               | \$ 1,448             | \$                   | \$ 1,005               | \$ 1,081             | \$                   |
| Consumer                                      | 393                    | 395                  |                      | 200                    | 205                  |                      |
| Commercial real estate                        | 1,557                  | 1,575                |                      | 1,368                  | 1,371                |                      |
| Commercial business                           |                        |                      |                      |                        |                      |                      |
| Purchased:                                    |                        |                      |                      |                        |                      |                      |
| Commercial real estate                        | 8,783                  | 12,301               |                      | 2,857                  | 4,148                |                      |
| Total   | 12,105                 | 15,719               |                      | 5,430                  | 6,805                |                      |
| Impaired loans with a valuation allowance:    |                        |                      |                      |                        |                      |                      |
| Originated:                                   |                        |                      |                      |                        |                      |                      |
| Residential real estate                       | 2,055                  | 1,983                | 367                  | 1,309                  | 1,278                | 190                  |
| Consumer                                      | 212                    | 204                  | 17                   | 40                     | 47                   | 6                    |
| Commercial real estate                        | 1,010                  | 1,003                | 21                   | 1,181                  | 1,187                | 84                   |
| Commercial business                           |                        |                      |                      |                        |                      |                      |
| Purchased:                                    |                        |                      |                      |                        |                      |                      |
| Commercial real estate                        | 1,333                  | 2,095                | 374                  | 1,890                  | 2,215                | 166                  |
| Total   | 4,610                  | 5,285                | 779                  | 4,420                  | 4,727                | 446                  |
| Total impaired loans                          | \$ 16,715              | \$ 21,004            | \$ 779               | \$ 9,850               | \$ 11,532            | \$ 446               |



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The following tables set forth information regarding interest income recognized on impaired loans.

|   | Three Months Ended December 31,   |                                  |                                   |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | 2014                              | Interest<br>Income<br>Recognized | 2013                              | Interest<br>Income<br>Recognized |
|   | Average<br>Recorded<br>Investment |                                  | Average<br>Recorded<br>Investment |                                  |
|   | (Dollars in thousands)            |                                  |                                   |                                  |
| Impaired loans without a valuation allowance: |                                   |                                  |                                   |                                  |
| Originated:                                   |                                   |                                  |                                   |                                  |
| Residential real estate                       | \$ 1,384                          | \$ 28                            | \$ 901                            | \$ 8                             |
| Consumer                                      | 292                               | 68                               | 96                                | 1                                |
| Commercial real estate                        | 1,182                             | 30                               | 413                               | 7                                |
| Commercial business                           |                                   |                                  | 72                                | 3                                |
| Purchased:                                    |                                   |                                  |                                   |                                  |
| Commercial real estate                        | 6,901                             | 85                               | 2,833                             | 41                               |
| Total   | 9,759                             | 211                              | 4,315                             | 60                               |
| Impaired loans with a valuation allowance:    |                                   |                                  |                                   |                                  |
| Originated:                                   |                                   |                                  |                                   |                                  |
| Residential real estate                       | 2,080                             | 7                                | 1,344                             | 19                               |
| Consumer                                      | 121                               | 15                               | 117                               | 2                                |
| Commercial real estate                        | 1,248                             | 11                               | 1,186                             | 19                               |
| Commercial business                           |                                   |                                  | 44                                | 1                                |
| Purchased:                                    |                                   |                                  |                                   |                                  |
| Commercial real estate                        | 1,295                             | 21                               | 1,067                             | 46                               |
| Total   | 4,744                             | 54                               | 3,758                             | 87                               |
| Total impaired loans                          | \$ 14,503                         | \$ 265                           | \$ 8,073                          | \$ 147                           |

|   | Six Months Ended December 31,     |                                  |                                   |                                  |
|---|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | 2014                              | Interest<br>Income<br>Recognized | 2013                              | Interest<br>Income<br>Recognized |
|   | Average<br>Recorded<br>Investment |                                  | Average<br>Recorded<br>Investment |                                  |
|   | (Dollars in thousands)            |                                  |                                   |                                  |
| Impaired loans without a valuation allowance: |                                   |                                  |                                   |                                  |
| Originated:                                   |                                   |                                  |                                   |                                  |
| Residential real estate                       | \$ 1,188                          | \$ 45                            | \$ 986                            | \$ 14                            |
| Consumer                                      | 297                               | 71                               | 93                                | 2                                |
| Commercial real estate                        | 1,462                             | 37                               | 420                               | 14                               |
| Commercial business                           |                                   |                                  | 63                                | 6                                |
| Purchased:                                    |                                   |                                  |                                   |                                  |
| Commercial real estate                        | 5,820                             | 160                              | 2,198                             | 48                               |
| Total   | 8,767                             | 313                              | 3,760                             | 84                               |
| Impaired loans with a valuation allowance:    |                                   |                                  |                                   |                                  |
| Originated:                                   |                                   |                                  |                                   |                                  |
| Residential real estate                       | 1,682                             | 35                               | 1,385                             | 37                               |
| Consumer                                      | 126                               | 16                               | 98                                | 3                                |
| Commercial real estate                        | 1,095                             | 31                               | 1,165                             | 45                               |
| Commercial business                           |                                   |                                  | 50                                | 1                                |
| Purchased:                                    |                                   |                                  |                                   |                                  |
| Commercial real estate                        | 1,612                             | 24                               | 778                               | 48                               |
| Total   | 4,515                             | 106                              | 3,476                             | 134                              |

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|                      |    |        |    |     |    |       |    |     |
|----------------------|----|--------|----|-----|----|-------|----|-----|
| Total impaired loans | \$ | 13,282 | \$ | 419 | \$ | 7,236 | \$ | 218 |
|----------------------|----|--------|----|-----|----|-------|----|-----|

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Credit Quality

The Company utilizes a ten-point internal loan rating system for commercial real estate, construction, commercial business, and certain residential loans as follows:

Loans rated 1 - 6: Loans in these categories are considered pass rated loans. Loans in categories 1-5 are considered to have low to average risk. Loans rated 6 are considered marginally acceptable business credits and have more than average risk.

Loans rated 7: Loans in this category are considered special mention. These loans show signs of potential weakness and are being closely monitored by management.

Loans rated 8: Loans in this category are considered substandard. Loans classified as substandard are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness or weaknesses that jeopardize the orderly repayment of the debt.

Loans rated 9: Loans in this category are considered doubtful. Loans classified as doubtful have all the weaknesses inherent in one graded 8 with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

Loans rated 10: Loans in this category are considered loss and of such little value that their continuance as loans is not warranted.

On an annual basis, or more often if needed, the Company formally reviews the ratings of all loans subject to risk ratings. Semi-annually, the Company engages an independent third-party to review a significant portion of loans within these segments. Management uses the results of these reviews as part of its annual review process. Risk ratings on purchased loans, with and without evidence of credit deterioration at acquisition, are determined relative to the Company's recorded investment in that loan, which may be significantly lower than the loan's unpaid principal balance.

The following tables present the Company's loans by risk rating.

|                        | December 31, 2014         |                        |                |                        |            |
|------------------------|---------------------------|------------------------|----------------|------------------------|------------|
|                        | Commercial<br>Real Estate | Originated Portfolio   |                | Purchased<br>Portfolio | Total      |
|                        |                           | Commercial<br>Business | Residential(1) |                        |            |
| (Dollars in thousands) |                           |                        |                |                        |            |
| Loans rated 1- 6       | \$ 119,210                | \$ 82,490              | \$ 9,795       | \$ 208,566             | \$ 420,061 |

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|                |            |           |           |            |            |
|----------------|------------|-----------|-----------|------------|------------|
| Loans rated 7  | 4,758      | 38        | 997       | 8,481      | 14,274     |
| Loans rated 8  | 1,599      | 144       | 657       | 3,345      | 5,745      |
| Loans rated 9  |            |           |           |            |            |
| Loans rated 10 |            |           |           |            |            |
|                | \$ 125,567 | \$ 82,672 | \$ 11,449 | \$ 220,392 | \$ 440,080 |

|                  | June 30, 2014             |                        |  |            |            |
|------------------|---------------------------|------------------------|--|------------|------------|
|                  | Originated Portfolio      |                        |  | Purchased  | Total      |
|                  | Commercial<br>Real Estate | Commercial<br>Business | Residential(1)<br>(Dollars in thousands) | Portfolio  |            |
| Loans rated 1- 6 | \$ 110,044                | \$ 41,271              | \$ 11,941                                | \$ 189,986 | \$ 353,242 |
| Loans rated 7    | 4,880                     | 46                     | 940                                      | 8,619      | 14,485     |
| Loans rated 8    | 1,693                     | 201                    | 670                                      | 4,845      | 7,409      |
| Loans rated 9    |                           |                        |  |            |            |
| Loans rated 10   |                           |                        |  |            |            |
|                  | \$ 116,617                | \$ 41,518              | \$ 13,551                                | \$ 203,450 | \$ 375,136 |

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(1) Certain of the Company's loans made for commercial purposes, but secured by residential collateral, are rated under the Company's risk-rating system.

Table of ContentsPast Due and Nonaccrual Loans

The following is a summary of past due and non-accrual loans:

|                            | December 31, 2014 |               |  |   |                      |                  |                |                          |
|----------------------------|-------------------|---------------|--|---|----------------------|------------------|----------------|--------------------------|
|                            | 30-59<br>Days     | 60-89<br>Days | Past Due<br>90 Days or<br>More-Still<br>Accruing | Past Due<br>90 Days or<br>More-<br>Nonaccrual | Total<br>Past<br>Due | Total<br>Current | Total<br>Loans | Non-<br>Accrual<br>Loans |
| (Dollars in thousands)     |                   |               |  |   |                      |                  |                |                          |
| Originated portfolio:      |                   |               |  |   |                      |                  |                |                          |
| Residential real estate    | \$ 314            | \$ 614        | \$   | \$ 1,509                                      | \$ 2,437             | \$ 109,835       | \$ 112,272     | \$ 2,706                 |
| Home equity                | 48                |               |  | 11  | 59                   | 25,475           | 25,534         | 11                       |
| Commercial real estate     | 212               |               |  | 1,040   | 1,252                | 124,315          | 125,567        | 1,166                    |
| Commercial business        |                   | 19            |  |   | 19                   | 82,653           | 82,672         |                          |
| Consumer                   | 222               | 31            |  | 124   | 377                  | 8,521            | 8,898          | 237                      |
| Total originated portfolio | 796               | 664           |  | 2,684   | 4,144                | 350,799          | 354,943        | 4,120                    |
| Purchased portfolio:       |                   |               |  |   |                      |                  |                |                          |
| Residential real estate    |                   |               |  |   |                      | 2,211            | 2,211          |                          |
| Commercial business        |                   |               |  |   |                      | 267              | 267            |                          |
| Commercial real estate     | 2,758             | 853           |  | 7,411   | 11,022               | 206,892          | 217,914        | 8,129                    |
| Total purchased portfolio  | 2,758             | 853           |  | 7,411   | 11,022               | 209,370          | 220,392        | 8,129                    |
| Total loans                | \$ 3,554          | \$ 1,517      | \$   | \$ 10,095                                     | \$ 15,166            | \$ 560,169       | \$ 575,335     | \$ 12,249                |

|                            | June 30, 2014 |               |  |   |                      |                  |                |                          |
|----------------------------|---------------|---------------|--|---|----------------------|------------------|----------------|--------------------------|
|                            | 30-59<br>Days | 60-89<br>Days | Past Due<br>90 Days or<br>More-Still<br>Accruing | Past Due<br>90 Days or<br>More-<br>Nonaccrual | Total<br>Past<br>Due | Total<br>Current | Total<br>Loans | Non-<br>Accrual<br>Loans |
| (Dollars in thousands)     |               |               |  |   |                      |                  |                |                          |
| Originated portfolio:      |               |               |  |   |                      |                  |                |                          |
| Residential real estate    | \$ 222        | \$ 728        | \$   | \$ 1,573                                      | \$ 2,523             | \$ 114,449       | \$ 116,972     | \$ 1,743                 |
| Home equity                | 109           | 7             |  | 120   | 236                  | 27,739           | 27,975         | 160                      |
| Commercial real estate     | 126           | 136           |  | 629   | 891                  | 115,726          | 116,617        | 1,162                    |
| Commercial business        |               |               |  |   |                      | 41,518           | 41,518         | 5                        |
| Consumer                   | 188           | 24            |  | 49  | 261                  | 9,623            | 9,884          | 139                      |
| Total originated portfolio | 645           | 895           |  | 2,371   | 3,911                | 309,055          | 312,966        | 3,209                    |
| Purchased portfolio:       |               |               |  |   |                      |                  |                |                          |
| Residential real estate    |               |               |  |   |                      | 3,687            | 3,687          |                          |
| Commercial business        |               |               |  |   |                      | 282              | 282            |                          |
| Commercial real estate     |               |               |  | 1,995   | 1,995                | 197,486          | 199,481        | 4,116                    |
| Total purchased portfolio  |               |               |  | 1,995   | 1,995                | 201,455          | 203,450        | 4,116                    |

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|             |    |     |    |     |    |       |    |       |    |         |    |         |    |       |
|-------------|----|-----|----|-----|----|-------|----|-------|----|---------|----|---------|----|-------|
| Total loans | \$ | 645 | \$ | 895 | \$ | 4,366 | \$ | 5,906 | \$ | 510,510 | \$ | 516,416 | \$ | 7,325 |
|-------------|----|-----|----|-----|----|-------|----|-------|----|---------|----|---------|----|-------|

Table of ContentsTroubled Debt Restructurings

The following table shows the Company's post-modification balance of TDRs by type of modification.

|                          | Three Months Ended December 31,<br>2014 |                        | 2013                   |                        | Six Months Ended December 31,<br>2014 |                        | 2013                   |                        |
|--------------------------|---|------------------------|------------------------|------------------------|---------------------------------------|------------------------|------------------------|------------------------|
|                          | Number of<br>Contracts                  | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment | Number of<br>Contracts                | Recorded<br>Investment | Number of<br>Contracts | Recorded<br>Investment |
|                          | (Dollars in thousands)                  |                        |                        |                        |                                       |                        |                        |                        |
| Extended maturity        | 1                                       | \$ 356                 | 3                      | \$ 1,763               | 3                                     | \$ 590                 | 4                      | \$ 1,777               |
| Adjusted interest rate   | 3                                       | 157                    |                        |                        | 4                                     | 195                    | 1                      | 82                     |
| Rate and maturity        |   |                        |                        |                        | 3                                     | 201                    |                        |                        |
| Principal deferment      |   |                        |                        |                        | 1                                     | 453                    | 2                      | 341                    |
| Court ordered concession |   |                        |                        |                        | 4                                     | 84                     |                        |                        |
|                          | 4                                       | \$ 513                 | 3                      | \$ 1,763               | 15                                    | \$ 1,523               | 7                      | \$ 2,200               |

The following table shows loans modified in a TDR and the change in the recorded investment subsequent to the modifications occurring.

|                            |   |        |        |   |          |    |       |
|----------------------------|---|--------|--------|---|----------|----|-------|
|                            |   |        |        |   |          |    |       |
| Originated portfolio:      |   |        |        |   |          |    |       |
| Residential real estate    | 2 | \$ 125 | \$ 125 |   | \$       |    | \$    |
| Home equity                |   |        |        |   |          |    |       |
| Commercial real estate     |   |        |        |   |          |    |       |
| Commercial business        |   |        |        |   |          |    |       |
| Consumer                   | 1 | 32     | 32     | 1 | 39       |    | 39    |
| Total originated portfolio | 3 | 157    | 157    | 1 | 39       |    | 39    |
| Purchased portfolio:       |   |        |        |   |          |    |       |
| Residential real estate    |   |        |        |   |          |    |       |
| Commercial real estate     |   |        |        |   |          |    |       |
|                            | 1 | 356    | 356    | 2 | 1,685    |    | 1,724 |
| Total purchased portfolio  | 1 | 356    | 356    | 2 | 1,685    |    | 1,724 |
| Total                      | 4 | \$ 513 | \$ 513 | 3 | \$ 1,724 | \$ | 1,763 |

|                            |    |       |       |   |       |       |
|----------------------------|----|-------|-------|---|-------|-------|
| Originated portfolio:      |    |       |       |   |       |       |
| Home equity                |    |       |       | 1 | 14    | 14    |
| Commercial business        |    |       |       | 1 | 18    | 18    |
| Total originated portfolio | 14 | 1,167 | 1,167 | 5 | 476   | 476   |
| Residential real estate    |    |       |       |   |       |       |
| Total purchased portfolio  | 1  | 356   | 356   | 2 | 1,685 | 1,724 |

The Company considers TDRs past due 90 days or more to be in payment default. Three loans modified in a TDR in the last twelve months defaulted during the six months ended December 31, 2014; the recorded investment of such loans was \$50 thousand. One loan modified in a TDR in the last twelve months defaulted during the three months ended December 31, 2014; the recorded investment of the loans was zero. As of December 31, 2014, there were no further commitments to lend associated with loans modified in a TDR.



Table of ContentsASC 310-30 Loans

The following table presents a summary of loans accounted for under ASC 310-30 that were acquired by the Company during the period indicated.

|  | Three Months Ended<br>December 31, 2014 |          | Six Months Ended<br>December 31, 2014 |          |
|--|---|----------|---------------------------------------|----------|
|  | (Dollars in thousands)                  |          |                                       |          |
| Contractually required payments receivable | \$                                      | 66,662   | \$                                    | 87,770   |
| Nonaccretable difference                   |   | (1,625)  |                                       | (1,929)  |
| Cash flows expected to be collected        |   | 65,037   |                                       | 85,841   |
| Accretable yield                           |   | (25,405) |                                       | (33,365) |
| Fair value of loans acquired               | \$                                      | 39,632   | \$                                    | 52,476   |

Certain of the loans accounted for under ASC 310-30 that were acquired by the Company are not accounted for using the income recognition model because the Company cannot reasonably estimate cash flows expected to be collected. The carrying amounts of such loans are as follows.

|                                  | As of and for the Three<br>Months Ended<br>December 31, 2014 |       | As of and for the Six<br>Months Ended<br>December 31, 2014 |        |
|----------------------------------|--|-------|--|--------|
|                                  | (Dollars in thousands)                                       |       |  |        |
| Loans acquired during the period | \$   | 35    | \$   | 357    |
| Loans at end of period           |  | 7,697 |  | 11,984 |

The following table summarizes the activity in the accretable yield for loans accounted for under ASC 310-30.

|                                       | Three Months Ended<br>December 31, 2014 |         | Six Months Ended<br>December 31, 2014 |          |
|---------------------------------------|---|---------|---------------------------------------|----------|
|                                       | (Dollars in thousands)                  |         |                                       |          |
| Beginning balance                     | \$                                      | 108,352 | \$                                    | 109,040  |
| Acquisitions                          |   | 25,405  |                                       | 33,365   |
| Accretion                             |   | (4,286) |                                       | (8,729)  |
| Reclassifications to accretable yield |   |         |                                       | 10       |
| Disposals and other changes           |   | (6,196) |                                       | (10,411) |
| End balance                           | \$                                      | 123,275 | \$                                    | 123,275  |

The following table provides information related to the unpaid principal balance and carrying amounts of ASC 310-30 loans.

|  | December 31, 2014      |         | June 30, 2014 |         |
|--|------------------------|---------|---------------|---------|
|  | (Dollars in thousands) |         |               |         |
|  | \$                     | 259,588 | \$            | 239,376 |

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|                          |    |         |    |         |
|--------------------------|----|---------|----|---------|
| Unpaid principal balance |    |         |    |         |
| Carrying amount          | \$ | 218,049 | \$ | 201,171 |

Table of Contents**5. Earnings Per Share (EPS)**

EPS is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding (including participating securities). The Company's only participating securities are unvested restricted stock awards that contain non-forfeitable rights to dividends. The following table shows the weighted average number of shares outstanding for the periods indicated. Shares issuable relative to stock options granted have been reflected as an increase in the shares outstanding used to calculate diluted EPS, after applying the treasury stock method. The number of shares outstanding for basic and diluted EPS is presented as follows:

|   | Three months Ended December 31,                         |            | Six months Ended December 31, |            |
|---|---|------------|-------------------------------|------------|
|   | 2014  | 2013       | 2014                          | 2013       |
|   | (Dollars in thousands, except share and per share data) |            |                               |            |
| Net income  | \$ 1,580  | \$ 1,393   | \$ 3,224                      | \$ 1,713   |
| Weighted average shares used in calculation of basic EPS        | 10,132,349  | 10,432,833 | 10,155,598                    | 10,436,673 |
| Incremental shares from assumed exercise of dilutive securities |   |            |                               |            |
| Weighted average shares used in calculation of diluted EPS      | 10,132,349  | 10,432,833 | 10,155,598                    | 10,436,673 |
| Earnings per common share:                                      |   |            |                               |            |
| Income from continuing operations                               | \$ 0.16   | \$ 0.13    | \$ 0.32                       | \$ 0.16    |
| Income from discontinued operations                             |   |            |                               |            |
| Earnings per common share                                       | \$ 0.16   | \$ 0.13    | \$ 0.32                       | \$ 0.16    |
| Diluted earnings per common share:                              |   |            |                               |            |
| Income from continuing operations                               | \$ 0.16   | \$ 0.13    | \$ 0.32                       | \$ 0.16    |
| Income from discontinued operations                             |   |            |                               |            |
| Diluted earnings per common share                               | \$ 0.16   | \$ 0.13    | \$ 0.32                       | \$ 0.16    |

For the three and six months ended December 31, 2014, the following stock options and warrants were excluded from the calculation of diluted EPS due to the exercise price of these options exceeding the average market price of the Company's common stock for the period. These options, which were not dilutive at that date, may potentially dilute EPS in the future.

|               | Three Months Ended December 31, |           | Six Months Ended December 31, |           |
|---------------|---------------------------------|-----------|-------------------------------|-----------|
|               | 2014                            | 2013      | 2014                          | 2013      |
| Stock options | 1,086,599                       | 1,136,080 | 1,105,694                     | 1,151,442 |
| Warrants      |                                 |           |                               |           |
|               | 1,086,599                       | 1,136,080 | 1,105,694                     | 1,151,442 |

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**6. Fair Value Measurements**

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. The Company uses prices and inputs that are current as of the measurement date, including during periods of market dislocation. In periods of market dislocation, the observability of prices and inputs may be reduced for many instruments. This condition could cause an instrument to be reclassified from one level to another. When market assumptions are not readily available, the Company's own assumptions are set to reflect those that market participants would use in pricing the asset or liability at the measurement date. If there has been a significant decrease in the volume and level of activity for the asset or liability, regardless of the valuation technique(s) used, the objective of a fair value measurement remains the same.

ASC 820 defines fair value and establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under ASC 820 are described below:

Level 1 Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 Valuations based on significant observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment exercised by the Company in determining fair value is greatest for instruments categorized in Level 3. A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

*Valuation techniques* - There have been no changes in the valuation techniques used during the current period.

*Transfers*- There were no transfers of assets and liabilities measured at fair value on a recurring or nonrecurring basis during the current period .

*Assets and Liabilities Measured at Fair Value on a Recurring Basis:*

*Available-for-sale securities* - Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Examples of such instruments include publicly-traded common and preferred stocks. If quoted prices are not available, then fair values are estimated by using pricing models ( *i.e.* , matrix pricing) and market interest rates and credit assumptions or quoted prices of securities with similar characteristics and are classified within Level 2 of the valuation hierarchy. Examples of such instruments include government agency and government sponsored agency mortgage-backed securities, as well as certain preferred and trust preferred stocks. Level 3 securities are securities for which significant unobservable inputs are utilized.

*Derivative financial instruments* - The valuation of the Company's interest rate swaps and caps are determined using widely accepted valuation techniques including discounted cash flow analyses on the expected cash flows of derivatives. These analyses reflect the contractual terms of the derivatives, including the period to maturity, and use observable market-based inputs, including interest rate curves and implied volatilities. Unobservable inputs, such as credit valuation adjustments are insignificant to the overall valuation of the Company's derivative financial instruments. Accordingly, the Company has determined that its interest rate derivatives fall within Level 2 of the fair value hierarchy.

The fair value of derivative loan commitments and forward loan sale agreements are estimated using the anticipated market price based on pricing indications provided from syndicate banks. These commitments and agreements are categorized as Level 2. The fair value of such instruments was nominal at each date presented.

*Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis:*

*Collateral Dependent Impaired Loans*- Valuations of impaired loans measured at fair value are determined by a review of collateral values. Certain inputs used in appraisals are not always observable, and therefore impaired loans are generally categorized as Level 3 within the fair value hierarchy.

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*Real Estate Owned and Other Repossessed collateral* - The fair values of real estate owned and other repossessed collateral are estimated based upon appraised values less estimated costs to sell. Certain inputs used in appraisals are not always observable, and therefore may be categorized as Level 3 within the fair value hierarchy. When inputs used in appraisals are primarily observable, they are classified as Level 2.

*Fair Value of other Financial Instruments:*

*Cash and cash equivalents* - The fair value of cash, due from banks, interest bearing deposits and FHLB overnight deposits approximates their relative book values, as these financial instruments have short maturities.

*FHLB stock* - The carrying value of FHLB stock approximates fair value based on redemption provisions of the FHLB.

*Loans* - Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimates of maturity are based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic conditions, lending conditions and the effects of estimated prepayments.

*Loans held for sale* - The fair value of loans held-for-sale is estimated based on bid quotations received from loan dealers.

*Interest receivable* - The fair value of this financial instrument approximates the book value as this financial instrument has a short maturity. It is the Company's policy to stop accruing interest on loans past due by more than 90 days. Therefore, this financial instrument has been adjusted for estimated credit loss.

*Deposits* - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW accounts and money market accounts, is equal to the amount payable on demand. The fair values of time deposits are based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market. If that value were considered, the fair value of the Company's net assets could increase.

*Borrowings* - The fair value of the Company's borrowings with the FHLB is estimated by discounting the cash flows through maturity or the next re-pricing date based on current rates available to the Company for borrowings with similar maturities. The fair value of the Company's short-term borrowings, capital lease obligations, wholesale repurchase agreements and other borrowings is estimated by discounting the cash flows through maturity based on current rates available to the Company for borrowings with similar maturities.

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*Off-Balance Sheet Credit-Related Instruments* -Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of such instruments was nominal at each date presented.

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Assets and liabilities measured at fair value on a recurring basis are summarized below.

|                                       | Total     | December 31, 2014 |           | Level 3 |
|---------------------------------------|-----------|-------------------|-----------|---------|
|                                       |           | Level 1           | Level 2   |         |
| (Dollars in thousands)                |           |                   |           |         |
| <u>Assets</u>                         |           |                   |           |         |
| Securities available-for-sale:        |           |                   |           |         |
| U.S. Government agency securities     | \$ 48,317 | \$                | \$ 48,317 | \$      |
| Agency mortgage-backed securities     | 59,524    |                   | 59,524    |         |
| Other assets interest rate caps       | 102       |                   | 102       |         |
| <u>Liabilities</u>                    |           |                   |           |         |
| Other liabilities interest rate swaps | \$ 1,411  | \$                | \$ 1,411  | \$      |

|                                      | Total     | June 30, 2014 |           | Level 3 |
|--------------------------------------|-----------|---------------|-----------|---------|
|                                      |           | Level 1       | Level 2   |         |
| (Dollars in thousands)               |           |               |           |         |
| <u>Assets</u>                        |           |               |           |         |
| Securities available-for-sale:       |           |               |           |         |
| U.S. Government agency securities    | \$ 48,418 | \$            | \$ 48,418 | \$      |
| Agency mortgage-backed securities    | 65,463    |               | 65,463    |         |
| Other assets interest rate caps      |           |               |           |         |
| <u>Liabilities</u>                   |           |               |           |         |
| Other liabilities interest rate swap | \$ 714    | \$            | \$ 714    | \$      |

Assets measured at fair value on a nonrecurring basis are summarized below.

|  | Total    | December 31, 2014 |         | Level 3  |
|--|----------|-------------------|---------|----------|
|  |          | Level 1           | Level 2 |          |
| (Dollars in thousands)                             |          |                   |         |          |
| Collateral dependent impaired loans                | \$ 978   | \$                | \$      | \$ 978   |
| Real estate owned and other repossessed collateral | 2,058    |                   |         | 2,058    |
| <u>December 31, 2014</u>                           |          |                   |         |          |
|  | Total    | June 30, 2014     |         | Level 3  |
|  |          | Level 1           | Level 2 |          |
| (Dollars in thousands)                             |          |                   |         |          |
| Collateral dependent impaired loans                | \$ 1,467 | \$                | \$      | \$ 1,467 |
| Real estate owned and other repossessed collateral | 1,991    |                   |         | 1,991    |





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The following table presents the estimated fair value of the Company's financial instruments.

|                                 | Carrying<br>Amount | Fair Value Measurements at December 31, 2014 |           |         |         |
|---------------------------------|--------------------|--|-----------|---------|---------|
|                                 |                    | Total  | Level 1   | Level 2 | Level 3 |
| (Dollars in thousands)          |                    |  |           |         |         |
| <b>Financial assets:</b>        |                    |  |           |         |         |
| Cash and cash equivalents       | \$ 83,269          | \$ 83,269                                    | \$ 83,269 | \$      | \$      |
| Available-for-sale securities   | 107,841            | 107,841                                      |           | 107,841 |         |
| Federal Home Loan Bank stock    | 4,102              | 4,102  |           | 4,102   |         |
| Loans held for sale             | 5,154              | 5,159  |           | 5,159   |         |
| Loans, net                      | 573,671            | 575,858                                      |           |         | 575,858 |
| Accrued interest receivable     | 1,136              | 1,136  |           | 1,136   |         |
| Interest rate caps              | 102                | 102  |           | 102     |         |
| <b>Financial liabilities:</b>   |                    |  |           |         |         |
| Deposits                        | 631,720            | 632,098                                      |           | 632,098 |         |
| FHLB advances                   | 35,244             | 36,031                                       |           | 36,031  |         |
| Wholesale repurchase agreements | 10,177             | 10,292                                       |           | 10,292  |         |
| Short-term borrowings           | 2,775              | 2,775  |           | 2,775   |         |
| Capital lease obligation        | 1,464              | 1,563  |           | 1,563   |         |
| Subordinated debentures         | 8,530              | 8,521  |           |         | 8,521   |
| Interest rate swaps             | 1,411              | 1,411  |           | 1,411   |         |

|                                 | Carrying<br>Amount | Fair Value Measurements at June 30, 2014 |           |         |         |
|---------------------------------|--------------------|--|-----------|---------|---------|
|                                 |                    | Total                                    | Level 1   | Level 2 | Level 3 |
| (Dollars in thousands)          |                    |  |           |         |         |
| <b>Financial assets:</b>        |                    |  |           |         |         |
| Cash and cash equivalents       | \$ 82,259          | \$ 82,259                                | \$ 82,259 | \$      | \$      |
| Available-for-sale securities   | 113,881            | 113,881                                  |           | 113,881 |         |
| Federal Home Loan Bank stock    | 4,102              | 4,102                                    |           | 4,102   |         |
| Loans held for sale             | 11,945             | 11,945                                   |           | 11,945  |         |
| Loans, net                      | 515,049            | 522,154                                  |           |         | 522,154 |
| Accrued interest receivable     | 1,216              | 1,216                                    |           | 1,216   |         |
| Interest rate caps              |                    |  |           |         |         |
| <b>Financial liabilities:</b>   |                    |  |           |         |         |
| Deposits                        | 574,329            | 574,868                                  |           | 574,868 |         |
| FHLB advances                   | 42,824             | 43,843                                   |           | 43,843  |         |
| Wholesale repurchase agreements | 10,199             | 10,484                                   |           | 10,484  |         |
| Short-term borrowings           | 2,984              | 2,984                                    |           | 2,984   |         |
| Capital lease obligation        | 1,558              | 1,701                                    |           | 1,701   |         |
| Subordinated debentures         | 8,440              | 7,858                                    |           |         | 7,858   |
| Interest rate swaps             | 714                | 714                                      |           | 714     |         |

**7. Derivatives and Hedging Activities**

The Company has stand-alone derivative financial instruments in the form of interest rate caps that derive their value from a fee paid and are adjusted to fair value based on index and strike rate, and swap agreements that derive their value from the underlying interest rate. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure arises in the event of nonperformance by the counterparties to these agreements, and is limited to the net difference between the calculated amounts to be received and paid, if any. Such differences, which represent the fair value of the derivative instruments, are reflected on the Company's balance sheet as derivative assets and derivative liabilities. The Company seeks to manage the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail to meet their obligations.

The Company currently holds derivative instruments that contain credit-risk related features that are in a net liability position, which may require that collateral be assigned to dealer banks. At December 31, 2014, the Company had posted cash collateral totaling \$3.3 million with dealer banks related to derivative instruments in a net liability position.

The Company does not offset fair value amounts recognized for derivative instruments. The Company does not net the amount recognized for the right to reclaim cash collateral against the obligation to return cash collateral arising from derivative instruments executed with the same counterparty under a master netting arrangement.

*Risk Management Policies - Derivative Instruments*

The Company evaluates the effectiveness of entering into any derivative instrument agreement by measuring the cost of such an agreement in relation to the reduction in net income volatility within an assumed range of interest rates.

*Interest Rate Risk Management - Cash Flow Hedging Instruments*

The Company uses variable rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If

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interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments.

Information pertaining to outstanding interest rate caps and swap agreements used to hedge variable rate debt is as follows.

| Notional Amount             | Inception Date | Termination Date | Index       | December 31, 2014 |          | Strike Rate | Unrealized Gain (Loss) | Fair Value | Balance Sheet Location |
|-----------------------------|----------------|------------------|-------------|-------------------|----------|-------------|------------------------|------------|------------------------|
|                             |                |                  |             | Receive Rate      | Pay Rate |             |                        |            |                        |
| <i>Interest rate swaps:</i> |                |                  |             |                   |          |             |                        |            |                        |
| \$ 10,000                   | February 2010  | February 2015    | 3 Mo. LIBOR | 2.14%             | 4.69%    | n/a         | \$ (22)                | \$ (37)    | Other Liabilities      |
| 5,000                       | July 2013      | July 2033        | 3 Mo. LIBOR | 0.25%             | 3.38%    | n/a         | (639)                  | (639)      | Other Liabilities      |
| 5,000                       | July 2013      | July 2028        | 3 Mo. LIBOR | 0.25%             | 3.23%    | n/a         | (485)                  | (485)      | Other Liabilities      |
| 5,000                       | July 2013      | July 2023        | 3 Mo. LIBOR | 0.25%             | 2.77%    | n/a         | (250)                  | (250)      | Other Liabilities      |
| <i>Interest rate caps:</i>  |                |                  |             |                   |          |             |                        |            |                        |
| \$ 6,000                    | October 2014   | September 2019   | 3 Mo. LIBOR | n/a               | n/a      | 2.50%       | (75)                   | 102        | Other Assets           |
| \$ 31,000                   |                |                  |             |                   |          |             | \$ (1,471)             | \$ (1,309) |                        |

| Notional Amount             | Inception Date | Termination Date | Index       | June 30, 2014 |          | Strike Rate | Unrealized Loss | Fair Value | Balance Sheet Location |
|-----------------------------|----------------|------------------|-------------|---------------|----------|-------------|-----------------|------------|------------------------|
|                             |                |                  |             | Receive Rate  | Pay Rate |             |                 |            |                        |
| <i>Interest rate swaps:</i> |                |                  |             |               |          |             |                 |            |                        |
| \$ 10,000                   | February 2010  | February 2015    | 3 Mo. LIBOR | 2.12%         | 4.69%    | n/a         | \$ (99)         | \$ (165)   | Other Liabilities      |
| 5,000                       | July 2013      | July 2033        | 3 Mo. LIBOR | 0.23%         | 3.38%    | n/a         | \$ (216)        | \$ (216)   | Other Liabilities      |
| 5,000                       | July 2013      | July 2028        | 3 Mo. LIBOR | 0.23%         | 3.23%    | n/a         | \$ (200)        | \$ (200)   | Other Liabilities      |
| 5,000                       | July 2013      | July 2023        | 3 Mo. LIBOR | 0.23%         | 2.77%    | n/a         | \$ (133)        | \$ (133)   | Other Liabilities      |
| <i>Interest rate caps:</i>  |                |                  |             |               |          |             |                 |            |                        |
| \$ 6,000                    | September 2009 | September 2014   | 3 Mo. LIBOR | n/a           | n/a      | 2.51%       | (16)            |            | Other Assets           |
| \$ 31,000                   |                |                  |             |               |          |             | \$ (664)        | \$ (714)   |                        |

During the three and six months ended December 31, 2014 and 2013, no interest rate cap or swap agreements were terminated prior to maturity. Changes in the fair value of interest rate caps and swaps designated as hedging instruments of the variability of cash flows associated with variable rate debt are reported in other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the debt affects earnings. Risk management results for the three and six months ended December 31, 2014 and 2013 related to the balance sheet hedging of variable rate debt indicates that the hedges were effective.



Table of Contents**8. Other Comprehensive Income**

The components of other comprehensive income (loss) follow.

|  | Three Months Ended December 31, |                                  |                     |                   |                                  |                     |
|--|---------------------------------|----------------------------------|---------------------|-------------------|----------------------------------|---------------------|
|  | Pre-tax<br>Amount               | 2014<br>Tax Expense<br>(Benefit) | After-tax<br>Amount | Pre-tax<br>Amount | 2013<br>Tax Expense<br>(Benefit) | After-tax<br>Amount |
|  | (Dollars in thousands)          |                                  |                     |                   |                                  |                     |
| Change in net unrealized gain or loss on available-for-sale securities | \$ 538                          | \$ 183                           | \$ 355              | \$ (647)          | \$ (220)                         | \$ (427)            |
| Reclassification adjustment for net gains included in net income       |                                 |                                  |                     |                   |                                  |                     |
| Total available-for-sale securities                                    | 538                             | 183                              | 355                 | (647)             | (220)                            | (427)               |
| Change in accumulated loss on effective cash flow hedges               | (500)                           | (171)                            | (329)               | 565               | 192                              | 373                 |
| Reclassification adjustment for net gains included in net income       | (24)                            | (8)                              | (16)                | (17)              | (6)                              | (11)                |
| Total derivatives and hedging activities                               | (524)                           | (179)                            | (345)               | 548               | 186                              | 362                 |
| Total other comprehensive income (loss)                                | \$ 14                           | \$ 4                             | \$ 10               | \$ (99)           | \$ (34)                          | \$ (65)             |

|  | Six Months Ended December 31, |                                  |                     |                   |                                  |                     |
|--|-------------------------------|----------------------------------|---------------------|-------------------|----------------------------------|---------------------|
|  | Pre-tax<br>Amount             | 2014<br>Tax Expense<br>(Benefit) | After-tax<br>Amount | Pre-tax<br>Amount | 2013<br>Tax Expense<br>(Benefit) | After-tax<br>Amount |
|  | (Dollars in thousands)        |                                  |                     |                   |                                  |                     |
| Change in net unrealized gain or loss on available-for-sale securities | \$ 263                        | \$ 90                            | \$ 173              | \$ (130)          | \$ (44)                          | \$ (86)             |
| Reclassification adjustment for net gains included in net income       |                               |                                  |                     |                   |                                  |                     |
| Total available-for-sale securities                                    | 263                           | 90                               | 173                 | (130)             | (44)                             | (86)                |
| Change in accumulated loss on effective cash flow hedges               | (770)                         | (261)                            | (509)               | 584               | 198                              | 386                 |
| Reclassification adjustment for net gains included in net income       | (34)                          | (12)                             | (22)                | (36)              | (12)                             | (24)                |
| Total derivatives and hedging activities                               | (804)                         | (273)                            | (531)               | 548               | 186                              | 362                 |
| Total other comprehensive income (loss)                                | \$ (541)                      | \$ (183)                         | \$ (358)            | \$ 418            | \$ 142                           | \$ 276              |

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Accumulated other comprehensive loss is comprised of the following.

|  | December 31, 2014      | June 30, 2014 |
|--|------------------------|---------------|
|  | (Dollars in thousands) |               |
| Unrealized loss on available-for-sale securities | \$ (1,016)             | \$ (1,278)    |
| Tax effect                                       | 345                    | 434           |
| Net-of-tax amount                                | (671)                  | (844)         |
| Unrealized loss on cash flow hedges              | (1,471)                | (664)         |
| Tax effect                                       | 501                    | 225           |
| Net-of-tax amount                                | (970)                  | (439)         |
| Accumulated other comprehensive loss             | \$ (1,641)             | \$ (1,283)    |

Table of Contents**9. Commitments and Contingencies**Commitments

The Company 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 and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company'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 Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Financial instruments with contract amounts which represent credit risk are as follows:

|                                | <b>December 31, 2014</b>      |        | <b>June 30, 2014</b> |
|--------------------------------|-------------------------------|--------|----------------------|
|                                | <b>(Dollars in thousands)</b> |        |                      |
| Commitments to originate loans | \$                            | 17,656 | \$ 14,282            |
| Unused lines of credit         |                               | 32,543 | 34,657               |
| Standby letters of credit      |                               | 116    | 166                  |

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 Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter party. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. The Company has recorded an allowance for possible losses on commitments and unfunded loans totaling \$30 thousand recorded in other liabilities at both December 31, 2014 and June 30, 2014

Contingencies

The Company and its subsidiary are parties to litigation and claims arising in the normal course of business. Management believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's consolidated financial position or results of operations.





Table of Contents**10. Discontinued Operations**

The Company concluded all investment brokerage activities in the second quarter of Fiscal 2014. Accordingly, operations associated with these activities have been classified as discontinued operations in the accompanying consolidated statements of income. The following summarizes the operations of the Company's investment brokerage division for the three and six months ended December 31, 2014 and 2013.

|                                 | Three Months Ended December 31, |      | Six Months Ended December 31, |      |      |
|---------------------------------|---------------------------------|------|-------------------------------|------|------|
|                                 | 2014                            | 2013 | 2014                          | 2013 |      |
|                                 | (Dollars in thousands)          |      |                               |      |      |
| Noninterest income:             |                                 |      |                               |      |      |
| Investment commissions          | \$                              | \$   | 296                           | \$   | 971  |
| Other noninterest income        |                                 |      |                               |      |      |
| Total noninterest income        |                                 |      | 296                           |      | 971  |
| Noninterest expense:            |                                 |      |                               |      |      |
| Salaries and employee benefits  |                                 |      | 261                           |      | 793  |
| Occupancy and equipment expense |                                 |      | 20                            |      | 60   |
| Data processing fees            |                                 |      | 25                            |      | 82   |
| Marketing expense               |                                 |      |                               |      | 8    |
| Other noninterest expense       |                                 |      | 17                            |      | 40   |
| Total noninterest expense       |                                 |      | 323                           |      | 983  |
| (Loss) income before tax        |                                 |      | (27)                          |      | (12) |
| Income tax (benefit) expense    |                                 |      | (9)                           |      | (4)  |
| Net (loss) income               | \$                              | \$   | (18)                          | \$   | (8)  |

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion should be read in conjunction with the consolidated financial statements, notes and tables included in Northeast Bancorp's Annual Report on Form 10-K for the fiscal year ended June 30, 2014, filed with the Securities and Exchange Commission.

**A Note about 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, such as statements relating to the Company's financial condition, prospective results of operations, future performance or expectations, plans, objectives, prospects, loan loss allowance adequacy, simulation of changes in interest rates, capital spending and finance sources and revenue sources. These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management's projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward-looking statements, which are based on various assumptions (some of which are beyond the Company's control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as believe, expect, estimate, anticipate, continue, plan, approximately, intend, objective, goal, project, or other similar terms or variations of the future or conditional verbs such as will, may, should, could, and would. Although the Company believes that these forward-looking statements are based on reasonable estimates and assumptions, they are not guarantees of future performance and are subject to known and unknown risks, uncertainties, contingencies, and other factors. Accordingly, the Company cannot give you any assurance that its expectations will, in fact, occur or that its estimates or assumptions will be correct. The Company cautions you that actual results could differ materially from those expressed or implied by such forward-looking statements as a result of, among other factors, changes in interest rates and real estate values; competitive pressures from other financial institutions; the effects of continuing weakness in general economic conditions on a national basis or in the local markets in which the Company operates, including changes which adversely affect borrowers' ability to service and repay the Company's loans; changes in loan defaults and charge-off rates; changes in the value of securities and other assets, adequacy of loan loss reserves, or deposit levels necessitating increased borrowing to fund loans and investments; changes in government regulation; the risk that the Company may not be successful in the implementation of its business strategy; the risk of compromises or breaches to our security systems; the risk that intangibles recorded in the Company's financial statements will become impaired; changes in assumptions used in making such forward-looking statements; and the other risks and uncertainties detailed in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2014 as updated in the Company's Quarterly Reports on Form 10-Q and other filings submitted to the Securities and Exchange Commission. These forward-looking statements speak only as of the date of this report and the Company does not undertake any obligation to update or revise any of these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events.

**Description of Business and Strategy**

Business Overview

Northeast Bancorp (we, our, us, Northeast or the Company), incorporated under Maine law in 1987, is a bank holding company registered with the Board of Governors of the Federal Reserve System (the Federal Reserve). As a bank holding company registered under the Bank Holding Company Act of 1956, as amended (the BHCA), the Company is subject to regulation and supervision by the Federal Reserve. The Company's primary subsidiary and principal asset is its wholly-owned banking subsidiary, Northeast Bank (the Bank or Northeast Bank), a Maine state-chartered bank originally organized in 1872. As a Federal Deposit Insurance Corporation (FDIC) insured Maine-chartered bank, the Bank is subject to regulation and supervision by the Maine Bureau of Financial Institutions (the Bureau) and the FDIC.

On December 29, 2010, the merger of the Company and FHB Formation LLC, a Delaware limited liability company ( FHB ), was consummated. As a result of the merger, the surviving company received a capital contribution of \$16.2 million (in addition to the approximately \$13.1 million in cash consideration paid to former shareholders), and the former members of FHB collectively acquired approximately 60% of the Company's outstanding common stock. The Company applied the acquisition method of accounting, as described in Accounting Standards Codification ( ASC ) 805, *Business Combinations* ( ASC 805 ) to the merger, which represents an acquisition by FHB of Northeast, with Northeast as the surviving company.

In connection with the transaction, as part of the regulatory approval process, the Company and the Bank made certain commitments to the Federal Reserve, the most significant of which are (i) to maintain a Tier 1 leverage ratio of at least 10%, (ii) to maintain a total risk-based capital ratio of at least 15%, (iii) to limit purchased loans to 40% of total loans, (iv) to fund 100% of the Company's loans with core deposits (defined as non-maturity deposits and non-brokered insured time deposits), and (v) to hold commercial real estate loans (including owner-occupied commercial real estate) to within 300% of total risk-based capital. On June 28, 2013, the Federal Reserve approved the amendment to exclude owner-occupied commercial real estate loans from the commitment to hold commercial real estate loans to within 300% of total risk-based capital. All other commitments made to the Federal Reserve in connection with the merger remain unchanged. The Company and the Bank are currently in compliance with all commitments to the Federal Reserve. Company's compliance ratios at December 31, 2014 follow.

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| Condition  | Ratios at December 31, 2014 |
|--|-----------------------------|
| (i) Tier 1 leverage ratio  | 14.81%                      |
| (ii) Total risk-based capital ratio  | 21.44%                      |
| (iii) Ratio of purchased loans to total loans, including loans held for sale | 37.97%                      |
| (iv) Ratio of loans to core deposits (1)                                     | 91.79%                      |
| (v) Ratio of commercial real estate loans to total risk-based capital (2)    | 190.05%                     |

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(1) Core deposits include all non-maturity deposits and maturity deposits less than \$250 thousand

(2) For purposes of calculating this ratio, commercial real estate includes all those loans defined as such by regulatory guidance, including all land development and construction loans.

As of December 31, 2014, the Company, on a consolidated basis, had total assets of \$810.0 million, total deposits of \$631.7 million, and shareholders' equity of \$110.9 million. The Company gathers retail deposits through its banking offices in Maine and its online affinity deposit program, ableBanking; originates loans through the Bank's Community Banking Division; and purchases and originates commercial loans through the Bank's Loan Acquisition and Servicing Group ( LASG ). The Community Banking Division, with ten full-service branches and two loan production offices, operates from the Bank's headquarters in Lewiston, Maine. The Company operates ableBanking and the LASG from its offices in Boston, Massachusetts.

Unless the context otherwise requires, references herein to the Company include the Company and its subsidiary on a consolidated basis.

Strategy

The Company's goal is to prudently grow its franchise, while maintaining sound operations and risk management, by implementing the following strategies:

*Measured growth of our national commercial loan portfolio.* The Company purchases performing commercial real estate loans, on a nationwide basis, typically at a discount from their outstanding principal balances, producing yields higher than those normally achieved on our originated loan portfolio. These loans are purchased from a variety of sources, including banks, insurance companies, investment funds and government agencies, either directly or indirectly through a loan sale advisor. We also originate commercial real estate and commercial business loans on a nationwide basis. We expect national originations to become an area of increasing focus for the Company, and in particular the origination of loans guaranteed by the Small Business Administration ( SBA ). As of December 31, 2014, the Company serviced SBA loans with an unpaid principal balance of \$52.6 million, of which \$37.3 million was held by third parties.

*Focus on core deposits.* The Company offers a full line of deposit products to customers in the Community Banking Division's market area through its ten-branch network. In addition, we utilize our online deposit program, ableBanking, a division of Northeast Bank, to provide an additional channel through which to raise core deposits to fund the Company's asset strategy.

*Continuing our community banking tradition.* The Community Banking Division retains a high degree of local autonomy and operational flexibility to better serve its customers. The Community Banking Division's focus on sales and service allows us to attract and retain core deposits in support of balance sheet growth, and to continue to generate new commercial and residential mortgage loans.

**Critical Accounting Policies**

Critical accounting policies are those that involve significant judgments and assessments by management, and which could potentially result in materially different results under different assumptions and conditions. The reader is encouraged to review each of the policies included in Form 10-K for the year ended June 30, 2014 to gain a better understanding of how Northeast's financial performance is measured and reported. There has been no material change in critical accounting policies during the six months ended December 31, 2014.

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**Overview**

Net income from continuing operations was \$1.6 million, or \$0.16 per diluted common share, for the quarter ended December 31, 2014, compared to \$1.4 million, or \$0.13 per diluted common share, for the quarter ended December 31, 2013. The current quarter included \$55 thousand of expenses related to severance, and excluding these items, which the Company considers to be non-core, net operating earnings were \$1.6 million, or \$0.16 per diluted common share.

Net income from continuing operations was \$3.2 million, or \$0.32 per diluted common share, for the six months ended December 31, 2014, compared to \$1.7 million, or \$0.16 per diluted common share, for the six months ended December 31, 2013. The current six month period included \$166 thousand of expenses related to severance, and excluding these items, which the Company considers to be non-core, net operating earnings were \$3.3 million, or \$0.33 per diluted common share.

Net interest and dividend income before provision increased by \$409 thousand, or 4.5%, to \$9.4 million for the quarter ended December 31, 2014 compared to the quarter ended December 31, 2013, due primarily to higher transactional interest income from purchased loan payoffs and the positive effect of balance sheet growth..

Noninterest income increased by \$535 thousand for the quarter ended December 31, 2014, compared to the quarter ended December 31, 2013, principally due to the following:

- An increase of \$432 thousand in gain on sales of portfolio loans, realized primarily on the sale of the guaranteed portion of SBA loans. The Company recognized \$445 thousand in gains on SBA loans sold for the three months ended December 31, 2014, compared to no SBA gain for the quarter ended December 31, 2013; and
- An increase of \$106 thousand in gains realized on sale of residential loans originated for sale in the secondary market, due principally to an increase in purchase-related mortgage loan activity in the current period.

Noninterest expense increased by \$596 thousand for the quarter ended December 31, 2014, compared to the quarter ended December 31, 2013, principally due to the following:

- An increase of \$484 thousand in salaries and employee benefits, principally due to increased employee head count and incentive compensation, offset by a decrease in group insurance expense and employee stock options expense;
- An increase of \$177 thousand in professional fees, due primarily to fees for temporary consulting services;
- An increase of \$123 thousand in loan acquisition and collection expenses, due in part to an increased level of loan purchases in the quarter ended December 31, 2014 when compared to the quarter ended December 31, 2013; and

- A decrease of \$130 thousand in occupancy and equipment expense, the result of a reduction in software maintenance and depreciation expense following the conversion of the Bank's core systems platform to an outsourced model in May 2014. The decrease in equipment expense was offset in part by higher data processing fees, which increased by \$70 thousand.

## Financial Condition

### Overview

Total assets increased by \$48.1 million, or 6.3%, to \$810.0 million at December 31, 2014, compared to June 30, 2014. The principal components of the change in the balance sheet were as follows:

- The loan portfolio excluding loans held for sale grew by \$58.9 million, or 11.4%, compared to June 30, 2014, the result of net growth of \$65.9 million in commercial loans purchased or originated by the Bank's Loan Acquisition and Servicing Group (LASG), offset by a \$7.0 million decrease in the Bank's Community Banking Division loan portfolio.

New loans generated by the LASG totaled \$68.2 million and \$121.7 million for the three and six-month periods, respectively, ending December 31, 2014. The quarterly growth in LASG loans consisted of \$39.7 million in purchases, at an average price of 85.7%, and \$28.5 million in originations. Residential and consumer loan production sold in the secondary market totaled \$26.0 million for the quarter.

As noted above in the *Business Overview* the Company made certain commitments to the Board of Governors of the Federal Reserve System in connection with the merger of FHB Formation LLC with and into the Company in December 2010. The Company's loan purchase and commercial real estate loan availability under these conditions follow.



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| Basis for Regulatory Condition | Condition  | Availability at December 31, 2014<br>(Dollars in millions) |       |
|--------------------------------|--|--|-------|
| Total Loans                    | Purchased loans may not exceed 40% of total loans                            | \$   | 19.7  |
| Regulatory Capital             | Commercial real estate loans may not exceed 300% of total risk-based capital | \$   | 132.6 |

An overview of the LASG portfolio follows.

|  | LASG Portfolio<br>Three Months Ended December 31, |                    |                                      |           |                    |            |
|--|---|--------------------|--------------------------------------|-----------|--------------------|------------|
|  | Purchased   | 2014<br>Originated | Total LASG<br>(Dollars in thousands) | Purchased | 2013<br>Originated | Total LASG |
| Loans purchased or originated during the period: |   |                    |                                      |           |                    |            |
| Unpaid principal balance                         | \$ 46,307   | \$ 28,579          | \$ 74,886                            | \$ 15,663 | \$ 17,138          | \$ 32,801  |
| Net investment basis                             | 39,667  | 28,565             | 68,232                               | 13,619    | 17,138             | 30,757     |
| Loan returns during the period:                  |   |                    |                                      |           |                    |            |
| Yield  | 13.27%  | 4.00%              | 10.17%                               | 13.82%    | 5.14%              | 11.38%     |
| Total Return (1)                                 | 13.72%  | 4.57%              | 10.67%                               | 13.76%    | 5.14%              | 11.35%     |

|  | Six Months Ended December 31, |                    |                                      |            |                    |            |
|--|-------------------------------|--------------------|--------------------------------------|------------|--------------------|------------|
|  | Purchased                     | 2014<br>Originated | Total LASG<br>(Dollars in thousands) | Purchased  | 2013<br>Originated | Total LASG |
| Loans purchased or originated during the period: |                               |                    |                                      |            |                    |            |
| Unpaid principal balance                         | \$ 62,425                     | \$ 68,915          | \$ 131,340                           | \$ 33,994  | \$ 43,564          | \$ 77,558  |
| Net investment basis                             | 52,834                        | 68,904             | 121,738                              | 29,967     | 43,564             | 73,531     |
| Loan returns during the period:                  |                               |                    |                                      |            |                    |            |
| Yield  | 13.02%                        | 5.08%              | 10.53%                               | 12.00%     | 5.37%              | 10.35%     |
| Total Return (1)                                 | 13.24%                        | 5.58%              | 10.85%                               | 12.20%     | 5.37%              | 10.51%     |
| Total loans as of period end:                    |                               |                    |                                      |            |                    |            |
| Unpaid principal balance                         | \$ 262,445                    | \$ 126,620         | \$ 389,065                           | \$ 212,767 | \$ 78,828          | \$ 291,595 |
| Net investment basis                             | \$ 220,391                    | \$ 126,563         | \$ 346,954                           | \$ 177,435 | \$ 78,868          | \$ 256,303 |

(1) The total return on purchased loans represents scheduled accretion, accelerated accretion, gains on asset sales, and other noninterest income recorded during the period divided by the average invested balance, on an annualized basis.

Assets

*Cash, Short-term Investments and Securities*

Cash and short-term investments were \$83.3 million as of December 31, 2014, an increase of \$1.0 million, or 1.2%, from \$82.3 million at June 30, 2014.

Available-for-sale securities, consisting of securities issued by government agencies and government-sponsored enterprises, totaled \$107.8 million as of December 31, 2014 as compared to \$113.9 million as of June 30, 2014, representing a decrease of \$6.0 million or 5.3%. At December 31, 2014, securities with a fair value of \$34.7 million were pledged for outstanding borrowings.

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The following represents the composition of the Company's loan portfolio.

| Originated loans:                             |    |         |    |         |            |         |
|---|----|---------|----|---------|------------|---------|
| Residential real estate                       | \$ | 111,963 | \$ | 309     | \$ 112,272 | 19.51%  |
| Home equity                                   |    | 25,534  |    |         | 25,534     | 4.44%   |
| Commercial real estate:<br>non-owner occupied |    | 49,355  |    | 39,392  | 88,747     | 15.43%  |
| Commercial real estate: owner<br>occupied     |    | 23,181  |    | 13,264  | 36,445     | 6.33%   |
| Construction                                  |    | 375     |    |         | 375        | 0.07%   |
| Commercial business                           |    | 9,074   |    | 73,598  | 82,672     | 14.37%  |
| Consumer                                      |    | 8,898   |    |         | 8,898      | 1.55%   |
| Subtotal                                      |    | 228,380 |    | 126,563 | 354,943    | 61.69%  |
| Purchased loans:                              |    |         |    |         |            |         |
| Residential real estate                       |    |         |    | 2,211   | 2,211      | 0.38%   |
| Commercial business                           |    |         |    | 267     | 267        | 0.05%   |
| Commercial real estate:<br>non-owner occupied |    |         |    | 171,975 | 171,975    | 29.89%  |
| Commercial real estate: owner<br>occupied     |    |         |    | 45,939  | 45,939     | 7.98%   |
| Subtotal                                      |    |         |    | 220,392 | 220,392    | 38.31%  |
| Total   | \$ | 228,380 | \$ | 346,955 | \$ 575,335 | 100.00% |

| June 30, 2014                                 |                                  |         |                                |         |            |                     |
|---|----------------------------------|---------|--------------------------------|---------|------------|---------------------|
|   | Community<br>Banking<br>Division |         | LASG<br>(Dollars in thousands) |         | Total      | Percent of<br>Total |
| Originated loans:                             |                                  |         |                                |         |            |                     |
| Residential real estate                       | \$                               | 116,660 | \$                             | 312     | \$ 116,972 | 22.66%              |
| Home equity                                   |                                  | 27,975  |                                |         | 27,975     | 5.42%               |
| Commercial real estate:<br>non-owner occupied |                                  | 46,191  |                                | 33,969  | 80,160     | 15.52%              |
| Commercial real estate: owner<br>occupied     |                                  | 24,519  |                                | 11,907  | 36,426     | 7.05%               |
| Construction                                  |                                  | 31      |                                |         | 31         | 0.01%               |
| Commercial business                           |                                  | 10,145  |                                | 31,373  | 41,518     | 8.04%               |
| Consumer                                      |                                  | 9,884   |                                |         | 9,884      | 1.91%               |
| Subtotal                                      |                                  | 235,405 |                                | 77,561  | 312,966    | 60.61%              |
| Purchased loans:                              |                                  |         |                                |         |            |                     |
| Residential real estate                       |                                  |         |                                | 3,687   | 3,687      | 0.71%               |
| Commercial business                           |                                  |         |                                | 282     | 282        | 0.05%               |
|   |                                  |         |                                | 133,581 | 133,581    | 25.87%              |

Commercial real estate:

non-owner occupied

Commercial real estate: owner

|          |    |         |    |         |        |         |         |
|----------|----|---------|----|---------|--------|---------|---------|
| occupied |    | 65,900  |    | 65,900  | 12.76% |         |         |
| Subtotal |    | 203,450 |    | 203,450 | 39.39% |         |         |
| Total    | \$ | 235,405 | \$ | 281,011 | \$     | 516,416 | 100.00% |

*Classification of Assets*

Loans are classified as non-performing when 90 days past due, unless a loan is well-secured and in the process of collection. Loans less than 90 days past due, for which collection of principal or interest is considered doubtful, also may be designated as non-performing. In both situations, accrual of interest ceases. The Company typically maintains such loans as non-performing until the respective borrowers have demonstrated a sustained period of payment performance.

In cases where a borrower experiences financial difficulties and the Company makes certain concessionary modifications, the loan is classified as a troubled debt restructuring ( TDR ). Concessionary modifications may include adjustments to interest rates, extensions of maturity, or other actions intended to minimize economic loss and avoid foreclosure or repossession of collateral. Nonaccrual loans that are restructured generally remain on nonaccrual status for a minimum period of six months to demonstrate that the borrower can meet the restructured terms. If the restructured loan is on accrual status prior to being modified, it is reviewed to determine if the modified loan should remain on accrual status. If the borrower's ability to meet the revised payment schedule is not reasonably assured, the loan is classified as a nonaccrual loan. With limited exceptions, loans classified as TDRs remain classified as such until the loan is paid off.

Other nonperforming assets include other real estate owned ( OREO ) and other personal property securing loans repossessed by the Bank. The real estate and personal property collateral for commercial and consumer loans is written down to its estimated realizable value upon repossession. Revenues and expenses are recognized in the period when received or incurred on OREO and in substance foreclosures. Gains and losses on disposition are recognized in noninterest income.

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The following table details the Company's nonperforming assets and other credit quality indicators as of December 31, 2014 and June 30, 2014. Management believes that, based on their carrying amounts, nonperforming assets are well secured based on the estimated fair value of underlying collateral.

| <b>Non-Performing Assets at December 31, 2014</b>  |                                   |  |                 |                  |
|--|-----------------------------------|--|-----------------|------------------|
|  | <b>Community Banking Division</b> |  | <b>LASG</b>     | <b>Total</b>     |
| (Dollars in thousands)                             |                                   |  |                 |                  |
| <b>Loans:</b>                                      |                                   |  |                 |                  |
| Residential real estate                            | \$ 2,535                          |  | \$ 171          | \$ 2,706         |
| Home equity  | 11                                |  |                 | 11               |
| Commercial real estate                             | 1,166                             |  | 8,129           | 9,295            |
| <b>Construction</b>                                |                                   |  |                 |                  |
| Commercial business                                |                                   |  |                 |                  |
| Consumer   | 237                               |  |                 | 237              |
| Subtotal   | 3,949                             |  | 8,300           | 12,249           |
| Real estate owned and other repossessed collateral | 2,058                             |  |                 | 2,058            |
| <b>Total</b>                                       | <b>\$ 6,007</b>                   |  | <b>\$ 8,300</b> | <b>\$ 14,307</b> |
|  |                                   |  |                 | 2.13%            |
| Ratio of nonperforming loans to total loans        |                                   |  |                 | 1.77%            |
| Ratio of nonperforming assets to total assets      |                                   |  |                 | 2.64%            |
| Ratio of loans past due to total loans             |                                   |  |                 | \$ 1,904         |
| Nonperforming loans that are current               |                                   |  |                 | \$ 1,746         |
| Commercial loans risk rated substandard or worse   |                                   |  |                 |                  |
| Troubled debt restructurings:                      |                                   |  |                 | \$ 5,351         |
| On accrual status                                  |                                   |  |                 | \$ 1,863         |
| On nonaccrual status                               |                                   |  |                 |                  |

| <b>Non-Performing Assets at June 30, 2014</b>      |                                   |  |                 |                 |
|--|-----------------------------------|--|-----------------|-----------------|
|  | <b>Community Banking Division</b> |  | <b>LASG</b>     | <b>Total</b>    |
| (Dollars in thousands)                             |                                   |  |                 |                 |
| <b>Loans:</b>                                      |                                   |  |                 |                 |
| Residential real estate                            | \$ 1,572                          |  | \$ 171          | \$ 1,743        |
| Home equity  | 160                               |  |                 | 160             |
| Commercial real estate                             | 1,162                             |  | 4,116           | 5,278           |
| <b>Construction</b>                                |                                   |  |                 |                 |
| Commercial business                                | 5                                 |  |                 | 5               |
| Consumer   | 139                               |  |                 | 139             |
| Subtotal   | 3,038                             |  | 4,287           | 7,325           |
| Real estate owned and other repossessed collateral | 1,991                             |  |                 | 1,991           |
| <b>Total</b>                                       | <b>\$ 5,029</b>                   |  | <b>\$ 4,287</b> | <b>\$ 9,316</b> |
|  |                                   |  |                 | 1.42%           |
| Ratio of nonperforming loans to total loans        |                                   |  |                 | 1.42%           |
| Ratio of nonperforming assets to total assets      |                                   |  |                 | 1.22%           |
|  |                                   |  |                 | 1.14%           |

Ratio of loans past due to total loans

|  |    |       |
|--|----|-------|
| Nonperforming loans that are current             | \$ | 651   |
| Commercial loans risk rated substandard or worse | \$ | 1,894 |
| Troubled debt restructurings:                    |    |       |
| On accrual status                                | \$ | 4,057 |
| Nonaccrual status                                | \$ | 2,117 |

At December 31, 2014, nonperforming assets totaled \$14.3 million, or 1.8% of total assets, as compared to \$9.3 million, or 1.2% of total assets at June 30, 2014. The increase in nonperforming assets during the six months ended December 31, 2014 was mainly due to the addition of one recently-purchased loan relationship.

#### *Allowance for Loan Losses*

In connection with the application of the acquisition method of accounting for the merger on December 29, 2010, the allowance for loan losses was reduced to zero when the loan portfolio was marked to its then current fair value. Since that date, the Company has provided for an allowance for loan losses as new loans are originated or in the event that credit exposure in the pre-merger loan portfolio or other acquired loans exceeds the exposure estimated when initial fair values were determined.

The Company's allowance for loan losses was \$1.7 million as of December 31, 2014, which represents an increase of \$297 thousand from \$1.4 million as of June 30, 2014. The increase during the period was principally due to increases in reserves necessary for loans accounted for under ASC 310-30 and due to increased volume of newly originated loans.

The following table details ratios related to the allowance for loan losses for the periods indicated.

|  | December 31, 2014 | June 30, 2014 | December, 2013 |
|--|-------------------|---------------|----------------|
| Allowance for loan losses to nonperforming loans       | 13.58%            | 18.66%        | 21.95%         |
| Allowance for loan losses to total loans               | 0.29%             | 0.26%         | 0.27%          |
| Last twelve months of net-charge offs to average loans | 0.08%             | 0.06%         | 0.09%          |



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|   |            |         |            |         |
|---|------------|---------|------------|---------|
| Term certificates of \$250 thousand or more | 1,153      | 0.18%   | 2,332      | 0.41%   |
| Total certificate accounts                  | 339,904    | 53.81%  | 341,948    | 59.54%  |
| Total deposits                              | \$ 631,720 | 100.00% | \$ 574,329 | 100.00% |



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Advances from the FHLB were \$35.2 million and \$42.8 million at December 31, 2014 and June 30, 2014, respectively; the decrease was due to \$7.5 million of maturing advances during the period. At December 31, 2014, the Company had pledged investment securities with a fair value of \$21.2 million, as well as certain residential real estate loans, commercial real estate loans, and FHLB deposits free of liens or pledges to secure outstanding advances and available additional borrowing capacity.

Wholesale repurchase agreements were \$10.1 million and \$10.2 million at December 31, 2014 and June 30, 2014, respectively. At December 31, 2014, the Company had pledged investment securities with a fair value of \$13.5 million as collateral for outstanding wholesale repurchase agreements.

Short-term borrowings, consisting of sweep accounts and repurchase agreements, were \$2.8 million and \$3.0 million as of December 31, 2014 and June 30, 2014, respectively.

*Liquidity*

The following table is a summary of unused borrowing capacity of the Company at December 31, 2014, in addition to traditional retail deposit products (dollars in thousands).

|   |    |         |   |
|---|----|---------|---|
| Brokered time deposits                              | \$ | 201,646 | Subject to policy limitation of 25% of total assets |
| Federal Home Loan Bank of Boston                    |    | 86,769  | Subject to eligible and qualified collateral        |
| Federal Reserve Discount Window Borrower-in-Custody |    | 1,414   | Subject to the pledge of indirect auto loans        |
| Total unused borrowing capacity                     |    | 289,829 |   |
| Unencumbered investment securities                  |    | 73,116  |   |
| Total sources of liquidity                          | \$ | 362,945 |   |

Retail deposits and other core deposit sources including deposit listing services are used by the Company to manage its overall liquidity position. While the Company typically does not seek wholesale funding such as brokered deposits, the ability to raise them remains an important part of its liquidity contingency planning. While management closely monitors and forecasts the Company's liquidity position, it is affected by asset growth, deposit withdrawals and other contractual obligations and commitments. The accuracy of management's forecast assumptions may increase or decrease the Company's overall available liquidity.

At December 31, 2014, the Company had \$362.9 million of immediately accessible liquidity, defined as additional cash that could be raised within seven days through collateralized borrowings, brokered deposits or security sales. This position represented 44.8% of total assets. The Company also had \$83.3 million of cash and cash equivalents at December 31, 2014.

Management believes that there are adequate funding sources to meet its liquidity needs for the foreseeable future. Primary funding sources are the repayment of principal and interest on loans, the renewal of time deposits, the potential for growth in the deposit base, and the credit availability from the FHLB. Management does not believe that the terms and conditions that will be present at the renewal of these funding sources will significantly impact the Company's operations, due to its management of the maturities of its assets and liabilities.

### *Capital*

The carrying amount and unpaid principal balance of junior subordinated debentures totaled \$8.5 million and \$16.5 million, respectively, as of December 31, 2014. This debt represents qualifying Tier 1 capital for the Company, up to a maximum of 25% of total Tier 1 capital. At December 31, 2014, the carrying amounts of the junior subordinated notes, net of the Company's \$496 thousand investment in the affiliated trusts, qualified as Tier 1 capital.

At December 31, 2014, shareholders' equity was \$110.9 million, a decrease of \$1.2 million, or 1.1% from June 30, 2014. Book value per outstanding common share was \$11.27 at December 31, 2014 and \$11.05 at June 30, 2014. Tier 1 capital to total average assets of the Company was 14.81% as of December 31, 2014 and 15.89% at June 30, 2014.

In addition to the risk-based capital requirements, under the rules in effect through December 31, 2014, the Federal Reserve required top-rated bank holding companies to maintain a minimum leverage capital ratio of Tier 1 capital (defined by reference to the risk-based capital guidelines) to its average total consolidated assets of at least 3.0%. For most other bank holding companies (including the Company), the minimum leverage capital ratio was 4.0%. Bank holding companies with supervisory, financial, operational or managerial weaknesses, as well as bank holding companies that are anticipating or experiencing significant growth, were expected to maintain capital ratios well above the minimum levels.

Prior to the effectiveness of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), the FDIC had adopted a statement of policy regarding the capital adequacy of state-chartered banks and promulgated regulations to implement the system of prompt corrective action established by Section 38 of the Federal Deposit Insurance Act (FDIA). Under the FDIC regulations, a bank was considered well capitalized if it had: (i) a total risk-based capital ratio of 10.0% or greater; (ii) a Tier 1 risk-based capital ratio of 6.0% or greater; (iii) a leverage capital ratio of 5.0% or greater; and (iv) was not subject to any written agreement, order, capital directive or prompt corrective action directive to meet and maintain a specific capital level for any capital measure.

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In 2010, the Basel Committee on Banking Supervision released new capital requirements, known as Basel III, setting forth higher capital requirements, enhanced risk coverage, a global leverage ratio, provisions for counter-cyclical capital, and liquidity standards. In 2013, the Federal Reserve, along with the other federal banking agencies, issued final rules implementing the Basel III capital standards and establishing the minimum capital requirements for banks and bank holding companies required under the Dodd-Frank Act. These rules, which became effective January 1, 2015, establish a minimum common equity Tier 1 capital ratio requirement of 4.5%, a minimum Tier 1 capital ratio requirement of 6%, a minimum total capital requirement of 8.0% and a minimum leverage ratio requirement of 4%. Additionally, subject to a transition schedule, these rules require that an institution establish a capital conservation buffer of common equity Tier 1 capital in an amount above the minimum risk-based capital requirements for adequately capitalized institutions equal to 2.5% of total risk weighted assets, or face restrictions on the ability to pay dividends, pay discretionary bonuses, and to engage in share repurchases.

Under rules effective January 1, 2015, a bank holding company, such as the Company, is considered well capitalized if the bank holding company (i) has a total risk based capital ratio of at least 10%, (ii) has a Tier 1 risk-based capital ratio of at least 6%, and (iii) is not subject to any written agreement order, capital directive or prompt corrective action directive to meet and maintain a specific capital level for any capital measure. In addition, the FDIC has amended its prompt corrective action rules to reflect the revisions made by the new capital rules implementing Basel III. Under the FDIC's revised rules, which became effective January 1, 2015, an FDIC supervised institution is considered well capitalized if it (i) has a total risk-based capital ratio of 10.0% or greater; (ii) a Tier 1 risk-based capital ratio of 8.0% or greater; (iii) a common Tier 1 equity ratio of at least 6.5% or greater, (iv) a leverage capital ratio of 5.0% or greater; and (iv) is not subject to any written agreement, order, capital directive, or prompt corrective action directive to meet and maintain a specific capital level for any capital measure.

The Company and Bank are considered well capitalized under all regulatory definitions.

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The Company's and the Bank's regulatory capital ratios are set forth below.

|   | Actual     |        | Minimum<br>Capital<br>Requirements |       | Minimum<br>To Be Well<br>Capitalized Under<br>Prompt Correction<br>Action Provisions |        |
|---|------------|--------|------------------------------------|-------|--|--------|
|   | Amount     | Ratio  | Amount                             | Ratio | Amount   | Ratio  |
| (Dollars in thousands)                  |            |        |                                    |       |  |        |
| December 31, 2014:                      |            |        |                                    |       |  |        |
| Total capital to risk weighted assets:  |            |        |                                    |       |  |        |
| Company                                 | \$ 120,629 | 21.44% | \$ 45,007                          | ≥8.0% | \$ N/A   | N/A    |
| Bank                                    | 107,010    | 18.98% | 45,110                             | ≥8.0% | 56,387   | ≥10.0% |
| Tier 1 capital to risk weighted assets: |            |        |                                    |       |  |        |
| Company                                 | 118,935    | 21.14% | 22,504                             | ≥4.0% | N/A  | N/A    |
| Bank                                    | 103,235    | 18.31% | 22,555                             | ≥4.0% | 33,832   | ≥6.0%  |
| Tier 1 capital to average assets:       |            |        |                                    |       |  |        |
| Company                                 | 118,935    | 14.81% | 32,114                             | ≥4.0% | N/A  | N/A    |
| Bank                                    | 103,235    | 12.88% | 32,067                             | ≥4.0% | 40,084   | ≥5.0%  |
| June 30, 2014:                          |            |        |                                    |       |  |        |
| Total capital to risk weighted assets:  |            |        |                                    |       |  |        |
| Company                                 | \$ 120,818 | 23.69% | \$ 40,808                          | ≥8.0% | \$ N/A   | N/A    |
| Bank                                    | 103,160    | 20.12% | 41,027                             | ≥8.0% | 51,284   | ≥10.0% |
| Tier 1 capital to risk weighted assets: |            |        |                                    |       |  |        |
| Company                                 | 119,421    | 23.41% | 20,404                             | ≥4.0% | N/A  | N/A    |
| Bank                                    | 99,256     | 19.35% | 20,514                             | ≥4.0% | 30,771   | ≥6.0%  |
| Tier 1 capital to average assets:       |            |        |                                    |       |  |        |
| Company                                 | 119,421    | 15.90% | 30,049                             | ≥4.0% | N/A  | N/A    |
| Bank                                    | 99,256     | 13.22% | 30,028                             | ≥4.0% | 37,536   | ≥5.0%  |

**Off-balance Sheet Financial Instruments**

The Company 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, unused lines of credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the condensed consolidated balance sheet. The contract or notional amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

See Part I. Item I. Notes to Unaudited Consolidated Financial Statements Note 9: Commitments and Contingencies for further discussion.

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Net income increased by \$187 thousand to \$1.6 million for the quarter ended December 31, 2014, compared to \$1.4 million for the quarter ended December 31, 2013. Net income increased by \$1.5 million to \$3.2 million for the six months ended December 31, 2014, compared to \$1.7 million for the six months ended December 31, 2013. When compared to the prior year, increases in net income for both the three and six months ended December 31, 2014 resulted principally from higher transactional income on purchased loans, positive balance sheet growth due to increased volume, and higher gains on sales of residential mortgages and gains on portfolio loans.

The following table details the total return on purchased loans, which includes transactional interest income of \$2.6 million for the quarter ended December 31, 2014, an increase of \$515 thousand from the quarter ended December 31, 2013. Transactional interest income for the six months ended December 31, 2014 was \$4.6 million, an increase of \$1.8 million from the six months ended December 31, 2013 principally due to higher payoffs in the first two quarters of fiscal 2015.

|  | 2014     |            | 2013     |            |
|--|----------|------------|----------|------------|
|  | Income   | Return (1) | Income   | Return (1) |
| <b>Total Return on Purchased Loans<br/>Three Months Ended December 31,</b> |          |            |          |            |
| <b>(Dollars in thousands)</b>  |          |            |          |            |
| Regularly scheduled interest and accretion                                 | \$ 4,376 | 8.31%      | \$ 4,014 | 9.02%      |
| Transactional income:  |          |            |          |            |
| Gains on loan sales  | 194      | 0.37%      | 11       | 0.02%      |
| Gain on sale of real estate owned  | 40       | 0.08%      |          | 0.00%      |
| Other noninterest income   |          | 0.00%      |          | 0.00%      |
| Accelerated accretion and loan fees  | 2,613    | 4.96%      | 2,098    | 4.72%      |
| Total transactional income   | 2,847    | 5.41%      | 2,109    | 4.74%      |
| Total  | \$ 7,223 | 13.72%     | \$ 6,123 | 13.76%     |

|  | 2014     |            | 2013     |            |
|--|----------|------------|----------|------------|
|  | Income   | Return (1) | Income   | Return (1) |
| <b>Six Months Ended December 31,</b>       |          |            |          |            |
| <b>(Dollars in thousands)</b>              |          |            |          |            |
| Regularly scheduled interest and accretion | \$ 8,873 | 8.55%      | \$ 7,753 | 8.78%      |
| Transactional income:                      |          |            |          |            |
| Gains on loan sales                        | 190      | 0.18%      | 227      | 0.26%      |
| Gain on sale of real estate owned          | 40       | 0.04%      |          | 0.00%      |
| Other noninterest income                   |          | 0.00%      |          | 0.00%      |
| Accelerated accretion and loan fees        | 4,638    | 4.47%      | 2,794    | 3.16%      |
| Total transactional income                 | 4,868    | 4.69%      | 3,021    | 3.42%      |

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Total \$ 13,741 13.24% \$ 10,774 12.20%

(1) The total return on purchased loans represents scheduled accretion, accelerated accretion, gains on asset sales, and other noninterest income recorded during the period divided by the average invested balance, on an annualized basis.

**Net Interest Income**

*Three Months Ended December 31, 2014 and 2013*

Net interest and dividend income before provision for the three months ended December 31, 2014 and 2013 was \$9.4 million and \$9.0 million, respectively. The increase of \$409 thousand was largely attributable to growth in the LASG loan portfolio, which earned a yield of 10.2% for the quarter ended December 31, 2014 on an average outstanding balance of \$314.1 million. The following table summarizes interest income and related yields recognized on the Company's loans for the three months ended December 31, 2014 and 2013.

|                                  | Average<br>Balance | Three Months Ended December 31, |                                 |                    |                            | 2013<br>Interest<br>Income | Yield |
|----------------------------------|--------------------|---------------------------------|---------------------------------|--------------------|----------------------------|----------------------------|-------|
|                                  |                    | 2014<br>Interest<br>Income      | Yield<br>(Dollars in thousands) | Average<br>Balance | 2013<br>Interest<br>Income |                            |       |
| Community<br>Banking<br>Division | \$ 236,127         | \$ 2,899                        | 4.87%                           | \$ 247,057         | \$ 3,284                   | 5.27%                      |       |
| LASG:                            |                    |                                 |                                 |                    |                            |                            |       |
| Originated                       | 105,167            | 1,060                           | 4.00%                           | 68,449             | 886                        | 5.14%                      |       |
| Purchased                        | 208,935            | 6,989                           | 13.27%                          | 175,469            | 6,112                      | 13.82%                     |       |
| Total LASG                       | 314,102            | 8,049                           | 10.17%                          | 243,918            | 6,998                      | 11.38%                     |       |
| Total                            | \$ 550,229         | \$ 10,948                       | 7.89%                           | \$ 490,975         | \$ 10,282                  | 8.31%                      |       |

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In the quarter ended December 31, 2014, net interest income was negatively affected by a lower level of noncash accretion of fair value adjustments resulting from the 2010 merger than in the quarter ended December 31, 2013. The effect of such accretion will continue to diminish as financial instruments held at the merger mature or prepay. The following table summarizes the effects of such accretion.

|  | Average<br>Balance | 2014<br>Income<br>(Expense) | Three Months Ended December 31, |                    | 2013<br>Income<br>(Expense) | Effect on<br>Yield / Rate |
|--|--------------------|-----------------------------|---------------------------------|--------------------|-----------------------------|---------------------------|
|  |                    |                             | Effect on<br>Yield / Rate       | Average<br>Balance |                             |                           |
| (Dollars in thousands)                           |                    |                             |                                 |                    |                             |                           |
| <b>Interest-earning assets:</b>                  |                    |                             |                                 |                    |                             |                           |
| Investment securities                            | \$ 109,498         | \$                          | 0.00%                           | \$ 116,888         | \$                          | 0.00%                     |
| Loans  | 550,229            | 51                          | 0.04%                           | 490,975            | 47                          | 0.04%                     |
| Other interest-earning<br>assets                 | 108,924            |                             | 0.00%                           | 84,770             |                             | 0.00%                     |
| <b>Total interest-earning<br/>assets</b>         | <b>\$ 768,651</b>  | <b>\$ 51</b>                | <b>0.03%</b>                    | <b>\$ 692,633</b>  | <b>\$ 47</b>                | <b>0.03%</b>              |
| <b>Interest-bearing liabilities:</b>             |                    |                             |                                 |                    |                             |                           |
| Interest-bearing deposits                        | 571,419            | 56                          | 0.04%                           | 488,562            | 214                         | 0.18%                     |
| Short-term borrowings                            | 2,869              |                             | 0.00%                           | 2,397              |                             | 0.00%                     |
| Borrowed funds                                   | 45,587             | 70                          | 0.61%                           | 59,941             | 107                         | 0.72%                     |
| Junior subordinated<br>debentures                | 8,508              | (45)                        | (2.10)%                         | 8,331              | (42)                        | (2.04)%                   |
| <b>Total interest-bearing<br/>liabilities</b>    | <b>\$ 628,383</b>  | <b>\$ 81</b>                | <b>0.05%</b>                    | <b>\$ 559,231</b>  | <b>\$ 279</b>               | <b>0.20%</b>              |
| <b>Total effect of noncash<br/>accretion on:</b> |                    |                             |                                 |                    |                             |                           |
| Net interest income                              |                    | \$ 132                      |                                 |                    | \$ 326                      |                           |
| Net interest margin                              |                    | 0.07%                       |                                 |                    | 0.19%                       |                           |



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The Company's interest rate spread and net interest margin both decreased by 29 basis points for the quarter ended December 31, 2014 compared to the quarter ended December 31, 2013. These decreases were principally rate driven with a slight decrease in yield on interest-earning assets and a slight increase in yield on interest-earning deposits. The following sets forth the average balance sheets, interest income and interest expense, and average yields and costs for the three months ended December 31, 2014 and 2013.

**NORTHEAST BANCORP AND SUBSIDIARY****CONSOLIDATED AVERAGE BALANCE SHEETS AND ANNUALIZED YIELDS**

(Unaudited)

(Dollars in thousands)

|   | Three Months Ended December 31, |  |                           |                    |  |                           |
|---|---------------------------------|--|---------------------------|--------------------|--|---------------------------|
|   | Average<br>Balance              | 2014<br>Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate | Average<br>Balance | 2013<br>Interest<br>Income/<br>Expense | Average<br>Yield/<br>Rate |
| <b>Assets:</b>                                    |                                 |  |                           |                    |  |                           |
| Interest-earning assets:                          |                                 |  |                           |                    |  |                           |
| Investment securities (1)                         | \$ 109,498                      | \$ 232                                 | 0.84%                     | \$ 116,888         | \$ 262                                 | 0.89%                     |
| Loans (2) (3)                                     | 550,229                         | 10,948                                 | 7.89%                     | 490,975            | 10,282                                 | 8.31%                     |
| Regulatory stock                                  | 4,102                           | 15                                     | 1.45%                     | 5,721              | 48                                     | 3.33%                     |
| Short-term investments (4)                        | 104,822                         | 64                                     | 0.24%                     | 79,049             | 48                                     | 0.24%                     |
| Total interest-earning assets                     | 768,651                         | 11,259                                 | 5.81%                     | 692,633            | 10,640                                 | 6.09%                     |
| Cash and due from banks                           | 2,637                           |  |                           | 3,053              |  |                           |
| Other non-interest earning<br>assets              | 32,500                          |  |                           | 36,222             |  |                           |
| Total assets                                      | \$ 803,788                      |  |                           | \$ 731,908         |  |                           |
| <b>Liabilities &amp; Stockholders<br/>Equity:</b> |                                 |  |                           |                    |  |                           |
| Interest-bearing liabilities:                     |                                 |  |                           |                    |  |                           |
| NOW accounts                                      | \$ 62,259                       | \$ 40                                  | 0.25%                     | \$ 58,987          | \$ 40                                  | 0.27%                     |
| Money market accounts                             | 127,394                         | 241                                    | 0.75%                     | 86,245             | 114                                    | 0.52%                     |
| Savings accounts                                  | 33,648                          | 12                                     | 0.14%                     | 33,540             | 12                                     | 0.14%                     |
| Time deposits                                     | 348,118                         | 988                                    | 1.13%                     | 309,790            | 813                                    | 1.04%                     |
| Total interest-bearing<br>deposits                | 571,419                         | 1,281                                  | 0.89%                     | 488,562            | 979                                    | 0.80%                     |
| Short-term borrowings                             | 2,869                           | 7                                      | 0.97%                     | 2,397              | 6                                      | 0.99%                     |
| Borrowed funds                                    | 45,587                          | 357                                    | 3.11%                     | 59,941             | 446                                    | 2.95%                     |
| Junior subordinated<br>debentures                 | 8,508                           | 188                                    | 8.77%                     | 8,331              | 192                                    | 9.14%                     |
| Total interest-bearing<br>liabilities             | 628,383                         | 1,833                                  | 1.16%                     | 559,231            | 1,623                                  | 1.15%                     |
| Non-interest bearing<br>liabilities:              |                                 |  |                           |                    |  |                           |
| Demand deposits and escrow<br>accounts            | 55,131                          |  |                           | 53,184             |  |                           |
| Other liabilities                                 | 7,130                           |  |                           | 5,677              |  |                           |

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|  |            |            |
|--|------------|------------|
| Total liabilities                          | 690,644    | 618,092    |
| Stockholders' equity                       | 113,144    | 113,816    |
| Total liabilities and stockholders' equity | \$ 803,788 | \$ 731,908 |
| Net interest income                        | \$ 9,426   | \$ 9,017   |
| Interest rate spread                       | 4.65%      | 4.94%      |
| Net interest margin (5)                    | 4.87%      | 5.16%      |

- (1) Interest income and yield are stated on a fully tax-equivalent basis using a 34% tax rate.
- (2) Includes loans held for sale.
- (3) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.
- (4) Short term investments include FHLB overnight deposits and other interest-bearing deposits.
- (5) Net interest margin is calculated as net interest income divided by total interest-earning assets.

The following table presents the extent to which changes in volume and interest rates of interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior period rate), (ii) changes attributable to changes in rates (changes in rates multiplied by prior period volume) and (iii) change attributable to a combination of changes in rate and volume (change in rates multiplied by the changes in volume). Changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

|                                      | Three Months Ended December 31, 2014 compared to 2013 |                    |              |
|--------------------------------------|---|--------------------|--------------|
|                                      | Change Due to Volume                                  | Change Due to Rate | Total Change |
|                                      | (Dollars in thousands)                                |                    |              |
| <b>Interest earning assets:</b>      |   |                    |              |
| Investment securities                | \$ (16)   | \$ (14)            | \$ (30)      |
| Loans                                | 1,197   | (531)              | 666          |
| Regulatory stock                     | (11)  | (22)               | (33)         |
| Short-term investments               | 16  |                    | 16           |
| Total interest-earning assets        | 1,186   | (567)              | 619          |
| <b>Interest-bearing liabilities:</b> |   |                    |              |
| Interest-bearing deposits            | 176   | 126                | 302          |
| Short-term borrowings                | 1   |                    | 1            |
| Borrowed funds                       | (111)   | 22                 | (89)         |
| Junior subordinated debentures       | 4   | (8)                | (4)          |
| Total interest-bearing liabilities   | 70  | 140                | 210          |
| Total change in net interest income  | \$ 1,116  | \$ (707)           | \$ 409       |

Table of Contents*Six Months Ended December 31, 2014 and 2013*

Net interest and dividend income before provision for the six months ended December 31, 2014 and 2013 was \$18.9 million and \$16.1 million, respectively. The increase of \$2.8 million was largely attributable to growth in the LASG loan portfolio, which earned a yield of 10.5% for the six ended December 31, 2014 on an average outstanding balance of \$299.6 million. The following table summarizes interest income and related yields recognized on the Company's loans for the six months ended December 31, 2014 and 2013.

|                            | Six Months Ended December 31, |                      |        |                 |                      |        |
|----------------------------|-------------------------------|----------------------|--------|-----------------|----------------------|--------|
|                            | Average Balance               | 2014 Interest Income | Yield  | Average Balance | 2013 Interest Income | Yield  |
| (Dollars in thousands)     |                               |                      |        |                 |                      |        |
| Community Banking Division | \$ 238,646                    | \$ 5,960             | 4.95%  | \$ 244,880      | \$ 6,626             | 5.37%  |
| LASG:                      |                               |                      |        |                 |                      |        |
| Originated                 | 93,751                        | 2,399                | 5.08%  | 57,828          | 1,566                | 5.37%  |
| Purchased                  | 205,896                       | 13,511               | 13.02% | 174,318         | 10,547               | 12.00% |
| Total LASG                 | 299,647                       | 15,910               | 10.53% | 232,146         | 12,113               | 10.35% |
| Total                      | \$ 538,293                    | \$ 21,870            | 8.06%  | \$ 477,026      | \$ 18,739            | 7.79%  |

In the six months ended December 31, 2014, net interest income was negatively affected by a lower level of noncash accretion of fair value adjustments resulting from the 2010 merger than in the six months ended December 31, 2013. The effect of such accretion will continue to diminish as financial instruments held at the merger mature or prepay. The following table summarizes the effects of such accretion.

|                                       | Six Months Ended December 31, |                       |                        |                 |                       |                        |
|---------------------------------------|-------------------------------|-----------------------|------------------------|-----------------|-----------------------|------------------------|
|                                       | Average Balance               | 2014 Income (Expense) | Effect on Yield / Rate | Average Balance | 2013 Income (Expense) | Effect on Yield / Rate |
| (Dollars in thousands)                |                               |                       |                        |                 |                       |                        |
| Interest-earning assets:              |                               |                       |                        |                 |                       |                        |
| Investment securities                 | \$ 110,874                    | \$                    | 0.00%                  | \$ 118,093      | \$                    | 0.00%                  |
| Loans                                 | 538,293                       | 127                   | 0.05%                  | 477,026         | 83                    | 0.03%                  |
| Other interest-earning assets         | 97,894                        |                       | 0.00%                  | 83,949          |                       | 0.00%                  |
| Total interest-earning assets         | \$ 747,061                    | \$ 127                | 0.03%                  | \$ 679,068      | \$ 83                 | 0.02%                  |
| Interest-bearing liabilities:         |                               |                       |                        |                 |                       |                        |
| Interest-bearing deposits             | 548,025                       | 120                   | 0.04%                  | 475,845         | 415                   | 0.17%                  |
| Short-term borrowings                 | 3,095                         |                       | 0.00%                  | 2,337           |                       | 0.00%                  |
| Borrowed funds                        | 49,283                        | 162                   | 0.65%                  | 59,964          | 215                   | 0.71%                  |
| Junior subordinated debentures        | 8,484                         | (90)                  | (2.10)%                | 8,309           | (84)                  | (2.01)%                |
| Total interest-bearing liabilities    | \$ 608,887                    | \$ 192                | 0.09%                  | \$ 546,455      | \$ 546                | 0.20%                  |
| Total effect of noncash accretion on: |                               |                       |                        |                 |                       |                        |
| Net interest income                   |                               | \$ 319                |                        |                 | \$ 629                |                        |
| Net interest margin                   |                               | 0.08%                 |                        |                 | 0.18%                 |                        |



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The Company's interest rate spread and net interest margin increased by 32 basis points and 31 basis points, respectively, for the six months ended December 31, 2014 compared to the six months ended December 31, 2013. These increases were principally the result of the aforementioned increase in loan volume and average yield. The following sets forth the average balance sheets, interest income and interest expense, and average yields and costs for the six months ended December 31, 2014 and 2013.

|  | Six Months Ended December 31, |                              |  |                 |                              |                    |
|--|-------------------------------|------------------------------|--|-----------------|------------------------------|--------------------|
|  | Average Balance               | 2014 Interest Income/Expense | Average Yield/Rate<br>(Dollars in thousands) | Average Balance | 2013 Interest Income/Expense | Average Yield/Rate |
| <b>Assets:</b>                             |                               |                              |  |                 |                              |                    |
| <b>Interest-earning assets:</b>            |                               |                              |  |                 |                              |                    |
| Investment securities                      | \$ 110,874                    | \$ 475                       | 0.85%  | \$ 118,093      | \$ 544                       | 0.91%              |
| Loans (1) (2)                              | 538,293                       | 21,870                       | 8.06%  | 477,026         | 18,739                       | 7.79%              |
| Regulatory stock                           | 4,102                         | 31                           | 1.50%  | 5,721           | 52                           | 1.80%              |
| Short-term investments (3)                 | 93,792                        | 115                          | 0.24%  | 78,228          | 95                           | 0.24%              |
| Total interest-earning assets              | 747,061                       | 22,491                       | 5.97%  | 679,068         | 19,430                       | 5.68%              |
| Cash and due from banks                    | 2,674                         |                              |  | 3,045           |                              |                    |
| Other non-interest earning assets          | 33,326                        |                              |  | 35,117          |                              |                    |
| Total assets                               | \$ 783,061                    |                              |  | \$ 717,230      |                              |                    |
| <b>Liabilities &amp; Stockholders</b>      |                               |                              |  |                 |                              |                    |
| <b>Equity:</b>                             |                               |                              |  |                 |                              |                    |
| <b>Interest-bearing liabilities:</b>       |                               |                              |  |                 |                              |                    |
| NOW accounts                               | \$ 62,934                     | \$ 81                        | 0.26%  | \$ 59,055       | \$ 80                        | 0.27%              |
| Money market accounts                      | 106,844                       | 365                          | 0.68%  | 85,967          | 226                          | 0.52%              |
| Savings accounts                           | 34,004                        | 23                           | 0.13%  | 33,733          | 24                           | 0.14%              |
| Time deposits                              | 344,243                       | 1,941                        | 1.12%  | 297,090         | 1,696                        | 1.13%              |
| Total interest-bearing deposits            | 548,025                       | 2,410                        | 0.87%  | 475,845         | 2,026                        | 0.84%              |
| Short-term borrowings                      | 3,095                         | 16                           | 1.03%  | 2,337           | 11                           | 0.93%              |
| Borrowed funds                             | 49,283                        | 771                          | 3.10%  | 59,964          | 886                          | 2.93%              |
| Junior subordinated debentures             | 8,484                         | 394                          | 9.21%  | 8,309           | 385                          | 9.19%              |
| Total interest-bearing liabilities         | 608,887                       | 3,591                        | 1.17%  | 546,455         | 3,308                        | 1.20%              |
| <b>Non-interest bearing liabilities:</b>   |                               |                              |  |                 |                              |                    |
| Demand deposits and escrow accounts        | 54,187                        |                              |  | 51,788          |                              |                    |
| Other liabilities                          | 7,220                         |                              |  | 5,619           |                              |                    |
| Total liabilities                          | 670,294                       |                              |  | 603,862         |                              |                    |
| Stockholders' equity                       | 112,767                       |                              |  | 113,368         |                              |                    |
| Total liabilities and stockholders' equity | \$ 783,061                    |                              |  | \$ 717,230      |                              |                    |
| Net interest income                        |                               | \$ 18,900                    |  |                 | \$ 16,122                    |                    |
| Interest rate spread                       |                               |                              | 4.80%  |                 |                              | 4.48%              |
| Net interest margin (4)                    |                               |                              | 5.02%  |                 |                              | 4.71%              |

- (1) Includes loans held for sale.
- (2) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.
- (3) Short term investments include FHLB overnight deposits and other interest-bearing deposits.
- (4) Net interest margin is calculated as net interest income divided by total interest-earning assets.

The following table presents the extent to which changes in volume and interest rates of interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior period rate), (ii) changes attributable to changes in rates (changes in rates multiplied by prior period volume) and (iii) changes attributable to a combination of changes in rate and volume (change in rates multiplied by the changes in volume). Changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

|  | <b>Six Months Ended December 31, 2014 compared to 2013</b> |                           |                     |
|--|--|---------------------------|---------------------|
|  | <b>Change Due to Volume</b>                                | <b>Change Due to Rate</b> | <b>Total Change</b> |
|  | <b>(Dollars in thousands)</b>                              |                           |                     |
| <b>Interest earning assets:</b>            |  |                           |                     |
| Investment securities                      | \$ (32)  | \$ (37)                   | \$ (69)             |
| Loans                                      | 2,472  | 659                       | 3,131               |
| Regulatory stock                           | (13)   | (8)                       | (21)                |
| Short-term investments                     | 19   | 1                         | 20                  |
| <b>Total interest-earning assets</b>       | <b>2,446</b>   | <b>615</b>                | <b>3,061</b>        |
| <b>Interest-bearing liabilities:</b>       |  |                           |                     |
| Interest-bearing deposits                  | 341  | 43                        | 384                 |
| Short-term borrowings                      | 4  | 1                         | 5                   |
| Borrowed funds                             | (165)  | 50                        | (115)               |
| Junior subordinated debentures             | 8  | 1                         | 9                   |
| <b>Total interest-bearing liabilities</b>  | <b>188</b>   | <b>95</b>                 | <b>283</b>          |
| <b>Total change in net interest income</b> | <b>\$ 2,258</b>  | <b>\$ 520</b>             | <b>\$ 2,778</b>     |

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***Provision for Loan Losses***

Quarterly, the Company determines the amount of the allowance for loan losses that is appropriate to provide for losses inherent in the Company's loan portfolios, with the provision for loan losses determined by the net change in the allowance for loan losses. For loans acquired with deteriorated credit quality, a provision for loan a loss is recorded when estimates of future cash flows are lower than had been previously expected. See Part I. Item I. Notes to Unaudited Consolidated Financial Statements Note 4: Loans, Allowance for Loan losses and Credit Quality for further discussion.

The provision for loan losses for periods subsequent to the merger with FHB Formation LLC reflects the impact of adjusting loans to their then fair values, as well as the elimination of the allowance for loan losses in accordance with the acquisition method of accounting. Subsequent to the merger, the provision for loan losses has been recorded based on estimates of inherent losses in newly originated loans and for incremental reserves required for pre-merger loans based on estimates of deteriorated credit quality post-merger.

*Three Months Ended December 31, 2014 and 2013*

The provision for loan losses for the quarter ended December 31, 2014 and 2013 was \$113 thousand and \$151 thousand, respectively. The decrease in the Company's loan loss provision resulted principally from favorable impairment trends in the purchased and originated loan portfolios.

*Six Months Ended December 31, 2014 and 2013*

The provision for loan losses for the six months ended December 31, 2014 and 2013 was \$433 thousand and \$227 thousand, respectively. The increase is principally due to increases in reserves necessary for loans accounted for under ASC 310-30 and due to increased volume of newly originated loans.

***Noninterest Income***

*Three Months Ended December 31, 2014 and 2013*

Noninterest income decreased by \$535 thousand for the current quarter, compared to the quarter ended December 31, 2013, principally due to the following:

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- An increase of \$432 thousand in gain on sales of portfolio loans, realized primarily on the sale of the guaranteed portion of SBA loans. The Company recognized \$445 thousand in gains on SBA loans sold for the three months ended December 31, 2014, compared to no SBA gain for the quarter ended December 31, 2013; and
- An increase of \$106 thousand in gains realized on sale of residential loans originated for sale in the secondary market, due principally to an increase in purchase-related mortgage loan activity in the current period.

### *Six Months Ended December 31, 2014 and 2013*

Noninterest income increased by \$400 thousand for the six months ended December 31, 2014, compared to the six months ended December 31, 2013, principally due to the following:

- An increase of \$295 thousand in gain on sales of portfolio loans, realized primarily on the sale of the guaranteed portion of SBA loans. The Company recognized \$529 thousand in gains on SBA loans sold for the six months ended December 31, 2014, compared to no SBA gain for the quarter ended December 31, 2013; and
- An increase of \$149 thousand in gains realized on sale of residential loans originated for sale in the secondary market, due principally to an increase in purchase-related mortgage loan activity in the current period.

### *Noninterest Expense*

#### *Three Months Ended December 31, 2014 and 2013*

Noninterest expense increased by \$596 thousand for the current quarter, compared to the quarter ended December 31, 2013, principally due to the following:



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- An increase of \$484 thousand in salaries and employee benefits, principally due to increased employee head count and incentive compensation, offset by a decrease in group insurance expense and employee stock options expense;
- An increase of \$177 thousand in professional fees, due primarily to fees for temporary consulting services;
- An increase of \$123 thousand in loan acquisition and collection expenses, due in part to an increased level of loan purchases in the quarter ended December 31, 2014 when compared to the quarter ended December 31, 2013; and
- A decrease of \$130 thousand in occupancy and equipment expense, the result of a reduction in software maintenance and depreciation expense following the conversion of the Bank's core systems platform to an outsourced model in May 2014. The decrease in equipment expense was offset in part by higher data processing fees, which increased by \$70 thousand.

*Six Months Ended December 31, 2014 and 2013*

Noninterest expense increased by \$483 thousand for the six months ended December 31, 2014, compared to the six months ended December 31, 2013, principally due to the following:

- An increase of \$405 thousand in salaries and employee benefits, principally due to an increase in average headcount, as well as higher employee benefits and stock-based compensation;
- An increase of \$109 thousand in professional fees, principally due to increased temporary consulting fees;
- An increase of \$138 thousand in data processing fees, primarily due to increased expense associated with the Bank's core systems conversion in May 2014;
- An increase of \$250 thousand in legal settlement expense resulting from an insurance recovery in the quarter ended September 30, 2013.
- A decrease of \$217 thousand in occupancy and equipment expense, primarily due to a reduction in software maintenance and depreciation expense due to the Bank's core conversion in May 2014. This decrease was offset in part by a \$179 thousand increase in data processing fees.
- A decrease of \$89 thousand in intangible asset amortization. The Company's core deposit intangible amortizes on an accelerated basis.

***Income Taxes***

*Three Months Ended December 31, 2014 and 2013*

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The Company's effective tax rate for the quarter ended December 31, 2014 was 36.1%, compared to 32.4% for the quarter ended December 31, 2013. The increase in the quarter was primarily the result of a change in estimated state tax apportionment.

### *Six Months Ended December 31, 2014 and 2013*

The Company's income tax expense was \$1.8 million or an effective rate of 36.1%, for the six months ended December 31, 2014, as compared to \$832 thousand, or an effective rate of 32.6%, for the six months ended December 30, 2013. The increased effective rate in six months ended December 31, 2014 principally resulted from a change in estimated state tax apportionment.

### **Results of Operations** **Discontinued Operations**

The Company concluded all investment brokerage activities in the second quarter of fiscal 2014. Accordingly, operations associated with these activities have been classified as discontinued operations.

The Company reported a net loss from discontinued operations of \$18 thousand in the quarter ended December 31, 2013.

The Company reported a net loss from discontinued operations of \$8 thousand for the six months ended December 31, 2013.

The net loss in both the quarter and six months ended December 31, 2013 was due to the discontinuance of brokerage activities in November 2013.

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**Item 3. Quantitative and Qualitative Disclosure about Market Risk**

Not required for smaller reporting companies.

**Item 4. Controls and Procedures**

The Company maintains controls and procedures designed to ensure that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934 ( Exchange Act ) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to the Company s management, including the Chief Executive Officer and Chief Financial Officer (the Company s principal executive officer and principal financial officer, respectively), as appropriate to allow for timely decisions regarding timely disclosure. In designing and evaluating disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost/benefit relationship of possible controls and procedures.

The Company s management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q.

Based on this evaluation of the Company s disclosure controls and procedures, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures were effective as of December 31, 2014.

There were no changes in the Company s internal controls over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the quarter ended December 31, 2014 that have materially affected, or is reasonably likely to materially affect, the Company s internal controls over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

None.

**Item 1A. Risk Factors**

Not required for smaller reporting companies.

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

On April 23, 2014, the Company announced that its Board of Directors authorized the Company to purchase up to 870,000 shares of its common stock, representing 8.3% of the Company's outstanding common shares and approximately \$8.4 million based on the Company's closing stock price on April 22, 2014. Such purchases will be made in open market or in privately negotiated transactions from time to time and in such amounts as market conditions warrant. The timing and actual number of shares repurchased will depend on a variety of factors including price, corporate and regulatory requirements, market conditions, and other corporate liquidity requirements and priorities. The stock repurchase program may be suspended or terminated at any time without prior notice, and will expire on April 23, 2016.

The following table sets forth information with respect to purchases made by us of our common stock during the three months ended December 31, 2014.

| <b>Period</b>    | <b>Total Number of Shares Purchased (1)</b> | <b>Average Price Per share</b> | <b>Total Number of Shares Purchased as Part of Publicly Announced Programs</b> | <b>Maximum Number of Shares that May Yet Be Purchased Under the Program</b> |
|------------------|---|--------------------------------|--|---|
| Jul. 1 - Jul. 31 | 2,100                                       | \$ 9.23                        | 293,300  | 576,700   |
| Aug. 1 - Aug. 31 | 12,300                                      | \$ 9.34                        | 305,600  | 564,400   |
| Sep. 1 - Sep. 30 |   |                                | 305,600  | 564,400   |
| Oct. 1 - Oct. 31 | 1,800                                       | 9.03                           | 307,400  | 562,600   |
| Nov. 1 - Nov. 30 | 36,900                                      | 9.05                           | 344,300  | 525,700   |
| Dec. 1 - Dec. 31 | 395,586                                     | 9.14                           | 739,886  | 130,114   |

(1) Based on trade date, not settlement date

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**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

Not applicable.

**Item 5. Other Information**

None.

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**Item 6. Exhibits**

**Exhibits**

| <b>No.</b> | <b>Description</b>   |
|------------|--|
| 31.1       | Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)). *   |
| 31.2       | Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(a)). *   |
| 32.1       | Certificate of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(b)). **   |
| 32.2       | Certificate of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Rule 13a-14(b)). **   |
| 101        | The following materials from Northeast Bancorp's Quarterly Report on Form 10-Q for the quarter ended December 31, 2014 formatted in XBRL: (i) Consolidated Balance Sheets at December 31, 2014 and June 30, 2014; (ii) Consolidated Statements of Income for the three and six months ended December 31, 2014 and 2013; (iii) Consolidated Statements of Comprehensive Income for the three and six months ended December 30, 2014 and 2013; (iv) Consolidated Statements of Changes in Shareholders' Equity for the six months ended December 31, 2014 and 2013; (v) Consolidated Statements of Cash Flows for the six months ended December 31, 2014 and 2013; and (v) Notes to Unaudited Consolidated Financial Statements. |

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\* Filed herewith

\*\* Furnished herewith

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**SIGNATURES**

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

Date: February 13, 2015

**NORTHEAST BANCORP**

By: /s/ Richard Wayne

Richard Wayne  
President and CEO

By: /s/ Brian Shaughnessy

Brian Shaughnessy  
Chief Financial Officer

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**NORTHEAST BANCORP**

**Index to Exhibits**

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