

MERCANTILE BANK CORP

Form 10-Q

November 08, 2011

[Table of Contents](#)

# U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

## FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from            to            .

Commission File No. 000-26719

## MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

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

**38-3360865**  
(IRS Employer Identification No.)

**310 Leonard Street, NW, Grand Rapids, MI 49504**

(Address of principal executive offices) (Zip Code)

**(616) 406-3000**

(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 subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

At November 8, 2011, there were 8,604,906 shares of Common Stock outstanding.

**Table of Contents**

MERCANTILE BANK CORPORATION

INDEX

	Page No.
PART I. <u>Financial Information</u>	
Item 1. Financial Statements	
<u>Consolidated Balance Sheets -</u> <u>September 30, 2011 (Unaudited) and December 31, 2010</u>	1
<u>Consolidated Statements of Operations -</u> <u>Three and Nine Months Ended September 30, 2011 (Unaudited) and September 30, 2010 (Unaudited)</u>	2
<u>Consolidated Statements of Changes in Shareholders' Equity -</u> <u>Nine Months Ended September 30, 2011 (Unaudited) and September 30, 2010 (Unaudited)</u>	4
<u>Consolidated Statements of Cash Flows -</u> <u>Nine Months Ended September 30, 2011 (Unaudited) and September 30, 2010 (Unaudited)</u>	6
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	8
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	44
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	64
<u>Item 4. Controls and Procedures</u>	67
PART II. <u>Other Information</u>	
<u>Item 1. Legal Proceedings</u>	68
<u>Item 1A. Risk Factors</u>	68
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	68
<u>Item 3. Defaults Upon Senior Securities</u>	69
<u>Item 4. Reserved</u>	69
<u>Item 5. Other Information</u>	69
<u>Item 6. Exhibits</u>	69
<u>Signatures</u>	71

**Table of Contents**

## MERCANTILE BANK CORPORATION

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## CONSOLIDATED BALANCE SHEETS

	September 30, 2011 (Unaudited)	December 31, 2010 (Audited)
<b>ASSETS</b>		
Cash and due from banks	\$ 18,890,000	\$ 6,674,000
Interest-bearing deposit balances	9,630,000	9,600,000
Federal funds sold	97,183,000	47,924,000
Total cash and cash equivalents	125,703,000	64,198,000
Securities available for sale	173,134,000	220,830,000
Federal Home Loan Bank stock	11,961,000	14,345,000
Loans	1,094,037,000	1,262,630,000
Allowance for loan losses	(39,351,000)	(45,368,000)
Loans, net	1,054,686,000	1,217,262,000
Premises and equipment, net	26,865,000	27,873,000
Bank owned life insurance	48,083,000	46,743,000
Accrued interest receivable	4,887,000	5,942,000
Other real estate owned and repossessed assets	17,287,000	16,675,000
Other assets	15,379,000	18,553,000
Total assets	\$ 1,477,985,000	\$ 1,632,421,000
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest-bearing	\$ 144,022,000	\$ 112,944,000
Interest-bearing	1,041,311,000	1,160,888,000
Total deposits	1,185,333,000	1,273,832,000
Securities sold under agreements to repurchase	69,340,000	116,979,000
Federal Home Loan Bank advances	45,000,000	65,000,000
Subordinated debentures	32,990,000	32,990,000
Other borrowed money	1,714,000	11,804,000
Accrued interest and other liabilities	6,875,000	5,880,000
Total liabilities	1,341,252,000	1,506,485,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; 21,000 shares outstanding at September 30, 2011 and December 31, 2010	20,266,000	20,077,000
	172,834,000	172,677,000

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

Common stock, no par value; 20,000,000 shares authorized; 8,605,053 shares outstanding at September 30, 2011 and 8,597,993 shares outstanding at December 31, 2010

Common stock warrant	1,138,000	1,138,000
Retained earnings (deficit)	(62,630,000)	(68,781,000)
Accumulated other comprehensive income	5,125,000	825,000
 Total shareholders' equity	 136,733,000	 125,936,000
 Total liabilities and shareholders' equity	 \$ 1,477,985,000	 \$ 1,632,421,000

See accompanying notes to consolidated financial statements.

1.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended Sept 30, 2011 (Unaudited)	Three Months Ended Sept 30, 2010 (Unaudited)	Nine Months Ended Sept 30, 2011 (Unaudited)	Nine Months Ended Sept 30, 2010 (Unaudited)
<b>Interest income</b>				
Loans, including fees	\$ 14,951,000	\$ 19,284,000	\$ 47,854,000	\$ 59,755,000
Securities, taxable	1,588,000	1,901,000	5,285,000	5,923,000
Securities, tax-exempt	439,000	497,000	1,368,000	1,802,000
Federal funds sold	60,000	41,000	138,000	110,000
Interest-bearing deposit balances	6,000	11,000	18,000	29,000
<b>Total interest income</b>	<b>17,044,000</b>	<b>21,734,000</b>	<b>54,663,000</b>	<b>67,619,000</b>
<b>Interest expense</b>				
Deposits	4,040,000	5,636,000	13,007,000	18,125,000
Short-term borrowings	73,000	394,000	350,000	1,091,000
Federal Home Loan Bank advances	410,000	1,441,000	1,622,000	4,713,000
Other borrowings	226,000	328,000	782,000	1,029,000
<b>Total interest expense</b>	<b>4,749,000</b>	<b>7,799,000</b>	<b>15,761,000</b>	<b>24,958,000</b>
<b>Net interest income</b>	<b>12,295,000</b>	<b>13,935,000</b>	<b>38,902,000</b>	<b>42,661,000</b>
Provision for loan losses	1,100,000	10,400,000	5,000,000	25,000,000
<b>Net interest income after provision for loan losses</b>	<b>11,195,000</b>	<b>3,535,000</b>	<b>33,902,000</b>	<b>17,661,000</b>
<b>Noninterest income</b>				
Services charges on accounts	405,000	452,000	1,228,000	1,365,000
Earnings on bank owned life insurance	452,000	445,000	1,340,000	1,310,000
Rental income from other real estate owned	208,000	362,000	599,000	1,153,000
Mortgage banking activities	195,000	346,000	453,000	576,000
Net gain on sales of securities	0	0	0	476,000
Gain on sales of commercial loans	0	99,000	0	324,000
Other income	544,000	585,000	1,639,000	1,736,000
<b>Total noninterest income</b>	<b>1,804,000</b>	<b>2,289,000</b>	<b>5,259,000</b>	<b>6,940,000</b>
<b>Noninterest expense</b>				
Salaries and benefits	4,636,000	4,649,000	13,371,000	13,874,000
Occupancy	707,000	696,000	2,116,000	2,169,000
Furniture and equipment depreciation, rent and maintenance	305,000	358,000	912,000	1,163,000
Nonperforming asset costs	1,589,000	2,895,000	6,637,000	7,859,000
FDIC insurance costs	639,000	1,097,000	2,274,000	3,450,000
Other expense	2,099,000	2,204,000	6,689,000	6,459,000
<b>Total noninterest expenses</b>	<b>9,975,000</b>	<b>11,899,000</b>	<b>31,999,000</b>	<b>34,974,000</b>

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

<b>Income (loss) before federal income tax expense (benefit)</b>	3,024,000	(6,075,000)	7,162,000	(10,373,000)
Federal income tax expense (benefit)	0	(718,000)	0	(2,010,000)
Net income (loss)	3,024,000	(5,357,000)	7,162,000	(8,363,000)
Preferred stock dividends and accretion	342,000	325,000	1,011,000	966,000
<b>Net income (loss) available to common shareholders</b>	<b>\$ 2,682,000</b>	<b>\$ (5,682,000)</b>	<b>\$ 6,151,000</b>	<b>\$ (9,329,000)</b>

See accompanying notes to consolidated financial statements.

2.

**Table of Contents**

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)

(Unaudited)

	Three Months Ended Sept 30, 2011 (Unaudited)	Three Months Ended Sept 30, 2010 (Unaudited)	Nine Months Ended Sept 30, 2011 (Unaudited)	Nine Months Ended Sept 30, 2010 (Unaudited)
Basic earnings (loss) per share	\$ 0.31	\$ (0.67)	\$ 0.72	\$ (1.10)
Diluted earnings (loss) per share	\$ 0.30	\$ (0.67)	\$ 0.69	\$ (1.10)
Cash dividends per share	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.01
Average basic shares outstanding	8,604,263	8,507,174	8,602,654	8,504,664
Average diluted shares outstanding	8,868,122	8,507,174	8,875,025	8,504,664

See accompanying notes to consolidated financial statements.

3.



**Table of Contents**

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

(\$ in thousands)	Preferred Stock	Common Stock	Common Stock Warrant	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balances, January 1, 2011</b>	\$ 20,077	\$ 172,677	\$ 1,138	\$ (68,781)	\$ 825	\$ 125,936
Accretion of preferred stock	189			(189)		0
Employee stock purchase plan (3,531 shares)		30				30
Stock option exercises (8,800 shares)		55				55
Dividend reinvestment plan (644 shares)		6				6
Stock-based compensation expense		66				66
Preferred stock dividends				(822)		(822)
Comprehensive income (loss):						
Net income for the period from January 1, 2011 through September 30, 2011				7,162		7,162
Change in net unrealized gain on securities available for sale, net of reclassifications					4,300	4,300
<b>Total comprehensive income</b>						<b>11,462</b>
<b>Balances, September 30, 2011</b>	\$ 20,266	\$ 172,834	\$ 1,138	\$ (62,630)	\$ 5,125	\$ 136,733

See accompanying notes to consolidated financial statements.

**Table of Contents**

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

(\$ in thousands)	Preferred Stock	Common Stock	Common Stock Warrant	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balances, January 1, 2010</b>	\$ 19,839	\$ 172,438	\$ 1,138	\$ (54,170)	\$ 859	\$ 140,104
Accretion of preferred stock	177			(177)		0
Employee stock purchase plan (7,702 shares)		35				35
Dividend reinvestment plan (687 shares)		2				2
Stock-based compensation expense		378				378
Cash dividends (\$0.01 per common share)		(85)				(85)
Preferred stock dividends				(790)		(790)
Comprehensive income (loss):						
Net loss for the period from January 1, 2010 through September 30, 2010				(8,363)		(8,363)
Change in net unrealized gain on securities available for sale, net of reclassifications and tax effect					3,243	3,243
Net unrealized gain on securities transferred from held to maturity to available for sale, net of tax effect					274	274
Reclassification of unrealized gain on interest rate swaps, net of tax effect					(64)	(64)
<b>Total comprehensive loss</b>						(4,910)
<b>Balances, September 30, 2010</b>	\$ 20,016	\$ 172,768	\$ 1,138	\$ (63,500)	\$ 4,312	\$ 134,734

See accompanying notes to consolidated financial statements.

**Table of Contents**

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended Sept 30, 2011	Nine Months Ended Sept 30, 2010
<b>Cash flows from operating activities</b>		
Net income (loss)	\$ 7,162,000	\$ (8,363,000)
Adjustments to reconcile net income (loss) to net cash from operating activities		
Depreciation and amortization	1,694,000	1,875,000
Provision for loan losses	5,000,000	25,000,000
Stock-based compensation expense	66,000	378,000
Proceeds from sales of mortgage loans held for sale	29,603,000	35,800,000
Origination of mortgage loans held for sale	(31,349,000)	(38,878,000)
Net gain from sales of mortgage loans held for sale	(338,000)	(425,000)
Gain from sale of commercial loans	0	(324,000)
Net gain from sale of held to maturity securities	0	(476,000)
Net loss from sale and valuation write-down of foreclosed assets	1,318,000	3,067,000
Recognition of unrealized gain on interest rate swaps	0	(99,000)
Earnings on bank owned life insurance	(1,340,000)	(1,310,000)
Net change in:		
Accrued interest receivable	1,055,000	945,000
Other assets	2,599,000	899,000
Accrued expenses and other liabilities	173,000	(1,784,000)
Net cash from operating activities	15,643,000	16,305,000
<b>Cash flows from investing activities</b>		
Loan originations and payments, net	149,809,000	170,466,000
Purchases of:		
Securities available for sale	(3,072,000)	(71,526,000)
Proceeds from:		
Maturities, calls and repayments of available for sale securities	55,179,000	84,491,000
Sales of held to maturity securities	0	20,452,000
Redemption of Federal Home Loan Bank stock	2,384,000	0
Proceeds from sales of commercial loans	0	7,395,000
Proceeds from sales of foreclosed assets	7,921,000	9,271,000
Purchases of premises and equipment, net	(222,000)	(84,000)
Net cash from investing activities	211,999,000	220,465,000
<b>Cash flows from financing activities</b>		
Net decrease in time deposits	(133,202,000)	(190,595,000)
Net increase in all other deposits	44,703,000	140,832,000
Net increase (decrease) in securities sold under agreements to repurchase	(47,639,000)	16,486,000
Net decrease in federal funds purchased	0	(2,600,000)
Maturities and prepayments of Federal Home Loan Bank advances	(20,000,000)	(45,000,000)
Maturities of wholesale repurchase agreements	(10,000,000)	(5,000,000)
Net decrease in other borrowed money	(90,000)	(59,000)

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

Proceeds from stock option exercises	55,000	0
Employee stock purchase plan	30,000	35,000
Dividend reinvestment plan	6,000	2,000
Payment of cash dividends on preferred stock	0	(525,000)
Payment of cash dividends on common shares	0	(85,000)
<b>Net cash for financing activities</b>	<b>(166,137,000)</b>	<b>(86,509,000)</b>

See accompanying notes to consolidated financial statements.

6.

**Table of Contents**

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Nine Months Ended Sept 30, 2011	Nine Months Ended Sept 30, 2010
Net change in cash and cash equivalents	61,505,000	150,261,000
Cash and cash equivalents at beginning of period	64,198,000	21,735,000
Cash and cash equivalents at end of period	\$ 125,703,000	\$ 171,996,000
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Interest	\$ 15,503,000	\$ 26,741,000
Federal income tax	0	0
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	9,851,000	7,626,000
Preferred stock cash dividend accrued	1,488,000	398,000

See accompanying notes to consolidated financial statements.

7.

---

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation:** The unaudited financial statements for the nine months ended September 30, 2011 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ( our bank ) and our bank s three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ), and Mercantile Insurance Center, Inc. ( our insurance center ). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended September 30, 2011 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2010.

We formed a business trust, Mercantile Bank Capital Trust I ( the trust ), in 2004 to issue trust preferred securities. We issued subordinated debentures to the trust in return for the proceeds raised from the issuance of the trust preferred securities. The trust is not consolidated, but instead we report the subordinated debentures issued to the trust as a liability.

**Earnings Per Share:** Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and our common stock warrant, and are determined using the treasury stock method. Our unvested restricted shares, which contain non-forfeitable rights to dividends whether paid or accrued (i.e., participating securities), are included in the number of shares outstanding for both basic and diluted earnings per share calculations. In the event of a net loss, our unvested restricted shares are excluded from the calculation of both basic and diluted earnings per share.

Approximately 70,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2011. In addition, stock options and a stock warrant for approximately 48,000 and 616,000 shares of common stock, respectively, were included in determining diluted earnings per share for the three and nine months ended September 30, 2011. Stock options for approximately 197,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2011.

Due to our net loss for the 2010 periods, approximately 87,000 unvested restricted shares were not included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2010. In addition, stock options and a stock warrant for approximately 283,000 and 616,000 shares of common stock, respectively, were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2010. Weighted average diluted common shares outstanding equals the weighted average common shares outstanding during the three and nine months ended September 30, 2010 due to the net loss recorded during those time periods.

(Continued)

---

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

**Allowance for Loan Losses:** The allowance for loan losses ( allowance ) is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when we believe the uncollectability of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged-off.

A loan is impaired when, based on current information and events, it is probable we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. We determine 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 delay, the reasons for delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. We do not separately identify individual residential and consumer loans for impairment disclosures.

**Troubled Debt Restructurings:** A loan is accounted for as a troubled debt restructuring if we, for economic or legal reasons, grant a concession to a borrower considered to be experiencing financial difficulties that we would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan, or a modification of terms such as a reduction of the stated interest rate or balance of the loan, a reduction of accrued interest, an extension of the maturity date or renewal of the loan at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans. Accruing troubled debt restructurings are generally excluded from nonperforming loans as it is considered probable that all contractual principal and interest due under the restructured terms will be collected.

In accordance with current accounting guidance, loans modified as troubled debt restructurings are, by definition, considered to be impaired loans. Impairment for these loans is measured on a loan-by-loan basis similar to other impaired loans as described above under Allowance for Loan Losses. Certain loans modified as troubled debt restructurings may have been previously measured for impairment under a general allowance methodology (i.e., pooling), thus at the time the loan is modified as a troubled debt restructuring the allowance will be impacted by the difference between the results of these two measurement methodologies. Loans modified as troubled debt restructurings that subsequently default are factored into the determination of the allowance in the same manner as other defaulted loans.

(Continued)

9.



**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

**Derivatives:** Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Used as part of our asset and liability management to help manage interest rate risk, our derivatives have historically consisted of interest rate swap agreements that qualified for hedge accounting. In June 2011, we simultaneously purchased and sold an interest rate cap, a structure commonly referred to as a "cap corridor", which does not qualify for hedge accounting. We do not use derivatives for trading purposes.

Changes in the fair value of derivatives that are designated, for accounting purposes, as a hedge of the variability of cash flows to be received on various loans and are effective are reported in other comprehensive income. They are later reclassified into earnings in the same periods during which the hedged transaction affects earnings and are included in the line item in which the hedged cash flows are recorded. If hedge accounting does not apply, changes in the fair value of derivatives are recognized immediately in current earnings as interest income or expense.

If designated as a hedge, we formally document the relationship between derivatives as hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions. This documentation includes linking cash flow hedges to specific assets on the balance sheet. If designated as a hedge, we also formally assess, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in cash flows of the hedged items. Ineffective hedge gains and losses are recognized immediately in current earnings as noninterest income or expense. We discontinue hedge accounting when we determine the derivative is no longer effective in offsetting changes in the cash flows of the hedged item, the derivative is settled or terminates, or treatment of the derivatives as a hedge is no longer appropriate or intended.

**Adoption of New Accounting Standards:** In January 2010, the Financial Accounting Standards Board (FASB) issued ASU 2010-06, *Improving Disclosure about Fair Value Measurements*. This ASU requires new disclosures on the amount and reason for transfers in and out of Level 1 and Level 2 recurring fair value measurements. The ASU also requires disclosure of activities (i.e., on a gross basis), including purchases, sales, issuances, and settlements, in the reconciliation of Level 3 recurring fair value measurements. The ASU clarifies existing disclosure requirements on levels of disaggregation and disclosures about inputs and valuation techniques. The new disclosure regarding Level 1 and Level 2 recurring fair value measurements and clarification of existing disclosures were effective beginning January 1, 2010. Upon adoption of those portions of the ASU in our 2010 first quarter, we began providing the required disclosures as currently presented in Note 11. The disclosures about the reconciliation of information in Level 3 recurring fair value measurements were required beginning January 1, 2011. There was no effect on our fair value disclosures presented in Note 11 upon adoption of the final portion of the ASU in our 2011 first quarter, as we currently have no Level 3 recurring fair value measurements.

(Continued)

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

In July 2010, the FASB issued ASU 2010-20, *Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. In order to provide greater transparency, this ASU requires significant new disclosures on a disaggregated basis about the allowance for credit losses (i.e., allowance for loan losses for banks) and the credit quality of financing receivables (i.e., loans for banks). Under the ASU, a rollforward schedule of the allowance for loan losses, with the ending allowance balance further disaggregated on the basis of the impairment method, along with the related ending loan balance and significant purchases and sales of loans during the period are to be disclosed by portfolio segment. Additional disclosures are required by class of loan, including credit quality, aging of past due loans, nonaccrual status and impairment information. Disclosure of the nature and extent of troubled debt restructurings ( TDR ) that occurred during the period and their effect on the allowance for loan losses as well as the effect on the allowance of TDRs that occurred within the prior twelve months and that defaulted during the current reporting period will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the loan portfolio's risk and performance. The majority of disclosures required as of the end of a reporting period were effective as of December 31, 2010. Upon adoption of those portions of the ASU on December 31, 2010, we began providing the required end of period disclosures as currently presented in Note 3. The disclosures about activity were effective January 1, 2011. Upon adoption of the final portion of the ASU in our 2011 first quarter, we began providing the required activity disclosures, with the exception of the new TDR related disclosures, as currently presented in Note 3. In January 2011, the FASB issued ASU 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, which temporarily deferred the effective date for disclosures related to TDRs. Beginning with the 2011 third quarter, we began providing the required TDR disclosures as presented in Note 3.

(Continued)

11.

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

In April 2011, the FASB issued ASU 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, to clarify when a loan modification or restructuring is considered a TDR. When performing this evaluation under the ASU, a creditor must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty, and (2) the lender has granted a concession to the borrower. The ASU amends current guidance to include indicators that a lender should consider in determining whether a borrower is experiencing financial difficulties. It further clarifies that a borrower could be experiencing financial difficulty even if it is not currently in default but default is probable in the foreseeable future. With respect to whether the lender has granted a concession to the borrower, the ASU indicates (1) a borrower's inability to access funds at a market interest rate for debt with similar risk characteristics as the restructured debt indicates that the modification was executed at a below-market rate and therefore may indicate a concession was granted, (2) a modification that permanently or temporarily increases a loan's contractual interest rate does not preclude it from being considered a concession because the rate may still be below the market interest rate for new debt with similar risk characteristics, and (3) a modification that results in a delay in payment that is insignificant is not considered to be a concession. The ASU also clarifies that a creditor is precluded from using the borrower's effective interest rate test when performing this evaluation. For TDR identification and disclosure purposes, the guidance became effective for our 2011 third quarter and was applied retrospectively to modifications occurring on or after January 1, 2011 that remained outstanding at September 30, 2011. The effect of the change in the method of calculating impairment was reflected in our 2011 third quarter. The ASU requires disclosure of the total recorded investment and allowance for loan losses for newly identified TDRs, based on the new guidance, as of September 30, 2011. Beginning in our 2011 third quarter, we disclosed the previously deferred TDR activity related disclosures required by ASU 2010-20 in Note 3.

In April 2011, the FASB issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*, to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets on substantially the agreed upon terms. This ASU eliminates consideration of the transferor's ability to fulfill its contractual rights and obligations from the criteria, as well as related implementation guidance (i.e., that it possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets), in determining effective control, even in the event of default by the transferee. Other criteria applicable to the assessment of effective control are not changed by this new guidance. This ASU is effective January 1, 2012. We do not expect the adoption of this new ASU to have a material effect on our results of operations or financial position.

(Continued)

12.

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES** (Continued)

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, to align the fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs). Many of the amendments in this ASU will not result in a change in requirements but simply clarify existing requirements. The amendments in this ASU that do not change a principle or requirement for measuring fair value or disclosing information about fair value measurements include the following: (1) the ASU permits an exception for measuring fair value when a reporting entity manages its financial instruments on the basis of its net exposure, rather than gross exposure, to those risks; (2) the ASU clarifies that the application of premiums and discounts in a fair value measurement is related to the unit of account for the asset or liability being measured at fair value and specifically prohibits blockage discounts for Level 2 and 3 investments; and (3) the amendments expand fair value measurement disclosures. The more significant new disclosures include: (1) for all Level 3 fair value measurements, quantitative information about significant unobservable inputs used as well as a qualitative discussion about the sensitivity of recurring Level 3 fair value measurements; (2) transfers between Level 1 and Level 2 fair value measurements on a gross basis, including the reasons for those transfers; and (3) the categorization by level of the fair value hierarchy for items that are not measured at fair value in the balance sheet but for which the fair value is required to be disclosed (e.g., held-to-maturity securities and loans). The ASU is to be applied prospectively and is effective January 1, 2012. We do not expect the adoption of this new ASU to have a material effect on our results of operations or financial position.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income*, to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The ASU eliminates the option to present components of other comprehensive income as part of the Statement of Changes in Shareholders' Equity. Instead, all changes in shareholders' equity must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the single continuous statement approach, the statement should present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present the components of net income and total net income followed consecutively by a second statement that should present the components of other comprehensive income, a total for other comprehensive income and a total for comprehensive income. Also known as recycling, companies will also be required to display reclassification adjustments and their effect on net income and other comprehensive income in the statement(s) in which they appear. The ASU does not change certain other current requirements including items that constitute net income and other comprehensive income. The ASU is to be applied retrospectively and is effective January 1, 2012. We are currently evaluating the two presentation approaches permitted by the ASU. On October 21, 2011, the FASB decided to defer the above-described presentation of reclassification adjustments until further consideration.

(Continued)

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES**

The amortized cost and fair value of available for sale securities and the related pre-tax gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b><u>September 30, 2011</u></b>				
U.S. Government agency debt obligations	\$ 82,452,000	\$ 2,136,000	\$ (76,000)	\$ 84,512,000
Mortgage-backed securities	35,235,000	3,232,000	0	38,467,000
Michigan Strategic Fund bonds	16,955,000	0	0	16,955,000
Municipal general obligation bonds	26,614,000	848,000	(4,000)	27,458,000
Municipal revenue bonds	4,301,000	98,000	0	4,399,000
Mutual funds	1,294,000	49,000	0	1,343,000
	\$ 166,851,000	\$ 6,363,000	\$ (80,000)	\$ 173,134,000
<b><u>December 31, 2010</u></b>				
U.S. Government agency debt obligations	\$ 121,633,000	\$ 1,704,000	\$ (1,775,000)	\$ 121,562,000
Mortgage-backed securities	44,340,000	2,601,000	0	46,941,000
Michigan Strategic Fund bonds	18,175,000	0	0	18,175,000
Municipal general obligation bonds	28,594,000	227,000	(779,000)	28,042,000
Municipal revenue bonds	4,841,000	46,000	(44,000)	4,843,000
Mutual funds	1,264,000	3,000	0	1,267,000
	\$ 218,847,000	\$ 4,581,000	\$ (2,598,000)	\$ 220,830,000

(Continued)

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES (Continued)**

Securities with unrealized losses at September 30, 2011 and December 31, 2010, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months Fair Value	Unrealized Loss	12 Months or More Fair Value	Unrealized Loss	Fair Value	Total Unrealized Loss
<b><u>September 30, 2011</u></b>						
U.S. Government agency debt obligations	\$ 12,585,000	\$ (76,000)	\$ 0	\$ 0	\$ 12,585,000	\$ (76,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Municipal general obligation bonds	0	0	589,000	(4,000)	589,000	(4,000)
Municipal revenue bonds	0	0	0	0	0	0
Mutual funds	0	0	0	0	0	0
	\$ 12,585,000	\$ (76,000)	\$ 589,000	\$ (4,000)	\$ 13,174,000	\$ (80,000)
<b><u>December 31, 2010</u></b>						
U.S. Government agency debt obligations	\$ 56,588,000	\$ (1,775,000)	\$ 0	\$ 0	\$ 56,588,000	\$ (1,775,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Municipal general obligation bonds	7,847,000	(299,000)	6,497,000	(480,000)	14,344,000	(779,000)
Municipal revenue bonds	811,000	(25,000)	805,000	(19,000)	1,616,000	(44,000)
Mutual funds	0	0	0	0	0	0
	\$ 65,246,000	\$ (2,099,000)	\$ 7,302,000	\$ (499,000)	\$ 72,548,000	\$ (2,598,000)

(Continued)

---

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES** (Continued)

We evaluate securities for other-than-temporary impairment at least on a quarterly basis. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability we have to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. For those debt securities whose fair value is less than their amortized cost basis, we also consider our intent to sell the security, whether it is more likely than not that we will be required to sell the security before recovery and if we do not expect to recover the entire amortized cost basis of the security. In analyzing an issuer's financial condition, we may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred and the results of reviews of the issuer's financial condition.

At September 30, 2011, 10 debt securities with a fair value totaling \$13.2 million have unrealized losses with aggregate depreciation of \$0.1 million, or 0.04% from the amortized cost basis of total securities. At September 30, 2011, 232 debt securities and a mutual fund with a fair value totaling \$142.0 million have unrealized gains with aggregate appreciation of \$6.4 million, or 3.8% from the amortized cost basis of total securities. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no declines are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at September 30, 2011, by contractual maturity, are shown below. The contractual maturity is utilized below for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

(Continued)

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES** (Continued)

The maturities of securities and their weighted average yields at September 30, 2011 are also shown in the following table. The yields for municipal securities are included at their tax equivalent yield.

	Weighted Average Yield	Amortized Cost	Fair Value
Due in 2011	NA	\$ 0	\$ 0
Due in 2012 through 2016	5.09%	6,589,000	6,952,000
Due in 2017 through 2021	4.43	18,505,000	18,859,000
Due in 2022 and beyond	4.75	88,273,000	90,558,000
Mortgage-backed securities	5.14	35,235,000	38,467,000
Michigan Strategic Fund bonds	2.88	16,955,000	16,955,000
Mutual funds	2.94	1,294,000	1,343,000
	4.61%	\$ 166,851,000	\$ 173,134,000

At September 30, 2011, and December 31, 2010, the amortized cost of securities issued by the State of Michigan and all its political subdivisions totaled \$30.9 million and \$33.4 million, respectively, with an estimated market value of \$31.9 million and \$32.9 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements and letters of credit issued on behalf of our customers was \$94.4 million and \$166.9 million at September 30, 2011 and December 31, 2010, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

(Continued)



**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES**

Our total loans at September 30, 2011 were \$1.09 billion compared to \$1.26 billion at December 31, 2010, a decrease of \$168.6 million, or 13.4%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at September 30, 2011 and December 31, 2010, and the percentage change in loans from the end of 2010 to the end of the third quarter of 2011, are as follows:

	September 30, 2011		December 31, 2010		Percent Increase (Decrease)
	Balance	%	Balance	%	
<b>Commercial:</b>					
Commercial and industrial	\$ 262,972,000	24.0%	\$ 288,515,000	22.8%	(8.9)%
Vacant land, land development, and residential construction	64,039,000	5.9	83,786,000	6.6	(23.6)
Real estate owner occupied	266,749,000	24.4	277,377,000	22.0	(3.8)
Real estate non-owner occupied	348,929,000	31.9	449,104,000	35.6	(22.3)
Real estate multi-family and residential rental	70,284,000	6.4	77,188,000	6.1	(8.9)
<b>Total commercial</b>	<b>1,012,973,000</b>	<b>92.6</b>	<b>1,175,970,000</b>	<b>93.1</b>	<b>(13.9)</b>
<b>Retail:</b>					
Home equity and other	44,751,000	4.1	51,186,000	4.1	(12.6)
1-4 family mortgages	36,313,000	3.3	35,474,000	2.8	2.4
<b>Total retail</b>	<b>81,064,000</b>	<b>7.4</b>	<b>86,660,000</b>	<b>6.9</b>	<b>(6.5)</b>
<b>Total loans</b>	<b>\$ 1,094,037,000</b>	<b>100.0%</b>	<b>\$ 1,262,630,000</b>	<b>100.0%</b>	<b>(13.4)%</b>

Nonperforming loans as of September 30, 2011 and December 31, 2010 were as follows:

	September 30, 2011	December 31, 2010
Loans past due 90 days or more still accruing interest	\$ 0	\$ 766,000
Nonaccrual loans, including troubled debt restructurings	39,540,000	63,915,000
Troubled debt restructurings, accruing interest	0	4,763,000
<b>Total nonperforming loans</b>	<b>\$ 39,540,000</b>	<b>\$ 69,444,000</b>

As discussed in the Troubled Debt Restructurings section of our Significant Accounting Policies, troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans whereas accruing troubled debt restructurings are generally excluded from nonperforming loans. At September 30, 2011, there were no accruing troubled debt restructurings included in nonperforming loans. At December 31, 2010, we categorized an accruing troubled debt restructured lending relationship as

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

nonperforming due to certain circumstances surrounding this particular relationship. That credit relationship has been paid-off.

(Continued)

18.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

The recorded principal balance of nonaccrual loans, including troubled debt restructurings, was as follows:

	September 30, 2011	December 31, 2010
<b>Commercial:</b>		
Commercial and industrial	\$ 6,755,000	\$ 10,128,000
Vacant land, land development, and residential construction	3,108,000	12,441,000
Real estate owner occupied	7,093,000	10,172,000
Real estate non-owner occupied	16,206,000	22,609,000
Real estate multi-family and residential rental	3,048,000	4,686,000
<b>Total commercial</b>	<b>36,210,000</b>	<b>60,036,000</b>
<b>Retail:</b>		
Home equity and other	1,630,000	2,425,000
1-4 family mortgages	1,700,000	1,454,000
<b>Total retail</b>	<b>3,330,000</b>	<b>3,879,000</b>
<b>Total nonaccrual loans</b>	<b>\$ 39,540,000</b>	<b>\$ 63,915,000</b>

(Continued)

19.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

An age analysis of past due loans is as follows as of September 30, 2011:

	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
<b>Commercial:</b>							
Commercial and industrial	\$ 258,000	\$ 100,000	\$ 2,937,000	\$ 3,295,000	\$ 259,677,000	\$ 262,972,000	\$ 0
Vacant land, land development, and residential construction	0	0	2,305,000	2,305,000	61,734,000	64,039,000	0
Real estate owner occupied	141,000	0	3,127,000	3,268,000	263,481,000	266,749,000	0
Real estate non-owner occupied	1,246,000	0	10,586,000	11,832,000	337,097,000	348,929,000	0
Real estate multi-family and residential rental	166,000	0	1,149,000	1,315,000	68,969,000	70,284,000	0
<b>Total commercial</b>	<b>1,811,000</b>	<b>100,000</b>	<b>20,104,000</b>	<b>22,015,000</b>	<b>990,958,000</b>	<b>1,012,973,000</b>	<b>0</b>
<b>Retail:</b>							
Home equity and other	94,000	0	783,000	877,000	43,874,000	44,751,000	0
1-4 family mortgages	0	222,000	650,000	872,000	35,441,000	36,313,000	0
<b>Total retail</b>	<b>94,000</b>	<b>222,000</b>	<b>1,433,000</b>	<b>1,749,000</b>	<b>79,315,000</b>	<b>81,064,000</b>	<b>0</b>
<b>Total past due loans</b>	<b>\$ 1,905,000</b>	<b>\$ 322,000</b>	<b>\$ 21,537,000</b>	<b>\$ 23,764,000</b>	<b>\$ 1,070,273,000</b>	<b>\$ 1,094,037,000</b>	<b>\$ 0</b>

(Continued)

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

An age analysis of past due loans is as follows as of December 31, 2010:

	30 59 Days Past Due	60 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	\$ 280,000	\$ 2,074,000	\$ 1,474,000	\$ 3,828,000	\$ 284,687,000	\$ 288,515,000	\$ 19,000
Vacant land, land development, and residential construction	0	453,000	3,586,000	4,039,000	79,747,000	83,786,000	0
Real estate owner occupied	1,194,000	574,000	6,497,000	8,265,000	269,112,000	277,377,000	0
Real estate non-owner occupied	164,000	4,341,000	12,520,000	17,025,000	432,079,000	449,104,000	747,000
Real estate multi-family and residential rental	672,000	0	2,692,000	3,364,000	73,824,000	77,188,000	0
Total commercial	2,310,000	7,442,000	26,769,000	36,521,000	1,139,449,000	1,175,970,000	766,000
Retail:							
Home equity and other	1,024,000	179,000	227,000	1,430,000	49,756,000	51,186,000	0
1-4 family mortgages	365,000	0	316,000	681,000	34,793,000	35,474,000	0
Total retail	1,389,000	179,000	543,000	2,111,000	84,549,000	86,660,000	0
Total past due loans	\$ 3,699,000	\$ 7,621,000	\$ 27,312,000	\$ 38,632,000	\$ 1,223,998,000	\$ 1,262,630,000	\$ 766,000

(Continued)

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Impaired loans were as follows as of September 30, 2011:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Third Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:					
Commercial:					
Commercial and industrial	\$ 1,403,000	\$ 1,274,000		\$ 1,353,000	\$ 1,704,000
Vacant land, land development and residential construction	5,493,000	2,703,000		2,278,000	6,387,000
Real estate owner occupied	5,437,000	3,547,000		4,071,000	4,233,000
Real estate non-owner occupied	14,652,000	8,836,000		9,286,000	12,306,000
Real estate multi-family and residential rental	1,681,000	905,000		1,579,000	979,000
Total commercial	28,666,000	17,265,000		18,567,000	25,609,000
Retail:					
Home equity and other	867,000	855,000		856,000	503,000
1-4 family mortgages	342,000	319,000		363,000	228,000
Total retail	1,209,000	1,174,000		1,219,000	731,000
Total with no related allowance recorded	\$ 29,875,000	\$ 18,439,000		\$ 19,786,000	\$ 26,340,000

(Continued)

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Third Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:					
Commercial:					
Commercial and industrial	\$ 6,128,000	\$ 5,922,000	\$ 1,808,000	\$ 4,886,000	\$ 6,422,000
Vacant land, land development and residential construction	4,269,000	3,259,000	1,076,000	2,064,000	3,814,000
Real estate owner occupied	6,930,000	5,385,000	1,523,000	4,205,000	5,821,000
Real estate non-owner occupied	19,661,000	13,424,000	3,726,000	11,291,000	10,650,000
Real estate multi-family and residential rental	2,772,000	2,301,000	410,000	2,428,000	2,887,000
Total commercial	39,760,000	30,291,000	8,543,000	24,874,000	29,594,000
Retail:					
Home equity and other	737,000	717,000	312,000	753,000	1,314,000
1-4 family mortgages	968,000	956,000	269,000	778,000	932,000
Total retail	1,705,000	1,673,000	581,000	1,531,000	2,246,000
Total with an allowance recorded	\$ 41,465,000	\$ 31,964,000	\$ 9,124,000	\$ 26,405,000	\$ 31,840,000
Total impaired loans:					
Commercial	\$ 68,426,000	\$ 47,556,000	\$ 8,543,000	\$ 43,441,000	\$ 55,203,000
Retail	2,914,000	2,847,000	581,000	2,750,000	2,977,000
Total impaired loans	\$ 71,340,000	\$ 50,403,000	\$ 9,124,000	\$ 46,191,000	\$ 58,180,000

The adoption of the new troubled debt restructuring guidance effective September 30, 2011 resulted in an increase of \$10.8 million in both the Unpaid Contractual Principal Balance and Recorded Principal Balance figures above, with an associated increase of \$4.2 million in the Related Allowance.

Interest income of \$0.2 million and \$0.7 million was recognized on impaired loans during the third quarter of 2011 and the first nine months of 2011, respectively.

(Continued)

23.



**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Impaired loans were as follows as of December 31, 2010:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial:			
Commercial and industrial	\$ 3,133,000	\$ 2,135,000	
Vacant land, land development and residential construction	13,255,000	10,071,000	
Real estate owner occupied	9,327,000	4,920,000	
Real estate non-owner occupied	23,380,000	15,775,000	
Real estate multi-family and residential rental	1,657,000	1,052,000	
Total commercial	50,752,000	33,953,000	
Retail:			
Home equity and other	277,000	151,000	
1-4 family mortgages	151,000	137,000	
Total retail	428,000	288,000	
Total with no related allowance recorded	\$ 51,180,000	\$ 34,241,000	
With an allowance recorded:			
Commercial:			
Commercial and industrial	\$ 7,405,000	\$ 6,922,000	\$ 3,554,000
Vacant land, land development and residential construction	5,702,000	4,370,000	954,000
Real estate owner occupied	7,047,000	6,257,000	1,996,000
Real estate non-owner occupied	13,773,000	7,875,000	1,091,000
Real estate multi-family and residential rental	5,544,000	3,472,000	909,000
Total commercial	39,471,000	28,896,000	8,504,000
Retail:			
Home equity and other	1,799,000	1,910,000	1,007,000
1-4 family mortgages	1,141,000	909,000	191,000
Total retail	2,940,000	2,819,000	1,198,000

Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

Total with an allowance recorded	\$ 42,411,000	\$ 31,715,000	\$ 9,702,000
Total impaired loans:			
Commercial	90,223,000	62,849,000	8,504,000
Retail	3,368,000	3,107,000	1,198,000
Total impaired loans	\$ 93,591,000	\$ 65,956,000	\$ 9,702,000

(Continued)

24.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

*Credit Quality Indicators.* We utilize a comprehensive grading system for our commercial loans. All commercial loans are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, operating performance, financial condition, collateral, industry condition and management. All commercial loans are graded at inception and reviewed and, if appropriate, re-graded at various intervals thereafter. The risk assessment for retail loans is primarily based on the type of collateral.

Loans by credit quality indicators were as follows as of September 30, 2011:

Commercial credit exposure credit risk profiled by internal credit risk grades:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 - 4	\$ 157,192,000	\$ 8,594,000	\$ 143,620,000	\$ 125,525,000	\$ 29,660,000
Grades 5 - 7	97,597,000	47,858,000	107,680,000	168,897,000	26,695,000
Grades 8 - 9	8,183,000	7,587,000	15,449,000	54,507,000	13,929,000
Total commercial	\$ 262,972,000	\$ 64,039,000	\$ 266,749,000	\$ 348,929,000	\$ 70,284,000

Retail credit exposure credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	\$ 44,751,000	\$ 36,313,000

(Continued)

25.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Loans by credit quality indicators were as follows as of December 31, 2010:

Commercial credit exposure credit risk profiled by internal credit risk grades:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 4	\$ 161,623,000	\$ 8,098,000	\$ 137,340,000	\$ 160,746,000	\$ 29,902,000
Grades 5 7	113,904,000	58,326,000	123,572,000	249,246,000	31,852,000
Grades 8 9	12,988,000	17,362,000	16,465,000	39,112,000	15,434,000
Total commercial	\$ 288,515,000	\$ 83,786,000	\$ 277,377,000	\$ 449,104,000	\$ 77,188,000

Retail credit exposure credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	\$ 51,186,000	\$ 35,474,000

(Continued)

**Table of Contents**

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

All commercial loans are graded using the following number system:

- Grade 1. Excellent credit rating that contain very little, if any, risk of loss.
- Grade 2. Strong sources of repayment and have low repayment risk.
- Grade 3. Good sources of repayment and have limited repayment risk.
- Grade 4. Adequate sources of repayment and acceptable repayment risk; however, characteristics are present that render the credit more vulnerable to a negative event.
- Grade 5. Marginally acceptable sources of repayment and exhibit defined weaknesses and negative characteristics.
- Grade 6. Well defined weaknesses which may include negative current cash flow, high leverage, or operating losses. Generally, if the credit does not stabilize or if further deterioration is observed in the near term, the loan will likely be downgraded and placed on the Watch List (i.e., list of lending relationships that receive increased scrutiny and review by the Board of Directors and senior management).
- Grade 7. Defined weaknesses or negative trends that merit close monitoring through Watch List status.
- Grade 8. Inadequately protected by current sound net worth, paying capacity of the obligor, or pledged collateral, resulting in a distinct possibility of loss requiring close monitoring through Watch List status.
- Grade 9. Vital weaknesses exist where collection of principal is highly questionable.
- Grade 10. Considered uncollectable and of such little value that their continuance as an asset is not warranted.

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and timeliness of scheduled payments. We have a policy of requesting and reviewing periodic financial statements from commercial loan customers and employ a disciplined and formalized review of the existence of collateral and its value. The primary risk element with respect to each residential real estate loan and consumer loan is the timeliness of scheduled payments. We have a reporting system that monitors past due loans and have adopted policies to pursue creditor's rights in order to preserve our collateral position.

(Continued)

27.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Activity in the allowance for loan losses and the recorded investments in loans as of and during the three and nine months ended September 30, 2011 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
<b>Allowance for loan losses:</b>				
Balance at June 30, 2011	\$ 35,986,000	\$ 2,641,000	\$ 93,000	\$ 38,720,000
Provision for loan losses	586,000	533,000	(19,000)	1,100,000
Charge-offs	(1,260,000)	(82,000)	0	(1,342,000)
Recoveries	838,000	35,000	0	873,000
Ending balance	\$ 36,150,000	\$ 3,127,000	\$ 74,000	\$ 39,351,000
<b>Allowance for loan losses:</b>				
Balance at December 31, 2010	\$ 42,358,000	\$ 2,972,000	\$ 38,000	\$ 45,368,000
Provision for loan losses	3,074,000	1,890,000	36,000	5,000,000
Charge-offs	(12,168,000)	(1,938,000)	0	(14,106,000)
Recoveries	2,886,000	203,000	0	3,089,000
Ending balance	\$ 36,150,000	\$ 3,127,000	\$ 74,000	\$ 39,351,000
Ending balance: individually evaluated for impairment	\$ 8,543,000	\$ 581,000	\$ 0	\$ 9,124,000
Ending balance: collectively evaluated for impairment	\$ 27,607,000	\$ 2,546,000	\$ 74,000	\$ 30,227,000
<b>Total loans:</b>				
Ending balance	\$ 1,012,973,000	\$ 81,064,000		\$ 1,094,037,000
Ending balance: individually evaluated for impairment	\$ 47,556,000	\$ 2,847,000		\$ 50,403,000
Ending balance: collectively evaluated for impairment	\$ 965,417,000	\$ 78,217,000		\$ 1,043,634,000



(Continued)

28.

**Table of Contents**

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Activity in the allowance for loan losses during the nine months ended September 30, 2010 is as follows:

Beginning balance	\$ 47,878,000
Provision for loan losses	25,000,000
Charge-offs	(31,236,000)
Recoveries	2,234,000
Ending balance	\$ 43,876,000

During the three and nine months ended September 30, 2011, there were no purchases or sales of loans or reclassifications of loans held for sale.

Loans modified as troubled debt restructurings during the three months ended September 30, 2011 were as follows:

	Number of Contracts	Pre- Modification Recorded Principal Balance	Post- Modification Recorded Principal Balance
<b>Commercial:</b>			
Commercial and industrial	2	\$ 110,000	\$ 110,000
Vacant land, land development and residential construction	6	2,219,000	2,219,000
Real estate owner occupied	0	0	0
Real estate non-owner occupied	2	701,000	701,000
Real estate multi-family and residential rental	6	709,000	549,000
<b>Total commercial</b>	<b>16</b>	<b>3,739,000</b>	<b>3,579,000</b>
<b>Retail:</b>			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
<b>Total retail</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Total</b>	<b>16</b>	<b>\$ 3,739,000</b>	<b>\$ 3,579,000</b>

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

There were no loans modified as troubled debt restructurings within the previous twelve months that became over 30 days past due during the three months ended September 30, 2011.

(Continued)

29.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Loans modified as troubled debt restructurings during the nine months ended September 30, 2011 were as follows:

	Number of Contracts	Pre- Modification Recorded Principal Balance	Post- Modification Recorded Principal Balance
<b>Commercial:</b>			
Commercial and industrial	14	\$ 2,339,000	\$ 2,330,000
Vacant land, land development and residential construction	8	3,422,000	3,421,000
Real estate owner occupied	7	3,973,000	3,466,000
Real estate non-owner occupied	9	7,006,000	7,004,000
Real estate multi-family and residential rental	10	1,450,000	1,290,000
<b>Total commercial</b>	<b>48</b>	<b>18,190,000</b>	<b>17,511,000</b>
<b>Retail:</b>			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
<b>Total retail</b>	<b>0</b>	<b>0</b>	<b>0</b>
<b>Total</b>	<b>48</b>	<b>\$ 18,190,000</b>	<b>\$ 17,511,000</b>

The following loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the nine months ended September 30, 2011 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
<b>Commercial:</b>		
Commercial and industrial	2	\$ 280,000
Vacant land, land development and residential construction	0	0
Real estate owner occupied	0	0
Real estate non-owner occupied	1	793,000
Real estate multi-family and residential rental	2	135,000

Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

Total commercial	5	1,208,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	5	\$ 1,208,000

(Continued)

30.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

As a result of adopting the amendments in ASU 2011-02 effective September 30, 2011, we reassessed all loan renewals and modifications that occurred on or after January 1, 2011 to determine whether they should now be considered troubled debt restructurings. In general, our policy dictates that a renewal or modification of an 8- or 9-rated loan meets the criteria of a troubled debt restructuring, although we review and consider all renewed and modified loans as part of our troubled debt restructuring assessment procedures. Loan relationships rated 8 contain significant financial weaknesses, resulting in a distinct possibility of loss, while relationships rated 9 reflect vital financial weaknesses, resulting in a highly questionable ability on our part to collect principal; we believe borrowers warranting such ratings would have difficulty obtaining financing from other market participants. Thus, due to the lack of comparable market rates for loans with similar risk characteristics, we believe 8- or 9-rated loans that were renewed or modified during the first nine months of 2011 were done so at below market rates. Loans that are identified as troubled debt restructurings are considered impaired and are individually evaluated for impairment when assessing these credits in our allowance for loan losses calculation. Certain of the loans, totaling \$10.8 million as of September 30, 2011, that were identified as troubled debt restructurings under the new guidance had been previously measured under a general allowance methodology (i.e., pooling) for calculation of our allowance for loan losses. The allowance for loan losses associated with these specific loans totaled \$4.2 million as of September 30, 2011, or approximately \$1.0 million higher than would have been recorded using a general allowance methodology.

**4. PREMISES AND EQUIPMENT, NET**

Premises and equipment are comprised of the following:

	September 30, 2011	December 31, 2010
Land and improvements	\$ 8,531,000	\$ 8,531,000
Buildings	24,528,000	24,528,000
Furniture and equipment	12,644,000	12,478,000
	45,703,000	45,537,000
Less: accumulated depreciation	18,838,000	17,664,000
Premises and equipment, net	\$ 26,865,000	\$ 27,873,000

Depreciation expense totaled \$0.4 million during the third quarter of 2011 and 2010. Depreciation expense totaled \$1.2 million during the first nine months of 2011, compared to \$1.5 million during the first nine months of 2010.

(Continued)

31.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**5. DEPOSITS**

Our total deposits at September 30, 2011 totaled \$1.19 billion compared to \$1.27 billion at December 31, 2010, a decrease of \$88.5 million, or 6.9%. The components of our outstanding balances at September 30, 2011 and December 31, 2010, and percentage change in deposits from the end of 2010 to the end of the third quarter of 2011, are as follows:

	September 30, 2011		December 31, 2010		Percent Increase (Decrease)
	Balance	%	Balance	%	
Noninterest-bearing demand	\$ 144,022,000	12.1%	\$ 112,944,000	8.9%	27.5%
Interest-bearing checking	165,707,000	14.0	158,177,000	12.4	4.8
Money market	152,603,000	12.9	150,631,000	11.8	1.3
Savings	37,336,000	3.1	60,201,000	4.7	(38.0)
Time, under \$100,000	65,966,000	5.6	75,857,000	6.0	(13.0)
Time, \$100,000 and over	212,486,000	17.9	206,954,000	16.2	2.7
	778,120,000	65.6	764,764,000	60.0	1.7
Out-of-area interest-bearing checking	26,987,000	2.3	0	NA	NA
Out-of-area time, under \$100,000	23,413,000	2.0	37,253,000	2.9	(37.2)
Out-of-area time, \$100,000 and over	356,813,000	30.1	471,815,000	37.1	(24.4)
	407,213,000	34.4	509,068,000	40.0	(20.0)
Total deposits	\$ 1,185,333,000	100.0%	\$ 1,273,832,000	100.0%	(6.9)%

**6. SHORT-TERM BORROWINGS**

Information relating to our securities sold under agreements to repurchase follows:

	Nine Months Ended September 30, 2011	Twelve Months Ended December 31, 2010
Outstanding balance at end of period	\$ 69,340,000	\$ 116,979,000
Average interest rate at end of period	0.29%	0.69%
Average daily balance during the period	\$ 82,719,000	\$ 107,781,000
Average interest rate during the period	0.57%	1.31%
Maximum daily balance during the period	\$ 116,979,000	\$ 133,280,000

Securities sold under agreements to repurchase ( repurchase agreements ) generally have original maturities of less than one year. Repurchase agreements are treated as financings and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the



## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

agreements are recorded as assets of our bank and are held in safekeeping by a correspondent bank. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements are secured by securities with an aggregate market value equal to the aggregate outstanding balance.

(Continued)

32.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**7. FEDERAL HOME LOAN BANK ADVANCES**

Our outstanding balances at September 30, 2011 totaled \$45.0 million and mature at varying dates from March 2012 through January 2014, with fixed rates of interest from 3.04% to 4.42% and averaging 3.57%. At December 31, 2010, outstanding balances totaled \$65.0 million with maturities ranging from June 2011 through January 2014, with fixed rates of interest from 3.04% to 4.42% and averaging 3.73%.

Each advance is payable at its maturity date, and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of September 30, 2011 totaled about \$117.0 million, with availability approximating \$70.0 million.

Maturities of currently outstanding FHLB advances during the next 60 months are:

2011	\$ 0
2012	30,000,000
2013	10,000,000
2014	5,000,000
2015	0

**8. COMMITMENTS AND OFF-BALANCE SHEET RISK**

Our bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Loan 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. Standby letters of credit are conditional commitments issued by our bank to guarantee the performance of a customer to a third party. 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.

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan 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 notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on our credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and is generally recorded as a liability. During the third quarter of 2011, we expensed \$0.4 million through provision for loan losses in association with a particular standby letter of credit. Due to the nature of the transaction and the insignificant amount, the \$0.4 million was included as a specific reserve within the allowance for loan losses as of September 30, 2011. There was no reserve or liability balance as of December 31, 2010.

(Continued)

33.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**8. COMMITMENTS AND OFF-BALANCE SHEET RISK** (Continued)

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at September 30, 2011 and December 31, 2010 follows:

	September 30, 2011	December 31, 2010
Commercial unused lines of credit	\$ 163,822,000	\$ 158,945,000
Unused lines of credit secured by 1-4 family residential properties	25,537,000	26,870,000
Credit card unused lines of credit	7,708,000	7,768,000
Other consumer unused lines of credit	4,099,000	4,052,000
Commitments to extend credit	23,671,000	9,840,000
Standby letters of credit	17,501,000	19,343,000
	<b>\$ 242,338,000</b>	<b>\$ 226,818,000</b>

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of September 30, 2011, the total notional amount of the underlying interest rate swap agreements was \$42.5 million, with a net fair value from our commercial loan customers' perspective of negative \$6.3 million. These risk participation agreements are considered financial guarantees in accordance with applicable accounting guidance and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

**9. HEDGING ACTIVITIES**

Our interest rate risk policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using net interest income simulation. Our policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within the policy parameters.

(Continued)

34.

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**9. HEDGING ACTIVITIES** (Continued)

A majority of our assets are comprised of commercial loans on which the interest rates are variable; however, the interest rates on a significant portion of these loans will likely lag an increase in market interest rates under a rising interest rate environment. As of September 30, 2011, the Mercantile Bank Prime Rate, the index on which a substantial portion of our commercial floating rate loans are based, was 4.50% compared to the Wall Street Journal Prime Rate of 3.25%. Historically, the two indices have been equal; however, we elected not to reduce the Mercantile Bank Prime Rate in late October and mid-December of 2008 when the Wall Street Journal Prime Rate declined by 50 and 75 basis points, respectively. It is our general intent to keep the Mercantile Bank Prime Rate unchanged until the Wall Street Journal Prime Rate equals the Mercantile Bank Prime Rate, at which time the two indices will likely remain equal in future periods. In addition, a majority of our floating rate loans, whether tied to the Mercantile Bank Prime Rate, Wall Street Journal Prime Rate or Libor rates, have interest rate floors that are currently higher than the indexed rate provides for. To help mitigate the negative impact to our net interest income in an increasing interest rate environment resulting from our cost of funds likely increasing at a higher rate than the yield on our assets, we may periodically enter into derivative financial instruments.

In June 2011, we simultaneously purchased and sold an interest rate cap with a correspondent bank, a structure commonly referred to as a cap corridor. The cap corridor, which does not qualify for hedge accounting, consisted of us purchasing a \$100 million interest rate cap with a strike rate in close proximity to the then-current 30-day Libor rate and selling a \$100 million interest rate cap with a strike rate that is 125 basis points higher than the purchased interest rate cap strike rate. On the settlement date, the present value of the purchased interest rate cap of \$729,500 was recorded as an asset, while the present value of the sold interest rate cap of \$213,500 was recorded as a liability. At each month end, the recorded balances of the purchased and sold interest rate caps are adjusted to reflect the current present values, with the offsetting entry being recorded to interest income on commercial loans. We recorded a net decrease of \$283,000 and \$231,000 during the third quarter and first nine months of 2011, respectively, to interest income on commercial loans to reflect the net change in present values. Payments made or received under the purchased and sold interest rate cap contracts, if any, are also recorded to interest income on commercial loans. No such payments were made or received during the third quarter or the first nine months of 2011.

(Continued)

35.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**10. FAIR VALUES OF FINANCIAL INSTRUMENTS**

Carrying amounts and estimated fair values of financial instruments were as follows as of September 30, 2011 and December 31, 2010:

	September 30, 2011		December 31, 2010	
	Carrying Values	Fair Values	Carrying Values	Fair Values
<b>Financial assets</b>				
Cash and cash equivalents	\$ 125,703,000	\$ 125,703,000	\$ 64,198,000	\$ 64,198,000
Securities available for sale	173,134,000	173,134,000	220,830,000	220,830,000
Federal Home Loan Bank stock	11,961,000	11,961,000	14,345,000	14,345,000
Loans, net	1,054,686,000	1,061,270,000	1,217,262,000	1,223,911,000
Bank owned life insurance	48,083,000	48,083,000	46,743,000	46,743,000
Accrued interest receivable	4,887,000	4,887,000	5,942,000	5,942,000
Purchased interest rate cap	347,000	347,000	0	0
<b>Financial liabilities</b>				
Deposits	1,185,333,000	1,193,486,000	1,273,832,000	1,284,767,000
Securities sold under agreements to repurchase	69,340,000	69,340,000	116,979,000	116,979,000
Federal Home Loan Bank advances	45,000,000	46,355,000	65,000,000	67,668,000
Subordinated debentures	32,990,000	33,061,000	32,990,000	33,006,000
Accrued interest payable	5,007,000	5,007,000	4,749,000	4,749,000
Sold interest rate cap	62,000	62,000	0	0

Carrying amount is the estimated fair value for cash and cash equivalents, Federal Home Loan Bank stock, accrued interest receivable and payable, bank owned life insurance, demand deposits, securities sold under agreements to repurchase, and variable rate loans and deposits that reprice frequently and fully. Security fair values are based on market prices or dealer quotes, and if no such information is available, on the rate and term of the security and information about the issuer. For fixed rate loans and deposits and for variable rate loans and deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of subordinated debentures and Federal Home Loan Bank advances is based on current rates for similar financing. Fair value of interest rate caps is determined primarily utilizing market-consensus forecasted yield curves. Fair value of off-balance sheet items is estimated to be nominal.

Current accounting pronouncements require disclosure of the estimated fair value of financial instruments as disclosed in Note 11. Given current market conditions, a portion of our loan portfolio is not readily marketable and market prices do not exist. We have not attempted to market our loans to potential buyers, if any exist, to determine the fair value of those instruments. Since negotiated prices in illiquid markets depend upon the then present motivations of the buyer and seller, it is reasonable to assume that actual sales prices could vary widely from any estimate of fair value made without the benefit of negotiations. Additionally, changes in market interest rates can dramatically impact the value of financial instruments in a short period of time. Accordingly, the fair value measurements for loans included in the table above are unlikely to represent the instruments' liquidation values.

(Continued)

36.



**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. The price of the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

We are required to use valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from independent sources, or unobservable, meaning those that reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. In that regard, we utilize a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that we have the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be derived from or corroborated by observable market data by correlation or other means.

Level 3: Significant unobservable inputs that reflect our own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The following is a description of our valuation methodologies used to measure and disclose the fair values of our financial assets and liabilities on a recurring or nonrecurring basis:

*Securities available for sale.* Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies, municipal general obligation and revenue bonds, Michigan Strategic Fund bonds and mutual funds. We have no Level 1 or 3 securities.

(Continued)

37.

**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES** (Continued)

*Securities held to maturity.* Securities held to maturity are carried at amortized cost when we have the positive intent and ability to hold them to maturity. The fair value of held to maturity securities is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. We had no securities held to maturity outstanding as of September 30, 2011 or December 31, 2010.

*Mortgage loans held for sale.* Mortgage loans held for sale are carried at the lower of aggregate cost or fair value and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of September 30, 2011 and December 31, 2010, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the \$5.0 million and \$2.7 million, respectively, of such loans at cost so they are not included in the nonrecurring table below.

*Loans.* We do not record loans at fair value on a recurring basis. However, from time to time, we record nonrecurring fair value adjustments to collateral dependent loans to reflect partial write-downs or specific reserves that are based on the observable market price or current estimated value of the collateral. These loans are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge-off.

*Foreclosed Assets.* At time of foreclosure or repossession, foreclosed and repossessed assets are adjusted to fair value less costs to sell upon transfer of the loans to foreclosed and repossessed assets, establishing a new cost basis. We subsequently adjust estimated fair value of foreclosed assets on a nonrecurring basis to reflect write-downs based on revised fair value estimates.

*Derivatives.* For interest rate cap contracts, we measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves, and accordingly, interest rate cap contracts are classified as Level 2.

(Continued)

38.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES** (Continued)*Assets and Liabilities Measured at Fair Value on a Recurring Basis*

The balances of assets and liabilities measured at fair value on a recurring basis as of September 30, 2011 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	\$ 84,512,000	\$ 0	\$ 84,512,000	\$ 0
Mortgage-backed securities	38,467,000	0	38,467,000	0
Michigan Strategic Fund bonds	16,955,000	0	16,955,000	0
Municipal general obligation bonds	27,458,000	0	27,458,000	0
Municipal revenue bonds	4,399,000	0	4,399,000	0
Mutual funds	1,343,000	0	1,343,000	0
Derivatives				
Interest rate cap contracts	285,000	0	285,000	0
Total	\$ 173,419,000	\$ 0	\$ 173,419,000	\$ 0

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first nine months of 2011.

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agency debt obligations	\$ 121,562,000	\$ 0	\$ 121,562,000	\$ 0
Mortgage-backed securities	46,941,000	0	46,941,000	0
Michigan Strategic Fund bonds	18,175,000	0	18,175,000	0

# Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

Municipal general obligation bonds	28,042,000	0	28,042,000	0
Municipal revenue bonds	4,843,000	0	4,843,000	0
Mutual funds	1,267,000	0	1,267,000	0
Total	\$ 220,830,000	\$ 0	\$ 220,830,000	\$ 0

(Continued)

39.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES** (Continued)

We had no interest rate cap contracts outstanding at December 31, 2010. There were no transfers in or out of Level 1, Level 2 or Level 3 during 2010.

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

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2011 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans <sup>(1)</sup>	\$ 29,284,000	\$ 0	\$ 0	\$ 29,284,000
Foreclosed assets <sup>(1)</sup>	17,287,000	0	0	17,287,000
<b>Total</b>	<b>\$ 46,571,000</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 46,571,000</b>

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2010 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans <sup>(1)</sup>	\$ 39,056,000	\$ 0	\$ 0	\$ 39,056,000
Foreclosed assets <sup>(1)</sup>	16,675,000	0	0	16,675,000
<b>Total</b>	<b>\$ 55,731,000</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 55,731,000</b>

## Edgar Filing: MERCANTILE BANK CORP - Form 10-Q

- <sup>(1)</sup> Represents carrying value and related write-downs for which adjustments are based on the estimated value of the property or other assets.

(Continued)

40.

**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**12. REGULATORY MATTERS**

We are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on our financial statements.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At September 30, 2011 and December 31, 2010, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since September 30, 2011 that we believe have changed our bank's categorization.

Our actual capital levels (dollars in thousands) and the minimum levels required to be categorized as adequately and well capitalized were:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>September 30, 2011</b>						
Total capital (to risk weighted assets)						
Consolidated	\$ 179,348	14.5%	\$ 98,850	8.0%	\$ NA	NA
Bank	178,991	14.5	98,767	8.0	123,458	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	163,608	13.2	49,425	4.0	NA	NA
Bank	163,263	13.2	49,384	4.0	74,075	6.0
Tier 1 capital (to average assets)						
Consolidated	163,608	10.9	60,186	4.0	NA	NA
Bank	163,263	10.9	60,146	4.0	75,182	5.0

(Continued)





**Table of Contents**

## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**12. REGULATORY MATTERS** (Continued)

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>December 31, 2010</b>						
Total capital (to risk weighted assets)						
Consolidated	\$ 175,029	12.5%	\$ 112,480	8.0%	\$ NA	NA
Bank	175,122	12.5	112,398	8.0	140,497	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	157,111	11.2	56,240	4.0	NA	NA
Bank	157,217	11.2	56,199	4.0	84,299	6.0
Tier 1 capital (to average assets)						
Consolidated	157,111	9.1	69,135	4.0	NA	NA
Bank	157,217	9.1	69,112	4.0	86,389	5.0

Our consolidated capital levels as of September 30, 2011 and December 31, 2010 include \$32.0 million of trust preferred securities issued by the trust in September 2004 and December 2004 subject to certain limitations. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in our Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than \$15.0 billion. As of September 30, 2011 and December 31, 2010, all \$32.0 million of the trust preferred securities were included in our consolidated Tier 1 capital.

On July 9, 2010, we announced via a Form 8-K filed with the SEC that we were deferring regularly scheduled quarterly interest payments on our subordinated debentures beginning with the quarterly interest payment scheduled to be paid on July 18, 2010. The deferral of interest payments on the subordinated debentures resulted in the deferral of distributions on our trust preferred securities. We also announced that we were deferring regularly scheduled quarterly dividend payments on our preferred stock beginning with the quarterly dividend payment scheduled to be paid on August 15, 2010. On October 18, 2011, we paid and brought current all accrued and unpaid interest on our subordinated debentures, and on October 19, 2011, we paid and brought current all accrued and unpaid dividends on our preferred stock.

(Continued)



**Table of Contents**

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**12. REGULATORY MATTERS** (Continued)

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. In April 2010, we suspended future payments of cash dividends on our common stock until economic conditions and our financial performance improve. In addition, during the period of July 9, 2010 through October 19, 2011, we were precluded from paying dividends on our common stock and preferred stock because, under the terms of our subordinated debentures, we could not pay dividends during periods when we had deferred the payment of interest on our subordinated debentures; and, as indicated above in this Note 12, we had been deferring such interest payments. Also, pursuant to our Articles of Incorporation, we were precluded from paying dividends on our common stock while any dividends accrued on our preferred stock had not been declared and paid. Because, as indicated above in this Note 12, we had suspended the payment of dividends on our preferred stock, we were precluded from paying dividends on our common stock. These restrictions are no longer in place as of October 19, 2011.

43.

## **Table of Contents**

### MERCANTILE BANK CORPORATION

#### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations** **Forward Looking Statements**

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and our company. Words such as anticipates, believes, estimates, expects, forecasts, intends, is likely, plans, projects, and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ( Future Factors ) that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. We undertake no obligation to update, amend, or clarify forward looking-statements, whether as a result of new information, future events (whether anticipated or unanticipated), or otherwise.

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2010 or in this report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

#### **Introduction**

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, Mercantile Bank of Michigan ( our bank ), our bank's three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ) and Mercantile Insurance Center, Inc. ( our insurance company ), at September 30, 2011 and December 31, 2010 and the results of operations for the three and nine months ended September 30, 2011 and September 30, 2010. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to us, we, our or the company include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

#### **Critical Accounting Policies**

Accounting principles generally accepted in the United States of America are complex and require us to apply significant judgment to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a discussion of our significant accounting policies, see Note 1 of the Notes to our Consolidated Financial Statements included on pages F-46 through F-51 in our Form 10-K for the fiscal year ended December 31, 2010 (Commission file number 000-26719). Our allowance for loan losses policy and accounting for income taxes are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements, and actual results may differ from those estimates. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

## Table of Contents

### MERCANTILE BANK CORPORATION

**Allowance for Loan Losses:** The allowance for loan losses ( allowance ) is maintained at a level we believe is adequate to absorb probable incurred losses identified and inherent in the loan portfolio. Our evaluation of the adequacy of the allowance is an estimate based on past loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations and estimated collateral values, guidance from bank regulatory agencies, and assessments of the impact of current and anticipated economic conditions on the loan portfolio. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged-off. Loan losses are charged against the allowance when we believe the uncollectability of a loan is likely. The balance of the allowance represents our best estimate, but significant downturns in circumstances relating to loan quality or economic conditions could result in a requirement for an increased allowance in the future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance in the future. In either instance, unanticipated changes could have a significant impact on operating earnings.

The allowance is increased through a provision charged to operating expense. Uncollectable loans are charged-off through the allowance. Recoveries of loans previously charged-off are added to the allowance. A loan is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement. Impairment is evaluated in aggregate for smaller-balance loans of similar nature such as residential mortgage, consumer and credit card loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. The timing of obtaining outside appraisals varies, generally depending on the nature and complexity of the property being evaluated, general breadth of activity within the marketplace and the age of the most recent appraisal. For collateral dependent impaired loans, in most cases we obtain and use the as is value as indicated in the appraisal report, adjusting for any expected selling costs. In certain circumstances, we may internally update outside appraisals based on recent information impacting a particular or similar property, or due to identifiable trends (e.g., recent sales of similar properties) within our markets. The expected future cash flows exclude potential cash flows from certain guarantors. To the extent these guarantors provide repayments, a recovery would be recorded upon receipt. Loans are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship. Our policy for recognizing income on impaired loans is to accrue interest unless a loan is placed on nonaccrual status. We put loans into nonaccrual status when the full collection of principal and interest is not expected.

**Income Tax Accounting:** Current income tax liabilities or assets are established for the amount of taxes payable or refundable for the current year. In the preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome may be uncertain. We periodically review and evaluate the status of our tax positions and make adjustments as necessary. Deferred income tax liabilities and assets are also established for the future tax consequences of events that have been recognized in our financial statements or tax returns. A deferred income tax liability or asset is recognized for the estimated future tax effects attributable to temporary differences that can be carried forward (used) in future years. The valuation of our net deferred income tax asset is considered critical as it requires us to make estimates based on provisions of the enacted tax laws. The assessment of the realizability of the net deferred income tax asset involves the use of estimates, assumptions, interpretations and judgments concerning accounting pronouncements, federal and state tax codes and the extent of future taxable income. There can be no assurance that future events, such as court decisions, positions of federal and state tax authorities, and the extent of future taxable income will not differ from our current assessment, the impact of which could be significant to the consolidated results of operations and reported earnings.

## **Table of Contents**

### MERCANTILE BANK CORPORATION

Accounting guidance requires that we assess whether a valuation allowance should be established against our net deferred tax asset based on the consideration of all available evidence using a more likely than not standard. In making such judgments, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors which may impact future operating results. Significant weight is given to evidence that can be objectively verified. Despite improvements in key areas such as an expanded net interest margin, increased regulatory capital levels, a continued shift to local funding sources and reduced controllable overhead costs, the loan provision expense and problem asset administrative costs remain sizable. The continuing impact from the distressed operating environment has restricted our ability to rely on projections of future taxable income to support the recovery of our deferred tax asset. Consequently, we have determined it necessary to establish and maintain a valuation allowance against our entire net deferred tax asset as of September 30, 2011 and December 31, 2010. We will continue to monitor our net deferred tax asset quarterly for changes affecting its realizability.

## **Financial Overview**

Over the past several years, our earnings performance has been negatively impacted by substantial provisions to the allowance for loan losses as well as administrative costs associated with problem assets. Ongoing state, regional and national economic struggles have negatively impacted some of our borrowers' cash flows and underlying collateral values, leading to an elevated level of nonperforming assets, higher loan charge-offs and increased overall credit risk within our loan portfolio. We have worked with our borrowers to develop constructive dialogue to strengthen our relationships and enhance our ability to resolve complex issues; however, with the environment for the banking industry likely to remain stressed until economic conditions improve, credit quality will continue to be our major concern. We will remain vigilant in the identification and administration of problem assets, but provisions to the allowance and problem asset administration costs will likely remain above historical levels for some period of time, dampening future earnings performance.

We recorded a net profit during the third quarter of 2011, our third consecutive quarterly net profit after two years of quarterly losses. A significantly lower provision expense primarily provided for the positive earnings performance; however, our improved earnings performance also reflects the many positive steps we have taken over the past several years to not only partially mitigate the impact of asset quality-related costs in the near term, but to benefit us on a longer-term basis as well. First, our net interest margin has improved as we have lowered local non-CD deposit rates and have replaced maturing higher-rate deposits and borrowed funds with lower-cost funds, while at the same time our commercial loan pricing initiatives offset the negative impact of a relatively high level of nonaccrual loans. Next, our regulatory risk-based capital ratios are increasing, reflecting the impact of the net income recorded during the first nine months of 2011, the sale of preferred stock under the Department of Treasury's Capital Purchase Program and the reduction of loans outstanding, which have more than offset the impact of our net losses recorded during 2010 and 2009. In addition, we are increasing our local deposit balances, reflecting the successful implementation of various initiatives, campaigns and product enhancements. The local deposit growth, combined with the reduction of loans outstanding, are providing for a substantial reduction of, and reliance on, wholesale funds. Lastly, we are seeing the positive effect of our branch consolidation and other overhead cost reduction initiatives, as we continue to make strides to reduce noninterest expense.

## **Table of Contents**

### MERCANTILE BANK CORPORATION

Our asset quality metrics are on an improving trend, and we are cautiously optimistic that the positive trend will continue. In aggregate dollar amounts, nonperforming asset levels have been declining over the past six quarters, and as of September 30, 2011 were at the lowest level since September 30, 2008. Progress in the stabilization of economic and real estate market conditions has provided for numerous loan rating upgrades and significantly lower volumes of loan rating downgrades, providing for a substantially lower provision expense during the first nine months of 2011. We believe a continuation of improved market conditions will provide for lower future period provision expense and problem asset administration costs when compared to levels over the past several years.

### **Financial Condition**

During the first nine months of 2011, our total assets decreased \$154.4 million, and totaled \$1.48 billion as of September 30, 2011. The decline in total assets was comprised primarily of a \$168.6 million reduction in total loans and a \$50.1 million decrease in securities, more than offsetting a \$61.5 million increase in cash and cash equivalents. Total deposits declined \$88.5 million, securities sold under agreements to repurchase ( repurchase agreements ) decreased \$47.6 million and Federal Home Loan Bank advances were down \$20.0 million.

Commercial loans declined \$163.0 million during the first nine months of 2011, and at September 30, 2011 totaled \$1.01 billion, or 92.6% of the loan portfolio. The decline in outstanding balances primarily reflects the impact of a concerted effort on our part to reduce exposure to certain non-owner occupied commercial real estate ( CRE ) lending and the sluggishness in business activity in our markets. During the first nine months of 2011, commercial loans collateralized by non-owner occupied CRE declined \$100.2 million. Our systematic approach to reducing our exposure to certain non-owner occupied CRE lending will be prolonged, given the nature of CRE lending and depressed economic conditions; however, we believe that such a reduction is in our best interest when taking into account the increased inherent credit risk and nominal deposit balances generally associated with the targeted borrowing relationships. Our commercial and industrial ( C&I ) loan portfolio declined \$25.5 million during the first nine months of 2011, in large part reflecting ongoing sluggish business activity. We would expect to see an increase in commercial line of credit usage when economic conditions improve. Also during the first nine months of 2011, commercial loans collateralized by owner-occupied CRE and commercial loans related to vacant land, land development and residential construction decreased \$10.6 million and \$19.7 million, respectively.

The commercial loan portfolio represents loans to businesses generally located within our market areas. Approximately 74% of the commercial loan portfolio is primarily secured by real estate properties, with the remaining generally secured by other business assets such as accounts receivable, inventory and equipment. The continued concentration of the loan portfolio in commercial loans is consistent with our strategy of focusing a substantial amount of our efforts on commercial banking. Corporate and business lending is an area of expertise for our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least ten years experience. Of each of the loan categories that we originate, commercial loans are most efficiently originated and managed, thus limiting overhead costs by necessitating the attention of fewer employees. Our commercial lending business generates the largest portion of local deposits and is our primary source of demand deposits.



## Table of Contents

### MERCANTILE BANK CORPORATION

The following table summarizes our loans secured by real estate, excluding residential mortgage loans representing permanent financing of owner occupied dwellings and home equity lines of credit:

	9/30/11	6/30/11	3/31/11	12/31/10	9/30/10
<b>Residential-Related:</b>					
Vacant Land	\$ 13,264,000	\$ 13,484,000	\$ 16,321,000	\$ 17,201,000	\$ 18,013,000
Land Development	17,441,000	18,134,000	27,171,000	28,147,000	29,735,000
Construction	4,647,000	4,706,000	4,906,000	5,621,000	5,854,000
	35,352,000	36,324,000	48,398,000	50,969,000	53,602,000
<b>Comm 1 Non-Owner Occupied:</b>					
Vacant Land	11,082,000	12,639,000	13,669,000	14,293,000	15,416,000
Land Development	14,541,000	16,348,000	16,492,000	17,807,000	18,221,000
Construction	11,061,000	10,709,000	10,046,000	31,827,000	39,620,000
Commercial Buildings	397,279,000	429,708,000	484,629,000	489,371,000	509,777,000