MERCANTILE BANK CORP
Form 10-Q
November 06, 2017

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, 2017

[ ] 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)

Michigan	38-3360865
(State or other jurisdiction of incorporation or organization)	(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 _X_ 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 _X_ No ___

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

Large accelerated filer ___ Accelerated filer X
Non-accelerated filer ___ Smaller reporting company __
Emerging growth company ___

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

Yes __ No _ _

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

Yes __ No _X_

At November 6, 2017, there were 16,491,790 shares of common stock outstanding.

MERCANTILE BANK CORPORATION

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PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	September 30, 2017	December 31, 2016
ASSETS		
Cash and due from banks	$53,941,000	$50,200,000
Interest-earning deposits	123,110,000	133,396,000
Total cash and cash equivalents	177,051,000	183,596,000
Securities available for sale	330,090,000	328,060,000
Federal Home Loan Bank stock	11,036,000	8,026,000
Loans	2,554,272,000	2,378,620,000
Allowance for loan losses	(19,193,000)	(17,961,000)
Loans, net	2,535,079,000	2,360,659,000
Premises and equipment, net	45,606,000	45,456,000
Bank owned life insurance	66,858,000	67,198,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	8,156,000	9,957,000
Other assets	31,306,000	30,146,000
Total assets	$3,254,655,000	$3,082,571,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$826,038,000	$810,600,000
Interest-bearing	1,663,005,000	1,564,385,000
Total deposits	2,489,043,000	2,374,985,000
Securities sold under agreements to repurchase	122,280,000	131,710,000
Federal Home Loan Bank advances	220,000,000	175,000,000
Subordinated debentures	45,347,000	44,835,000
Accrued interest and other liabilities	15,439,000	15,230,000

Total liabilities	2,892,109,000	2,741,760,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; none issued	0	0
Common stock, no par value; 40,000,000 shares authorized; 16,490,279 shares issued and outstanding at September 30, 2017 and 16,416,695 shares issued and outstanding at December 31, 2016	309,033,000	305,488,000
Retained earnings	55,258,000	40,904,000
Accumulated other comprehensive loss	(1,745,000)	(5,581,000)
Total shareholders' equity	362,546,000	340,811,000
Total liabilities and shareholders' equity	$3,254,655,000	$3,082,571,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended Sept 30, 2017	Three Months Ended Sept 30, 2016	Nine Months Ended Sept 30, 2017	Nine Months Ended Sept 30, 2016
Interest income				
Loans, including fees	$30,746,000	$27,553,000	$86,406,000	$81,219,000
Securities, taxable	1,322,000	1,488,000	3,885,000	5,661,000
Securities, tax-exempt	584,000	545,000	1,709,000	1,622,000
Other interest-earning assets	382,000	120,000	641,000	240,000
Total interest income	33,034,000	29,706,000	92,641,000	88,742,000
Interest expense				
Deposits	2,652,000	1,924,000	6,543,000	5,608,000
Short-term borrowings	45,000	62,000	142,000	154,000
Federal Home Loan Bank advances	1,033,000	670,000	2,690,000	1,595,000
Subordinated debentures and other borrowings	660,000	600,000	1,920,000	1,952,000
Total interest expense	4,390,000	3,256,000	11,295,000	9,309,000
Net interest income	28,644,000	26,450,000	81,346,000	79,433,000
Provision for loan losses	1,000,000	600,000	2,350,000	2,300,000
Net interest income after provision for loan losses	27,644,000	25,850,000	78,996,000	77,133,000
Noninterest income				
Services charges on deposit and sweep accounts	1,076,000	1,140,000	3,148,000	3,178,000
Credit and debit card income	1,215,000	1,090,000	3,497,000	3,185,000
Mortgage banking income	1,326,000	1,236,000	3,233,000	2,578,000
Earnings on bank owned life insurance	328,000	349,000	2,394,000	933,000
Gain on trust preferred securities repurchase	0	0	0	2,970,000
Other income	660,000	1,469,000	2,226,000	3,590,000
Total noninterest income	4,605,000	5,284,000	14,498,000	16,434,000
Noninterest expense				

Salaries and benefits	11,636,000	11,162,000	33,796,000	32,959,000
Occupancy	1,598,000	1,515,000	4,707,000	4,600,000
Furniture and equipment depreciation, rent and maintenance	543,000	531,000	1,625,000	1,579,000
Data processing costs	2,071,000	1,987,000	6,155,000	5,949,000
FDIC insurance costs	250,000	351,000	708,000	1,108,000
Other expense	4,112,000	4,117,000	12,877,000	12,530,000
Total noninterest expenses	20,210,000	19,663,000	59,868,000	58,725,000
Income before federal income tax expense	12,039,000	11,471,000	33,626,000	34,842,000
Federal income tax expense	3,702,000	3,626,000	10,331,000	11,014,000
Net income	$8,337,000	$7,845,000	$23,295,000	$23,828,000
Basic earnings per share	$0.51	$0.48	$1.41	$1.46
Diluted earnings per share	$0.51	$0.48	$1.41	$1.46
Cash dividends per share	$0.19	$0.17	$0.55	$0.49
Average basic shares outstanding	16,483,492	16,282,804	16,463,245	16,271,848
Average diluted shares outstanding	16,494,540	16,307,350	16,474,534	16,294,093

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended Sept 30, 2017	Three Months Ended Sept 30, 2016	Nine Months Ended Sept 30, 2017	Nine Months Ended Sept 30, 2016
Net income	$8,337,000	$7,845,000	$23,295,000	$23,828,000
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	(1,381,000)	(1,495,000)	5,833,000	722,000
Fair value of interest rate swap	13,000	113,000	69,000	88,000
Total other comprehensive income	(1,368,000)	(1,382,000)	5,902,000	810,000
Tax effect of unrealized holding gains (losses) on securities available for sale	484,000	523,000	(2,042,000)	(253,000)
Tax effect of fair value of interest rate swap	(5,000)	(40,000)	(24,000)	(31,000)
Total tax effect of other comprehensive income	479,000	483,000	(2,066,000)	(284,000)
Other comprehensive income (loss), net of tax	(889,000)	(899,000)	3,836,000	526,000
Comprehensive income	$7,448,000	$6,946,000	$27,131,000	$24,354,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2017	$ 0	$ 305,488	$ 40,904	$ (5,581)	$ 340,811
Employee stock purchase plan (1,053 shares)		36			36
Dividend reinvestment plan (43,938 shares)		1,426			1,426
Stock option exercises (25,075 shares)		289			289
Stock grants to directors for retainer fees (11,712 shares)		363			363
Stock-based compensation expense		1,431			1,431
Cash dividends ($0.55 per common share)			(8,941)		(8,941)
Net income for the nine months ended September 30, 2017			23,295		23,295
Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect				3,791	3,791
Change in fair value of interest rate swap, net of tax effect				45	45
Balances, September 30, 2017	$ 0	$ 309,033	$ 55,258	$ (1,745)	$ 362,546

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2016	$ 0	$ 304,819	$ 27,722	$ 1,263	$ 333,804
Employee stock purchase plan (1,121 shares)		27			27
Dividend reinvestment plan (44,535 shares)		1,079			1,079
Stock option exercises (50,323 shares)		606			606
Stock grants to directors for retainer fees (13,000 shares)		327			327
Stock-based compensation expense		901			901
Share repurchase program (167,878 shares)		(3,732)			(3,732)
Cash dividends ($0.49 per common share)			(7,895)		(7,895)
Net income for the nine months ended September 30, 2016			23,828		23,828
Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect				469	469
Change in fair value of interest rate swap, net of tax effect				57	57
Balances, September 30, 2016	$ 0	$ 304,027	$ 43,655	$ 1,789	$ 349,471

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended Sept 30, 2017	Nine Months Ended Sept 30, 2016
Cash flows from operating activities		
Net income	$23,295,000	$23,828,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	7,820,000	6,730,000
Accretion of acquired loans	(1,867,000)	(3,253,000)
Provision for loan losses	2,350,000	2,300,000
Stock-based compensation expense	1,431,000	901,000
Stock grants to directors for retainer fee	363,000	327,000
Proceeds from sales of mortgage loans held for sale	81,368,000	83,440,000
Origination of mortgage loans held for sale	(81,570,000)	(83,000,000)
Net gain from sales of mortgage loans held for sale	(2,875,000)	(2,463,000)
Gain on trust preferred securities repurchase	0	(2,970,000)
Net gain from sales and valuation write-down of foreclosed assets	(199,000)	(322,000)
Net (gain) loss from sales and valuation write-down of former bank premises	123,000	(10,000)
Net loss from sales of fixed assets	67,000	174,000
Net (gain) loss from sales of available for sale securities	(36,000)	1,000
Earnings on bank owned life insurance	(2,394,000)	(933,000)
Net change in:		
Accrued interest receivable	(1,404,000)	(228,000)
Other assets	(1,987,000)	(1,554,000)
Accrued interest and other liabilities	278,000	(809,000)
Net cash from operating activities	24,763,000	22,159,000
Cash flows from investing activities		
Loan originations and payments, net	(172,665,000)	(124,126,000)
Purchases of securities available for sale	(50,276,000)	(130,414,000)
Proceeds from maturities, calls and repayments of securities available for sale	46,177,000	152,781,000
Proceeds from sales of securities available for sale	6,706,000	264,000
Proceeds from sales of foreclosed assets	772,000	1,458,000
Proceeds from sales of former bank premises	22,000	45,000
Purchases of Federal Home Loan Bank stock	(3,010,000)	(459,000)
Proceeds from bank owned life insurance cash value release and death benefits	2,720,000	0

Purchases of bank owned life insurance	0	(7,000,000)
Net purchases of premises and equipment	(4,192,000)	(1,051,000)
Net cash for investing activities	(173,746,000)	(108,502,000)

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Nine Months Ended Sept 30, 2017	Nine Months Ended Sept 30, 2016
Cash flows from financing activities		
Net increase (decrease) in time deposits	(49,466,000)	17,823,000
Net increase in all other deposits	163,524,000	36,232,000
Net decrease in securities sold under agreements to repurchase	(9,430,000)	(7,928,000)
Maturities of Federal Home Loan Bank advances	(45,000,000)	0
Proceeds from Federal Home Loan Bank advances	90,000,000	110,000,000
Proceeds from stock option exercises	289,000	606,000
Employee stock purchase plan	36,000	27,000
Dividend reinvestment plan	1,426,000	1,079,000
Repurchase of common stock shares	0	(3,732,000)
Repurchase of trust preferred securities	0	(8,030,000)
Payment of cash dividends to common shareholders	(8,941,000)	(7,895,000)
Net cash from financing activities	142,438,000	138,182,000
Net change in cash and cash equivalents	(6,545,000)	51,839,000
Cash and cash equivalents at beginning of period	183,596,000	89,891,000
Cash and cash equivalents at end of period	$177,051,000	$141,730,000
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	$11,064,000	$9,218,000
Federal income tax	10,275,000	10,950,000
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	839,000	297,000
Transfers from bank premises to other real estate owned	1,737,000	371,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the nine months ended September 30, 2017 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 two subsidiaries, 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, 2017 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, 2016.

We have five separate business trusts that were formed to issue trust preferred securities. Subordinated debentures were issued to the trusts in return for the proceeds raised from the issuance of the trust preferred securities. The trusts are not consolidated, but instead we report the subordinated debentures issued to the trusts 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 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 220,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2017. In addition, stock options for approximately 28,000 shares of common stock were included in determining diluted earnings per share for the three and nine months ended September 30, 2017. Stock options for approximately 7,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2017.

Approximately 148,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2016. In addition, stock options for approximately 79,000 shares of common stock were included in determining diluted earnings per share for the three and nine months ended September 30, 2016. Stock options for approximately 4,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2016.

Securities: Debt securities classified as held to maturity are carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities are classified as available for sale when they might be sold prior to maturity. Equity securities with readily determinable fair values are classified as available for sale. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. Federal Home Loan Bank stock is carried at cost.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Interest income includes amortization of purchase premiums and accretion of discounts. Premiums and discounts on securities are amortized or accreted on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Declines in the fair value of debt securities below their amortized cost that are other than temporary ("OTTI") are reflected in earnings or other comprehensive income, as appropriate. For those debt securities whose fair value is less than their amortized cost, we 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 whether we expect to recover the entire amortized cost of the security based on our assessment of the issuer's financial condition. In analyzing an issuer's financial condition, we consider whether the securities are issued by the federal government or its agencies, and whether downgrades by bond rating agencies have occurred. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement, and 2) OTTI related to other factors, such as liquidity conditions in the market or changes in market interest rates, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost.

Loans: Loans that we have the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Interest income on commercial loans and mortgage loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer and credit card loans are typically charged-off no later than when they are 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is

considered doubtful.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. As of September 30, 2017 and December 31, 2016, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of $4.1 million and $1.0 million, respectively. Loans held for sale are reported as part of our total loans on the balance sheet.

Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold, which is reduced by the cost allocated to the servicing right. We generally lock in the sale price to the purchaser of the loan at the same time we make a rate commitment to the borrower. These mortgage banking activities are not designated as hedges and are carried at fair value. The net gain or loss on mortgage banking derivatives is included in the gain on sale of loans. Mortgage loans serviced for others totaled approximately $611 million as of September 30, 2017.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Mortgage Banking Activities: Mortgage loan servicing rights are recognized as assets based on the allocated value of retained servicing rights on mortgage loans sold. Mortgage loan servicing rights are carried at the lower of amortized cost or fair value and are expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the rights using groupings of the underlying mortgage loans as to interest rates. Any impairment of a grouping is reported as a valuation allowance.

Servicing fee income is recorded for fees earned for servicing mortgage loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. Amortization of mortgage loan servicing rights is netted against mortgage loan servicing income and recorded in mortgage banking activities in the income statement.

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 below 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.

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 considered to be 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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 generally consisted of interest rate swap agreements that qualified for hedge accounting. In February 2012, we entered into an interest rate swap agreement that qualifies for hedge accounting. The current outstanding interest rate swap is discussed in more detail in Note 9. 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 assets and liabilities 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 the derivatives and 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 and liabilities 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 derivative as a hedge is no longer appropriate or intended.

Goodwill and Core Deposit Intangible: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If

the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. The quantitative test is a two-step process consisting of comparing the carrying value of the reporting unit to an estimate of its fair value. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2015 and 2016, we elected to perform a qualitative assessment for our annual impairment test and concluded it is more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required.

The core deposit intangible that arose from the Firstbank Corporation acquisition was initially measured at fair value and is being amortized into noninterest expense over a ten-year period using the sum-of-the-years-digits methodology.

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Adoption of New Accounting Standards: In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. This ASU establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. This ASU was originally effective for annual and interim periods beginning after December 15, 2016, with two transition methods available – full retrospective and cumulative effect approach. In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers – Deferral of Effective Date*, which delays the implementation of this guidance by one year. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance will not have an impact on interest income. We are completing an overall assessment of revenue streams and review of related contracts potentially affected by the ASU. In addition, we are evaluating the ASU's expanded disclosure requirements. We plan to adopt this ASU on January 1, 2018 utilizing the modified retrospective approach with a cumulative effect adjustment to opening retained earnings, if such adjustment is applicable.

In January 2016, the FASB issued ASU 2016-1, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU requires an entity to (i) measure equity investments at fair value through net income, with certain exceptions; (ii) present in OCI the changes in instrument-specific credit risk for financial liabilities measured using the fair value option; (iii) present financial assets and financial liabilities by measurement category and form of financial asset; (iv) calculate the fair value of financial instruments for disclosure purposes based on an exit price; and (v) assess a valuation allowance on deferred tax assets related to unrealized losses on available for sale debt securities in combination with other deferred tax assets. This ASU provides an election to subsequently measure certain nonmarketable equity investments at cost less any impairment and adjusted for certain observable price changes. This ASU also requires a qualitative impairment assessment of such equity investments and amends certain fair value disclosure requirements. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017, and are not expected to have a material effect on our financial position or results of operations when adopted.

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The ASU is effective for annual and interim periods beginning after December 15, 2018. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

In March 2016, the FASB issued ASU 2016-09, *Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting*. This ASU requires that, prospectively, all tax effects related to share-based payments be made through the income statement at the time of settlement as opposed to excess tax benefits being recognized in additional paid-in capital under the current guidance. The ASU also removes the requirement to delay recognition of a tax benefit until it reduces current taxes payable. This change is required to be applied on a modified retrospective basis, with a cumulative-effect adjustment to opening retained earnings. Additionally, all tax related cash flows resulting from share-based payments are to be reported as operating activities on the statement of cash flows, a change from the current requirement to present tax benefits as an inflow from financing activities and an outflow from operating activities. Finally, entities will be allowed to withhold an amount up to the employees' maximum individual tax rate (as opposed to the minimum statutory tax rate) in the relevant jurisdiction without resulting in liability classification of the award. The change in withholding requirements will be applied on a modified retrospective approach. This standard will be effective for annual and interim periods beginning after December 15, 2016. Adoption of this ASU did not have a material effect on our financial position or results of operations.

In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard will replace the current "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (i) financial assets subject to credit losses and measured at amortized cost, and (ii) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans, and expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. This ASU is effective for interim and annual reporting periods beginning after December 15, 2019, and early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. This ASU will make eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows and is effective for fiscal years beginning after December 15, 2017. The new standard will require adoption on a retrospective basis unless it is impractical to apply, in which case it would be required to apply the amendments prospectively as of the earliest date practicable. We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, *Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. This ASU simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under this ASU, an entity should perform the Step 1 annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying value. If the carrying amount exceeds the fair value, an entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, not to exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. This ASU is effective January 1, 2020 and early adoption is permitted. The ASU should be applied prospectively. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

In March 2017, the FASB issued ASU No. 2017-08, *Premium Amortization on Purchased Callable Debt Securities*. This ASU requires the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. Previously, entities were allowed to amortize to contractual maturity or to call date. This ASU is effective for annual reporting periods beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements.

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 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2017				
U.S. Government agency debt obligations	$165,551,000	$208,000	$(4,591,000)	$161,168,000
Mortgage-backed securities	39,304,000	405,000	(214,000)	39,495,000
Municipal general obligation bonds	121,803,000	1,750,000	(243,000)	123,310,000
Municipal revenue bonds	4,099,000	51,000	(16,000)	4,134,000
Other investments	2,002,000	0	(19,000)	1,983,000

	$332,759,000	$2,414,000	$(5,083,000)	$330,090,000
<u>December 31, 2016</u>				
U.S. Government agency debt obligations	$159,271,000	$106,000	$(7,337,000)	$152,040,000
Mortgage-backed securities	47,329,000	486,000	(423,000)	47,392,000
Municipal general obligation bonds	120,284,000	312,000	(1,549,000)	119,047,000
Municipal revenue bonds	7,699,000	23,000	(91,000)	7,631,000
Other investments	1,979,000	0	(29,000)	1,950,000
	$336,562,000	$927,000	$(9,429,000)	$328,060,000

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2. SECURITIES (Continued)

Securities with unrealized losses at September 30, 2017 and December 31, 2016, 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		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2017						
U.S. Government agency debt obligations	$81,981,000	$2,496,000	$47,265,000	$2,095,000	$129,246,000	$4,591,000
Mortgage-backed securities	21,482,000	121,000	9,416,000	93,000	30,898,000	214,000
Municipal general obligation bonds	10,280,000	90,000	8,436,000	153,000	18,716,000	243,000
Municipal revenue bonds	0	0	1,101,000	16,000	1,101,000	16,000
Other investments	1,502,000	19,000	0	0	1,502,000	19,000
	$115,245,000	$2,726,000	$66,218,000	$2,357,000	$181,463,000	$5,083,000

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2016						
U.S. Government agency debt obligations	$110,160,000	$7,172,000	$5,073,000	$165,000	$115,233,000	$7,337,000
Mortgage-backed securities	3,670,000	4,000	37,072,000	419,000	40,742,000	423,000
Municipal general obligation bonds	65,895,000	1,360,000	27,734,000	189,000	93,629,000	1,549,000
Municipal revenue bonds	1,921,000	90,000	206,000	1,000	2,127,000	91,000

Other investments	1,479,000	29,000	0	0	1,479,000	29,000
	$183,125,000	$8,655,000	$70,085,000	$774,000	$253,210,000	$9,429,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED 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, 2017, 195 debt securities and one mutual fund with fair values totaling $181 million have unrealized losses aggregating $5.1 million. 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 the 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 unrealized losses are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at September 30, 2017, by maturity, are shown in the following table. The contractual maturity is utilized 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 penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

	Weighted Average	Amortized Cost	Fair Value

	Yield			
Due in 2017	1.51	%	$3,307,000	$3,307,000
Due in 2018 through 2022	2.20		95,857,000	96,451,000
Due in 2023 through 2027	2.71		99,198,000	98,217,000
Due in 2028 and beyond	2.94		93,091,000	90,637,000
Mortgage-backed securities	2.06		39,304,000	39,495,000
Other investments	2.03		2,002,000	1,983,000
Total available for sale securities	2.53	%	$332,759,000	$330,090,000

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of $113 million at September 30, 2017 and $109 million at December 31, 2016, with estimated market values of $114 million and $107 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of $13.4 million and $19.5 million at September 30, 2017 and December 31, 2016, respectively, with estimated market values of $13.6 million and $19.5 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, did not exceed 10% of shareholders' equity.

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2. SECURITIES (Continued)

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was $122 million and $132 million at September 30, 2017 and December 31, 2016, respectively. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans originated for investment are stated at their principal amount outstanding adjusted for partial charge-offs, the allowance, and net deferred loan fees and costs. Interest income on loans is accrued over the term of the loans primarily using the simple interest method based on the principal balance outstanding. Interest is not accrued on loans where collectability is uncertain. Accrued interest is presented separately in the consolidated balance sheet. Loan origination fees and certain direct costs incurred to extend credit are deferred and amortized over the term of the loan or loan commitment period as an adjustment to the related loan yield.

Acquired loans are those purchased in the Firstbank merger. These loans were recorded at estimated fair value at the merger date with no carryover of the related allowance. The acquired loans were segregated between those considered to be performing ("acquired non-impaired loans") and those with evidence of credit deterioration ("acquired impaired loans"). Acquired loans are considered impaired if there is evidence of credit deterioration and if it is probable, at acquisition, all contractually required payments will not be collected. Acquired loans restructured after acquisition are not considered or reported as troubled debt restructurings if the loans evidenced credit deterioration as of the merger date and are accounted for in pools.

The fair value estimates for acquired loans are based on expected prepayments and the amount and timing of discounted expected principal, interest and other cash flows. Credit discounts representing the principal losses

expected over the life of the loan are also a component of the initial fair value. In determining the merger date fair value of acquired impaired loans, and in subsequent accounting, we have generally aggregated acquired commercial and consumer loans into pools of loans with common risk characteristics.

The difference between the fair value of an acquired non-impaired loan and contractual amounts due at the merger date is accreted into income over the estimated life of the loan. Contractually required payments represent the total undiscounted amount of all uncollected principal and interest payments. Acquired non-impaired loans are placed on nonaccrual status and reported as nonperforming or past due using the same criteria applied to the originated loan portfolio.

The excess of an acquired impaired loan's undiscounted contractually required payments over the amount of its undiscounted cash flows expected to be collected is referred to as the non-accretable difference. The non-accretable difference, which is neither accreted into income nor recorded on the consolidated balance sheet, reflects estimated future credit losses and uncollectible contractual interest expected to be incurred over the life of the acquired impaired loan. The excess cash flows expected to be collected over the carrying amount of the acquired loan is referred to as the accretable yield. This amount is accreted into interest income over the remaining life of the acquired loans or pools using the level yield method. The accretable yield is affected by changes in interest rate indices for variable rate loans, changes in prepayment speed assumptions and changes in expected principal and interest payments over the estimated lives of the acquired impaired loans.

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MERCANTILE BANK CORPORATION

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(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

We evaluate quarterly the remaining contractual required payments receivable and estimate cash flows expected to be collected over the lives of the impaired loans. Contractually required payments receivable may increase or decrease for a variety of reasons, for example, when the contractual terms of the loan agreement are modified, when interest rates on variable rate loans change, or when principal and/or interest payments are received. Cash flows expected to be collected on acquired impaired loans are estimated by incorporating several key assumptions similar to the initial estimate of fair value. These key assumptions include probability of default, loss given default, and the amount of actual prepayments after the merger date. Prepayments affect the estimated lives of loans and could change the amount of interest income, and possibly principal, expected to be collected. In re-forecasting future estimated cash flows, credit loss expectations are adjusted as necessary. The adjustments are based, in part, on actual loss severities recognized for each loan type, as well as changes in the probability of default. For periods in which estimated cash flows are not re-forecasted, the prior reporting period’s estimated cash flows are adjusted to reflect the actual cash received and credit events that transpired during the current reporting period.

Increases in expected cash flows of acquired impaired loans subsequent to the merger date are recognized prospectively through adjustments of the yield on the loans or pools over their remaining lives, while decreases in expected cash flows are recognized as impairment through a provision for loan losses and an increase in the allowance.

Our total loans at September 30, 2017 were $2.55 billion compared to $2.38 billion at December 31, 2016, an increase of $176 million, or 7.4%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at September 30, 2017 and December 31, 2016, and the percentage change in loans from the end of 2016 to the end of the third quarter of 2017, are as follows:

	September 30, 2017		December 31, 2016		Percent Increase
	Balance	%	Balance	%	(Decrease)
Originated loans					
Commercial:					

Commercial and industrial	$710,699,000	33.3 %	$636,771,000	33.8 %	11.6 %
Vacant land, land development, and residential construction	21,272,000	1.0	26,519,000	1.4	(19.8)
Real estate – owner occupied	411,367,000	19.3	363,509,000	19.3	13.2
Real estate – non-owner occupied	721,304,000	33.8	652,054,000	34.6	10.6
Real estate – multi-family and residential rental	58,356,000	2.7	50,045,000	2.6	16.6
Total commercial	1,922,998,000	90.1	1,728,898,000	91.7	11.2
Retail:					
Home equity and other	69,325,000	3.3	69,831,000	3.7	(0.7)
1-4 family mortgages	141,443,000	6.6	85,819,000	4.6	64.8
Total retail	210,768,000	9.9	155,650,000	8.3	35.4
Total originated loans	$2,133,766,000	100.0%	$1,884,548,000	100.0%	13.2 %

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	September 30, 2017 Balance	%	December 31, 2016 Balance	%	Percent Increase (Decrease)
Acquired loans					
Commercial:					
Commercial and industrial	$65,864,000	15.7 %	$77,132,000	15.6 %	(14.6%)
Vacant land, land development, and residential construction	7,303,000	1.7	8,309,000	1.7	(12.1)
Real estate – owner occupied	73,980,000	17.6	86,955,000	17.6	(14.9)
Real estate – non-owner occupied	83,863,000	19.9	96,215,000	19.5	(12.8)
Real estate – multi-family and residential rental	60,814,000	14.5	67,838,000	13.7	(10.4)
Total commercial	291,824,000	69.4	336,449,000	68.1	(13.3)
Retail:					
Home equity and other	34,051,000	8.1	48,216,000	9.8	(29.4)
1-4 family mortgages	94,631,000	22.5	109,407,000	22.1	(13.5)
Total retail	128,682,000	30.6	157,623,000	31.9	(18.4)
Total acquired loans	$420,506,000	100.0%	$494,072,000	100.0%	(14.9%)

	September 30, 2017 Balance	%	December 31, 2016 Balance	%	Percent Increase (Decrease)
Total loans					
Commercial:					
Commercial and industrial	$776,563,000	30.4%	$713,903,000	30.0%	8.8 %
Vacant land, land development, and residential construction	28,575,000	1.1	34,828,000	1.5	(18.0)
Real estate – owner occupied	485,347,000	19.0	450,464,000	18.9	7.7
Real estate – non-owner occupied	805,167,000	31.5	748,269,000	31.5	7.6
Real estate – multi-family and residential rental	119,170,000	4.7	117,883,000	4.9	1.1

Total commercial	2,214,822,000	86.7	2,065,347,000	86.8	7.2
Retail:					
Home equity and other	103,376,000	4.0	118,047,000	5.0	(12.4)
1-4 family mortgages	236,074,000	9.3	195,226,000	8.2	20.9
Total retail	339,450,000				