NORTHEAST BANCORP /ME/
Form 10-Q
February 08, 2019

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

**FORM 10-Q**

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

**For the quarterly period ended December 31, 2018**

**Commission File Number: 1-14588**

**Northeast Bancorp**

**(Exact name of registrant as specified in its charter)**

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

**(207) 786-3245**

**Registrant's telephone number, including area code**

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No ___

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

| | |
|---|---|
| Large accelerated filer | Accelerated filer |
| Non-accelerated filer | Smaller reporting company |
| Emerging growth company | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of February 1, 2019, the registrant had outstanding 8,227,945 shares of voting common stock, $1.00 par value per share and 811,946 shares of non-voting common stock, $1.00 par value per share.

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PART 1- FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

**NORTHEAST BANCORP AND SUBSIDIARY**
**CONSOLIDATED BALANCE SHEETS**
(Unaudited)
(In thousands, except share and per share data)

| | December 31, 2018 | June 30, 2018 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $*2,416* | $*3,889* |
| Short-term investments | *135,200* | *153,513* |
| Total cash and cash equivalents | *137,616* | *157,402* |
| | | |
| Available-for-sale debt securities, at fair value | *78,132* | *81,068* |
| Equity securities, at fair value | *6,711* | *6,619* |
| Total investment securities | *84,843* | *87,687* |
| | | |
| Residential real estate loans held for sale | *1,510* | *3,405* |
| SBA loans held for sale | *289* | *3,750* |
| Total loans held for sale | *1,799* | *7,155* |
| | | |
| Loans: | | |
| Commercial real estate | *633,439* | *579,450* |
| Commercial and industrial | *209,493* | *188,852* |
| Residential real estate | *92,566* | *100,256* |
| Consumer | *2,788* | *3,244* |
| Total loans | *938,286* | *871,802* |
| Less: Allowance for loan losses | *5,308* | *4,807* |
| Loans, net | *932,978* | *866,995* |
| | | |
| Premises and equipment, net | *6,112* | *6,591* |
| Real estate owned and other repossessed collateral, net | *1,463* | *2,233* |
| Federal Home Loan Bank stock, at cost | *1,652* | *1,652* |
| Intangible assets, net | *649* | *867* |
| Servicing rights, net | *2,934* | *2,970* |
| Bank-owned life insurance | *16,839* | *16,620* |
| Other assets | *7,242* | *7,564* |
| Total assets | $*1,194,127* | $*1,157,736* |

| | | |
|---|---|---|
| Liabilities and Shareholders' Equity | | |
| Deposits: | | |
| Demand | $*68,324* | $*72,272* |
| Savings and interest checking | *107,769* | *109,637* |
| Money market | *345,149* | *420,886* |
| Time | *464,349* | *352,145* |
| Total deposits | *985,591* | *954,940* |
| | | |
| Federal Home Loan Bank advances | *15,000* | *15,000* |
| Subordinated debt | *24,128* | *23,958* |
| Capital lease obligation | *466* | *605* |
| Other liabilities | *20,451* | *24,803* |
| Total liabilities | *1,045,636* | *1,019,306* |
| | | |
| Commitments and contingencies | - | - |
| | | |
| Shareholders' equity: | | |
| Preferred stock, $1.00 par value, 1,000,000 shares authorized; no shares issued and outstanding at December 31, 2018 and June 30, 2018 | - | - |
| Voting common stock, $1.00 par value, 25,000,000 shares authorized; 8,236,917 and 8,056,527 shares issued and outstanding at December 31, 2018 and June 30, 2018, respectively | *8,237* | *8,057* |
| Non-voting common stock, $1.00 par value, 3,000,000 shares authorized; 811,946 and 882,314 shares issued and outstanding at December 31, 2018 and June 30, 2018, respectively | *812* | *882* |
| Additional paid-in capital | *77,455* | *77,016* |
| Retained earnings | *63,535* | *54,236* |
| Accumulated other comprehensive loss | *(1,548* ) | *(1,761* ) |
| Total shareholders' equity | *148,491* | *138,430* |
| Total liabilities and shareholders' equity | $*1,194,127* | $*1,157,736* |

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

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

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Interest and dividend income: | | | | |
| Interest and fees on loans | $18,934 | $14,501 | $36,460 | $29,883 |
| Interest on available-for-sale securities | 425 | 267 | 784 | 533 |
| Other interest and dividend income | 970 | 492 | 1,851 | 1,022 |
| Total interest and dividend income | 20,329 | 15,260 | 39,095 | 31,438 |
| | | | | |
| Interest expense: | | | | |
| Deposits | 3,982 | 2,129 | 7,664 | 4,305 |
| Federal Home Loan Bank advances | 125 | 148 | 242 | 319 |
| Subordinated debt | 573 | 517 | 1,174 | 1,025 |
| Obligation under capital lease agreements | 6 | 9 | 14 | 21 |
| Total interest expense | 4,686 | 2,803 | 9,094 | 5,670 |
| Net interest and dividend income before provision for loan losses | 15,643 | 12,457 | 30,001 | 25,768 |
| Provision for loan losses | 101 | 437 | 633 | 792 |
| Net interest and dividend income after provision for loan losses | 15,542 | 12,020 | 29,368 | 24,976 |
| | | | | |
| Noninterest income: | | | | |
| Fees for other services to customers | 340 | 475 | 832 | 1,002 |
| Gain on sales of SBA loans | 942 | 341 | 1,793 | 1,361 |
| Gain on sales of residential loans held for sale | 104 | 255 | 279 | 545 |
| Gain on sales of other loans | - | 21 | - | 21 |
| Net unrealized gain on equity securities | 50 | - | 10 | - |
| Gain (loss) on real estate owned, other repossessed collateral and premises and equipment, net | (24) | 11 | (64) | 11 |
| Bank-owned life insurance income | 110 | 111 | 219 | 223 |
| Other noninterest income | 23 | 14 | 29 | 23 |
| Total noninterest income | 1,545 | 1,228 | 3,098 | 3,186 |
| | | | | |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 5,699 | 5,173 | 11,208 | 10,427 |
| Occupancy and equipment expense | 957 | 1,150 | 2,084 | 2,260 |

| | | | | |
|---|---|---|---|---|
| Professional fees | *656* | *425* | *1,190* | *867* |
| Data processing fees | *830* | *624* | *1,431* | *1,227* |
| Marketing expense | *130* | *70* | *253* | *157* |
| Loan acquisition and collection expense | *585* | *368* | *1,024* | *733* |
| FDIC insurance premiums | *81* | *80* | *162* | *160* |
| Intangible asset amortization | *109* | *109* | *218* | *218* |
| Other noninterest expense | *856* | *564* | *1,687* | *1,228* |
| Total noninterest expense | *9,903* | *8,563* | *19,257* | *17,277* |
| Income before income tax expense | *7,184* | *4,685* | *13,209* | *10,885* |
| Income tax expense | *2,059* | *1,381* | *3,550* | *2,995* |
| Net income | $*5,125* | $*3,304* | $*9,659* | $*7,890* |
| | | | | |
| Weighted-average shares outstanding: | | | | |
| Basic | *9,048,397* | *8,924,495* | *9,022,161* | *8,883,003* |
| Diluted | *9,201,557* | *9,168,084* | *9,192,643* | *9,129,010* |
| | | | | |
| Earnings per common share: | | | | |
| Basic | $*0.57* | $*0.37* | $*1.07* | $*0.89* |
| Diluted | *0.56* | *0.36* | *1.05* | *0.86* |
| | | | | |
| Cash dividends declared per common share | $*0.01* | $*0.01* | $*0.02* | $*0.02* |

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

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**NORTHEAST BANCORP AND SUBSIDIARY CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**
(Unaudited)
(In thousands)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Net income | $5,125 | $3,304 | $9,659 | $7,890 |
| Other comprehensive income, before tax: | | | | |
| Available-for-sale securities: | | | | |
| Change in net unrealized gain (loss) on available-for-sale securities | 633 | (297) | 560 | (175) |
| Derivatives and hedging activities: | | | | |
| Change in accumulated (loss) gain on effective cash flow hedges | (1,104) | 160 | (623) | 181 |
| Reclassification adjustments included in interest expense | 38 | 26 | 107 | 49 |
| Total derivatives and hedging activities | (1,066) | 186 | (516) | 230 |
| Total other comprehensive (loss) income, before tax | (433) | (111) | 44 | 55 |
| Income tax (benefit) expense related to other comprehensive (loss) income | (117) | (43) | 11 | 19 |
| Other comprehensive (loss) income, net of tax | (316) | (68) | 33 | 36 |
| Comprehensive income | $4,809 | $3,236 | $9,692 | $7,926 |

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

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

| | Preferred Stock | | Voting Common Stock | | Non-voting Common Stock | | Additional | Retained | Accumulated Other Comprehensive | Total Shareholders' |
|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Shares | Amount | Paid-in Capital | Earnings | Loss | Equity |
| Balance at June 30, 2017 | - | - | 7,840,460 | $ 7,841 | 991,194 | $ 991 | $ 77,455 | $ 38,142 | $ (1,632) | $ 122,797 |
| Net income | - | - | - | - | - | - | - | 7,890 | - | 7,890 |
| Other comprehensive income, net of tax | - | - | - | - | - | - | - | - | 36 | 36 |
| Conversions between voting common stock and non- voting common stock, net | - | - | 69,255 | 69 | (69,255) | (69) | - | - | - | - |
| Dividends on common stock at $0.02 per share | - | - | - | - | - | - | - | (177) | - | (177) |
| Stock-based compensation | - | - | - | - | - | - | 485 | - | - | 485 |
| Issuance of restricted common stock | - | - | 12,000 | 12 | - | - | (12) | - | - | - |
| Cancellation and forfeiture of restricted common stock | - | - | (15,756) | (16) | - | - | (39) | - | - | (55) |
| Stock options exercised, net | - | - | 111,375 | 111 | - | - | (1,084) | - | - | (973) |
| | - | $ - | 8,017,334 | $ 8,017 | 921,939 | $ 922 | $ 76,805 | $ 45,855 | $ (1,596) | $ 130,003 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Balance at December 31, 2017 | | | | | | | | | | |
| Balance at June 30, 2018 | - | - | *8,056,527* | $ *8,057* | *882,314* | $ *882* | $ *77,016* | $ *54,236* | $ *(1,761* ) | $ *138,430* |
| Net income | - | - | - | - | - | - | - | *9,659* | - | *9,659* |
| Other comprehensive income, net of tax | - | - | - | - | - | - | - | - | *33* | *33* |
| Conversions between voting common stock and non- voting common stock, net | - | - | *70,368* | *70* | *(70,368* ) | *(70* ) | - | - | - | - |
| Dividends on common stock at $0.02 per share | - | - | - | - | - | - | - | *(180* ) | - | *(180* ) |
| Stock-based compensation | - | - | - | - | - | - | *687* | - | - | *687* |
| Issuance of restricted common stock | - | - | *116,925* | *117* | - | - | *(117* ) | - | - | - |
| Cancellation and forfeiture of restricted common stock | - | - | *(7,877* ) | *(8* ) | - | - | *(126* ) | - | - | *(134* ) |
| Stock options exercised, net | - | - | *974* | *1* | - | - | *(5* ) | - | - | *(4* ) |
| Adjustment for adoption of ASU 2016-01 | - | - | - | - | - | - | - | *(180* ) | *180* | - |
| Balance at December 31, 2018 | - | $ - | *8,236,917* | $ *8,237* | *811,946* | $ *812* | $ *77,455* | $ *63,535* | $ *(1,548* ) | $ *148,491* |

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

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**NORTHEAST BANCORP AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)
(In thousands)

| | Six Months Ended December 31, 2018 | 2017 |
|---|---|---|
| Operating activities: | | |
| Net income | $9,659 | $7,890 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 633 | 792 |
| Loss (gain) on sale and impairment of real estate owned and other repossessed collateral, net | 64 | (11) |
| Net unrealized gain on equity securities | (10) | - |
| Accretion of fair value adjustments on loans, net | (3,700) | (4,830) |
| Amortization of fair value adjustments on borrowings, net | 115 | 104 |
| Amortization of subordinated debt issuance costs | 55 | 55 |
| Originations of loans held for sale | (44,203) | (49,309) |
| Net proceeds from sales of loans held for sale | 48,201 | 50,946 |
| Gain on sales of residential loans held for sale | (279) | (545) |
| Gain on sales of SBA and other loans held for sale | (1,793) | (1,382) |
| Net decrease (increase) in servicing rights | 36 | (159) |
| Amortization of intangible assets | 218 | 218 |
| Bank-owned life insurance income, net | (219) | (223) |
| Depreciation of premises and equipment | 662 | 636 |
| Stock-based compensation | 687 | 485 |
| Deferred income tax expense | - | 498 |
| Amortization of available-for-sale debt securities, net | 197 | 450 |
| Changes in other assets and liabilities: | | |
| Other assets | 391 | (1,376) |
| Other liabilities | (4,948) | (3,231) |
| Net cash provided by operating activities | 5,766 | 1,008 |
| Investing activities: | | |
| Purchases of available-for-sale debt securities | (21,986) | (9,222) |
| Proceeds from maturities and principal payments on investment securities, net | 25,203 | 12,951 |
| Loan purchases | (84,137) | (38,453) |
| Loan originations, principal collections, and purchased loan paydowns, net | 24,601 | 45,540 |
| Purchases and disposals of premises and equipment, net | (183) | (795) |
| Redemption of Federal Home Loan Bank stock | - | 180 |
| Proceeds from sales of real estate owned and other repossessed collateral | 756 | 1,264 |
| Net cash (used in) provided by investing activities | (55,746) | 11,465 |
| Financing activities: | | |
| Net increase (decrease) in deposits | 30,651 | (41,196) |
| Dividends paid on common stock | (180) | (177) |
| Repayment of Federal Home Loan Bank advances | - | (5,000) |

| | | |
|---|---|---|
| Repayment of capital lease obligation | *(139* ) | *(132* ) |
| Repurchases for tax withholdings on restricted common stock | *(134* ) | *(55* ) |
| Stock options exercised, net | *(4* ) | *(973* ) |
| Net cash provided by (used in) financing activities | *30,194* | *(47,533* ) |
| Net decrease in cash and cash equivalents | *(19,786* ) | *(35,060* ) |
| Cash and cash equivalents, beginning of period | *157,402* | *163,283* |
| Cash and cash equivalents, end of period | $*137,616* | $*128,223* |
| Supplemental schedule of noncash investing activities: | | |
| Transfers from loans to real estate owned and other repossessed collateral, net | $*50* | $*1,302* |

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

**NORTHEAST BANCORP AND SUBSIDIARY**

**Notes to Unaudited Consolidated Financial Statements**

**December 31, 2018**

## *1.* Basis of Presentation

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

These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to Form *10*-Q and Article *10* of Regulation S-*X.* Accordingly, they do *not* include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting principally of normal recurring accruals) considered necessary for a fair presentation of the Company's financial position, results of operations, and cash flows for the interim periods presented. These accompanying unaudited financial statements and notes should be read in conjunction with the audited consolidated financial statements and notes thereto for the fiscal year ended *June 30, 2018 (*“Fiscal *2018”*) included in the Company's Annual Report on Form *10*-K filed with the Securities and Exchange Commission (the “SEC”).

## *2.* Recent Accounting Pronouncements

In *May 2014,* the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“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 *2015-14”*) was issued in *August 2015* which deferred adoption to annual reporting periods beginning after *December 15, 2017,* which was adopted during the *three* months ended *September 30, 2018.* The timing of the Company’s revenue recognition did *not* change. The Company’s largest portions of revenue, interest and fees on loans, interest and dividend income on securities and short-term investments, bank-owned life insurance income, and gain on sales of loans, are specifically excluded from the scope of the guidance. Additionally, fees for other services to customers includes loan servicing fee income which is accounted for under ASC Topic *860, Transfers and Servicing*, ("Topic *860"*), and is *not* subject to Topic *606.* The other component of fees for other services to customers is deposit fees. The majority of the Company's deposit fees are specifically related to a customer accessing its funds, in which case the revenue is currently recognized in a consistent manner with Topic *606.* Revenue that is *not* specifically related to a customer accessing its funds (i.e. account maintenance fees), can be waived; however, the amount of waived fees is *not* considered material, and thus the revenue is consistently recognized with Topic *606.* All other revenue is also recognized in a manner consistent with Topic *606.* Because of the above, management believes that revenue recognized under the new guidance approximates revenue recognized under current GAAP.

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 GAAP. The Company adopted this guidance during the *three* months ended *September 30, 2018.* This adoption resulted in a reclassification of *$180* thousand from accumulated other comprehensive loss to retained earnings in the consolidated financial statements, with *no* net effect on shareholders' equity. In addition, the disclosure of the fair value of "Loans, net" in "Notes to Unaudited Consolidated Financial Statements – Note *10:* Fair Value Measurements" is now calculated based on an exit pricing strategy versus an entry pricing strategy.

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* to determine the potential impact it will have on its consolidated financial statements. The Company's assets and liabilities will increase based on the present value of the remaining lease payments for leases in place at the adoption date; however, this is *not* expected to be material to the Company's results of operations.

In *June 2016,* the FASB issued ASU *2016-13, Financial Instruments – Credit Losses (Topic 326)* (“ASU *2016-13”*). This guidance 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 guidance replace the incurred loss impairment methodology in current 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 evaluating the provisions of the guidance, and will closely monitor developments and additional guidance to determine the potential impact on the Company’s consolidated financial statements. Management is in the process of identifying the methodologies and the additional data requirements necessary to implement the guidance and has engaged an existing *third*-party service provider to assist in implementation.

In *May 2017,* the FASB issued ASU *2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting* (“ASU *2017-09”*) which amends the scope of modification accounting for share-based payment arrangements. This update provides guidance on the types of changes to the terms or conditions of share-based payment awards to which an entity would be required to apply modification accounting. Specifically, an entity would *not* apply modification accounting if the fair value, vesting conditions, and classification of the awards are the same immediately before and after the modification. This update was adopted during the *three* months ended *September 30, 2018* and did *not* have an impact on the Company’s consolidated financial statements.

In *August 2017,* the FASB issued ASU *2017-12, Derivatives and Hedging (Topic 815)* (“ASU *2017-12”*). This guidance permits hedge accounting for risk components in hedging relationships involving nonfinancial risk and interest rate risk, and improves the financial reporting of hedging relationships to better portray the economic results of an entity’s risk management activities in its financial statements. The amendments in this guidance are effective for public business entities for fiscal years beginning after *December 15, 2018,* and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The adoption of this guidance is *not* expected to have a significant impact on the Company’s consolidated financial statements.

In *July 2018,* the FASB issued ASU *2018-10, Codification Improvements to Topic 842, Leases* (“ASU *2018-10”*) and ASU *2018-11, Leases (Topic 842)* (“ASU *2018-11”*). The guidance provides clarification on the application of ASU *2016-02,* specifically on certain narrow aspects of the guidance issued under ASU *2016-02,* including comparative reporting requirements for initial adoption and, for lessors only, separating lease and non-lease components in a contract and allocating the consideration in the contract to the separate components. For entities that have *not* adopted ASU *2016-02* before the issuance of these updates, the amendments in this guidance are the same as the effective date and transition requirements in ASU *2016-02.* The adoption of this guidance is *not* expected to have a significant impact on the Company’s consolidated financial statements.

In *August 2018,* the FASB issued ASU *2018-13, Fair Value Measurements (Topic 820)* (“ASU *2018-13”*). This update modifies disclosure requirements on fair value measurements in Topic *820,* Fair Value Measurement. This includes removing requirements related to transfers between Level *1* and Level *2,* the policy of timing of transfers between levels, and the valuation process for Level *3* fair value measurements, modifying disclosure requirements related to investments in certain entities that calculate net asset value, and adding disclosure requirements for changes in unrealized gains and losses for recurring Level *3* fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level *3* fair value measurements. The amendments in this guidance are effective for public business entities for fiscal years beginning after *December 15, 2019,* and interim periods within those fiscal years. Early adoption is permitted. The adoption of this guidance is *not* expected to have a significant impact on the Company’s consolidated financial statements.

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## *3.* **Investment Securities**

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

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (Dollars in thousands) | | | |
| U.S. Government agency securities | $*57,056* | $ *79* | $ *(110* ) | $*57,025* |
| Agency mortgage-backed securities | *21,853* | - | *(746* ) | *21,107* |
| Equity investments measured at net asset value | *6,947* | - | *(236* ) | *6,711* |
| Total investment securities | $*85,856* | $ *79* | $ *(1,092* ) | $*84,843* |

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (Dollars in thousands) | | | |
| U.S. Government agency securities | $*57,129* | $ - | $ *(242* ) | $*56,887* |
| Agency mortgage-backed securities | *25,276* | - | *(1,095* ) | *24,181* |
| Equity investments measured at net asset value | *6,866* | - | *(247* ) | *6,619* |
| Total investment securities | $*89,271* | $ - | $ *(1,584* ) | $*87,687* |

At *December 31, 2018* and *June 30, 2018,* the Company held *no* securities of any single issuer (excluding the U. S. Government and government 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 the *three* and *six* months ended *December 31, 2018* or *2017.* At *December 31, 2018, no* investment securities were pledged as collateral to secure outstanding borrowings.

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

| | December 31, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | 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 | $ *10,914* | $ *(20* ) | $ *18,009* | $ *(90* ) | $ *28,923* | $ *(110* ) |
| Agency mortgage-backed securities | - | - | *21,107* | *(746* ) | *21,107* | *(746* ) |
| Equity investments measured at net asset value | - | - | *5,147* | *(236* ) | *5,147* | *(236* ) |
| Total investment securities | $ *10,914* | $ *(20* ) | $ *44,263* | $ *(1,072* ) | $ *55,177* | $ *(1,092* ) |

| | June 30, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | 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 | $ *25,988* | $ *(126* ) | $ *30,899* | $ *(116* ) | $ *56,887* | $ *(242* ) |
| Agency mortgage-backed securities | *1,265* | *(27* ) | *22,916* | *(1,068* ) | *24,181* | *(1,095* ) |
| Equity investments measured at net asset value | - | - | *5,076* | *(247* ) | *5,076* | *(247* ) |
| Total investment securities | $ *27,253* | $ *(153* ) | $ *58,891* | $ *(1,431* ) | $ *86,144* | $ *(1,584* ) |

There were *no* other-than-temporary impairment losses on securities during the *three* and *six* months ended *December 31, 2018* or *2017.*

At *December 31, 2018,* the Company had *33* securities in an unrealized loss position. At *December 31, 2018,* 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 investment securities at *December 31, 2018* 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 *December 31, 2018,* 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 investment securities are other-than-temporarily impaired at *December 31, 2018.*

The investments measured at net asset value include a fund that seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies, as well as a fund that primarily invests in the federally guaranteed portion of SBA *7*(a) loans that adjust quarterly or monthly and are indexed to the Prime Rate. The underlying composition of these funds is primarily government agencies, other investment-grade investments, or the guaranteed portion of SBA *7*(a) loans, as applicable. As of *December 31, 2018,* the effective duration of the fund that seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies is *4.66* years.

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ASU *2016-01, Recognition and Measurements of Financial Assets and Financial Liabilities*, was adopted on *July 1, 2018,* and a cumulative effect adjustment of *$180* thousand was recorded to reclassify the amount of accumulated unrealized losses, net, related to equity securities from accumulated other comprehensive loss to retained earnings. For the *three* and *six* months ended *December 31, 2018,* there were *$50* thousand and *$10* thousand of increases in net unrealized gains on equity securities recognized in the consolidated statements of income, respectively.

The amortized cost and fair values of available-for-sale debt securities by contractual maturity are shown below as of *December 31, 2018.* Actual maturities *may* differ from contractual maturities because borrowers *may* have the right to prepay obligations with or without prepayment penalties.

| | Amortized Cost | Fair Value |
|---|---|---|
| | (Dollars in thousands) | |
| Due within one year | $*20,094* | $*20,003* |
| Due after one year through five years | *36,962* | *37,022* |
| Due after five years through ten years | - | - |
| Due after ten years | - | - |
| Total U.S. Government agency securities | *57,056* | *57,025* |
| Agency mortgage-backed securities | *21,853* | *21,107* |
| Total available-for-sale debt securities | $*78,909* | $*78,132* |

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

Loans are carried at the principal amounts outstanding, or amortized acquired fair value in the case of acquired loans, adjusted by partial charge-offs and net of deferred loan costs or fees. Loan fees and certain direct origination costs are deferred and amortized into interest income over the expected term of the loan using the level-yield method. When a loan is paid off in full, 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 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 and interest 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.

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

| | December 31, 2018 | | |
|---|---|---|---|
| | Originated | Purchased | Total |
| | (Dollars in thousands) | | |
| Commercial real estate | $*259,451* | $*313,261* | $*572,712* |
| Commercial and industrial | *202,150* | *788* | *202,938* |
| Residential real estate | *75,972* | *16,594* | *92,566* |
| Consumer | *2,788* | - | *2,788* |
| SBA | *67,282* | - | *67,282* |
| Total loans | $*607,643* | $*330,643* | $*938,286* |

| | June 30, 2018 | | |
|---|---|---|---|
| | Originated | Purchased | Total |
| | (Dollars in thousands) | | |
| Commercial real estate | $*249,428* | $*276,051* | $*525,479* |
| Commercial and industrial | *181,800* | *995* | *182,795* |
| Residential real estate | *86,202* | *13,926* | *100,128* |
| Consumer | *3,244* | - | *3,244* |
| SBA | *60,156* | - | *60,156* |
| Total loans | $*580,830* | $*290,972* | $*871,802* |

Total loans include deferred loan origination costs, net, of *$190* thousand and *$223* thousand as of *December 31, 2018* and *June 30, 2018,* respectively.

*Past Due and Nonaccrual Loans*

The following is a summary of past due and nonaccrual loans:

| December 31, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|
| Past Due 30-59 | Past Due 60-89 | Past Due 90 Days or More-Still | Past Due 90 Days or More- | Total Past | Total | Total | Nonaccrual |

| | Days | Days | Accruing | Nonaccrual | Due | Current | Loans | Loans |
|---|---|---|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | | | | |
| Originated portfolio: | | | | | | | | |
| Residential real estate | $1,141 | $247 | $ - | $ 1,640 | $3,028 | $72,944 | $75,972 | $ 2,595 |
| Commercial real estate | 238 | 309 | - | 2,237 | 2,784 | 256,667 | 259,451 | 2,351 |
| Commercial and industrial | - | - | - | 40 | 40 | 202,110 | 202,150 | 40 |
| Consumer | 62 | 67 | - | 121 | 250 | 2,538 | 2,788 | 216 |
| SBA | 1,325 | 62 | - | 1,273 | 2,660 | 64,622 | 67,282 | 1,793 |
| Total originated portfolio | 2,766 | 685 | - | 5,311 | 8,762 | 598,881 | 607,643 | 6,995 |
| Purchased portfolio: | | | | | | | | |
| Residential real estate | - | - | - | 202 | 202 | 16,392 | 16,594 | 202 |
| Commercial real estate | 5,363 | 1,205 | - | 2,612 | 9,180 | 304,081 | 313,261 | 4,755 |
| Commercial and industrial | - | - | - | 139 | 139 | 649 | 788 | 394 |
| Total purchased portfolio | 5,363 | 1,205 | - | 2,953 | 9,521 | 321,122 | 330,643 | 5,351 |
| Total loans | $8,129 | $1,890 | $ - | $ 8,264 | $18,283 | $920,003 | $938,286 | $ 12,346 |

| | June 30, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Past Due 30-59 Days | Past Due 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 | Nonaccrual Loans |
| | (Dollars in thousands) | | | | | | | |
| Originated portfolio: | | | | | | | | |
| Residential real estate | $493 | $ 181 | $ - | $ 1,355 | $2,029 | $84,173 | $86,202 | $ 3,212 |
| Commercial real estate | 27 | 210 | - | 98 | 335 | 249,093 | 249,428 | 1,428 |
| Commercial and industrial | - | - | - | 32 | 32 | 181,768 | 181,800 | 34 |
| Consumer | 77 | 82 | - | 19 | 178 | 3,066 | 3,244 | 134 |
| SBA | - | - | - | 831 | 831 | 59,325 | 60,156 | 1,405 |
| Total originated portfolio | 597 | 473 | - | 2,335 | 3,405 | 577,425 | 580,830 | 6,213 |
| Purchased portfolio: | | | | | | | | |
| Residential real estate | - | - | - | 202 | 202 | 13,724 | 13,926 | 202 |
| Commercial real estate | 659 | 274 | - | 3,086 | 4,019 | 272,032 | 276,051 | 5,180 |
| Commercial and industrial | 17 | - | - | 91 | 108 | 887 | 995 | 363 |
| Total purchased portfolio | 676 | 274 | - | 3,379 | 4,329 | 286,643 | 290,972 | 5,745 |
| Total loans | $1,273 | $ 747 | $ - | $ 5,714 | $7,734 | $864,068 | $871,802 | $ 11,958 |

*Allowance for Loan Losses and Impaired Loans*

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. For residential and consumer loans, a charge-off is recorded *no* later than the point at which a loan is *180* days past due if the loan balance exceeds the fair value of the collateral, less estimated 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: residential real estate, commercial real estate, commercial and industrial, consumer, purchased loans, and SBA 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 and operating statements, 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. This segment also includes loans to non-bank lenders, which are generally secured by a collateral assignment of the notes and mortgages on loans originated by the non-bank lenders. Weakness in national or regional economic conditions, and a corresponding weakness in consumer or business spending, will have an adverse effect on the credit quality of this segment.

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

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

SBA: Loans in this segment are comprised of both commercial real estate and commercial and industrial loans to small businesses, underwritten and originated by the Bank's national SBA group ("SBA Division"). Loans are underwritten and originated primarily in accordance with SBA *7*(a) guidelines, and are partially guaranteed by the SBA. Loans are primarily secured by income-producing properties and/or assets of the businesses or borrowers. Adverse developments 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.

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;

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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 the 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.

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

| | Three Months Ended December 31, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential Real Estate | Commercial Real Estate | Commercial and Industrial | Consumer | Purchased | SBA | Total |
| | (Dollars in thousands) | | | | | | |
| Beginning balance | $ *625* | $ *1,627* | $ *789* | $ *43* | $ *597* | $ *1,607* | $ *5,288* |
| Provision (credit) | *40* | *(76* ) | *83* | *(24* ) | *2* | *76* | *101* |
| Recoveries | *1* | - | *2* | *12* | - | - | *15* |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Charge-offs | (81) | - | - | (15) | - | - | (96) |
| Ending balance | $585 | $ 1,551 | $ 874 | $ 16 | $ 599 | $1,683 | $5,308 |

| Three Months Ended December 31, 2017 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential Real Estate | Commercial Real Estate | Commercial and Industrial | Consumer | Purchased | SBA | Total |
| | (Dollars in thousands) | | | | | | |
| Beginning balance | $508 | $ 1,248 | $ 596 | $ 41 | $ 310 | $1,331 | $4,034 |
| Provision (credit) | 176 | 64 | (40) | 19 | 210 | 8 | 437 |
| Recoveries | 1 | - | 5 | 25 | - | - | 31 |
| Charge-offs | (112) | - | - | (35) | - | - | (147) |
| Ending balance | $573 | $ 1,312 | $ 561 | $ 50 | $ 520 | $1,339 | $4,355 |

| Six Months Ended December 31, 2018 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential Real Estate | Commercial Real Estate | Commercial and Industrial | Consumer | Purchased | SBA | Total |
| | (Dollars in thousands) | | | | | | |
| Beginning balance | $605 | $ 1,527 | $ 620 | $ 39 | $ 587 | $1,429 | $4,807 |
| Provision | 139 | 17 | 246 | (35) | 12 | 254 | 633 |
| Recoveries | 3 | 7 | 10 | 30 | - | - | 50 |
| Charge-offs | (162) | - | (2) | (18) | - | - | (182) |
| Ending balance | $585 | $ 1,551 | $ 874 | $ 16 | $ 599 | $1,683 | $5,308 |

| Six Months Ended December 31, 2017 | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential Real Estate | Commercial Real Estate | Commercial and Industrial | Consumer | Purchased | SBA | Total |
| | (Dollars in thousands) | | | | | | |
| Beginning balance | $472 | $ 1,219 | $ 394 | $ 53 | $ 303 | $1,224 | $3,665 |
| Provision | 217 | 93 | 144 | 6 | 217 | 115 | 792 |
| Recoveries | 8 | - | 23 | 31 | - | - | 62 |
| Charge-offs | (124) | - | - | (40) | - | - | (164) |
| Ending balance | $573 | $ 1,312 | $ 561 | $ 50 | $ 520 | $1,339 | $4,355 |

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

| | December 31, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential Real Estate | Commercial Real Estate | Commercial and Industrial | Consumer | Purchased | SBA | Total |
| | (Dollars in thousands) | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Individually evaluated | $ *260* | $ *148* | $ *2* | $ *4* | $ - | $ *313* | $ *727* |
| Collectively evaluated | *325* | *1,403* | *872* | *12* | - | *1,370* | *3,982* |
| ASC 310-30 | - | - | - | - | *599* | - | *599* |
| Total | $ *585* | $ *1,551* | $ *874* | $ *16* | $ *599* | $ *1,683* | $ *5,308* |
| | | | | | | | |
| Loans: | | | | | | | |
| Individually evaluated | $ *4,856* | $ *3,434* | $ *40* | $ *270* | $ - | $ *3,642* | $ *12,242* |
| Collectively evaluated | *71,116* | *256,017* | *202,110* | *2,518* | - | *63,640* | *595,401* |
| ASC 310-30 | - | - | - | - | *330,643* | - | *330,643* |
| Total | $ *75,972* | $ *259,451* | $ *202,150* | $ *2,788* | $ *330,643* | $ *67,282* | $ *938,286* |

| | June 30, 2018 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Residential Real Estate | Commercial Real Estate | Commercial and Industrial | Consumer | Purchased | SBA | Total |
| | (Dollars in thousands) | | | | | | |
| Allowance for loan losses: | | | | | | | |
| Individually evaluated | $ *322* | $ *139* | $ *8* | $ *6* | $ - | $ *112* | $ *587* |
| Collectively evaluated | *283* | *1,388* | *612* | *33* | - | *1,317* | *3,633* |
| ASC 310-30 | - | - | - | - | *587* | - | *587* |
| Total | $ *605* | $ *1,527* | $ *620* | $ *39* | $ *587* | $ *1,429* | $ *4,807* |
| | | | | | | | |
| Loans: | | | | | | | |
| Individually evaluated | $ *5,682* | $ *2,687* | $ *33* | $ *292* | $ - | $ *3,170* | $ *11,864* |
| Collectively evaluated | *80,520* | *246,741* | *181,767* | *2,952* | - | *56,986* | *568,966* |
| ASC 310-30 | - | - | - | - | *290,972* | - | *290,972* |
| Total | $ *86,202* | $ *249,428* | $ *181,800* | $ *3,244* | $ *290,972* | $ *60,156* | $ *871,802* |

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

| | December 31, 2018 | June 30, 2018 |
|---|---|---|

| | 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 | $ 2,782 | $ 2,766 | $ - | $ 3,162 | $ 3,154 | $ - |
| Commercial real estate | 2,369 | 2,364 | - | 1,445 | 1,438 | - |
| Commercial and industrial | 12 | 12 | - | - | - | - |
| Consumer | 252 | 275 | - | 271 | 296 | - |
| SBA | 1,920 | 1,920 | - | 2,597 | 2,597 | - |
| Purchased: | | | | | | |
| Residential real estate | 202 | 217 | - | 202 | 217 | - |
| Commercial real estate | 6,456 | 8,782 | - | 6,601 | 9,330 | - |
| Commercial and industrial | 85 | 163 | - | 108 | 186 | - |
| Total | 14,078 | 16,499 | - | 14,386 | 17,218 | - |
| | | | | | | |
| Impaired loans with a valuation allowance: | | | | | | |
| Originated: | | | | | | |
| Residential real estate | 2,074 | 2,146 | 260 | 2,520 | 2,497 | 322 |
| Commercial real estate | 1,065 | 1,057 | 148 | 1,242 | 1,234 | 139 |
| Commercial and industrial | 28 | 28 | 2 | 33 | 33 | 8 |
| Consumer | 18 | 19 | 4 | 21 | 22 | 6 |
| SBA | 1,722 | 1,722 | 313 | 573 | 573 | 112 |
| Purchased: | | | | | | |
| Residential real estate | - | - | - | - | - | - |
| Commercial real estate | 3,587 | 3,856 | 240 | 4,748 | 5,362 | 280 |
| Commercial and industrial | 404 | 463 | 359 | 349 | 407 | 307 |
| Total | 8,898 | 9,291 | 1,326 | 9,486 | 10,128 | 1,174 |
| Total impaired loans | $ 22,976 | $ 25,790 | $ 1,326 | $ 23,872 | $ 27,346 | $ 1,174 |

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

| | Three Months Ended December 31, | | | |
|---|---|---|---|---|
| | 2018 | | 2017 | |
| | 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 | $2,907 | $ 12 | $3,992 | $ 38 |
| Commercial real estate | 1,816 | (3 ) | 2,454 | 1 |
| Commercial and industrial | 15 | - | - | - |
| Consumer | 266 | 1 | 285 | 7 |
| SBA | 1,878 | 49 | 1,794 | 2 |
| Purchased: | | | | |
| Residential real estate | 202 | - | 566 | - |
| Commercial real estate | 6,419 | 68 | 9,814 | 102 |
| Commercial and industrial | 90 | - | 26 | - |
| Total | 13,593 | 127 | 18,931 | 150 |
| Impaired loans with a valuation allowance: | | | | |
| Originated: | | | | |
| Residential real estate | 2,090 | 31 | 1,904 | 42 |
| Commercial real estate | 1,171 | 19 | 1,388 | 27 |
| Commercial and industrial | 29 | - | 44 | 2 |
| Consumer | 40 | - | 32 | 1 |
| SBA | 1,736 | 1 | 806 | - |
| Purchased: | | | | |
| Residential real estate | - | - | 83 | 1 |
| Commercial real estate | 3,994 | 24 | 4,108 | 38 |
| Commercial and industrial | 381 | 1 | 228 | 3 |
| Total | 9,441 | 76 | 8,593 | 114 |
| Total impaired loans | $23,034 | $ 203 | $27,524 | $ 264 |

| | Six Months Ended December 31, | | | |
|---|---|---|---|---|
| | 2018 | | 2017 | |
| | 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 | $2,992 | $ 31 | $4,012 | $ 74 |
| Commercial real estate | 1,692 | - | 1,756 | 94 |
| Commercial and industrial | 10 | - | - | - |
| Consumer | 267 | 3 | 273 | 13 |
| SBA | 2,118 | 89 | 1,819 | 39 |
| Purchased: | | | | |
| Residential real estate | 202 | - | 729 | - |
| Commercial real estate | 6,479 | 127 | 9,441 | 182 |
| Commercial and industrial | 96 | - | 28 | - |
| Total | 13,856 | 250 | 18,058 | 402 |
| | | | | |
| Impaired loans with a valuation allowance: | | | | |
| Originated: | | | | |
| Residential real estate | 2,233 | 54 | 1,811 | 63 |
| Commercial real estate | 1,195 | 41 | 1,392 | 49 |
| Commercial and industrial | 30 | - | 30 | 3 |
| Consumer | 33 | - | 36 | 2 |
| SBA | 1,348 | 7 | 811 | 3 |
| Purchased: | | | | |
| Residential real estate | - | - | 55 | 1 |
| Commercial real estate | 4,245 | 55 | 3,915 | 65 |
| Commercial and industrial | 370 | 1 | 183 | 3 |
| Total | 9,454 | 158 | 8,233 | 189 |
| Total impaired loans | $23,310 | $ 408 | $26,291 | $ 591 |

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*Credit Quality*

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

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

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

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

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

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

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

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

| | December 31, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Originated Portfolio | | | | | |
| | Commercial Real Estate | Commercial and Industrial | SBA | Residential[1] | Purchased Portfolio | Total |
| | (Dollars in thousands) | | | | | |
| Loans rated 1- 6 | $ *255,540* | $ *201,858* | $ *60,248* | $ *14,583* | $ *318,693* | $ *850,922* |
| Loans rated 7 | *1,521* | - | *5,100* | *93* | *6,467* | *13,181* |
| Loans rated 8 | *2,390* | *292* | *1,934* | *812* | *5,483* | *10,911* |
| Loans rated 9 | - | - | - | - | - | - |
| Loans rated 10 | - | - | - | - | - | - |
| Total | $ *259,451* | $ *202,150* | *67,282* | $ *15,488* | $ *330,643* | $ *875,014* |

| | June 30, 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Originated Portfolio | | | | | |
| | Commercial Real Estate | Commercial and Industrial | SBA | Residential[1] | Purchased Portfolio | Total |
| | (Dollars in thousands) | | | | | |
| Loans rated 1- 6 | $ *246,107* | $ *181,515* | $ *54,730* | $ *13,403* | $ *279,111* | $ *774,866* |
| Loans rated 7 | *1,821* | - | *3,882* | *100* | *5,899* | *11,702* |
| Loans rated 8 | *1,500* | *285* | *1,544* | *823* | *5,962* | *10,114* |
| Loans rated 9 | - | - | - | - | - | - |
| Loans rated 10 | - | - | - | - | - | - |
| Total | $ *249,428* | $ *181,800* | *60,156* | $ *14,326* | $ *290,972* | $ *796,682* |

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

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*Troubled Debt Restructurings*

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

| | Three Months Ended December 31, | | | | Six Months Ended December 31, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2018 | | 2017 | | 2018 | | 2017 | |
| | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| | (Dollars in thousands) | | | | | | | |
| Extended maturity | *2* | $ *20* | - | $ - | *2* | $ *20* | *1* | $ *18* |
| Adjusted interest rate | - | - | *1* | *15* | - | - | *1* | *15* |
| Rate and maturity | *1* | - | *3* | *2,263* | *4* | *170* | *3* | *2,263* |
| Principal deferment | - | - | *2* | *283* | - | - | *3* | *938* |
| | *3* | $ *20* | *6* | $ *2,561* | *6* | $ *190* | *8* | $ *3,234* |

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

| | Three Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | 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 | - | $ - | $ - | *2* | $ *29* | $ *30* |
| Commercial real estate | - | - | - | *2* | *2,079* | *2,140* |
| Commercial and industrial | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - |
| Total originated portfolio | - | - | - | *4* | *2,108* | *2,170* |
| Purchased portfolio: | | | | | | |
| Residential real estate | - | - | - | - | - | - |
| Commercial real estate | - | - | - | *1* | *123* | *123* |
| Commercial and industrial | *3* | *20* | *20* | *1* | *268* | *268* |
| Total purchased portfolio | *3* | *20* | *20* | *2* | *391* | *391* |
| Total | *3* | $ *20* | $ *20* | *6* | $ *2,499* | $ *2,561* |

| | Six Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | 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 | *3* | $ *170* | $ *170* | *3* | $ *47* | $ *48* |
| Commercial real estate | - | - | - | *2* | *2,079* | *2,140* |
| Commercial and industrial | - | - | - | *1* | *655* | *655* |
| Consumer | - | - | - | - | - | - |
| Total originated portfolio | *3* | *170* | *170* | *6* | *2,781* | *2,843* |
| Purchased portfolio: | | | | | | |
| Residential real estate | - | - | - | - | - | - |
| Commercial real estate | - | - | - | *1* | *123* | *123* |
| Commercial and industrial | *3* | *20* | *20* | *1* | *268* | *268* |
| Total purchased portfolio | *3* | *20* | *20* | *2* | *391* | *391* |
| Total | *6* | $ *190* | $ *190* | *8* | $ *3,172* | $ *3,234* |

The Company considers TDRs past due *90* days or more to be in payment default. Two loans modified in a TDR in the last *twelve* months totaling *$1.5* million defaulted during both the *three* and *six* months ended *December 31, 2018.* As of *December 31, 2018,* there were *no* further commitments to lend to borrowers associated with loans modified in a TDR.

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*ASC 310-30 Loans*

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

| | Three Months Ended December 31, 2018 | Three Months Ended December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Contractually required payments receivable | $*60,028* | $*49,408* |
| Nonaccretable difference | *(875* ) | *(1,667* ) |
| Cash flows expected to be collected | *59,153* | *47,741* |
| Accretable yield | *(9,819* ) | *(12,939* ) |
| Fair value of loans acquired | $*49,334* | $*34,802* |

| | Six Months Ended December 31, 2018 | Six Months Ended December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Contractually required payments receivable | $*121,568* | $*55,320* |
| Nonaccretable difference | *(1,049* ) | *(1,824* ) |
| Cash flows expected to be collected | *120,519* | *53,496* |
| Accretable yield | *(36,382* ) | *(15,043* ) |
| Fair value of loans acquired | $*84,137* | $*38,453* |

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

| | As of and for the Three Months Ended December 31, 2018 | As of and for the Six Months Ended December 31, 2018 |
|---|---|---|
| | (Dollars in thousands) | |
| Loans acquired during the period | $ - | $ - |
| Loans at end of period | *4,908* | *4,908* |

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

| | Three Months Ended December 31, 2018 | Three Months Ended December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Beginning balance | $ *152,794* | $ *122,923* |
| Acquisitions | *9,819* | *12,939* |
| Accretion | *(5,648* ) | *(4,244* ) |
| Reclassifications from non-accretable difference to accretable yield | *410* | *1,095* |
| Disposals and other changes | *(4,540* ) | *(7,810* ) |
| Ending balance | $ *152,835* | $ *124,903* |

| | Six Months Ended December 31, 2018 | Six Months Ended December 31, 2017 |
|---|---|---|
| | (Dollars in thousands) | |
| Beginning balance | $ *138,178* | $ *131,197* |
| Acquisitions | *36,382* | *15,043* |
| Accretion | *(11,181* ) | *(8,669* ) |
| Reclassifications from non-accretable difference to accretable yield | *988* | *4,523* |
| Disposals and other changes | *(11,532* ) | *(17,191* ) |
| Ending balance | $ *152,835* | $ *124,903* |

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

| | December 31, 2018 | June 30, 2018 |
|---|---|---|
| | (Dollars in thousands) | |
| Unpaid principal balance | $*361,741* | $*318,876* |
| Carrying amount | *324,890* | *284,317* |

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

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

Capitalized servicing rights as of *December 31, 2018* and *June 30, 2018* totaled *$2.9* million and *$3.0* million, respectively, and are classified as servicing rights, net, on the consolidated balance sheets.

Mortgage loans sold during the *three* months ended *December 31, 2018* totaled *$7.7* million, compared to *$17.6* million during the *three* months ended *December 31, 2017.* Mortgage loans sold during the *six* months ended *December 31, 2018* totaled *$20.9* million, compared to *$36.7* million during the *six* months ended *December 31, 2017.* Mortgage loans serviced for others totaled *$7.7* million at *December 31, 2018* and *$8.7* million at *June 30, 2018.* Additionally, the Company was servicing commercial loans participated out to various other institutions amounting to *$23.7* million and *$32.2* million at *December 31, 2018* and *June 30, 2018,* respectively.

SBA loans sold during the *three* months ended *December 31, 2018* totaled *$12.8* million, compared to *$3.4* million during the *three* months ended *December 31, 2017.* SBA loans sold during the *six* months ended *December 31, 2018* totaled *$25.2* million, compared to *$12.5* million during the *six* months ended *December 31, 2017.* SBA loans serviced for others totaled *$174.7* million at *December 31, 2018* and *$162.0* million at *June 30, 2018.*

Mortgage and SBA loans serviced for others are accounted for as sales and therefore are *not* included on 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 *$101* thousand and *$234* thousand for the *three* months ended *December 31, 2018* and *2017,* respectively, and were included as a component of loan-related fees within noninterest income. Contractually specified servicing fees were *$349* thousand and *$497* thousand for the *six* months ended *December 31, 2018* and *2017,* respectively.

The significant assumptions used in the valuation of the servicing rights included a range of discount rates from *8.8%* to *17.7%* and a weighted average prepayment speed assumption of *12.4%.*

***6.* Earnings Per Share (EPS)**

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

| | Three months Ended December 31, | | Six months Ended December 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands, except share and per share data) | | | |
| Net income | $*5,125* | $*3,304* | $*9,659* | $*7,890* |
| Weighted average shares used in calculation of basic EPS | *9,048,397* | *8,924,495* | *9,022,161* | *8,883,003* |
| Incremental shares from assumed exercise of dilutive securities | *153,160* | *243,589* | *170,482* | *246,007* |
| Weighted average shares used in calculation of diluted EPS | *9,201,557* | *9,168,084* | *9,192,643* | *9,129,010* |
| Basic earnings per common share | $*0.57* | $*0.37* | $*1.07* | $*0.89* |
| Diluted earnings per common share | $*0.56* | $*0.36* | $*1.05* | $*0.86* |

For the *three* and *six* months ended *December 31, 2018* and *2017, no* stock options were excluded from the calculation of diluted EPS.

***7.* Derivatives and Hedging Activities**

The Company has stand-alone derivative financial instruments in the form of interest rate caps that derive their value from a fee paid and are adjusted to fair value based on index and strike rate, and swap agreements that derive their value from the underlying interest rate. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivative are based. Notional amounts do *not* represent direct credit exposures. Direct credit exposure arises in the event of nonperformance by the counterparties to these agreements, and is limited to the net difference between the calculated amounts to be received and paid, if any.

Such differences, which represent the fair value of the derivative instruments, are reflected on the Company's balance sheet as derivative assets and derivative liabilities. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does *not* expect any counterparties to fail to meet their obligations.



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The Company currently holds derivative instruments that contain credit-risk related features that are in a net liability position, which *may* require that collateral be assigned to dealer banks. At *December 31, 2018,* the Company had posted cash collateral totaling *$1.0* million with dealer banks related to derivative instruments in a net liability position.

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

*Risk Management Policies—Derivative Instruments*

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

*Interest Rate Risk Management—Cash Flow Hedging Instruments*

The Company uses variable rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments.

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

| December 31, 2018 | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Notional Amount | Inception Date | Termination Date | Index | Receive Rate | Pay Rate | Strike Rate | Unrealized Loss | Fair Value | Balance Sheet Location |
| (Dollars in thousands) | | | | | | | | | |
| *Interest rate swaps:* | | | | | | | | | |
| $ *5,000* | July 2013 | July 2033 | 3 Mo. LIBOR | *2.80* % | *3.38%* | *n/a* | $ *(393)* | $ *(393)* | Other Liabilities |
| *5,000* | July 2013 | July 2028 | | *2.80* % | *3.23%* | *n/a* | *(247)* | *(247)* | |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3 Mo. LIBOR | | | | | | Other Liabilities |
| *5,000* | July 2013 | July 2023 | 3 Mo. LIBOR | *2.80 %* | *2.77%* | *n/a* | *(51 )* | *(51 )* | Other Liabilities |
| *Forward-starting interest rate swaps:* | | | | | | | | | |
| *6,000* | February 2018 | September 2029 | 3 Mo. LIBOR | *5.60 %* | *5.88%* | *n/a* | *(212 )* | *(212 )* | Other Liabilities |
| *10,000* | February 2018 | February 2030 | 3 Mo. LIBOR | *4.69 %* | *4.98%* | *n/a* | *(346 )* | *(346 )* | Other Liabilities |
| *Interest rate caps:* | | | | | | | | | |
| *6,000* | October 2014 | September 2019 | 3 Mo. LIBOR | *n/a* | *n/a* | *2.50 %* | *(29 )* | *12* | Other Assets |
| *10,000* | March 2015 | February 2020 | 3 Mo. LIBOR | *n/a* | *n/a* | *2.50 %* | *(65 )* | *27* | Other Assets |
| $*47,000* | | | | | | | $ *(1,343 )* | $*(1,210)* | |

June 30, 2018

| Notional Amount | Inception Date | Termination Date | Index | Receive Rate | Pay Rate | Strike Rate | Unrealized Loss | Fair Value | Balance Sheet Location |
|---|---|---|---|---|---|---|---|---|---|
| (Dollars in thousands) | | | | | | | | | |
| *Interest rate swaps:* | | | | | | | | | |
| $*5,000* | July 2013 | July 2033 | 3 Mo. LIBOR | *2.05 %* | *3.38%* | *n/a* | $ *(293 )* | $*(293)* | Other Liabilities |
| *5,000* | July 2013 | July 2028 | 3 Mo. LIBOR | *2.05 %* | *3.23%* | *n/a* | *(154 )* | *(154)* | Other Liabilities |
| *5,000* | July 2013 | July 2023 | 3 Mo. LIBOR | *2.05 %* | *2.77%* | *n/a* | *15* | *15* | Other Assets |
| *Forward-starting interest rate swaps:* | | | | | | | | | |
| 6,000 | *February 2018* | September 2029 | 3 Mo. LIBOR | *5.14 %* | *5.88%* | *n/a* | *(81 )* | *(81 )* | Other Liabilities |
| 10,000 | *February 2018* | February 2030 | 3 Mo. LIBOR | *4.23 %* | *4.98%* | *n/a* | *(140 )* | *(140)* | Other Liabilities |
| *Interest rate caps:* | | | | | | | | | |
| *6,000* | October 2014 | September 2019 | 3 Mo. LIBOR | *n/a* | *n/a* | *2.50 %* | *(91 )* | *15* | Other Assets |
| *10,000* | March 2015 | February 2020 | 3 Mo. LIBOR | *n/a* | *n/a* | *2.50 %* | *(83 )* | *49* | Other Assets |
| $*47,000* | | | | | | | $ *(827 )* | $*(589)* | |

During the *three* and *six* months ended *December 31, 2018* and *2017, no* interest rate cap or swap agreements were terminated prior to maturity. Changes in the fair value of interest rate caps and swaps designated as hedging instruments of the variability of cash flows associated with variable rate debt are reported in other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the debt affects earnings. Risk management results for the *three* and *six* months ended *December 31, 2018* and *2017* related to the balance sheet hedging of variable rate debt indicates that the hedges were effective.

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## *8.* **Other Comprehensive Income**

The components of other comprehensive income are as follows:

| | Three Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | 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 loss on available-for-sale debt securities | $633 | $ 171 | $ 462 | $(297) | $ (113 ) | $ (184 ) |
| Change in accumulated loss on effective cash flow hedges | (1,104) | (298 ) | (806 ) | 160 | 60 | 100 |
| Reclassification adjustment for losses included in net income | 38 | 10 | 28 | 26 | 10 | 16 |
| Total derivatives and hedging activities | (1,066) | (288 ) | (778 ) | 186 | 70 | 116 |
| Total other comprehensive loss | $(433 ) | $ (117 ) | $ (316 ) | $(111) | $ (43 ) | $ (68 ) |

| | Six Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | Pre-tax Amount | Tax Expense (Benefit) | After-tax Amount | Pre-tax Amount | Tax Expense (Benefit) | After-tax Amount |
| | (Dollars in thousands) | | | | | |
| Change in net unrealized gain or loss on available-for-sale securities | $560 | $ 152 | $ 408 | $(175) | $ (68 ) | $ (107 ) |
| Change in accumulated loss on effective cash flow hedges | (623) | (170 ) | (453 ) | 181 | 68 | 113 |
| Reclassification adjustment for losses included in net income | 107 | 29 | 78 | 49 | 19 | 30 |
| Total derivatives and hedging activities | (516) | (141 ) | (375 ) | 230 | 87 | 143 |
| Total other comprehensive income | $44 | $ 11 | $ 33 | $55 | $ 19 | $ 36 |

Accumulated other comprehensive loss is comprised of the following:

| | December 31, | June 30, |
|---|---|---|

| | 2018 | 2018 |
|---|---|---|
| | (Dollars in thousands) | |
| Unrealized loss on investment securities | $(777) | $(1,584) |
| Tax effect | 210 | 428 |
| After tax amount | (567) | (1,156) |
| Unrealized loss on cash flow hedges | (1,343) | (827) |
| Tax effect | 362 | 222 |
| After tax amount | (981) | (605) |
| Accumulated other comprehensive loss | $(1,548) | $(1,761) |

***9.* Commitments and Contingencies**

*Commitments*

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit, and commitments to fund investments. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on 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:

| | December 31, 2018 | June 30, 2018 |
|---|---|---|
| | (Dollars in thousands) | |
| Commitments to grant loans | $6,128 | $20,431 |
| Unfunded commitments under lines of credit | 23,829 | 29,478 |
| Standby letters of credit | 3,183 | 3,183 |

Commitments to extend credit are agreements to lend to a customer as long as there is *no* violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and *may* require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do *not* necessarily represent future cash requirements. The Company evaluates each customer’s credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management’s credit evaluation of the counter party. Collateral held varies but *may* include accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties. The Company has recorded an allowance for possible losses on commitments and unfunded loans totaling *$52* thousand recorded in other liabilities at both *December 31, 2018* and *June 30, 2018.*

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*Contingencies*

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

## *10*. Fair Value Measurements

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

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

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

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

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

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

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

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

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

*Investment 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 enterprise mortgage-backed securities, as well as certain preferred and trust preferred stocks. Level *3* securities are securities for which significant unobservable inputs are utilized.

Certain investments are measured at fair value using the net asset value per share as a practical expedient. These investments include a fund that seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies, as well as a fund that primarily invests in the federally guaranteed portion of SBA *7*(a) loans. The Company's investment in securities either issued or guaranteed by the U.S. government or its agencies can be redeemed daily at the closing net asset value per share. The Company's investment in SBA *7*(a) loans can be redeemed quarterly with *sixty* days' notice. In accordance with ASU *2015-07,* these investments have *not* been included in the fair value hierarchy.

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

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

*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.*

*Servicing rights, net* - The fair value of the 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 servicing rights, net 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 Federal Home Loan Bank of Boston ("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.

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

*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.

*FHLBB advances, capital lease obligations and subordinated debentures* - 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 capital lease obligations and subordinated debentures are estimated by discounting the cash flows through maturity based on current rates available to the Company for borrowings with similar maturities.

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

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

| | December 31, 2018 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| | (Dollars in thousands) | | | |
| Assets | | | | |
| Available-for-sale debt securities: | | | | |
| U.S. Government agency securities | $*57,025* | $ - | $*57,025* | $ - |
| Agency mortgage-backed securities | *21,107* | - | *21,107* | - |
| Equity investments measured at net asset value[1] | *6,711* | - | - | - |
| Other assets – interest rate caps | *39* | - | *39* | - |
| Liabilities | | | | |
| Other liabilities – interest rate swaps | $*1,249* | $ - | $*1,249* | $ - |

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| | (Dollars in thousands) | | | |
| Assets | | | | |
| Available-for-sale debt securities: | | | | |
| U.S. Government agency securities | $*56,887* | $ - | $*56,887* | $ - |
| Agency mortgage-backed securities | *24,181* | - | *24,181* | - |
| Equity investments measured at net asset value[1] | *6,619* | - | - | - |
| Other assets – interest rate caps | *64* | - | *64* | - |
| Other assets – interest rate swaps | *15* | - | *15* | - |
| Liabilities | | | | |
| Other liabilities – interest rate swap | $*668* | $ - | $*668* | $ - |

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

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

| December 31, 2018 | | | |
|---|---|---|---|
| Total | Level 1 | Level 2 | Level 3 |

| | | | | |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| Collateral dependent impaired loans | $*2,408* | $ - | $ - | $*2,408* |
| Real estate owned and other repossessed collateral | *1,463* | - | - | *1,463* |
| Servicing rights, net | *2,934* | - | - | *2,934* |

| | June 30, 2018 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| | (Dollars in thousands) | | | |
| Collateral dependent impaired loans | $*1,917* | $ - | $ - | $*1,917* |
| Real estate owned and other repossessed collateral | *2,233* | - | - | *2,233* |
| Servicing rights, net | *2,970* | - | - | *2,970* |

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 | | |
|---|---|---|---|
| | December 31, 2018 | June 30, 2018 | Valuation Technique |
| | (Dollars in thousands) | | |
| Collateral dependent impaired loans | $*2,408* | $*1,917* | Appraisal of collateral(1) |
| Real estate owned and other repossessed collateral | *1,463* | *2,223* | Appraisal of collateral(1) |
| Servicing rights, net | *2,934* | *2,970* | Discounted cash flow(2) |

(*1*) Fair value is generally determined through independent appraisals of the underlying collateral. The Company *may* also use another available source of collateral assessment to determine a reasonable estimate of the fair value of the collateral. Appraisals *may* be adjusted by management for qualitative factors such as economic factors and estimated liquidation expenses. The range of these possible adjustments was *0%* to *100%.*

(*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 *10.6%* to *12.4%.* For discount rates, the range was *8.8%* to *17.7%.*

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The table below summarizes the total gains (losses) on assets measured at fair value on a non-recurring basis for the *three* and *six* months ended *December 31, 2018* and *2017.*

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| | (In thousands) | | | |
| Collateral dependent impaired loans | $*(22)* | $*(328)* | $*(234)* | $*(351)* |
| Real estate owned and other repossessed collateral | *(25)* | *45* | *(25 )* | *45* |
| Loan servicing rights | *(31)* | *110* | *(138)* | *110* |
| Total | $*(78)* | $*(173)* | $*(397)* | $*(196)* |

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

| | Carrying | Fair Value Measurements at December 31, 2018 | | | |
|---|---|---|---|---|---|
| | Amount | Total | Level 1 | Level 2 | Level 3 |
| | (Dollars in thousands) | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $*137,616* | $*137,616* | $*137,616* | $- | $- |
| Available-for-sale debt securities | *78,132* | *78,132* | - | *78,132* | - |
| Equity investments measured at net asset value[1] | *6,711* | *6,711* | - | - | - |
| Federal Home Loan Bank stock | *1,652* | *1,652* | - | *1,652* | - |
| Loans held for sale | *1,799* | *1,799* | - | *1,799* | - |
| Loans, net | *932,978* | *930,578* | - | - | *930,578* |
| Accrued interest receivable | *2,987* | *2,987* | - | *2,987* | - |
| Interest rate caps | *39* | *39* | - | *39* | - |
| Financial liabilities: | | | | | |
| Deposits | *985,591* | *984,047* | - | *984,047* | - |
| Federal Home Loan Bank advances | *15,000* | *15,000* | - | *15,000* | - |
| Capital lease obligation | *466* | *473* | - | *473* | - |
| Subordinated debt | *24,128* | *26,423* | - | - | *26,423* |
| Interest rate swaps | *1,249* | *1,249* | - | *1,249* | - |

| | Carrying | Fair Value Measurements at June 30, 2018 |
|---|---|---|

| | Amount | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|---|
| | (Dollars in thousands) | | | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ *157,402* | $ *157,402* | $ *157,402* | $ - | $ - |
| Available-for-sale debt securities | *81,068* | *81,068* | - | *81,068* | - |
| Equity investments measured at net asset value[1] | *6,619* | *6,619* | - | - | - |
| Federal Home Loan Bank stock | *1,652* | *1,652* | - | *1,652* | - |
| Loans held for sale | *7,155* | *7,155* | - | *7,155* | - |
| Loans, net | *866,995* | *868,730* | - | - | *868,730* |
| Accrued interest receivable | *2,528* | *2,528* | - | *2,528* | - |
| Interest rate caps | *64* | *64* | - | *64* | - |
| Interest rate swaps | *15* | *15* | | *15* | |
| Financial liabilities: | | | | | |
| Deposits | *954,940* | *953,216* | - | *953,216* | - |
| Federal Home Loan Bank advances | *15,000* | *15,000* | - | *15,000* | - |
| Capital lease obligation | *605* | *619* | - | *619* | - |
| Subordinated debt | *23,958* | *25,961* | - | - | *25,961* |
| Interest rate swaps | *668* | *668* | - | *668* | - |

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

## *11*. Subsequent Event

On *January 7, 2019* the Company entered into an Agreement and Plan of Merger (the “Plan of Merger”) with its wholly-owned bank subsidiary, Northeast Bank (the “Bank”). Under the terms of the Plan of Merger, the Company will merge with and into the Bank (the “Reorganization”), with the Bank continuing as the surviving entity. If the proposed Reorganization is approved and effected, the bank holding company structure will be eliminated and the Bank will become the top-level company.

At the effective time of the Reorganization, each outstanding share of voting and non-voting common stock of the Company, par value *$1.00* per share, respectively, will be canceled and converted into the right to receive *one* share of voting and non-voting common stock, respectively, of the Bank. As a result, the shares of the Bank’s common stock are expected to be owned directly by the Company’s shareholders in the same proportion as their ownership of the Company’s common stock immediately prior to the Reorganization.

Following the Reorganization, it is expected that the surviving entity, the Bank, will be a publicly-traded company listed on the NASDAQ Global Market under the same ticker symbol currently used by the Company, “NBN.” It is also expected that the Bank’s common stock will be registered under the Securities Exchange Act of *1934* (the “Exchange Act”), which vests the Federal Deposit Insurance Corporation (the “FDIC”) with the power to administer and enforce certain sections of the Exchange Act applicable to banks. Following the Reorganization, the Bank will file periodic and current reports and other materials required by the Exchange Act with the FDIC, and the Company will *no* longer file these reports and materials with the SEC.

The Bank will have the same board of directors following the Reorganization as the Company had immediately prior to the Reorganization, and the executive officers of the Company will hold the same positions and titles.

The Reorganization has been approved by the boards of directors of the Company and the Bank. The Company will initiate the filings and other actions required in connection with the Reorganization, including filing a proxy statement and other proxy materials with the SEC and convening a special meeting of its shareholders to consider and vote upon the Plan of Merger. In addition to shareholder approval, the Reorganization will be subject to various closing conditions, including, among others, the receipt of all required regulatory approvals, including the approval of the Maine Bureau of Financial Institutions and the FDIC.

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

The following discussion should be read in conjunction with the consolidated financial statements, notes and tables included in Northeast Bancorp’s Annual Report on Form 10-K for the fiscal year ended June 30, 2018, filed with the SEC.

**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 Northeast Bancorp’s financial condition, prospective results of operations, future performance or expectations, plans, objectives, prospects, loan loss allowance adequacy, simulation of changes in interest rates, capital spending and finance sources and revenue sources. These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management’s projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward-looking statements, which are based on various assumptions (some of which are beyond the Company’s control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as “believe”, “expect”, “estimate”, “anticipate”, “continue”, “plan”, “approximate “intend”, “objective”, “goal”, “project”, or other similar terms or variations on those terms, or the future or conditional verbs such as “will”, “may”, “should”, “could”, and “would”. Although the Company believes that these forward-looking statements are based on reasonable estimates and assumptions, they are not guarantees of future performance and are subject to known and unknown risks, uncertainties, contingencies, and other factors. Accordingly, the Company cannot give you any assurance that its expectations will, in fact, occur or that its estimates or assumptions will be correct. The Company cautions you that actual results could differ materially from those expressed or implied by such forward-looking statements as a result of, among other factors, changes in interest rates and real estate values; competitive pressures from other financial institutions; weakness in general economic conditions on a national basis or in the local markets in which the Company operates, including changes which adversely affect borrowers’ ability to service and repay the Company’s loans; changes in loan defaults and charge-off rates; changes in the value of securities and other assets, adequacy of loan loss reserves, or deposit levels necessitating increased borrowing to fund loans and investments; changes in government regulation; operational risks including, but not limited to, cybersecurity breaches, fraud and natural disasters; the risk that the Company may not be successful in the execution of its business strategy; the risk that intangibles recorded in the Company’s financial statements will become impaired; the ability of the Company and the Bank to satisfy the conditions to the completion of the Reorganization; the ability of the Company and the Bank to meet expectations regarding the timing, completion and accounting and tax treatments of the Reorganization; the possibility that any of the anticipated benefits of the Reorganization will not be realized or will not be realized as expected; the failure of the Reorganization to close for any reason; the possibility that the Reorganization may be more expensive to complete than anticipated, including as a result of unexpected factors or events; changes in assumptions used in making such forward-looking statements; and the other risks and uncertainties detailed in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2018 as updated in the Company’s Quarterly Reports on Form 10-Q and other filings submitted to the SEC. These forward-looking statements speak only as of the date of this report and the Company does not undertake any obligation to update or revise any of these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events.

**Description of Business and Strategy**

*Business Overview*

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

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

In connection with the transaction, as part of the regulatory approval process, the Company and the Bank made certain commitments to the Federal Reserve, the most significant of which are (i) to maintain a Tier 1 leverage ratio of at least 10%, (ii) to maintain a total risk-based capital ratio of at least 15%, (iii) to limit purchased loans to 40% of total loans, (iv) to fund 100% of the Company's loans with core deposits (defined as non-maturity deposits and non-brokered insured time deposits), and (v) to hold commercial real estate loans (including owner-occupied commercial real estate) to within 300% of total risk-based capital. On June 28, 2013, the Federal Reserve approved the amendment to exclude owner-occupied commercial real estate loans from the commitment to hold commercial real estate loans to within 300% of total risk-based capital. The Company and the Bank are currently in compliance with all commitments to the Federal Reserve. The Company's compliance ratios at December 31, 2018 follow:

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| Condition | Ratios as of December 31, 2018 | |
|---|---|---|
| (i) Tier 1 leverage capital ratio | 13.20 | % |
| (ii) Total capital ratio | 19.42 | % |
| (iii) Ratio of purchased loans to total loans, including loans held for sale | 35.17 | % |
| (iv) Ratio of loans to core deposits (1) | 94.84 | % |
| (v) Ratio of non-owner occupied commercial real estate loans to total capital (2) | 242.38 | % |

(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.

On January 7, 2019, the Company announced the Reorganization, pursuant to which its bank holding company structure would be eliminated and the Bank would become the top-level company. If the Reorganization is completed, these commitments to the Federal Reserve will no longer be applicable. The Bank intends to replace these commitments with standards relating to its capital levels and asset portfolio composition, which will be incorporated into its policies and procedures. These newly established standards are designed to help ensure the Bank will continue to operate in a safe and sound manner, but may permit more growth in the Bank’s loan portfolio as compared to operating under the existing commitments.

As a result of the Reorganization, the Bank intends to incorporate the following standards into its policies and procedures:

- Maintain a Tier 1 leverage ratio of at least 10%, which is unchanged from the requirement in the commitments to the FRB;
- Maintain a Total capital ratio of at least 13.5% (as opposed to 15%);
- Limit purchased loans to 60% of total loans (as opposed to 40%); and
- Maintain a ratio of the Bank’s loans to core deposits of not more than 125% (as opposed to 100%).

A requirement to hold non-owner occupied commercial real estate loans to within 300% of total capital will not formally be incorporated into the Bank’s risk management policies. The Bank nonetheless would continue to be evaluated by the FDIC through the supervisory process under the 300% “screen” used by the federal banking agencies to identify institutions that are potentially exposed to commercial real estate concentration risk.

As of December 31, 2018, the Company, on a consolidated basis, had total assets of $1.2 billion, total deposits of $985.6 million, and shareholders' equity of $148.5 million. The Company gathers retail deposits through its banking offices in Maine and the Bank's online affinity deposit program, ableBanking; originates loans through the Bank's Community Banking Division; originates SBA and United States Department of Agriculture loans through the Bank's SBA Division; and purchases and originates commercial loans through the Bank's LASG. The Community Banking Division, with ten full-service branches, operates from the Bank's headquarters in Lewiston, Maine.
LASG, ableBanking, and the SBA Division operate from the Company's offices in Boston, Massachusetts.

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

*Strategy*

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

*Continuing to grow the 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 Small Business Administration ("SBA") 7(a) program, which provides the partial guarantee of the SBA.

*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.

*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.

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**Critical Accounting Policies**

Critical accounting policies are those that involve significant judgments and assessments by management, and which could potentially result in materially different results under different assumptions and conditions. The reader is encouraged to review each of the policies included in Form 10-K for the year ended June 30, 2018 to gain a better understanding of how Northeast's financial performance is measured and reported. There has been no material change in critical accounting policies during the three and six months ended December 31, 2018.

**Overview**

Net income increased by $1.8 million to $5.1 million for the quarter ended December 31, 2018, compared to net income of $3.3 million for the quarter ended December 31, 2017.

Net interest and dividend income before provision for loan losses increased by $3.2 million to $15.6 million for the quarter ended December 31, 2018, compared to $12.4 million the quarter ended December 31, 2017. The increase was primarily due to higher average balances in the loan portfolio. These increases were partially offset by higher funding costs and higher average deposit balances.

Noninterest income increased by $317 thousand for the quarter ended December 31, 2018, compared to the quarter ended December 31, 2017, principally due to an increase in gain on sale of SBA loans of $601 thousand, due to larger guarantee balances sold in the quarter; partially offset by a decrease in gain on sale of residential loans of $151 thousand and a decrease in fees for other services to customers of $135 thousand.

Noninterest expense increased by $1.3 million for the quarter ended December 31, 2018 compared to the quarter ended December 31, 2017, primarily due to the following:

- An increase in salaries and employee benefits expense of $526 thousand, primarily due to increases in base salary, stock-based compensation expense, incentive compensation, and a decrease in deferred salaries expense;
- An increase in other noninterest expense of $292 thousand, primarily due to a $141 thousand increase in expense related to the quarterly valuation of SBA servicing rights, and increases in travel expense and employee recruitment expense;
- An increase in professional fees of $231 thousand, primarily due to increased legal expense related to the Reorganization and other consulting costs; and
- An increase in loan acquisition and collection expense of $217 thousand, largely driven by increased loan expenses and collection expenses incurred on the increased SBA and purchased loan activity during the quarter.

Income tax expense increased by $678 thousand to $2.1 million, or an effective tax rate of 28.7%, for the quarter ended December 31, 2018, compared to $1.4 million, or an effective tax rate of 29.5%, for the quarter ended December 31, 2017. The increase in expense was primarily due to the increase in earnings. The decrease in effective tax rate was primarily due to the following:

- The new federal corporate income tax rate of 21.0% for the quarter ended December 31, 2018, as compared to the blended federal corporate income tax rate of 28.0% for the quarter ended December 31, 2017; and
- The $498 thousand revaluation of the deferred tax asset as a result of the Tax Cuts and Jobs Act recorded in the quarter ended December 31, 2017; partially offset by,
- A decrease in the income tax benefit recognized of $275 thousand arising from the treatment of vested restricted stock awards under ASU 2016-09, *Compensation–Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*, whereby the tax effects of vested awards or exercised options are treated as a discrete item in the reporting period in which they occur.

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**Financial Condition**

*Overview*

As of December 31, 2018, total assets were $1.2 billion, an increase of $36.4 million, or 3.1%, from total assets of $1.2 billion as of June 30, 2018. The principal components of the changes in the balance sheet follow:

1. The following table highlights the changes in the loan portfolio for the three and six months ended December 31, 2018:

Loan Portfolio Changes

| | Three Months Ended December 31, 2018 | | | |
|---|---|---|---|---|
| | December 31, 2018 Balance | September 30, 2018 Balance | Change ($) | Change (%) |
| | (Dollars in thousands) | | | |
| LASG Purchased | $330,643 | $300,548 | $30,095 | 10.01 % |
| LASG Originated | 435,817 | 407,822 | 27,995 | 6.86 % |
| SBA | 67,282 | 67,212 | 70 | 0.10 % |
| Community Banking | 104,544 | 111,614 | (7,070) | (6.33 %) |
| Total | $938,286 | $887,196 | $51,090 | 5.76 % |

| | Six Months Ended December 31, 2018 | | | |
|---|---|---|---|---|
| | December 31, 2018 Balance | June 30, 2018 Balance | Change ($) | Change (%) |
| | (Dollars in thousands) | | | |
| LASG Purchased | $330,643 | $290,972 | $39,671 | 13.63 % |
| LASG Originated | 435,817 | 397,363 | 38,454 | 9.68 % |
| SBA | 67,282 | 60,156 | 7,126 | 11.85 % |
| Community Banking | 104,544 | 123,311 | (18,767) | (15.22 %) |
| Total | $938,286 | $871,802 | $66,484 | 7.63 % |

Loans generated by the Bank's LASG for the quarter ended December 31, 2018 totaled $113.5 million, which consisted of $49.4 million of purchased loans, at an average price of 93.7% of unpaid principal balance, and $64.1

million of originated loans. The Bank's SBA Division closed $13.8 million and funded $13.1 million of new loans during the quarter ended December 31, 2018. In addition, the Company sold $12.8 million of the guaranteed portion of SBA loans in the secondary market, of which $7.6 million were originated in the current quarter and $5.2 million were originated in prior quarters. Residential loan production sold in the secondary market totaled $7.7 million for the quarter ended December 31, 2018.

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

| Basis for Regulatory Condition | Condition | Availability at December 31, 2018 (Dollars in millions) |
| --- | --- | --- |
| Total Loans | Purchased loans may not exceed 40% of total loans | $ 75.7 |
| Regulatory Capital | Non-owner occupied commercial real estate loans may not exceed 300% of total capital | 102.8 |

On January 7, 2019, the Company announced a corporate reorganization pursuant to which its bank holding company structure would be eliminated and the Bank would become the top-level company. If the Reorganization is completed, these commitments to the FRB will no longer be applicable. The Bank intends to replace these commitments with standards relating to its capital levels and asset portfolio composition, which will be incorporated into its policies and procedures, and compliance with FDIC policy on commercial real estate concentration risk. These newly established standards are designed to help ensure the Bank will continue to operate in a safe and sound manner, but may permit more growth in the Bank's loan portfolio as compared to operating under the existing commitments.

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An overview of the Bank's LASG portfolio follows:

| | LASG Portfolio | | | | | |
|---|---|---|---|---|---|---|
| | Three Months Ended December 31, | | | | | |
| | 2018 | | | 2017 | | |
| | Purchased | Originated | Total LASG | Purchased | Originated | Total LASG |
| | (Dollars in thousands) | | | | | |
| Loans purchased or originated during the period: | | | | | | |
| Unpaid principal balance | $52,672 | $ 64,117 | $116,789 | $38,205 | $ 44,285 | $82,490 |
| Net investment basis | 49,334 | 64,117 | 113,451 | 34,802 | 44,285 | 79,087 |
| Loan returns during the period: | | | | | | |
| Yield | 10.30 % | 7.61 % | 8.75 % | 11.00 % | 6.49 % | 8.31 % |
| Total Return on Purchased Loans (1) | 10.30 % | 7.61 % | 8.75 % | 11.00 % | 6.49 % | 8.31 % |

| | Six Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | Purchased | Originated | Total LASG | Purchased | Originated | Total LASG |
| | (Dollars in thousands) | | | | | |
| Loans purchased or originated during the period: | | | | | | |
| Unpaid principal balance | $89,748 | $ 135,253 | $225,001 | $42,523 | $ 85,064 | $ 127,587 |
| Net investment basis | 84,137 | 135,253 | 219,390 | 38,453 | 85,064 | 123,517 |
| Loan returns during the period: | | | | | | |
| Yield | 9.88 % | 7.53 % | 8.53 % | 11.65 % | 6.42 % | 8.58 % |
| Total Return on Purchased Loans (1) | 9.88 % | 7.53 % | 8.53 % | 11.65 % | 6.42 % | 8.58 % |
| Total loans as of period end: | | | | | | |
| Unpaid principal balance | $368,345 | $435,817 | $804,162 | $276,440 | $ 346,874 | $623,314 |
| Net investment basis | 330,643 | 435,817 | 766,460 | 244,177 | 346,874 | 591,051 |

(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, which includes purchased loans held for sale, on an annualized basis. The total return on purchased loans does not include the effect of purchased loan charge-offs or recoveries during the period. Total return on purchased loans is considered a non-GAAP financial measure. See reconciliation in below table entitled "Total Return on Purchased Loans."

*Assets*

*Cash and Due from Banks, Short-Term Investments and Investment Securities*

Cash and cash equivalents were $137.6 million as of December 31, 2018, a decrease of $19.8 million, or 12.6%, from $157.4 million at June 30, 2018. The decrease is primarily due to the increase in loans, offset by the increase in deposits in the period.

Investment securities totaled $84.8 million as of December 31, 2018, compared to $87.7 million as of June 30, 2018, representing a decrease of $2.8 million, or 3.2%, primarily due to principal payments on mortgage-backed securities. Included in investment securities are securities issued by government agencies and government-sponsored enterprises, as well as an investment of $5.1 million in a Community Reinvestment Act ("CRA") qualified fund that seeks to invest in securities either issued or guaranteed by the U.S. government or its agencies and an investment of $1.5 million in a CRA qualified fund that primarily invests in the federally guaranteed portion of SBA 7(a) loans. At December 31, 2018, no securities were pledged for outstanding borrowings.

*Loans*

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

| | December 31, 2018 | | | | |
|---|---|---|---|---|---|
| | Community Banking Division | LASG | SBA Division | Total | Percent of Total |
| | (Dollars in thousands) | | | | |
| Originated loans: | | | | | |
| Residential real estate | $66,248 | $9,724 | $- | $75,972 | 8.10 % |
| Commercial real estate: non-owner occupied | 17,049 | 156,158 | 36,597 | 209,804 | 22.36 % |
| Commercial real estate: owner occupied | 10,100 | 76,144 | 24,130 | 110,374 | 11.76 % |
| Commercial and industrial | 8,359 | 193,791 | 6,555 | 208,705 | 22.24 % |
| Consumer | 2,788 | - | - | 2,788 | 0.30 % |
| Total originated loans | 104,544 | 435,817 | 67,282 | 607,643 | 64.76 % |
| Purchased loans: | | | | | |
| Residential real estate | - | 16,594 | - | 16,594 | 1.77 % |
| Commercial real estate: non-owner occupied | - | 187,558 | - | 187,558 | 19.99 % |
| Commercial real estate: owner occupied | - | 125,703 | - | 125,703 | 13.40 % |
| Commercial and industrial | - | 788 | - | 788 | 0.08 % |
| Total purchased loans | - | 330,643 | - | 330,643 | 35.24 % |
| Total loans | $104,544 | $766,460 | $67,282 | $938,286 | 100.00% |

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| | June 30, 2018 | | | | |
|---|---|---|---|---|---|
| | Community Banking Division | LASG | SBA Division | Total | Percent of Total |
| | (Dollars in thousands) | | | | |
| Originated loans: | | | | | |
| Residential real estate | $79,091 | $7,111 | $128 | $86,330 | 9.90 % |
| Commercial real estate: non-owner occupied | 18,698 | 137,463 | 29,488 | 185,649 | 21.29 % |
| Commercial real estate: owner occupied | 11,351 | 81,916 | 24,483 | 117,750 | 13.51 % |
| Commercial and industrial | 10,927 | 170,873 | 6,057 | 187,857 | 21.55 % |
| Consumer | 3,244 | - | - | 3,244 | 0.37 % |
| Total originated loans | 123,311 | 397,363 | 60,156 | 580,830 | 66.62 % |
| Purchased loans: | | | | | |
| Residential real estate | - | 13,926 | - | 13,926 | 1.60 % |
| Commercial real estate: non-owner occupied | - | 150,805 | - | 150,805 | 17.30 % |
| Commercial real estate: owner occupied | - | 125,246 | - | 125,246 | 14.37 % |
| Commercial and industrial | - | 995 | - | 995 | 0.11 % |
| Total purchased loans | - | 290,972 | - | 290,972 | 33.38 % |
| Total loans | $123,311 | $688,335 | $60,156 | $871,802 | 100.00% |

*Classification of Assets*

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

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

Other nonperforming assets include other real estate owned (“OREO”) and other personal property securing loans repossessed by the Bank. The real estate and personal property collateral for commercial and consumer loans is recorded at fair value less estimated costs to sell upon repossession. Revenues and expenses are recognized in the period when received or incurred on OREO and in-substance foreclosures. Gains and losses on disposition are recognized in noninterest income.

The following table details the Company's nonperforming assets and other credit quality indicators as of December 31, 2018 and June 30, 2018. Management believes that, based on their carrying amounts, nonperforming assets are well secured based on the estimated fair value of underlying collateral.

| | Nonperforming Assets at December 31, 2018 | | | |
|---|---|---|---|---|
| | Originated | Purchased | Total | |
| | (Dollars in thousands) | | | |
| Loans: | | | | |
| Residential real estate | $2,595 | $ 202 | $2,797 | |
| Commercial real estate | 2,764 | 4,755 | 7,519 | |
| Commercial and industrial | 1,420 | 394 | 1,814 | |
| Consumer | 216 | - | 216 | |
| Total nonperforming loans | 6,995 | 5,351 | 12,346 | |
| Real estate owned and other repossessed collateral | 32 | 1,431 | 1,463 | |
| Total nonperforming assets | $7,027 | $ 6,782 | $13,809 | |
| Ratio of nonperforming loans to total loans | | | 1.32 | % |
| Ratio of nonperforming assets to total assets | | | 1.16 | % |
| Ratio of loans past due to total loans | | | 1.95 | % |
| Nonperforming loans that are current | | | $3,125 | |
| Commercial loans risk rated substandard or worse | | | $8,931 | |
| Troubled debt restructurings: | | | | |
| On accrual status | | | $10,629 | |
| On nonaccrual status | | | $3,193 | |

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| | Nonperforming Assets at June 30, 2018 | | |
|---|---|---|---|
| | Originated | Purchased | Total |
| | (Dollars in thousands) | | |
| Loans: | | | |
| Residential real estate | $3,212 | $ 202 | $3,414 |
| Commercial real estate | 1,499 | 5,180 | 6,679 |
| Commercial and industrial | 1,368 | 363 | 1,731 |
| Consumer | 134 | - | 134 |
| Total nonperforming loans | 6,213 | 5,745 | 11,958 |
| Real estate owned and other repossessed collateral | 115 | 2,118 | 2,233 |
| Total nonperforming assets | $6,328 | $ 7,863 | $14,191 |
| Ratio of nonperforming loans to total loans | | | 1.37 % |
| Ratio of nonperforming assets to total assets | | | 1.23 % |
| Ratio of loans past due to total loans | | | 0.89 % |
| Nonperforming loans that are current | | | $4,897 |
| Commercial loans risk rated substandard or worse | | | $9,090 |
| Troubled debt restructurings: | | | |
| On accrual status | | | $11,915 |
| Nonaccrual status | | | $3,543 |

As of December 31, 2018, nonperforming assets totaled $13.8 million, or 1.16% of total assets, as compared to $14.2 million, or 1.23% of total assets, as of June 30, 2018.

OREO decreased by $770 thousand, or 34.5%, to $1.5 million at December 31, 2018, compared to $2.2 million at June 30, 2018. The decrease was primarily the result of the sale of one property in the quarter ended September 30, 2018.

*Allowance for Loan Losses*

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

The Company’s allowance for loan losses was $5.3 million as of December 31, 2018, compared to $4.8 million as of June 30, 2018. The increase in the period is primarily the result of changes in the composition of the loan portfolio from an increase in loans originated by the SBA division, as well as an increase in specific reserve on two loan relationships.

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

| | December 31, 2018 | June 30, 2018 | December 31, 2017 |
|---|---|---|---|
| Allowance for loan losses to nonperforming loans | 42.99% | 40.20% | 24.07% |
| Allowance for loan losses to total loans | 0.57% | 0.55% | 0.56% |
| Last twelve months of net-charge offs to average loans | 0.04% | 0.04% | 0.04% |

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

*Other Assets*

Premises and equipment, net, decreased by $479 thousand, or 7.3%, to $6.1 million at December 31, 2018, compared to $6.6 million at June 30, 2018. The decrease was primarily due to depreciation and amortization.

Intangible assets totaled $649 thousand and $867 thousand at December 31, 2018 and June 30, 2018, respectively. The $218 thousand decrease was the result of intangible asset amortization during the period.

Servicing rights, net totaled $2.9 million and $3.0 million at December 31, 2018 and June 30, 2018, respectively. The $36 thousand decrease was the result of amortization and the revaluation of the servicing rights performed on a quarterly basis, offset by SBA loans sold during the six months ended December 31, 2018.

The cash surrender value of the Company’s bank-owned life insurance (“BOLI”) assets increased $219 thousand, or 1.3% to $16.8 million at December 31, 2018, compared to $16.6 million at June 30, 2018. Increases in cash surrender value are recognized in noninterest income and are not subject to income taxes. Borrowing on, or surrendering a policy, may subject the Company to income tax expense on the increase in cash surrender value. For these reasons, management considers BOLI an illiquid asset. BOLI represented 9.4% of the Company’s regulatory total capital at December 31, 2018.

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***Deposits, FHLBB Advances, Subordinated Debt, Liquidity, and Capital***

*Deposits*

The Company's principal source of funding is its core deposit accounts. At December 31 2018, non-maturity accounts and non-brokered insured time deposits represented 100% of total deposits.

Total deposits increased by $30.7 million, or 3.2%, from June 30, 2018, attributable primarily to an increase in time deposits of $112.2 million, or 31.9%, as a result of campaigns in the current period, partially offset by decreases in money market accounts of $75.7 million, or 18.0%, and demand deposits of $3.9 million, or 5.5%.

The composition of total deposits at December 31, 2018 and June 30, 2018 is as follows:

| | December 31, 2018 | | June 30, 2018 | |
|---|---|---|---|---|
| | Amount | Percent of Total | Amount | Percent of Total |
| | (Dollars in thousands) | | | |
| Demand deposits | $68,324 | 6.93 % | $72,272 | 7.57 % |
| NOW accounts | 72,679 | 7.37 % | 73,347 | 7.68 % |
| Regular and other savings | 35,090 | 3.56 % | 36,290 | 3.80 % |
| Money market deposits | 345,149 | 35.03 % | 420,886 | 44.07 % |
| Total non-certificate accounts | 521,242 | 52.89 % | 602,795 | 63.12 % |
| Term certificates of $250 thousand or less | 464,349 | 47.11 % | 352,145 | 36.88 % |
| Term certificates greater than $250 thousand | - | 0.00 % | - | 0.00 % |
| Total certificate accounts | 464,349 | 47.11 % | 352,145 | 36.88 % |
| Total deposits | $985,591 | 100.00% | $954,940 | 100.00% |

*FHLBB Advances*

Advances from the FHLBB were $15.0 million at both December 31, 2018 and June 30, 2018. As of December 31, 2018, the Company had pledged certain residential real estate loans and commercial real estate loans to secure outstanding advances and provide additional borrowing capacity. As of December 31, 2018, no securities were pledged for outstanding borrowings.

*Subordinated Debt*

On June 29, 2016, the Company entered into a Subordinated Note Purchase Agreement with certain institutional accredited investors pursuant to which the Company issued subordinated notes equal to $15.1 million in aggregate principal amount with an interest rate of 6.75% fixed-to-floating maturing in 2026 (“subordinated notes”). The subordinated notes, net of issuance costs, totaled $14.8 million and $14.7 million at December 31, 2018 and June 30, 2018, respectively.

The Company had junior subordinated debentures issued to affiliated trusts totaling $9.4 million and $9.2 million at December 31, 2018 and June 30, 2018, respectively. The unpaid principal balance of the junior subordinated debentures totaled $16.5 million at both December 31, 2018 and June 30, 2018.

In connection with the Reorganization, the Company intends to redeem the junior subordinated debentures and the Bank will assume the Company’s obligations under the subordinated notes.

*Liquidity*

The following table is a summary of unused borrowing capacity of the Company at December 31, 2018, in addition to traditional retail deposit products:

| | As of December 31, 2018 (Dollars in thousands) | |
|---|---|---|
| Brokered time deposits | $ 298,532 | Subject to policy limitation of 25% of total assets |
| Federal Home Loan Bank of Boston | 39,902 | Unused advance capacity subject to eligible and qualified collateral |
| Federal Discount Window Borrower-in-Custody | 991 | Unused credit line subject to the pledge of loans |
| Other available lines | 17,500 | |
| Total unused borrowing capacity | $ 356,925 | |

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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 of the FHLBB may be required.

At December 31, 2018, the Company had $422.7 million of immediately accessible liquidity, defined as cash that the Bank reasonably believes could be raised within seven days through collateralized borrowings, brokered deposits or security sales. This position represented 35.4% of total assets. The Company also had $137.6 million of cash and cash equivalents at December 31, 2018.

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

*Capital*

The unpaid principal balance and carrying amount of junior subordinated debentures totaled $16.5 million and $9.4 million, respectively, as of December 31, 2018. The unpaid principal balance and carrying amount of subordinated debt totaled $15.1 million and $14.8 million, respectively, as of December 31, 2018. The junior subordinated debt represents qualifying Tier 1 capital for the Company, up to a maximum of 25% of total Tier 1 capital, and subordinated debt represents qualifying Tier 2 capital for the Company. At December 31, 2018, the carrying amounts of the junior subordinated debt, net of the Company's $496 thousand investment in the affiliated trusts, qualified as Tier 1 capital, and the subordinated debt qualified as Tier 2 capital.

At December 31, 2018, shareholders' equity was $148.5 million, an increase of $10.1 million, or 7.3% from June 30, 2018. Book value per outstanding common share was $16.41 at December 31, 2018 and $15.49 at June 30, 2018. Tier 1 capital to total average assets of the Company was 13.2% as of December 31, 2018 and 13.1% at June 30, 2018.

Under the capital rules, risk-based capital ratios are calculated by dividing Tier 1 and total capital, respectively, by risk-weighted assets. Assets and off-balance sheet credit equivalents are assigned to one of several risk-weight categories, based primarily on relative risk. The rules require banks and bank holding companies to maintain a minimum common equity Tier 1 capital ratio of 4.5%, a minimum Tier 1 capital ratio of 6%, a total capital ratio of 8% and a leverage ratio of 4%. Additionally, subject to a transition schedule, the capital rules require a bank holding company to establish a capital conservation buffer of Tier 1 capital in an amount above the minimum risk-based capital requirements for "adequately capitalized" institutions equal to 2.5% of total risk weighted assets, or face restrictions on the ability to pay dividends, pay discretionary bonuses, and to engage in share repurchases.

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

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

| | Actual | | Minimum Capital Requirements | | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions | | Minimum Capital Ratio with Capital Conservation Buffer |
|---|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Ratio |
| | (Dollars in thousands) | | | | | | |
| December 31, 2018: | | | | | | | |
| Common equity tier 1 capital to risk weighted assets: | | | | | | | |
| Company | $149,439 | 16.26% | $41,356 | ≥4.5% | N/A | N/A | 7.0% |
| Bank | 167,805 | 18.25% | 41,374 | ≥4.5% | $59,762 | ≥6.5% | 7.0% |
| Total capital to risk weighted assets: | | | | | | | |
| Company | 178,431 | 19.42% | 73,521 | ≥8.0% | N/A | N/A | 10.5% |
| Bank | 173,165 | 18.83% | 73,554 | ≥8.0% | 91,942 | ≥10.0% | 10.5% |
| Tier 1 capital to risk weighted assets: | | | | | | | |
| Company | 158,297 | 17.22% | 55,141 | ≥6.0% | N/A | N/A | 8.5% |
| Bank | 167,805 | 18.25% | 55,165 | ≥6.0% | 73,554 | ≥8.0% | 8.5% |
| Tier 1 capital to average assets: | | | | | | | |
| Company | 158,297 | 13.20% | 47,975 | ≥4.0% | N/A | N/A | 4.0% |
| Bank | 167,805 | 14.00% | 47,948 | ≥4.0% | 59,935 | ≥5.0% | 4.0% |
| June 30, 2018: | | | | | | | |
| Common equity tier 1 capital to risk weighted assets: | | | | | | | |
| Company | $139,247 | 16.02% | $39,113 | ≥4.5% | N/A | N/A | 7.0% |
| Bank | 156,856 | 18.04% | 39,120 | ≥4.5% | $56,506 | ≥6.5% | 7.0% |
| Total capital to risk weighted assets: | | | | | | | |
| Company | 167,567 | 19.28% | 69,535 | ≥8.0% | N/A | N/A | 10.5% |
| Bank | 161,714 | 18.60% | 69,546 | ≥8.0% | 86,933 | ≥10.0% | 10.5% |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Tier 1 capital to risk weighted assets: | | | | | | | |
| Company | 147,990 | 17.03% | 52,151 | ≥6.0 % | N/A | N/A | 8.5 % |
| Bank | 156,856 | 18.04% | 52,160 | ≥6.0 % | 69,546 | ≥8.0 % | 8.5 % |
| Tier 1 capital to average assets: | | | | | | | |
| Company | 147,990 | 13.12% | 45,102 | ≥4.0 % | N/A | N/A | 4.0 % |
| Bank | 156,856 | 13.92% | 45,075 | ≥4.0 % | 56,344 | ≥5.0 % | 4.0 % |

In addition to the minimum regulatory capital required for capital adequacy purposes included in the table above, the Company is required to maintain a capital conservation buffer, in the form of common equity, in order to avoid restrictions on capital distributions and discretionary bonuses. The required amount of the capital conservation buffer was 2.5% on January 1, 2019.

The Bank may not declare or pay a cash dividend on, or repurchase, any of its capital stock from the Company 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 on December 29, 2010, 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.

As discussed in more detail above, in connection with the Reorganization, the Bank intends to replace these commitments with standards relating to its capital levels and asset portfolio composition, which will be incorporated into its policies and procedures, and compliance with FDIC policy on commercial real estate concentration risk.

***Off-Balance Sheet Financial Instruments***

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit, standby letters of credit, and commitments to fund investments. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized on 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.

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

## ***Results of Operations***

### ***General***

Net income increased by $1.8 million to $5.1 million for the quarter ended December 31, 2018, compared to net income of $3.3 million for the quarter ended December 31, 2017, primarily due to the increase in net interest income and noninterest income, offset by an increase in noninterest expense.

### ***Net Interest Income***

*Three Months Ended December 31, 2018 and 2017*

Net interest and dividend income before provision for loan losses increased by $3.2 million to $15.6 million for the quarter ended December 31, 2018, compared to $12.4 million the quarter ended December 31, 2017. The increase was primarily due to higher average balances in the loan portfolio. These increases were partially offset by higher funding costs and higher average deposit balances.

The following table summarizes interest income and related yields recognized on the loan portfolios:

| | Interest Income and Yield on Loans | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Three Months Ended December 31, | | | | | | | |
| | 2018 | | | | 2017 | | | |
| | Average Balance (1) | Interest Income | Yield | | Average Balance (1) | Interest Income | Yield | |
| | (Dollars in thousands) | | | | | | | |
| Community Banking | $108,344 | $1,448 | 5.30 | % | $141,486 | $1,753 | 4.92 | % |
| SBA | 73,467 | 1,440 | 7.78 | % | 49,457 | 814 | 6.53 | % |
| LASG: | | | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Originated | 420,816 | 8,077 | 7.61 % | 340,240 | 5,565 | 6.49 % |
| Purchased | 307,094 | 7,969 | 10.30 % | 229,732 | 6,369 | 11.00 % |
| Total LASG | 727,910 | 16,046 | 8.75 % | 569,972 | 11,934 | 8.31 % |
| Total | $909,721 | $18,934 | 8.26 % | $760,915 | $14,501 | 7.56 % |

(1) Includes loans held for sale.

The following table details the "Total Return" on purchased loans. When compared to the three months ended December 31, 2017, transactional income for the three months ended December 31, 2018 increased by $206 thousand. The total return on purchased loans for the three months ended December 31, 2018 was 10.3%. The following table details the total return on purchased loans:

| | Total Return on Purchased Loans Three Months Ended December 31, | | | |
|---|---|---|---|---|
| | 2018 | | 2017 | |
| | Income | Return (1) | Income | Return (1) |
| | (Dollars in thousands) | | | |
| Regularly scheduled interest and accretion | $5,860 | 7.57 % | $4,466 | 7.71 % |
| Transactional income: | | | | |
| Gain on loan sales | - | 0.00 % | - | 0.00 % |
| Gain on sale of real estate owned | - | 0.00 % | - | 0.00 % |
| Other noninterest income | - | 0.00 % | - | 0.00 % |
| Accelerated accretion and loan fees | 2,109 | 2.73 % | 1,903 | 3.29 % |
| Total transactional income | 2,109 | 2.73 % | 1,903 | 3.29 % |
| Total | $7,969 | 10.30 % | $6,369 | 11.00 % |

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

The Company's interest rate spread increased by 32 basis points and net interest margin increased by 40 basis points for the quarter ended December 31, 2018 compared to the quarter ended December 31, 2017. The increase was principally due to higher transactional income and higher average balances in the quarter, offset by higher deposit rates and average deposit balances.

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The following sets forth the average balance sheets, interest income and interest expense, and average yields and costs for the three months ended December 31, 2018 and 2017.

| | Three Months Ended December 31, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2018 | | | | 2017 | | | |
| | Average Balance | Interest Income/ Expense | Average Yield/ Rate | | Average Balance | Interest Income/ Expense | Average Yield/ Rate | |
| Assets: | | | | | | | | |
| Interest-earning assets: | | | | | | | | |
| Investment securities | $85,325 | $425 | 1.98 | % | $93,945 | $267 | 1.13 | % |
| Loans (1) (2) (3) | 909,721 | 18,934 | 8.26 | % | 760,915 | 14,501 | 7.56 | % |
| Federal Home Loan Bank stock | 1,652 | 24 | 5.76 | % | 1,860 | 21 | 4.48 | % |
| Short-term investments (4) | 168,768 | 946 | 2.22 | % | 145,305 | 471 | 1.29 | % |
| Total interest-earning assets | 1,165,466 | 20,329 | 6.92 | % | 1,002,025 | 15,260 | 6.04 | % |
| Cash and due from banks | 2,600 | | | | 2,731 | | | |
| Other non-interest earning assets | 31,344 | | | | 33,164 | | | |
| Total assets | $1,199,410 | | | | $1,037,920 | | | |
| Liabilities & Shareholders' Equity: | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | |
| NOW accounts | $74,027 | $69 | 0.37 | % | $70,287 | $52 | 0.29 | % |
| Money market accounts | 373,409 | 1,461 | 1.55 | % | 367,265 | 1,030 | 1.11 | % |
| Savings accounts | 35,004 | 14 | 0.16 | % | 36,872 | 12 | 0.13 | % |
| Time deposits | 443,779 | 2,438 | 2.18 | % | 303,246 | 1,035 | 1.35 | % |
| Total interest-bearing deposits | 926,219 | 3,982 | 1.71 | % | 777,670 | 2,129 | 1.09 | % |
| Federal Home Loan Bank advances | 15,000 | 125 | 3.31 | % | 17,719 | 148 | 3.31 | % |
| Subordinated debt | 24,087 | 573 | 9.44 | % | 23,745 | 517 | 8.64 | % |
| Capital lease obligations | 490 | 6 | 4.86 | % | 764 | 9 | 4.67 | % |
| Total interest-bearing liabilities | 965,796 | 4,686 | 1.92 | % | 819,898 | 2,803 | 1.36 | % |
| Non-interest bearing liabilities: | | | | | | | | |
| Demand deposits and escrow accounts | 81,223 | | | | 83,855 | | | |
| Other liabilities | 6,513 | | | | 5,676 | | | |
| Total liabilities | 1,053,532 | | | | 909,429 | | | |
| Shareholders' equity | 145,878 | | | | 128,491 | | | |
| Total liabilities and shareholders' equity | $1,199,410 | | | | $1,037,920 | | | |
| Net interest income | | $15,643 | | | | $12,457 | | |
| Interest rate spread | | | 5.00 | % | | | 4.68 | % |
| Net interest margin (5) | | | 5.33 | % | | | 4.93 | % |

(1) Interest income and

yield are stated on a fully tax-equivalent basis using the statutory tax rate.
(2) Includes loans held for sale.
(3) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.
(4) Short term investments include FHLB overnight deposits and other interest-bearing deposits.

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

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

Three Months Ended
December 31, 2018
Compared to 2017

| | Change Due to Volume | Change Due to Rate | Total Change |
|---|---|---|---|
| | (Dollars in thousands) | | |
| Interest earning assets: | | | |
| Investment securities | $(26) | $184 | $158 |
| Loans | 3,013 | 1,420 | 4,433 |
| Federal Home Loan Bank stock | (2) | 5 | 3 |
| Short-term investments | 86 | 389 | 475 |
| Total interest-earning assets | 3,071 | 1,998 | 5,069 |
| | | | |
| Interest-bearing liabilities: | | | |
| Interest-bearing deposits | 595 | 1,258 | 1,853 |
| Federal Home Loan Bank advances | (23) | - | (23) |
| Subordinated debt | 7 | 49 | 56 |
| Capital lease obligations | (3) | - | (3) |
| Total interest-bearing liabilities | 576 | 1,307 | 1,883 |
| Total change in net interest income | $2,495 | $691 | $3,186 |

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*Six Months Ended December 31, 2018 and 2017*

Net interest and dividend income before provision for loan losses increased by $4.2 million for the quarter ended December 31, 2018, compared to the quarter ended December 31, 2017. The increase was primarily due to higher average balances in the loan portfolio. These increases were partially offset by lower transactional income, higher funding costs and higher average deposit balances.

The following table summarizes interest income and related yields recognized on the loan portfolios:

| | Interest Income and Yield on Loans | | | | | |
|---|---|---|---|---|---|---|
| | Six Months Ended December 31, | | | | | |
| | 2018 | | | 2017 | | |
| | Average Balance (1) | Interest Income | Yield | Average Balance (1) | Interest Income | Yield |
| | (Dollars in thousands) | | | | | |
| Community Banking | $114,342 | $2,970 | 5.15 % | $145,832 | $3,496 | 4.76 % |
| SBA | 72,316 | 2,726 | 7.48 % | 51,499 | 1,756 | 6.76 % |
| LASG: | | | | | | |
| Originated | 409,575 | 15,541 | 7.53 % | 334,507 | 10,831 | 6.42 % |
| Purchased | 305,600 | 15,223 | 9.88 % | 234,928 | 13,800 | 11.65 % |
| Total LASG | 715,175 | 30,764 | 8.53 % | 569,435 | 24,631 | 8.58 % |
| Total | $901,833 | $36,460 | 8.02 % | $766,766 | $29,883 | 7.73 % |

(2) Includes loans held for sale.

The following table details the “Total Return” on purchased loans. When compared to the six months ended December 31, 2017, transactional income for the six months ended December 31, 2018 decreased by $1.1 million. This decrease over the prior comparable period was primarily due to lower accelerated accretion and loan fees in the six months ended December 31, 2018. The total return on purchased loans for the six months ended December 31, 2018 was 9.9%. The following table details the total return on purchased loans:

| Total Return on Purchased Loans | | | |
|---|---|---|---|
| Six Months Ended December 31, | | | |
| 2018 | | 2017 | |
| Income | Return (1) | Income | Return (1) |
| (Dollars in thousands) | | | |

| | | | | |
|---|---|---|---|---|
| Regularly scheduled interest and accretion | $11,621 | 7.54 % | $9,079 | 7.67 % |
| Transactional income: | | | | |
| Gain on loan sales | - | 0.00 % | - | 0.00 % |
| Gain on sale of real estate owned | - | 0.00 % | - | 0.00 % |
| Other noninterest income (expense) | - | 0.00 % | - | 0.00 % |
| Accelerated accretion and loan fees | 3,602 | 2.34 % | 4,721 | 3.98 % |
| Total transactional income | 3,602 | 2.34 % | 4,721 | 3.98 % |
| Total | $15,223 | 9.88 % | $13,800 | 11.65 % |

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

The Company's interest rate spread increased by one basis point and net interest margin increased by 10 basis points for the six months ended December 31, 2018 compared to the six months ended December 31, 2017. The increase was principally due to higher average balances in the loan portfolio, offset by higher deposit rates and average deposit balances, as well as lower transactional income recognized in the six months ended December 31, 2018.

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The following sets forth the average balance sheets, interest income and interest expense, and average yields and costs for the six months ended December 31, 2018 and 2017.

| | Six Months Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2018 | | | 2017 | | |
| | Average Balance | Interest Income/ Expense | Average Yield/ Rate | Average Balance | Interest Income/ Expense | Average Yield/ Rate |
| Assets: | | | | | | |
| Interest-earning assets: | | | | | | |
| Investment securities | $86,599 | $784 | 1.80 % | $94,886 | $533 | 1.11 % |
| Loans (1) (2) (3) | 901,833 | 36,460 | 8.02 % | 766,766 | 29,893 | 7.73 % |
| Federal Home Loan Bank stock | 1,652 | 49 | 5.88 % | 1,899 | 41 | 4.28 % |
| Short-term investments (4) | 170,705 | 1,802 | 2.09 % | 152,830 | 981 | 1.27 % |
| Total interest-earning assets | 1,160,789 | 39,095 | 6.68 % | 1,016,381 | 31,448 | 6.14 % |
| Cash and due from banks | 2,585 | | | 2,933 | | |
| Other non-interest earning assets | 31,289 | | | 32,025 | | |
| Total assets | $1,194,663 | | | $1,051,339 | | |
| Liabilities & Shareholders' Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| NOW accounts | $71,866 | $124 | 0.34 % | $69,931 | $102 | 0.29 % |
| Money market accounts | 389,757 | 3,008 | 1.53 % | 377,449 | 2,127 | 1.12 % |
| Savings accounts | 35,590 | 28 | 0.16 % | 36,953 | 25 | 0.13 % |
| Time deposits | 424,965 | 4,504 | 2.10 % | 307,865 | 2,051 | 1.32 % |
| Total interest-bearing deposits | 922,178 | 7,664 | 1.65 % | 792,198 | 4,305 | 1.08 % |
| Federal Home Loan Bank advances | 15,000 | 242 | 3.20 % | 18,863 | 319 | 3.35 % |
| Subordinated debt | 24,042 | 1,174 | 9.69 % | 23,703 | 1,025 | 8.58 % |
| Capital lease obligations | 525 | 14 | 5.29 % | 797 | 21 | 5.23 % |
| Total interest-bearing liabilities | 961,745 | 9,094 | 1.88 % | 835,561 | 5,670 | 1.35 % |
| Non-interest bearing liabilities: | | | | | | |
| Demand deposits and escrow accounts | 81,615 | | | 82,210 | | |
| Other liabilities | 8,126 | | | 7,071 | | |
| Total liabilities | 1,051,486 | | | 924,842 | | |
| Shareholders' equity | 143,177 | | | 126,497 | | |
| Total liabilities and shareholders' equity | $1,194,663 | | | $1,051,339 | | |
| Net interest income (5) | | $30,001 | | | $25,778 | |
| Interest rate spread | | | 4.80 % | | | 4.79 % |
| Net interest margin (6) | | | 5.13 % | | | 5.03 % |

(1) Interest income and yield are stated on a fully tax-equivalent basis using the statutory tax rate.
(2) Includes loans held for sale.

(3) Nonaccrual loans are included in the computation of average, but unpaid interest has not been included for purposes of determining interest income.
(4) Short term investments include FHLB overnight deposits and other interest-bearing deposits.

(5) Includes tax exempt interest income of $10 thousand for the six months ended December 31, 2017.
(6) Net interest margin is calculated as net interest income divided by total interest-earning assets.

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

| | Six Months Ended December 31, 2018 Compared to 2017 | | |
|---|---|---|---|
| | Change Due to Volume | Change Due to Rate | Total Change |
| | (Dollars in thousands) | | |
| Interest earning assets: | | | |
| Investment securities | $(130) | $381 | $251 |
| Loans | 5,427 | 1,140 | 6,567 |
| Federal Home Loan Bank stock | (14) | 22 | 8 |
| Short-term investments | 126 | 695 | 821 |
| Total interest-earning assets | 5,409 | 2,238 | 7,647 |
| Interest-bearing liabilities: | | | |
| Interest-bearing deposits | 996 | 2,363 | 3,359 |
| Federal Home Loan Bank advances | (63) | (14) | (77) |
| Subordinated debt | 15 | 134 | 149 |
| Capital lease obligations | (8) | 1 | (7) |
| Total interest-bearing liabilities | 940 | 2,484 | 3,424 |
| Total change in net interest income | $4,469 | $(246) | $4,223 |

***Provision for Loan Losses***

Quarterly, the Company determines the amount of the allowance for loan losses that is appropriate to provide for losses inherent in the Company's loan portfolios, with the provision for loan losses determined by the net change in the allowance for loan losses. For loans accounted for under ASC 310-30, a provision for loan loss is recorded when estimates of future cash flows are lower than had been previously expected. See Part I. Item I. "Notes to Unaudited Consolidated Financial Statements — Note 4: Loans, Allowance for Loan Losses and Credit Quality" for further discussion.

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

*Three Months Ended December 31, 2018 and 2017*

The provision for loan losses for the three months ended December 31, 2018 and 2017 was $101 thousand and $437 thousand, respectively. The decrease in the Company's provision for loan losses was primarily due to changes in the composition of the loan portfolio.

*Six Months Ended December 31, 2018 and 2017*

The provision for loan losses for the six months ended December 31, 2018 and 2017 was $633 thousand and $792 thousand, respectively. The decrease in the Company's provision for loan losses was primarily due to changes in the composition of the loan portfolio.

***Noninterest Income***

*Three Months Ended December 31, 2018 and 2017*

Noninterest income increased by $317 thousand for the quarter ended December 31, 2018, compared to the quarter ended December 31, 2017, principally due to the following:

- An increase in gain on sale of SBA loans of $601 thousand, due to larger guarantee balances sold in the quarter; partially offset by,
- A decrease in gain on sale of residential loans of $151 thousand, due to lower volume of residential loans sold in the quarter; and
- A decrease in fees for other services to customers of $135 thousand, due to lower commercial loan servicing fees as a result of the write-off of servicing assets related to SBA loans that paid off during the quarter.

*Six Months Ended December 31, 2018 and 2017*

Noninterest income decreased by $88 thousand for the six months ended December 31, 2018, compared to the six months ended December 31, 2017, principally due to the following:

- A decrease in gain on sale of residential loans of $266 thousand, due to lower volume of residential loans sold in the period; and
- A decrease in fees for other services to customers of $170 thousand, due to lower commercial loan servicing fees as a result of the write-off of servicing assets related to SBA loans that paid off during the quarter.; offset by,
- An increase in gain on sale of SBA loans of $432 thousand, due to a higher volume of SBA guarantees sold.

***Noninterest Expense***

*Three Months Ended December 31, 2018 and 2017*

Noninterest expense increased by $1.3 million for the quarter ended December 31, 2018 compared to the quarter ended December 31, 2017, primarily due to the following:

- An increase in salaries and employee benefits expense of $526 thousand, primarily due to increases in base salary, stock-based compensation expense, incentive compensation, and a decrease in deferred salaries expense;
- An increase in other noninterest expense of $292 thousand, primarily due to a $141 thousand increase in expense related to the quarterly valuation of SBA servicing rights, and increases in travel expense and employee recruitment expense;
- An increase in professional fees of $231 thousand, primarily due to increased legal expense related to the anticipated reorganization and other consulting costs; and
- An increase in loan acquisition and collection expense of $217 thousand, largely driven by increased loan expenses and collection expenses incurred on the increased SBA and purchased loan activity during the quarter.

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*Six Months Ended December 31, 2018 and 2017*

Noninterest expense increased by $2.0 million for the six months ended December 31, 2018, compared to the six months ended December 31, 2017, primarily due to the following:

- An increase in salaries and employee benefits expense of $781 thousand, primarily due to increases in incentive compensation and stock-based compensation expense;
- An increase in other noninterest expense of $459 thousand, primarily due to the quarterly valuation of SBA servicing rights;
- An increase in professional fees of $323 thousand, primarily due to increased legal expense related to the anticipated reorganization and other consulting costs; and
- An increase in loan acquisition and collection expense of $291 thousand, largely driven by increased loan expenses and collection expenses incurred on the increased SBA and purchased loan activity during the period.

***Income Taxes***

*Three Months Ended December 31, 2018 and 2017*

Income tax expense increased by $678 thousand to $2.1 million, or an effective tax rate of 28.7%, for the quarter ended December 31, 2018, compared to $1.4 million, or an effective tax rate of 29.5%, for the quarter ended December 31, 2017. The increase in expense was primarily due to the increase in earnings. The decrease in the effective tax rate was primarily d