



2016 ANNUAL REPORT



Richard Wayne  
President and Chief Executive Officer

“ I believe that we  
have built significant  
franchise value through  
our diversified lending  
and deposit gathering  
platforms. ”

## Dear Shareholders,

It is with great pleasure that I report on the results of fiscal 2016. Over the past year, we continued to execute on our business plan and focus on our commitment to the Company's shareholders. This commitment is singularly focused on producing quality and consistent returns from our balance sheet, funding our growth cost-effectively with core deposits, and increasing shareholder value through prudent capital management.

Year over year, Northeast grew earnings per share by 11% to \$0.80 and had a return on equity of 6.7%. This increase in earnings was driven largely by net loan growth of 13.1%, a solid net interest margin of 4.59%, transactional interest income resulting from the resolution of loans purchased at a discount, fee income from the sale of the guaranteed portion of Small Business Administration (“SBA”) and United States Department of Agriculture (“USDA”) loans into the secondary market, and keeping our operating expenses in check.

To achieve our goals, we remain focused on building our franchise through the implementation of the following business 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 the Loan Acquisition and Servicing Group's (“LASG”) national origination and purchase 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 and USDA origination business.** We originate loans on a national basis to small businesses benefitting from partial guarantees from the SBA or USDA.
- **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 and ableBanking, our online savings platform. We also offer state-of-the-art cash management services.

## Community Banking Division

In the Community Banking Division, we continued to further our small business lending across Maine in order to foster job creation and support local businesses. Working within a very

competitive market, our community bank lenders had success in originating new loans, which aggregated \$22 million for the year, and maintaining strong relationships with our existing customer base.

Our Residential Mortgage Division had another strong year, generating \$93.8 million in originations for fiscal 2016. We sold a significant portion of these loans into the secondary market and realized gains on sale totaling \$1.7 million.

As part of our ongoing efforts to support our communities, we continue to devote both monetary and volunteer resources to worthwhile local non-profit organizations. Our Community Involvement Volunteer Program continues to be a key driver of employee engagement. With two days annually made available for community service, this program allows our 175+ employees to mobilize in response to community needs and the causes they are passionate about.

## LASG

Our LASG continued to build its national commercial loan portfolio, generating \$210.6 million in new purchases and originations in fiscal 2016, and achieving net growth of 21%, or \$81.6 million. During the year, we purchased loans with an aggregate unpaid principal balance of \$108.7 million at an aggregate purchase price of \$100 million. At June 30, 2016, net of pay-downs, payoffs and sales, the purchased loan portfolio stood at \$239.7 million, and produced a total return of 11.4% for the year; a measure that includes both interest income and gains on asset sales.

In addition, the LASG team has continued to grow the commercial origination platform to supplement purchasing activities and to further leverage the team's expertise. Excluding secured loans to broker-dealers, the originated portfolio grew by 48% to \$175 million at June 30, 2016, and earned an average yield of 6.11%.

## SBA Division

In fiscal 2016, we continued to capitalize on our national credit platform by growing our SBA division. In the past year, we originated \$54.5 million of SBA and USDA loans and sold \$39 million of the guaranteed portion of these loans into the secondary market at premiums ranging from 108.8% to 117.6%, realizing net gains of \$4.2 million for the year.

## Deposits

We rely on three channels to generate the deposits necessary to fund asset growth: our ten retail branches across Maine; our direct savings platform, ableBanking; and time deposits through

deposit listing services. In the past year we had net deposit growth of approximately \$125 million or 19%. In fiscal 2016, 96% of the net growth was due to an increase in our non-maturity accounts which consist of our money market, savings and demand deposit products. The growth in these core deposit products has strengthened our overall deposit mix such that non-maturity accounts represent approximately 56% of total deposits as of June 30, 2016.

## Capital Management

The Company remains dedicated to increasing shareholder value through the sound execution of our business strategies and prudent capital management. In the past year, because we believed that our shares were undervalued, we repurchased 322,900 shares of Northeast stock at an average share price of \$10.40.

In addition, in fiscal 2016 the Company issued \$15.05 million of subordinated notes that qualify for Tier 2 capital treatment. The subordinated notes will allow us to continue to implement our growth strategy, and diversify our capital mix, with a source of non-dilutive, low-cost capital.

With the share buyback and issuance of subordinated notes, our capital position remains strong, with a Tier 1 leverage ratio of 13.27% and a Total capital ratio of 20.39%.

\* \* \*

I am very proud of our achievements in fiscal 2016, and excited about what the future holds for our Company and shareholders. I believe that we have built significant franchise value through our diversified lending and deposit gathering platforms. Each day, our management team and Board are focused on achieving the goals that we set for ourselves at the beginning of each fiscal year. We believe our operational capacity, lending expertise and capital resources leave us very well-positioned to achieve those goals.

Thank you for your continued support.

Sincerely,



Richard Wayne

President and Chief Executive Officer



**United States**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended June 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from to

Commission file number (1-14588)

**NORTHEAST BANCORP**

(Exact name of registrant as specified in its charter)

Maine  
(State or other jurisdiction of incorporation or organization)

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

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

04240  
(Zip Code)

Registrant's telephone number, including area code: (207) 786-3245

Securities registered pursuant to Section 12(b) of the Act:

Title of each class:  
Voting Common Stock, \$1.00 par value

Name of each exchange on which registered:  
The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 subject 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 Website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated filer

Non-accelerated filer  Smaller Reporting Company

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

The aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates, computed by reference to the last reported sales price of the registrant's voting common stock on the NASDAQ Global Market on December 31, 2015 was approximately \$76,592,849.

As of September 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.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's proxy statement for the 2016 Annual Meeting of Shareholders to be held on November 22, 2016 are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K. The registrant intends to file such proxy statement with the Securities and Exchange Commission no later than 120 days after the end of its fiscal year ended June 30, 2016.

**EXPLANATORY NOTE**

The Company has determined that as of the end of its fiscal year ended June 30, 2016, it is an accelerated filer as defined in Rule 12b-2 promulgated under the Securities Exchange Act of 1934, as amended. As permitted by Item 10(f) of Regulation S-K, the Company is providing scaled disclosure applicable to smaller reporting companies in this Annual Report on Form 10-K.

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## Table of Contents

### Part I.

Item 1. Business.....	1
Item 1A. Risk Factors.....	16
Item 1B. Unresolved Staff Comments.....	24
Item 2. Properties.....	24
Item 3. Legal Proceedings .....	24
Item 4. Mine Safety Disclosures.....	24

### Part II

Item 5. Market for Registrant’s Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities.....	25
Item 6. Selected Financial Data .....	27
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations .....	28
Item 7A. Quantitative and Qualitative Disclosures About Market Risk.....	48
Item 8. Financial Statements and Supplementary Data .....	49
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure .....	93
Item 9A Controls and Procedures.....	93
Item 9.B Other Information.....	96

### Part III

Item 10. Directors, Executive Officers and Corporate Governance .....	96
Item 11. Executive Compensation .....	96
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters	96
Item 13. Certain Relationships and Related Transactions, and Director Independence .....	96
Item 14. Principal Accounting Fees and Services.....	96

### Part IV

Item 15. Exhibits, Financial Statement Schedules .....	97
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## **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 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, finance sources and revenue sources of Northeast Bancorp ("we," "our," "us," "Northeast" or the "Company"). These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management's projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward looking statements, which are based on various assumptions (some of which are beyond the Company's control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as "believe", "expect", "estimate", "anticipate", "continue", "plan", "approximately", "intend", "objective", "goal", "project", or other similar terms or variations on those terms, or the future or conditional verbs such as "will", "may", "should", "could", and "would".

Such forward-looking statements reflect our current views and expectations based largely on information currently available to our management, and on our current expectations, assumptions, plans, estimates, judgments, and projections about our business and our industry, and they involve inherent risks and uncertainties. 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, the factors referenced in this report under Item 1A. "Risk Factors"; changes in interest rates; competitive pressures from other financial institutions; the effects of a deterioration 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 our 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 we may not be successful in the implementation of our business strategy; the risk that intangibles recorded in the Company's financial statements will become impaired; and changes in assumptions used in making such forward-looking statements. 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.



## PART I

### Item 1. Business

#### Overview

Northeast Bancorp, incorporated under Maine law in 1987, is a bank holding company, registered with the Board of Governors of the Federal Reserve System (the "Federal Reserve") under the Bank Holding Company Act of 1956, as amended. 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.

On December 29, 2010, the merger of the Company and FHB Formation LLC, a Delaware limited liability company ("FHB"), was consummated. 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 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 capital. On June 28, 2013, the Federal Reserve approved the amendment of the commitment to hold commercial real estate loans to within 300% of total capital to exclude owner-occupied commercial real estate loans. 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.

As of June 30, 2016, the Company, on a consolidated basis, had total assets of \$986.2 million, total deposits of \$800.4 million, and shareholders' equity of \$116.6 million. We gather retail deposits through the Community Banking Division's ten full-service branches in Maine and through its online deposit program, ableBanking; originate loans through the Community Banking Division; purchase and originate commercial loans on a nationwide basis through the Bank's Loan Acquisition and Servicing Group ("LASG"); and originate Small Business Administration ("SBA") loans on a nationwide basis through the Bank's national SBA group ("SBA Division").

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.

#### Market Area and Competition

The Community Banking Division's market area includes the six New England states, with the majority of its activities centered in the western and central regions of the State of Maine. We encounter significant competition in the Community Banking Division market area in originating loans, attracting deposits, and selling other customer products and services. Our competitors include savings banks, commercial banks, credit unions, mutual funds, insurance companies, brokerage and investment banking companies, finance companies, and other financial intermediaries. Many of our primary competitors there have substantially greater resources, larger established customer bases, higher lending limits, extensive branch

networks, numerous ATMs and greater advertising and marketing budgets. They may also offer services that we do not currently provide. ableBanking has nationwide scope in its deposit gathering activities and competes with banks and credit unions, as well as other, larger, online direct banks having a national reach.

The LASG, the SBA Division and ableBanking activities are nationwide. The LASG competes primarily with community banks, regional banks and private equity funds operating nationwide in its bid to acquire commercial loans. We believe that we often have a competitive advantage in bidding against private equity funds on performing loans because those funds generally have higher funding costs and, therefore, higher expectations for return on investment than we do. Furthermore, private equity funds typically do not compete for small balance commercial loans and typically pursue larger, bulk transactions. Due to improving credit quality over the past several years and the continued low interest rate environment, the supply of loans available for purchase has declined, competition has increased, and spreads have tightened. Despite these trends, we believe that the LASG continues to have a competitive advantage in bidding against other banks because we have a specialized group with experience in purchasing commercial real estate loans. Additionally, most banks we compete against are community banks looking to acquire loans in their market; these banks usually have specific criteria for their acquisition activities and do not pursue pools with collateral or geographic diversity.

The SBA Division competes primarily with community banks, regional banks, national/global banks, and non-bank licensed lenders on a nationwide basis. Capitalizing on our LASG origination loan infrastructure, the SBA Division is in a position to review and act quickly on a variety of lending opportunities. Risk management, approvals, underwriting and other due diligence for these loans is similar to that for the LASG loans. We believe that the SBA Division has an advantage in originating commercial loans because of its ability to utilize in-house staff to quickly and accurately screen loan opportunities and accelerate the underwriting process.

## **Lending Activities**

### ***General***

We conduct our loan-related activities through three primary channels: the Community Banking Division, the LASG, and the SBA Division. The Community Banking Division originates loans directly to consumers and businesses located in its market area. The LASG purchases primarily performing commercial real estate loans, on a nationwide basis, typically at a discount from their outstanding principal balances, producing yields higher than those normally achieved on the Company's originated loan portfolio. The LASG also originates commercial real estate and commercial and industrial loans on a nationwide basis. The SBA Division originates loans to small businesses, primarily through the SBA 7(a) program, which provides the partial guarantee of the SBA. At June 30, 2016, our total loan portfolio (excluding loans held for sale) was \$692.4 million, of which \$203.4 million, or 29.4%, was originated by the Community Banking Division, \$462.6 million, or 66.8%, was purchased or originated by the LASG and \$26.4 million, or 3.8%, was originated by the SBA Division.

The following table sets forth certain information concerning our portfolio loan purchases and originations for the periods indicated (including loans held for sale):

	Year Ended June 30,	
	2016	2015
	(Dollars in thousands)	
Loans, including loans held for sale, beginning of year.....	\$ 621,172	\$ 528,361
Additions:		
LASG Purchases and Originations:		
Originations.....	110,578	130,502
Purchases.....	99,999	82,654
Subtotal.....	210,577	213,156
SBA Division Originations.....	54,469	34,544
Community Bank Originations:		
Residential mortgages held for sale .....	90,011	97,438
Residential mortgage held to maturity .....	3,828	7,857
Home equity.....	765	1,024
Commercial real estate.....	15,029	13,580
Commercial and industrial.....	6,973	6,317
Consumer.....	185	211
Subtotal.....	116,791	126,427
Total originations and purchases .....	381,837	374,127
Reductions:		
Sales of residential loans held for sale.....	(89,901)	(106,045)
Sales of portfolio loans .....	(39,081)	(22,351)
Charge-offs .....	(1,265)	(238)
Pay-downs and amortization, net.....	(172,807)	(152,682)
Total reductions .....	(303,054)	(281,316)
Loans, including loans held for sale, end of year .....	\$ 699,955	\$ 621,172
Annual percentage increase in loans .....	12.68%	17.57%

We individually underwrite all loans that we originate and purchase. Our loan underwriting policies are reviewed and approved annually by our Board of Directors. Each loan, regardless of whether it is originated or purchased, must meet underwriting criteria set forth in our lending policies and the requirements of applicable federal and state regulations. All loans are subject to approval procedures and amount limitations, and the Board approves loan relationships exceeding certain prescribed dollar limits. Our policies are reviewed and approved at least annually by our Board of Directors. We supplement our own supervision of the loan underwriting and approval process with periodic loan audits by internal personnel and outside professionals experienced in loan review. As of June 30, 2016, the Bank's legal lending limit was \$24.0 million.

We typically retain servicing rights for all loans that we originate or purchase, except for residential loans that we originate and sell servicing released in the secondary market.

### ***Community Banking Division Originations***

*Loan Portfolio.* The Community Banking Division's loan portfolio consists primarily of loans to businesses and consumers in the Community Banking Division's market area.

- *Residential Mortgage Loans.* We originate residential mortgage loans secured by one- to four-family properties throughout Maine, southern New Hampshire, and Massachusetts. Such loans may be originated for sale in the secondary market or to be held on the Bank's balance sheet. We also offer home equity loans and home equity lines of credit, which are secured by first or second mortgages on one- to four-family owner-occupied properties and which are held on our balance sheet. At June 30, 2016, portfolio residential loans totaled \$111.3 million, or 16.1% of total loans. Of the residential loans we held for investment at June 30, 2016, approximately 51.6% were adjustable rate. Included in residential loans are home equity lines of credit and other second mortgage loans aggregating approximately \$18.0 million.

- *Commercial Real Estate Loans.* We originate multi-family and other commercial real estate loans secured by property located primarily in the Community Banking Division's market area. At June 30, 2016, commercial real estate loans outstanding were \$70.1 million, or 10.1% of total loans. Although the largest commercial real estate loan originated by the Community Banking Division had a principal balance of \$4.1 million at June 30, 2016, the majority of the commercial real estate loans originated by the Community Banking Division had principal balances less than \$500 thousand.
- *Commercial and industrial Loans.* We originate commercial and industrial loans, including term loans, lines of credit and equipment and receivables financing to businesses located primarily in the Community Banking Division's market area. At June 30, 2016, commercial and industrial loans outstanding were \$16.1 million, or 2.3% of total loans. At June 30, 2016, there were 112 commercial and industrial loans outstanding with an average principal balance of \$143 thousand. The largest of these commercial and industrial loans had a principal balance of \$2.3 million at June 30, 2016.
- *Consumer Loans.* We originate, on a direct basis, automobile, boat and recreational vehicle loans. At June 30, 2016, consumer loans outstanding were \$6.0 million, or 0.9% of total loans.

*Underwriting of Loans.* Most residential loans, including those held for investment, are originated in accordance with the standards of the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Federal Housing Authority, or other third party correspondent lenders. Our underwriting process for all other loans originated by the Community Banking Division is as follows:

- Most of our Community Bank originated loans are sourced through relationships between loan officers and third party referral sources or current or previous customers.
- After a loan officer has taken basic information from the borrower, the request is submitted to the Community Banking Division's loan production department. The loan production department obtains comprehensive information from the borrower and third parties, and conducts verification and analysis of the borrower information, which is assembled into a single underwriting package that is submitted for final approval.

#### ***LASG Purchases and Originations***

*General.* Of the loans originated or purchased by the LASG that were outstanding as of June 30, 2016, \$336.4 million, or 72.7%, consisted of commercial real estate loans. The following table summarizes the LASG loan portfolio as of June 30, 2016:

	Purchased	(Dollars in thousands)		Total
		Originated		
Non-owner occupied commercial real estate .....	\$ 142,286	\$ 52,744	\$	195,030
Owner occupied commercial real estate.....	94,666	46,727		141,393
Commercial and industrial .....	198	123,447		123,645
1-4 family residential .....	2,559	-		2,559
Total .....	<u>\$ 239,709</u>	<u>\$ 222,918</u>	<u>\$</u>	<u>462,627</u>

Since the inception of the LASG through June 30, 2016, we have purchased loans for an aggregate investment of \$486 million, of which \$100.0 million was purchased during fiscal 2016. We have also originated loans totaling \$346 million, of which \$110.6 million was originated in fiscal 2016. As of June 30, 2016, the unpaid principal balance of loans purchased or originated by the LASG ranged from \$1 thousand to \$12.0 million and, excluding secured loans to broker-dealers, have an average balance of \$756 thousand. Included in the balance are non-real estate secured loans to broker-dealers, which have balances of \$12.0 million each. The real estate loans were secured principally by retail, industrial, hospitality, multi-family and office properties in 36 states.

The following table shows the LASG loan portfolio stratified by book value as of June 30, 2016, excluding deferred fees and costs:

Range	Amount	Percent of Total
(Dollars in thousands)		
\$0 - \$500 .....	\$ 58,644	12.69%
\$500 - \$1,000 .....	74,481	16.12%
\$1,000 - \$2,000 .....	105,202	22.77%
\$2,000 - \$3,000 .....	54,915	11.89%
\$3,000 - \$4,000 .....	37,313	8.08%
Greater than \$4,000 .....	131,487	28.45%
	\$ 462,042	100.00%

The following tables show the LASG loan portfolio by location and type of collateral as of June 30, 2016, excluding deferred fees and costs:

Collateral Type	Amount	Percent of Total	State	Amount	Percent of Total
	(Dollars in thousands)			(Dollars in thousands)	
Multifamily .....	\$ 42,881	9.28%	CA .....	\$ 65,591	14.20%
Office .....	37,809	8.18%	NY .....	69,300	15.00%
Hospitality .....	67,450	14.60%	NJ .....	32,586	7.05%
Retail .....	70,266	15.21%	FL .....	14,958	3.24%
Industrial .....	67,970	14.71%	AZ .....	17,858	3.86%
Securities .....	54,346	11.76%	IL .....	14,461	3.13%
Other real estate....	37,084	8.03%	TX .....	19,349	4.19%
All other .....	84,236	18.23%	Non-real estate ..	74,164	16.05%
	\$ 462,042	100.00%	All other .....	153,775	33.28%
				\$ 462,042	100.00%

*Loan Purchase Strategies.* The LASG's loan purchasing strategy involves the acquisition of commercial loans, typically secured by real estate or other business assets located throughout the United States.

We acquire commercial loans typically at a discount to their unpaid principal balances. While we acquire loans on a nationwide basis, we seek to avoid significant concentration in any geographic region or in any one collateral type. We do not seek acquisition opportunities for which the primary collateral is land, construction, or one- to four-family residential property, although in a very limited number of cases, loans secured by such collateral may be included in a pool of otherwise desirable loans. Purchased loans are sourced on a nationwide basis from banks, insurance companies, investment funds and government agencies, either directly or indirectly through advisors.

We focus on servicing released, whole loan or lead participation transactions so that we can control the management of the portfolio through our experienced asset management professionals. Purchased loans can be acquired as a single relationship or combined with other borrowers in a larger pool. Loans are bid to a minimal acceptable yield to maturity based on the overall risk of the loan, including expected repayment terms and the underlying collateral value. Updated loan-to-value ratios and loan terms both influence the amount of discount the Bank requires in determining whether a loan meets the Bank's guidelines. We often achieve actual results in excess of our minimal acceptable yield to maturity when a loan is prepaid.

At June 30, 2016, purchased loans had an unpaid principal balance of \$271.3 million and a book value of \$239.7 million, representing discount across the portfolio of 11.6%.

The following table shows the purchased loan portfolio as of June 30, 2016 by original purchase price percentage:

Initial Investment as a % of Unpaid Principal Balance	Amount	Percent of Total
	(Dollars in thousands)	
0% - 60%.....	\$ 4,355	1.82%
60% - 70%.....	4,065	1.70%
70% - 80%.....	21,412	8.93%
80% - 90%.....	62,959	26.26%
>90%.....	146,918	61.29%
	\$ 239,709	100.00%

*Secondary Market for Commercial Loans.* Commercial whole loans are typically sold either directly by sellers or through loan sale advisors. Because a central database for commercial whole loan transactions does not exist, we attempt to compile our own statistics by both polling major loan sale advisors to obtain their aggregate trading volume and tracking the deal flow that we see directly via a proprietary database. This data reflects only a portion of the total market, as commercial whole loans that are sold in private direct sales or through other loan sale advisors are not included in our surveys. In recent years, the ratio of performing loans to total loans in the market has increased, in part, because sellers have worked through their most troubled, non-performing loans or are looking to minimize the discount they would receive in a secondary market transaction. While the 2008-2010 economic crisis led to a high level of trading volume, we also expect the market to remain active in times of economic prosperity, as sellers tend to have additional reserve capacity to sell their unwanted assets. Furthermore, we believe that the continued consolidation of the banking industry will create secondary market activity as acquirers often sell non-strategic borrowing relationships or assets that create excess loan concentrations.

*Underwriting of Purchased Loans.* We review many loan purchase opportunities and commence underwriting on a relatively small percentage of them. During fiscal 2016, we reviewed approximately 105 transactions representing loans with \$799.8 million in unpaid principal balance. Of those transactions that we reviewed, we placed bids in 61 transactions representing loans with \$255.7 million in unpaid principal balance. Ultimately, we closed 35 transactions in which we acquired \$108.7 million in unpaid principal balance for an aggregate purchase price of \$100.0 million, or 92.0% of the unpaid principal balance.

Purchased loans are underwritten by a team of in-house, seasoned analysts before being considered for approval. Prior to commencing underwriting, loans are analyzed for performance characteristics, loan terms, collateral quality, and price expectations. We also consider whether the loans would make our total purchased loan portfolio more or less diverse with respect to geography, loan type and collateral type. The opportunity is underwritten once it has been identified as fitting our investment parameters. While the extent of underwriting may vary based on investment size, procedures generally include the following:

- A loan analyst reviews and analyzes the seller credit file and our own internal and third party research in order to assess credit risk.
- With the assistance of local counsel, where appropriate, an in-house attorney makes a determination regarding the quality of loan documentation and enforceability of loan terms.
- An in-house real estate specialist performs real estate collateral evaluations, which includes conducting original market research for trends and sale and lease comparables, and develops a valuation based on current data reflecting what we believe are recent trends.
- An environmental assessment is performed on real estate collateral where appropriate.
- A property inspection is generally performed on all real estate collateral securing a loan, focusing on several characteristics, including, among other things, the physical quality of the property, current occupancy, general quality and occupancy within the neighborhood, market position and nearby property listings.
- An underwriting package containing the analysis and results is reviewed and submitted for approval by the LASG Credit Committee.

*Collateral Valuation.* The estimated value of the real property collateralizing the loan is determined by the LASG's in-house real estate group, which considers, among other factors, the type of property, its condition, location and its highest and best use in its marketplace. An inspection is conducted for the real property securing all loans bid upon. For loans that exceed a certain dollar threshold as prescribed in our credit policy, members of the LASG typically conduct an in-person site inspection.

We generally view cash flow from operations as the primary source of repayment on purchased loans. The LASG analyzes the current and likely future cash flows generated by the collateral to repay the loan. Also considered are minimum debt service coverage ratios, consisting of the ratio of net operating income to total principal and interest payments. Consideration of the debt service coverage ratio is critical to the pricing and rating of purchased and originated loans, and is analyzed carefully. For purchased loans, care is taken to ensure that, unless significantly offset by other factors in the credit, the purchase price results in an adjusted debt service coverage ratio that is within the Bank's lending limits. Moreover, if the debt service coverage ratio based on the contractual payments, regardless of the Bank's exposure, is significantly below 1.0x, then steps are taken to document alternative sources of repayment or develop a realistic plan to ensure continued performance of the loan.

*Loan Pricing.* In determining the amount that we are willing to bid to acquire individual loans or loan pools, the LASG considers the following:

- Collateral securing the loan;
- Geographic location;
- Financial resources of the borrower or guarantors, if any;
- Recourse nature of the loan;
- Age and performance of the loan;
- Length of time during which the loan has performed in accordance with its repayment term;
- Yield expected to be earned; and
- Servicing restrictions, if any.

In addition to the factors listed above and despite the fact that purchased loans are typically performing loans, the LASG also estimates the amount that we may realize through collection efforts or foreclosure and sale of the collateral, net of expenses, and the length of time and costs required to complete the collection or foreclosure process in the event a loan becomes non-performing or is non-performing at the time of purchase.

*Loan Originations.* In addition to purchasing loans, the LASG also originates commercial loans on a nationwide basis. Capitalizing on our purchased loan infrastructure, the LASG is in a position to review and act quickly on a variety of lending opportunities. Risk management, approvals, underwriting and other due diligence for these loans is similar to that for purchased loans, other than the appraisal and documentation process, which mirrors the Community Banking Division's practice of employing local attorneys and real estate appraisers to assist in the process. We believe that the LASG has an advantage in originating commercial loans because of its ability to utilize in-house staff to quickly and accurately screen loan opportunities and accelerate the underwriting process.

*Loan Servicing.* We conduct all loan servicing for purchased and originated loans with an in-house team of experienced asset managers who actively manage the loan portfolio. Asset managers initiate and maintain regular borrower contact, and ensure that the loan credit analysis is accurate. Collateral valuations, property inspections, and other collateral characteristics are updated periodically as a result of our ongoing in-house real estate analysis. All asset management activity and analysis is contained within a central database.

### ***SBA Division***

*General.* The SBA Division, launched in November 2014, originates loans to small businesses nationwide, most often through the SBA's 7(a) program, which provides a partial government guarantee. Our loans are typically secured by liens on business assets and mortgages on commercial properties, and also benefit from SBA guarantees. We seek to build a loan portfolio that is diverse with respect to geography, loan type and collateral type.

The following table summarizes the SBA Division loan portfolio as of June 30, 2016:

	SBA Division (Dollars in thousands)
Non-owner occupied commercial real estate .....	\$ 5,639
Owner occupied commercial real estate .....	14,414
Commercial and industrial .....	6,242
1-4 family residential .....	133
Total .....	<u>\$ 26,428</u>

The Company's SBA loan portfolio includes owner and non-owner occupied loans as defined under regulatory call report instructions. The regulatory call report instructions primarily consider the primary source of repayment on the loan for this determination. However, these loans meet the SBA requirements to be considered owner occupied as the owner or controlling entity are actively involved in the daily operations of the underlying core business.

In addition to the loans held in the SBA Division loan portfolio, as of June 30, 2016, \$1.1 million in the loans held for sale portfolio were attributable to the SBA Division, consisting of the guaranteed portion of the SBA Division loans that we expect to sell in the secondary market.

*Secondary Market for SBA Guarantees.* We typically sell the SBA-guaranteed portion of our variable-rate originations (generally 75% of the principal balance) at a premium in the secondary market. We generally retain a 25% unguaranteed interest and the accompanying servicing rights to the entire loan. We hold most fixed-rate SBA loan originations in portfolio.

*Underwriting of SBA Division Loans.* Our loan policies and procedures establish guidelines governing our SBA lending program. Generally, these guidelines address the types of loans that we seek, target markets, underwriting and collateral requirements, terms, interest rate and yield considerations and compliance with laws and regulations. All loans or credit lines are subject to approval procedures and amount limitations. Our policies are reviewed and approved at least annually by our Board of Directors to ensure that we are following SBA underwriting guidelines.

*Loan Servicing.* We conduct all loan servicing for SBA Division loans with an in-house team of experienced asset managers who actively manage the loan portfolio. Asset managers initiate and maintain regular borrower contact, and ensure that the loan credit analysis is accurate. Collateral valuations, property inspections, and other collateral characteristics are updated periodically as a result of our ongoing in-house real estate analysis. All asset management activity and analysis is contained within a central database.

## **Investment Activities**

Our securities portfolio and short-term investments provide and maintain liquidity, assist in managing the interest rate sensitivity of our balance sheet, and serve as collateral for certain of our obligations. Individual investment decisions are made based on the credit quality of the investment, liquidity requirements, potential returns, cash flow targets, and consistency with our asset/liability management objectives.

## **Sources of Funds**

Deposits have traditionally been the primary source of the Bank's funds for lending and other investment purposes. In addition to deposits, the Bank obtains funds from the amortization and prepayment of loans and mortgage-backed securities, the sale, call or maturity of investment securities, advances from the Federal Home Loan Bank of Boston (the "FHLBB"), other term borrowings and cash flows generated by operations.

## **Deposits**

We offer a full line of deposit products to customers in western and south-central Maine through our ten-branch network. Our deposit products consist of demand deposit, NOW, money market, savings and certificate of deposit accounts. Our customers access their funds through ATMs, MasterCard® Debit Cards, Automated Clearing House funds (electronic transfers) and checks. We also offer telephone banking, online banking and bill payment, mobile banking and remote deposit capture services. Interest rates on our deposits are based upon factors that include prevailing loan demand, deposit maturities,



alternative costs of funds, interest rates offered by competing financial institutions and other financial service firms, and general economic conditions. At June 30, 2016, we had core deposits of \$800.4 million, representing 100% of total deposits. We define core deposits as non-maturity deposits and non-brokered insured time deposits.

Our online deposit program, ableBanking, provides an additional channel through which to obtain core deposits to support our growth. ableBanking, which was launched in late fiscal 2012 as a division of Northeast Bank, had \$142.6 million in money market and time deposits as of June 30, 2016. We also use deposit listing services to gather deposits from time to time, in support of our liquidity and asset/liability management objectives. At June 30, 2016, listing service deposits totaled \$196.6 million, bearing a weighted average remaining term of 0.81 years.

### ***Borrowings***

While we currently consider core deposits (defined as non-maturity deposits and non-brokered insured time deposits) as our primary source of funding to support asset growth, advances from the FHLBB and other sources of wholesale funding remain an important part of our liquidity contingency planning. Northeast Bank may borrow up to 50% of its total assets from the FHLBB, and borrowings are typically collateralized by mortgage loans and securities pledged to the FHLBB. At June 30, 2016, we had \$16.8 million of available borrowing capacity based on collateral. Northeast Bank can also borrow from the Federal Reserve Bank of Boston, with any such borrowing collateralized by consumer loans pledged to the Federal Reserve.

For the foreseeable future, we expect to rely less on borrowings than other banks of similar size, because of our regulatory commitment to fund 100% of our loans with core deposits, although the availability of FHLBB and Federal Reserve Bank of Boston advances and other sources of wholesale funding remain an important part of our liquidity contingency planning.

### **Employees**

As of June 30, 2016, the Company employed 183 full-time and 20 part-time employees. The Company's employees are not represented by any collective bargaining unit. The Company believes that its relations with its employees are good.

### **Other Subsidiaries**

As of June 30, 2016, the Bank had five wholly-owned non-bank subsidiaries:

- Northeast Bank Insurance Group, Inc. ("NBIG"). The insurance agency assets of NBIG were sold on September 1, 2011. The entity currently holds the real estate formerly used in its insurance agency business.
- 200 Elm Realty, LLC, which was established to hold commercial real estate acquired as a result of loan workouts.
- 500 Pine Realty, LLC, which was established to hold residential real estate acquired as a result of loan workouts.
- 17 Dogwood Realty, LLC, which was established to hold commercial real estate acquired as a result of loan workouts.
- Portland, Inc., which was established to employ a business development officer to solicit SBA loans in New Jersey.

The Company's wholly-owned subsidiary, ASI Data Services, Inc. ("ASI"), is an inactive corporate subsidiary. ASI initially provided data processing services to the Company and its subsidiaries. The Company's Board transferred the assets and operations of ASI to the Bank in 1996.

### **Supervision and Regulation**

#### ***General***

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. 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. This regulatory framework is intended to protect depositors, the federal deposit insurance fund, consumers and the banking system as a whole, and not necessarily investors in the Company. The following discussion is qualified in its entirety by reference to the full text of the statutes, regulations, policies and guidelines described below.

### ***Bank Holding Company Regulation***

Unless a bank holding company becomes a financial holding company under the BHCA, as amended by the Gramm-Leach-Bliley Act ("GLBA") as discussed below, the BHCA generally prohibits a bank holding company from engaging directly or indirectly in activities other than those of banking, managing or controlling banks or furnishing services to its subsidiary banks or other activities permitted under the BHCA and from acquiring a direct or indirect interest in or control of more than 5% of the voting shares of any company that is not a bank or a bank holding company. However, subject to complying with applicable prior notice or approval requirements under the BHCA, a bank holding company may engage in, and may own shares of companies engaged in certain activities, that the Federal Reserve had determined as of November 11, 1999 to be so closely related to banking or managing and controlling banks so as to be incident thereto. The BHCA requires every bank holding company to obtain the prior approval of the Federal Reserve before it may merge with another bank holding company, acquire all or substantially all of the assets of any bank, or acquire ownership or control of any voting shares of a bank or bank holding company, if, after such acquisition, it would own or control, directly or indirectly, more than 5% of any class of voting securities of such bank or bank holding company.

GLBA amended the BHCA to permit bank holding companies that qualify, and have elected to be treated as financial holding companies, to engage in financial activities and acquire interests in companies engaged in financial activities. "Financial activities" is broadly defined to include not only banking, insurance and securities underwriting activities, but also merchant banking and additional activities that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to such financial activities, or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), however, a bank holding company and its affiliates are prohibited from engaging in proprietary trading and from sponsoring and investing in hedge funds and private equity funds, except as permitted under certain limited circumstances. In order to engage in financial activities under GLBA, a bank holding company must qualify as and make an effective election to be a "financial holding company." To qualify as a financial holding company, a bank holding company and each of its depository institution subsidiaries must be "well capitalized" and "well managed." A financial holding company may not commence any additional financial activity not permissible for all bank holding companies or acquire a company engaged in any financial activity that is not permissible for all bank holding companies if any depository institution subsidiary of the company has received on its most recent examination under the Community Reinvestment Act of 1977 ("CRA") a rating less than "satisfactory." A bank holding company that elects to be treated as a financial holding company may face significant consequences if it or any of its insured depository institution subsidiaries fail to maintain the required capital and management qualifications, including entering into an agreement with the Federal Reserve which imposes limitations on its operations and may even require divestitures. Although the Company believes that it meets the qualifications to become a financial holding company under GLBA, it has not elected "financial holding company" status, but rather to retain its pre-GLBA bank holding company regulatory status for the present time.

The Company is required by the BHCA to file an annual report and additional reports required with the Federal Reserve. The Federal Reserve also makes periodic inspections of the Company and its subsidiaries.

### ***Dividend Restrictions***

The Company is a legal entity separate and distinct from the Bank. The revenue of the Company (on a parent company only basis) is derived primarily from interest and dividends from the Bank. The right of the Company, and consequently the right of shareholders of the Company, to participate in any distribution of the assets or earnings of the Bank through the payment of such dividends or otherwise is necessarily subject to the prior claims of creditors of the Bank (including depositors), except to the extent that certain claims of the Company in a creditor capacity may be recognized.

It is the policy of the Federal Reserve that a bank holding company should eliminate, defer or significantly reduce dividends if the organization's net income available to shareholders for the past four quarters is not sufficient to fully fund the dividends, the prospective rate of earnings retention is not consistent with the organization's capital needs, asset quality and overall financial condition, or the bank holding company will not meet or is in danger of not meeting its minimum regulatory capital adequacy ratios. The Federal Reserve has the authority to prohibit a bank holding company, such as the Company, from paying dividends if it deems such payment to be an unsafe or unsound practice.

The FDIC has the authority to use its enforcement powers to prohibit a bank from paying dividends if, in its opinion, the payment of dividends would constitute an unsafe or unsound practice. Federal law also prohibits the payment of dividends by a bank that will result in the bank failing to meet its applicable capital requirements on a pro forma basis. Maine law requires the approval of the Bureau for any dividend that would reduce a bank's capital below prescribed limits.

### ***Source of Strength***

Under the Dodd-Frank Act, the Company is required to serve as a source of financial strength for the Bank in the event of the financial distress of the Bank. This provision codifies the longstanding policy of the Federal Reserve. In addition, any capital loans by a bank holding company to any of its bank subsidiaries are subordinate to the payment of deposits and to certain other indebtedness. In the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a bank subsidiary will be assumed by the bankruptcy trustee and entitled to a priority of payment.

### ***Certain Transactions by Bank Holding Companies with their Affiliates***

There are various statutory restrictions on the extent to which bank holding companies and their non-bank subsidiaries may borrow, obtain credit from or otherwise engage in "covered transactions" with their insured depository institution subsidiaries. In general, an "affiliate" of an insured depository institution includes the depository institution's parent holding company and any subsidiary of the parent holding company. However, an "affiliate" does not generally include an operating subsidiary of an insured depository institution. The Dodd-Frank Act amended the definition of affiliate to include any investment fund for which the depository institution or one of its affiliates is an investment adviser. An insured depository institution (and its subsidiaries) may not lend money to, or engage in other covered transactions with, its non-depository institution affiliates if the aggregate amount of covered transactions outstanding involving the bank, plus the proposed transaction, exceeds the following limits: (a) in the case of any one such affiliate, the aggregate amount of covered transactions of the insured depository institution and its subsidiaries cannot exceed 10% of the capital stock and surplus of the insured depository institution; and (b) in the case of all affiliates, the aggregate amount of covered transactions of the insured depository institution and its subsidiaries cannot exceed 20% of the capital stock and surplus of the insured depository institution. For this purpose, "covered transactions" are defined by statute to include a loan or extension of credit to an affiliate, a purchase of or investment in securities issued by an affiliate, a purchase of assets from an affiliate, the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company, the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate, securities borrowing or lending transactions with an affiliate that creates a credit exposure to such affiliate, or a derivatives transaction with an affiliate that creates a credit exposure to such affiliate. Certain covered transactions are also subject to collateral security requirements. Covered transactions as well as other types of transactions between a bank and a bank holding company must be on market terms, which means that the transaction must be conducted on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with or involving nonaffiliates or, in the absence of comparable transactions, that in good faith would be offered to or would apply to nonaffiliates. Moreover, Section 106 of the Bank Holding Company Act Amendments of 1970 provides that, to further competition, a bank holding company and its subsidiaries are prohibited from engaging in certain tying arrangements in connection with any extension of credit, lease or sale of property of any kind, or furnishing of any service.

### ***Regulation of the Bank***

As a Maine-chartered bank, the Bank is subject to the supervision of and regulation by the Bureau and the FDIC, as the Bank's insurer of deposits. This supervision and regulation is for the protection of depositors, the FDIC's Deposit Insurance Fund ("DIF"), and consumers, and is not for the protection of the Company's shareholders. The prior approval of the Bureau and the FDIC is required, among other things, for the Bank to establish or relocate a branch office, assume deposits, or engage in any merger, consolidation, purchase or sale of all or substantially all of the assets of any bank. The Federal Reserve may directly examine the subsidiaries of the Company, including the Bank. However, the BHCA requires that the Federal Reserve provide notice to and consult with the federal bank supervisory agencies and other functional regulatory agencies before commencing an examination of a depository institution or a functionally regulated subsidiary and, to the fullest extent possible, avoid duplication of examination activities, reporting requirements and requests for information.

### ***Capital Adequacy and Safety and Soundness***

***Regulatory Capital Requirements.*** The Federal Reserve has issued risk-based and leverage capital rules applicable to bank holding companies such as the Company, and the FDIC has issued similar rules that apply to insured state nonmember banks, such as the Bank. These guidelines are intended to reflect the relationship between the banking organization's capital and the degree of risk associated with its operations based on transactions recorded on-balance sheet as well as off-balance sheet items. The FRB and the FDIC may from time to time require that a banking organization maintain capital above the minimum levels discussed below, due to the banking organization's financial condition or actual or anticipated growth.

The capital adequacy rules define qualifying capital instruments and specify minimum amounts of capital as a percentage of assets that banking organizations are required to maintain. Common equity Tier 1 capital for banks and bank holding companies consists of common shareholders' equity and related surplus. Tier 1 capital for banks and bank holding companies generally consists of the sum of common shareholders' equity, non-cumulative perpetual preferred stock, and related surplus and, in certain cases and subject to limitations, minority interest in consolidated subsidiaries, less goodwill, other non-qualifying intangible assets and certain other deductions. Tier 2 capital generally consists of hybrid capital instruments, perpetual debt and mandatory convertible debt securities, cumulative perpetual preferred stock, term subordinated debt and intermediate-term preferred stock, and, subject to limitations, allowances for loan losses. The sum of Tier 1 and Tier 2 capital less certain required deductions represents qualifying total capital.

Prior to the effectiveness of certain provisions of the Dodd-Frank Act, bank holding companies were permitted to include trust preferred securities and cumulative perpetual preferred stock in Tier 1 capital, subject to limitations. However, the FRB's capital rule applicable to bank holding companies permanently grandfathered nonqualifying capital instruments, including trust preferred securities, issued before May 19, 2010 by depository institution holding companies with less than \$15 billion in total assets as of December 31, 2009, subject to a limit of 25% of Tier 1 capital. In addition, under rules that became effective January 1, 2016, accumulated other comprehensive income (positive or negative) must be reflected in Tier 1 capital; however, the Company was permitted to make a one-time, permanent election to continue to exclude accumulated other comprehensive income from capital. In March 2016, the Company made a one time, permanent election to continue to exclude accumulated other comprehensive income from capital.

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.

Under rules effective January 1, 2015, a bank holding company, such as the Company, is considered "well capitalized" if the bank holding company (i) has a total 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.

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

Generally, a bank, upon being notified that it is not adequately capitalized (i.e., that it is "undercapitalized"), becomes subject to the prompt corrective action provisions of Section 38 of the Federal Deposit Insurance Act (the "FDIA") that, for example, (i) restrict payment of capital distributions and management fees, (ii) require that the Federal Reserve monitor the condition of the institution and its efforts to restore its capital, (iii) require submission of a capital restoration plan, (iv) restrict the growth of the institution's assets and (v) require prior regulatory approval of certain expansion proposals. A bank that is required to submit a capital restoration plan must concurrently submit a performance guarantee by each company that controls the bank. A bank that is "critically undercapitalized" (i.e., has a ratio of tangible equity to total assets that is equal to or less than 2.0%) will be subject to further restrictions, and generally will be placed in conservatorship or receivership within 90 days.

*Deposit Insurance.* Deposits in the Bank are insured by the FDIC to the maximum extent permitted by law. Pursuant to the Dodd-Frank Act, FDIC deposit insurance has been permanently increased from \$100,000 to \$250,000 per depositor for deposits maintained by the depositor in the same right and capacity. The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank's capital level and supervisory rating ("CAMELS rating"). CAMELS ratings reflect the applicable bank regulatory agency to applicable limits by the DIF and are subject to deposit, management, earnings, liquidity and sensitivity to risk. Assessment rates may also vary for certain institutions based on long term debt issuer ratings, secured or brokered deposits. Pursuant to the Dodd-Frank Act, deposit premiums are based on assets rather than insurable deposits. To determine its actual insurance premiums, the Bank computes

the base amount on its average consolidated assets less its average tangible equity (defined as the amount of Tier 1 capital) and its applicable assessment rate. After adjustments, assessment rates range from 2.5 to 9 basis points on the broader assessment base for banks in the lowest risk category up to 30 to 45 basis points for banks in the highest risk category.

The Dodd-Frank Act required the FDIC to take action to increase the minimum DIF reserve ratio, the ratio of the fund balance to estimated insured deposits, from 1.15% to 1.35% by September 30, 2020. Further, the Dodd-Frank Act required that, in setting assessments, the FDIC offset the effect of the increase in the minimum reserve ratio from 1.15% to 1.35% on banks with less than \$10 billion in assets.

To satisfy these requirements, on March 15, 2016, the FDIC's Board of Directors approved a final rule to increase the DIF's reserve ratio to the statutorily required minimum ratio of 1.35% of estimated insured deposits. The final rule imposes on large banks a surcharge of 4.5 basis points of their assessment base, after making certain adjustments. Large banks will pay quarterly surcharges in addition to their regular risk-based assessments. Overall regular risk-based assessment rates will decline once the reserve ratio reaches 1.15%.

If the reserve ratio reaches 1.15% before July 1, 2016, surcharges will begin July 1. If the reserve ratio has not reached 1.15% by July 1, 2016, surcharges will begin the first quarter after the reserve ratio reaches 1.15%. The surcharges will continue through the quarter in which the reserve ratio first meets or exceeds 1.35%, but not past the fourth quarter of 2018. If the reserve ratio has not reached 1.35% by the end of 2018, a shortfall assessment will be imposed on large banks to close the gap.

Small banks will receive credits to offset the portion of their assessments that help to raise the reserve ratio from 1.15% to 1.35%. After the reserve ratio reaches 1.38%, the FDIC will automatically apply a small bank's credits to reduce its regular assessment up to the entire amount of the assessment.

In addition, on April 26, 2016, the FDIC's Board of Directors adopted a final rule that amends the way insurance assessment rates are calculated for established small banks, generally those banks with less than \$10 billion of assets that have been insured for at least five years. The rule updates the data and methodology that the FDIC uses to determine risk-based assessment rates for these institutions with the intent of better reflecting risks and ensuring that banks that take on greater risks pay more for deposit insurance than their less risky counterparts. The rule revises the financial ratios method used to determine assessment rates for these banks so that it is based on a statistical model that estimates the probability of failure over three years. The rule eliminates risk categories for established small banks and uses the financial ratios method for all such banks (subject to minimum or maximum assessment rates based on a bank's CAMELS composite rating). Under the small bank pricing rule, beginning the first assessment period after June 30, 2016, where the DIF's reserve ratio has reached 1.15%, assessments for established small banks with a CAMELS rating of 1 or 2 will range from 1.5 to 16 basis points, after adjustments, while assessment rates for established small institutions with a CAMELS composite rating of 4 or 5 may range from 11 to 30 basis points, after adjustments. Under the FDIA, the FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

*Safety and Soundness Standard.* The FDIA requires the federal bank regulatory agencies to prescribe standards, by regulations or guidelines, relating to internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, stock valuation and compensation, fees and benefits, and such other operational and managerial standards as the agencies deem appropriate. Guidelines adopted by the federal bank regulatory agencies establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth and compensation, fees and benefits. In general, these guidelines require, among other things, appropriate systems and practices to identify and manage the risk and exposures specified in the guidelines. The guidelines prohibit excessive compensation as an unsafe and unsound practice and describe compensation as excessive when the amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director or principal shareholder. In addition, the federal banking agencies adopted regulations that authorize, but do not require, an agency to order an institution that has been given notice by an agency that it is not satisfying any of such safety and soundness standards to submit a compliance plan. If, after being so notified, an institution fails to submit an acceptable compliance plan or fails in any material respect to implement an acceptable compliance plan, the agency must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized institution is subject under the "prompt corrective action" provisions of FDIA. See "Regulatory Capital Requirements" above. If an institution fails to comply with such an order, the agency may seek to enforce such order in judicial proceedings and to impose civil money penalties.

*Depositor Preference.* The FDIA provides that, in the event of the "liquidation or other resolution" of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including depositors whose deposits are payable only outside of the United States and the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

### ***Activities and Investments of Insured State Banks***

The powers of a Maine-chartered bank, such as the Bank, include provisions designed to provide Maine banks with competitive equity to the powers of national banks. In general, the FDIA prohibits a state insured bank from directly or indirectly engaging as a principal in any activity that is not permissible for a national bank and from making any equity investment of a type that is not permissible for a national bank. However, GLBA amended the FDIA to authorize state banks to establish financial subsidiaries that engage in "activities as principal that would only be permissible" for a national bank to conduct in a financial subsidiary. This provision permits state banks, to the extent permitted under state law, to engage in certain financial activities which are permissible for subsidiaries of a financial holding company. Because Maine law explicitly permits banks chartered by the state to engage in all activities permissible for federally-chartered banks, the Bank is permitted to form subsidiaries to engage in the activities authorized by GLBA for financial subsidiaries of state banks. In order to form a financial subsidiary, a state bank must be well managed, the state bank and all of its insured depository institution affiliates must be well-capitalized, and the state bank must comply with certain capital deduction, risk management and affiliate transaction rules. A state bank may not commence new activities that may only be conducted through a financial subsidiary or directly or indirectly acquire a company engaged in such activities if the bank or any of its affiliates received a CRA rating of less than "satisfactory" in its most recent CRA examination.

### ***Consumer Protection Regulation***

The Company and the Bank are subject to a number of federal and state laws designed to protect consumers and prohibit unfair or deceptive business practices. These laws include the Equal Credit Opportunity Act, the Fair Housing Act, Home Ownership Protection Act, the Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act of 2003 ("FACT Act"), GLBA, the Truth in Lending Act, CRA, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the National Flood Insurance Act, Electronic Funds Transfer Act, Truth in Savings Act, Secure and Fair Enforcement Act, Expedited Funds Availability Act, and various state law counterparts. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must interact with customers when taking deposits, making loans, collecting loans and providing other services. Further, the Dodd-Frank Act established the CFPB, which has the responsibility for making rules and regulations under the federal consumer protection laws relating to financial products and services. The CFPB also has a broad mandate to prohibit unfair or deceptive acts and practices and is specifically empowered to require certain disclosures to consumers and draft model disclosure forms. Failure to comply with consumer protection laws and regulations can subject financial institutions to enforcement actions, fines and other penalties. The FDIC examines the Bank for compliance with CFPB rules and enforces CFPB rules with respect to the Bank.

### ***Mortgage Reform***

The Dodd-Frank Act prescribes certain standards that mortgage lenders must consider before making a residential mortgage loan, including verifying a borrower's ability to repay such mortgage loan. The Dodd-Frank Act also allows borrowers to assert violations of certain provisions of the Truth-in-Lending Act as a defense to foreclosure proceedings. Under the Dodd-Frank Act, prepayment penalties are prohibited for certain mortgage transactions and creditors are prohibited from financing insurance policies in connection with a residential mortgage loan or home equity line of credit. The Dodd-Frank Act requires mortgage lenders to make additional disclosures prior to the extension of credit, in each billing statement and for negative amortization loans and hybrid adjustable rate mortgages. Additionally, the Dodd-Frank Act prohibits mortgage originators from receiving compensation based on the terms of residential mortgage loans and generally limits the ability of a mortgage originator to be compensated by others if compensation is received from a consumer.

### ***Privacy and Customer Information Security***

GLBA requires financial institutions to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to nonaffiliated third parties. In general, the Bank must provide its customers with an annual disclosure that explains its policies and procedures regarding the disclosure of such nonpublic personal information and, except as otherwise required or permitted by law, the Bank is prohibited from disclosing such information except as provided in such policies and procedures. However, as a result of amendments made by the Fixing America's Surface Transportation

Act, a financial institution is not required to send an annual privacy notice if the institution only discloses nonpublic personal information in accordance with certain exceptions from the GLBA that do not require an opt-out to be provided and if the institution has not changed its policies and practices since the most recent privacy disclosure provided to consumers. GLBA also requires that the Bank develop, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information (as defined under GLBA), to protect against anticipated threats or hazards to the security or integrity of such information; and to protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. The Bank is also required to send a notice to customers whose "sensitive information" has been compromised if unauthorized use of this information has occurred or is "reasonably possible." Most states, including Maine, have enacted legislation concerning breaches of data security and the duties of the Bank in response to a data breach. Congress continues to consider federal legislation that would require consumer notice of data security breaches. Pursuant to the FACT Act, the Bank must also develop and implement a written identity theft prevention program to detect, prevent, and mitigate identity theft in connection with the opening of certain accounts or certain existing accounts. Additionally, the FACT Act amends the Fair Credit Reporting Act to generally prohibit a person from using information received from an affiliate to make a solicitation for marketing purposes to a consumer, unless the consumer is given notice and a reasonable opportunity and a reasonable and simple method to opt out of the making of such solicitations.

### ***Regulatory Enforcement Authority***

The enforcement powers available to the federal banking agencies include, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties, as defined. In general, these enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities. Under certain circumstances, federal and state law requires public disclosure and reports of certain criminal offenses and also final enforcement actions by the federal banking agencies.

### ***Community Reinvestment Act***

Pursuant to the CRA, regulatory authorities review the performance of the Bank in meeting the credit needs of the communities it serves. The applicable regulatory authorities consider compliance with this law in connection with the applications for, among other things, approval for *de novo* branches, branch relocations and acquisitions of banks and bank holding companies. The Bank received a "satisfactory" rating at its CRA examination dated September 1, 2016, its most recent exam.

Failure of an institution to receive at least a "satisfactory" rating could inhibit such institution or its holding company from undertaking certain activities, including engaging in activities permitted for a financial holding company under GLBA, and acquisitions of other financial institutions. The FDIC must take into account the record of performance of banks in meeting the credit needs of the entire community served, including low- and moderate-income neighborhoods. Current CRA regulations for large banks primarily rely on objective criteria of the performance of institutions under three key assessment tests: a lending test, a service test and an investment test. For smaller banks, current CRA regulations primarily evaluate the performance of institutions under two key assessment tests: a lending test and, in addition, for intermediate small banks, a community development test. The Company is committed to meeting the existing or anticipated credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations.

### ***Branching and Acquisitions***

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended ("Riegle-Neal") and the Dodd-Frank Act permit well capitalized and well managed bank holding companies, as determined by the Federal Reserve, to acquire banks in any state subject to certain concentration limits and other conditions. Riegle-Neal also generally authorizes the interstate merger of banks. In addition, among other things, Riegle-Neal and the Dodd-Frank Act permit banks to establish new branches on an interstate basis to the same extent a bank chartered by the host state may establish branches. Bank holding companies are required to obtain prior Federal Reserve approval to directly or indirectly acquire more than 5% of a class of voting securities, or substantially all of the assets, of a bank holding company, bank or savings association.

### ***Anti-Money Laundering and the Bank Secrecy Act***

Under the Bank Secrecy Act ("BSA"), a financial institution is required to have systems in place to detect certain transactions, based on the size and nature of the transaction. Financial institutions are generally required to report to the United States Treasury any cash transactions involving more than \$10,000. In addition, financial institutions are required to file suspicious

activity reports for transactions that involve more than \$5,000 and which the financial institution knows, suspects or has reason to suspect involves illegal funds, is designed to evade the requirements of the BSA or has no lawful purpose. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA PATRIOT Act"), which amended the BSA, is designed to deny terrorists and others the ability to obtain anonymous access to the U.S. financial system. The USA PATRIOT Act has significant implications for financial institutions and businesses of other types involved in the transfer of money. The USA PATRIOT Act, together with the implementing regulations of various federal regulatory agencies, has caused financial institutions, such as the Bank, to adopt and implement additional policies or amend existing policies and procedures with respect to, among other things, anti-money laundering compliance, suspicious activity, currency transaction reporting, customer identity verification and customer risk analysis. In evaluating an application under Section 3 of the BHCA to acquire a bank or an application under the Bank Merger Act to merge banks or affect a purchase of assets and assumption of deposits and other liabilities, the applicable federal banking regulator must consider the anti-money laundering compliance record of both the applicant and the target.

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These sanctions, which are administered by the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"), take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons); and (iii) restrictions on transactions with or involving certain persons or entities. Blocked assets (for example, property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC.

### ***Federal Home Loan Bank System***

The Bank is a member of the Federal Home Loan Bank of Boston (the "FHLBB"), which is one of the regional Federal Home Loan Banks comprising the Federal Home Loan Bank System. Each Federal Home Loan Bank provides a central credit facility primarily for member institutions. Member institutions are required to acquire and hold shares of capital stock in the FHLBB in an amount at least equal to the sum of 0.35% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations based on year-end call report data and up to 4.5% of its advances (borrowings) from the FHLBB. The Bank was in compliance with this requirement with an investment in FHLBB stock as of June 30, 2016 of \$2.4 million. The Bank receives dividends on its FHLBB stock. The FHLBB has recently declared dividends equal to an annual yield of approximately the daily average three-month LIBOR yield for the quarter for which the dividend has been declared. Dividend income on FHLBB stock of \$113 thousand was recorded during the most recent fiscal year.

Any advances from the FHLBB must be secured by specified types of collateral, and long-term advances may be used for the purpose of providing funds for residential housing finance, commercial lending and to purchase investments. Long term advances may also be used to help manage interest rate risk for asset and liability management purposes. As of June 30, 2016, the Bank had \$30.1 million in outstanding FHLBB advances.

### **Item 1A. Risk Factors**

Investing in our common stock involves a high degree of risk. You should carefully consider the following risks and uncertainties, together with all other information in this prospectus, including our consolidated financial statements and related notes, before investing in our common stock. Any of the risk factors we describe below could adversely affect our business, financial condition or results of operations. The trading price of our voting common stock could decline if one or more of these risks or uncertainties actually occur, causing you to lose all or part of your investment. Certain statements below are forward-looking statements. See "A Note About Forward-Looking Statements."

#### **Risks Associated With Our Business**

***We are subject to regulatory conditions that could constrain our ability to grow our business.***

In conjunction with the regulatory approvals received for the merger with FHB Formation LLC, we committed to maintain a Tier 1 leverage ratio of at least 10%, maintain a total capital ratio of at least 15%, fund 100% of our loans with core deposits, limit purchased loans to 40% of total loans and hold non-owner occupied commercial real estate loans to within 300% of total capital. Core deposits, for purposes of this commitment, are defined as non-brokered non-maturity deposits and non-brokered insured time deposits. At June 30, 2016, the ratio of our purchased loans to total loans was 34.3%. Our continued



ability to purchase loans will be dependent on our ability to maintain the growth of our originated loan portfolio. To the extent that our ability to originate loans is constrained by market forces or for any other reason, our ability to execute our loan acquisition strategy would be similarly constrained.

***A significant portion of loans held in our loan portfolio were originated by third parties, and such loans may not have been subject to the same level of due diligence that Northeast Bank would have conducted had it originated the loans.***

At June 30, 2016, 34.3% of the loans held in our loan portfolio were originated by third parties, and therefore may not have been subject to the same level of due diligence that Northeast Bank would have conducted had it originated the loans. Although the LASG conducts a comprehensive review of all loans that it purchases, loans originated by third parties may lack current financial information and may have incomplete legal documentation and outdated appraisals. As a result, the LASG may not have information with respect to an acquired loan which, if known at the time of acquisition, would have caused it to reduce its bid price or not bid for the loan at all. This may adversely affect our yield on loans or cause us to increase our provision for loan losses.

***Our experience with loans held in our loan portfolio that were originated by third parties is limited.***

At June 30, 2016, the 34.3% of the loans held in our loan portfolio that were originated by third parties had been held by us for approximately 1.8 years, calculated on a weighted average basis. Consequently, we have had only a relatively short period of time to evaluate the performance of those loans and the price at which we purchased them. Further experience with these loans may provide us with information that could cause us to increase our provision for loan losses.

***Our loan portfolio includes commercial real estate and commercial and industrial loans, which are generally riskier than other types of loans.***

At June 30, 2016, our commercial real estate mortgage and commercial and industrial loan portfolios comprised 82.7% of total loans. Commercial loans generally carry larger loan balances and involve a higher risk of nonpayment or late payment than residential mortgage loans. These loans, and purchased loans in particular, may lack standardized terms and may include a balloon payment feature. The ability of a borrower to make or refinance a balloon payment may be affected by a number of factors, including the financial condition of the borrower, prevailing economic conditions and prevailing interest rates. Repayment of these loans is generally more dependent on the economy and the successful operation of a business. Because of the risks associated with commercial loans, we may experience higher rates of default than if the portfolio were more heavily weighted toward residential mortgage loans. Higher rates of default could have an adverse effect on our financial condition and results of operations.

***If our allowance for loan losses is not sufficient to absorb actual losses or if we are required to increase our allowance, our financial condition and results of operations could be adversely affected.***

We are exposed to the risk that our borrowers may default on their obligations. A borrower's default on its obligations under one or more loans of the Bank may result in lost principal and interest income and increased operating expenses as a result of the allocation of management time and resources to the collection and work-out of the loan. In certain situations, where collection efforts are unsuccessful or acceptable work-out arrangements cannot be reached, the Bank may have to write off the loan in whole or in part. In such situations, the Bank may acquire real estate or other assets, if any, that secure the loan through foreclosure or other similar available remedies, and often the amount owed under the defaulted loan exceeds the value of the assets acquired.

We periodically make a determination of an allowance for loan losses based on available information, including, but not limited to, our historical loss experience, the quality of the loan portfolio, certain economic conditions, the value of the underlying collateral, expected cash flows from purchased loans, and the level of non-accruing and criticized loans. We rely on our loan quality reviews, our experience and our evaluation of economic conditions, among other factors, in determining the amount of provision required for the allowance for loan losses. Provisions to this allowance result in an expense for the period. If, as a result of general economic conditions, previously incorrect assumptions, or an increase in defaulted loans, we determine that additional increases in the allowance for loan losses are necessary, we will incur additional expenses.

Determining the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. At any time, there are likely to be loans in our portfolio that will result in losses but that have not been identified as nonperforming or potential problem credits. We cannot be sure that we will be able to identify deteriorating credits before they become nonperforming assets or that we will be able to limit losses on those loans that are identified. We have in the past been, and in the future may be, required to increase our allowance for loan losses for any of several reasons. State and federal regulators, in reviewing our

loan portfolio as part of a regulatory examination, may request that we increase our allowance for loan losses. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in our allowance for loan losses. In addition, if charge-offs in future periods exceed those estimated in our determination of our allowance for loan losses, we will need additional increases in our allowance for loan losses. Any increases in our allowance for loan losses will result in a decrease in our net income and, possibly, our capital, and could have an adverse effect on our financial condition and results of operations.

***Environmental liability associated with our lending activities could result in losses.***

In the course of business, we may acquire, through foreclosure, properties securing loans we have originated or purchased that are in default. Particularly in commercial real estate lending, there is a risk that hazardous substances could be discovered on these properties. In this event, we might be required to remove these substances from the affected properties at our sole cost and expense or we may be held liable to a government entity or to third parties for property damage, personal injury, investigation and cleanup costs incurred by these parties in connection with environmental contamination or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. The costs associated with investigation or remediation activities could substantially exceed the value of affected properties. We may not have adequate remedies against the prior owner or other responsible parties and could find it difficult or impossible to sell the affected properties. If we become subject to significant environmental liabilities, our business, financial condition and results of operations could be adversely affected.

***We may not be able to attract and retain qualified key employees, which could adversely affect our business prospects, including our competitive position and results of operations.***

Our success is dependent upon our ability to attract and retain highly skilled individuals. There is significant competition for those individuals with the experience and skills required to conduct many of our business activities. We may not be able to hire or retain the key personnel that we depend upon for success. The unexpected loss of services of one or more of these or other key personnel could have a material adverse impact on our business because of their skills, knowledge of the markets in which we operate, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

***We are subject to liquidity risk.***

Liquidity is the ability to meet cash flow needs on a timely basis by converting assets into cash or cash equivalents and by increasing liabilities at a reasonable cost. Liquidity sources include the amount of unencumbered or “free” investment portfolio securities that the Bank owns, borrowings, cash flow from loan and investment principal payments and prepayments and residential mortgage loan sales. Our liquidity is used principally to originate or purchase loans, to repay deposit liabilities and other liabilities when they come due, and to fund operating costs. The Company also requires funds for dividends to shareholders, repurchases of shares, and for general corporate purposes. Customer demand for non-maturity deposits can be difficult to predict. Changes in market interest rates, increased competition within our markets, and other factors may make deposit gathering more difficult. Disruptions in the capital markets or interest rate changes may make the terms of wholesale funding sources—which include Federal Home Loan Bank advances, the Federal Reserve's Borrower-in-Custody program, securities sold under repurchase agreements, federal funds purchased and brokered certificates of deposit—less favorable and may make it difficult to sell securities when needed to provide additional liquidity. As a result, there is a risk that the cost of funding will increase or that we will not have sufficient funds to meet our obligations when they come due.

***We are subject to security and operational risks relating to our use of technology.***

Communication and information systems are critical to the conduct of our business because we use these systems to manage our customer relationships and process accounting and financial reporting information. Although we have established policies and procedures to prevent or limit the impact of system failures, interruptions and security breaches of these systems, including cyber security breaches, there can be no assurance that such events will not occur or that they will be adequately addressed if they do. In addition, any compromise of our security systems could prevent customers from using our website and our online banking services, both of which involve the transmission of confidential information. Although we rely on security and processing systems to provide the security and authentication necessary to securely transmit data, these precautions may not protect our systems from compromises or breaches of security. Information security risks have increased significantly due to the use of online, telephone and mobile banking channels by clients and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in the loss of business, subject us to

increased regulatory scrutiny or expose us to civil litigation and possible financial liability, including the costs of customer notification and remediation efforts. Any of these occurrences could have an adverse effect on our financial condition and results of operations.

***We rely on other companies to provide key components of our business infrastructure.***

Third party vendors provide key components of our business infrastructure such as internet connections, network access and core application processing. While we have selected these third party vendors carefully, we do not control their actions. Any problems caused by these third parties, including as a result of their not providing us their services for any reason or their performing their services poorly, could adversely affect our ability to deliver products and services to our customers or otherwise conduct our business efficiently and effectively. Replacing these third party vendors could also entail significant delay and expense.

***Damage to our reputation could significantly harm our business, including our competitive position and business prospects.***

We are dependent on our reputation within our market area, as a trusted and responsible financial company, for all aspects of our relationships with customers, employees, vendors, third-party service providers, and others, with whom we conduct business or potential future business. Our ability to attract and retain customers and employees could be adversely affected if our reputation is damaged. Our actual or perceived failure to address various issues, including our ability to (a) identify and address potential conflicts of interest, ethical issues, money-laundering, or privacy issues; (b) meet legal and regulatory requirements applicable to the Bank and to the Company; (c) maintain the privacy of customer and accompanying personal information; (d) maintain adequate record keeping; (e) engage in proper sales and trading practices; and (f) identify the legal, reputational, credit, liquidity and market risks inherent in our products, could give rise to reputational risk that could cause harm to us and our business prospects. These issues also include, but are not limited to, legal and regulatory requirements; properly maintaining customer and employee personal information; record keeping; money-laundering; sales and trading practices; ethical issues; appropriately addressing potential conflicts of interest; and the proper identification of the legal, reputational, credit, liquidity and market risks inherent in our products. Failure to appropriately address any of these issues could also give rise to additional regulatory restrictions and legal risks, which could, among other consequences, increase the size and number of litigation claims and damages asserted or subject us to enforcement actions, fines and penalties and cause us to incur related costs and expenses.

***Internal controls may fail or be circumvented.***

Effective controls over financial reporting are necessary to help ensure reliable financial reporting and prevent fraud. Management is responsible for maintaining an effective system of internal control and assessing system effectiveness. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the system of internal control could have an adverse effect on our business, profitability, and financial condition, and could further result in regulatory actions and loss of investor confidence.

***Difficult economic conditions, both in the Community Banking Division's market area and more generally, could adversely affect our financial condition and results of operations.***

Our financial performance generally, and in particular the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans, is highly dependent upon the business environment in the markets where we operate and in the United States as a whole. Our Community Banking Division primarily serves individuals and businesses located in western and south-central Maine. As a result, a significant portion of our earnings are closely tied to the economy of Maine. In addition, our loan portfolio includes commercial loans acquired or originated by the LASG and the SBA Division that are secured by assets located nationwide. Deterioration in the economic conditions of the Community Banking Division's market area in Maine, and deterioration of the economy nationally could result in the following consequences:

- Loan delinquencies may increase;
- Problem assets and foreclosures may increase;
- Demand for our products and services may decline;

- Collateral for our loans may decline in value, in turn reducing a customer's borrowing power and reducing the value of collateral securing a loan; and
- The net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us.

***Our future growth, if any, may require us to raise additional capital, but that capital may not be available when we need it.***

As a bank, we are required by regulatory authorities to maintain adequate levels of capital to support our operations. In addition, in conjunction with the regulatory approvals received for the merger with FHB Formation LLC, we committed to maintain a Tier 1 leverage ratio of at least 10% and a total capital ratio of at least 15%. We may need to raise additional capital to support our operations or our growth, if any. Our ability to raise additional capital will depend, in part, on conditions in the capital markets and our financial performance at that time. Accordingly, we may be unable to raise additional capital, if and when needed, on acceptable terms, or at all. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired. In addition, if we decide to raise additional equity capital, investors' interests could be diluted. Our failure to meet any applicable regulatory guideline related to our lending activities or any capital requirement otherwise imposed upon us or to satisfy any other regulatory requirement could subject us to certain activity restrictions or to a variety of enforcement remedies available to the regulatory authorities, including limitations on our ability to pay dividends or pursue acquisitions, the issuance by regulatory authorities of a capital directive to increase capital and the termination of deposit insurance by the FDIC.

***The soundness of other financial institutions could adversely affect us.***

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty and other relationships. We have exposure to many different counterparties, and we routinely execute transactions with counterparties in the financial industry, including brokers and dealers, other commercial banks, investment banks, mutual and hedge funds, and other financial institutions. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, could lead to market-wide liquidity problems and losses or defaults by us or by other institutions and organizations. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be liquidated or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due to us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

## **Risks Associated With the Industry**

***Competition in the financial services industry is intense and could result in us losing business or experiencing reduced margins.***

Our future growth and success will depend on our ability to continue to compete effectively in the Community Banking Division's market area, and in the markets in which the LASG, the SBA Division, and ableBanking operate. We face aggressive competition from other domestic and foreign lending institutions and from numerous other providers of financial services. The ability of non-banking financial institutions to provide services previously limited to commercial banks has intensified competition. Because non-banking financial institutions are not subject to the same regulatory restrictions as banks and bank holding companies, they can often operate with greater flexibility and lower cost structures. Securities firms and insurance companies that elect to become financial holding companies may acquire banks and other financial institutions. This may significantly change the competitive environment in which we conduct our business. Some of our competitors have significantly greater financial resources, lending limits, and/or face fewer regulatory constraints and offer certain services that we do not or cannot provide. As a result of these various sources of competition, we could lose business to competitors or could be forced to price products and services on less advantageous terms to retain or attract clients, either of which would adversely affect its profitability.

***Changes in interest rates could adversely affect our net interest income and profitability.***

The majority of our assets and liabilities are monetary in nature. As a result, our earnings and growth are significantly affected by interest rates, which are subject to the influence of economic conditions generally, both domestic and foreign, to events in the capital markets and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve. The nature and timing of any changes in such policies or general economic conditions and their effect on us cannot be controlled and are extremely difficult to predict. Changes in interest rates can affect our net interest income as well as the value of our assets and liabilities. Net interest income is the difference between (i) interest income on interest-earning assets,

such as loans and securities, and (ii) interest expense on interest-bearing liabilities, such as deposits and borrowings. Changes in market interest rates, changes in the relationships between short-term and long-term market interest rates, or the yield curve, or changes in the relationships between different interest rate indices can affect the interest rates charged on interest-earning assets differently than the interest rates paid on interest-bearing liabilities. This difference could result in an increase in interest expense relative to interest income, and therefore reduce our net interest income. Further, declines in market interest rates may trigger loan prepayments, which in many cases are within our customers' discretion, and which in turn may serve to reduce our net interest income if we are unable to lend those funds to other borrowers or invest the funds at the same or higher interest rates.

***We operate in a highly regulated industry, and laws and regulations, or changes in them, could limit or restrict our activities and could have an adverse impact in our operations.***

We are subject to regulation and supervision by the Federal Reserve, and our banking subsidiary, Northeast Bank, is subject to regulation and supervision by the FDIC and the Maine Bureau of Financial Institutions. Federal and state laws and regulations govern numerous matters, including changes in the ownership or control of banks and bank holding companies, maintenance of adequate capital and the financial condition of a financial institution, permissible types, amounts and terms of extensions of credit and investments, permissible non-banking activities, the level of reserves against deposits and restrictions on dividend payments. The Federal Reserve, the FDIC and the Maine Bureau of Financial Institutions have the power to issue cease and desist orders to prevent or remedy unsafe or unsound practices or violations of law by banks subject to their regulation, and the Federal Reserve possesses similar powers with respect to bank holding companies. These and other restrictions limit the manner in which we and Northeast Bank may conduct business and obtain financing.

Because our business is highly regulated, the laws, rules, regulations, and supervisory guidance and policies applicable to us are subject to regular modification and change. Such changes may, among other things, increase the cost of doing business, limit permissible activities, or affect the competitive balance between banks and other financial institutions. The Dodd-Frank Act instituted major changes to the banking and financial institutions regulatory regimes in light of government intervention in the financial services sector following the 2008 financial crisis. Other changes to statutes, regulations, or regulatory policies, including changes in interpretation or implementation of statutes, regulations, or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer, and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations, or policies could result in sanctions by regulatory agencies, civil money penalties, and/or reputation damage, which could have a material adverse effect on our business, financial condition, and results of operations. See "Supervision and Regulation" in Item 1, "Business."

***The FDIC's assessment rates could adversely affect our financial condition and results of operations.***

The FDIC insures deposits at FDIC-insured depository institutions, such as Northeast Bank, up to applicable limits. As a result of recent economic conditions and the enactment of the Dodd-Frank Act, the FDIC has increased deposit insurance assessment rates. If these increases are insufficient for the deposit insurance fund of the FDIC to meet its funding requirements, there may need to be further special assessments or increases in deposit insurance premiums. We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there is additional bank or financial institution failures, we may be required to pay even higher FDIC premiums than the recently increased levels. Any future additional assessments, increases or required prepayments in FDIC insurance premiums may materially adversely affect results of operations, including by reducing our profitability or limiting our ability to pursue certain business opportunities.

***Changes in accounting standards can materially impact our financial statements.***

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time, the Financial Accounting Standards Board or regulatory authorities change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in our restating prior period financial statements.

***We may incur fines, penalties and other negative consequences from regulatory violations, possibly even inadvertent or unintentional violations.***

We maintain systems and procedures designed to ensure that we comply with applicable laws and regulations. However, some legal/regulatory frameworks provide for the imposition of fines or penalties for noncompliance even though the noncompliance was inadvertent or unintentional and even though there was in place at the time systems and procedures designed to ensure compliance. For example, we are subject to regulations issued by the Office of Foreign Assets Control, or "OFAC," that prohibit financial institutions from participating in the transfer of property belonging to the governments of certain foreign countries and designated nationals of those countries and certain other persons or entities whose interest in property is blocked by OFAC-administered sanctions. OFAC may impose penalties for inadvertent or unintentional violations even if reasonable processes are in place to prevent the violations. There may be other negative consequences resulting from a finding of noncompliance, including restrictions on certain activities. Such a finding may also damage our reputation as described below and could restrict the ability of institutional investment managers to invest in our securities.

### **Risks Associated With Our Common Stock**

***Market volatility has affected and may continue to affect the value of our common stock.***

The performance of our common stock has been and may continue to be affected by many factors, including volatility in the credit, mortgage and housing markets, and the markets with respect to financial institutions generally. Government action and changes in government regulations may affect the value of our common stock. More general market fluctuations, industry factors and general economic and political conditions and events, such as economic slowdowns or interest rate changes could also cause the value of our common stock to decrease regardless of our operating results.

***Our common stock trading volume may not provide adequate liquidity for investors.***

Our voting common stock is listed on the NASDAQ Global Market. The average daily trading volume for Northeast voting common stock is less than the corresponding trading volume for larger financial institutions. Due to this relatively low trading volume, significant sales of Northeast voting common stock, or the expectation of these sales, may place significant downward pressure on the market price of Northeast voting common stock. No assurance can be given that a more active trading market in our common stock will develop in the foreseeable future or can be maintained. There can also be no assurance that the offering will result in a material increase in the "float" for our common stock, which we define as the aggregate market value of our voting common stock held by shareholders who are not affiliates of Northeast, because our affiliates may purchase shares of voting common stock in the offering.

***There is a limited market for and restrictions on the transferability of our non-voting common stock.***

Our non-voting common stock is not and will not be listed on any exchange. Additionally, the non-voting common stock can only be transferred in certain limited circumstances set forth in our articles of incorporation. Accordingly, holders of our non-voting common stock may be required to bear the economic consequences of holding such non-voting common stock for an indefinite period of time.

***If we defer payments of interest on our outstanding junior subordinated debt securities or if certain defaults relating to those debt securities or our outstanding subordinated notes occur, we will be prohibited from declaring or paying dividends or distributions on, and from making liquidation payments with respect to, our common stock.***

As of June 30, 2016, we had outstanding \$16.5 million in aggregate principal amount of junior subordinated debt securities issued in connection with the sale of trust preferred securities by affiliates of ours that are statutory business trusts. We have also guaranteed those trust preferred securities. The indenture under which the junior subordinated debt securities were issued, together with the guarantee, prohibits us, subject to limited exceptions, from declaring or paying any dividends or distributions on, or redeeming, repurchasing, acquiring or making any liquidation payments with respect to, any of our capital stock at any time when (i) there shall have occurred and be continuing an event of default under the indenture; (ii) we are in default with respect to payment of any obligations under the guarantee; or (iii) we have elected to defer payment of interest on the junior subordinated debt securities. In that regard, we are entitled, at our option but subject to certain conditions, to defer payments of interest on the junior subordinated debt securities from time to time for up to five years.

Events of default under the indenture generally consist of our failure to pay interest on the junior subordinated debt securities under certain circumstances, our failure to pay any principal of or premium on such junior subordinated debt securities when due, our failure to comply with certain covenants under the indenture, and certain events of bankruptcy, insolvency or liquidation relating to us.

As a result of these provisions, if we were to elect to defer payments of interest on the junior subordinated debt securities, or if any of the other events described in clause (i) or (ii) of the first paragraph of this risk factor were to occur, we would be prohibited from declaring or paying any dividends on our capital stock, from redeeming, repurchasing or otherwise acquiring any of our capital stock, and from making any payments to holders of our capital stock in the event of our liquidation, which would likely have a material adverse effect on the market value of our common stock.

As of June 30, 2016, we had outstanding \$15.05 million in aggregate principal amount of 6.75% fixed-to-floating subordinated notes due 2026. If we were to be in default with respect to payment of any obligation under the notes, we would be prohibited from declaring or paying any dividends. We would also be prohibited from paying any distributions on, redeeming, purchasing, acquiring, or making a liquidation payment with respect to any of the Company's capital stock, which would likely have a material adverse effect on the market value of our common stock.

***We are dependent upon our subsidiaries for dividends, distributions and other payments.***

We are a separate and distinct legal entity from Northeast Bank, and depend on dividends, distributions and other payments from Northeast Bank to fund dividend payments on our common stock and to fund all payments on our other obligations. We and Northeast Bank are subject to laws that authorize regulatory authorities to block or reduce the flow of funds from Northeast Bank to us. Regulatory action of that kind could impede access to the funds that Northeast needs in order to make payments on its obligations or dividend payments. In addition, if Northeast Bank does not maintain sufficient capital levels or its earnings are not sufficient to make dividend payments to us, we may not be able to make dividend payments to our common and preferred shareholders. Further, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of Northeast Bank's creditors.

***We may not be able to pay dividends and, if we pay dividends, we cannot guarantee the amount and frequency of such dividends.***

The continued payment of dividends on shares of our common stock will depend upon our debt and equity structure, earnings and financial condition, need for capital in connection with possible future acquisitions, growth and other factors, including economic conditions, regulatory restrictions, and tax considerations. We cannot guarantee that we will pay dividends or, if we pay dividends, the amount and frequency of these dividends.

***We may issue additional shares of common or preferred stock in the future, which could dilute a shareholder's ownership of common stock.***

Our articles of incorporation authorize our Board of Directors, generally without shareholder approval, to, among other things, issue additional shares of common or preferred stock. The issuance of any additional shares of common or preferred stock could be dilutive to a shareholder's ownership of our common stock. To the extent that we issue options or warrants to purchase common stock in the future and the options or warrants are exercised, our shareholders may experience further dilution. Holders of shares of our common stock have no preemptive rights that entitle holders to purchase their pro rata share of any offering of shares of any class or series and, therefore, shareholders may not be permitted to invest in future issuances of Northeast common or preferred stock. We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. Accordingly, regulatory requirements and/or deterioration in our asset quality may require us to sell common stock to raise capital under circumstances and at prices that result in substantial dilution.

***We may issue debt and equity securities that are senior to our common stock as to distributions and in liquidation, which could negatively affect the value of our common stock.***

In the future, we may increase our capital resources by entering into debt or debt-like financing or issuing debt or equity securities, which could include issuances of senior notes, subordinated notes, preferred stock or common stock. In the event of our liquidation, our lenders and holders of its debt or preferred securities would receive a distribution of our available assets before distributions to the holders of Northeast common stock. Our decision to incur debt and issue securities in future offerings will depend on market conditions and other factors beyond our control. We cannot predict or estimate the amount, timing or nature of our future offerings and debt financings. Future offerings could reduce the value of shares of our common stock and dilute a shareholder's interest in Northeast.

***Our common stock is not insured by any governmental entity.***

Our common stock is not a deposit account or other obligation of any bank and is not insured by the FDIC or any other governmental entity.

***Anti-takeover provisions could negatively impact our shareholders.***

Federal law imposes restrictions, including regulatory approval requirements, on persons seeking to acquire control over Northeast. Provisions of Maine law and provisions of our articles of incorporation and by-laws could make it more difficult for a third party to acquire control of us or have the effect of discouraging a third party from attempting to acquire control of us. We have a classified Board of Directors, meaning that approximately one-third of our directors are elected annually. Additionally, our articles of organization authorize our Board of Directors to issue preferred stock without shareholder approval and such preferred stock could be issued as a defensive measure in response to a takeover proposal. Other provisions that could make it more difficult for a third party to acquire us even if an acquisition might be in the best interest of our shareholders include supermajority voting requirements to remove a director from office without cause; restrictions on shareholders calling a special meeting; a requirement that only directors may fill a Board vacancy; and provisions regarding the timing and content of shareholder proposals and nominations.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

At June 30, 2016, the Company conducted its business from its headquarters in Lewiston, Maine, an office in Boston, Massachusetts, and an office in Portland, Maine. The Company also conducts business from its ten full-service bank branches and six loan production offices located in western and south-central Maine and southern New Hampshire. The Company believes that all of its facilities are well maintained and suitable for the purpose for which they are used.

In addition to its Lewiston, Maine, Boston, Massachusetts and Portland, Maine offices, the Company leases eleven of its other locations. For information regarding the Company's lease commitments, please refer to "Lease Obligations" under Note 15 of the Notes to the Consolidated Financial Statements in Item 8 of this Annual Report.

**Item 3. Legal Proceedings**

From time to time, the Company and its subsidiaries are subject to certain legal proceedings and claims in the ordinary course of business. Management presently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not be material to the Company or its consolidated financial position. The Company establishes reserves for specific legal matters when it determines that the likelihood of an unfavorable outcome is probable and the loss is reasonably estimable. Legal proceedings are subject to inherent uncertainties, and unfavorable rulings could occur that could cause the Company to establish litigation reserves or could have, individually or in the aggregate, a material adverse effect on its business, financial condition, or operating results.

**Item 4. Mine Safety Disclosures**

Not applicable.



## PART II

### Item 5. Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

(a) The Company's voting common stock currently trades on the NASDAQ under the symbol "NBN." There is no established public trading market for the Company's non-voting common stock. As of the close of business on September 2, 2016, there were approximately 419 registered shareholders of record.

The following table sets forth the high and low closing sale prices of the Company's voting common stock, as reported on NASDAQ, and quarterly dividends paid on the Company's voting and non-voting common stock during the periods indicated:

Fiscal year ended June 30, 2016	High	Low	Dividend Paid
Jul 1 – Sep 30 .....	\$ 11.02	\$ 9.82	\$ 0.01
Oct 1 – Dec 31.....	11.02	9.91	0.01
Jan 1 – Mar 31.....	11.00	9.56	0.01
Apr 1 – Jun 30.....	11.72	10.31	0.01
Fiscal year ended June 30, 2015	High	Low	Dividend Paid
Jul 1 – Sep 30 .....	\$ 9.60	\$ 9.19	\$ 0.01
Oct 1 – Dec 31.....	9.68	8.79	0.01
Jan 1 – Mar 31.....	9.73	8.92	0.01
Apr 1 – Jun 30.....	10.25	9.14	0.01

On September 2, 2016, the last reported sale price of the Company's voting common stock, as reported on NASDAQ was \$11.42. Holders of the Company's voting and non-voting common stock are entitled to receive dividends when and if declared by the Board of Directors out of funds legally available. The amount and timing of future dividends payable on the Company's voting and non-voting common stock will depend on, among other things, the financial condition of the Company, regulatory considerations, and other factors. The Company is a legal entity separate from the Bank, but its revenues are derived primarily from the Bank. Accordingly, the ability of the Company to pay cash dividends on its stock in the future generally will be dependent upon the earnings of the Bank and the Bank's ability to pay dividends to the Company. The payment of dividends by the Bank will depend on a number of factors, including capital requirements, regulatory limitations, the Bank's results of operations and financial condition, tax considerations, and general economic conditions. National banking laws regulate and restrict the ability of the Bank to pay dividends to the Company. See "Item 1. Business—Supervision and Regulation."

Information regarding securities authorized for issuance under our equity compensation plans will be included in the Proxy Statement relating to our 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

(b) Not applicable.

(c) On April 30, 2015, the Board of Directors voted to amend the Company's existing stock repurchase program to authorize the Company to purchase an additional 500,000 shares of its common stock, representing 5.1% of the Company's outstanding common shares or approximately \$4.7 million based on the Company's closing stock price on April 29, 2015. The amended stock repurchase program will expire on April 30, 2017.

On February 25, 2016, the Board of Directors voted to further amend the Company's existing stock repurchase program subject to regulatory approval, which was received on March 2, 2016. The approved amendment, which was effective March 2, 2016, increased the existing stock repurchase program by an additional 600,000 shares of the Company's common stock, representing 6.3% of the Company's outstanding common shares or approximately \$6.3 million based on the Company's closing stock price on March 2, 2016. The amended stock repurchase program will expire on March 2, 2018.

The following table sets forth information with respect to purchases made by us of our common stock during the fourth quarter of fiscal year ended June 30, 2016:

Period	Total Number of Shares Purchased (1)	Weighted Average Price Per share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Number of Shares that May Yet Be Purchased Under the Program
Apr. 1 –Apr. 30 .....	11,800	\$ 10.78	1,323,162	646,838
May 1 –May 31 .....	1,600	11.14	1,324,762	645,238
Jun. 1 –Jun. 30.....	-	-	1,324,762	645,238 <sup>(2)</sup>

(1) Based on trade date, not settlement date

(2) On August 22, 2016, the Company purchased 645,238 shares at a price of \$10.75 per share.

## Item 6. Selected Financial Data

The following table sets forth our selected financial and operating data on a historical basis. The data set forth below does not purport to be complete. It should be read in conjunction with, and is qualified in its entirety by, the more detailed information, including the Company's Consolidated Financial Statements and related notes, appearing elsewhere herein.

	Twelve Months Ended June 30, 2016	Twelve Months Ended June 30, 2015	Twelve Months Ended June 30, 2014	Twelve Months Ended June 30, 2013	Twelve Months Ended June 30, 2012
(Dollars in thousands, except per share data)					
Selected operations data:					
Interest and dividend income ....	\$ 47,235	\$ 44,588	\$ 38,371	\$ 36,543	\$ 27,014
Interest expense .....	7,855	7,220	6,653	6,596	6,317
Net interest income .....	39,380	37,368	31,718	29,947	20,697
Provision for loan losses .....	1,618	717	531	1,122	946
Noninterest income .....	7,773	7,089	4,869	8,514	5,782
Net securities gains .....	-	-	-	792	1,111
Noninterest expense .....	33,812	32,604	31,777	31,955	25,680
Income before income taxes .....	11,723	11,136	4,279	6,176	964
Income tax expense .....	4,104	3,995	1,579	1,881	102
Net income from continuing operations .....	7,619	7,141	2,700	4,295	862
Net (loss) income from discontinued operations .....	-	-	(8)	125	1,301
Net income.....	<u>\$ 7,619</u>	<u>\$ 7,141</u>	<u>\$ 2,692</u>	<u>\$ 4,420</u>	<u>\$ 2,163</u>
Consolidated per share data:					
Earnings:					
Basic:					
Continuing operations.....	\$ 0.80	\$ 0.72	\$ 0.26	\$ 0.38	\$ 0.11
Discontinued operations.....	0.00	0.00	0.00	0.01	0.30
Net income .....	<u>\$ 0.80</u>	<u>\$ 0.72</u>	<u>\$ 0.26</u>	<u>\$ 0.39</u>	<u>\$ 0.41</u>
Diluted:					
Continuing operations.....	\$ 0.80	\$ 0.72	\$ 0.26	\$ 0.38	\$ 0.11
Discontinued operations.....	0.00	0.00	0.00	0.01	0.30
Net income .....	<u>\$ 0.80</u>	<u>\$ 0.72</u>	<u>\$ 0.26</u>	<u>\$ 0.39</u>	<u>\$ 0.41</u>
Cash dividends .....	\$ 0.04	\$ 0.04	\$ 0.28	\$ 0.36	\$ 0.36
Book value .....	12.51	11.77	11.05	10.89	11.07
Selected balance sheet data:					
Total assets .....	\$ 986,153	\$ 850,718	\$ 761,931	\$ 670,639	\$ 669,196
Loans .....	692,436	612,137	516,416	435,376	356,254
Deposits .....	800,432	674,759	574,329	484,623	422,188
Borrowings and capital lease obligations .....	54,534	52,568	66,005	64,069	120,859
Total shareholders' equity .....	116,591	112,727	112,066	113,802	119,139
Other ratios:					
Return on average assets .....	0.85%	0.89%	0.37%	0.64%	0.36%
Return on average equity .....	6.66%	6.35%	2.39%	3.79%	3.03%
Efficiency ratio.....	71.71%	73.34%	86.85%	81.41%	93.08%
Average equity to average total assets .....	12.71%	14.00%	15.38%	16.93%	11.90%
Common dividend payout ratio .....	5.00%	5.56%	107.6%	92.25%	71.26%
Tier 1 leverage capital ratio.....	13.27%	14.49%	15.90%	17.78%	19.91%
Total capital ratio .....	20.39%	20.14%	23.69%	27.54%	33.34%

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Northeast Bancorp is a Maine corporation and a bank holding company registered with the Federal Reserve under the Bank Holding Company Act of 1956. The Company also is a registered Maine financial institution holding company, and is subject to regulation by both the Maine Bureau of Financial Institutions and the Federal Reserve. The Company's principal asset is the capital stock of Northeast Bank, a Maine state-chartered universal bank, which is regulated by the FDIC and the Bureau. The Company's results of operations are primarily dependent on the results of the operations of the Bank.

The Management's Discussion and Analysis of Financial Condition and Results of Operations, which follows, presents a review of the consolidated operating results of the Company for the fiscal year ended June 30, 2016 ("fiscal 2016") and the fiscal year ended June 30, 2015 ("fiscal 2015"). This discussion and analysis is intended to assist you in understanding the results of our operations and financial condition. You should read this discussion together with your review of the Company's Consolidated Financial Statements and related notes and other statistical information included in this report. Certain amounts in the periods prior to fiscal 2016 have been reclassified to conform to the fiscal 2016 presentation.

### Overview

On December 29, 2010, the merger (the "Merger") of the Company and FHB Formation LLC, a Delaware limited liability company ("FHB"), was consummated. In connection with the transaction, as part of the regulatory approval process the Company made certain commitments to the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the most significant of which are, (i) maintain a Tier 1 leverage ratio of at least 10%, (ii) maintain a total capital ratio of at least 15%, (iii) limit purchased loans to 40% of total loans, (iv) fund 100% of the Company's loans with core deposits (defined as non-maturity deposits and non-brokered insured time deposits), and (v) hold commercial real estate loans (including owner-occupied commercial real estate) to within 300% of total capital.

On June 28, 2013, the Federal Reserve approved the amendment of the commitment to hold commercial real estate loans to within 300% of total capital to exclude owner-occupied commercial real estate loans. 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 June 30, 2016 are as follows:

Condition	Ratio
(i) Tier 1 leverage ratio .....	13.27%
(ii) Total capital ratio .....	20.39%
(iii) Ratio of purchased loans to total loans.....	34.25%
(iv) Ratio of loans to core deposits (1) .....	87.15%
(v) Ratio of non-owner occupied commercial real estate loans to total capital (2) .....	174.12%

- (1) Core deposits include all non-maturity deposits and non-brokered insured time deposits
- (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

### Fiscal 2016 Financial Highlights

The Company's financial and strategic highlights for fiscal 2016 include the following:

- Earned net income of \$7.6 million, or \$0.80 per diluted share, as compared to \$7.1 million, or \$0.72 per diluted share, in fiscal 2015.
- Generated loans of \$382 million, growing the portfolio on a net basis by \$80.3 million or 13.1%.
- LASG purchased loans totaling \$100.0 million and originated loans totaling \$110.6 million, earning average portfolio yields of 11.4% and 6.1%, respectively. The purchased loan yield of 11.4% includes regularly scheduled interest and accretion, and accelerated accretion and fees recognized on loan payoffs. The Company also monitors the "total return" on its purchased loan portfolio, a measure that includes gains on sales of purchased loans, as well as interest, scheduled accretion and accelerated accretion and fees. On this basis, the purchased loan portfolio earned a total return of 11.4% for fiscal 2016.

An overview of the LASG portfolio follows:

	Year Ended June 30,							
	2016				2015			
	<u>Purchased</u>	<u>Originated</u>	<u>Secured Loans to Broker- Dealers</u>	<u>Total LASG</u>	<u>Purchased</u>	<u>Originated</u>	<u>Secured Loans to Broker- Dealers</u>	<u>Total LASG</u>
	(Dollars in thousands)							
Loans purchased or originated during the period:								
Unpaid principal balance .....	\$ 108,716	\$ 110,578	\$ -	\$ 219,294	\$ 93,694	\$ 82,502	\$ 48,000	\$ 224,196
Net investment basis .	99,999	110,578	-	210,577	82,654	82,502	48,000	213,156
Loan returns during the period:								
Yield (1).....	11.37%	6.11%	0.50%	8.03%	13.00%	6.44%	0.47%	9.73%
Total Return (1) (2).....	11.38%	6.10%	0.50%	8.04%	13.33%	6.75%	0.47%	10.02%
Total loans as of period end:								
Unpaid principal balance .....	\$ 271,268	\$ 174,918	\$ 48,000	\$ 494,186	\$ 239,933	\$ 118,416	\$ 60,000	\$ 418,349
Net investment basis ...	239,709	174,918	48,000	462,627	202,592	118,416	60,000	381,008

(1) The yield and total return on LASG originated loans includes \$385 thousand of fees related to one loan in the quarter ended June 30, 2016.

(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, on an annualized basis. The total return does not include the effect of purchased loan charge-offs or recoveries in the quarter.

- Increased the Company's deposit base by \$125.7 million, mainly the result of the increase in money market accounts attracted through the Bank's Community Banking division.
- Originated \$54.5 million in SBA guaranteed loans through June 30, 2016, and sold \$39.1 million of loans, for a gain on sale of \$4.2 million.
- Raised \$15.05 million of subordinated notes at a cost of 6.75% which qualify for Tier 2 Capital treatment.
- Repurchased 322,900 shares at an average repurchase price of \$10.40.

## Results of Operations

### General

Net income for the year ended June 30, 2016 was \$7.6 million, a \$478 thousand increase from \$7.1 million for the year ended June 30, 2015.

Items of significance affecting the Company's earnings included:

- An increase in net interest and dividend income before provision for loan losses, which grew to \$39.4 million as compared to \$37.4 million for the year ended June 30, 2015, principally due to higher average balances in the total loan portfolio.

The following table summarizes interest income and related yields recognized on the Company's loans:

	Interest Income and Yield on Loans					
	Year Ended June 30,					
	2016			2015		
Average Balance (1)	Interest Income (2)	Yield	Average Balance (1)	Interest Income	Yield	
(Dollars in thousands)						
Community						
Banking.....	\$ 218,649	\$ 10,483	4.79%	\$ 233,506	\$ 11,599	4.97%
SBA.....	23,786	1,448	6.09%	2,622	148	5.64%
LASG:						
Originated.....	147,193	8,987	6.11%	76,448	4,924	6.44%
Purchased.....	216,763	24,638	11.37%	203,822	26,500	13.00%
Secured Loans to						
Broker-Dealers	58,511	293	0.50%	44,942	212	0.47%
Total LASG...	422,467	33,918	8.03%	325,212	31,636	9.73%
Total .....	\$ 664,902	\$ 45,849	6.90%	\$ 561,340	\$ 43,383	7.73%

(1) Includes loans held for sale.

(2) SBA interest income includes SBA fees of \$33 thousand for the year ended June 30, 2016.

The yield on purchased loans is affected by unscheduled loan payoffs, which resulted in immediate recognition of the prepaid loans' discount in interest income. The following table details the "total return" on purchased loans, which includes total transactional income of \$7.3 million for the year ended June 30, 2016, a decrease of \$2.6 million from the year ended June 30, 2015. The following table summarizes the total return recognized on the purchased loan portfolio:

	Year Ended June 30,			
	2016		2015	
	Income	Return (1)	Income	Return (1)
(Dollars in thousands)				
Regularly scheduled interest and accretion .....	\$ 17,382	8.02%	\$ 17,327	8.48%
Transactional income:				
Gain on loan sales.....	-	0.00%	190	0.09%
Gain on sale of real estate owned .....	23	0.01%	607	0.30%
Other noninterest income (loss).....	12	0.00%	(69)	-0.03%
Accelerated accretion and loan fees .....	7,256	3.35%	9,173	4.49%
Total transactional income .....	7,291	3.36%	9,901	4.85%
Total .....	\$ 24,673	11.38%	\$ 27,228	13.33%

(1) The total return on purchased loans represents scheduled accretion, accelerated accretion, gains on asset sales, gains on real estate owned and other noninterest income recorded during the period divided by the average invested balance, on an annualized basis. The total return does not include the effect of purchased loan charge-offs or recoveries in the quarter.

- An increase of \$901 thousand in the provision for loan losses principally due to two loans which were provided for in the second quarter and increased volume of newly originated loans.
- An increase of \$684 thousand in noninterest income, principally resulting from an increase of \$1.4 million in gains realized on sale of portfolio loans. The year ended June 30, 2016 includes gains realized on sale of SBA loans of \$4.2 million. The increase is offset by a decrease of \$193 thousand in gains realized on sale of residential loans held for sale due to lower volume, as well as a decrease of \$683 thousand in gain recognized on real estate owned and other repossessed collateral, net.
- An increase of \$1.2 million in noninterest expense, principally due to an increase of \$731 thousand in salaries and employee benefits from increased employee head count and higher employee benefits costs. Additionally, there was an increase of \$428 thousand in other expense, attributable to the valuation of SBA servicing rights.

## Net Interest Income

The following table sets forth average balance sheets, average yields and costs, and certain other information for the periods indicated:

	Year Ended June 30,								
	2016			2015			2014		
	Average Balance	Interest Income/Expense	Average Yield/Rate	Average Balance	Interest Income/Expense	Average Yield/Rate	Average Balance	Interest Income/Expense	Average Yield/Rate
	(Dollars in thousands)								
Assets:									
Interest-earning assets:									
Investment securities .....	\$ 100,503	\$ 930	0.93%	\$ 108,204	\$ 913	0.84%	\$ 115,849	\$ 1,048	0.90%
Loans (1) (2) (3) .....	664,902	45,921	6.91%	561,340	43,456	7.74%	495,113	37,009	7.47%
Regulatory stock .....	2,960	113	3.82%	4,102	67	1.63%	5,620	123	2.19%
Short-term investments (4) .....	91,563	343	0.37%	92,354	225	0.24%	78,838	191	0.24%
Total interest-earning assets .....	<u>859,928</u>	<u>47,307</u>	5.50%	<u>766,000</u>	<u>44,661</u>	5.83%	<u>695,420</u>	<u>38,371</u>	5.52%
Cash and due from banks .....	3,596			2,704			2,876		
Other non-interest earning assets .....	35,607			33,741			33,958		
Total assets .....	<u>\$899,131</u>			<u>\$802,445</u>			<u>\$732,254</u>		
Liabilities & Shareholders' Equity:									
Interest-bearing liabilities:									
NOW accounts .....	\$ 68,304	\$ 182	0.27%	\$ 63,181	\$ 162	0.26%	\$ 61,146	\$ 162	0.26%
Money market accounts .....	212,102	1,845	0.87%	133,266	1,002	0.75%	85,333	447	0.52%
Savings accounts .....	36,062	48	0.13%	34,495	46	0.13%	34,391	44	0.13%
Time deposits .....	349,978	3,952	1.13%	340,046	3,800	1.12%	314,848	3,470	1.10%
Total interest-bearing deposits .....	666,446	6,027	0.90%	570,988	5,010	0.88%	495,718	4,123	0.83%
Short-term borrowings .....	1,634	20	1.22%	2,578	29	1.12%	2,230	24	1.08%
Borrowed funds .....	32,432	1,094	3.37%	45,661	1,389	3.04%	58,468	1,658	2.98%
Subordinated debt .....	8,762	651	7.43%	8,531	718	8.42%	8,352	765	9.16%
Capital lease obligations .....	1,242	63	5.07%	1,457	74	5.08%	1,643	83	5.05%
Total interest-bearing liabilities .....	<u>710,516</u>	<u>7,855</u>	1.11%	<u>629,215</u>	<u>7,220</u>	1.15%	<u>566,411</u>	<u>6,653</u>	1.18%
Non-interest bearing liabilities:									
Demand deposits and escrow accounts .....	67,041			54,940			50,890		
Other liabilities .....	7,252			5,913			2,319		
Total liabilities .....	784,809			690,068			619,620		
Shareholders' equity .....	114,322			112,377			112,634		
Total liabilities and shareholders' equity .....	<u>\$899,131</u>			<u>\$802,445</u>			<u>\$732,254</u>		
Net interest income .....		<u>\$ 39,452</u>			<u>\$ 37,441</u>			<u>\$ 31,718</u>	
Interest rate spread .....			4.39%			4.68%			4.34%
Net interest margin (5) .....			4.59%			4.89%			4.56%

(1) Interest income and yield are stated on a fully tax-equivalent basis using a 34% tax rate.

(2) Includes loans held for sale.

(3) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.

(4) Short term investments include FHLBB overnight deposits and other interest-bearing deposits.

(5) Net interest margin is calculated as net income divided by total interest-earning assets.

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

	Year Ended June 30, 2016		
	Compared to the Year Ended June 30, 2015		
	Change Due to Volume	Change Due to Rate	Total Change
	(Dollars in thousands)		
Interest earning assets:			
Investment securities .....	\$ (68)	\$ 85	\$ 17
Loans .....	7,471	(5,006)	2,465
Regulatory stock .....	(23)	69	46
Short-term investments .....	(2)	120	118
Total increase (decrease) in interest income .....	7,378	(4,732)	2,646
Interest-bearing liabilities:			
Interest-bearing deposits .....	793	224	1,017
Short-term borrowings .....	(12)	3	(9)
Borrowed funds .....	(434)	139	(295)
Subordinated debt .....	19	(86)	(67)
Capital lease obligations .....	(11)	-	(11)
Total increase in interest expense .....	355	280	635
Total increase (decrease) in net interest and dividend income .....	\$ 7,023	\$ (5,012)	\$ 2,011

	Year Ended June 30, 2015		
	Compared to the Year Ended June 30, 2014		
	Change Due to Volume	Change Due to Rate	Total Change
	(Dollars in thousands)		
Interest earning assets:			
Investment securities .....	\$ (67)	\$ (68)	\$ (135)
Loans .....	5,090	1,357	6,447
Regulatory stock .....	(29)	(27)	(56)
Short-term investments .....	33	1	34
Total increase in interest income .....	5,027	1,263	6,290
Interest bearing liabilities:			
Interest bearing deposits .....	612	275	887
Short-term borrowings .....	4	1	5
Borrowed funds .....	(314)	45	(269)
Subordinated debt .....	16	(63)	(47)
Capital lease obligations .....	(9)	-	(9)
Total increase in interest expense .....	309	258	567
Total increase in net interest and dividend income ...	\$ 4,718	\$ 1,005	\$ 5,723

For the year ended June 30, 2016, the \$7.0 million volume-related change in net interest income was mainly the result of the significant increase in loans, which grew by \$103.6 million on average compared to fiscal 2015. The rate-related change in fiscal 2016 compared to fiscal 2015 was principally due to the purchased loan yield differential, and a decline in yields on the originated loan portfolios. For fiscal 2016, the net interest margin earned of 4.59% was 30 basis points lower than that earned for the year ended June 30, 2015, principally due to the decrease in transactional income on purchased loans.

The Company's total cost of funds improved to 1.01% in fiscal 2016, down from 1.06% in fiscal 2015, principally due to the payoff of interest-bearing liabilities in fiscal 2016.



### ***Provision for Loan Losses***

Quarterly, the Company determines the amount of its allowance for loan losses adequate to provide for losses inherent in the Company's loan portfolios, with the provision for loan losses determined by the net periodic change in the allowance for loan losses. For acquired loans accounted for under ASC 310-30, *Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality* ("ASC 310-30"), a provision for loan loss is recorded when estimates of future cash flows decrease due to credit deterioration.

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

The provision for loan losses for the fiscal year ended June 30, 2016 was \$1.6 million. This compares to a provision for loan losses of \$717 thousand for the year ended June 30, 2015. At June 30, 2016 and 2015, the allowance for loan losses was \$2.4 million and \$1.9 million, respectively, and the ratio of allowance for loan losses to total loans was 0.34% and 0.31%, respectively.

Net charge-offs for the fiscal year ended June 30, 2016 totaled \$1.2 million, representing approximately 0.18% of the Company's average portfolio loan balance during the fiscal year. This compares to \$158 thousand, or 0.03%, in fiscal 2015, representing an increase of \$1.0 million in fiscal 2016. The increase was principally due to two loans which were provided for in the second quarter, and subsequently charged off.

For additional information on the allowance for loan losses, see "Asset Quality."

### ***Noninterest Income***

Noninterest income for the fiscal year ended June 30, 2016 totaled \$7.8 million, an increase of \$684 thousand, or 9.6%, from fiscal 2015. When compared to fiscal 2015, the increase was principally due to the following:

- An increase of \$1.4 million in gains realized on sale of portfolio loans. The year ended June 30, 2016 includes gains realized on sale of SBA loans of \$4.2 million, compared to a \$2.8 million gain on sale of SBA loans and LASG purchased loans in the year ended June 30, 2015; and
- A \$683 thousand decrease in net gain recognized on real estate owned and other repossessed collateral, net.

### ***Noninterest Expense***

Noninterest expense for the fiscal year ended June 30, 2016 totaled \$33.8 million, an increase of \$1.2 million, or 3.7%, from fiscal 2015. When compared to fiscal 2015, the increase was principally due to the following:

- An increase of \$731 thousand in salaries and employee benefit costs, principally due to increased employee head count, as well as higher employee benefits; and
- An increase of \$428 thousand in other expense, which is primarily attributed to the valuation of SBA servicing rights.

### ***Income Taxes***

Income tax expense for the fiscal year ended June 30, 2016 totaled \$4.1 million, representing 35.0% of pretax income, as compared to \$4.0 million, or 35.9% of pretax income, in fiscal 2015. The decrease in the Company's effective tax rate was principally due to the adoption of ASU 2014-01, *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* ("ASU 2014-01") in fiscal 2016 and changes in state apportionment. See Note 1 of the Notes to the Company's Consolidated Financial Statements in this Annual Report for impact related to the adoption of ASU 2014-01.

## Financial Condition

### Overview

The Company's total assets grew to \$986.2 million at June 30, 2016, representing an increase of \$135.5 million, or 15.9%, compared to \$850.7 million at June 30, 2015. Significant changes in the Company's balance sheet components include:

- The loan portfolio – excluding loans held for sale – has grown by \$80.3 million, or 13.1%, compared to June 30, 2015, principally on the strength of \$81.6 million of net growth in commercial loans purchased or originated by the LASG, net growth of \$15.5 million in originations by the SBA Division and net growth of \$3.9 million in commercial originations by the Community Banking Division. The total net growth was offset by a pay down of one secured loan to a broker-dealer for \$12.0 million in the LASG portfolio and a \$20.9 million decrease in the Community Banking Division residential and consumer loan portfolio;
- Deposits increased \$125.7 million, or 18.6%, primarily due to growth in non-maturity accounts of \$120.3 million, or 36.6%, and growth in time deposits of \$5.4 million, or 1.6%; and
- Shareholders' equity increased by \$3.9 million from June 30, 2015, due principally to earnings of \$7.6 million, offset by \$3.4 million in share repurchases (representing 322,900 shares). Additionally, there was an increase in stock-based compensation of \$613 thousand, offset by a decrease in accumulated other comprehensive loss of \$618 thousand and \$380 thousand in dividends paid on common stock.

### Cash and Cash Equivalents

Cash and cash equivalents increased \$61.3 million, or 68.2%, to \$151.2 million at June 30, 2016 as compared to \$89.9 million at June 30, 2015. This increase was principally the result of net deposit growth of \$125.7 million and the issuance of \$15.05 million of subordinated notes in fiscal 2016, partially offset by net loan growth of \$80.3 million.

### Investments Securities

The available-for-sale securities portfolio totaled \$100.6 million and \$101.9 million at June 30, 2016 and 2015, respectively. The Company's investment portfolio was comprised primarily of U.S. Government-sponsored enterprise bonds and mortgage-backed securities guaranteed by government agencies. Generally, funds retained by the Company as a result of increases in deposits or decreases in loans, to the extent not immediately deployed by the Bank, are invested in securities held in its investment portfolio, which serves as a source of liquidity for the Company. The composition of the Company's securities portfolio at the dates indicated follows.

	June 30, 2016		June 30, 2015		June 30, 2014	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)					
U.S. Government agency securities .	\$ 51,948	\$ 52,046	\$ 48,191	\$ 48,230	\$ 48,415	\$ 48,418
Agency mortgage-backed securities.	43,330	43,368	54,553	53,678	66,744	65,463
Other investment measured at net asset value .....	5,097	5,158	-	-	-	-
	<u>\$ 100,375</u>	<u>\$ 100,572</u>	<u>\$ 102,744</u>	<u>\$ 101,908</u>	<u>\$ 115,159</u>	<u>\$ 113,881</u>

The table below sets forth certain information regarding the contractual maturities and weighted average yields of the Company's securities portfolio at June 30, 2016. Actual maturities of mortgage-backed securities will differ from contractual maturities due both to scheduled amortization and prepayments.

	Within One Year		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield
(Dollars in thousands)										
U.S. Government agency securities .....	\$ 12,014	0.54%	\$ 40,032	0.83%	\$ -	0.00%	\$ -	0.00%	\$ 52,046	0.76%
Agency mortgage-backed securities .....	-	0.00%	-	0.00%	19,797	0.85%	23,571	1.30%	43,368	1.09%
	<u>\$ 12,014</u>	<u>0.54%</u>	<u>\$ 40,032</u>	<u>0.83%</u>	<u>\$ 19,797</u>	<u>0.85%</u>	<u>\$ 23,571</u>	<u>1.30%</u>	<u>\$ 95,414</u>	<u>0.91%</u>

The other investment measured at net asset value has no scheduled maturity date. However, the Company's investment can be redeemed daily at the closing net asset value.

Management reviews the portfolio of investments on an ongoing basis to determine if there have been any other-than-temporary declines in value. No other-than-temporary impairment expense was recognized during fiscal 2016 or fiscal 2015.

### Loans

Loans, including loans held-for-sale, totaled \$700.0 million at June 30, 2016, compared to \$621.2 million at June 30, 2015. The increase of \$78.8 million, or 12.7%, at June 30, 2016, was principally due to net increases of \$77.9 million in commercial real estate and \$22.8 million in commercial and industrial, offset by a net decrease of \$18.7 million in residential loans, \$1.7 million in consumer loans and \$1.5 million in loans held for sale. During fiscal 2016, the LASG purchased \$100.0 million in loans, consisting principally of commercial real estate loans. Additionally, during fiscal 2016, the LASG originated \$110.6 million in loans.

The composition of the Company's loan portfolio (excluding loans held-for-sale) at the dates indicated is as follows:

	June 30, 2016		June 30, 2015		June 30, 2014		June 30, 2013		June 30, 2012	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
(Dollars in thousands)										
Residential real estate ...	\$ 113,962	16.46%	\$ 132,669	21.67%	\$ 148,634	28.79%	\$ 127,829	29.36%	\$ 137,571	38.61%
Commercial real estate ..	426,568	61.60%	348,676	56.96%	316,098	61.21%	264,490	60.75%	181,922	51.07%
Commercial and industrial.....	145,956	21.08%	123,133	20.12%	41,800	8.09%	29,720	6.83%	19,612	5.51%
Consumer and other .....	5,950	0.86%	7,659	1.25%	9,884	1.91%	13,337	3.06%	17,149	4.81%
Total loans .....	692,436	100.00%	612,137	100.00%	516,416	100.00%	435,376	100.00%	356,254	100.00%
Less: Allowance for loan losses .....	2,350		1,926		1,367		1,143		824	
Loans, net.....	<u>\$ 690,086</u>		<u>\$ 610,211</u>		<u>\$ 515,049</u>		<u>\$ 434,233</u>		<u>\$ 355,430</u>	

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

June 30, 2016						
	Community Banking Division	LASG	SBA Division	Total	Percent of Total	
(Dollars in thousands)						
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 .....	<u>\$ 203,381</u>	<u>\$ 462,627</u>	<u>\$ 26,428</u>	<u>\$ 692,436</u>	<u>100.00%</u>	

June 30, 2015						
	Community Banking Division	LASG	SBA Division	Total	Percent of Total	
(Dollars in thousands)						
Originated loans:						
Residential real estate .....	\$ 106,138	\$ 137	\$ -	\$ 106,275	17.37%	
Home equity .....	24,326	-	-	24,326	3.97%	
Commercial real estate: non- owner occupied.....	48,933	53,051	3,865	105,849	17.29%	
Commercial real estate: owner occupied .....	21,657	16,507	4,461	42,625	6.96%	
Commercial and industrial.....	11,597	108,577	2,637	122,811	20.06%	
Consumer .....	7,659	-	-	7,659	1.25%	
Subtotal .....	220,310	178,272	10,963	409,545	66.90%	
Purchased loans:						
Residential real estate .....	-	2,068	-	2,068	0.34%	
Commercial real estate: non- owner occupied.....	-	128,182	-	128,182	20.94%	
Commercial real estate: owner occupied .....	-	72,069	-	72,069	11.77%	
Commercial and industrial.....	-	273	-	273	0.05%	
Subtotal .....	-	202,592	-	202,592	33.10%	
Total .....	<u>\$ 220,310</u>	<u>\$ 380,864</u>	<u>\$ 10,963</u>	<u>\$ 612,137</u>	<u>100.00%</u>	

The following table summarizes the scheduled maturity of the Company's loan portfolio at June 30, 2016. Demand loans, loans having no stated repayment schedule, and overdraft loans are reported as being due in less than one year.

Scheduled Loan Maturities					
	Within One Year	After One Year Through Five Years	After Five Years Through Ten Years	After Ten Years	Total
(Dollars in thousands)					
Mortgages:					
Residential:					
Originated .....	\$ 856	\$ 4,374	\$ 8,808	\$ 85,815	\$ 99,853
Purchased .....	7	250	1,125	1,177	2,559
Commercial:					
Originated .....	21,609	52,417	57,496	58,095	189,617
Purchased .....	36,510	81,865	22,937	95,641	236,953
Non-mortgage loans:					
Commercial:					
Originated .....	75,776	55,040	11,934	3,008	145,758
Purchased .....	-	198	-	-	198
Consumer and other.....	1,118	8,463	4,995	2,922	17,498
Total loans.....	<u>\$ 135,876</u>	<u>\$ 202,607</u>	<u>\$ 107,295</u>	<u>\$ 246,658</u>	<u>\$ 692,436</u>

Loans Due After One Year, by Interest Rate Type			
	Predetermined rate	Floating or Adjustable	Total
(Dollars in thousands)			
Mortgages:			
Residential:			
Originated .....	\$ 53,730	\$ 45,267	\$ 98,997
Purchased .....	1,125	1,427	2,552
Commercial:			
Originated .....	15,654	152,354	168,008
Purchased .....	78,329	122,113	200,442
Non-mortgage loans:			
Commercial:			
Originated .....	20,016	49,966	69,982
Purchased .....	-	198	198
Consumer and other.....	5,717	10,664	16,381
Total .....	<u>\$ 174,571</u>	<u>\$ 381,989</u>	<u>\$ 556,560</u>

Approximately 62.7% of total portfolio loans at June 30, 2016, were variable rate products, compared to 54.4% at June 30, 2015.

Certain purchased loans have been identified as having evidence of credit deterioration since their origination, and it is probable that the Company will not collect all contractually required principal and interest payments. Purchased loans are accounted for using the measurement provisions set forth in ASC 310-30. The nonaccretable difference represents a loan's contractually required payments receivable in excess of the amount of cash flows expected to be collected. Improvements in expected cash flows result in prospective yield adjustments. The effect of a decrease in expected cash flows due to further credit deterioration are recorded through the allowance for loan losses.

### Other Assets

The cash surrender value of the Company's BOLI assets increased \$449 thousand, or 2.9%, to \$15.7 million at June 30, 2016, compared to \$15.3 million at June 30, 2015. BOLI assets are invested in the general account of three insurance companies and in separate accounts of a fourth insurance company. A general account policy's cash surrender value is supported by the general assets of the insurance company. A separate account policy's cash surrender value is supported by assets segregated from the general assets of the insurance company. Standard and Poor's rated these companies A+ or better at June 30, 2016. Interest earnings, net of mortality costs, increase the cash surrender value. These interest earnings are based on interest rates

that reset each year, and are subject to minimum guaranteed rates. These increases in cash surrender value are recognized in other income and are not subject to income taxes. Management considers BOLI an illiquid asset. BOLI represented 11.0% of the Company's total capital at June 30, 2016.

Intangible assets totaled \$1.7 million and \$2.2 million at June 30, 2016 and June 30, 2015, respectively. The \$477 thousand decrease was the result of core deposit intangible amortization during fiscal 2016.

### Deposits

The Company's principal source of funding is its core deposit accounts. At June 30, 2016, core deposits, which the Company defines as non-maturity deposits and non-brokered insured time deposits, represented 100% of total deposits.

Total deposits increased \$125.7 million to \$800.4 million as of June 30, 2016 from \$674.8 million as of June 30, 2015. The increase mainly resulted from the increase in money market accounts attracted through the Community Banking Division.

The following tables set forth certain information relative to the composition of the Company's average deposit accounts and the weighted average interest rate on each category of deposits for the periods indicated:

	Year Ended June 30, 2016		
	Average Balance	Weighted Average Rate	Percent of Total Average Deposits
(Dollars in thousands)			
Non-interest bearing demand deposits and escrow accounts .....	\$ 67,041	0.00%	9.14%
Regular savings .....	36,062	0.13%	4.92%
NOW accounts .....	68,304	0.27%	9.31%
Money market accounts .....	212,102	0.87%	28.92%
Time deposits .....	349,978	1.13%	47.71%
Total average deposits .....	<u>\$ 733,487</u>	<u>0.82%</u>	<u>100.00%</u>

	Year Ended June 30, 2015			Year Ended June 30, 2014		
	Average Balance	Weighted Average Rate	Percent of Total Average Deposits	Average Balance	Weighted Average Rate	Percent of Total Average Deposits
(Dollars in thousands)						
Non-interest bearing demand deposits and escrow accounts .....	\$ 54,940	0.00%	8.78%	\$ 50,890	0.00%	9.31%
Regular savings .....	34,495	0.13%	5.51%	34,391	0.14%	6.29%
NOW accounts .....	63,181	0.26%	10.09%	61,146	0.26%	11.19%
Money market accounts .....	133,266	0.75%	21.29%	85,333	0.52%	15.61%
Time deposits .....	340,046	1.12%	54.33%	314,848	1.10%	57.60%
Total average deposits .....	<u>\$ 625,928</u>	<u>0.79%</u>	<u>100.00%</u>	<u>\$ 546,608</u>	<u>0.75%</u>	<u>100.00%</u>

There were no time deposits greater than \$250 thousand as of June 30, 2016, and there were \$569 thousand of time deposits greater than \$250 thousand as of June 30, 2015. The scheduled maturity of deposits greater than or equal to \$100 thousand is set forth below:

	June 30, 2016	
	(Dollars in thousands)	
3 months or less .....	\$	45,744
Over 3 through 6 months .....		52,597
Over 6 through 12 months .....		86,933
Over 12 months .....		93,627
Total time certificates greater than or equal to \$100 thousand .....	<u>\$</u>	<u>278,901</u>

## ***Borrowings***

FHLBB advances, subordinated debt, and junior subordinated debentures have been the Company's sources of funding other than deposits. In fiscal 2016, total borrowings increased by \$2.2 million, or 4.3%, to \$53.4 million.

Advances from the FHLBB were \$30.1 million and \$30.2 million at June 30, 2016 and June 30, 2015, respectively. Pledges of residential real estate loans, certain commercial real estate loans and certain FHLBB deposits free of liens or pledges are required to secure outstanding advances and available additional borrowing capacity from the FHLBB. There were no wholesale repurchase agreements at June 30, 2016 and \$10.0 million at June 30, 2015. At June 30, 2016, the Company had no pledged investment securities.

There were no short-term borrowings at June 30, 2016, compared to \$2.3 million at June 30, 2015. At June 30, 2016, the Company had \$23.4 million of letters of credit issued by the FHLBB for certain customer relationships.

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 \$15.05 million in aggregate principal amount of 6.75% fixed-to-floating subordinated notes due 2026.

There were no balances outstanding at June 30, 2016 and 2015, respectively, for advances under the Federal Reserve Discount Window Borrower-in-custody program. The available credit under the program was \$1.9 million and \$2.2 million at June 30, 2016 and June 30, 2015, respectively, with the decrease in fiscal 2016 attributable to payoffs of consumer loans pledged as collateral.

The Company had junior subordinated debentures issued to affiliated trusts totaling \$8.8 million and \$8.6 million at June 30, 2016 and 2015, respectively. See "Capital" below for more information on our junior subordinated debentures and affiliated trusts.

## **Asset Quality**

### ***Allowance for Loan Losses***

The allowance for loan losses is maintained at a level that management considers adequate to provide for probable loan losses based upon evaluation of known and inherent risks in the loan portfolio. The allowance is increased by providing for loan losses through a charge to expense and by recoveries of loans previously charged-off and is reduced by loans being charged-off.

At June 30, 2016, the allowance for loan losses totaled \$2.4 million, or 0.34% of total loans, as compared to \$1.9 million, or 0.31% of total loans, at June 30, 2015. The year over year increase in the Company's allowance for losses was principally the result of loan growth. The following table sets forth activity in Company's allowance for loan losses for the periods indicated.

	Year Ended June 30, 2016	Year Ended June 30, 2015	Year Ended June 30, 2014	Year Ended June 30, 2013	Year Ended June 30, 2012
	(Dollars in thousands)				
Allowance at beginning of period .....	\$ 1,926	\$ 1,367	\$ 1,143	\$ 824	\$ 437
Loans charged-off during the period:					
Residential real estate .....	134	207	267	369	248
Commercial real estate .....	988	-	26	135	26
Commercial and industrial .....	77	3	43	203	17
Consumer and other .....	66	28	69	148	352
Total loans charged-off .....	<u>1,265</u>	<u>238</u>	<u>405</u>	<u>855</u>	<u>643</u>
Recoveries on loans previously charged-off:					
Residential real estate .....	35	24	63	6	3
Commercial real estate .....	5	1	2	10	-
Commercial and industrial .....	14	34	8	7	44
Consumer and other .....	17	21	25	29	37
Total recoveries .....	<u>71</u>	<u>80</u>	<u>98</u>	<u>52</u>	<u>84</u>
Net loans charged off during the period .....	1,194	158	307	803	559
Provision for loan losses .....	1,618	717	531	1,122	946
Allowance at end of period .....	<u>\$ 2,350</u>	<u>\$ 1,926</u>	<u>\$ 1,367</u>	<u>\$ 1,143</u>	<u>\$ 824</u>
Total loans at end of period <sup>(1)</sup> .....	\$ 692,436	\$ 612,137	\$ 516,416	\$ 435,376	\$ 356,254
Average loans outstanding during the period <sup>(1)</sup> .....	659,995	555,073	488,172	376,660	333,053
Allowance as a percentage of total loans .....	0.34%	0.31%	0.26%	0.26%	0.23%
Ratio of net charge-offs to average loans outstanding	0.18%	0.03%	0.06%	0.21%	0.17%
Allowance as a percentage of non-performing loans...	30.02%	18.41%	18.66%	23.54%	13.48%

(1) Amounts and resulting ratios exclude loans held for sale

The following table allocates the allowance for loan losses by loan category and the percent of loans in each category to total loans at the dates indicated below.

	June 30, 2016		June 30, 2015		June 30, 2014		June 30, 2013		June 30, 2012	
	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans	Amount	Percent of Loans to Total Loans
	(Dollars in thousands)									
Residential real estate .....	\$ 663	16.46%	\$ 741	21.67%	\$ 580	28.79%	\$ 594	29.36%	\$ 214	38.61%
Commercial real estate .....	1,328	61.60%	976	56.96%	625	61.21%	249	60.75%	93	51.07%
Commercial and industrial .....	297	21.08%	118	20.12%	48	8.09%	70	6.83%	292	5.51%
Consumer .....	62	0.86%	35	1.25%	79	1.91%	189	3.06%	225	4.81%
Unallocated .....	-	0.00%	56	0.00%	35	0.00%	41	0.00%	-	0.00%
Total .....	<u>\$ 2,350</u>	<u>100.00%</u>	<u>\$ 1,926</u>	<u>100.00%</u>	<u>\$ 1,367</u>	<u>100.00%</u>	<u>\$ 1,143</u>	<u>100.00%</u>	<u>\$ 824</u>	<u>100.00%</u>



The following table reflects the annual trend of total loans 30 days or more past due, as a percentage of total loans at June 30:

	2016	2015	2014	2013	2012
Past due loans to total loans ...	1.00%	1.08%	1.14%	1.68%	1.95%

### Non-performing Assets

The table below sets forth the amounts and categories of the Company's non-performing assets at the dates indicated:

	June 30, 2016	June 30, 2015	June 30, 2014	June 30, 2013	June 30, 2012
	(Dollars in thousands)				
Nonperforming loans:					
Originated portfolio:					
Residential real estate.....	\$ 2,613	\$ 3,021	\$ 1,743	\$ 2,346	\$ 3,090
Commercial real estate.....	474	994	1,162	473	417
Home equity.....	48	11	160	334	220
Commercial and industrial .....	17	2	5	110	1,008
Consumer .....	163	190	139	136	324
Total originated portfolio .....	3,315	4,218	3,209	3,399	5,059
Purchased portfolio:					
Residential real estate.....	1,125	-	-	-	-
Commercial real estate.....	3,387	6,532	4,116	1,457	1,055
Total purchased portfolio .....	4,512	6,532	4,116	1,457	1,055
Total nonperforming loans.....	7,827	10,750	7,325	4,856	6,114
Real estate owned and other repossessed collateral.....	1,652	1,651	1,991	2,134	834
Total nonperforming assets .....	\$ 9,479	\$ 12,401	\$ 9,316	\$ 6,990	\$ 6,948
Nonperforming loans that are current .....	\$ 2,271	\$ 484	\$ 651	\$ 887	\$ 377
Non-performing loans to total loans.....	1.13%	1.76%	1.42%	1.12%	1.72%
Non-performing assets to total assets.....	0.96%	1.46%	1.22%	1.04%	1.04%

At June 30, 2016, the Company had \$9.5 million of nonperforming assets, or 0.96% of total assets, compared to \$12.4 million of nonperforming assets, or 1.5% of total assets, as of June 30, 2015. The decrease in nonperforming assets in fiscal 2016 was principally associated with a decrease in purchased commercial real estate loans on nonaccrual.

Troubled Debt Restructurings ("TDRs") represent loans for which concessions (such as extension of repayment terms or reductions of interest rates to below market rates) are granted due to a borrower's financial condition. Such concessions may include reductions of interest rates to below-market terms and/or extension of repayment terms. The balances and payment status of TDRs follow:

	June 30, 2016	June 30, 2015	June 30, 2014
	(Dollars in thousands)		
Nonaccrual .....	\$ 1,152	\$ 2,131	\$ 2,117
Accrual.....	7,036	6,365	4,057
Total TDRs.....	\$ 8,188	\$ 8,496	\$ 6,174

At June 30, 2016, the Company had real estate owned and other repossessed collateral of \$1.7 million, with no net change from June 30, 2015. The real estate and personal property collateral for commercial and consumer loans are written down to fair value upon transfer to acquired assets. Revenues and expenses are recognized in the period when received or incurred on other real estate and in substance foreclosures. Gains and losses on disposition are recognized in noninterest income.

We continue to focus on asset quality and allocate significant resources to credit policy, loan review, asset management, collection, and workout functions. Despite this ongoing effort, there can be no assurance that adverse changes in the real estate markets and economic conditions will not result in higher non-performing assets levels in the future and negatively impact our results of operations through higher provision for loan losses, net loan charge-offs, decreased accrual of income and increased noninterest expenses.

## Potential Problem Loans

Commercial real estate and commercial loans are periodically evaluated under a ten-point rating system. These ratings are guidelines in assessing the risk of a particular loan. The Company had \$6.2 million and \$8.9 million of loans rated substandard or worse at June 30, 2016 and June 30, 2015, respectively, a decrease primarily attributable to upgraded purchased loans. The following tables present the Company's loans by risk rating.

	June 30, 2016				
	Originated Portfolio				Total
	Commercial Real Estate	Commercial and Industrial	Residential Real Estate <sup>(1)</sup>	Purchased Portfolio	
	(Dollars in thousands)				
Pass (1- 6).....	\$ 186,165	\$ 142,451	\$ 7,659	\$ 227,895	\$ 564,170
Special mention (7) .....	2,493	3,290	431	7,147	13,361
Substandard (8) .....	958	17	537	4,667	6,179
Doubtful (9).....	-	-	23	-	23
Loss (10) .....	-	-	-	-	-
	<u>\$ 189,616</u>	<u>\$ 145,758</u>	<u>\$ 8,650</u>	<u>\$ 239,709</u>	<u>\$ 583,733</u>
	June 30, 2015				
	Originated Portfolio				Total
	Commercial Real Estate	Commercial and Industrial	Residential Real Estate <sup>(1)</sup>	Purchased Portfolio	
	(Dollars in thousands)				
Pass (1- 6).....	\$ 142,321	\$ 122,829	\$ 8,049	\$ 190,193	\$ 463,392
Special mention (7) .....	4,417	31	634	5,628	10,710
Substandard (8) .....	1,687	-	429	6,771	8,887
Doubtful (9).....	-	-	23	-	23
Loss (10) .....	-	-	-	-	-
	<u>\$ 148,425</u>	<u>\$ 122,860</u>	<u>\$ 9,135</u>	<u>\$ 202,592</u>	<u>\$ 483,012</u>

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

## Risk Management

Management and the Board of Directors of the Company recognize that taking and managing risk is fundamental to the business of banking. Through the development, implementation and monitoring of its policies with respect to risk management, the Company strives to measure, evaluate and control the risks it faces. The Board and management understand that an effective risk management system is critical to the Company's safety and soundness. Chief among the risks faced by us are credit risk, market risk (including interest rate risk), liquidity risk, and operational (transaction) risk.

### Credit Risk

The Company considers credit risk to be the most significant risk that it faces, in that it has the greatest potential to affect the financial condition and operating results of the Company. Credit risk is managed through a combination of policies and limits established by the Board, the monitoring of compliance with these policies and limits, and the periodic evaluation of loans in the portfolio, including those with problem characteristics. The Company also utilizes the services of independent third-parties to provide loan review services, which consist of a variety of monitoring techniques after a loan is purchased or originated.

In general, Northeast's policies establish limits on the maximum amount of credit that may be granted to a single borrower (including affiliates), the aggregate amount of loans outstanding by type in relation to total assets and capital, and concentrations of loans by size, property type, and geography. Underwriting criteria, such as collateral and debt service coverage ratios and approval limits are also specified in loan policies. The Company's policies also address the performance of periodic credit reviews, the risk rating of loans, when loans should be placed on non-performing status and factors that should be considered in establishing the Bank's allowance for loan losses. For additional information, refer to "Asset Quality" above and Item 1, "Business—Lending Activities."

## ***Market Risk***

Market risk is the risk of loss due to adverse changes in market prices and rates, and typically encompasses exposures such as sensitivity to changes in market interest rates, foreign currency exchange rates, and commodity prices. The Company has no exposure to foreign currency exchange or commodity price movements. Because net interest income is our primary source of revenue, interest rate risk is a significant market risk to which the Company is exposed.

Interest rate risk can be defined as the exposure of future net interest income to adverse movements in interest rates. Net interest income is affected by changes in interest rates as well as by fluctuations in the level, mix and duration of the Company's assets and liabilities. Over and above the influence that interest rates have on net interest income, changes in rates also affect the volume of lending activity, the ability of borrowers to repay loans, the volume of loan prepayments, the flow and mix of deposits, and the market value of the Company's assets and liabilities.

The Company's management has established an Asset Liability Management Committee ("ALCO"), which is responsible for managing the Company's interest rate risk in accordance with policies and limits approved by the Board of Directors. With regard to management of market risk, the ALCO is charged with managing the Company's mix of assets and funding sources to produce results that are consistent with the Company's liquidity, capital adequacy, growth, and profitability goals.

Exposure to interest rate risk is managed by Northeast through periodic evaluations of the current interest rate risk inherent in its rate-sensitive assets and liabilities, coupled with determinations of the level of risk considered appropriate given the Company's capital and liquidity requirements, business strategy, and performance objectives. Through such management, Northeast seeks to mitigate the potential volatility in its net interest income due to changes in interest rates in a manner consistent with the risk appetite established by the Board of Directors.

The ALCO's primary tool for measuring, evaluating, and managing interest rate risk is income simulation analysis. Income simulation analysis measures the interest rate risk inherent in the Company's balance sheet at a given point in time by showing the effect of interest rate shifts on net interest income over defined time horizons. These simulations take into account the specific repricing, maturity, prepayment and call options of financial instruments that vary under different interest rate scenarios. The ALCO reviews simulation results to determine whether the exposure to a decline in net interest income remains within established tolerance levels over the simulation horizons and to develop appropriate strategies to manage this exposure. The Company considers a variety of specified rate scenarios, including instantaneous rate shocks, against static (or flat) rates when measuring interest rate risk, and evaluates results over two consecutive twelve-month periods. All changes are measured in comparison to the projected net interest income that would result from an "unchanged" scenario, where interest rates remain stable over the measured time horizon(s). As of June 30, 2016, the income simulation analysis (as noted in the table below) for the first twelve-month period indicated that exposure to changing interest rates fell within the Company's policy levels of tolerance.

While the ALCO reviews simulation assumptions to ensure they are reasonable, and back-tests simulation results on a periodic basis as a monitoring tool, income simulation analysis may not always prove to be an accurate indicator of the Company's interest rate risk or future earnings. There are inherent shortcomings in income simulation, given the number and variety of assumptions that must be made to perform it. For example, the projected level of future market interest rates and the shape of future interest rate yield curves have a major impact on income simulation results. Many assumptions concerning the repricing of financial instruments, the degree to which non-maturity deposits react to changes in market rates, and the expected prepayment rates on loans, mortgage-backed securities, and callable debt securities are also inherently uncertain. In addition, as income simulation analysis assumes that the Company's balance sheet will remain static over the simulation horizon, the results do not reflect the Company's expectations for future balance sheet growth, nor changes in business strategy that the Company could implement in response to rate shifts to mitigate its loss exposures. As such, although the analysis described above provides an indication of the Company's sensitivity to interest rate changes at a point in time, these estimates are not intended to and do not provide a precise forecast of the effect of changes in market interest rates on the Company's net interest income and will differ from actual results.

Assuming a 200 basis point increase and 100 basis point decrease in interest rates starting on June 30, 2016, we estimate that our net interest income in the following 12 months would increase by 0.4% if rates increased by 200 basis points and decrease by 1.6% if rates declined by 100 basis points. These results indicate a modest level of asset sensitivity in our balance sheet. An asset-sensitive position indicates that there are more rate-sensitive assets than rate-sensitive liabilities repricing or maturing within specific time horizons, which would generally imply a favorable impact on net interest income in periods of rising interest rates and a negative impact in periods of falling rates. A liability-sensitive position would generally imply a negative impact on net interest income in periods of rising rates and a positive impact in periods of falling rates.

	Up 200 Basis Points	Down 100 Basis Points
June 30, 2016 .....	0.4%	-1.6%
June 30, 2015 .....	1.3%	-0.2%
June 30, 2014 .....	0.4%	-1.1%

### **Liquidity Risk**

Liquidity risk is defined as the risk associated with an organization's ability to meet current and future financial obligations of a short-term nature. The Company uses its liquidity on a regular basis to fund existing and future loan commitments, to pay interest on deposits and on borrowings, to fund maturing certificates of deposit and borrowings, to fund other deposit withdrawals, to invest in other interest-earning assets, to make dividend payments to shareholders, and to meet operating expenses. The Company's primary sources of liquidity consist of deposit inflows, borrowed funds, and the amortization, prepayment and maturities of loans and securities. While scheduled payments from the amortization and maturities of loans and investment securities are relatively predictable sources of funds, deposit flows and loan and investment prepayments can be greatly influenced by general interest rates, economic conditions and competition. In addition to these regular sources of funds, the Company may choose to sell portfolio loans and investment securities to meet liquidity demands.

We monitor and forecast our liquidity position. There are several interdependent methods used by us for this purpose, including daily review of Federal Funds positions, monthly review of balance sheet changes, monthly review of liquidity ratios, quarterly review of liquidity forecasts and periodic review of contingent funding plans. Using these methods, the Company actively manages its liquidity position under the direction of the ALCO.

The following is a summary of the unused borrowing capacity of the Company at June 30, 2016 available to meet our short-term funding needs (dollars in thousands):

Brokered time deposits .....	\$ 246,538	Subject to policy limitation of 25% of total assets
Federal Home Loan Bank of Boston .....	16,752	Unused advance capacity subject to eligible and qualified collateral
Federal Discount Window Borrower-in-Custody .....	1,936	Unused credit line subject to the pledge of loans
Other available lines.....	<u>17,500</u>	
Total unused borrowing capacity.....	<u>\$ 282,726</u>	

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 in the amount of \$1.8 million is required. At June 30, 2016, the Bank had \$365.8 million of immediately accessible liquidity, defined as cash that the Bank reasonably believes could be raised within 7 days through collateralized borrowings, brokered deposits or security sales. This position represented 37.1% of total assets. Further, at June 30, 2016, the Company had \$151.2 million of cash and cash equivalents. This level of balance sheet liquidity is intended, in part, for future purchases of commercial real estate loans.

On a parent company only basis, commitments and debt service requirements at June 30, 2016 consisted of junior subordinated debentures issued to NBN Capital Trust II, NBN Capital Trust III and NBN Capital Trust IV with a principal balance of \$16.5 million as well as subordinated debt issued in June 2016 with a principal balance of \$15.05 million. See Note 9 of the Notes to the Consolidated Financial Statements for carrying values, maturity dates and the use of purchased interest rate caps and swaps to hedge the interest expense in periods of rising interest rates. Based on the interest rates at June 30, 2016, the annual aggregate payments to meet the debt service of the junior subordinated debentures is approximately \$412 thousand. In addition, the expected annual interest expense on subordinated notes issued in June 2016 is \$1.1 million.

The principal sources of funds for the Company to meet parent-only obligations are dividends from the Bank, which are subject to regulatory limitations, and borrowings from public and private sources. For information on the restrictions on the payment of dividends by Northeast Bank, see Note 10 of the Notes to the Company's Consolidated Financial Statements in this Annual Report.

## Operational Risk

Operational risk, which we define as the risk of loss from failed internal processes, people and systems, and external events, is inherent in all of our business activities. The principal ways in which we manage operational risk include the establishment of departmental and business-specific policies and procedures, internal controls and monitoring requirements. Some specific examples include our information security program, business continuity planning and testing, our vendor management program, reconciliation processes, our enterprise risk assessment process, and new product and/or system introduction processes. Periodic internal audits provide an important independent check on adherence to policies, procedures and controls designed to mitigate risk exposure.

## Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the condensed consolidated balance sheet. The contract or notional amounts of these instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

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, unused lines of credit and standby letters of credit is represented by the contractual amount of those instruments. 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 committed amounts do not necessarily represent future cash requirements. To control the credit risk associated with entering into commitments and issuing letters of credit, the Company uses the same credit quality, collateral policies, and monitoring controls in making commitments and letters of credit as it does with its lending activities.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

Unused lines of credit and commitments to extend credit typically result in loans with a market interest rate.

A summary of the amounts of the Company's contractual obligations and other commitments with off-balance sheet risk as of June 30, 2016 follows:

	Payments Due - By Period				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years
	(Dollars in thousands)				
Contractual obligations:					
Federal Home Loan Bank advances .....	\$ 30,000	\$ 25,000	\$ 5,000	\$ -	\$ -
Junior subordinated debentures .....	16,496	-	-	-	16,496
Subordinated debt .....	15,050	-	-	-	15,050
Capital lease obligation .....	1,249	306	612	331	-
Total debt obligations .....	62,795	25,306	5,612	331	31,546
Operating lease obligations .....	9,269	1,249	2,421	2,435	3,164
Total contractual obligations .....	<u>\$ 72,064</u>	<u>\$ 26,555</u>	<u>\$ 8,033</u>	<u>\$ 2,766</u>	<u>\$ 34,710</u>
	Amount of Commitment Expiring - By Period				
Total	Less Than 1 Year	1-3 Years	4-5 Years	After 5 Years	
(Dollars in thousands)					
Commitments with off-balance sheet risk:					
Commitments to extend credit .....	\$ 44,684	\$ 44,684	\$ -	\$ -	\$ -
Unused lines of credit .....	58,412	12,841	30,070	6,765	8,736
Standby letters of credit .....	3,822	3,822	-	-	-
Commitment to fund investment .....	2,500	2,500	-	-	-
Total commitments .....	<u>\$ 109,418</u>	<u>\$ 63,847</u>	<u>\$ 30,070</u>	<u>\$ 6,765</u>	<u>\$ 8,736</u>

## Capital

Shareholders' equity was \$116.6 million at June 30, 2016, an increase of \$3.9 million from June 30, 2015. The increase was due principally to earnings of \$7.6 million, and an increase in stock-based compensation of \$613 thousand, offset by \$3.4 million in share repurchases (representing 322,900 shares), a decrease in accumulated other comprehensive income of \$618 thousand and \$380 thousand in dividends paid on common stock.

See Note 10 of the Notes to the Consolidated Financial Statements for information on the Company's capital ratios. Regulatory capital ratios for the Company and the Bank currently exceed all applicable requirements, including the commitments made to the Federal Reserve and the Bureau in connection with the merger with FHB Formation LLC to maintain minimum Tier 1 leverage and total capital ratios of 10% and 15%, respectively.

## Impact of Inflation

The consolidated financial statements and related notes have been presented in terms of historic dollars without considering changes in the relative purchasing power of money over time due to inflation. Unlike industrial companies, nearly all of the assets and virtually all of the liabilities of the Company are monetary in nature. As a result, interest rates have a more significant impact on the Company's performance than the general level of inflation. Over short periods of time, interest rates may not necessarily move in the same direction or in the same magnitude as inflation.

## Impact of New Accounting Standards

Note 1 of the Notes to the Consolidated Financial Statement includes the Financial Accounting Standards Board ("FASB") and the SEC issued statements and interpretations affecting the Company.

## Critical Accounting Policies

Critical accounting policies are those that involve significant judgments and assessments by management, and that could potentially result in materially different results under different assumptions and conditions. The Company considers the following to be its critical accounting policies:

### Allowance for Loan Losses

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

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

Commercial 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. Continued 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 LASG. Loans acquired by the LASG are, with limited exceptions, performing loans at the date of purchase. Loans in this segment acquired with specific material credit deterioration since origination are identified as purchased credit-impaired. Repayment of loans in this segment is largely dependent on cash flow from the successful operation of the property, in the case of non-owner occupied property, or operating business, in the case of owner-occupied property. Loan performance may be adversely affected by factors affecting the general economy or conditions specific to the real estate market, such as geographic location or property type.

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

- Levels and trends in delinquencies;
- 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 for commercial and industrial and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan.

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

### Purchased Loans

Loans that the Company purchases are initially recorded at fair value with no carryover of the related allowance for loan and lease losses. Determining the fair value of the purchased loans involves estimating the amount and timing of principal and interest cash flows initially expected to be collected on the loans and discounting those cash flows at an appropriate market rate of interest. The Company continues to evaluate the reasonableness of expectations for the timing and the amount of cash to be collected. Subsequent decreases in expected cash flows may result in changes in the amortization or accretion of fair market value adjustments, and in some cases may result in a loan being considered impaired.

### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

See Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Risk Management” and accompanying table set forth therein for quantitative and qualitative disclosures about market risk.



**Item 8. Financial Statements and Supplementary Data**

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Northeast Bancorp

We have audited the accompanying consolidated balance sheet of Northeast Bancorp and subsidiary (the Company) as of June 30, 2016, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of June 30, 2016, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of June 30, 2016, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated September 13, 2016 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ RSM US LLP

Boston, Massachusetts  
September 13, 2016

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Northeast Bancorp

We have audited the accompanying consolidated balance sheet of Northeast Bancorp and subsidiary as of June 30, 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Northeast Bancorp and subsidiary at June 30, 2015, and the consolidated results of their operations and their cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP

Boston, Massachusetts  
September 28, 2015

**NORTHEAST BANCORP AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS**

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

	<u>June 30, 2016</u>	<u>June 30, 2015</u>
<b>Assets</b>		
Cash and due from banks .....	\$ 2,459	\$ 2,789
Short-term investments .....	148,698	87,061
Total cash and cash equivalents .....	151,157	89,850
Available-for-sale securities, at fair value.....	100,572	101,908
Residential real estate loans held for sale.....	6,449	7,093
SBA loans held for sale.....	1,070	1,942
Total loans held for sale.....	7,519	9,035
<b>Loans</b>		
Commercial real estate.....	426,568	348,676
Residential real estate.....	113,962	132,669
Commercial and industrial .....	145,956	123,133
Consumer .....	5,950	7,659
Total loans.....	692,436	612,137
Less: Allowance for loan losses .....	2,350	1,926
Loans, net.....	690,086	610,211
Premises and equipment, net.....	7,801	8,253
Real estate owned and other repossessed collateral, net.....	1,652	1,651
Federal Home Loan Bank stock, at cost.....	2,408	4,102
Intangible assets, net .....	1,732	2,209
Bank owned life insurance .....	15,725	15,276
Other assets.....	7,501	8,223
Total assets.....	<u>\$ 986,153</u>	<u>\$ 850,718</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits:</b>		
Demand.....	\$ 66,686	\$ 60,383
Savings and interest checking .....	107,218	100,134
Money market.....	275,437	168,527
Time .....	351,091	345,715
Total deposits .....	800,432	674,759
Federal Home Loan Bank advances.....	30,075	30,188
Wholesale repurchase agreements .....	-	10,037
Short-term borrowings .....	-	2,349
Subordinated debt .....	23,331	8,626
Capital lease obligation.....	1,128	1,368
Other liabilities .....	14,596	10,664
Total liabilities .....	869,562	737,991
Commitments and contingencies (Note 15)		
<b>Shareholders' equity</b>		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized; no shares issued and outstanding at June 30, 2016 and June 30, 2015 .....	-	-
Voting common stock, \$1.00 par value, 25,000,000 shares authorized; 8,089,790 and 8,575,144 shares issued and outstanding at June 30, 2016 and June 30, 2015, respectively ..	8,089	8,575
Non-voting common stock, \$1.00 par value, 3,000,000 shares authorized; 1,227,683 and 1,012,739 shares issued and outstanding at June 30, 2016 and June 30, 2015, respectively ..	1,228	1,013
Additional paid-in capital .....	83,020	85,506
Retained earnings.....	26,160	18,921
Accumulated other comprehensive loss .....	(1,906)	(1,288)
Total shareholders' equity .....	116,591	112,727
Total liabilities and shareholders' equity .....	<u>\$ 986,153</u>	<u>\$ 850,718</u>

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

**NORTHEAST BANCORP AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Dollars in thousands, except share and per share data)

	Year Ended June 30,	
	2016	2015
Interest and dividend income:		
Interest and fees on loans.....	\$ 45,849	\$ 43,383
Interest on available-for-sale securities .....	930	913
Other interest and dividend income .....	456	292
Total interest and dividend income .....	47,235	44,588
Interest expense:		
Deposits .....	6,027	5,010
Federal Home Loan Bank advances .....	1,027	1,101
Wholesale repurchase agreements .....	67	288
Short-term borrowings.....	20	29
Subordinated debt.....	651	718
Obligation under capital lease agreements .....	63	74
Total interest expense.....	7,855	7,220
Net interest and dividend income before provision for loan losses.....	39,380	37,368
Provision for loan losses .....	1,618	717
Net interest and dividend income after provision for loan losses.....	37,762	36,651
Noninterest income:		
Fees for other services to customers .....	1,657	1,494
Gain on sales of residential loans held for sale.....	1,684	1,877
Gain on sales of portfolio loans .....	4,178	2,821
(Loss) gain recognized on real estate owned and other repossessed collateral, net.....	(255)	428
Bank-owned life insurance income.....	449	440
Other noninterest income.....	60	29
Total noninterest income.....	7,773	7,089
Noninterest expense:		
Salaries and employee benefits.....	19,548	18,817
Occupancy and equipment expense.....	5,227	4,939
Professional fees.....	1,463	1,658
Data processing fees .....	1,487	1,355
Marketing expense.....	285	244
Loan acquisition and collection expense .....	1,368	1,458
FDIC insurance premiums .....	489	504
Intangible asset amortization .....	477	589
Other noninterest expense.....	3,468	3,040
Total noninterest expense.....	33,812	32,604
Income before income tax expense .....	11,723	11,136
Income tax expense .....	4,104	3,995
Net income .....	\$ 7,619	\$ 7,141
Weighted-average shares outstanding:		
Basic .....	9,474,999	9,980,733
Diluted .....	9,484,635	9,980,733
Earnings per common share:		
Basic .....	\$ 0.80	\$ 0.72
Diluted .....	0.80	0.72
Cash dividends declared per common share .....	\$ 0.04	\$ 0.04

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

**NORTHEAST BANCORP AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
(Dollars in thousands)

	Year Ended June 30,	
	2016	2015
Net income .....	\$ 7,619	\$ 7,141
Other comprehensive loss, before tax:		
Available-for-sale securities:		
Change in net unrealized gain on available-for-sale securities .....	1,033	442
Derivatives and hedging activities:		
Change in accumulated loss on effective cash flow hedges.....	(2,032)	(529)
Reclassification adjustments included in net income.....	(3)	(49)
Total derivatives and hedging activities .....	<u>(2,035)</u>	<u>(578)</u>
Total other comprehensive loss, before tax .....	(1,002)	(136)
Income tax benefit related to other comprehensive loss .....	(384)	(131)
Other comprehensive loss, net of tax.....	<u>(618)</u>	<u>(5)</u>
Comprehensive income .....	<u>\$ 7,001</u>	<u>\$ 7,136</u>

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

**NORTHEAST BANCORP AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(Dollars in thousands, except share and per share data)

	Preferred Stock		Voting Common Stock		Non-voting Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	Shares	Amount	Shares	Amount	Shares	Amount				
Balance at June 30, 2014 .....	-	\$ -	9,260,331	\$ 9,260	880,963	\$ 881	\$ 90,914	\$ 12,182	\$ (1,283)	\$ 111,954
Net income .....	-	-	-	-	-	-	-	7,141	-	7,141
Other comprehensive income, net of tax .....	-	-	-	-	-	-	-	-	(5)	(5)
Common stock repurchased .....	-	-	(710,662)	(711)	-	-	(5,955)	-	-	(6,666)
Conversion of voting common stock to non-voting common stock .....	-	-	(131,776)	(132)	131,776	132	-	-	-	-
Dividends on common stock at \$0.04 per share .....	-	-	-	-	-	-	-	(402)	-	(402)
Stock-based compensation .....	-	-	-	-	-	-	705	-	-	705
Issuance of restricted common stock .....	-	-	174,000	174	-	-	(174)	-	-	-
Forfeiture of restricted common stock .....	-	-	(16,749)	(16)	-	-	16	-	-	-
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 .....	-	-	-	-	-	-	-	7,619	-	7,619
Other comprehensive income, net of tax .....	-	-	-	-	-	-	-	-	(618)	(618)
Common stock repurchased .....	-	-	(322,900)	(323)	-	-	(3,036)	-	-	(3,359)
Conversion of voting common stock to non-voting common stock .....	-	-	(214,944)	(215)	214,944	215	-	-	-	-
Dividends on common stock at \$0.04 per share .....	-	-	-	-	-	-	-	(380)	-	(380)
Stock-based compensation .....	-	-	-	-	-	-	613	-	-	613
Issuance of restricted common stock .....	-	-	100,000	100	-	-	(100)	-	-	-
Cancellations and forfeiture of restricted common stock .....	-	-	(47,510)	(48)	-	-	37	-	-	(11)
Balance at June 30, 2016 .....	-	\$ -	8,089,790	8,089	1,227,683	\$ 1,228	\$ 83,020	\$ 26,160	\$ (1,906)	\$ 116,591

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

**NORTHEAST BANCORP AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Dollars in thousands)

	Year Ended June 30,	
	2016	2015
Operating activities:		
Net income .....	\$ 7,619	\$ 7,141
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses .....	1,618	717
Loss (gain) recognized on real estate owned and other repossessed collateral, net.....	243	(428)
Loss on premises and equipment .....	11	91
Accretion of fair value adjustments on loans, net .....	(9,384)	(11,899)
Accretion of fair value adjustments on deposits, net.....	(6)	(171)
Accretion of fair value adjustments on borrowings, net.....	43	(112)
Originations of loans held for sale .....	(130,010)	(98,383)
Net proceeds from sales of loans held for sale .....	134,522	126,430
Gain on sales of residential loans held for sale, net.....	(1,684)	(1,877)
Gain on sales of portfolio loans, net.....	(4,178)	(2,821)
Amortization of intangible assets .....	477	589
Bank-owned life insurance income, net .....	(449)	(440)
Depreciation of premises and equipment .....	1,631	1,666
Deferred income tax expense (benefit) .....	2,122	(1,185)
Stock-based compensation .....	613	705
Amortization of available-for-sale securities, net.....	1,025	1,001
Changes in other assets and liabilities:		
Other assets .....	(1,001)	(60)
Other liabilities.....	1,882	556
Net cash provided by operating activities .....	<u>5,094</u>	<u>21,520</u>
Investing activities:		
Purchases of available-for-sale securities.....	(45,160)	-
Proceeds from maturities and principal payments on available-for-sale securities .....	46,504	11,414
Loan purchases.....	(99,999)	(82,654)
Loan originations, principal collections, and purchased loan paydowns, net.....	28,975	(24,585)
Purchases and disposals of premises and equipment, net.....	(1,190)	(1,244)
Proceeds from sales of premises and equipment .....	-	369
Proceeds from sales of real estate owned and other repossessed collateral.....	1,537	2,563
Redemption of Federal Home Loan Bank stock .....	1,694	-
Net cash used in investing activities .....	<u>(67,639)</u>	<u>(94,137)</u>
Financing activities:		
Issuance of subordinated debt, net of debt issuance costs .....	14,512	-
Net increase in deposits.....	125,679	100,601
Net decrease in short-term borrowings .....	(2,349)	(635)
Dividends paid on common stock .....	(380)	(402)
Repurchase of common stock .....	(3,359)	(6,666)
Repayment of FHLBB borrowings and wholesale repurchase agreements.....	(10,000)	(12,500)
Repayment of capital lease obligation.....	(240)	(190)
Taxes paid through cancellation of common stock .....	(11)	-
Net cash provided by financing activities .....	<u>123,852</u>	<u>80,208</u>
Net increase in cash and cash equivalents.....	61,307	7,591
Cash and cash equivalents, beginning of year.....	89,850	82,259
Cash and cash equivalents, end of year .....	<u>\$ 151,157</u>	<u>\$ 89,850</u>
Supplemental schedule of cash flow information:		
Interest paid.....	\$ 7,773	\$ 7,487
Income taxes paid, net.....	2,166	5,664
Supplemental schedule of noncash investing and financing activities:		
Transfers from loans to real estate owned and other repossessed collateral, net.....	\$ 1,781	\$ 1,764

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### **1. Summary of Significant Accounting Policies**

The accounting and reporting policies of Northeast Bancorp and Subsidiary (the "Company" or "Northeast") conform to accounting principles generally accepted in the United States of America ("US GAAP") and conform to practices within the financial services industry.

#### *Business*

The Company is a Maine corporation and a bank holding company registered with the Federal Reserve Bank of Boston ("FRB") under the Bank Holding Company Act of 1956. As a bank holding company, the Company is subject to the regulation and supervision of the FRB. The Company provides a full range of banking services to individual and corporate customers throughout south-central and western Maine and conducts loan purchasing and origination activities nationwide through its wholly-owned subsidiary, Northeast Bank (the "Bank"), a Maine state-chartered universal bank. The Bank is subject to supervision and regulation by applicable state and federal banking agencies, including the State of Maine Bureau of Financial Institutions, the Federal Deposit Insurance Corporation ("FDIC"), and the FRB. The Bank faces competition from banks and other financial institutions.

#### *Business Combination Accounting*

On December 29, 2010, the Company merged with FHB Formation LLC (the "Merger"). The Company applied the acquisition method of accounting to this business combination, which represented an acquisition by FHB Formation LLC ("FHB") of Northeast, with Northeast as the surviving company. Under the acquisition method, the acquiring entity in a business combination recognizes the assets acquired and liabilities assumed at their acquisition date fair values. Management utilizes valuation techniques appropriate for the asset or liability being measured in determining these fair values. Any excess of the purchase price over amounts allocated to assets acquired, including identifiable intangible assets, and liabilities assumed is recorded as goodwill. In the Merger, amounts allocated to assets acquired and liabilities assumed were greater than the purchase price, which resulted in the recognition of a bargain purchase gain. Acquisition-related costs were expensed as incurred.

#### *Principles of Consolidation*

The accompanying consolidated financial statements include the accounts of Northeast Bancorp, and its wholly-owned subsidiary, Northeast Bank (including the Bank's wholly-owned subsidiaries). All significant intercompany transactions and balances have been eliminated in consolidation.

NBN Capital Trust II, NBN Capital Trust III and NBN Capital Trust IV are considered affiliates and are deconsolidated pursuant to criteria established by FASB Accounting Standards Codification ("ASC") 810, *Consolidation* ("ASC 810"). The investments in these affiliates were \$496 thousand in aggregate and are included in other assets.

#### *Reclassifications*

Certain previously reported amounts have been reclassified to conform to the current year's presentation.

#### *Use of Estimates*

The financial statements have been prepared in conformity with US GAAP. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the statement of financial condition and income and expenses for the period. Actual results could differ significantly from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses and the determination of fair values in conjunction with the application of loan acquisition accounting.



### Concentrations of Credit Risk

Most of the Community Banking Division's business activity is with customers located within the State of Maine. However, the business activities of the Bank's Loan Acquisition and Servicing Group ("LASG") and the SBA Division are diversified across the country. In all regions, the Company's focus is to originate and purchase commercial real estate loans. Repayment of loans is expected from cash flows of the borrower. Losses on secured loans are limited by the value of the collateral upon default of the borrowers. The Company does not have any significant concentrations to any one industry or customer.

### Cash and Cash Equivalents

For purposes of presentation in the consolidated statements of cash flows, cash and cash equivalents consist of cash and due from banks and short-term investments. The Company is required to maintain a certain reserve balance in the form of cash or deposits with other financial institutions. At June 30, 2016 and 2015, such reserve balances totaled \$4.0 million and \$4.4 million, respectively.

### Available-for-Sale Securities

Securities for which the Company has the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at amortized cost. Those securities held for indefinite periods of time but not necessarily to maturity are classified as available-for-sale. Securities held for indefinite periods of time include securities that management intends to use as part of its asset/liability, liquidity, or capital management strategies and may be sold in response to changes in interest rates, maturities, asset/liability mix, liquidity needs, regulatory capital needs or other business factors. Securities available-for-sale are carried at estimated fair value with unrealized gains and losses reported on an after-tax basis in shareholders' equity as accumulated other comprehensive income or loss.

Interest and dividends on securities are recorded on the accrual method. Premiums and discounts on securities are amortized or accreted into interest income by the level-yield method over the remaining period to contractual maturity, adjusted for the effect of actual prepayments in the case of mortgage-backed securities. These estimates of prepayment assumptions are made based upon the actual performance of the underlying security, current interest rates, the general market consensus regarding changes in mortgage interest rates, the contractual repayment terms of the underlying loans, the priority rights of the investors to the cash flows from the mortgage securities and other economic conditions. When differences arise between anticipated prepayments and actual prepayments, the effective yield is recalculated to reflect actual payments to date and anticipated future payments. Unamortized premium or discount is adjusted to the amount that would have existed had the new effective yield been applied since purchase, with a corresponding charge or credit to interest income.

Security transactions are recorded on the trade date. Realized gains and losses are determined using the specific identification method and are recorded in non-interest income.

Management evaluates securities for other-than-temporary impairment on a periodic basis. Factors considered in determining whether an impairment is other-than-temporary include: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) the intent and ability of the Company to hold the investment for a period of time sufficient to allow for any anticipated recovery in fair value. If the Company intends to sell an impaired security, the Company records an other-than-temporary loss in an amount equal to the entire difference between the fair value and amortized cost. If a security is determined to be other-than-temporarily impaired but the Company does not intend to sell the security, only the credit portion of the estimated loss is recognized in earnings, with the other portion of the loss recognized in other comprehensive income.

### Federal Home Loan Bank Stock

During the periods presented, the Company has owned investments in the stock of the Federal Home Loan Bank of Boston ("FHLBB"). No ready market exists for these stocks, and they have no quoted market values. The Bank, as a member of the FHLBB, is required to maintain investments in the capital stock of the FHLBB equal to their membership base investments plus an activity-based investment determined according to the Bank's level of outstanding FHLBB advances. The Company reviews its investments in FHLBB stock periodically to determine if other-than-temporary impairment exists. The Company reviews recent public filings, rating agency analysis and other factors, when making the determination. As of June 30, 2016 and 2015, no impairment has been recognized.

### Loans Held for Sale and Loan Servicing

Residential real estate mortgage loans are designated as held for sale or held to maturity based on intent, which is determined when loans are underwritten. Loans originated and held for sale in the secondary market are carried at the lower of cost or fair value. The SBA Division loans are designated as held for sale based on intent to sell, which is determined on a quarterly basis. The guaranteed portions of the loans are transferred to held for sale and are carried at the lower of cost or fair value. Realized gains and losses on sales of residential loans are determined using the specific identification method, and realized gains and losses on sales of SBA loans are determined using the allocation of participating interests sold and retained. Direct loan origination costs and fees related to loans held for sale are deferred upon origination and are recognized as an adjustment to the gain or loss on the date of sale.

In its mortgage banking activities, the Company sells loans both on a servicing released and servicing retained basis. The Company recognizes as separate assets the rights to service mortgage loans for others, which is included in other assets on the consolidated balance sheet. The Company capitalizes mortgage servicing rights at their allocated cost (based on the relative fair values of the rights and the related loans) upon the sale of the related loans. The Company uses the amortization method to subsequently measure servicing assets. Mortgage servicing rights are amortized over the estimated weighted average life of the loans. The Company's assumptions with respect to prepayments, which affect the estimated average life of the loans, are adjusted quarterly and as necessary to reflect current circumstances. The Company evaluates the estimated life and fair value of its servicing portfolio based on data that is disaggregated to reflect note rate, type, and term on the underlying loans. The Company performs an assessment of capitalized mortgage servicing rights for impairment based on the current fair value of those rights. Fair value of the mortgage servicing rights is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, prepayment speeds and default rates and losses. Impairment is recognized through a valuation allowance to the extent that fair value is less than the capitalized amount. If the Company later determines that all or a portion of the impairment no longer exists, a reduction of the allowance may be recorded as an increase to income.

In connection with the mortgage loans to be held for sale, the Company often offers interest rate lock commitments to prospective borrowers. The Company manages this interest rate risk by entering into offsetting forward sale agreements with third party investors for certain funded loans and loan commitments. The Company uses "best efforts" forward loan sale commitments to mitigate the risk of potential decreases in the values of loans that would result from the exercise of the derivative loan commitments. The gross effect of the derivative loan commitments and forward sale agreements is nominal at each date presented.

In its SBA Division activities, the Company recognizes the SBA servicing rights as separate assets, which is included in other assets on the consolidated balance sheet. The Company capitalizes SBA servicing rights at the net present value of the fee income and fee cost spread upon the sale of the related loans. The Company uses the amortization method to subsequently measure servicing assets. The SBA servicing rights are amortized over the estimated weighted average life of the loans. The Company's assumptions with respect to prepayments, which affect the estimated average life of the loans, are adjusted quarterly and as necessary to reflect current circumstances. The Company evaluates the estimated life and fair value of its servicing portfolio based on data that is disaggregated to reflect note rate, type, and term on the underlying loans. The Company performs an assessment of capitalized SBA servicing rights for impairment based on the current fair value of those rights. Fair value of the servicing rights is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, prepayment speeds and default rates and losses. Impairment is recognized through a valuation allowance to the extent that fair value is less than the capitalized amount. If the Company later determines that all or a portion of the impairment no longer exists, a reduction of the allowance may be recorded as an increase to income.

### Loans

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.

#### Allowance for Loan Losses

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.

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 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.

### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed by the straight-line method over the estimated useful lives of the assets. Premises and equipment under capital leases are amortized over the estimated useful lives of the assets or the respective lease terms, whichever is shorter. Maintenance and repairs are charged to expense as incurred and the cost of major renewals and betterments are capitalized.

### Intangible Assets

Identifiable intangible assets subject to amortization are amortized over the estimated lives of the intangibles using a method that approximates the amount of economic benefits that are realized by the Company. Identifiable intangible assets are reviewed for impairment annually and whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable.

### Real Estate Owned and Other Repossessed Collateral

Assets in control of the Company or acquired through foreclosure or repossession are held for sale and are initially recorded at fair value less cost to sell at the date control is established, resulting in a new cost basis. The amount by which the recorded investment in the loan exceeds the fair value (net of estimated cost to sell) of the foreclosed asset is charged to the allowance for loan losses. Subsequent declines in the fair value of the foreclosed asset below the new cost basis are recorded through the use of a valuation allowance or through a direct write-off. Subsequent increases in the fair value may only be recorded to the extent of any previously recognized valuation allowance. Rental revenue received and gains and losses recognized on foreclosed assets is included in other noninterest income, whereas operating expenses and changes in the valuation allowance relating to foreclosed assets are included in other noninterest expense.

### Impairment of Long-Lived Assets

The Company reviews long-lived assets, including premises and equipment, for impairment whenever events or changes in business circumstances indicate that the remaining useful life may warrant revision or that the carrying amount of the long-lived asset may not be fully recoverable. The Company performs undiscounted cash flow analyses to determine if impairment exists. If impairment is determined to exist, any related impairment loss is calculated based on fair value. Impairment losses on assets to be disposed of, if any, are based on the estimated proceeds to be received, less costs of disposal.

### Bank Owned Life Insurance

Increases in the cash surrender value of life insurance policies, as well as death benefits received net of any cash surrender value, are recorded in other noninterest income, and are not subject to income taxes. The cash surrender value of the policies not previously endorsed to participants are recorded as assets of the Company. Any amounts owed to participants relating to these policies are recorded as liabilities of the Company. The Company reviews the financial strength of the insurance carriers prior to the purchase of life insurance policies and no less than annually thereafter.

### Income Taxes

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in the period that includes the enactment date. The Company's policy is to recognize interest and penalties assessed on uncertain tax positions in income tax expense.

### Stock-Based Compensation

The Company's stock-based compensation plans provide for awards of stock options, restricted stock and other stock-based compensation to directors, officers and employees. The cost of employee services received in exchange for awards of equity instruments is based on the grant-date fair value of those awards. Compensation cost is recognized over the requisite service period as a component of compensation expense. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. The Company uses the Black-Scholes model to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards.

### Comprehensive Income

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale, unrealized losses related to factors other than credit on debt securities, unrealized gains and losses on cash flow hedges and deferred gains on hedge accounting transactions.

### Earnings Per Share

Basic earnings per share is calculated using the two-class method. The two-class method is an earnings allocation formula under which earnings per share is calculated from common stock and participating securities according to dividends declared and participation rights in undistributed earnings. Under this method, all earnings distributed and undistributed, are allocated to participating securities and common shares based on their respective rights to receive dividends. Unvested share-based payment awards that contain non-forfeitable rights to dividends are considered participating securities (i.e. unvested restricted stock), not subject to performance based measures. Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding (inclusive of participating securities). Diluted earnings per share have been calculated in a manner similar to that of basic earnings per share except that the weighted average number of common shares outstanding is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares (such as those resulting from the exercise of stock options or the attainment of performance measures) were issued during the period, computed using the treasury stock method.

### Derivatives

Derivative instruments are carried at fair value in the Company's financial statements. The accounting for changes in the fair value of a derivative instrument is determined by whether it has been designated and qualifies as part of a hedging relationship, and further, by the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, the Company designates the hedging instrument, based upon the exposure being hedged, as either a fair value hedge or a cash flow hedge. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive income, net of related tax, and reclassified into earnings in the same period or periods during which the hedged transactions affect earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of future cash flows of the hedged item (i.e., the ineffective portion), if any, is recognized in current earnings during the period. For derivative instruments designated and qualifying as a fair value hedge (i.e., hedging the exposure to changes in the fair value of an asset or liability or an identified portion thereof that is attributable to the hedged risk), the gain or loss on the derivative instrument, as well as the offsetting gain or loss on the hedged item attributable to the hedged risk, are recognized in current earnings during the period of the change in fair values. At the inception of a hedge, the Company documents certain items, including but not limited to the following: the relationship between hedging instruments and hedged items, Company risk management objectives, hedging strategies, and the evaluation of hedge transaction effectiveness. Documentation includes linking all derivatives designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific forecasted transactions.

Hedge accounting is discontinued prospectively when (1) a derivative is no longer highly effective in offsetting changes in the fair value or cash flow of a hedged item, (2) a derivative expires or is sold, (3) a derivative is de-designated as a hedge, because it is unlikely that a forecasted transaction will occur, or (4) it is determined that designation of a derivative as a hedge is no longer appropriate. For derivative instruments not designated as hedging instruments, the gain or loss on the derivative is recognized in current earnings during the period of change.

### Transfer of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets. There are no agreements to repurchase before their maturity.

Transfers of a portion of a loan must meet the criteria of a participating interest. If it does not meet the criteria of a participating interest, the transfer must be accounted for as a secured borrowing. In order to meet the criteria for a participating interest, all cash flows from the loan must be divided proportionately, the rights of each loan holder must have the same priority, and the loan holders must have no recourse to the transferor other than standard representations and warranties and no loan holder has the right to pledge or exchange the entire loan.

The Company sells financial assets in the normal course of business, the majority of which are related to the SBA-guaranteed portion of loans, as well as residential mortgage loan sales through established programs, commercial loan sales through participation agreements, and other individual or portfolio loan and securities sales. In accordance with accounting guidance for asset transfers, the Company considers any ongoing involvement with transferred assets in determining whether the assets can be derecognized from the balance sheet. With the exception of servicing and certain performance-based guarantees, the Company's continuing involvement with financial assets sold is minimal and generally limited to market customary representation and warranty clauses.

When the Company sells financial assets, it may retain servicing rights and/or other interests in the financial assets. The gain or loss on sale depends on the previous carrying amount of the transferred financial assets, the servicing right recognized, and the consideration received and any liabilities incurred in exchange for the transferred assets. Upon transfer, any servicing assets and other interests held by the Company are carried at the lower of cost or fair value.

### Segment Reporting

All of the Company's operations are considered by management to be one operating segment.

### Recent Accounting Pronouncements

In January 2014, the FASB issued ASU No. 2014-01, *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects* ("ASU 2014-01"). The amendments in ASU 2014-01 provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014 and should be applied retrospectively to all periods presented. Early adoption is permitted. The Company's adoption of this guidance did not have a material impact on its consolidated financial statements.

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

In May 2015, the FASB issued ASU 2015-07, *Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* ("ASU 2015-07"). The amendment affects reporting entities that elect to measure the fair value of an investment using the net asset value per share as a practical expedient. The Company adopted the standard in the current period. See Part I. Item I. "Notes to Consolidated Financial Statements – Note 18: Fair Value Measurements" for further discussion and related effect.

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.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments (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.

## **2. 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.

	June 30, 2016			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
	(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
	<u>\$ 100,375</u>	<u>\$ 249</u>	<u>\$ (52)</u>	<u>\$ 100,572</u>



	June 30, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(Dollars in thousands)		
U.S. Government agency securities .....	\$ 48,191	\$ 40	\$ (1)	\$ 48,230
Agency mortgage-backed securities.....	54,553	2	(877)	53,678
Other investment measured at net asset value .....	-	-	-	-
	<u>\$ 102,744</u>	<u>\$ 42</u>	<u>\$ (878)</u>	<u>\$ 101,908</u>

At June 30, 2016, the Company held no securities of any single issuer (excluding the U. S. Government and federal agencies) with a book value that exceeded 10% of shareholders' equity.

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 fiscal 2016 or fiscal 2015. At June 30, 2016, no investment securities were pledged as collateral to secure outstanding wholesale repurchase agreements and FHLBB advances.

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.

	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 .....	-	-	-	-	-	-
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 25,350</u>	<u>\$ (52)</u>	<u>\$ 25,350</u>	<u>\$ (52)</u>

	June 30, 2015					
	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 .....	\$ 2,999	\$ (1)	\$ -	\$ -	\$ 2,999	\$ (1)
Agency mortgage-backed securities .....	10,295	(106)	41,349	(771)	51,644	(877)
Other investment measured at net asset value .....	-	-	-	-	-	-
	<u>\$ 13,294</u>	<u>\$ (107)</u>	<u>\$ 41,349</u>	<u>\$ (771)</u>	<u>\$ 54,643</u>	<u>\$ (878)</u>

There were no other-than-temporary impairment losses on securities during the years ended June 30, 2016 and 2015.

At June 30, 2016, the Company had eleven securities in a continuous loss position for greater than twelve months. At June 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 June 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 June 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 June 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 the fund is primarily government agencies or other investment-grade investments. The effective duration of the investments is 4.52 years.

The amortized cost and fair values of available-for-sale debt securities by contractual maturity are shown below as of June 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 .....	\$ 12,011	\$ 12,014
Due after one year through five years .....	39,937	40,032
Due after five years through ten years.....	19,708	19,797
Due after ten years .....	23,622	23,571
Total .....	<u>\$ 95,278</u>	<u>\$ 95,414</u>

### **3. Loans, Allowance for Loan Losses and Credit Quality**

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

	June 30, 2016			June 30, 2015		
	Originated	Purchased	Total	Originated	Purchased	Total
(Dollars in thousands)						
Residential real estate.....	\$ 93,391	\$ 2,559	\$ 95,950	\$ 106,275	\$ 2,068	\$ 108,343
Home equity .....	18,012	-	18,012	24,326	-	24,326
Commercial real estate .....	189,616	236,952	426,568	148,425	200,251	348,676
Commercial and industrial .....	145,758	198	145,956	122,860	273	123,133
Consumer .....	5,950	-	5,950	7,659	-	7,659
Total loans .....	<u>\$ 452,727</u>	<u>\$ 239,709</u>	<u>\$ 692,436</u>	<u>\$ 409,545</u>	<u>\$ 202,592</u>	<u>\$ 612,137</u>

Total loans include deferred loan origination fees, net, of \$58 thousand and \$236 thousand as of June 30, 2016 and June 30, 2015, respectively.

Loans pledged as collateral with the FHLBB for outstanding borrowings and additional borrowing capacity totaled \$106.2 million and \$131.3 million at June 30, 2016 and 2015, respectively.

Past Due and Nonaccrual Loans

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

	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

	June 30, 2015							
	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....	\$ 239	\$ 973	\$ -	\$ 1,393	\$ 2,605	\$ 103,670	\$ 106,275	\$ 3,021
Home equity.....	9	-	-	11	20	24,306	24,326	11
Commercial real estate..	300	-	-	704	1,004	147,421	148,425	994
Commercial and industrial.....	-	-	-	2	2	122,858	122,860	2
Consumer .....	105	29	-	56	190	7,469	7,659	190
Total originated portfolio..	653	1,002	-	2,166	3,821	405,724	409,545	4,218
Purchased portfolio:								
Residential real estate ...	-	-	-	-	-	2,068	2,068	-
Commercial and industrial.....	-	-	-	-	-	273	273	-
Commercial real estate..	86	299	-	2,410	2,795	197,456	200,251	6,532
Total purchased portfolio..	86	299	-	2,410	2,795	199,797	202,592	6,532
Total loans.....	\$ 739	\$ 1,301	\$ -	\$ 4,576	\$ 6,616	\$ 605,521	\$ 612,137	\$ 10,750

Allowance for Loan Losses and Impaired Loans

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

	Year Ended June 30, 2016						
	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	547	243	76	787	(56)	1,618
Recoveries.....	35	5	14	17	-	-	71
Charge-offs .....	(134)	(51)	(77)	(66)	(937)	-	(1,265)
Ending balance.....	\$ 663	\$ 1,195	\$ 297	\$ 62	\$ 133	\$ -	\$ 2,350

Year Ended June 30, 2015

	Residential Real Estate	Commercial Real Estate	Commercial and Industrial	Consumer	Purchased	Unallocated	Total
	(Dollars in thousands)						
Beginning balance.	\$ 580	\$ 358	\$ 48	\$ 79	\$ 268	\$ 34	\$ 1,367
Provision .....	344	335	38	(37)	15	22	717
Recoveries .....	24	1	34	21	-	-	80
Charge-offs .....	(207)	-	(3)	(28)	-	-	(238)
Ending balance .....	<u>\$ 741</u>	<u>\$ 694</u>	<u>\$ 117</u>	<u>\$ 35</u>	<u>\$ 283</u>	<u>\$ 56</u>	<u>\$ 1,926</u>

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

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 .....	<u>\$ 663</u>	<u>\$ 1,195</u>	<u>\$ 297</u>	<u>\$ 62</u>	<u>\$ 133</u>	<u>\$ -</u>	<u>\$ 2,350</u>
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 .....	<u>\$ 111,403</u>	<u>\$ 189,616</u>	<u>\$ 145,758</u>	<u>\$ 5,950</u>	<u>\$ 239,709</u>	<u>\$ -</u>	<u>\$ 692,436</u>

June 30, 2015

	Residential Real Estate	Commercial Real Estate	Commercial and Industrial	Consumer	Purchased	Unallocated	Total
	(Dollars in thousands)						
Allowance for loan losses:							
Individually evaluated .....	\$ 435	\$ 21	\$ -	\$ -	\$ -	\$ -	\$ 456
Collectively evaluated .....	306	673	117	35	-	56	1,187
ASC 310-30 .....	-	-	-	-	283	-	283
Total .....	<u>\$ 741</u>	<u>\$ 694</u>	<u>\$ 117</u>	<u>\$ 35</u>	<u>\$ 283</u>	<u>\$ 56</u>	<u>\$ 1,926</u>
Loans:							
Individually evaluated .....	\$ 4,095	\$ 2,381	\$ 2	\$ 253	\$ -	\$ -	\$ 6,731
Collectively evaluated .....	126,506	146,044	122,858	7,406	-	-	402,814
ASC 310-30 .....	-	-	-	-	202,592	-	202,592
Total .....	<u>\$ 130,601</u>	<u>\$ 148,425</u>	<u>\$ 122,860</u>	<u>\$ 7,659</u>	<u>\$ 202,592</u>	<u>\$ -</u>	<u>\$ 612,137</u>

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

	June 30, 2016			June 30, 2015		
	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.....	\$ 3,192	\$ 3,299	\$ -	\$ 1,975	\$ 2,076	\$ -
Consumer .....	257	282	-	253	262	-
Commercial real estate.....	451	453	-	1,505	1,510	-
Commercial and industrial .....	15	15	-	2	2	-
Purchased:						
Residential real estate.....	1,125	1,125	-	-	-	-
Commercial real estate.....	4,574	4,886	-	7,673	9,606	-
Total .....	9,614	10,060	-	11,408	13,456	-
Impaired loans with a valuation allowance:						
Originated:						
Residential real estate.....	1,847	1,802	386	2,120	2,060	435
Consumer .....	105	112	23	-	-	-
Commercial real estate.....	1,235	1,223	59	876	870	21
Commercial and industrial .....	2	2	2	-	-	-
Purchased:						
Commercial real estate.....	1,484	1,812	66	1,208	1,644	260
Total .....	4,673	4,951	536	4,204	4,574	716
Total impaired loans.....	\$ 14,287	\$ 15,011	\$ 536	\$ 15,612	\$ 18,030	\$ 716

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

	Year Ended June 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.....	\$ 2,584	\$ 151	\$ 1,490	\$ 92
Consumer .....	255	27	226	80
Commercial real estate.....	978	31	1,436	71
Commercial and industrial .....	9	-	1	1
Purchased:				
Residential real estate.....	563	51	-	-
Commercial real estate.....	6,123	140	5,265	249
Total .....	10,512	400	8,418	493
Impaired loans with a valuation allowance:				
Originated:				
Residential real estate.....	1,984	96	1,715	87
Consumer .....	53	3	20	17
Commercial real estate.....	1,056	63	1,029	59
Commercial and industrial .....	1	-	-	-
Purchased:				
Commercial real estate.....	1,346	83	1,549	41
Total .....	4,440	245	4,313	204
Total impaired loans.....	\$ 14,952	\$ 645	\$ 12,731	\$ 697

### 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.

	June 30, 2016				
	Originated Portfolio				
	Commercial Real Estate	Commercial and Industrial	Residential Real Estate <sup>(1)</sup>	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.....	-	-	-	-	-
	<u>\$ 189,616</u>	<u>\$ 145,758</u>	<u>\$ 8,650</u>	<u>\$ 239,709</u>	<u>\$ 583,733</u>

	June 30, 2015				
	Originated Portfolio				
	Commercial Real Estate	Commercial and Industrial	Residential Real Estate <sup>(1)</sup>	Purchased Portfolio	Total
	(Dollars in thousands)				
Loans rated 1- 6.....	\$ 142,321	\$ 122,829	\$ 8,049	\$ 190,193	\$ 463,392
Loans rated 7.....	4,417	31	634	5,628	10,710
Loans rated 8.....	1,687	-	429	6,771	8,887
Loans rated 9.....	-	-	23	-	23
Loans rated 10.....	-	-	-	-	-
	<u>\$ 148,425</u>	<u>\$ 122,860</u>	<u>\$ 9,135</u>	<u>\$ 202,592</u>	<u>\$ 483,012</u>

(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.

Troubled Debt Restructurings

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

	Year Ended June 30,			
	2016		2015	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
	(Dollars in thousands)			
Extended maturity .....	-	\$ -	7	\$ 1,934
Adjusted interest rate .....	4	129	9	430
Rate and maturity .....	9	1,297	6	211
Principal deferment.....	-	-	1	443
Court ordered concession.....	-	-	4	84
	<u>13</u>	<u>\$ 1,426</u>	<u>27</u>	<u>\$ 3,102</u>

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

	Year Ended June 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	9	\$ 502	\$ 533	17	\$ 1,223	\$ 1,223
Home equity .....	-	-	-	-	-	-
Commercial real estate.....	1	154	154	1	200	200
Commercial and industrial.....	1	2	2	-	-	-
Consumer .....	1	19	19	6	51	51
Total originated portfolio.....	<u>12</u>	<u>677</u>	<u>708</u>	<u>24</u>	<u>1,474</u>	<u>1,474</u>
Purchased portfolio:						
Commercial real estate.....	1	718	718	3	1,628	1,628
Total purchased portfolio.....	<u>1</u>	<u>718</u>	<u>718</u>	<u>3</u>	<u>1,628</u>	<u>1,628</u>
Total .....	<u>13</u>	<u>\$ 1,395</u>	<u>\$ 1,426</u>	<u>27</u>	<u>\$ 3,102</u>	<u>\$ 3,102</u>

As of June 30, 2016, there were no further commitments to lend to borrowers associated with loans modified in a TDR.

The Company considers TDRs past due 90 days or more to be in payment default. One loan modified in a TDR in the last twelve months defaulted during the year ended June 30, 2016, with a balance of \$8 thousand, compared to three loans during the twelve months ended June 30, 2015, with an aggregate balance of \$100 thousand.

#### 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.

	Year Ended June 30, 2016	Year Ended June 30, 2015
	(Dollars in thousands)	
Contractually required payments receivable .....	\$ 148,394	\$ 128,452
Nonaccretable difference.....	(2,050)	(2,042)
Cash flows expected to be collected.....	146,344	126,410
Accretable yield .....	(46,345)	(43,756)
Fair value of loans acquired .....	<u>\$ 99,999</u>	<u>\$ 82,654</u>

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

	As of and for the Year Ended June 30, 2016	As of and for the Year Ended June 30, 2015
	(Dollars in thousands)	
Loans acquired during the period.....	\$ 424	\$ 357
Loans at end of period.....	4,512	6,127

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

	Year Ended June 30, 2016	Year Ended June 30, 2015
	(Dollars in thousands)	
Beginning balance.....	\$ 111,449	\$ 109,040
Acquisitions .....	46,345	43,756
Accretion.....	(16,900)	(16,886)
Reclassifications from non-accretable difference to accretable yield .....	7,079	157
Disposals and other changes .....	(23,822)	(24,618)
Ending balance.....	<u>\$ 124,151</u>	<u>\$ 111,449</u>

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

	June 30, 2016	June 30, 2015
	(Dollars in thousands)	
Unpaid principal balance .....	\$ 267,985	\$ 235,716
Carrying amount .....	237,054	199,113

#### **4. 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 June 30, 2016 totaled \$1.8 million, compared to \$1.1 million as of June 30, 2015, and are included in other assets on the consolidated balance sheets.

Mortgage loans sold in the year ended June 30, 2016 totaled \$89.1 million, compared to \$101.3 million in the year ended June 30, 2015. Mortgage loans serviced for others totaled \$12.9 million at June 30, 2016 and \$16.1 million at June 30, 2015. Additionally, the Company was servicing commercial loans participated out to various other institutions amounting to \$35.9 million and \$38.8 million at June 30, 2016 and June 30, 2015, respectively.



SBA loans sold during the year ended June 30, 2016 totaled \$39.1 million, compared to \$22.2 million in the year ended June 30, 2015. SBA loans serviced for others totaled \$80.8 million at June 30, 2016 and \$53.5 million at June 30, 2015.

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 \$649 thousand and \$471 thousand for the years ended June 30, 2016 and 2015, respectively, and were included as a component of fees for other services to customers within non-interest income.

The significant assumptions used in the valuation for mortgage servicing rights as of June 30, 2016 included a weighted average discount rate of 6.3% and a weighted average prepayment speed assumption of 19.4%. For the SBA servicing rights, the significant assumptions used in the valuation included a discount rate, ranging from 7.8% to 13.0% and a weighted average prepayment speed assumption of 7.5%.

Residential mortgage servicing rights activity was as follows:

	June 30, 2016
	(Dollars in thousands)
Balance, June 30, 2014 .....	\$ 64
Amortization .....	(28)
Allowance Adjustment.....	1
Balance, June 30, 2015 .....	37
Amortization .....	(19)
Allowance Adjustment.....	(1)
Balance, June 30, 2016 .....	<u>\$ 17</u>

SBA servicing rights activity was as follows:

	June 30, 2016
	(Dollars in thousands)
Balance, June 30, 2014 .....	\$ 236
Additions.....	940
Amortization .....	(80)
Allowance Adjustment.....	(19)
Balance, June 30, 2015 .....	1,077
Additions.....	1,230
Disposals.....	(38)
Amortization .....	(52)
Allowance Adjustment.....	(463)
Balance, June 30, 2016 .....	<u>\$ 1,754</u>

## 5. Premises and Equipment

Premises and equipment consists of the following:

	June 30, 2016	June 30, 2015	Estimated Useful Life
	(Dollars in thousands)		(In years)
Land .....	\$ 804	\$ 804	n/a
Buildings .....	1,760	1,760	39
Assets recorded under capital lease .....	1,850	1,850	Term of lease
Leasehold and building improvements .....	3,452	3,051	5-39 (or term of lease, if shorter)
Furniture, fixtures and equipment .....	7,962	7,745	3-7
	<u>15,828</u>	<u>15,210</u>	
Less accumulated depreciation .....	8,027	6,957	
Net premises and equipment .....	<u>\$ 7,801</u>	<u>\$ 8,253</u>	

Depreciation and amortization of premises and equipment included in occupancy and equipment expense was \$1.6 million for the year ended June 30, 2016 and \$1.7 million for the year ended June 30, 2015.

## 6. Intangible Assets

At June 30, 2016 and 2015, intangible assets consisted of a core deposit intangible. The Company's core deposit intangible is being amortized on an accelerated basis over 9.5 years, with an estimated remaining life of 4 years.

The changes in the carrying amount of the core deposit intangible follow:

	<u>June 30, 2016</u>
	(Dollars in thousands)
Balance, June 30, 2014.....	\$ 2,798
Amortization .....	(589)
Balance, June 30, 2015.....	2,209
Amortization .....	(477)
Balance, June 30, 2016.....	<u>\$ 1,732</u>

The components of core deposit intangible follow:

	<u>June 30, 2016</u>	<u>June 30, 2015</u>
	(Dollars in thousands)	
Core Deposit Intangible:		
Gross carrying amount.....	\$ 6,348	\$ 6,348
Accumulated amortization.....	(4,616)	(4,139)
Net carrying amount .....	<u>\$ 1,732</u>	<u>\$ 2,209</u>

Expected annual amortization expense associated with the core deposit intangible over the period of estimated economic benefit is as follows:

Fiscal Year	<u>Expected Amortization Expense</u>	
	(Dollars in thousands)	
2017.....	\$	432
2018.....		433
2019.....		433
2020.....		434
Total .....	<u>\$</u>	<u>1,732</u>

## 7. Deposits

The composition of deposits is as follows:

	<u>June 30, 2016</u>	<u>June 30, 2015</u>
	(Dollars in thousands)	
Demand .....	\$ 66,686	\$ 60,383
NOW .....	71,148	64,289
Money market .....	275,437	168,527
Regular savings .....	36,070	35,845
Time certificates of less than \$100 thousand .....	72,190	82,973
Time certificates of greater than \$100 thousand .....	278,901	262,742
Total .....	<u>\$ 800,432</u>	<u>\$ 674,759</u>

There were no time deposits greater than \$250 thousand as of June 30, 2016, and there were \$569 thousand of time deposits greater than \$250 thousand as of June 30, 2015.

The scheduled maturities of time certificates by fiscal year are as follows:

Fiscal Year	June 30, 2016
	(Dollars in thousands)
2017.....	226,515
2018.....	72,264
2019.....	33,030
2020.....	14,326
Thereafter.....	4,956
Total.....	\$ 351,091

## **8. Borrowings**

### Federal Home Loan Bank Advances

A summary of advances from the Federal Home Loan Bank of Boston follows:

Maturity By Fiscal Year	Unpaid Principal Balance		Carrying Amount <sup>(1)</sup>		Weighted Average Interest Rate	
	2016	2015	2016	2015	2016	2015
	(Dollars in thousands)					
2016	-	15,000	-	15,000	-	0.38%
2017	25,000	10,000	25,037	10,123	2.10%	2.84%
2018	5,000	5,000	5,038	5,065	4.29%	1.43%
	\$ 30,000	\$ 30,000	\$ 30,075	\$ 30,188	2.46%	2.34%

- (1) The difference between the carrying amount and the unpaid principal balance is the result of purchase accounting. The premium or discount is being amortized or accreted as interest expense over the instrument's contractual life.

At June 30, 2016, FHLBB advances with unpaid principal of \$10.0 million were subject to call provisions and may be called prior to the stated maturity.

Certain mortgage loans, free of liens, pledges and encumbrances and certain investment securities maintained at the FHLBB not otherwise pledged have been pledged under a blanket agreement to secure these advances. The Company is required to own stock in the Federal Home Loan Bank of Boston in order to borrow from the FHLBB.

At June 30, 2016, the Company had approximately \$16.8 million of additional capacity to borrow from the FHLBB.

### Wholesale Repurchase Agreements

As of June 30, 2016, the Company did not have any outstanding wholesale repurchase agreements. During the year ended June 30, 2016, the Company paid off the wholesale repurchase agreements at maturity. At June 30, 2015, the Company had wholesale repurchase agreements with an unpaid principal balance and carrying amount of \$10.0 million, with a weighted average interest rate of 4.44%.

### Capital Lease Obligation

In fiscal 2006, the Company recognized a capital lease obligation for its Lewiston, Maine, headquarters. The present value of the lease payments over fifteen years exceeded 90% of the fair value of the property.

The outstanding capital lease obligations are as follows for years ending June 30:

	<u>Capital Lease Obligation</u> (Dollars in thousands)
2017.....	\$ 306
2018.....	306
2019.....	306
2020.....	306
2021.....	25
Total .....	<u>1,249</u>
Imputed interest .....	(121)
Capital lease obligation .....	<u>\$ 1,128</u>

### Short-Term Borrowings

Short-term borrowings are sweep accounts, which are a demand account product that moves balances in excess of an agreed upon target amount from a demand deposit account into an interest-bearing account overnight. The weighted average interest rate on short-term borrowings was 1.91% at June 30, 2015. The Company held no short-term borrowings as of June 30, 2016.

## **9. Subordinated Debt**

### Trust Preferred Securities and Junior Subordinated Debentures

NBN Capital Trust II and NBN Capital Trust III were created in December 2003. NBN Capital Trust IV was created in December 2004. Each such trust is a Delaware statutory trust (together, the "Private Trusts"). The exclusive purpose of the Private Trusts was (i) issuing and selling common securities and preferred securities in a private placement offering (the "Private Trust Securities"), (ii) using the proceeds of the sale of the Private Trust Securities to acquire Junior Subordinated Deferrable Interest Notes ("Junior Subordinated Debentures"); and (iii) engaging only in those other activities necessary, convenient or incidental thereto. Accordingly, the Junior Subordinated Debentures are the sole assets of each of the Private Trusts.

The following table summarizes the Junior Subordinated Debentures issued by the Company to each affiliated trust and the Private Trust Securities issued by each affiliated trust as of June 30, 2016. Amounts include the junior subordinated debentures acquired by the affiliated trusts from the Company with the capital contributed by the Company in exchange for the common securities of such trust, which were \$93 thousand each for NBN Capital Trust II and III and \$310 thousand for NBN Capital Trust IV. The trust preferred securities (the "Preferred Securities") were sold in two separate private placement offerings. The Company has the right to redeem the Junior Subordinated Debentures, in whole or in part, on or after March 30, 2009, for NBN Capital Trust II and III, and on or after February 23, 2010, for NBN Capital Trust IV, at the redemption price specified in the associated Indenture, plus accrued but unpaid interest to the redemption date.

	<u>Maturity Date</u>	<u>Unpaid Principal Balance</u>		<u>Carrying Amount<sup>(1)</sup></u>	
		<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
		(Dollars in thousands)			
NBN Capital Trust II.....	March 30, 2034	\$ 3,093	\$ 3,093	\$ 1,868	\$ 1,835
NBN Capital Trust III .....	March 30, 2034	3,093	3,093	1,868	1,835
NBN Capital Trust IV .....	February 23, 2035	10,310	10,310	5,083	4,956
		<u>\$ 16,496</u>	<u>\$ 16,496</u>	<u>\$ 8,819</u>	<u>\$ 8,626</u>

- (1) The difference between the carrying amount and the unpaid principal balance is the result of purchase accounting. The premium or discount is being amortized or accreted as interest expense over the instrument's contractual life.

NBN Capital Trust II and III pay a variable rate based on three month LIBOR plus 2.80%, and NBN Capital Trust IV pays a variable rate based on three month LIBOR plus 1.89%. Accordingly, the Preferred Securities of the Private Trusts currently pay quarterly distributions at an annual rate of 3.45% for the stated liquidation amount of \$1,000 per Preferred Security for NBN Capital Trust II and III and an annual rate of 2.54% for the stated liquidation amount of \$1,000 per Preferred Security for NBN Capital Trust IV. The Company has fully and unconditionally guaranteed all of the obligations of each trust. The guaranty covers the quarterly distributions and payments on liquidation or redemption of the Private Trust Securities, but only to the extent of funds held by the trusts.

The Junior Subordinated Debentures each have variable rates indexed to three-month LIBOR. During the fiscal year ended June 30, 2015, the Company purchased two interest rate caps to hedge the interest rate risk on notional amounts of \$6 million and \$10 million, respectively, of the Company's Junior Subordinated Debentures. Each is a cash flow hedge used to manage the risk to net interest income in a period of rising rates.

The interest rate caps hedge the junior subordinated debt resulting from the issuance of trust preferred securities by our affiliates NBN Capital Trust II, NBN Capital Trust III and NBN Capital Trust IV. The notional amount of \$6 million and \$10 million for each interest rate cap represents the outstanding junior subordinated debt from each trust. The strike rate is 2.50%. The Company will recognize higher interest expense on the junior subordinated debt for the first 200 basis points increase in three-month LIBOR. Once the three-month LIBOR rate exceeds 2.50% on a quarterly reset date, there will be a payment by the counterparty to the Company at the following quarter end. The effective date of the purchased interest rate caps were October 2014 and March 2015, respectively, and mature five years after.

### Subordinated Notes

On June 29, 2016, the Company entered into a Subordinated Note Purchase Agreement with certain institutional accredited investors (the "Purchasers") whereby the Company sold and issued \$15.05 million in aggregate principal amount of 6.75% fixed-to-floating subordinated notes due 2026 (the "Notes"). The Notes were issued by the Company to the Purchasers at a price equal to 100% of their face amount. Issuance costs were \$538 thousand and have been netted against Subordinated Debt on the consolidated balance sheet. These costs are being amortized over the life of the Notes.

The Notes mature on July 1, 2026, with a fixed interest rate of 6.75% payable semiannually in arrears for five years until July 1, 2021. Subsequently, the Company will be obligated to pay 3-month LIBOR plus 557 basis points quarterly in arrears until either the early redemption date or the maturity date. The Notes are not convertible into or exchangeable for any other securities or assets of the Company or any of its subsidiaries. The Notes are redeemable by the Company, in whole or in part, on or after July 1, 2021 and at any time upon the occurrence of certain events. Any redemption by the Company would be at a redemption price equal to 100% of the outstanding principal amount of the Notes being redeemed, including any accrued and unpaid interest.

## **10. Capital and Regulatory Matters**

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

The prompt corrective action regulations define specific capital categories based on an institution's capital ratios. The capital categories, in declining order, are "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized."

As of June 30, 2016 and 2015, the most recent notification from the Company's and the Bank's regulator categorized the Company and the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Company and the Bank must maintain minimum Common equity tier 1 capital, total capital, Tier 1 capital and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the institution's regulatory designation as "well-capitalized" under the regulatory framework for prompt corrective action.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios as set forth in the table below. At June 30, 2016 and 2015, the Company's and the Bank's ratios exceeded the regulatory requirements. Management believes that the Company and the Bank met all capital adequacy requirements to which they were subject as of June 30, 2016 and 2015. 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 Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
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:						
Company .....	126,046	17.97%	42,079	≥6.0%	N/A	N/A
Bank .....	117,212	16.69%	42,148	≥6.0%	56,197	≥8.0%
Tier 1 capital to average assets:						
Company .....	126,046	13.27%	38,006	≥4.0%	N/A	N/A
Bank .....	117,212	12.33%	38,022	≥4.0%	47,528	≥5.0%
June 30, 2015:						
Common equity tier 1 capital to risk weighted assets:						
Company .....	\$ 121,224	19.82%	\$ 27,523	≥4.5%	\$ N/A	N/A
Bank .....	107,477	17.55%	27,558	≥4.5%	39,806	≥6.5%
Total capital to risk weighted assets:						
Company .....	123,187	20.14%	48,932	≥8.0%	N/A	N/A
Bank .....	111,228	18.16%	48,999	≥8.0%	61,249	≥10.0%
Tier 1 capital to risk weighted assets:						
Company .....	121,224	19.82%	24,465	≥4.0%	N/A	N/A
Bank .....	107,477	17.55%	24,496	≥4.0%	36,744	≥6.0%
Tier 1 capital to average assets:						
Company .....	121,224	14.49%	33,464	≥4.0%	N/A	N/A
Bank .....	107,477	12.86%	33,421	≥4.0%	41,776	≥5.0%

The Bank may not declare or pay a cash dividend on, or repurchase, any of its capital stock from the Parent if the effect thereof would cause the capital of the Bank to be reduced below the capital requirements imposed by the regulatory authorities or if such amount exceeds the otherwise allowable amount under FRB rules.

In connection with the Merger, 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 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 non-owner occupied commercial real estate loans to within 300% of total capital. The Company and the Bank are currently in compliance with all commitments to the Federal Reserve.

## 11. Earnings Per Common Share

EPS is computed by dividing net income allocated to common shareholders by the weighted average common shares outstanding. 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:

	Year ended June 30,	
	2016	2015
	(Dollars in thousands, except share and per share data)	
Net income .....	\$ 7,619	\$ 7,141
Weighted average shares used in calculation of basic earnings per share.....	9,474,999	9,980,733
Incremental shares from assumed exercise of dilutive securities .....	9,636	-
Weighted average shares used in calculation of diluted earnings per share .....	<u>9,484,635</u>	<u>9,980,733</u>
Earnings per common share: .....	\$ 0.80	\$ 0.72
Diluted earnings per common share: .....	\$ 0.80	\$ 0.72

For the years ended June 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.

	Year ended June 30,	
	2016	2015
Stock options.....	714,545	1,059,721

## 12. Income Taxes

The current and deferred components of income tax expense follows:

	Year Ended June 30,	
	2016	2015
	(Dollars in thousands)	
Current provision		
Federal .....	\$ 1,544	\$ 4,282
State .....	438	898
Total current provision .....	1,982	5,180
Deferred expense (benefit)		
Federal .....	1,761	(901)
State .....	361	(284)
Total deferred expense (benefit) .....	2,122	(1,185)
Total tax provision .....	<u>\$ 4,104</u>	<u>\$ 3,995</u>

The reconciliation between the statutory federal income tax rate of 34% and the effective tax rate on income follows:

	Year Ended June 30,	
	2016	2015
	(Dollars in thousands)	
Expected income tax expense at federal tax rate .....	\$ 3,986	\$ 3,786
State tax, net of federal tax benefit.....	527	379
Non-taxable BOLI income .....	(153)	(150)
Low-income housing tax credit, net of adoption of ASU 2014-01 .....	(42)	(42)
Tax exempt interest income .....	(76)	(76)
Other .....	(138)	98
Total tax provision .....	<u>\$ 4,104</u>	<u>\$ 3,995</u>

The tax effect of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at June 30 follows:

	June 30,	
	2016	2015
	(Dollars in thousands)	
Deferred tax assets		
Allowance for loan losses.....	\$ 899	\$ 722
Loan basis differential .....	1,322	3,781
Time deposit basis differential.....	2	4
Capital lease.....	431	521
Compensation and benefits.....	937	809
Stock-based compensation.....	1,314	1,167
Unrealized loss on derivatives .....	1,243	472
Unrealized loss on available for sale securities .....	-	318
Interest on nonperforming loans.....	313	289
Other.....	701	788
Gross deferred tax asset .....	<u>7,162</u>	<u>8,871</u>
Less: valuation allowance .....	-	49
Total deferred tax assets .....	<u>7,162</u>	<u>8,822</u>
Deferred tax liabilities		
Unrealized gain on available for sale securities.....	75	-
Intangible assets.....	662	842
Prepaid expenses.....	300	368
Premises and equipment .....	1,239	1,231
Borrowings basis differential.....	2,863	2,869
Other.....	677	424
Total deferred tax liability.....	<u>5,816</u>	<u>5,734</u>
Net deferred tax asset .....	<u>\$ 1,346</u>	<u>\$ 3,088</u>

The net deferred tax asset was included in other assets in the accompanying balance sheet as of June 30, 2016 and June 30, 2015.

In accordance with ASC 740, *Income Taxes*, deferred tax assets are to be reduced by a valuation allowance if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. The realization of the tax benefit depends upon the existence of sufficient taxable income within the carry-back and future periods. The Company believes that it is more likely than not that the net deferred tax asset as of June 30, 2016 will be realized, based upon the ability to generate future taxable income as well as the availability of current and historical taxable income.

For federal tax purposes, the Company has a \$2.0 million reserve for loan losses which remains subject to recapture. If any portion of the reserve is used for purposes other than to absorb the losses for which it was established, approximately 150% of the amount actually used (limited to the amount of the reserve) would be subject to taxation in the year in which used. As the Company intends to use the reserve only to absorb loan losses, no provision has been made for potential liability that would result if 100% of the reserve were recaptured.



From time to time, the Internal Revenue Service (the "IRS") and state tax authorities may review or challenge specific tax positions taken by the Company in its ordinary course of business. The Company accounts for uncertainties in income taxes by reserving for tax positions that may not be upheld under examination. Increases to the Company's unrealized tax positions occur as a result of accruing for the unrecognized tax benefit as well the accrual of interest and penalties related to prior year positions. Decreases in the Company's unrealized tax positions occur as a result of the statute of limitation lapsing on prior year positions or settlements relating to outstanding positions. The Company reserves for uncertain tax positions, as well as related interest and penalties, as a component of income tax expense therefore affecting the effective tax rate. The following is a reconciliation of the beginning and ending amounts of the Company's uncertain tax positions:

	Tax Position	Interest and Penalties	Total
	(Dollars in thousands)		
Balance, June 30, 2014.....	\$ 101	\$ 12	\$ 113
Reduction of tax positions for prior years .....	-	-	-
Increase for prior year tax position.....	8	6	14
Increase for current year tax position .....	-	-	-
Balance, June 30, 2015.....	<u>\$ 109</u>	<u>\$ 18</u>	<u>\$ 127</u>
Reduction of tax positions for prior years .....	(42)	(4)	(46)
Increase for prior year tax position.....	-	-	-
Increase for current year tax position .....	-	-	-
Balance, June 30, 2016.....	<u>\$ 67</u>	<u>\$ 14</u>	<u>\$ 81</u>

The Company is currently open to audit under the statute of limitations by the IRS and state taxing authorities for the fiscal 2013 tax return and forward.

### **13. Employee Benefit Plans**

#### *401(k) Plan*

The Company offers a contributory 401(k) plan that is available to all full-time salaried and hourly-paid employees who have attained age 18, and completed 90 days of employment. Employees may contribute up to 100% of their base compensation, subject to IRS limitations. The Company will match 50% of each employee's contribution up to the first 6% contributed. For the years ended June 30, 2016 and 2015, the Company contributed \$331 thousand and \$315 thousand, respectively.

#### *Deferred Compensation*

The Company has individual deferred compensation agreements with five former senior officers. The Company recognized deferred compensation expense of \$31 thousand and \$30 thousand for the years ended June 30, 2016 and 2015, respectively. At June 30, 2016 and 2015, the Company's deferred compensation liability was \$541 thousand and \$512 thousand, respectively.

### **14. Stock-Based Compensation**

At the 2012 annual meeting of shareholders, the Company's shareholders approved the Northeast Bancorp Amended and Restated 2010 Stock Option and Incentive Plan (the "Restated Plan"). The Restated Plan amends and restates the Northeast Bancorp 2010 Option and Incentive Plan (the "2010 Plan"). The key material differences between the 2010 Plan and the Restated Plan are:

- The maximum number of shares of common stock to be issued under the Restated Plan is increased by 600,000 shares, from 810,054 shares to 1,410,054 shares;
- The method by which shares subject to previously granted awards are added back to the Restated Plan has been revised so that the only shares added back to the Restated Plan are those subject to awards that are forfeited, canceled or otherwise terminated. The following shares shall not be added back to the Restated Plan: (i) shares tendered or held back upon exercise of an option or settlement of an award to cover the exercise price or tax withholding, and (ii) shares subject to a stock appreciation right that are not issued in connection with the stock settlement of the stock appreciation right upon exercise thereof.
- Minimum vesting periods are required for grants of restricted stock, restricted stock units and performance share awards; and

- The term of the Restated Plan will now expire on November 28, 2022, while grants of incentive options under the Restated Plan may be made until September 21, 2022.

A summary of stock option activity for the year ended June 30, 2016 follows:

	Shares	Weighted Average Exercise Price
Outstanding at beginning of year .....	1,059,721	\$ 12.58
Granted .....	-	-
Exercised .....	-	-
Forfeited .....	(96,118)	10.06
Outstanding at end of year .....	<u>963,603</u>	12.83
Exercisable .....	<u>466,385</u>	13.05

	Shares	Weighted Average Grant Date Fair Value
Exercisable, beginning of year .....	305,595	\$ 3.55
Vested .....	167,456	2.96
Exercised .....	-	-
Forfeited or expired .....	(6,666)	4.43
Exercisable, end of year .....	<u>466,385</u>	3.48

There were no options granted in the year ended June 30, 2016. The fair values of options granted have been estimated on the date of grant using the Black-Scholes option-pricing model using the following weighted-average assumptions for the year ended June 30, 2015.

	<u>Year Ended June 30, 2015</u>
Assumptions:	
Dividend yield .....	0.43%
Expected life (in years).....	7.0
Expected volatility .....	30.30%
Risk-free interest rate.....	2.03%
Weighted average fair value per option.....	\$3.11

The expected volatility is based on historical volatility. The risk-free interest rate is for periods within the expected life of the awards, and is based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on expected exercise experience.

During the year ended June 30, 2013, certain provisions of outstanding stock options with market-based conditions were modified. The options, consisting of 237,616 shares, were granted to three executives of the Company in December of 2010 and were to vest in three equal tranches upon the Company's common stock reaching applicable hurdle prices over specified time periods. The applicable hurdle price varies depending on the number of years that have elapsed since the date of grant. With respect to the first tranche, the applicable hurdle price was \$27.86 for the period from December 29, 2010 through December 29, 2015; \$31.34 for the period from December 29, 2015 through December 29, 2016; and \$34.83 for the period from December 29, 2016 through December 29, 2017. With respect to the second tranche, the hurdle price was \$31.34 for the period from December 29, 2010 through December 29, 2016; and \$34.83 for the period from December 29, 2016 through December 29, 2017. With respect to the third tranche, the hurdle price was \$34.83 for the period from December 29, 2010 through December 29, 2017.

The Company's Compensation Committee approved amending the hurdle prices as follows:

With respect to the first tranche, the applicable hurdle price is \$16.43 for the period from December 29, 2010 through December 28, 2015; \$18.58 for the period from December 29, 2015 through December 28, 2016; and \$20.77 for the period from December 29, 2016 through December 28, 2017. With respect to the second tranche, the hurdle price is \$18.58 for the period from December 29, 2010 through December 28, 2016; and \$20.77 for the period from December 29, 2016 through December 28, 2017. With respect to the third tranche, the hurdle price is \$20.77 for the period from December 29, 2010 through December 28, 2017.

Except as modified by this amendment, all other terms and conditions of each of the outstanding performance-based stock options, including the option exercise price of \$13.93 per share, remain in full force and effect.

The incremental expense resulting from the modification was calculated as the difference between the stock option's fair value immediately before and after the modification using the Hull-White option pricing model and the following weighted-average assumptions:

Assumptions:

Dividend yield .....	3.72%
Expected life (in years).....	7.8
Expected volatility .....	28.45% - 32.84%
Risk-free interest rate.....	0.07% - 1.54%
Incremental weighted average fair value per option .....	\$0.52

The following table summarizes information about stock options outstanding at June 30, 2016:

Options Outstanding				Options Exercisable			
(Dollars in thousands, except per share data)							
Weighted Average Exercise Price	Number	Weighted Average Remaining Life (in years)	Aggregate Intrinsic Value	Weighted Average Exercise Price	Number	Weighted Average Remaining Life (in years)	Aggregate Intrinsic Value
9.30	20,000	7.64	39	9.30	-	7.64	-
9.38	195,999	6.59	366	9.38	65,333	6.59	122
9.38	33,059	2.50	62	9.38	33,059	2.50	62
12.63	12,500	5.58	-	12.63	8,334	5.58	-
13.93	540,035	4.50	-	13.93	278,655	4.50	-
14.52	162,010	3.73	-	14.52	81,004	3.73	-
12.83	<u>963,603</u>	4.81	<u>467</u>	13.05	<u>466,385</u>	4.81	<u>184</u>

A summary of restricted stock activity for the year ended June 30, 2016 follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested at beginning of period .....	212,010	\$ 9.34
Granted .....	100,000	10.82
Vested .....	(13,597)	9.33
Forfeited .....	(46,554)	9.53
Unvested at end of period.....	<u>251,859</u>	9.93

At June 30, 2016 and 2015, the Company has accrued a liability of \$48 thousand representing the maximum cash payment for performance-based stock appreciation rights ("SARs") granted in the fiscal year ended June 30, 2011. The SARs expire in December of 2020.

Stock-based compensation totaled \$613 thousand for the year ended June 30, 2016 and \$705 thousand for the year ended June 30, 2015. The tax benefit related to stock-based compensation expensed totaled \$215 thousand for the year ended June 30, 2016 and \$253 thousand for the year ended June 30, 2015. The estimated amount and timing of future pre-tax stock-based compensation expense to be recognized are as follows.

	Year Ended June 30,					
	2017	2018	2019	2020	2021	Total
	(Dollars in thousands)					
Stock options.....	\$ 116	\$ 49	\$ 5	\$ -	\$ -	\$ 170
Restricted stock ....	518	494	460	279	51	1,802
	<u>\$ 634</u>	<u>\$ 543</u>	<u>\$ 465</u>	<u>\$ 279</u>	<u>\$ 51</u>	<u>\$ 1,972</u>

## 15. Commitments, Contingent Liabilities and Other Off-Balance Sheet Risks

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

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

	June 30,	
	2016	2015
	(Dollars in thousands)	
Commitments to originate loans.....	\$ 44,684	\$ 24,966
Unused lines of credit .....	58,412	39,414
Standby letters of credit .....	3,822	60
Commitment to fund investment.....	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 counterparty. 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 \$81 thousand and \$37 thousand recorded in other liabilities at June 30, 2016 and 2015, respectively.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are issued to support private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. As of June 30, 2016 and 2015, the maximum potential amount of the Company's obligation was \$3.8 million and \$60 thousand, respectively, for financial and standby letters of credit. The Company's outstanding letters of credit generally have a term of less than one year. If a letter of credit is drawn upon, the Company may seek recourse through the customer's underlying line of credit. If the customer's line of credit is also in default, the Company may take possession of the collateral, if any, securing the line of credit.

### Lease Obligations

The Company leases certain properties used in operations under terms of operating leases that include renewal options. The leases contain renewal options and escalation clauses which provide for increased rental expense as these leases expire. Rental expense under leases totaled \$1.2 million for the year ended June 30, 2016 and \$1.2 million for the year ended June 30, 2015.

Approximate future minimum lease payments over the remaining terms of the Company's leases at June 30, 2016 are as follows:

	Minimum lease payments (Dollars in thousands)
2017.....	\$ 1,249
2018.....	1,214
2019.....	1,207
2020.....	1,205
2021.....	1,230
Thereafter .....	3,164
Total .....	<u>\$ 9,269</u>

### Legal Proceedings

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.

### **16. Other Comprehensive Loss**

The components of other comprehensive loss follow:

	Year Ended June 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 on available-for-sale securities .....	\$ 1,033	\$ 393	\$ 640	\$ 442	\$ 116	\$ 326
Change in accumulated loss on effective cash flow hedges....	(2,032)	(776)	(1,256)	(529)	(228)	(301)
Reclassification adjustment included in net income.....	(3)	(1)	(2)	(49)	(19)	(30)
Total derivatives and hedging activities .....	<u>(2,035)</u>	<u>(777)</u>	<u>(1,258)</u>	<u>(578)</u>	<u>(247)</u>	<u>(331)</u>
Total other comprehensive loss ....	<u>\$ (1,002)</u>	<u>\$ (384)</u>	<u>\$ (618)</u>	<u>\$ (136)</u>	<u>\$ (131)</u>	<u>\$ (5)</u>

Accumulated other comprehensive loss is comprised of the following components:

	June 30, 2016	June 30, 2015
	(Dollars in thousands)	
Unrealized gain (loss) on available-for-sale securities.....	\$ 197	\$ (836)
Tax effect.....	(75)	318
Net-of-tax amount.....	<u>122</u>	<u>(518)</u>
Unrealized loss on cash flow hedges.....	(3,276)	(1,242)
Tax effect.....	1,248	472
Net-of-tax amount.....	<u>(2,028)</u>	<u>(770)</u>
Accumulated other comprehensive loss .....	<u>\$ (1,906)</u>	<u>\$ (1,288)</u>

## 17. Derivatives

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 June 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 junior subordinated debt and FHLBB advances is as follows:

June 30, 2016									
Notional Amount	Inception Date	Termination Date	Index	Receive Rate	Pay Rate	Strike Rate	Unrealized Gain (Loss)	Fair Value	Balance Sheet Location
(Dollars in thousands)									
<i>Interest rate swaps:</i>									
\$ 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
<i>Interest rate caps:</i>									
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
<u>\$ 31,000</u>							<u>\$ (3,276)</u>	<u>\$ (2,882)</u>	

June 30, 2015									
Notional Amount	Inception Date	Termination Date	Index	Receive Rate	Pay Rate	Strike Rate	Unrealized Loss	Fair Value	Balance Sheet Location
(Dollars in thousands)									
<i>Interest rate swaps:</i>									
\$ 5,000	July 2013	July 2033	3 Mo. LIBOR	0.28%	3.38%	n/a	\$ (472)	\$ (472)	Other Liabilities
5,000	July 2013	July 2028	3 Mo. LIBOR	0.28%	3.23%	n/a	(368)	(368)	Other Liabilities
5,000	July 2013	July 2023	3 Mo. LIBOR	0.28%	2.77%	n/a	(208)	(208)	Other Liabilities
<i>Interest rate caps:</i>									
6,000	October 2014	September 2019	3 Mo. LIBOR	n/a	n/a	2.50%	(114)	63	Other Assets
10,000	March 2015	February 2020	3 Mo. LIBOR	n/a	n/a	2.50%	(80)	136	Other Assets
<u>\$ 31,000</u>							<u>\$ (1,242)</u>	<u>\$ (849)</u>	

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

During the periods presented, amounts recognized in income related to hedge ineffectiveness resulted from amortization of the non-zero fair value associated with the Company's single interest rate swap held at the time of the merger with FHB Formation LLC in December 2010. During the periods presented, amounts recognized in income related to amounts excluded from effectiveness testing resulted from amortization of the acquisition price of interest rate caps. The table below presents amounts recognized in income related to both hedge ineffectiveness and amounts excluded from effectiveness testing.

	Year Ended June 30,	
	2016	2015
(Dollars in thousands)		
Interest income (expense):		
Interest rate caps.....	\$ 3	\$ (15)
Interest rate swap.....	-	64
Total .....	<u>\$ 3</u>	<u>\$ 49</u>

The Company does not expect to record interest income or interest expense related to interest rate swap or interest rate cap ineffectiveness in the next twelve months.

## **18. 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 other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

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

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

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

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

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

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

The other investment is 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 investment can be redeemed daily at the closing net asset value per share. In accordance with ASC 820-10, the investment has 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 interest rate curves and implied volatilities. Unobservable inputs, such as credit valuation adjustments are insignificant to the overall valuation of the Company's derivative financial instruments. Accordingly, the Company has determined that its interest rate derivatives fall within Level 2 of the fair value hierarchy.

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

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

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

*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.

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

	June 30, 2016			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
<u>Assets</u>				
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 <sup>(1)</sup> .....	5,158	-	-	-
Other assets – interest rate caps.....	35	-	35	-
<u>Liabilities</u>				
Other liabilities – interest rate swaps .....	\$ 2,917	\$ -	\$ 2,917	\$ -

	June 30, 2015			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
<u>Assets</u>				
Securities available-for-sale:				
U.S. Government agency securities.....	\$ 48,230	\$ -	\$ 48,230	\$ -
Agency mortgage-backed securities .....	53,678	-	53,678	-
Other investment measured at net asset value <sup>(1)</sup> .....	-	-	-	-
Other assets – interest rate caps.....	199	-	199	-
<u>Liabilities</u>				
Other liabilities – interest rate swap.....	\$ 1,048	\$ -	\$ 1,048	\$ -

(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 is 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.

	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
	June 30, 2015			
	Total	Level 1	Level 2	Level 3
	(Dollars in thousands)			
Collateral dependent impaired loans .....	\$ 932	\$ -	\$ -	\$ 932
Real estate owned and other repossessed collateral .....	1,651	-	-	1,651
Loan servicing rights.....	1,123	-	-	1,123

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		Valuation Technique
	June 30, 2016	June 30, 2015	
	(Dollars in thousands)		
Collateral dependent impaired loans .....	\$ 922	\$ 932	Appraisal of collateral <sup>(1)</sup>
Real estate owned and other repossessed collateral .....	1,652	1,651	Appraisal of collateral <sup>(1)</sup>
Loan servicing rights.....	1,771	1,123	Discounted cash flow <sup>(2)</sup>

(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 10% to 75%.

(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 4.0% to 19.4%. For discount rates, the range was 6.3% to 13.0%.

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

	Carrying Amount	Fair Value Measurements at June 30, 2016			
		Total	Level 1	Level 2	Level 3
(Dollars in thousands)					
<b>Financial assets:</b>					
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 <sup>(1)</sup> .....	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	-
<b>Financial liabilities:</b>					
Deposits.....	800,432	801,045	-	801,045	-
Federal Home Loan Bank advances.....	30,075	30,396	-	30,396	-
Short-term borrowings.....	-	-	-	-	-
Capital lease obligation.....	1,128	1,219	-	1,219	-
Subordinated debt.....	23,331	25,664	-	-	25,664
Interest rate swaps.....	2,917	2,917	-	2,917	-
(Dollars in thousands)					
	Carrying Amount	Fair Value Measurements at June 30, 2015			
		Total	Level 1	Level 2	Level 3
<b>Financial assets:</b>					
Cash and cash equivalents.....	\$ 89,850	\$ 89,850	\$ 89,850	\$ -	\$ -
Available-for-sale securities.....	101,908	101,908	-	101,908	-
Other investment measured at net asset value <sup>(1)</sup> .....	-	-	-	-	-
Federal Home Loan Bank stock.....	4,102	4,102	-	4,102	-
Loans held for sale.....	9,035	9,035	-	9,035	-
Loans, net.....	610,211	613,896	-	-	613,896
Accrued interest receivable.....	1,335	1,335	-	1,335	-
Interest rate caps.....	199	199	-	199	-
<b>Financial liabilities:</b>					
Deposits.....	674,759	675,285	-	675,285	-
Federal Home Loan Bank advances.....	30,188	30,867	-	30,867	-
Wholesale repurchase agreements.....	10,037	10,098	-	10,098	-
Short-term borrowings.....	2,349	2,349	-	2,349	-
Capital lease obligation.....	1,368	1,448	-	1,448	-
Subordinated debt.....	8,626	8,471	-	-	8,471
Interest rate swaps.....	1,048	1,048	-	1,048	-

(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 is intended to permit reconciliation of the fair value amount to the consolidated financial statements.

## 19. Condensed Parent Information

Condensed financial information for Northeast Bancorp follows:

	<u>June 30, 2016</u>	<u>June 30, 2015</u>
	(Dollars in thousands)	
<u>Balance Sheets</u>		
Assets:		
Cash .....	\$ 24,528	\$ 13,251
Investment in subsidiary .....	117,228	109,275
Investment in common securities of affiliated trusts .....	496	496
Other assets .....	226	434
Total assets .....	<u>\$ 142,478</u>	<u>\$ 123,456</u>
Liabilities and Shareholders' Equity:		
Subordinated debt .....	\$ 23,331	\$ 8,626
Other liabilities .....	2,556	1,991
Total liabilities .....	25,887	10,617
Shareholders' equity .....	116,591	112,839
Total liabilities and shareholders' equity .....	<u>\$ 142,478</u>	<u>\$ 123,456</u>
	<u>Year Ended June 30,</u>	
	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
<u>Statements of Income</u>		
Income:		
Other income .....	\$ 62	\$ 14
Total income .....	62	14
Expenses:		
Interest expense .....	651	718
General and administrative expenses .....	954	1,128
Total expenses .....	1,605	1,846
Loss before income tax benefit and equity in undistributed net income of subsidiary .....	(1,543)	(1,832)
Income tax benefit .....	(579)	(684)
Loss before equity in undistributed net income of subsidiary .....	(964)	(1,148)
Equity in undistributed net income of subsidiary .....	8,583	8,289
Net income .....	<u>\$ 7,619</u>	<u>\$ 7,141</u>

	Year Ended June 30,	
	2016	2015
(Dollars in thousands)		
<b>Statements of Cash Flows</b>		
Operating activities:		
Net income .....	\$ 7,619	\$ 7,141
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of fair value adjustment for borrowings .....	193	186
Stock-based compensation .....	613	705
Undistributed earnings of subsidiary .....	(8,583)	(8,289)
Increase in other assets and liabilities .....	673	1,029
Net cash provided by operating activities .....	<u>515</u>	<u>772</u>
Investing activities:		
Increase in investment of bank subsidiary .....	-	-
Net cash used in investing activities .....	<u>-</u>	<u>-</u>
Financing activities:		
Issuance of subordinated debt, net of debt issuance costs .....	14,512	-
Taxes paid through cancellation of common stock .....	(11)	-
Repurchase of common stock .....	(3,359)	(6,666)
Dividends paid to shareholders .....	(380)	(402)
Net cash provided by (used in) financing activities .....	<u>10,762</u>	<u>(7,068)</u>
Net increase (decrease) in cash .....	11,277	(6,296)
Cash, beginning of year .....	13,251	19,547
Cash, end of year .....	<u>\$ 24,528</u>	<u>\$ 13,251</u>

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None

**Item 9A. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures*

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2016, the Company's disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in the Company's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. In addition, no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934) occurred during the fourth quarter of our fiscal year ended June 30, 2016 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

An evaluation was performed under the supervision and with the participation of the Company's management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our internal controls and procedures over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) as of the end of the period covered by this annual report.

*Management Report on Internal Control over Financial Reporting*

Management is responsible for establishing and maintaining adequate internal controls over financial reporting. The standard measures adopted by management in making its evaluation are the measures in *Interest Control—Integrated Framework (2013)* published by the Committee of Sponsoring Organizations of the Treadway Commission. We do not expect that our disclosure controls and procedures will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objective will be met. Further, the

design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues, errors, and instances of fraud, if any, within the Company have been or will be detected. The inherent limitations include, among other things, the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Controls and procedures also can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management or employee override of the controls and procedures. The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls and procedures may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitation in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Based on their evaluation of disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer concluded, subject to the limitations described above, that our internal controls and procedures over financial reporting as of the end of the period covered by this report were effective and that there were no material weaknesses.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of Northeast Bancorp

We have audited Northeast Bancorp's and subsidiary (the Company) internal control over financial reporting as of June 30, 2016, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying "Management Report on Internal Control over Financial Reporting". Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (a) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (b) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (c) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2016, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Northeast Bancorp and subsidiary as of June 30, 2016, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the year then ended, and our report dated September 13, 2016 expressed an unqualified opinion.

/s/ RSM US LLP

Boston, Massachusetts  
September 13, 2016

### *Changes in Internal Control over Financial Reporting*

There have been no significant changes in our internal controls, or in other factors that could significantly affect our internal controls, subsequent to the date the Chief Executive Officer and Chief Financial Officer completed their evaluation, including any corrective actions with regard to significant deficiencies or material weaknesses.

#### **Item 9B. Other Information.**

None.

### **PART III**

#### **Item 10. Directors, Executive Officers, and Corporate Governance.**

The information required by Item 10 is included in the Proxy Statement relating to our 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

#### **Item 11. Executive Compensation**

The information required by Item 11 is included in the Proxy Statement relating to our 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

#### **Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholders**

The information required by Item 12 is included in the Proxy Statement relating to our 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

#### **Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by Item 13 is included in the Proxy Statement relating to our 2016 Annual Meeting of Shareholders and is incorporated herein by reference.

#### **Item 14. Principal Accounting Fees and Services**

The information required by Item 14 is included in the Proxy Statement relating to our 2016 Annual Meeting of Shareholders and is incorporated herein by reference.



## PART IV

### Item 15. Exhibits, Financial Statement Schedules

#### (a) Financial Statements and Financial Statement Schedules

Consolidated Balance Sheets as of June 30, 2016 and 2015

Consolidated Statements of Income for the years ended June 30, 2016 and 2015

Consolidated Statements of Comprehensive Income for the years ended June 30, 2016 and 2015

Consolidated Statements of Changes in Shareholders' Equity for the years ended June 30, 2016 and 2015

Consolidated Statements of Cash Flows for the years ended June 30, 2016 and 2015

Notes to Consolidated Financial Statements

#### (b) Exhibits

- 2.1 Agreement and Plan of Merger, dated as of March 30, 2010, by and between Northeast Bancorp and FHB Formation LLC (incorporated by reference to Exhibit 2.1 of Northeast Bancorp's Form 8-K filed with Securities and Exchange Commission on March 31, 2010).
- 3.1 Amended and Restated Articles of Incorporation of Northeast Bancorp (incorporated by reference to Exhibit 3.1 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 3.2 Articles of Amendment to the Amended and Restated Articles of Incorporation of Northeast Bancorp (incorporated by reference to Exhibit 3.1 of Northeast Bancorp's Current Report on Form 8-K filed on March 22, 2011).
- 3.3 Articles of Amendment to the Amended and Restated Articles of Incorporation of Northeast Bancorp (incorporated by reference to Exhibit 3.1 of Northeast Bancorp's Current Report on Form 8-K filed on November 29, 2012).
- 3.4 Amended and Restated Bylaws of Northeast Bancorp (incorporated by reference to Exhibit 3.2 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 4.1 Registration Rights Schedule to the Agreement and Plan of Merger, dated as of March 30, 2010, by and between Northeast Bancorp and FHB Formation LLC (incorporated by reference to Amendment No. 1 on Form 10-K/A of Northeast Bancorp filed on March 19, 2012).
- 10.1+ Form of Indemnification Agreement, dated as of December 29, 2010, by and between Northeast Bancorp and each of the members of the Board (incorporated by reference to Exhibit 10.1 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.2+ Employment Agreement, dated December 30, 2010, by and between Northeast Bancorp and Richard Wayne (incorporated by reference to Exhibit 10.2 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.3+ Employment Agreement, dated December 30, 2010, by and between Northeast Bancorp and Claire Bean (incorporated by reference to Exhibit 10.3 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.4+ Employment Agreement, dated December 30, 2010, by and between Northeast Bancorp and Heather Campion (incorporated by reference to Exhibit 10.4 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.5+ Separation Agreement & General Release, dated August 15, 2013, by and between Northeast Bancorp and Heather Campion (incorporated by reference to Exhibit 10.1 of Northeast Bancorp's Current Report on Form 8-K filed on August 15, 2013).
- 10.6+ Non-Qualified Time-Based Stock Option Agreement, dated December 29, 2010, by and between Northeast Bancorp and Richard Wayne (incorporated by reference to Exhibit 10.5 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.7+ Non-Qualified Performance-Based Stock Option Agreement, dated March 22, 2013, by and between Northeast Bancorp and Richard Wayne (incorporated by reference to Exhibit 10.1 of Northeast Bancorp's Current Report on Form 8-K filed on March 26, 2013).
- 10.8+ Non-Qualified Time-Based Stock Option Agreement, dated December 29, 2010, by and between Northeast Bancorp and Claire Bean (incorporated by reference to Exhibit 10.7 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).

- 10.9+ Non-Qualified Performance-Based Stock Option Agreement, dated March 22, 2013, by and between Northeast Bancorp and Claire Bean (incorporated by reference to Exhibit 10.2 of Northeast Bancorp's Current Report on Form 8-K filed on March 26, 2013).
- 10.10+ Non-Qualified Time-Based Stock Option Agreement, dated December 29, 2010, by and between Northeast Bancorp and Heather Campion (incorporated by reference to Exhibit 10.8 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.11+ Non-Qualified Performance-Based Stock Option Agreement, dated March 22, 2013, by and between Northeast Bancorp and Heather Campion (incorporated by reference to Exhibit 10.3 of Northeast Bancorp's Current Report on Form 8-K filed on March 26, 2013).
- 10.12+ Non-Qualified Stock Option Agreement, dated December 30, 2010, by and between Northeast Bancorp and Robert Glauber (incorporated by reference to Exhibit 10.11 of Northeast Bancorp's Current Report on Form 8-K filed on January 5, 2011).
- 10.13+ Amended and Restated Performance-Based Stock Appreciation Rights Agreement, dated March 24, 2011, by and between Northeast Bancorp and Matthew Botein (incorporated by reference to Exhibit 10.1 of Northeast Bancorp's Current Report on Form 8-K filed on March 30, 2011).
- 10.14+ Non-Qualified Time-Based Stock Option Agreement, dated March 24, 2011, by and between Northeast Bancorp and Matthew Botein (incorporated by reference to Exhibit 10.2 of Northeast Bancorp's Current Report on Form 8-K filed on March 30, 2011).
- 10.15+ Non-Qualified Performance-Based Stock Option Agreement, dated March 24, 2011, by and between Northeast Bancorp and Matthew Botein (incorporated by reference to Exhibit 10.3 of Northeast Bancorp's Current Report on Form 8-K filed on March 30, 2011).
- 10.16 Subordinated Note Purchase Agreement, dated June 29, 2016, by and among Northeast Bancorp and the Purchasers identified therein (incorporated by reference to Exhibit 10.1 of Northeast Bancorp's Current Report on Form 8-K filed on June 29, 2016).
- 10.17 Form of 6.75% Fixed-to-Floating Subordinated Note due 2026 (incorporated by reference to Exhibit 4.1 of Northeast Bancorp's Current Report on Form 8-K filed on June 29, 2016).
- 21\* Subsidiaries of Northeast Bancorp
- 23.1\* Consent of RSM US LLP
- 23.2\* Consent of Ernst & Young LLP
- 31.1\* Rule 13a-14(a)/15d-14(a) Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Rule 13a-14(a)/15d-14(a) Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\*\* Rule 13a-14(b) Certifications of the Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document\*
- 101.SCH XBRL Taxonomy Extension Schema Document\*
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document\*
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document\*
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document\*
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document\*

\* Filed herewith.

\*\* Furnished herewith

+ Management contract or compensatory plan or agreement

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NORTHEAST BANCORP

Date: September 13, 2016

By:                     /s/ RICHARD WAYNE                      
**Richard Wayne**  
**Chief Executive Officer**  
**(Principal Executive Officer)**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>                    /s/ RICHARD WAYNE                    </u> <b>Richard Wayne</b>	Chief Executive Officer and Director (Principal Executive Officer)	September 13, 2016
<u>                    /s/ BRIAN SHAUGHNESSY                    </u> <b>Brian Shaughnessy</b>	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	September 13, 2016
<u>                    /s/ ROBERT GLAUBER                    </u> <b>Robert Glauber</b>	Chairman of the Board	September 13, 2016
<u>                    /s/ MATTHEW BOTEIN                    </u> <b>Matthew Botein</b>	Director	September 13, 2016
<u>                    /s/ CHERYL DORSEY                    </u> <b>Cheryl Dorsey</b>	Director	September 13, 2016
<u>                    /s/ PETER MCCLEAN                    </u> <b>Peter McClean</b>	Director	September 13, 2016
<u>                    /s/ JOHN C. ORESTIS                    </u> <b>John C. Orestis</b>	Director	September 13, 2016
<u>                    /s/ DAVID TANNER                    </u> <b>David Tanner</b>	Director	September 13, 2016
<u>                    /s/ JUDITH E. WALLINGFORD                    </u> <b>Judith E. Wallingford</b>	Director	September 13, 2016

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## Board of Directors

for Northeast Bancorp  
and Northeast Bank

### **Robert R. Glauber, Chairman**

*Lecturer*  
Harvard Kennedy School of  
Government

### **Matthew B. Botein**

*Global Chief Investment  
Officer and Co-Head*  
*BlackRock Alternative Investors*  
BlackRock

### **Cheryl Lynn Dorsey**

*President*  
Echoing Green

### **John C. Orestis**

*President and*  
*Chief Executive Officer*  
North Country Associates

### **David A. Tanner**

*Managing Director*  
Arlon Group LLC

### **Judith E. Wallingford**

*President*  
The Maine Water Company

### **Richard Wayne**

*President and*  
*Chief Executive Officer*  
Northeast Bancorp

## Senior Management

### **Richard Wayne**

*President and*  
*Chief Executive Officer*

### **Patrick Dignan**

*Executive Vice President*

### **Brian Fenwick**

*SVP, Director of Loan Underwriting*

### **Christopher Hickey**

*Director of Asset Management*  
*and Managing Director*

### **Jeanne A. Hulit**

*President, Community Banking*  
*Division*

### **Heidi Jacques**

*SVP, Director of Human Resources*

### **Julie Jenkins**

*SVP, Director of Operations*

### **James Krumsiek, Esq.**

*Managing Director and*  
*Legal Counsel*

### **Theresa Morrison**

*SVP, Director of Real Estate*  
*Valuation*

### **Brian Pinheiro**

*Chief Risk Officer*

### **Brian Shaughnessy**

*Chief Financial Officer and*  
*Treasurer*

### **Jonathan Smith**

*SVP, Director of SBA Lending*

### **Jeff Wright**

*SVP, Retail Sales &*  
*Operations Manager,*  
*Community Banking Division*



## Shareholder Information

### Annual Meeting

10:00 am EST, Tuesday, November 22, 2016 at the offices of Goodwin Procter LLP, 100 Northern Avenue, Boston, MA 02210.

### Transfer Agent

Computershare, Inc.  
250 Royall Street  
Canton, MA 02021  
800.942.5909

### Annual Report on Form 10-K and Other Financial Information

A copy of Northeast Bancorp's Annual Report on Form 10-K filed with the Securities and Exchange Commission may be obtained from the Company by sending a written request to:

Shareholder Relations  
Northeast Bancorp  
500 Canal Street  
Lewiston, ME 04240

The common stock of Northeast Bancorp trades on NASDAQ under the symbol NBN.

### Forward-Looking Statements

Certain statements in this report that are not historical facts may be considered forward-looking statements. For more information regarding factors that could cause actual results to differ materially from those projected in the forward-looking statements, see "A Note About Forward-Looking Statements" in the Company's 2016 Annual Report on Form 10-K.

Northeast Bancorp and its subsidiaries are an Equal Opportunity Employer.

## Corporate Offices

Northeast Bancorp  
500 Canal Street  
Lewiston, ME 04240  
207.786.3245

Northeast Bancorp  
200 Berkeley Street  
Boston, MA 02116  
617.585.3200

Northeast Bancorp  
27 Pearl Street  
Portland, ME 04101  
207.774.1426

Connecting All Locations  
800.284.5989  
www.northeastbank.com

## Loan Production Offices

### Maine

**BANGOR**  
21 Main Street, Suite 203  
Bangor, ME 04401  
207.217.6750

### New Hampshire

**HAMPTON**  
881 Lafayette Road, Unit D  
Hampton, NH 03842  
603.570.4879

## Branch Offices

**AUBURN**  
232 Center Street\*  
Auburn, ME 04210  
207.783.5632

**AUGUSTA**  
235 Western Avenue\*  
Augusta, ME 04330  
207.623.0603

**BETHEL**  
11 Main Street\*\*  
Bethel, ME 04217  
207.824.2117

**BRUNSWICK**  
186 Maine Street\*  
Brunswick, ME 04011  
207.729.8711

**BUCKFIELD**  
2 Depot Street\*\*  
Buckfield, ME 04220  
207.336.2371

**HARRISON**  
46 Main Street  
Harrison, ME 04040  
207.583.2954

**LEWISTON**  
500 Canal Street\*\*  
Lewiston, ME 04240  
207.786.3245

**POLAND**  
1399 Maine Street\*  
Poland, ME 04274  
207.998.3475

**PORTLAND**  
27 Pearl Street\*\*  
Portland, ME 04101  
207.774.1426

**SOUTH PARIS**  
235 Main Street\*  
South Paris, ME 04281  
207.743.8168

\* Drive-up ATM

\*\* Walk-up ATM

