MERCANTILE BANK CORP
Form 10-Q
November 08, 2011
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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)

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, 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	x

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

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS

	September 30, 2011 (Unaudited)	December 31, 2010 (Audited)
ASSETS		
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
LIABILITIES AND SHAREHOLDERS EQUITY		
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

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.

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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)
Interest income				
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
Total interest income	17,044,000	21,734,000	54,663,000	67,619,000
Interest expense				
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
Total interest expense	4,749,000	7,799,000	15,761,000	24,958,000
Net interest income	12,295,000	13,935,000	38,902,000	42,661,000
Provision for loan losses	1,100,000	10,400,000	5,000,000	25,000,000
Net interest income after provision for loan losses	11,195,000	3,535,000	33,902,000	17,661,000
Noninterest income				
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
Total noninterest income	1,804,000	2,289,000	5,259,000	6,940,000
Noninterest expense				
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
Total noninterest expenses	9,975,000	11,899,000	31,999,000	34,974,000

Income (loss) before federal income tax expense (benefit)	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
Net income (loss) available to common shareholders	$ 2,682,000	$ (5,682,000)	$ 6,151,000	$ (9,329,000)

See accompanying notes to consolidated financial statements.

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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.

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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
Balances, January 1, 2011	$ 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
Total comprehensive income						11,462
Balances, September 30, 2011	$ 20,266	$ 172,834	$ 1,138	$ (62,630)	$ 5,125	$ 136,733

See accompanying notes to consolidated financial statements.

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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
Balances, January 1, 2010	$ 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)
Total comprehensive loss						(4,910)
Balances, September 30, 2010	$ 20,016	$ 172,768	$ 1,138	$ (63,500)	$ 4,312	$ 134,734

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended Sept 30, 2011	Nine Months Ended Sept 30, 2010
Cash flows from operating activities		
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
Cash flows from investing activities		
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
Cash flows from financing activities		
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)

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)
Net cash for financing activities	(166,137,000)	(86,509,000)

See accompanying notes to consolidated financial statements.

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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.

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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)

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)

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.

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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.

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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.

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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.

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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
September 30, 2011				
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
December 31, 2010				
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

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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		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2011						
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)
December 31, 2010						
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)

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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.

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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.

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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
	Balance	%	Balance	%	Increase (Decrease)
Commercial:					
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)
Total commercial	1,012,973,000	92.6	1,175,970,000	93.1	(13.9)
Retail:					
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
Total retail	81,064,000	7.4	86,660,000	6.9	(6.5)
Total loans	$ 1,094,037,000	100.0%	$ 1,262,630,000	100.0%	(13.4)%

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
Total nonperforming loans	$ 39,540,000	$ 69,444,000

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

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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
Commercial:		
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
Total commercial	36,210,000	60,036,000
Retail:		
Home equity and other	1,630,000	2,425,000
1-4 family mortgages	1,700,000	1,454,000
Total retail	3,330,000	3,879,000
Total nonaccrual loans	$ 39,540,000	$ 63,915,000

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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
Commercial:							
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
Total commercial	1,811,000	100,000	20,104,000	22,015,000	990,958,000	1,012,973,000	0
Retail:							
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
Total retail	94,000	222,000	1,433,000	1,749,000	79,315,000	81,064,000	0
Total past due loans	$ 1,905,000	$ 322,000	$ 21,537,000	$ 23,764,000	$ 1,070,273,000	$ 1,094,037,000	$ 0

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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

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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

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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.

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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

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

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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

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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