NORTHEAST BANCORP /ME/
Form 10-Q
November 09, 2016
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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 September 30, 2016

Commission File Number: 1-14588

Northeast Bancorp

(Exact name of registrant as specified in its charter)

Maine	**01-0425066**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
500 Canal Street, Lewiston, Maine	**04240**
(Address of Principal executive offices)	**(Zip Code)**

(207) 786-3245

Registrant's telephone number, including area code

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 November 2, 2016, the registrant had outstanding 7,487,552 shares of voting common stock, $1.00 par value per share and 1,343,683 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 and per share data)

	September 30, 2016	June 30, 2016
Assets		
Cash and due from banks	$ 3,574	$ 2,459
Short-term investments	122,675	148,698
Total cash and cash equivalents	126,249	151,157
Available-for-sale securities, at fair value	94,583	100,572
Residential real estate loans held for sale	4,623	6,449
SBA loans held for sale	2,630	1,070
Total loans held for sale	7,253	7,519
Loans		
Commercial real estate	449,553	426,568
Residential real estate	110,223	113,962
Commercial and industrial	156,110	145,956
Consumer	5,532	5,950
Total loans	721,418	692,436
Less: Allowance for loan losses	2,506	2,350
Loans, net	718,912	690,086
Premises and equipment, net	7,452	7,801
Real estate owned and other repossessed collateral, net	3,774	1,652
Federal Home Loan Bank stock, at cost	2,408	2,408
Intangible assets, net	1,623	1,732
Bank owned life insurance	15,839	15,725
Other assets	7,475	7,501
Total assets	$ 985,568	$ 986,153
Liabilities and Shareholders' Equity		
Liabilities		

Deposits		
Demand	$ 74,249	$ 66,686
Savings and interest checking	107,365	107,218
Money market	302,079	275,437
Time	321,716	351,091
Total deposits	805,409	800,432
Federal Home Loan Bank advances	30,046	30,075
Subordinated debt	23,393	23,331
Capital lease obligation	1,066	1,128
Other liabilities	14,101	14,596
Total liabilities	874,015	869,562
Commitments and contingencies	-	-
Shareholders' equity		
Preferred stock, $1.00 par value, 1,000,000 shares authorized; no shares issued and outstanding at September 30, 2016 and June 30, 2016	-	-
Voting common stock, $1.00 par value, 25,000,000 shares authorized; 7,487,552 and 8,089,790 shares issued and outstanding at September 30, 2016 and June 30, 2016, respectively	7,487	8,089
Non-voting common stock, $1.00 par value, 3,000,000 shares authorized; 1,343,683 and 1,227,683 shares issued and outstanding at September 30, 2016 and June 30, 2016, respectively	1,344	1,228
Additional paid-in capital	76,765	83,020
Retained earnings	27,818	26,160
Accumulated other comprehensive loss	(1,861)	(1,906)
Total shareholders' equity	111,553	116,591
Total liabilities and shareholders' equity	$ 985,568	$ 986,153

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

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

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

	Three Months Ended September 30,	
	2016	2015
Interest and dividend income:		
Interest and fees on loans	$ 11,803	$ 10,790
Interest on available-for-sale securities	239	228
Other interest and dividend income	215	95
Total interest and dividend income	12,257	11,113
Interest expense:		
Deposits	1,754	1,365
Federal Home Loan Bank advances	255	260
Wholesale repurchase agreements	-	67
Short-term borrowings	-	9
Subordinated debt	459	154
Obligation under capital lease agreements	14	17
Total interest expense	2,482	1,872
Net interest and dividend income before provision for loan losses	9,775	9,241
Provision for loan losses	193	169
Net interest and dividend income after provision for loan losses	9,582	9,072
Noninterest income:		
Fees for other services to customers	408	408
Gain on sales of residential loans held for sale	542	560
Gain on sales of SBA loans	743	675
Loss recognized on real estate owned and other repossessed collateral, net	(14)	(59)
Bank-owned life insurance income	114	112
Other noninterest income	15	9
Total noninterest income	1,808	1,705
Noninterest expense:		
Salaries and employee benefits	5,314	4,256
Occupancy and equipment expense	1,229	1,290

Professional fees	496	430
Data processing fees	421	349
Marketing expense	87	70
Loan acquisition and collection expense	227	451
FDIC insurance premiums	124	114
Intangible asset amortization	109	131
Other noninterest expense	619	719
Total noninterest expense	8,626	7,810
Income before income tax expense	2,764	2,967
Income tax expense	1,013	1,100
Net income	$1,751	$1,867
Weighted-average shares outstanding:		
Basic	9,106,144	9,562,812
Diluted	9,133,383	9,562,812
Earnings per common share:		
Basic	$0.19	$0.20
Diluted	0.19	0.20
Cash dividends declared per common share	$0.01	$0.01

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

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Dollars in thousands)

	Three Months Ended September 30,	
	2016	2015
Net income	$1,751	$1,867
Other comprehensive income (loss), before tax:		
Available-for-sale securities:		
Change in net unrealized (loss) gain on available-for-sale securities	(78)	466
Derivatives and hedging activities:		
Change in accumulated gain (loss) on effective cash flow hedges	154	(838)
Reclassification adjustments included in net income	-	-
Total derivatives and hedging activities	154	(838)
Total other comprehensive income (loss), before tax	76	(372)
Income tax (benefit) expense related to other comprehensive loss	31	(141)
Other comprehensive income (loss), net of tax	45	(231)
Comprehensive income	$1,796	$1,636

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

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

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

	Preferred Stock		Voting Common Stock		Non-voting Common Stock		Additional		Accumulated Other	Total
							Paid-in	Retained	Comprehensive	Shareholders'
	Shares	Amount	Shares	Amount	Shares	Amount	Capital	Earnings	Loss	Equity
Balance at June 30, 2015	-	$ -	8,575,144	$ 8,575	1,012,739	$ 1,013	$ 85,506	$ 18,921	$ (1,288)	$ 112,727
Net income	-	-	-	-	-	-	-	1,867	-	1,867
Other comprehensive loss, net of tax	-	-	-	-	-	-	-	-	(231)	(231)
Common stock repurchased	-	-	(52,500)	(53)	-	-	(495)	-	-	(548)
Conversion of voting common stock to non-voting common stock	-	-	(9,978)	(10)	9,978	10	-	-	-	-
Dividends on common stock at $0.01 per share	-	-	-	-	-	-	-	(95)	-	(95)
Stock-based compensation	-	-	-	-	-	-	(16)	-	-	(16)
Issuance of restricted common stock	-	-	97,500	98	-	-	(98)	-	-	-
Cancellation and forfeiture of restricted common stock	-	-	(40,554)	(40)	-	-	40	-	-	-
Balance at September 30, 2015	-	$ -	8,569,612	$ 8,570	1,022,717	$ 1,023	$ 84,937	$ 20,693	$ (1,519)	$ 113,704

Balance at June 30, 2016	-	-	8,089,790	$ 8,089	1,227,683	$ 1,228	$ 83,020	$ 26,160	$ (1,906)	$ 116,591
Net income	-	-	-	-	-	-	-	1,751	-	1,751
Other comprehensive loss, net of tax	-	-	-	-	-	-	-	-	45	45
Common stock repurchased	-	-	(645,238)	(645)	-	-	(6,298)	-	-	(6,943)
Conversion of voting common stock to non-voting common stock	-	-	(116,000)	(116)	116,000	116	-	-	-	-
Dividends on common stock at $0.01 per share	-	-	-	-	-	-	-	(93)	-	(93)
Stock-based compensation	-	-	-	-	-	-	202	-	-	202
Issuance of restricted common stock	-	-	160,000	160	-	-	(160)	-	-	-
Cancellation and forfeiture of restricted common stock	-	-	(1,000)	(1)	-	-	1	-	-	-
Balance at September 30, 2016	-	$ -	7,487,552	$ 7,487	1,343,683	$ 1,344	$ 76,765	$ 27,818	$ (1,861)	$ 111,553

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

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NORTHEAST BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Dollars in thousands)

	Three Months Ended September 30,	
	2016	2015
Operating activities:		
Net income	$1,751	$1,867
Adjustments to reconcile net income to net cash used in operating activities:		
Provision for loan losses	193	169
Loss on sale and impairment of real estate owned and other repossessed collateral, net	13	53
Loss on sale and disposal of premises and equipment, net	1	6
Accretion of fair value adjustments on loans, net	(2,133)	(2,248)
Accretion of fair value adjustments on deposits, net	(1)	(3)
Accretion of fair value adjustments on borrowings, net	(29)	(18)
Amortization of subordinated debt issuance costs	62	-
Originations of loans held for sale	(33,459)	(26,877)
Net proceeds from sales of loans held for sale	33,758	35,318
Gain on sales of residential loans held for sale	(542)	(560)
Gain on sales of SBA loans held for sale	(743)	(675)
Amortization of intangible assets	109	131
Bank-owned life insurance income, net	(114)	(112)
Depreciation of premises and equipment	395	405
Stock-based compensation	202	(16)
Amortization of available-for-sale securities, net	286	222
Changes in other assets and liabilities:		
Other assets	(15)	521
Other liabilities	(345)	(3,059)
Net cash (used in) provided by operating activities	(611)	5,124
Investing activities:		
Purchases of available-for-sale securities	(9,056)	(5,000)
Proceeds from maturities and principal payments on available-for-sale securities	14,681	5,808
Loan purchases	(13,853)	(23,458)
Loan originations, principal collections, and purchased loan paydowns, net	(13,969)	5,712
Purchases and disposals of premises and equipment, net	(47)	(618)
Proceeds from sales of real estate owned and other repossessed collateral	67	642
Net cash used in investing activities	(22,177)	(16,914)
Financing activities:		
Net increase in deposits	4,978	18,722
Net increase (decrease) in short-term borrowings	-	130

Repurchase of common stock	(6,943)	(548)
Dividends paid on common stock	(93)	(95)
Repayment of wholesale repurchase agreements	-	(10,000)
Repayment of capital lease obligation	(62)	(56)
Net cash (used in) provided by financing activities	(2,120)	8,153
Net decrease in cash and cash equivalents	(24,908)	(3,637)
Cash and cash equivalents, beginning of period	151,157	89,850
Cash and cash equivalents, end of period	$126,249	$86,213
Supplemental schedule of noncash investing activities:		
Transfers from loans to real estate owned and other repossessed collateral	$2,188	$323

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

NORTHEAST BANCORP AND SUBSIDIARY

Notes to Unaudited Consolidated Financial Statements

September 30, 2016

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 (“US 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, 2016 (“Fiscal 2016”) 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 2015-14, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”) was issued in August 2015 which defers adoption to annual reporting periods beginning after December 15, 2017. The Company is currently evaluating the impact of the adoption of ASU 2014-09 on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* (“ASU 2016-01”). This guidance changes how entities account for equity investments that do not result in consolidation and are not accounted for under the equity method of accounting. Entities will be required to measure these investments at fair value at the end of each reporting period and recognize changes in fair value in net income. A practicability exception will be available for equity investments that do not have readily determinable fair values, however; the exception requires the Company to adjust the carrying amount for impairment and observable price changes in orderly transactions for the identical or a similar investment of the same issuer. This guidance also changes certain disclosure requirements and other aspects of current US GAAP. This guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within the fiscal year. Early adoption is permitted for only one of the six amendments. The Company is currently evaluating the impact of the adoption of ASU 2016-01 on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)* (“ASU 2016-02”). The new guidance establishes the principles to report transparent and economically neutral information about the assets and liabilities that arise from leases. Entities will be required to recognize the lease assets and lease liabilities that arise from leases in the statement of financial position and to disclose qualitative and quantitative information about lease transactions, such as information about variable lease payments and options to renew and terminate leases. This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within the fiscal year. The Company is currently evaluating the impact of the adoption of ASU 2016-02 on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-05, *Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships* (“ASU 2016-05”). The new guidance clarifies that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require de-designation of that hedging relationship provided that all other hedge accounting criteria continue to be met. This guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. The adoption of this guidance is not expected to have a significant impact on the Company’s financial statements.

In March 2016, the FASB issued ASU 2016-09, *Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting* (“ASU 2016-09”). The new guidance simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Entities will be required to recognize the income tax effects of awards in the income statement when the awards vest or are settled. This guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within those annual periods. The adoption of this guidance is not expected to have a significant impact on the Company’s financial statements.

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In June 2016, the FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326)* (“ASU 2016-13”). This update is intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in this update replace the incurred loss impairment methodology in current US GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This ASU will be effective for fiscal years beginning after December 15, 2019. Early adoption is available as of the fiscal year beginning after December 15, 2018. The Company is currently evaluating the impact of this ASU on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, *Statement of Cash Flows (Topic 230)* (“ASU 2016-15”). This update clarifies and provides guidance on several cash receipt and cash payment classification issues, including debt prepayment and extinguishment costs, settlement of zero-coupon debt instruments, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies, distributions received from equity method investees, beneficial interests in securitization transactions, and separately identifiable cash flows and application of the predominance principle. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The adoption of this guidance is not expected to have a significant impact on the Company’s financial statements.

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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.

	September 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
U.S. Government agency securities	$48,856	$ 24	$ (31)	$48,849
Agency mortgage-backed securities	40,483	117	(29)	40,571
Other investment measured at net asset value	5,125	38	-	5,163
	$94,464	$ 179	$ (60)	$94,583

	June 30, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
U.S. Government agency securities	$51,948	$ 98	$ -	$52,046
Agency mortgage-backed securities	43,330	90	(52)	43,368
Other investment measured at net asset value	5,097	61	-	5,158
	$100,375	$ 249	$ (52)	$100,572

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 months ended September 30, 2016 or 2015. At September 30, 2016, no investment securities 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.

September 30, 2016

	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
U.S. Government agency securities	$36,671	$ (31)	$-	$ -	$36,671	$ (31)
Agency mortgage-backed securities	2,082	(1)	15,780	(28)	17,862	(29)
Other investment measured at net asset value	-	-	-	-	-	-
	$38,753	$ (32)	$15,780	$ (28)	$54,533	$ (60)

	June 30, 2016					
	Less than 12 Months		More than 12 Months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(Dollars in thousands)					
U.S. Government agency securities	$-	$ -	$-	$ -	$-	$ -
Agency mortgage-backed securities	-	-	25,350	(52)	25,350	(52)
Other investment measured at net asset value	-	-	-	-	-	-
	$-	$ -	$25,350	$ (52)	$25,350	$ (52)

There were no other-than-temporary impairment losses on securities during the three months ended September 30, 2016 or 2015.

At September 30, 2016, the Company had seven securities in a continuous loss position for greater than twelve months. At September 30, 2016, 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 September 30, 2016 is attributable to changes in interest rates.

In addition to considering current trends and economic conditions that may affect the quality of individual securities within the Company’s investment portfolio, management of the Company also considers the Company’s ability and intent to hold such securities to maturity or recovery of cost. At September 30, 2016, the Company does not intend to sell and it is not more likely than not that the Company will be required to sell the investment securities before recovery of its amortized cost. As such, management does not believe any of the Company’s available-for-sale securities are other-than-temporarily impaired at September 30, 2016.

The investment measured at net asset value is a fund that seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies. The underlying composition of such fund is primarily government agencies or other investment-grade investments. The effective duration of the investments is 4.67 years at September 30, 2016.

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The amortized cost and fair values of available-for-sale debt securities by contractual maturity are shown below as of September 30, 2016. 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.

	Amortized Cost	Fair Value
	(Dollars in thousands)	
Due within one year	$-	$-
Due after one year through five years	48,856	48,849
Due after five years through ten years	18,104	18,217
Due after ten years	22,379	22,354
Total	$89,339	$89,420

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 modified 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.

	September 30, 2016			June 30, 2016		
	Originated	Purchased	Total	Originated	Purchased	Total
	(Dollars in thousands)					
Residential real estate	$90,230	$2,895	$93,125	$93,391	$2,559	$95,950
Home equity	17,098	-	17,098	18,012	-	18,012
Commercial real estate	218,236	231,317	449,553	189,616	236,952	426,568
Commercial and industrial	154,008	2,102	156,110	145,758	198	145,956
Consumer	5,532	-	5,532	5,950	-	5,950
Total loans	$485,104	$236,314	$721,418	$452,727	$239,709	$692,436

Total loans include deferred loan origination costs of $367 thousand and fees of $58 thousand as of September 30, 2016 and June 30, 2016, respectively.

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Past Due and Nonaccrual Loans

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

	September 30, 2016							
	30-59 Days	60-89 Days	Past Due 90 Days or More-Still Accruing	Past Due 90 Days or More-Nonaccrual	Total Past Due	Total Current	Total Loans	Non-Accrual Loans
	(Dollars in thousands)							
Originated portfolio:								
Residential real estate	$75	$637	$ -	$ 2,367	$3,079	$87,151	$90,230	$3,273
Home equity	50	-	-	48	98	17,000	17,098	48
Commercial real estate	256	-	-	94	350	217,886	218,236	361
Commercial and industrial	-	-	-	-	-	154,008	154,008	347
Consumer	92	8	-	95	195	5,337	5,532	121
Total originated portfolio	473	645	-	2,604	3,722	481,382	485,104	4,150
Purchased portfolio:								
Residential real estate	1,108	-	-	-	1,108	1,787	2,895	1,107
Commercial and industrial	-	93	-	-	93	2,009	2,102	48
Commercial real estate	179	1,411	-	3,269	4,859	226,458	231,317	3,618
Total purchased portfolio	1,287	1,504	-	3,269	6,060	230,254	236,314	4,773
Total loans	$1,760	$2,149	$ -	$ 5,873	$9,782	$711,636	$721,418	$8,923

	June 30, 2016							
	30-59 Days	60-89 Days	Past Due 90 Days or More-Still Accruing	Past Due 90 Days or More-Nonaccrual	Total Past Due	Total Current	Total Loans	Non-Accrual Loans
	(Dollars in thousands)							
Originated portfolio:								
Residential real estate	$302	$910	$ -	$ 1,555	$2,767	$90,624	$93,391	$2,613
Home equity	146	-	-	48	194	17,818	18,012	48
Commercial real estate	132	-	-	188	320	189,296	189,616	474
Commercial and industrial	-	-	-	15	15	145,743	145,758	17
Consumer	73	56	-	74	203	5,747	5,950	163
Total originated portfolio	653	966	-	1,880	3,499	449,228	452,727	3,315
Purchased portfolio:								
Residential real estate	-	-	-	-	-	2,559	2,559	1,125

Commercial and industrial	-	-	-	-	-	198	198	-
Commercial real estate	-	19	-	3,387	3,406	233,546	236,952	3,387
Total purchased portfolio	-	19	-	3,387	3,406	236,303	239,709	4,512
Total loans	$653	$985	$ -	$ 5,267	$6,905	$685,531	$692,436	$7,827

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 and industrial, 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, loan-to-value ratio and income 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.

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Commercial and industrial: 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.

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. 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 for originated loans 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;

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; and

Other effects resulting from trends in the valuation of underlying collateral.

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 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.

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 expected 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.

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

	Three Months Ended September 30, 2016						
	Residential Real Estate	Commercial Real Estate	Commercial and Industrial	Consumer	Purchased	Unallocated	Total
	(Dollars in thousands)						
Beginning balance	$663	$ 1,195	$ 297	$ 62	$ 133	$ -	$2,350
Provision	(99)	226	17	24	25	-	193
Recoveries	2	-	5	11	-	-	18
Charge-offs	(25)	-	(1)	(29)	-	-	(55)
Ending balance	$541	$ 1,421	$ 318	$ 68	$ 158	$ -	$2,506

	Three Months Ended September 30, 2015						
	Residential Real Estate	Commercial Real Estate	Commercial and Industrial	Consumer	Purchased	Unallocated	Total
	(Dollars in thousands)						
Beginning balance	$741	$ 694	$ 117	$ 35	$ 283	$ 56	$1,926
Provision	(21)	62	16	31	81	-	169
Recoveries	12	5	1	2	-	-	20
Charge-offs	-	(28)	-	(22)	-	-	(50)
Ending balance	$732	$ 733	$ 134	$ 46	$ 364	$ 56	$2,065

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

	September 30, 2016						
	Residential Real Estate	Commercial Real Estate	Commercial and Industrial	Consumer	Purchased	Unallocated	Total
	(Dollars in thousands)						
Allowance for loan losses:							
Individually evaluated	$326	$ 50	$ 2	$ 22	$ -	$ -	$400
Collectively evaluated	215	1,371	316	46	-	-	1,948
ASC 310-30	-	-	-	-	158	-	158
Total	$541	$ 1,421	$ 318	$ 68	$ 158	$ -	$2,506

Loans:							
Individually evaluated	$5,790	$ 1,565	$ 346	$ 330	$ -	$ -	$8,031
Collectively evaluated	101,538	216,671	153,662	5,202	-	-	477,073
ASC 310-30	-	-	-	-	236,314	-	236,314
Total	$107,328	$ 218,236	$ 154,008	$ 5,532	$236,314	$ -	$721,418

	June 30, 2016						
	Residential Real Estate	Commercial Real Estate	Commercial and Industrial	Consumer	Purchased	Unallocated	Total
	(Dollars in thousands)						
Allowance for loan losses:							
Individually evaluated	$386	$ 59	$ 2	$ 23	$ -	$ -	$470
Collectively evaluated	277	1,136	295	39	-	-	1,747
ASC 310-30	-	-	-	-	133	-	133
Total	$663	$ 1,195	$ 297	$ 62	$133	$ -	$2,350
Loans:							
Individually evaluated	$5,039	$ 1,686	$ 17	$ 362	$ -	$ -	$7,104
Collectively evaluated	106,364	187,930	145,741	5,588	-	-	445,623
ASC 310-30	-	-	-	-	239,709	-	239,709
Total	$111,403	$ 189,616	$ 145,758	$ 5,950	$239,709	$ -	$692,436

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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.

	September 30, 2016			June 30, 2016		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
	(Dollars in thousands)					
Impaired loans without a valuation allowance:						
Originated:						
Residential real estate	$4,268	$4,320	$ -	$3,192	$3,299	$ -
Consumer	228	263	-	257	282	-
Commercial real estate	443	445	-	451	453	-
Commercial and industrial	344	344	-	15	15	-
Purchased:						
Residential real estate	1,108	1,150	-	1,125	1,125	-
Commercial real estate	4,897	5,939	-	4,574	4,886	-
Commercial and industrial	48	88	-	-	-	-
Total	11,336	12,549	-	9,614	10,060	-
Impaired loans with a valuation allowance:						
Originated:						
Residential real estate	1,522	1,510	326	1,847	1,802	386
Consumer	102	114	22	105	112	23
Commercial real estate	1,122	1,114	50	1,235	1,223	59
Commercial and industrial	2	2	2	2	2	2
Purchased:						
Commercial real estate	1,574	1,865	111	1,484	1,812	66
Total	4,322	4,605	511	4,673	4,951	536
Total impaired loans	$15,658	$17,154	$ 511	$14,287	$15,011	$ 536

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

	Three Months Ended September 30,			
	2016		2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
	(Dollars in thousands)			

Impaired loans without a valuation allowance:				
Originated:				
Residential real estate	$3,730	$ 49	$2,520	$ 39
Consumer	243	3	290	5
Commercial real estate	447	8	1,200	7
Commercial and industrial	180	3	2	-
Purchased:				
Residential real estate	1,117	3	-	-
Commercial real estate	4,736	52	7,842	14
Commercial and industrial	24	-	-	-
Total	10,477	118	11,854	65
Impaired loans with a valuation allowance:				
Originated:				
Residential real estate	1,685	16	2,064	23
Consumer	104	2	23	1
Commercial real estate	1,179	18	924	12
Commercial and industrial	2	-	-	-
Purchased:				
Commercial real estate	1,529	17	1,976	36
Total	4,499	53	4,987	72
Total impaired loans	$14,976	$ 171	$16,841	$ 137

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Credit Quality

The Company utilizes a ten-point internal loan rating system for commercial real estate, construction, commercial and industrial, 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.

	September 30, 2016				
	Originated Portfolio				
	Commercial Real Estate	Commercial and Industrial	Residential[1]	Purchased Portfolio	Total
	(Dollars in thousands)				
Loans rated 1- 6	$214,276	$ 153,599	$ 7,591	$224,071	$599,537
Loans rated 7	3,125	397	500	8,424	12,446
Loans rated 8	835	12	515	3,819	5,181
Loans rated 9	-	-	23	-	23
Loans rated 10	-	-	-	-	-
	$218,236	$ 154,008	$ 8,629	$236,314	$617,187

	June 30, 2016				
	Originated Portfolio				
	Commercial Real Estate	Commercial and Industrial	Residential[1]	Purchased Portfolio	Total
	(Dollars in thousands)				
Loans rated 1- 6	$186,165	$ 142,451	$ 7,659	$227,895	$564,170
Loans rated 7	2,493	3,290	431	7,147	13,361
Loans rated 8	958	17	537	4,667	6,179
Loans rated 9	-	-	23	-	23
Loans rated 10	-	-	-	-	-
	$189,616	$ 145,758	$ 8,650	$239,709	$583,733

(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.

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Troubled Debt Restructurings

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

	Three Months Ended September 30,			
	2016		2015	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
	(Dollars in thousands)			
Extended maturity	-	$ -	-	$ -
Adjusted interest rate	1	9	-	-
Rate and maturity	1	334	-	-
Principal deferment	-	-	-	-
Court ordered concession	-	-	-	-
	2	$ 343	-	$ -

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

	Three Months Ended September 30,					
	2016			2015		
	Number of Contracts	Recorded Investment Pre-Modification	Recorded Investment Post-Modification	Number of Contracts	Recorded Investment Pre-Modification	Recorded Investment Post-Modification
	(Dollars in thousands)					
Originated portfolio:						
Residential real estate	1	$ 9	$ 9	-	$ -	$ -
Home equity	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-
Commercial and industrial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total originated portfolio	1	9	9	-	-	-
Purchased portfolio:						
Residential real estate	-	-	-	-	-	-

Commercial real estate	1		334		334	-		-		-
Total purchased portfolio	1		334		334	-		-		-
Total	2	$	343	$	343	-	$	-	$	-

The Company considers TDRs past due 90 days or more to be in payment default. No loans modified in a TDR in the last twelve months defaulted during the three months ended September 30, 2016. As of September 30, 2016, there were no further commitments to lend to borrowers associated with loans modified in a TDR.

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ASC 310-30 Loans

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

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015
	(Dollars in thousands)	
Contractually required payments receivable	$26,254	$ 31,276
Nonaccretable difference	(2,517)	(291)
Cash flows expected to be collected	23,737	30,985
Accretable yield	(9,884)	(7,527)
Fair value of loans acquired	$13,853	$ 23,458

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. These loans when acquired are placed on non-accrual. The carrying amounts of such loans are as follows.

	As of and for the Three Months Ended September 30, 2016	As of and for the Three Months Ended September 30, 2015
	(Dollars in thousands)	
Loans acquired during the period	$1,103	$ -
Loans at end of period	4,439	6,826

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

	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015
	(Dollars in thousands)	
Beginning balance	$124,151	$111,449
Acquisitions	9,884	7,527
Accretion	(4,652)	(3,755)
Reclassifications from non-accretable difference to accretable yield	(1,105)	277
Disposals and other changes	(4,255)	(5,883)
Ending balance	$124,023	$109,615

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

	September 30, 2016 (1)	June 30, 2016 (1)
	(Dollars in thousands)	
Unpaid principal balance	$265,571	$267,985
Carrying amount	234,076	237,054

(1) Balances include loans held for sale of $789 thousand at September 30, 2016 and $0 at June 30, 2016.

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5. **Transfers and Servicing of Financial Assets**

The Company sells loans in the secondary market and for certain loans, retains the servicing responsibility. Consideration for the sale includes the cash received as well as the related servicing rights asset. The Company receives fees for the services provided.

Capitalized servicing rights as of September 30, 2016 totaled $2.2 million, compared to $1.8 million as of June 30, 2016, included in other assets on the consolidated balance sheets.

Mortgage loans sold in the quarter ended September 30, 2016 totaled $25.0 million, compared to $28.9 million in the quarter ended September 30, 2015. Mortgage loans serviced for others totaled $12.5 million at September 30, 2016 and $12.9 million at June 30, 2016. Additionally, the Company was servicing commercial loans participated out to various other institutions amounting to $33.2 million and $35.9 million at September 30, 2016 and June 30, 2016, respectively.

SBA loans sold during the quarter ended September 30, 2016 totaled $7.4 million, compared to $5.5 million in the quarter September 30, 2015. SBA loans serviced for others totaled $103.6 million at September 30, 2016 and $80.8 million at June 30, 2016.

Mortgage and SBA loans serviced for others are accounted for as sales and therefore are not included in the accompanying consolidated balance sheets. The risks inherent in mortgage servicing assets and SBA servicing assets relate primarily to changes in prepayments that result from shifts in interest rates.

Contractually specified servicing fees were $160 thousand and $149 thousand for the quarters ended September 30, 2016 and 2015, respectively, and were included as a component of loan related fees within non-interest income.

The significant assumptions used in the valuation for mortgage servicing rights as of September 30, 2016 included a weighted average discount rate of 5.5% and a weighted average prepayment speed assumption of 18.7%. For the SBA servicing rights, the significant assumptions used in the valuation included a range of discount rates from 8.5% to 14.1% and a weighted average prepayment speed assumption of 7.7%

6. 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 September 30,	
	2016	2015
	(Dollars in thousands, except share and per share data)	
Net income	$1,751	$1,867
Preferred stock dividends or accretion	-	-
Net income available to common shareholders	$1,751	$1,867
Weighted average shares used in calculation of basic EPS	9,106,144	9,562,812
Incremental shares from assumed exercise of dilutive securities	27,239	-
Weighted average shares used in calculation of diluted EPS	9,133,383	9,562,812
Earnings per common share:		
Basic	$0.19	$0.20
Diluted	0.19	0.20

For the three months ended September 30, 2016 and 2015, the following stock options 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 September 30,	
	2016	2015
Stock options	714,545	980,269

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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 controls 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 September 30, 2016, the Company had posted cash collateral totaling $3.1 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 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.

September 30, 2016

Notional Amount	Inception Date	Termination Date	Index	Receive Rate	Pay Rate	Strike Rate	Unrealized Loss	Fair Value	Balance Sheet Location
(Dollars in thousands)									
Interest rate swaps:									
$5,000	July 2013	July 2033	3 Mo. LIBOR	0.85 %	3.38%	n/a	$ (1,314)	$(1,314)	Other Liabilities
5,000	July 2013	July 2028	3 Mo. LIBOR	0.85 %	3.23%	n/a	(947)	(947)	Other Liabilities
5,000	July 2013	July 2023	3 Mo. LIBOR	0.85 %	2.77%	n/a	(493)	(493)	Other Liabilities
Interest rate caps:									
6,000	October 2014	September 2019	3 Mo. LIBOR	n/a	n/a	2.50 %	(170)	7	Other Assets
10,000	March 2015	February 2020	3 Mo. LIBOR	n/a	n/a	2.50 %	(198)	18	Other Assets
$31,000							$ (3,122)	$(2,729)	

June 30, 2016

Notional Amount	Inception Date	Termination Date	Index	Receive Rate	Pay Rate	Strike Rate	Unrealized Loss	Fair Value	Balance Sheet Location
(Dollars in thousands)									
Interest rate swaps:									
$5,000	July 2013	July 2033	3 Mo. LIBOR	0.65 %	3.38%	n/a	$ (1,352)	$(1,352)	Other Liabilities
5,000	July 2013	July 2028	3 Mo. LIBOR	0.65 %	3.23%	n/a	(1,005)	(1,005)	Other Liabilities
5,000	July 2013	July 2023	3 Mo. LIBOR	0.65 %	2.77%	n/a	(560)	(560)	Other Liabilities
Interest rate caps:									
6,000	October 2014	September 2019	3 Mo. LIBOR	n/a	n/a	2.50 %	(167)	10	Other Assets
10,000	March 2015	February 2020	3 Mo. LIBOR	n/a	n/a	2.50 %	(192)	25	Other Assets

$31,000	$ (3,276)	$(2,882)

During the three months ended September 30, 2016 and 2015, 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 months ended September 30, 2016 and 2015 related to the balance sheet hedging of variable rate debt indicates that the hedges were effective.

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8. Other Comprehensive Income

The components of other comprehensive income (loss) are as follows:

	Three Months Ended September 30,					
	2016			2015		
	Pre-tax Amount	Tax Expense (Benefit)	After-tax Amount	Pre-tax Amount	Tax Expense (Benefit)	After-tax Amount
	(Dollars in thousands)					
Change in net unrealized gain or loss on available-for-sale securities	$(78)	$ (30)	$ (48)	$466	$ 178	$ 288
Change in accumulated loss on effective cash flow hedges	154	61	93	(838)	(319)	(519)
Reclassification adjustment for net gains included in net income	-	-	-	-	-	-
Total derivatives and hedging activities	154	61	93	(838)	(319)	(519)
Total other comprehensive loss	$76	$ 31	$ 45	$(372)	$ (141)	$ (231)

Accumulated other comprehensive loss is comprised of the following:

	September 30, 2016	June 30, 2016
	(Dollars in thousands)	
Unrealized loss on available-for-sale securities	$119	$197
Tax effect	(45)	(75)
Net-of-tax amount	74	122
Unrealized loss on cash flow hedges	(3,122)	(3,276)
Tax effect	1,187	1,248
Net-of-tax amount	(1,935)	(2,028)
Accumulated other comprehensive loss	$(1,861)	$(1,906)

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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, standby letters of credit, and commitments to fund investments. 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:

	September 30, 2016	June 30, 2016
	(Dollars in thousands)	
Commitments to grant loans	$24,920	$44,684
Unfunded commitments under lines of credit	58,635	58,412
Standby letters of credit	3,822	3,822
Commitment to fund investment	2,500	2,500

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 $56 thousand and $81 thousand recorded in other liabilities at September 30, 2016 and June 30, 2016, respectively.

The Company committed $2.5 million to a fund that acquires CRA qualified investments in loans for the Company's portfolio. The Fund Manager will call the funds from the Company when an investment is successfully acquired. Through the three months ended September 30, 2016, the fund has not called any funds from the Company.

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.

10. Stock-Based Compensation

A summary of restricted share activity for the quarter ended September 30, 2016 follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested at beginning of period	251,859	$ 9.93
Granted	160,000	11.20
Vested	-	-
Forfeited	(1,000)	9.47
Unvested at end of period	410,859	10.43

A summary of the vesting schedule for the shares granted in the quarter ended September 30, 2016 follows:

15,000 restricted shares vest in full on August 25, 2019;
50,000 restricted shares are subject to performance-based vesting over a three year period (the "performance shares"). The performance shares include an absolute metric and a sliding metric within the performance period. The absolute metric requires that the Company be in compliance with the regulatory commitments made to the Federal Reserve

Bank and Maine Bureau of Financial Institutions. The sliding metric is based on reaching certain thresholds in regards to the company's return on equity ("ROE"). The performance shares shall vest in certain defined increments for such periods if the ROE is at least 70% of such targeted returns. This performance will be measured on both a year-by-year basis for three years, and an average basis over the three year performance period; and,
95,000 restricted shares vest in three equal installments, commencing on August 25, 2019.

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11. 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 technique*s - 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.

Certain investments are measured at fair value using the net asset value per share as a practical expedient. The fund seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies. The Company’s investments can be redeemed daily at the closing net asset value per share. In accordance with ASU 2015-07, these investments have not been included in the fair value hierarchy.

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 forward 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.

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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.

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.

Loan servicing rights— The fair value of the SBA and mortgage servicing rights is based on a valuation model that calculates the present value of estimated future net servicing income. Adjustments are only recorded when the discounted cash flows derived from the valuation model are less than the carrying value of the asset. Certain inputs are not observable, and therefore loan servicing rights are generally categorized as Level 3 within the fair value hierarchy.

Fair Value of other Financial Instruments:

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

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

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.

Accrued Interest receivable - The fair value of this financial instrument approximates the book value. 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 FHLBB 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.

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.

	September 30, 2016			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Assets				
Securities available-for-sale:				
U.S. Government agency securities	$48,849	$ -	$48,849	$ -
Agency mortgage-backed securities	40,571	-	40,571	-
Other investment measured at net asset value[1]	5,163	-	-	-
Other assets – interest rate caps	25	-	25	-
Liabilities				
Other liabilities – interest rate swaps	2,754	-	2,754	-

	June 30, 2016			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Assets				
Securities available-for-sale:				
U.S. Government agency securities	$52,046	$ -	$52,046	$ -
Agency mortgage-backed securities	43,368	-	43,368	-
Other investment measured at net asset value[1]	5,158	-	-	-
Other assets – interest rate caps	35	-	35	-
Liabilities				
Other liabilities – interest rate swap	2,917	-	2,917	-

(1) In accordance with ASU 820-10, certain investments that are measured at fair value using the net asset value per share (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. The fair value amount presented in the table are intended to permit reconciliation of the fair value amount to the consolidated financial statements.

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

	September 30, 2016			
	Total	Level 1	Level 2	Level 3

	(Dollars in thousands)			
Collateral dependent impaired loans	$1,743	$ -	$ -	$1,743
Real estate owned and other repossessed collateral	3,774	-	-	3,774
Loan servicing rights	2,174	-	-	2,174

	June 30, 2016			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Collateral dependent impaired loans	$922	$ -	$ -	$922
Real estate owned and other repossessed collateral	1,652	-	-	1,652
Loan servicing rights	1,771	-	-	1,771

The table below presents quantitative information about significant unobservable inputs (Level 3) for assets measured at fair value on a nonrecurring basis at the dates indicated.

	Fair Value		
	September 30, 2016	June 30, 2016	Valuation Technique
	(Dollars in thousands)		
Collateral dependent impaired loans	$1,743	$922	Appraisal of collateral(1)
Real estate owned and other repossessed collateral	3,774	1,652	Appraisal of collateral(1)
Loan servicing rights	2,174	1,771	Discounted cash flow(2)

(1) Fair value is generally determined through independent appraisals of the underlying collateral. The Company may also use another available source of collateral assessment to determine a reasonable estimate of the fair value of the collateral. Appraisals may be adjusted by management for qualitative factors such as economic factors and estimated liquidation expenses. The range of these possible adjustments was 6% to 71%.

(2) Fair value is determined using a discounted cash flow model. The unobservable inputs include anticipated rate of loan prepayments and discount rates. The range of prepayment assumptions used was 7.7% to 18.7%. For discount rates, the range was 5.5% to 14.1%.

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

	Carrying	Fair Value Measurements at September 30, 2016			
	Amount	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)				
Financial assets:					
Cash and cash equivalents	$126,249	$126,249	$126,249	$-	$-
Available-for-sale securities	89,420	89,420	-	89,420	-
Other investment measured at net asset value[(1)]	5,163	5,163	-	-	-
Federal Home Loan Bank stock	2,408	2,408	-	2,408	-
Loans held for sale	7,253	7,253	-	7,253	-
Loans, net	718,912	727,794	-	-	727,794
Accrued interest receivable	1,728	1,728	-	1,728	-
Interest rate caps	25	25	-	25	-
Financial liabilities:					
Deposits	805,409	806,325	-	806,325	-
FHLBB advances	30,046	30,262	-	30,262	-
Capital lease obligation	1,066	1,145	-	1,145	-
Subordinated debentures	23,393	25,932	-	-	25,932
Interest rate swaps	2,754	2,754	-	2,754	-

	Carrying	Fair Value Measurements at June 30, 2016			
	Amount	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)				
Financial assets:					
Cash and cash equivalents	$151,157	$151,157	$151,157	$-	$-
Available-for-sale securities	95,414	95,414	-	95,414	-
Other investment measured at net asset value[(1)]	5,158	5,158	-	-	-
Federal Home Loan Bank stock	2,408	2,408	-	2,408	-
Loans held for sale	7,519	7,519	-	7,519	-
Loans, net	690,086	695,830	-	-	695,830
Accrued interest receivable	1,579	1,579	-	1,579	-
Interest rate caps	35	35	-	35	-
Financial liabilities:					
Deposits	800,432	801,045	-	801,045	-
FHLBB advances	30,075	30,396	-	30,396	-
Capital lease obligation	1,128	1,219	-	1,219	-
Subordinated debentures	23,331	25,664	-	-	25,664
Interest rate swaps	2,917	2,917	-	2,917	-

(1) In accordance with ASU 820-10, certain investments that are measured at fair value using the net asset value per share (or its equivalent) as a practical expedient have not been classified in the fair value hierarchy. The fair value amount presented in the table are intended to permit reconciliation of the fair value amount to the consolidated financial statements.

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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, 2016, 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”, “approximate “intend”, “objective”, “goal”, “project”, or other similar terms or variations on those terms, or 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; 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 of the company's 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, 2016 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 holdin 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.

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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. The Company’s compliance ratios at September 30, 2016 follow:

Condition	Ratios as of September 30, 2016	
(i) Tier 1 leverage capital ratio	12.25	%
(ii) Total capital ratio	18.82	%
(iii) Ratio of purchased loans to total loans, including loans held for sale	32.54	%
(iv) Ratio of loans to core deposits (1)	90.22	%
(v) Ratio of commercial real estate loans to total risk-based capital (2)	179.96	%

(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 non-owner occupied commercial real estate loans defined as such by regulatory guidance, including all land development and construction loans.

As of September 30, 2016, the Company, on a consolidated basis, had total assets of $985.6 million, total deposits of $805.4 million, and shareholders’ equity of $111.6 million. The Company gathers retail deposits through its banking offices in Maine and the Bank's online affinity deposit program, ableBanking; originates loans through the Bank’s Community Banking Division; originates Small Business Administration (“SBA”) loans through the Bank’s national SBA group (“SBA Division”); and purchases and originates commercial loans through the LASG. The Community Banking Division, with ten full-service branches and two loan production offices, operates from the Bank’s headquarters in Lewiston, Maine. LASG, ableBanking, and the SBA Division operate from the Company's 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:

Continuing our community banking tradition. With a history that dates to 1872, our Community Banking Division maintains its focus on sales and service, with the goal of attracting and retaining deposits, and serving the lending needs of retail and commercial customers within our core markets.

Growing LASG's national originated and purchased loan business. We purchase commercial real estate loans nationally, at prices that on average have produced yields significantly higher than those available on our originated loan portfolio. We also originate loans nationally, taking advantage of our core expertise in underwriting and servicing national credits.

Growing our national SBA origination business. We originate loans on a national basis to small businesses, primarily through the SBA 7(a) program, which provides the partial guarantee of the SBA.

Generating deposits to fund our business. We offer a full line of deposit products through our ten-branch network located in the Community Banking Division's market. ableBanking is a direct savings platform providing an additional channel to raise core deposits to fund our asset strategy.

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, 2016 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 three months ended September 30, 2016.

Overview

Net income was $1.8 million, or $0.19 per diluted common share, for the quarter ended September 30, 2016, compared to $1.9 million, or $0.20 per diluted common share, for the quarter ended September 30, 2015.

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Net interest and dividend income before provision for loan losses increased by $534 thousand, or 5.8%, to $9.8 million for the quarter ended September 30, 2016 compared to the quarter ended September 30, 2015. The increase is primarily due to higher average balances in the total loan portfolio, offset by higher average deposit balances and the effect of the issuance of the subordinated debt.

Noninterest income increased by $103 thousand for the quarter ended September 30, 2016, compared to the quarter ended September 30, 2015, principally due to an increase in gains realized on sale of SBA loans.

Noninterest expense increased by $816 thousand for the quarter ended September 30, 2016, compared to the quarter ended September 30, 2015, primarily due to an increase in salaries and employee benefits of $1.1 million, largely attributable to higher employee headcount, increased incentive compensation, and the benefit recognized upon the forfeiture of stock awards in the quarter ended September 30, 2015.

Financial Condition

Overview

Total assets decreased by $585 thousand, or 0.1%, to $985.6 million at September 30, 2016, compared to June 30, 2016. The principal components of the change in the balance sheet were as follows:

The loan portfolio – excluding loans held for sale – has grown by $29.0 million, or 4.2%, compared to June 30, 2016, principally on the strength of $28.5 million of net growth in commercial loans purchased or originated by the LASG and net growth of $5.1 million in originations by the SBA Division. This net growth was offset by a $4.6 million decrease in the Bank's Community Banking Division loan portfolio.

Loans generated by the LASG totaled $55.9 million for the quarter ended September 30, 2016. The growth in LASG loans consisted of $13.9 million of purchased loans, at an average price of 82.5% of unpaid principal balance, and $42.0 million of originated loans. SBA loans closed during the quarter totaled $15.2 million, of which $13.3 million were fully funded in the quarter. In addition, the Company sold $7.4 million of the guaranteed portion of SBA loans in the secondary market, of which $6.3 million were originated in the current quarter and $1.1 million were originated in prior quarters. Residential loan production sold in the secondary market totaled $25.0 million for the quarter.

As noted above in the "*Business Overview*" section, 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.

Basis for Regulatory Condition	Condition	Availability at September 30, 2016 (Dollars in millions)
Total Loans	Purchased loans may not exceed 40% of total loans	$ 90.6
Regulatory Capital	Non-owner occupied commercial real estate loans may not exceed 300% of total capital	$ 165.8

An overview of the Bank's LASG portfolio follows:

	LASG Portfolio Three Months Ended September 30,							
	2016				2015			
	Purchased (1)	Originated	Secured Loans to Broker-Dealers	Total LASG	Purchased	Originated	Secured Loans to Broker-Dealers	Total LASG
	(Dollars in thousands)							
Loans purchased or originated during the period:								
Unpaid principal balance	$16,790	$42,002	$ -	$58,792	$23,583	$10,941	$ -	$34,524
Net investment basis	13,853	42,002	-	55,855	23,458	10,941	-	34,399
Loan returns during the period:								
Yield	10.40 %	5.88 %	0.50 %	7.58 %	12.07 %	5.67 %	0.50 %	8.23 %
Total Return (2)	10.43 %	5.88 %	0.50 %	7.59 %	12.11 %	5.67 %	0.50 %	8.26 %
Total loans as of period end:								

Unpaid principal balance	$269,462	$206,748	$ 48,000	$524,210	$249,229	$119,732	$ 60,000	$428,961
Net investment basis	237,103	206,748	48,000	491,851	214,199	119,732	60,000	393,931

(1) Purchased loan balances include loans held for sale of $789 thousand.

(2) 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, which includes loans held for sale, on an annualized basis. The total return does not include the effect of purchased loan charge-offs or recoveries in the quarter. The total return presented is a non-GAAP measure.

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Assets

Cash, Short-term Investments and Securities

Cash and short-term investments were $126.2 million as of September 30, 2016, a decrease of $24.9 million, or 16.5%, from $151.2 million at June 30, 2016. The decrease is primarily due to the increase in loans, offset by the increase in deposits in the period.

Available-for-sale securities totaled $94.6 million as of September 30, 2016, compared to $100.6 million as of June 30, 2016, representing a decrease of $6.0 million, or 6.0% due to the maturity of securities issued by government agencies as well as principal payments on mortgage backed securities. Included in available-for-sale securities are securities issued by government agencies and government-sponsored enterprises, as well as an investment of approximately $5.2 million in a CRA qualified fund that seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies. At September 30, 2016, no securities were pledged for outstanding borrowings.

Loans

The Company's loan portfolio (excluding loans held-for-sale) by lending division follows:

	September 30, 2016					
	Community Banking Division	LASG	SBA Division	Total	Percent of Total	
	(Dollars in thousands)					
Originated loans:						
Residential real estate	$90,097	$-	$133	$90,230	12.51	%
Home equity	17,098	-	-	17,098	2.37	%
Commercial real estate: non-owner occupied	50,246	56,801	9,341	116,388	16.13	%
Commercial real estate: owner occupied	19,173	66,657	16,018	101,848	14.12	%

Commercial and industrial	16,639	131,290	6,079	154,008	21.35	%
Consumer	5,532	-	-	5,532	0.77	%
Subtotal	198,785	254,748	31,571	485,104	67.25	%
Purchased loans:						
Residential real estate	-	2,895	-	2,895	0.40	%
Commercial real estate: non-owner occupied	-	132,911	-	132,911	18.42	%
Commercial real estate: owner occupied	-	98,406	-	98,406	13.64	%
Commercial and industrial	-	2,102	-	2,102	0.29	%
Subtotal	-	236,314	-	236,314	32.75	%
Total	$198,785	$491,062	$31,571	$721,418	100.00	%

	June 30, 2016 Community Banking Division (Dollars in thousands)	LASG	SBA Division	Total	Percent of Total	
Originated loans:						
Residential real estate	$ 93,258	$ -	$ 133	$ 93,391	13.49	%
Home equity	18,012	-	-	18,012	2.60	%
Commercial real estate: non-owner occupied	49,514	52,744	5,639	107,897	15.58	%
Commercial real estate: owner occupied	20,578	46,727	14,414	81,719	11.80	%
Commercial and industrial	16,069	123,447	6,242	145,758	21.05	%
Consumer	5,950	-	-	5,950	0.86	%
Subtotal	203,381	222,918	26,428	452,727	65.38	%
Purchased loans:						
Residential real estate	-	2,559	-	2,559	0.37	%
Commercial real estate: non-owner occupied	-	142,286	-	142,286	20.55	%
Commercial real estate: owner occupied	-	94,666	-	94,666	13.67	%
Commercial and industrial	-	198	-	198	0.03	%
Subtotal	-	239,709	-	239,709	34.62	%
Total	$ 203,381	$ 462,627	$ 26,428	$ 692,436	100.00	%

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Classification of Assets

Loans are classified as non-performing when 90 or more 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.

The following table details the Company's nonperforming assets and other credit quality indicators as of September 30, 2016 and June 30, 2016. Management believes that, based on their carrying amounts, nonperforming assets are well secured based on the estimated fair value of underlying collateral.

	Non-Performing Assets at September 30, 2016		
	Originated	Purchased	Total
	(Dollars in thousands)		
Loans:			
Residential real estate	$3,273	$ 1,107	$4,380
Home equity	48	-	48
Commercial real estate	361	3,618	3,979
Commercial and industrial	347	48	395

Consumer	121	-	121
Subtotal	4,150	4,773	8,923
Real estate owned and other repossessed collateral	764	3,010	3,774
Total	$4,914	$ 7,783	$12,697
Ratio of nonperforming loans to total loans			1.24 %
Ratio of nonperforming assets to total assets			1.29 %
Ratio of loans past due to total loans			1.36 %
Nonperforming loans that are current			$1,682
Commercial loans risk rated substandard or worse			$3,558
Troubled debt restructurings:			
On accrual status			$6,456
On nonaccrual status			$1,320

	Non-Performing Assets at June 30, 2016		
	Originated	Purchased	Total
	(Dollars in thousands)		
Loans:			
Residential real estate	$2,613	$ 1,125	$3,738
Home equity	48	-	48
Commercial real estate	474	3,387	3,861
Commercial and industrial	17	-	17
Consumer	163	-	163
Subtotal	3,315	4,512	7,827
Real estate owned and other repossessed collateral	830	822	1,652
Total	$4,967	$ 4,512	$9,479
Ratio of nonperforming loans to total loans			1.13 %
Ratio of nonperforming assets to total assets			0.96 %
Ratio of loans past due to total loans			1.00 %
Nonperforming loans that are current			$2,271
Commercial loans risk rated substandard or worse			$4,518
Troubled debt restructurings:			
On accrual status			$7,036
Nonaccrual status			$1,152

At September 30, 2016, nonperforming assets totaled $12.7 million, or 1.29% of total assets, as compared to $9.5 million, or 0.96% of total assets, at June 30, 2016. The increase is largely due to one loan added to OREO and the effect of loans acquired in the current quarter which were classified as non-performing upon purchase.

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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 $2.5 million as of September 30, 2016, which represents an increase of $156 thousand from $2.4 million as of June 30, 2016. The increase during the period was principally due to loan growth in the quarter.

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

	September 30, 2016	June 30, 2016	September 30, 2015
Allowance for loan losses to nonperforming loans	28.08%	30.02%	19.11%
Allowance for loan losses to total loans	0.35%	0.34%	0.33%
Last twelve months of net-charge offs to average loans	0.18%	0.18%	0.03%

While management believes that it uses the best information available to make its determinations with respect to the allowance for loan losses, there can be no assurance that the Company will not have to increase its provision for loan losses in the future as a result of changing economic conditions, adverse markets for real estate or other factors.

Other Assets

The cash surrender value of the Company's bank-owned life insurance ("BOLI") assets increased $114 thousand, or 0.7% to $15.8 million at September 30, 2016, compared to $15.7 million at June 30, 2016. Increases in cash surrender value are recognized in other income and are not subject to income taxes. Borrowing on, or surrendering a policy, may subject the Company to income tax expense on the increase in cash surrender value. For these reasons, management considers BOLI an illiquid asset. BOLI represented 11.5% of the Company's total capital at September 30, 2016.

Intangible assets totaled $1.6 million and $1.7 million at September 30, 2016 and June 30, 2016, respectively. The $109 thousand decrease was the result of core deposit intangible asset amortization during the period.

Deposits, Borrowed Funds, Subordinated Debt, Liquidity, Capital, and Stock Repurchases

Deposits

The Company's principal source of funding is its core deposit accounts. At September 30, 2016, non-maturity accounts, and certificates of deposit with balances less than $250 thousand represented 99.9% of total deposits.

Total deposits increased $5.0 million to $805.4 million as of September 30, 2016 from $800.4 million as of June 30, 2016. The increase, which funded growth in the Company's loan portfolio, was centered mainly in money market accounts attracted through the Bank's Community Banking Division.

The composition of total deposits at September 30, 2016 and June 30, 2016 is as follows:

	September 30, 2016		June 30, 2016	
	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)			
Demand deposits	$74,249	9.22 %	$66,686	8.33 %
NOW accounts	71,853	8.92 %	71,148	8.89 %
Regular and other savings	35,512	4.41 %	36,070	4.51 %
Money market deposits	302,079	37.51 %	275,437	34.41 %
Total non-certificate accounts	483,693	60.06 %	449,341	56.14 %
Term certificates less than $250 thousand	321,215	39.88 %	351,091	43.86 %
Term certificates of $250 thousand or more	501	0.06 %	-	0.00 %
Total certificate accounts	321,716	39.94 %	351,091	43.86 %
Total deposits	$805,409	100.00 %	$800,432	100.00 %

Borrowed Funds

Advances from the FHLBB were $30.0 million at September 30, 2016, as compared to $30.1 million at June 30, 2016. At September 30, 2016, the Company had pledged certain residential real estate loans, commercial real estate loans, and FHLBB deposits free of liens or pledges to secure outstanding advances and provide additional borrowing capacity. At September 30, 2016, no securities were pledged for outstanding borrowings.

Subordinated Debt

On June 29, 2016, the Company entered into a Subordinated Note Purchase Agreement with certain institutional accredited investors pursuant to which the Company sold and issued subordinated notes equal to $15.05 million in aggregate principal amount with an interest rate of 6.75% fixed-to-floating maturing in 2026 (“subordinated notes”). The subordinated notes, net of issuance costs of $524 thousand, totaled $14.5 million at both September 30, 2016 and June 30, 2016, respectively.

The Company had junior subordinated debentures issued to affiliated trusts totaling $8.9 million and $8.8 million at September 30, 2016 and June 30, 2016, respectively.

Liquidity

The following table is a summary of unused borrowing capacity of the Company at September 30, 2016, in addition to traditional retail deposit products (dollars in thousands):

Brokered time deposits	$ 246,392	Subject to policy limitation of 25% of total assets
Federal Home Loan Bank of Boston	68,478	Unused advance capacity subject to eligible and qualified collateral
Federal Discount Window Borrower-in-Custody	1,742	Unused credit line subject to the pledge of loans
Other available lines	17,500	
Total unused borrowing capacity	$ 334,112	

Retail deposits and other core deposit sources including deposit listing services are used by the Bank to manage its overall liquidity position. While we currently do not seek wholesale funding such as FHLBB advances and brokered deposits, the ability to raise them remains an important part of our liquidity contingency planning. While we closely monitor and forecast our liquidity position, it is affected by asset growth, deposit withdrawals and meeting other contractual obligations and commitments. The accuracy of our forecast assumptions may increase or decrease our overall available liquidity. To utilize the FHLBB advance capacity, the purchase of additional capital stock in the Federal Home Loan Bank of Boston may be required.

At September 30, 2016, the Company had $411.2 million of immediately accessible liquidity, defined as cash that the Bank reasonably believes could be raised within seven days through collateralized borrowings, brokered deposits or security sales. This position represented 41.9% of total assets. The Company also had $126.2 million of cash and cash equivalents at September 30, 2016.

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 unpaid principal balance and carrying amount of junior subordinated debentures totaled $16.5 million and $8.9 million, respectively, as of September 30, 2016. This debt represents qualifying Tier 1 capital for the Company, up to a maximum of 25% of total Tier 1 capital. At September 30, 2016, 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 September 30, 2016, shareholders' equity was $111.6 million, a decrease of $5.0 million, or 4.3% from June 30, 2016. Book value per outstanding common share was $12.63 at September 30, 2016 and $12.51 at June 30, 2016. Tier 1 capital to total average assets of the Company was 12.25% as of September 30, 2016 and 13.27% at June 30, 2016.

Under the capital rules, risk-based capital ratios are calculated by dividing Tier 1 and total capital, respectively, by risk-weighted assets. Assets and off-balance sheet credit equivalents are assigned to one of several risk-weight categories, based primarily on relative risk. The rules require banks and bank holding companies to maintain a minimum common equity Tier 1 capital ratio of 4.5%, a minimum Tier 1 capital ratio of 6%, a total capital ratio of 8% and a leverage ratio of 4%. Additionally, subject to a transition schedule, the capital rules require a bank holding company to establish a capital conservation buffer of 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.

A bank holding company, such as the Company, is considered "well capitalized" if the bank holding company (i) has a total 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 revised capital rules described above. Under the FDIC's revised rules, which became effective January 1, 2015, an insured state nonmember bank is considered "well capitalized" if it (i) has a total 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 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.

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The Company and the Banks are considered "well capitalized" under all regulatory definitions. The Company's and the Bank's regulatory capital ratios are set forth below.

	Actual		Minimum Capital Requirements		Minimum To Be Well Capitalized Under Prompt Correction Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Dollars in thousands)					
September 30, 2016:						
Common equity tier 1 capital to risk weighted assets:						
Company	$112,672	15.35%	$ 33,024	≥4.5%	$ N/A	N/A
Bank	119,472	16.27%	33,048	≥4.5%	47,736	≥6.5%
Total capital to risk weighted assets:						
Company	138,130	18.82%	58,709	≥8.0%	N/A	N/A
Bank	122,243	16.65%	58,753	≥8.0%	73,441	≥10.0%
Tier 1 capital to risk weighted assets:						
Company	121,043	16.49%	44,032	≥6.0%	N/A	N/A
Bank	119,472	16.27%	44,064	≥6.0%	58,753	≥8.0%
Tier 1 capital to average assets:						
Company	121,043	12.25%	39,538	≥4.0%	N/A	N/A
Bank	119,472	12.09%	39,542	≥4.0%	49,428	≥5.0%
June 30, 2016:						
Common equity tier 1 capital to risk weighted assets:						
Company	$126,046	17.97%	$ 31,559	≥4.5%	$ N/A	N/A
Bank	117,212	16.69%	31,611	≥4.5%	45,660	≥6.5%
Total capital to risk weighted assets:						
Company	142,988	20.39%	56,105	≥8.0%	N/A	N/A
Bank	119,971	17.08%	56,197	≥8.0%	70,246	≥10.0%
Tier 1 capital to risk weighted assets:						