

MERCANTILE BANK CORP
Form 10-Q
August 05, 2016
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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2016

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 No

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

Yes No

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

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company

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

Yes No

At August 5, 2016, there were 16,279,351 shares of common stock outstanding.

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PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	June 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	\$60,087,000	\$42,829,000
Interest-earning deposits	46,896,000	46,463,000
Federal funds sold	0	599,000
Total cash and cash equivalents	106,983,000	89,891,000
Securities available for sale	323,452,000	346,992,000
Federal Home Loan Bank stock	8,026,000	7,567,000
Loans	2,379,940,000	2,277,727,000
Allowance for loan losses	(17,110,000)	(15,681,000)
Loans, net	2,362,830,000	2,262,046,000
Premises and equipment, net	45,558,000	46,862,000
Bank owned life insurance	66,537,000	58,971,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	11,228,000	12,631,000
Other assets	25,849,000	29,123,000
Total assets	\$2,999,936,000	\$2,903,556,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	\$733,573,000	\$674,568,000
Interest-bearing	1,546,145,000	1,600,814,000
Total deposits	2,279,718,000	2,275,382,000
Securities sold under agreements to repurchase	136,690,000	154,771,000
Federal Home Loan Bank advances	178,000,000	68,000,000

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Subordinated debentures	44,494,000	55,154,000
Accrued interest and other liabilities	16,457,000	16,445,000
Total liabilities	2,655,359,000	2,569,752,000
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; 16,271,061 shares outstanding at June 30, 2016 and 16,358,711 shares outstanding at December 31, 2015	303,336,000	304,819,000
Retained earnings	38,553,000	27,722,000
Accumulated other comprehensive income	2,688,000	1,263,000
Total shareholders' equity	344,577,000	333,804,000
Total liabilities and shareholders' equity	\$2,999,936,000	\$2,903,556,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Interest income				
Loans, including fees	\$26,887,000	\$25,587,000	\$53,666,000	\$50,898,000
Securities, taxable	2,657,000	1,489,000	4,173,000	3,174,000
Securities, tax-exempt	540,000	523,000	1,077,000	1,060,000
Other interest-earning assets	63,000	64,000	120,000	120,000
Total interest income	30,147,000	27,663,000	59,036,000	55,252,000
Interest expense				
Deposits	1,819,000	1,775,000	3,685,000	3,675,000
Short-term borrowings	47,000	39,000	91,000	76,000
Federal Home Loan Bank advances	575,000	151,000	925,000	303,000
Subordinated debentures and other borrowings	606,000	657,000	1,353,000	1,308,000
Total interest expense	3,047,000	2,622,000	6,054,000	5,362,000
Net interest income	27,100,000	25,041,000	52,982,000	49,890,000
Provision for loan losses	1,100,000	(600,000)	1,700,000	(1,000,000)
Net interest income after provision for loan losses	26,000,000	25,641,000	51,282,000	50,890,000
Noninterest income				
Services charges on deposit and sweep accounts	1,090,000	812,000	2,038,000	1,582,000
Credit and debit card income	1,080,000	1,079,000	2,095,000	2,291,000
Mortgage banking activities	744,000	999,000	1,342,000	1,687,000
Earnings on bank owned life insurance	298,000	262,000	584,000	548,000
Gain on trust preferred securities repurchase	0	0	2,970,000	0
Other income	852,000	869,000	2,121,000	1,607,000
Total noninterest income	4,064,000	4,021,000	11,150,000	7,715,000

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Noninterest expense				
Salaries and benefits	10,801,000	11,074,000	21,796,000	21,158,000
Occupancy	1,480,000	1,479,000	3,084,000	3,052,000
Furniture and equipment	522,000	596,000	1,047,000	1,220,000
Data processing costs	1,970,000	1,872,000	3,962,000	3,642,000
FDIC insurance costs	365,000	483,000	757,000	960,000
Other expense	4,055,000	4,846,000	8,415,000	9,559,000
Total noninterest expenses	19,193,000	20,350,000	39,061,000	39,591,000
Income before federal income tax expense	10,871,000	9,312,000	23,371,000	19,014,000
Federal income tax expense	3,437,000	2,754,000	7,388,000	5,810,000
Net income	\$7,434,000	\$6,558,000	\$15,983,000	\$13,204,000
Basic earnings per share	\$0.46	\$0.39	\$0.98	\$0.78
Diluted earnings per share	\$0.46	\$0.39	\$0.98	\$0.78
Cash dividends per share	\$0.16	\$0.14	\$0.32	\$0.28
Average basic shares outstanding	16,240,966	16,767,393	16,266,311	16,852,002
Average diluted shares outstanding	16,268,839	16,803,846	16,293,250	16,887,702

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 June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Net income	\$7,434,000	\$6,558,000	\$15,983,000	\$13,204,000
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	299,000	(2,722,000)	2,218,000	165,000
Fair value of interest rate swap	(4,000)	71,000	(25,000)	(126,000)
	295,000	(2,651,000)	2,193,000	39,000
Tax effect of unrealized holding gains (losses) on securities available for sale	(105,000)	981,000	(777,000)	(30,000)
Tax effect of fair value of interest rate swap	1,000	(25,000)	9,000	44,000
	(104,000)	956,000	(768,000)	14,000
Other comprehensive income (loss), net of tax	191,000	(1,695,000)	1,425,000	53,000
Comprehensive income	\$7,625,000	\$4,863,000	\$17,408,000	\$13,257,000

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 (Deficit)	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 (773 shares)		18			18
Dividend reinvestment plan (38,195 shares)		909			909
Stock option exercises (31,249 shares)		379			379
Stock grants to directors for retainer fees (13,000 shares)		327			327
Stock-based compensation expense		616			616
Share repurchase program (167,878 shares)		(3,732)			(3,732)
Cash dividends (\$0.32 per common share)			(5,152)		(5,152)
Net income for the six months ended June 30, 2016			15,983		15,983
Change in net unrealized holding gain on securities available for sale, net of tax effect				1,441	1,441
Change in fair value of interest rate swap, net of tax effect				(16)	(16)
Balances, June 30, 2016	\$ 0	\$303,336	\$38,553	\$ 2,688	\$ 344,577

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 (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2015	\$ 0	\$317,904	\$10,218	\$ 16	\$ 328,138
Employee stock purchase plan (1,110 shares)		23			23
Dividend reinvestment plan (13,788 shares)		283			283
Stock option exercises (26,375 shares)		275			275
Stock grants to directors for retainer fees (20,094 shares)		402			402
Stock-based compensation expense		359			359
Share repurchase program (463,060 shares)		(9,110)			(9,110)
Cash dividends (\$0.28 per common share)			(4,656)		(4,656)
Net income for the six months ended June 30, 2015			13,204		13,204
Change in net unrealized holding gain on securities available for sale, net of tax effect				135	135
Change in fair value of interest rate swap, net of tax effect				(82)	(82)
Balances, June 30, 2015	\$ 0	\$310,136	\$18,766	\$ 69	\$ 328,971

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months	Six Months
	Ended	Ended
	June 30,	June 30,
	2016	2015
Cash flows from operating activities		
Net income	\$ 15,983,000	\$ 13,204,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	4,275,000	5,588,000
Accretion of acquired loans	(2,251,000)	(2,910,000)
Provision for loan losses	1,700,000	(1,000,000)
Stock-based compensation expense	616,000	359,000
Stock grants to directors for retainer fee	327,000	402,000
Proceeds from sales of mortgage loans held for sale	46,441,000	57,735,000
Origination of mortgage loans held for sale	(46,715,000)	(56,853,000)
Net gain from sales of mortgage loans held for sale	(1,290,000)	(1,706,000)
Gain on trust preferred securities repurchase	(2,970,000)	0
Net gain from sales and valuation write-down of foreclosed assets	(322,000)	(71,000)
Net gain from sales and valuation write-down of former bank premises	(10,000)	0
Net (gain) loss from sales of fixed assets	171,000	(10,000)
Net (gain) loss from sales of available for sale securities	1,000	(5,000)
Earnings on bank owned life insurance	(584,000)	(548,000)
Net change in:		
Accrued interest receivable	568,000	212,000
Other assets	(120,000)	(188,000)
Accrued interest and other liabilities	(13,000)	896,000
Net cash from operating activities	15,807,000	15,105,000
Cash flows from investing activities		
Loan originations and payments, net	(99,276,000)	(82,399,000)
Purchases of securities available for sale	(60,873,000)	(4,868,000)
Proceeds from maturities, calls and repayments of securities available for sale	86,872,000	62,135,000
Proceeds from sales of securities available for sale	264,000	665,000
Proceeds from sales of foreclosed assets	1,371,000	1,131,000
Proceeds from sales of former bank premises	46,000	0

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Proceeds from FHLB stock redemption	0	6,132,000
Purchases of FHLB stock	(459,000)	0
Purchases of bank owned life insurance	(7,000,000)	0
Net purchases of premises and equipment	(307,000)	(589,000)
Net cash for investing activities	(79,362,000)	(17,793,000)

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Six Months	Six Months
	Ended	Ended
	June 30, 2016	June 30, 2015
Cash flows from financing activities		
Net decrease in time deposits	(17,540,000)	(84,451,000)
Net increase in all other deposits	21,876,000	87,505,000
Net decrease in securities sold under agreements to repurchase	(18,081,000)	(15,488,000)
Maturities of Federal Home Loan Bank advances	0	(6,000,000)
Proceeds from Federal Home Loan Bank advances	110,000,000	0
Proceeds from stock option exercises	379,000	275,000
Employee stock purchase plan	18,000	23,000
Dividend reinvestment plan	909,000	283,000
Repurchase of common stock shares	(3,732,000)	(9,110,000)
Repurchase of trust preferred securities	(8,030,000)	0
Payment of cash dividends to common shareholders	(5,152,000)	(4,656,000)
Net cash from (for) financing activities	80,647,000	(31,619,000)
Net change in cash and cash equivalents	17,092,000	(34,307,000)
Cash and cash equivalents at beginning of period	89,891,000	172,738,000
Cash and cash equivalents at end of period	\$ 106,983,000	\$ 138,431,000
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	\$6,016,000	\$5,564,000
Federal income tax	6,700,000	5,700,000
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	236,000	1,098,000
Transfers from bank premises to other real estate owned	371,000	0

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the six months ended June 30, 2016 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 June 30, 2016 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, 2015.

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 150,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2016. In addition, stock options for approximately 92,000 shares of

common stock were included in determining diluted earnings per share for the three and six months ended June 30, 2016. 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 six months ended June 30, 2016.

Approximately 100,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2015. In addition, stock options for approximately 108,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 2015. Stock options for approximately 91,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2015.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 June 30, 2016 and December 31, 2015, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$2.9 million and \$1.3 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 \$597 million as of June 30, 2016.

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 serving 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 2014 and 2015, 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.

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 three transition methods available – full retrospective, 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. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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 is not expected to have a material effect on our financial position or results of operations.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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: (1) financial assets subject to credit losses and measured at amortized cost, and (2) 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.

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	Gross	Gross	Fair
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	Cost	Unrealized Gains	Unrealized Losses	Value
<u>June 30, 2016</u>				
U.S. Government agency debt obligations	\$ 132,085,000	\$ 895,000	\$ (38,000)	\$ 132,942,000
Mortgage-backed securities	56,616,000	979,000	(50,000)	57,545,000
Municipal general obligation bonds	119,878,000	2,602,000	(94,000)	122,386,000
Municipal revenue bonds	8,498,000	95,000	0	8,593,000
Other investments	1,962,000	24,000	0	1,986,000
	\$ 319,039,000	\$ 4,595,000	\$ (182,000)	\$ 323,452,000
<u>December 31, 2015</u>				
U.S. Government agency debt obligations	\$ 146,660,000	\$ 1,932,000	\$ (1,552,000)	\$ 147,040,000
Mortgage-backed securities	66,670,000	708,000	(304,000)	67,074,000
Municipal general obligation bonds	120,679,000	1,549,000	(205,000)	122,023,000
Municipal revenue bonds	8,841,000	76,000	(3,000)	8,914,000
Other investments	1,946,000	0	(5,000)	1,941,000
	\$ 344,796,000	\$ 4,265,000	\$ (2,069,000)	\$ 346,992,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

Securities with unrealized losses at June 30, 2016 and December 31, 2015, 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	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Loss	Value	Loss	Value	Loss
June 30, 2016						
U.S. Government agency debt obligations	\$3,991,000	\$ 9,000	\$2,958,000	\$ 29,000	\$6,949,000	\$ 38,000
Mortgage-backed securities	3,212,000	16,000	9,899,000	34,000	13,111,000	50,000
Municipal general obligation bonds	850,000	5,000	9,042,000	89,000	9,892,000	94,000
Municipal revenue bonds	557,000	0	0	0	557,000	0
Other investments	0	0	0	0	0	0
	\$8,610,000	\$ 30,000	\$21,899,000	\$ 152,000	\$30,509,000	\$ 182,000

	Less than 12 Months		12 Months or More		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Loss	Value	Loss	Value	Loss
December 31, 2015						
U.S. Government agency debt obligations	\$0	\$ 0	\$76,496,000	\$1,552,000	\$76,496,000	\$1,552,000
Mortgage-backed securities	18,025,000	69,000	34,660,000	235,000	52,685,000	304,000
Municipal general obligation bonds	1,981,000	4,000	30,134,000	201,000	32,115,000	205,000
Municipal revenue bonds	0	0	1,134,000	3,000	1,134,000	3,000

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Other investments	1,446,000	5,000	0	0	1,446,000	5,000
	\$21,452,000	\$ 78,000	\$142,424,000	\$1,991,000	\$163,876,000	\$2,069,000

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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 June 30, 2016, 93 debt securities with fair values totaling \$30.5 million have unrealized losses aggregating \$0.2 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 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 June 30, 2016, 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	Amortized	Fair
Average	Cost	Value

Yield

Due in 2016	1.44	% \$32,582,000	\$32,601,000
Due in 2017 through 2021	1.83	119,275,000	120,413,000
Due in 2022 through 2026	3.10	55,510,000	56,994,000
Due in 2027 and beyond	3.27	53,094,000	53,913,000
Mortgage-backed securities	1.76	56,616,000	57,545,000
Other investments	3.06	1,962,000	1,986,000
	2.24	% \$319,039,000	\$323,452,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of \$107 million and \$106 million at June 30, 2016 and December 31, 2015, respectively, with estimated market values of \$109 million and \$107 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$21.5 million and \$24.0 million at June 30, 2016 and December 31, 2015, respectively, with estimated market values of \$21.8 million and \$24.1 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.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was \$137 million and \$155 million at June 30, 2016, and December 31, 2015, 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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.

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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Our total loans at June 30, 2016 were \$2.38 billion compared to \$2.28 billion at December 31, 2015, an increase of \$102 million, or 4.5%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at June 30, 2016 and December 31, 2015, and the percentage change in loans from the end of 2015 to the end of the second quarter of 2016, are as follows:

	June 30, 2016		December 31, 2015		Percent Increase (Decrease)	
	Balance	%	Balance	%		
<u>Originated loans</u>						
Commercial:						
Commercial and industrial	\$653,135,000	36.3 %	\$577,872,000	35.7 %	13.0	%
Vacant land, land development, and residential construction	30,232,000	1.7	30,138,000	1.9	0.3	
Real estate – owner occupied	338,909,000	18.8	330,798,000	20.5	2.5	
Real estate – non-owner occupied	603,236,000	33.5	520,754,000	32.2	15.8	
Real estate – multi-family and residential rental	39,233,000	2.2	33,954,000	2.1	15.5	
Total commercial	1,664,745,000	92.5	1,493,516,000	92.4	11.5	
Retail:						
Home equity and other	69,396,000	3.9	67,816,000	4.2	2.3	
1-4 family mortgages	65,813,000	3.6	55,255,000	3.4	19.1	
Total retail	135,209,000	7.5	123,071,000	7.6	9.9	
Total originated loans	\$1,799,954,000	100.0%	\$1,616,587,000	100.0%	11.3	%

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	June 30, 2016		December 31, 2015		Percent Increase (Decrease)	
	Balance	%	Balance	%		
<u>Acquired loans</u>						
Commercial:						
Commercial and industrial	\$97,001,000	16.7 %	\$118,431,000	17.9 %	(18.1)%
Vacant land, land development, and residential construction	10,297,000	1.8	14,982,000	2.3	(31.3)
Real estate – owner occupied	99,889,000	17.2	115,121,000	17.4	(13.2)
Real estate – non-owner occupied	113,694,000	19.6	123,597,000	18.7	(8.0)
Real estate – multi-family and residential rental	74,129,000	12.8	81,049,000	12.3	(8.5)
Total commercial	395,010,000	68.1	453,180,000	68.6	(12.8)
Retail:						
Home equity and other	61,671,000	10.6	72,830,000	11.0	(15.3)
1-4 family mortgages	123,305,000	21.3	135,130,000	20.4	(8.7)
Total retail	184,976,000	31.9	207,960,000	31.4	(11.1)
Total acquired loans	\$579,986,000	100.0%	\$661,140,000	100.0%	(12.3%)

	June 30, 2016		December 31, 2015		Percent Increase (Decrease)	
	Balance	%	Balance	%		
<u>Total loans</u>						
Commercial:						
Commercial and industrial	\$750,136,000	31.5 %	\$696,303,000	30.6 %	7.7	%
Vacant land, land development, and residential construction	40,529,000	1.7	45,120,000	2.0	(10.2)
Real estate – owner occupied	438,798,000	18.4	445,919,000	19.6	(1.6)
Real estate – non-owner occupied	716,930,000	30.1	644,351,000	28.3	11.3	

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Real estate – multi-family and residential rental	113,362,000	4.8	115,003,000	5.0	(1.4)
Total commercial	2,059,755,000	86.5	1,946,696,000	85.5	5.8	
Retail:						
Home equity and other	131,067,000	5.5	140,646,000	6.2	(6.8)
1-4 family mortgages	189,118,000	8.0	190,385,000	8.3	(0.7)
Total retail	320,185,000	13.5	331,031,000	14.5	(3.3)
Total loans	\$2,379,940,000	100.0%	\$2,277,727,000	100.0%	4.5	%

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The total contractually required payments due on and carrying value of acquired impaired loans were \$19.2 million and \$8.8 million, respectively, as of June 30, 2016. The total contractually required payments due on and carrying value of acquired impaired loans were \$24.6 million and \$13.1 million, respectively, as of December 31, 2015. Changes in the accretible yield for acquired impaired loans for the three and six months ended June 30, 2016 and June 30, 2015 were as follows:

Balance at March 31, 2016	\$6,319,000
Additions	0
Accretion income	(674,000)
Net reclassification from nonaccretable to accretible	1,193,000
Reductions (1)	(236,000)
Balance at June 30, 2016	\$6,602,000
Balance at December 31, 2015	\$5,193,000
Additions	21,000
Accretion income	(1,354,000)
Net reclassification from nonaccretable to accretible	3,565,000
Reductions (1)	(823,000)
Balance at June 30, 2016	\$6,602,000
Balance at March 31, 2015	\$5,241,000
Additions	0
Accretion income	(681,000)
Net reclassification from nonaccretable to accretible	708,000
Reductions (1)	(153,000)
Balance at June 30, 2015	\$5,115,000

Balance at December 31, 2014	\$4,998,000
Additions	0
Accretion income	(1,327,000)
Net reclassification from nonaccretable to accretable	1,649,000
Reductions (1)	(205,000)
Balance at June 30, 2015	\$5,115,000

(1) Reductions primarily reflect the result of exit events, including loan payoffs and charge-offs.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Nonperforming originated loans as of June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016	December 31, 2015
Loans past due 90 days or more still accruing interest	\$0	\$0
Nonaccrual loans	2,042,000	1,954,000
Total nonperforming originated loans	\$2,042,000	\$1,954,000

Nonperforming acquired loans as of June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016	December 31, 2015
Loans past due 90 days or more still accruing interest	\$0	\$5,000
Nonaccrual loans	3,126,000	3,485,000
Total nonperforming acquired loans	\$3,126,000	\$3,490,000

The recorded principal balance of nonperforming loans was as follows:

	June 30, 2016	December 31, 2015
Commercial:		
Commercial and industrial	\$819,000	\$458,000
Vacant land, land development, and residential construction	125,000	155,000
Real estate – owner occupied	1,465,000	1,797,000
Real estate – non-owner occupied	51,000	79,000
Real estate – multi-family and residential rental	114,000	157,000
Total commercial	2,574,000	2,646,000
Retail:		
Home equity and other	616,000	771,000
1-4 family mortgages	1,978,000	2,027,000
Total retail	2,594,000	2,798,000
Total nonperforming loans	\$5,168,000	\$5,444,000

Acquired impaired loans are not reported as nonperforming loans based on acquired impaired loan accounting. 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of June 30, 2016:

	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
<u>Originated loans</u>							
Commercial:							
Commercial and industrial	\$ 1,000	\$ 0	\$ 0	\$ 1,000	\$ 653,134,000	\$ 653,135,000	\$ 0
Vacant land, land development, and residential construction	0	0	0	0	30,232,000	30,232,000	0
Real estate – owner occupied	0	197,000	0	197,000	338,712,000	338,909,000	0
Real estate – non-owner occupied	0	0	0	0	603,236,000	603,236,000	0
Real estate – multi-family and residential rental	0	0	0	0	39,233,000	39,233,000	0
Total commercial	1,000	197,000	0	198,000	1,664,547,000	1,664,745,000	0
Retail:							
Home equity and other	129,000	21,000	11,000	161,000	69,235,000	69,396,000	0
1-4 family mortgages	97,000	0	403,000	500,000	65,313,000	65,813,000	0
Total retail	226,000	21,000	414,000	661,000	134,548,000	135,209,000	0
Total past due loans	\$ 227,000	\$ 218,000	\$ 414,000	\$ 859,000	\$ 1,799,095,000	\$ 1,799,954,000	\$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	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
<u>Acquired loans</u>							
Commercial:							
Commercial and industrial	\$ 14,000	\$ 0	\$ 350,000	\$ 364,000	\$ 96,637,000	\$ 97,001,000	\$ 0
Vacant land, land development, and residential construction	29,000	0	0	29,000	10,268,000	10,297,000	0
Real estate – owner occupied	243,000	50,000	398,000	691,000	99,198,000	99,889,000	0
Real estate – non-owner occupied	159,000	0	419,000	578,000	113,116,000	113,694,000	0
Real estate – multi-family and residential rental	164,000	42,000	80,000	286,000	73,843,000	74,129,000	0
Total commercial	609,000	92,000	1,247,000	1,948,000	393,062,000	395,010,000	0
Retail:							
Home equity and other	568,000	43,000	11,000	622,000	61,049,000	61,671,000	0
1-4 family mortgages	1,188,000	261,000	344,000	1,793,000	121,512,000	123,305,000	0
Total retail	1,756,000	304,000	355,000	2,415,000	182,561,000	184,976,000	0
Total past due loans	\$ 2,365,000	\$ 396,000	\$ 1,602,000	\$ 4,363,000	\$ 575,623,000	\$ 579,986,000	\$ 0

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED 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, 2015:

	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
Originated loans							
Commercial:							
Commercial and industrial	\$0	\$0	\$0	\$0	\$577,872,000	\$577,872,000	\$ 0
Vacant land, land development, and residential construction	0	0	0	0	30,138,000	30,138,000	0
Real estate – owner occupied	432,000	0	9,000	441,000	330,357,000	330,798,000	0
Real estate – non-owner occupied	0	0	0	0	520,754,000	520,754,000	0
Real estate – multi-family and residential rental	0	0	0	0	33,954,000	33,954,000	0
Total commercial	432,000	0	9,000	441,000	1,493,075,000	1,493,516,000	0
Retail:							
Home equity and other	186,000	108,000	0	294,000	67,522,000	67,816,000	0
1-4 family mortgages	107,000	95,000	356,000	558,000	54,697,000	55,255,000	0
Total retail	293,000	203,000	356,000	852,000	122,219,000	123,071,000	0

Total past due loans	\$725,000	\$203,000	\$365,000	\$1,293,000	\$1,615,294,000	\$1,616,587,000	\$ 0
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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	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
<u>Acquired Loans</u>							
Commercial:							
Commercial and industrial	\$0	\$5,000	\$541,000	\$546,000	\$117,885,000	\$118,431,000	\$0
Vacant land, land development, and residential construction	27,000	0	0	27,000	14,955,000	14,982,000	0
Real estate – owner occupied	323,000	425,000	1,142,000	1,890,000	113,231,000	115,121,000	0
Real estate – non-owner occupied	53,000	703,000	79,000	835,000	122,762,000	123,597,000	0
Real estate – multi-family and residential rental	223,000	54,000	0	277,000	80,772,000	81,049,000	0
Total commercial	626,000	1,187,000	1,762,000	3,575,000	449,605,000	453,180,000	0
Retail:							
Home equity and other	395,000	44,000	28,000	467,000	72,363,000	72,830,000	5,000
1-4 family mortgages	960,000	354,000	416,000	1,730,000	133,400,000	135,130,000	0
Total retail	1,355,000	398,000	444,000	2,197,000	205,763,000	207,960,000	5,000
Total past due loans	\$1,981,000	\$1,585,000	\$2,206,000	\$5,772,000	\$655,368,000	\$661,140,000	\$5,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired originated loans as of June 30, 2016, and average originated impaired loans for the three and six months ended June 30, 2016, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$2,147,000	\$2,146,000		\$2,017,000	\$ 1,845,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	348,000	251,000		160,000	275,000
Real estate – non-owner occupied	5,623,000	5,623,000		5,641,000	5,660,000
Real estate – multi-family and residential rental	0	0		0	0
Total commercial	8,118,000	8,020,000		7,818,000	7,780,000
Retail:					
Home equity and other	129,000	120,000		65,000	45,000
1-4 family mortgages	1,324,000	668,000		621,000	633,000
Total retail	1,453,000	788,000		686,000	678,000
Total with no related allowance recorded	\$9,571,000	\$8,808,000		\$8,504,000	\$ 8,458,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid	Recorded	Related	Second Quarter Average	Year-To-Date Average
	Contractual	Principal	Allowance	Recorded	Recorded
	Principal	Balance		Principal	Principal
	Balance			Balance	Balance
<u>With an allowance recorded</u>					
Commercial:					
Commercial and industrial	\$249,000	\$199,000	\$47,000	\$217,000	\$246,000
Vacant land, land development and residential construction	2,002,000	1,625,000	72,000	1,633,000	1,640,000
Real estate – owner occupied	5,930,000	1,378,000	235,000	1,339,000	1,331,000
Real estate – non-owner occupied	4,704,000	4,704,000	180,000	4,729,000	4,766,000
Real estate – multi-family and residential rental	979,000	979,000	293,000	993,000	1,004,000
Total commercial	13,864,000	8,885,000	827,000	8,911,000	8,987,000
Retail:					
Home equity and other	550,000	512,000	137,000	491,000	515,000
1-4 family mortgages	205,000	163,000	72,000	145,000	139,000
Total retail	755,000	675,000	209,000	636,000	654,000
Total with an allowance recorded	\$14,619,000	\$9,560,000	\$1,036,000	\$9,547,000	\$9,641,000
Total impaired loans:					
Commercial	\$21,982,000	\$16,905,000	\$827,000	\$16,729,000	\$16,767,000
Retail	2,208,000	1,463,000	209,000	1,322,000	1,332,000
Total impaired loans	\$24,190,000	\$18,368,000	\$1,036,000	\$18,051,000	\$18,099,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of June 30, 2016, and average impaired acquired loans for the three and six months ended June 30, 2016, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$1,694,000	\$1,681,000		\$1,556,000	\$1,535,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	1,314,000	1,300,000		1,485,000	1,640,000
Real estate – non-owner occupied	811,000	811,000		792,000	821,000
Real estate – multi-family and residential rental	295,000	295,000		289,000	327,000
Total commercial	4,114,000	4,087,000		4,122,000	4,323,000
Retail:					
Home equity and other	367,000	365,000		321,000	317,000
1-4 family mortgages	1,305,000	1,305,000		1,290,000	1,376,000
Total retail	1,672,000	1,670,000		1,611,000	1,693,000
Total with no related allowance recorded	\$5,786,000	\$5,757,000		\$5,733,000	\$6,016,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid	Recorded	Related	Second Quarter Average	Year-To-Date Average
	Contractual	Principal	Allowance	Recorded	Recorded
	Principal	Balance		Principal	Principal
	Balance			Balance	Balance
<u>With an allowance recorded</u>					
Commercial:					
Commercial and industrial	\$356,000	\$356,000	\$101,000	\$367,000	\$370,000
Vacant land, land development and residential construction	0	0	0	0	0
Real estate – owner occupied	49,000	49,000	4,000	50,000	50,000
Real estate – non-owner occupied	0	0	0	0	0
Real estate – multi-family and residential rental	20,000	20,000	1,000	20,000	21,000
Total commercial	425,000	425,000	106,000	437,000	441,000
Retail:					
Home equity and other	0	0	0	0	0
1-4 family mortgages	174,000	174,000	5,000	87,000	116,000
Total retail	174,000	174,000	5,000	87,000	116,000
Total with an allowance recorded	\$599,000	\$599,000	\$111,000	\$524,000	\$557,000
Total impaired loans:					
Commercial	\$4,539,000	\$4,512,000	\$106,000	\$4,559,000	\$4,764,000
Retail	1,846,000	1,844,000	5,000	1,698,000	1,809,000
Total impaired loans	\$6,385,000	\$6,356,000	\$111,000	\$6,257,000	\$6,573,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired originated loans as of December 31, 2015, and average impaired originated loans for the three and six months ended June 30, 2015, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$1,509,000	\$1,501,000		\$1,930,000	\$1,674,000
Vacant land, land development and residential construction	0	0		98,000	135,000
Real estate – owner occupied	712,000	505,000		1,062,000	1,342,000
Real estate – non-owner occupied	5,696,000	5,696,000		2,937,000	2,362,000
Real estate – multi-family and residential rental	0	0		306,000	309,000
Total commercial	7,917,000	7,702,000		6,333,000	5,822,000
Retail:					
Home equity and other	14,000	5,000		189,000	190,000
1-4 family mortgages	1,328,000	657,000		615,000	597,000
Total retail	1,342,000	662,000		804,000	787,000
Total with no related allowance recorded	\$9,259,000	\$8,364,000		\$7,137,000	\$6,609,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid	Recorded	Related	Second Quarter Average	Year-To-Date Average
	Contractual	Principal	Allowance	Recorded	Recorded
	Principal	Balance		Principal	Principal
	Balance			Balance	Balance
<u>With an allowance recorded</u>					
Commercial:					
Commercial and industrial	\$ 352,000	\$ 305,000	\$ 165,000	\$ 2,812,000	\$ 3,617,000
Vacant land, land development and residential construction	2,017,000	1,655,000	245,000	2,092,000	2,061,000
Real estate – owner occupied	5,867,000	1,314,000	242,000	8,806,000	11,095,000
Real estate – non-owner occupied	4,841,000	4,841,000	201,000	10,319,000	12,195,000
Real estate – multi-family and residential rental	1,028,000	1,028,000	365,000	1,321,000	1,338,000
Total commercial	14,105,000	9,143,000	1,218,000	25,350,000	30,306,000
Retail:					
Home equity and other	600,000	562,000	209,000	165,000	138,000
1-4 family mortgages	165,000	128,000	47,000	217,000	811,000
Total retail	765,000	690,000	256,000	382,000	949,000
Total with an allowance recorded	\$ 14,870,000	\$ 9,833,000	\$ 1,474,000	\$ 25,732,000	\$ 31,255,000
Total impaired loans:					
Commercial	\$ 22,022,000	\$ 16,845,000	\$ 1,218,000	\$ 31,683,000	\$ 36,128,000
Retail	2,107,000	1,352,000	256,000	1,186,000	1,736,000
Total impaired loans	\$ 24,129,000	\$ 18,197,000	\$ 1,474,000	\$ 32,869,000	\$ 37,864,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of December 31, 2015, and average impaired acquired loans for the three and six months ended June 30, 2015, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$ 1,528,000	\$ 1,494,000		\$ 1,244,000	\$ 1,356,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	2,233,000	1,952,000		317,000	249,000
Real estate – non-owner occupied	880,000	880,000		427,000	393,000
Real estate – multi-family and residential rental	452,000	404,000		2,037,000	1,520,000
Total commercial	5,093,000	4,730,000		4,025,000	3,518,000
Retail:					
Home equity and other	471,000	310,000		365,000	456,000
1-4 family mortgages	1,804,000	1,548,000		801,000	823,000
Total retail	2,275,000	1,858,000		1,166,000	1,279,000
Total with no related allowance recorded	\$ 7,368,000	\$ 6,588,000		\$ 5,191,000	\$ 4,797,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid	Recorded	Related	Second Quarter Average	Year-To-Date Average
	Contractual	Principal	Allowance	Recorded	Recorded
	Principal	Balance		Principal	Principal
	Balance			Balance	Balance
<u>With an allowance recorded</u>					
Commercial:					
Commercial and industrial	\$383,000	\$376,000	\$102,000	\$97,000	\$65,000
Vacant land, land development and residential construction	0	0	0	0	0
Real estate – owner occupied	51,000	51,000	4,000	1,256,000	1,338,000
Real estate – non-owner occupied	0	0	0	0	0
Real estate – multi-family and residential rental	23,000	23,000	0	28,000	19,000
Total commercial	457,000	450,000	106,000	1,381,000	1,422,000
Retail:					
Home equity and other	0	0	0	0	0
1-4 family mortgages	175,000	175,000	6,000	283,000	189,000
Total retail	175,000	175,000	6,000	283,000	189,000
Total with an allowance recorded	\$632,000	\$625,000	\$112,000	\$1,664,000	\$1,611,000
Total impaired loans:					
Commercial	\$5,550,000	\$5,180,000	\$106,000	\$5,406,000	\$4,940,000
Retail	2,450,000	2,033,000	6,000	1,449,000	1,468,000
Total impaired loans	\$8,000,000	\$7,213,000	\$112,000	\$6,855,000	\$6,408,000

Impaired loans for which no allocation of the allowance for loan losses has been made generally reflect situations whereby the loans have been charged-down to estimated collateral value. Interest income recognized on accruing troubled debt restructurings totaled \$0.2 million and \$0.4 million during the second quarter of 2016 and 2015, respectively, and \$0.5 million and \$0.8 million during the first six months of 2016 and 2015, respectively. No interest income was recognized on nonaccrual loans during the second quarter and first six months of 2016 or during the respective 2015 periods.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED 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 and payment activity.

Credit quality indicators were as follows as of June 30, 2016:

Originated loans

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

	Commercial			Commercial
Commercial	Vacant Land,	Commercial	Commercial	Real Estate -
and	Land	Real Estate -	Real Estate -	Multi-Family
Industrial	Development,	Owner	Non-Owner	and
	and	Occupied	Occupied	Residential
	Residential			Rental
	Construction			

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Internal credit risk grade groupings:

Grades 1 – 4	\$455,134,000	\$ 19,014,000	\$237,652,000	\$491,928,000	\$20,438,000
Grades 5 – 7	197,701,000	11,093,000	99,961,000	111,308,000	17,816,000
Grades 8 – 9	300,000	125,000	1,296,000	0	979,000
Total commercial	\$653,135,000	\$ 30,232,000	\$338,909,000	\$603,236,000	\$39,233,000

Retail credit exposure – credit risk profiled by collateral type:

Retail		Retail	
Home Equity		1-4 Family	
and Other		Mortgages	
Total retail	\$69,396,000		\$65,813,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

	Commercial	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	\$50,716,000	\$ 2,322,000		\$41,217,000	\$70,569,000	\$42,729,000
Grades 5 – 7	43,819,000	7,648,000		55,364,000	41,431,000	30,692,000
Grades 8 – 9	2,466,000	327,000		3,308,000	1,694,000	708,000
Total commercial	\$97,001,000	\$ 10,297,000		\$99,889,000	\$113,694,000	\$74,129,000

Retail credit exposure – credit risk profiled by collateral type:

Retail Retail

Home Equity and Other	1-4 Family Mortgages
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Total retail \$61,671,000 \$123,305,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit quality indicators were as follows as of December 31, 2015:

Originated loans

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

	Commercial	Commercial	Commercial	Commercial	Commercial
	Vacant Land,	Commercial	Commercial	Commercial	Commercial
	Land	Real Estate -	Real Estate -	Real Estate -	Real Estate -
	Development,	Owner	Non-Owner	Non-Owner	Multi-Family
	and	Occupied	Occupied	Occupied	and
	Residential				Residential
	Construction				Rental
Internal credit risk grade groupings:					
Grades 1 – 4	\$417,120,000	\$ 18,118,000	\$230,629,000	\$400,350,000	\$ 19,121,000
Grades 5 – 7	160,454,000	10,365,000	98,332,000	120,404,000	13,806,000
Grades 8 – 9	298,000	1,655,000	1,837,000	0	1,027,000
Total commercial	\$577,872,000	\$ 30,138,000	\$330,798,000	\$520,754,000	\$ 33,954,000

Retail credit exposure – credit risk profiled by collateral type:

Retail	Retail
Home Equity	1-4 Family
and Other	Mortgages
Total retail	
\$67,816,000	\$55,255,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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	\$67,978,000	\$ 3,095,000	\$45,807,000	\$71,197,000	\$44,763,000
Grades 5 – 7	47,589,000	11,364,000	63,563,000	50,066,000	35,288,000
Grades 8 – 9	2,864,000	523,000	5,751,000	2,334,000	998,000
Total commercial	\$118,431,000	\$ 14,982,000	\$115,121,000	\$123,597,000	\$81,049,000

Retail credit exposure – credit risk profiled by collateral type:

Retail	Retail
Home Equity	1-4 Family
and Other	Mortgages

Total retail \$72,830,000 \$135,130,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

All commercial loans are graded using the following criteria:

Grade 1. Excellent credit rating that contain very little, if any, risk of loss.

Grade 2. Strong sources of repayment and have low repayment risk.

Grade 3. Good sources of repayment and have limited repayment risk.

Grade 4. Adequate sources of repayment and acceptable repayment risk; however, characteristics are present that render the credit more vulnerable to a negative event.

Grade 5. Marginally acceptable sources of repayment and exhibit defined weaknesses and negative characteristics.

Grade 6. Well defined weaknesses which may include negative current cash flow, high leverage, or operating losses. Generally, if the credit does not stabilize or if further deterioration is observed in the near term, the loan will likely be downgraded and placed on the Watch List (i.e., list of lending relationships that receive increased scrutiny and review by the Board of Directors and senior management).

Grade 7. Defined weaknesses or negative trends that merit close monitoring through Watch List status.

Grade 8. Inadequately protected by current sound net worth, paying capacity of the obligor, or pledged collateral, resulting in a distinct possibility of loss requiring close monitoring through Watch List status.

Grade 9. Vital weaknesses exist where collection of principal is highly questionable.

Grade 10. Considered uncollectable and of such little value that continuance as an asset is not warranted.

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses and the recorded investments in originated loans as of and during the three and six months ended June 30, 2016 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2016	\$ 13,924,000	\$ 1,834,000	\$ 214,000	\$ 15,972,000
Provision for loan losses	842,000	296,000	20,000	1,158,000
Charge-offs	(166,000)	(231,000)	0	(397,000)
Recoveries	129,000	14,000	0	143,000
Ending balance	\$ 14,729,000	\$ 1,913,000	\$ 234,000	\$ 16,876,000
Allowance for loan losses:				
Balance at December 31, 2015	\$ 13,672,000	\$ 1,421,000	\$ 140,000	\$ 15,233,000
Provision for loan losses	936,000	799,000	94,000	1,829,000
Charge-offs	(255,000)	(617,000)	0	(872,000)
Recoveries	376,000	310,000	0	686,000
Ending balance	\$ 14,729,000	\$ 1,913,000	\$ 234,000	\$ 16,876,000
Ending balance: individually evaluated for impairment	\$ 827,000	\$ 209,000	\$ 0	\$ 1,036,000
Ending balance: collectively evaluated for impairment	\$ 13,902,000	\$ 1,704,000	\$ 234,000	\$ 15,840,000
Total loans:				
Ending balance	\$ 1,664,745,000	\$ 135,209,000		\$ 1,799,954,000

Ending balance: individually evaluated for impairment	\$ 16,905,000	\$ 1,463,000	\$ 18,368,000
Ending balance: collectively evaluated for impairment	\$ 1,647,840,000	\$ 133,746,000	\$ 1,781,586,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses for acquired loans during the three and six months ended June 30, 2016 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2016	\$ 266,000	\$ 24,000	\$ 0	\$ 290,000
Provision for loan losses	(57,000)	(1,000)	0	(58,000)
Charge-offs	0	0	0	0
Recoveries	2,000	0	0	2,000
Ending balance	\$ 211,000	\$ 23,000	\$ 0	\$ 234,000
Allowance for loan losses:				
Balance at December 31, 2015	\$ 420,000	\$ 28,000	\$ 0	\$ 448,000
Provision for loan losses	(167,000)	38,000	0	(129,000)
Charge-offs	0	0	0	0
Recoveries	(42,000)	(43,000)	0	(85,000)
Ending balance	\$ 211,000	\$ 23,000	\$ 0	\$ 234,000

The negative loan recoveries reflected for acquired loans during the first six months of 2016 resulted from reversals of prior-period recoveries associated with certain purchased credit impaired (“PCI”) loans that were subject to pre-acquisition charge-offs. Post-acquisition payments received on these PCI loans were previously reported as loan loss recoveries in prior periods; during the first quarter of 2016, these recoveries were reversed and reported as recovery income if associated with specifically reviewed PCI loans or retained gains if associated with PCI-pooled loans.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses and the recorded investments in originated loans as of and during the three and six months ended June 30, 2015 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2015	\$ 18,977,000	\$ 1,235,000	\$ 39,000	\$ 20,251,000
Provision for loan losses	(1,151,000)	513,000	(5,000)	(643,000)
Charge-offs	(4,199,000)	(154,000)	0	(4,353,000)
Recoveries	365,000	120,000	0	485,000
Ending balance	\$ 13,992,000	\$ 1,714,000	\$ 34,000	\$ 15,740,000
Allowance for loan losses:				
Balance at December 31, 2014	\$ 17,736,000	\$ 1,487,000	\$ 76,000	\$ 19,299,000
Provision for loan losses	(1,651,000)	592,000	(42,000)	(1,101,000)
Charge-offs	(4,277,000)	(517,000)	0	(4,794,000)
Recoveries	2,184,000	152,000	0	2,336,000
Ending balance	\$ 13,992,000	\$ 1,714,000	\$ 34,000	\$ 15,740,000
Ending balance: individually evaluated for impairment	\$ 2,146,000	\$ 178,000	\$ 0	\$ 2,324,000
Ending balance: collectively evaluated for impairment	\$ 11,846,000	\$ 1,536,000	\$ 34,000	\$ 13,416,000
Total loans:				
Ending balance	\$ 1,322,388,000	\$ 107,235,000		\$ 1,429,623,000

Ending balance: individually evaluated for impairment	\$ 19,108,000	\$ 1,180,000	\$ 20,288,000
Ending balance: collectively evaluated for impairment	\$ 1,303,280,000	\$ 106,055,000	\$ 1,409,335,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses for acquired loans during the three and six months ended June 30, 2015 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2015	\$ 622,000	\$ 177,000	\$ 0	\$ 799,000
Provision for loan losses	(31,000)	74,000	0	43,000
Charge-offs	(30,000)	0	0	(30,000)
Recoveries	0	9,000	0	9,000
Ending balance	\$ 561,000	\$ 260,000	\$ 0	\$ 821,000
Allowance for loan losses:				
Balance at December 31, 2014	\$ 681,000	\$ 61,000	\$ 0	\$ 742,000
Provision for loan losses	(90,000)	191,000	0	101,000
Charge-offs	(31,000)	(7,000)	0	(38,000)
Recoveries	1,000	15,000	0	16,000
Ending balance	\$ 561,000	\$ 260,000	\$ 0	\$ 821,000

In accordance with acquisition accounting rules, acquired loans were recorded at fair value at the merger date and the prior allowance was eliminated.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the three months ended June 30, 2016 were as follows:

	Number of Contracts	Pre- Modification Recorded Principal Balance	Post- Modification Recorded Principal Balance
<u>Originated loans</u>			
Commercial:			
Commercial and industrial	0	\$ 0	\$ 0
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	1	167,000	167,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	1	167,000	167,000
Retail:			
Home equity and other	2	184,000	184,000
1-4 family mortgages	1	33,000	40,000
Total originated retail	3	217,000	224,000
Total originated loans	4	\$ 384,000	\$ 391,000
<u>Acquired loans</u>			
Commercial:			
Commercial and industrial	0	\$ 0	\$ 0
Vacant land, land development and residential construction	0	0	0

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Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	1	60,000	60,000
Real estate – multi-family and residential rental	1	7,000	7,000
Total acquired commercial	2	67,000	67,000
Retail:			
Home equity and other	1	25,000	25,000
1-4 family mortgages	0	0	0
Total acquired retail	1	25,000	25,000
Total acquired loans	3	\$ 92,000	\$ 92,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the six months ended June 30, 2016 were as follows:

		Pre- Modification Recorded Principal Balance	Post- Modification Recorded Principal Balance
<u>Originated loans</u>			
Commercial:			
Commercial and industrial	1	\$ 20,000	\$ 20,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	1	167,000	167,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	2	187,000	187,000
Retail:			
Home equity and other	2	184,000	184,000
1-4 family mortgages	1	33,000	40,000
Total originated retail	3	217,000	224,000
Total originated loans	5	\$ 404,000	\$ 411,000
<u>Acquired loans</u>			
Commercial:			
Commercial and industrial	0	\$ 0	\$ 0
Vacant land, land development and residential construction	0	0	0

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Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	1	60,000	60,000
Real estate – multi-family and residential rental	1	7,000	7,000
Total acquired commercial	2	67,000	67,000
Retail:			
Home equity and other	2	51,000	51,000
1-4 family mortgages	1	19,000	19,000
Total acquired retail	3	70,000	70,000
Total acquired loans	5	\$ 137,000	\$ 137,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the three months ended June 30, 2015 were as follows:

		Pre-	Post-
	Number	Modification	Modification
	of	Recorded	Recorded
	Contracts	Principal	Principal
		Balance	Balance
<u>Originated loans</u>			
Commercial:			
Commercial and industrial	4	\$ 1,308,000	\$ 1,308,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	4	1,308,000	1,308,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total originated retail	0	0	0
Total originated loans	4	\$ 1,308,000	\$ 1,308,000
<u>Acquired loans</u>			
Commercial:			
Commercial and industrial	2	\$ 286,000	\$ 286,000
Vacant land, land development and residential construction	0	0	0

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Real estate – owner occupied	3	119,000	119,000
Real estate – non-owner occupied	1	302,000	302,000
Real estate – multi-family and residential rental	3	265,000	265,000
Total acquired commercial	9	972,000	972,000
Retail:			
Home equity and other	1	161,000	161,000
1-4 family mortgages	0	0	0
Total acquired retail	1	161,000	161,000
Total acquired loans	10	\$ 1,133,000	\$ 1,133,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the six months ended June 30, 2015 were as follows:

		Pre-	Post-
	Number	Modification	Modification
	of	Recorded	Recorded
	Contracts	Principal	Principal
		Balance	Balance
<u>Originated loans</u>			
Commercial:			
Commercial and industrial	10	\$ 1,876,000	\$ 1,901,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	10	1,876,000	1,901,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total originated retail	0	0	0
Total originated loans	10	\$ 1,876,000	\$ 1,901,000
<u>Acquired loans</u>			
Commercial:			
Commercial and industrial	2	\$ 286,000	\$ 286,000
Vacant land, land development and residential construction	0	0	0

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Real estate – owner occupied	5	169,000	169,000
Real estate – non-owner occupied	1	302,000	302,000
Real estate – multi-family and residential rental	3	265,000	265,000
Total acquired commercial	11	1,022,000	1,022,000
Retail:			
Home equity and other	1	161,000	161,000
1-4 family mortgages	0	0	0
Total acquired retail	1	161,000	161,000
Total acquired loans	12	\$ 1,183,000	\$ 1,183,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2016 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	0	0
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	0	\$ 0

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2016 (amounts as of period end):

Number of	Recorded
--------------	----------

Contracts Principal

		Balance
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	0	0
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	0	\$ 0

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MERCANTILE BANK CORPORATION

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2016 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	1	22,000
Total commercial	1	22,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	\$ 22,000

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2016 (amounts as of period end):

Number of	Recorded
--------------	----------

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Contracts Principal

		Balance
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	1	22,000
Total commercial	1	22,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	\$ 22,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2015 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	\$0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	1,182,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	1,182,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	\$1,182,000

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2015 (amounts as of period end):

Number of	Recorded
--------------	----------

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Contracts Principal

		Balance
Commercial:		
Commercial and industrial	0	\$0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	1,182,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	1,182,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	\$1,182,000

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MERCANTILE BANK CORPORATION

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2015 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	18,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	18,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	\$ 18,000

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2015 (amounts as of period end):

Number of	Recorded
--------------	----------

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Contracts Principal

		Balance
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	18,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	18,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	\$ 18,000

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the three months ended June 30, 2016 is as follows:

	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 1,946,000	\$ 2,062,000	\$ 1,369,000	\$ 10,529,000	\$ 469,000
Charge-Offs	0	0	0	0	0
Payments	0	(26,000)	(35,000)	(94,000)	(8,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	157,000	0	97,000	0	0
Ending Balance	\$ 2,103,000	\$ 2,036,000	\$ 1,431,000	\$ 10,435,000	\$ 461,000

Retail Retail

Home 1-4
 Equity Family

 and Mortgages
 Other

Retail Loan Portfolio:

Beginning Balance	\$ 146,000	\$ 126,000
Charge-Offs	0	0
Payments	(1,000)	(3,000)
Transfers to ORE	0	0
Net Additions/Deletions	184,000	40,000
Ending Balance	\$ 329,000	\$ 163,000

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the three months ended June 30, 2016 is as follows:

	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 1,687,000	\$ 0	\$ 1,455,000	\$ 637,000	\$ 278,000
Charge-Offs	0	0	0	0	0
Payments	(43,000)	0	(172,000)	(12,000)	(11,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	0	0	0	56,000	7,000
Ending Balance	\$ 1,644,000	\$ 0	\$ 1,283,000	\$ 681,000	\$ 274,000

Retail	Retail
Home Equity	1-4 Family

	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$ 161,000	\$ 335,000
Charge-Offs	0	0
Payments	(7,000)	(2,000)
Transfers to ORE	0	0
Net Additions/Deletions	26,000	0
Ending Balance	\$ 180,000	\$ 333,000

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MERCANTILE BANK CORPORATION

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the six months ended June 30, 2016 is as follows:

	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 2,028,000	\$ 2,086,000	\$ 1,400,000	\$ 10,657,000	\$ 476,000
Charge-Offs	0	0	0	0	0
Payments	(101,000)	(50,000)	(66,000)	(222,000)	(15,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	176,000	0	97,000	0	0
Ending Balance	\$ 2,103,000	\$ 2,036,000	\$ 1,431,000	\$ 10,435,000	\$ 461,000

Retail

Retail

Home 1-4
 Equity Family

 and Mortgages
 Other

Retail Loan Portfolio:

Beginning Balance	\$ 146,000	\$ 128,000
Charge-Offs	0	0
Payments	(1,000)	(5,000)
Transfers to ORE	0	0
Net Additions/Deletions	184,000	40,000
Ending Balance	\$ 329,000	\$ 163,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the six months ended June 30, 2016 is as follows:

	Commercial	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 1,686,000	\$ 0	\$ 1,652,000	\$ 647,000	\$ 331,000
Charge-Offs	(48,000)	0	0	0	0
Payments	(43,000)	0	(369,000)	(22,000)	(64,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	49,000	0	0	56,000	7,000
Ending Balance	\$ 1,644,000	\$ 0	\$ 1,283,000	\$ 681,000	\$ 274,000

Retail Retail
Home

	Equity	1-4 Family
	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$ 141,000	\$ 316,000
Charge-Offs	0	0
Payments	(14,000)	(3,000)
Transfers to ORE	0	0
Net Additions/Deletions	53,000	20,000
Ending Balance	\$ 180,000	\$ 333,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the three months ended June 30, 2015 is as follows:

	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 6,556,000	\$ 2,654,000	\$ 16,966,000	\$ 16,063,000	\$ 498,000
Charge-Offs	0	0	(4,198,000)	0	0
Payments	(5,380,000)	(22,000)	(10,550,000)	(4,981,000)	(7,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	1,266,000	0	0	0	0
Ending Balance	\$ 2,442,000	\$ 2,632,000	\$ 2,218,000	\$ 11,082,000	\$ 491,000

Retail
Home
Equity
and
Other

Retail
1-4
Family
Mortgages

Retail Loan Portfolio:

Beginning Balance	\$ 0	\$ 302,000
Charge-Offs	0	(23,000)
Payments	0	(9,000)
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	\$ 0	\$ 270,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the three months ended June 30, 2015 is as follows:

	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 1,519,000	\$ 0	\$ 1,492,000	\$ 62,000	\$ 333,000
Charge-Offs	0	0	(31,000)	0	0
Payments	(275,000)	0	(292,000)	0	(6,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	277,000	0	181,000	299,000	253,000
Ending Balance	\$ 1,521,000	\$ 0	\$ 1,350,000	\$ 361,000	\$ 580,000

Retail Retail
Home

	Equity	1-4 Family
	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$0	\$ 177,000
Charge-Offs	0	0
Payments	0	0
Transfers to ORE	0	0
Net Additions/Deletions	152,000	0
Ending Balance	\$ 152,000	\$ 177,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the six months ended June 30, 2015 is as follows:

	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
Commercial Loan Portfolio:					
Beginning Balance	\$ 7,026,000	\$ 2,680,000	\$ 17,160,000	\$ 17,439,000	\$ 505,000
Charge-Offs	0	0	(4,198,000)	0	0
Payments	(6,535,000)	(48,000)	(10,744,000)	(6,357,000)	(14,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	1,951,000	0	0	0	0
Ending Balance	\$ 2,442,000	\$ 2,632,000	\$ 2,218,000	\$ 11,082,000	\$ 491,000

Retail

Retail 1-4 Family
 Home
 Mortgages
 Equity

and
 Other

Retail Loan Portfolio:

Beginning Balance	\$ 0	\$ 1,967,000
Charge-Offs	0	(148,000)
Payments	0	(1,549,000)
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	\$ 0	\$ 270,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the six months ended June 30, 2015 is as follows:

	Commercial	Commercial	Commercial	Commercial	Commercial
	Commercial	Vacant Land, Land Development, and Residential Construction	Commercial Real Estate Owner Occupied	Commercial Real Estate Non-Owner Occupied	Real Estate - Multi Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	\$ 1,439,000	\$ 0	\$ 1,569,000	\$ 64,000	\$ 381,000
Charge-Offs	0	0	(31,000)	0	0
Payments	(275,000)	0	(471,000)	(2,000)	(54,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	357,000	0	283,000	299,000	253,000
Ending Balance	\$ 1,521,000	\$ 0	\$ 1,350,000	\$ 361,000	\$ 580,000

Retail Retail
Home

	Equity	1-4 Family and Other	Mortgages
Retail Loan Portfolio:			
Beginning Balance	\$26,000		\$178,000
Charge-Offs	0		0
Payments	(26,000)		(1,000)
Transfers to ORE	0		0
Net Additions/Deletions	152,000		0
Ending Balance	\$152,000		\$177,000

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MERCANTILE BANK CORPORATION

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The allowance related to loans categorized as troubled debt restructurings was as follows:

	June 30, 2016	December 31, 2015
Commercial:		
Commercial and industrial	\$ 131,000	\$ 221,000
Vacant land, land development, and residential construction	43,000	186,000
Real estate – owner occupied	108,000	115,000
Real estate – non-owner occupied	180,000	201,000
Real estate – multi-family and residential rental	294,000	365,000
Total commercial	756,000	1,088,000
Retail:		
Home equity and other	48,000	14,000
1-4 family mortgages	5,000	6,000
Total retail	53,000	20,000
Total related allowance	\$ 809,000	\$ 1,108,000

In general, our policy dictates that a renewal or modification of an 8- or 9-rated commercial loan meets the criteria of a troubled debt restructuring, although we review and consider all renewed and modified loans as part of our troubled debt restructuring assessment procedures. Loan relationships rated 8 contain significant financial weaknesses, resulting in a distinct possibility of loss, while relationships rated 9 reflect vital financial weaknesses, resulting in a

highly questionable ability on our part to collect principal; we believe borrowers warranting such ratings would have difficulty obtaining financing from other market participants. Thus, due to the lack of comparable market rates for loans with similar risk characteristics, we believe 8- or 9-rated loans renewed or modified were done so at below market rates. Loans that are identified as troubled debt restructurings are considered impaired and are individually evaluated for impairment when assessing these credits in our allowance for loan losses calculation.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. PREMISES AND EQUIPMENT, NET

Premises and equipment are comprised of the following:

	June 30, 2016	December 31, 2015
Land and improvements	\$ 16,438,000	\$ 16,529,000
Buildings	39,422,000	39,394,000
Furniture and equipment	17,072,000	16,978,000
	72,932,000	72,901,000
Less: accumulated depreciation	27,374,000	26,039,000
Premises and equipment, net	\$45,558,000	\$46,862,000

Depreciation expense totaled \$0.7 million during the second quarter of 2016, compared to \$0.8 million during the second quarter of 2015. Depreciation expense totaled \$1.4 million during the first six months of 2016, compared to \$1.5 million during the first six months of 2015.

5. DEPOSITS

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Our total deposits at June 30, 2016 totaled \$2.28 billion, an increase of \$4.3 million, or 0.2%, from December 31, 2015. The components of our outstanding balances at June 30, 2016 and December 31, 2015, and percentage change in deposits from the end of 2015 to the end of the second quarter of 2016, are as follows:

	June 30, 2016		December 31, 2015		Percent	
	Balance	%	Balance	%	Increase (Decrease)	
Noninterest-bearing demand	\$733,573,000	32.2	% \$674,568,000	29.6	% 8.7	%
Interest-bearing checking	326,752,000	14.3	403,354,000	17.7	(19.0)
Money market	305,217,000	13.4	274,395,000	12.1	11.2	
Savings	341,445,000	15.0	332,794,000	14.6	2.6	
Time, under \$100,000	146,477,000	6.4	155,655,000	6.9	(5.9)
Time, \$100,000 and over	329,601,000	14.5	313,247,000	13.8	5.2	
	2,183,065,000	95.8	2,154,013,000	94.7	1.3	
Out-of-area time, under \$100,000	0	0.0	149,000	< 0.1	NA	
Out-of-area time, \$100,000 and over	96,653,000	4.2	121,220,000	5.3	(20.3)
	96,653,000	4.2	121,369,000	5.3	(20.4)
Total deposits	\$2,279,718,000	100.0%	\$2,275,382,000	100.0%	0.2	%

Total time deposits of more than \$250,000 totaled \$209 million and \$180 million at June 30, 2016 and December 31, 2015, respectively.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase (“repurchase agreements”) are offered principally to certain large deposit customers. Information relating to our repurchase agreements follows:

	Six Months Ended	Twelve Months Ended
	June 30, 2016	December 31, 2015
Outstanding balance at end of period	\$136,690,000	\$154,771,000
Average interest rate at end of period	0.14 %	0.11 %
Average daily balance during the period	\$153,578,000	\$146,826,000
Average interest rate during the period	0.12 %	0.11 %
Maximum daily balance during the period	\$175,088,000	\$168,211,000

Repurchase agreements generally have maturities of one business day. Repurchase agreements are treated as financings and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the agreements are recorded as assets of our bank and are held in safekeeping by a correspondent bank. Repurchase agreements are secured by securities with an aggregate market value equal to the aggregate outstanding balance.

7. FEDERAL HOME LOAN BANK OF INDIANAPOLIS ADVANCES

Federal Home Loan Bank of Indianapolis (“FHLBI”) advances totaled \$178 million at June 30, 2016, and mature at varying dates from December 2016 through April 2023, with fixed rates of interest from 1.04% to 2.11% and averaging 1.47%. FHLBI advances totaled \$68.0 million at December 31, 2015, and were to mature at varying dates ranging from December 2016 through August 2022, with fixed rates of interest from 1.22% to 2.11% and averaging 1.49%.

Each advance is payable at its maturity date and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of June 30, 2016 totaled about \$491 million, with availability based on collateral approximating \$313 million.

Maturities of currently outstanding FHLBI advances are as follows:

2016	\$3,000,000
2017	45,000,000
2018	20,000,000
2019	20,000,000
2020	20,000,000
Thereafter	70,000,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. COMMITMENTS AND OFF-BALANCE SHEET RISK

Our bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Loan commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are conditional commitments issued by our bank to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on our credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and is generally recorded as a liability. There was no reserve or liability balance for these instruments as of June 30, 2016 and December 31, 2015.

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at June 30, 2016 and December 31, 2015 follows:

	June 30,	December 31,
	2016	2015
Commercial unused lines of credit	\$516,345,000	\$522,658,000

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Unused lines of credit secured by 1 – 4 family residential properties	59,163,000	61,905,000
Credit card unused lines of credit	18,295,000	15,612,000
Other consumer unused lines of credit	6,970,000	8,583,000
Commitments to make loans	212,873,000	178,034,000
Standby letters of credit	33,206,000	34,946,000
	\$846,852,000	\$821,738,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of June 30, 2016, the total notional amount of the underlying interest rate swap agreements was \$14.2 million, with a net fair value from our commercial loan customers' perspective of negative \$2.6 million. These risk participation agreements are considered financial guarantees in accordance with applicable accounting guidance and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

9. HEDGING ACTIVITIES

Our interest rate risk policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using net interest income simulation. Our policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within the policy parameters. To help mitigate the negative impact to our net interest income in an increasing interest rate environment resulting from our cost of funds likely increasing at a higher rate than the yield on our assets, we may periodically enter into derivative financial instruments.

In February 2012, we entered into an interest rate swap agreement with a correspondent bank to hedge the floating rate on our subordinated debentures, which became effective in January 2013 and matures in January 2018. Our \$32.0 million of subordinated debentures have a rate equal to the 90-Day Libor Rate plus a fixed spread of 218 basis points, and are subject to repricing quarterly. The interest rate swap agreement provides for us to pay our correspondent bank a fixed rate, while our correspondent bank will pay us the 90-Day Libor Rate on a \$32.0 million notional amount. The quarterly re-set dates for the floating rate on the interest rate swap agreement are the same as the re-set dates for the floating rate on the subordinated debentures. The interest rate swap agreement does qualify for hedge accounting; therefore, monthly fluctuations in the present value of the interest rate swap agreement, net of tax effect, are recorded to other comprehensive income. As of June 30, 2016 and December 31, 2015, the fair value of the interest rate swap agreement was recorded as a liability in the amount of \$0.3 million.

Effective January 26, 2016, the notional amount of the interest rate swap agreement was reduced from \$32.0 million down to \$21.0 million, reflecting the \$11.0 million repurchase of the associated trust preferred securities on that date. We reclassified out of accumulated other comprehensive income and recorded interest expense of approximately \$0.2 million in January 2016 as part of the transaction, reflecting the market value (i.e., present value of expected future cash flows) of the interest rate swap on that date of the \$11.0 million portion.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUES OF FINANCIAL INSTRUMENTS

The carrying amounts, estimated fair values and level within the fair value hierarchy of financial instruments were as follows as of June 30, 2016 and December 31, 2015 (dollars in thousands):

	Level in Fair Value Hierarchy	June 30, 2016		December 31, 2015	
		Carrying Values	Fair Values	Carrying Values	Fair Values
Financial assets:					
Cash	Level 1	\$12,406	\$12,406	\$12,496	\$12,496
Cash equivalents	Level 2	94,577	94,577	77,395	77,395
Securities available for sale	(1)	323,452	323,452	346,992	346,992
FHLBI stock	(2)	8,026	8,026	7,567	7,567
Loans, net	Level 3	2,359,951	2,356,483	2,260,730	2,259,710
Loans held for sale	Level 2	2,879	2,879	1,316	1,316
Bank owned life insurance	Level 2	66,537	66,537	58,971	58,971
Accrued interest receivable	Level 2	7,268	7,268	7,836	7,836
Financial liabilities:					
Deposits	Level 2	2,279,718	2,226,310	2,275,382	2,208,724
Repurchase agreements	Level 2	136,690	136,690	154,771	154,771
FHLBI advances	Level 2	178,000	180,504	68,000	68,858
Subordinated debentures	Level 2	44,494	44,505	55,154	55,760
Accrued interest payable	Level 2	1,517	1,517	1,479	1,479
Interest rate swap	(1)	278	278	253	253

(1)

See Note 11 for a description of the fair value hierarchy as well as a disclosure of levels for classes of financial assets and liabilities.

- (2) It is not practical to determine the fair value of FHLBI stock due to transferability restrictions.

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

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MERCANTILE BANK CORPORATION

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11. FAIR VALUES

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

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

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

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

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

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11. FAIR VALUES (Continued)

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

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies, municipal general obligation and revenue bonds and mutual funds. Level 3 securities include bonds issued by certain relatively small municipalities located within our markets that have very limited marketability due to their size and lack of ratings from a recognized rating service. We carry these bonds at historical cost, which we believe approximates fair value, unless our periodic financial analysis or other information becomes known which necessitates a valuation allowance. There was no such valuation allowance as of June 30, 2016 or December 31, 2015. We have no Level 1 securities available for sale.

Derivatives. The interest rate swap is measured at fair value on a recurring basis. We measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves, and accordingly, the interest rate swap agreement is classified as Level 2.

Mortgage 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, and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of June 30, 2016 and December 31, 2015, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$2.9 million and \$1.3 million, respectively.

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

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

The balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2016 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	\$ 132,942,000	\$ 0	\$ 132,942,000	\$ 0
Mortgage-backed securities	57,545,000	0	57,545,000	0
Municipal general obligation bonds	122,386,000	0	115,917,000	6,469,000
Municipal revenue bonds	8,593,000	0	8,593,000	0
Other investments	1,986,000	0	1,986,000	0
Interest rate swap	(278,000)	0	(278,000)	0
Total	\$ 323,174,000	\$ 0	\$ 316,705,000	\$ 6,469,000

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first six months of 2016.

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2015 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	\$ 147,040,000	\$ 0	\$ 147,040,000	\$ 0
Mortgage-backed securities	67,074,000	0	67,074,000	0
Municipal general obligation bonds	122,023,000	0	113,604,000	8,419,000
Municipal revenue bonds	8,914,000	0	8,914,000	0
Other investments	1,941,000	0	1,941,000	0
Interest rate swap	(253,000)	0	(253,000)	0
Total	\$ 346,739,000	\$ 0	\$ 338,320,000	\$ 8,419,000

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2015.

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. FAIR VALUES (Continued)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2016 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans ⁽¹⁾	\$9,012,000	\$0	\$0	\$9,012,000
Foreclosed assets ⁽¹⁾	815,000	0	0	815,000
Total	\$9,827,000	\$0	\$0	\$9,827,000

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2015 are as follows:

		Quoted		
		Prices in	Significant	
		Active	Other	Significant
		Markets	Observable	Unobservable
Total		for	Inputs	Inputs
		Identical	(Level 3)	
		Assets	(Level 2)	
		(Level		
		1)		
Impaired loans ⁽¹⁾	\$8,970,000	\$ 0	\$ 0	\$ 8,970,000
Foreclosed assets ⁽¹⁾	1,293,000	0	0	1,293,000
Total	\$10,263,000	\$ 0	\$ 0	\$ 10,263,000

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

12. REGULATORY MATTERS

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REGULATORY MATTERS (Continued)

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At June 30, 2016 and December 31, 2015, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since June 30, 2016 that we believe have changed our bank's categorization.

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

	Actual	Minimum Required for Capital Adequacy Purposes	Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations
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	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>June 30, 2016</u>						
Total capital (to risk weighted assets)						
Consolidated	\$347,819	13.0 %	\$214,866	8.0 %	\$NA	NA
Bank	350,224	13.1	214,632	8.0	268,290	10.0 %
Tier 1 capital (to risk weighted assets)						
Consolidated	330,710	12.3	161,150	6.0	NA	NA
Bank	333,114	12.4	160,974	6.0	214,632	8.0
Common equity tier 1 (to risk weighted assets)						
Consolidated	288,289	10.7	120,863	4.5	NA	NA
Bank	333,114	12.4	120,731	4.5	174,388	6.5
Tier 1 capital (to average assets)						
Consolidated	330,710	11.4	115,944	4.0	NA	NA
Bank	333,114	11.5	115,924	4.0	144,905	5.0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REGULATORY MATTERS (Continued)

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>December 31, 2015</u>						
Total capital (to risk weighted assets)						
Consolidated	\$345,539	13.5 %	\$205,602	8.0 %	\$NA	NA
Bank	347,433	13.5	205,624	8.0	257,030	10.0 %
Tier 1 capital (to risk weighted assets)						
Consolidated	329,858	12.8	154,201	6.0	NA	NA
Bank	331,752	12.9	154,218	6.0	205,624	8.0
Common equity tier 1 (to risk weighted assets)						
Consolidated	280,171	10.9	115,804	4.5	NA	NA
Bank	331,752	12.9	115,664	4.5	167,070	6.5
Tier 1 capital (to average assets)						
Consolidated	329,858	11.6	114,138	4.0	NA	NA
Bank	331,752	11.6	114,280	4.0	142,850	5.0

Our consolidated capital levels as of June 30, 2016 and December 31, 2015 include \$42.2 million and \$53.1 million, respectively, of trust preferred securities subject to certain limitations. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in our Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than \$15.0 billion. As of June 30, 2016 and December 31, 2015, all \$42.2 million and \$53.1 million, respectively, of the trust preferred securities were included in our consolidated Tier 1 capital.

Our regulatory capital calculations and the minimum requirements to be categorized as well capitalized and adequately capitalized under the prompt corrective action regulations were impacted by BASEL III, which became effective January 1, 2015 and are included in the tables above. The net impact on our regulatory capital ratios and our overall capital position was not material.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REGULATORY MATTERS (Continued)

On January 26, 2016, we closed on a repurchase of trust preferred securities that were auctioned as part of a pooled collateralized debt obligation (“Fund”). The Fund owned \$11.0 million of the \$32.0 million in trust preferred securities that had been issued by Mercantile Bank Capital Trust I, a wholly-owned business trust subsidiary. The \$11.0 million in trust preferred securities was retired upon the repurchase, resulting in a commensurate reduction in the related Floating Rate Junior Subordinate Note, leaving \$21.0 million outstanding. Our accepted bid equated to 73% of the \$11.0 million par value, with the 27% discount resulting in a pre-tax gain of approximately \$3.0 million (after-tax gain of approximately \$1.8 million, or \$0.11 per diluted share). On a pro forma basis as of December 31, 2015, the repurchase resulted in a nine basis point increase in our tangible equity to tangible assets ratio and an \$0.11 increase in our tangible book value per share, but an approximately 35 basis point decline in our regulatory tier 1 capital and total risk-based capital ratios. The repurchase was funded via a cash dividend from our bank, resulting in a similar decline of approximately 35 basis points in the regulatory capital ratios. Subsequent to the repurchase, the regulatory capital ratios of both Mercantile and our bank remained well above the minimum thresholds to be categorized as well capitalized.

Our and our bank’s ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. On January 14, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.16 per share that was paid on March 23, 2016 to shareholders of record as of March 11, 2016. On April 14, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.16 per share that was paid on June 23, 2016 to shareholders of record as of June 10, 2016. On July 14, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.17 per share that will be paid on September 21, 2016 to shareholders of record as of September 9, 2016.

On January 30, 2015, we announced that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced that our Board of Directors had authorized a \$15.0 million expansion of the existing common stock repurchase program. During the first six months of 2016, we purchased approximately 168,000 shares of common stock at an average price of \$22.23, totaling

about \$3.7 million. Since the program's inception, we have purchased approximately 956,000 shares of common stock at an average price of \$20.38, totaling about \$19.5 million. All common stock repurchases to date have been funded from cash dividends paid to us from our bank, and we expect future common stock repurchases to be funded in the same manner.

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MERCANTILE BANK CORPORATION

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

Forward Looking Statements

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

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2015 or in this report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

Introduction

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, including 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 company”), at June 30, 2016 and December 31, 2015 and the results of operations for the three months and six months ended June 30, 2016 and June 30, 2015. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to “us,” “we,” “our” or “the company” include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

Critical Accounting Policies

Accounting principles generally accepted in the United States of America are complex and require us to apply significant judgment to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a discussion of our significant accounting policies, see Note 1 of the Notes to our Consolidated Financial Statements included on pages F-43 through F-50 in our Form 10-K for the fiscal year ended December 31, 2015 (Commission file number 000-26719). Our allowance for loan losses policy and accounting for income taxes are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements, and actual results may differ from those estimates. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

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MERCANTILE BANK CORPORATION

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

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

Income Tax Accounting: Current income tax assets and liabilities are established for the amount of taxes payable or refundable for the current year. In the preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome may be uncertain. We periodically review and evaluate the status of our tax positions and make adjustments as necessary. Deferred income tax assets and liabilities are also established for the future tax consequences of events that have been recognized in our financial statements or tax

returns. A deferred income tax asset or liability is recognized for the estimated future tax effects attributable to temporary differences that can be carried forward (used) in future years. The valuation of our net deferred income tax asset is considered critical as it requires us to make estimates based on provisions of the enacted tax laws. The assessment of the realizability of the net deferred income tax asset involves the use of estimates, assumptions, interpretations and judgments concerning accounting pronouncements, federal and state tax codes and the extent of future taxable income. There can be no assurance that future events, such as court decisions, positions of federal and state tax authorities, and the extent of future taxable income will not differ from our current assessment, the impact of which could be significant to the consolidated results of operations and reported earnings.

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MERCANTILE BANK CORPORATION

Accounting guidance requires that we assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. In making such judgments, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors which may impact future operating results. Significant weight is given to evidence that can be objectively verified.

Securities and Other Financial Instruments: Securities available for sale consist of bonds and notes which might be sold prior to maturity due to changes in interest rate, prepayment risks, yield and availability of alternative investments, liquidity needs or other factors. Securities classified as available for sale are reported at their fair value. Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other than temporary losses, management considers: (1) the length of time and extent that fair value has been less than carrying value (2) the financial condition and near term prospects of the issuer and (3) the Company’s ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value. Fair values for securities available for sale are obtained from outside sources and applied to individual securities within the portfolio. The difference between the amortized cost and the current fair value of securities is recorded as a valuation adjustment and reported in other comprehensive income.

Mortgage Servicing Rights: Mortgage servicing rights are recognized as assets based on the allocated fair value of retained servicing rights on loans sold. 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 income. We utilize a discounted cash flow model to determine the value of our servicing rights. The valuation model utilizes mortgage prepayment speeds, the remaining life of the mortgage pool, delinquency rates, our cost to service loans, and other factors to determine the cash flow that we will receive from serving each grouping of loans. These cash flows are then discounted based on current interest rate assumptions to arrive at the fair value of the right to service those loans. Impairment is evaluated quarterly based on the fair value of the servicing rights, using groupings of the underlying loans classified by interest rates. Any impairment of a grouping is reported as a valuation allowance.

Goodwill: Generally accepted accounting principles require us to determine the fair value of all of the assets and liabilities of an acquired entity, and record their fair value on the date of acquisition. We employ a variety of means in determination of the fair value, including the use of discounted cash flow analysis, market comparisons, and projected future revenue streams. For certain items that we believe we have the appropriate expertise to determine the fair value, we may choose to use our own calculation of the value. In other cases, where the value is not easily determined, we consult with outside parties to determine the fair value of the asset or liability. Once valuations have been adjusted, the net difference between the price paid for the acquired company and the value of its balance sheet is recorded as goodwill.

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 if conditions in the market place or changes in the company's organizational structure occur. We use a discounted income approach and a market valuation model, which compares the inherent value of our company to valuations of recent transactions in the market place to determine if our goodwill has been impaired.

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MERCANTILE BANK CORPORATION

Financial Overview

We reported net income of \$7.4 million for the second quarter of 2016, and net income of \$16.0 million for the first six months of 2016. On a diluted earnings per share basis, we earned \$0.46 per share during the second quarter and \$0.98 per share during the first six months of 2016. Our earnings performance during 2016 reflects an 18% increase in diluted earnings per share during the second quarter when compared to the second quarter of 2015, and a 26% increase in diluted earnings per share during the first six months of the year when compared to the same time period in 2015. Our net interest income during the first six months of 2016, and especially the second quarter, was positively impacted by calls on U.S. Government Agency bonds that had been purchased at a discounted price. Accelerated discount accretion totaled \$1.5 million during the second quarter (\$0.06 per diluted share), and \$1.8 million (\$0.07 per diluted share) during the first six months. In January, we repurchased \$11.0 million in trust preferred securities at a 27% discount, resulting in a pre-tax gain of \$3.0 million (\$0.11 per diluted share).

The overall quality of our loan portfolio remains strong, with nonperforming loans equaling only 0.22% of total loans as of June 30, 2016. Gross loan charge-offs equaled \$0.4 million during the second quarter of 2016, and totaled \$0.9 million for the first six months of the year, while recoveries of prior period loan charge-offs equaled \$0.1 million and \$0.6 million during the respective time periods. Net loan charge-offs, as a percent of average total loans, equaled an annualized 0.04% and 0.02% during the second quarter and first six months of 2016, respectively. We have recorded a net loan recovery during seven out of the last fourteen quarters. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries.

New commercial term loan originations totaled approximately \$193 million during the second quarter of 2016, bringing the year-to-date total to about \$298 million. We also experienced net increases in commercial lines of credit during those time periods, in large part reflecting lines that are part of new commercial lending relationships established during recent quarterly periods. Net loan growth equaled \$84.3 million and \$102 million during the second quarter and first six months of 2016, respectively, reflecting the impact of scheduled monthly payments as well as expected and unexpected commercial loan payoffs. The new loan pipeline remains strong, and at June 30, 2016, we had \$92 million in unfunded loan commitments on commercial construction and development loans that are in the construction phase. We believe our loan portfolio is well diversified, with commercial and industrial loans equaling 32%, commercial real estate non-owner occupied loans comprising 30%, commercial real estate owner occupied loans comprising 18% and residential mortgage and consumer loans aggregating 14% of total loans at June 30, 2016. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans equaled 58% at June 30, 2016.

We recorded a provision expense of \$1.1 million during the second quarter of 2016, bringing total provision expense for the first six months of 2016 to \$1.7 million. During 2015, we recorded a negative provision expense of \$0.6 million during the second quarter and \$1.0 million during the first six months. The provision expense during 2016 was primarily driven by our loan growth and an assessment change in our qualitative economic and concentration environmental allowance factors, the latter equating to about a \$0.5 million provision expense.

We believe our funding structure is also well diversified. As of June 30, 2016, noninterest-bearing checking accounts comprised 28% of total funds, interest-bearing checking and sweep accounts combined for 18%, savings deposits and money market accounts aggregated to 25% and local time deposits accounted for 18%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank of Indianapolis (“FHLBI”) advances, represented 11% of total funds.

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MERCANTILE BANK CORPORATION

Financial Condition

Our total assets increased \$96.4 million during the first six months of 2016, and totaled \$3.00 billion as of June 30, 2016. Total loans increased \$102 million, while securities available for sale declined \$23.5 million and cash and cash equivalents increased \$17.1 million. Total deposits increased \$4.3 million, while FHLBI advances were up \$110 million and securities sold under agreements to repurchase (“sweep accounts”) were down \$18.1 million during the first six months of 2016. Since the merger with Firstbank that was consummated on June 1, 2014, we have generally funded net loan growth with cash flows from our securities portfolio and other interest-earning assets; however, we reached the desired levels of our securities portfolio and other interest-earning assets during the second quarter of 2016. As a result, we expect to fund future net loan growth primarily from increases in deposits and borrowed funds.

Commercial loans increased \$113 million during the first six months of 2016, and at June 30, 2016 totaled \$2.06 billion, or 86.5% of the loan portfolio. As of December 31, 2015, the commercial loan portfolio comprised 85.5% of total loans. The increase in commercial loans during the first six months of 2016 primarily reflects new commercial term loans to existing and new borrowers. Commercial and industrial loans were up \$53.8 million, non-owner occupied commercial real estate (“CRE”) loans increased \$72.6 million, owner occupied CRE loans decreased \$7.1 million, multi-family and residential rental loans were down \$1.6 million and vacant land, land development and residential construction loans declined \$4.6 million. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans equaled 57.7% as of June 30, 2016, compared to 58.7% at December 31, 2015.

We significantly enhanced our commercial loan sales efforts over the past few years. We are very pleased with the approximately \$1.5 billion in new commercial term loan fundings since the beginning of 2012, including about \$298 million during the first six months of 2016. As of June 30, 2016, availability on existing construction and development loans totaled \$92 million, with most of those funds expected to be drawn over the next twelve months. Our loan pipeline reports indicate continued strong commercial loan funding opportunities in future periods, including approximately \$213 million in new lending commitments, a majority of which we expect to be accepted and funded over the next 12 to 18 months. Our commercial lenders also report substantial additional opportunities they are currently discussing with existing and potentially new borrowers.

We continue to experience commercial loan principal paydowns and payoffs. While a portion of the principal paydowns and payoffs received have been welcomed, such as on stressed loan relationships, we have also experienced instances where well-performing relationships have been refinanced at other financial institutions or non-bank entities, and other situations where the borrower has sold the underlying asset. In many of those instances where the loans

were refinanced elsewhere, we believed the terms and conditions of the new lending arrangements were too aggressive, generally reflecting the very competitive banking environment in our markets. We remain committed to prudent underwriting standards that provide for an appropriate yield and risk relationship, as well as concentration limits we have established within our commercial loan portfolio. In addition, we continue to receive accelerated principal paydowns from certain borrowers who have elevated deposit balances generally resulting from profitable operations and an apparent unwillingness to expand their businesses and/or replace equipment primarily due to economic- and tax-related uncertainties. Usage of existing commercial lines of credit has remained relatively steady.

One-to-four family mortgage loans and other consumer loans declined a combined \$10.8 million during the first six months of 2016, and at June 30, 2016, totaled \$320 million, or 13.5% of total loans. One-to-four family mortgage loans and other consumer loans, when combined, equated to 14.5% of total loans as of December 31, 2015.

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MERCANTILE BANK CORPORATION

The following table summarizes our loan portfolio over the past twelve months:

	6/30/16	3/31/16	12/31/15	9/30/15	6/30/15
Commercial:					
Commercial & Industrial	\$750,136,000	\$714,612,000	\$696,303,000	\$643,118,000	\$622,073,000
Land Development & Construction	40,529,000	39,630,000	45,120,000	47,734,000	47,622,000
Owner Occupied Commercial RE	438,798,000	441,662,000	445,919,000	427,016,000	422,354,000
Non-Owner Occupied Commercial RE	716,930,000	666,013,000	644,351,000	636,227,000	603,724,000
Multi-Family & Residential Rental	113,362,000	112,533,000	115,003,000	123,525,000	124,658,000
Total Commercial	2,059,755,000	1,974,450,000	1,946,696,000	1,877,620,000	1,820,431,000
Retail:					
1-4 Family Mortgages	189,118,000	185,535,000	190,385,000	193,003,000	201,907,000
Home Equity & Other Consumer Loans	131,067,000	135,683,000	140,646,000	146,765,000	149,494,000
	320,185,000	321,218,000	331,031,000	339,768,000	351,401,000
Total	\$2,379,940,000	\$2,295,668,000	\$2,277,727,000	\$2,217,388,000	\$2,171,832,000

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans to provide effective loan portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans, which exhibit characteristics (financial or otherwise) that could cause the loans to become nonperforming or require restructuring in the future, are included on an internal watch list. Senior management and the Board of Directors review this list regularly. Market value estimates of collateral on impaired loans, as well as on foreclosed and repossessed assets, are reviewed periodically; however, we have a process in place to monitor whether value estimates at each quarter-end are reflective of current market conditions. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside and internal valuations based on identifiable trends within our markets, such as recent sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address distressed market conditions.

Nonperforming assets, comprised of nonaccrual loans, loans past due 90 days or more and accruing interest and foreclosed properties, totaled \$6.0 million (0.2% of total assets) as of June 30, 2016, compared to \$6.7 million (0.2% of total assets) as of December 31, 2015. Given the low level of nonperforming loans and accruing loans 30 to 89 days delinquent, combined with the declining level of watch list credits and what we believe are strong credit administration practices, we are pleased with the overall quality of the loan portfolio.

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MERCANTILE BANK CORPORATION

The following tables provide a breakdown of nonperforming assets by collateral type:

NONPERFORMING LOANS

	6/30/16	3/31/16	12/31/15	9/30/15	6/30/15
Residential Real Estate:					
Land Development	\$42,000	\$30,000	\$23,000	\$25,000	\$27,000
Construction	319,000	0	0	0	0
Owner Occupied / Rental	2,638,000	2,484,000	2,917,000	2,588,000	2,384,000
	2,999,000	2,514,000	2,940,000	2,613,000	2,411,000
Commercial Real Estate:					
Land Development	125,000	140,000	155,000	170,000	184,000
Construction	0	0	0	0	0
Owner Occupied	1,786,000	1,970,000	2,131,000	2,602,000	2,587,000
Non-Owner Occupied	51,000	51,000	108,000	2,539,000	2,677,000
	1,962,000	2,161,000	2,394,000	5,311,000	5,448,000
Non-Real Estate:					
Commercial Assets	165,000	137,000	69,000	271,000	212,000
Consumer Assets	42,000	30,000	41,000	19,000	32,000
	207,000	167,000	110,000	290,000	244,000
Total	\$5,168,000	\$4,842,000	\$5,444,000	\$8,214,000	\$8,103,000

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

	6/30/16	3/31/16	12/31/15	9/30/15	6/30/15
Residential Real Estate:					
Land Development	\$0	\$0	\$0	\$353,000	\$353,000
Construction	0	0	0	0	0
Owner Occupied / Rental	255,000	471,000	598,000	1,126,000	932,000
	255,000	471,000	598,000	1,479,000	1,285,000

Commercial Real Estate:

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Land Development	0	0	0	0	0
Construction	0	0	0	0	0
Owner Occupied	477,000	907,000	612,000	139,000	139,000
Non-Owner Occupied	83,000	100,000	83,000	654,000	609,000
	560,000	1,007,000	695,000	793,000	748,000
Non-Real Estate:					
Commercial Assets	0	0	0	0	0
Consumer Assets	0	0	0	0	0
	0	0	0	0	0
Total	\$815,000	\$1,478,000	\$1,293,000	\$2,272,000	\$2,033,000

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The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

	2nd Qtr 2016	1st Qtr 2016	4th Qtr 2015	3rd Qtr 2015	2nd Qtr 2015
Beginning balance	\$4,842,000	\$5,444,000	\$8,214,000	\$8,103,000	\$26,267,000
Additions, net of transfers to ORE	1,082,000	528,000	902,000	743,000	2,486,000
Returns to performing status	0	0	(43,000)	0	0
Principal payments	(495,000)	(774,000)	(3,457,000)	(567,000)	(16,414,000)
Loan charge-offs	(261,000)	(356,000)	(172,000)	(65,000)	(4,236,000)
Total	\$5,168,000	\$4,842,000	\$5,444,000	\$8,214,000	\$8,103,000

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION

	2nd Qtr 2016	1st Qtr 2016	4th Qtr 2015	3rd Qtr 2015	2nd Qtr 2015
Beginning balance	\$1,478,000	\$1,293,000	\$2,272,000	\$2,033,000	\$1,664,000
Additions	14,000	595,000	676,000	581,000	652,000
Sale proceeds	(642,000)	(402,000)	(1,300,000)	(319,000)	(220,000)
Valuation write-downs	(35,000)	(8,000)	(355,000)	(23,000)	(63,000)
Total	\$815,000	\$1,478,000	\$1,293,000	\$2,272,000	\$2,033,000

Gross loan charge-offs equaled \$0.4 million during the second quarter of 2016, and totaled \$0.9 million for the first six months of the year, while recoveries of prior period loan charge-offs equaled \$0.1 million and \$0.6 million during the respective time periods. Net loan charge-offs, as a percent of average total loans, equaled an annualized 0.04% and 0.02% during the second quarter and first six months of 2016, respectively. We have recorded a net loan recovery during seven out of the last fourteen quarters. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries.

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at an adequate level. Through the loan review and credit departments, we establish portions of the allowance based on specifically identifiable problem loans. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Allowance Analysis, loan loss migration analysis, composition of the loan portfolio, third party analysis of the loan administration processes and portfolio, and general economic conditions.

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The Allowance Analysis applies reserve allocation factors to non-impaired outstanding loan balances, the result of which is combined with specific reserves to calculate an overall allowance dollar amount. For non-impaired commercial loans, reserve allocation factors are based on the loan ratings as determined by our standardized grade paradigms and by loan purpose. Our commercial loan portfolio is segregated into five classes: 1) commercial and industrial loans; 2) vacant land, land development and residential construction loans; 3) owner occupied real estate loans; 4) non-owner occupied real estate loans; and 5) multi-family and residential rental property loans. The reserve allocation factors are primarily based on the historical trends of net loan charge-offs through a migration analysis whereby net loan losses are tracked via assigned grades over various time periods, with adjustments made for environmental factors reflecting the current status of, or recent changes in, items such as: lending policies and procedures; economic conditions; nature and volume of the loan portfolio; experience, ability and depth of management and lending staff; volume and severity of past due, nonaccrual and adversely classified loans; effectiveness of the loan review program; value of underlying collateral; loan concentrations; and other external factors such as competition and regulatory environment. Adjustments for specific lending relationships, particularly impaired loans, are made on a case-by-case basis. Non-impaired retail loan reserve allocations are determined in a similar fashion as those for non-impaired commercial loans, except that retail loans are segmented by type of credit and not a grading system. We regularly review the Allowance Analysis and make needed adjustments based upon identifiable trends and experience.

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired commercial loans. Our migration analysis takes into account various time periods, with most weight placed on the time frame from December 31, 2010 through June 30, 2016. We believe this time period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general consensus of economic conditions in the near future.

Although the migration analysis provides a historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our commercial loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data. Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our commercial loan portfolio.

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

The allowance for originated loans equaled \$16.9 million as of June 30, 2016, or 0.9% of total originated loans outstanding, compared to \$15.2 million, or 0.9% of total originated loans outstanding at December 31, 2015. We also had an allowance for acquired loans as of June 30, 2016 and December 31, 2015, equaling \$0.2 million and \$0.5 million, respectively. The allowance equaled 331% of nonperforming loans as of June 30, 2016, compared to 288% as of December 31, 2015. The increase in this ratio during the first six months of 2016 primarily reflects an increase in the balance of the allowance and a decline in total nonperforming loans.

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As of June 30, 2016, the allowance for originated loans was comprised of \$15.9 million in general reserves relating to non-impaired loans, \$0.3 million in specific reserve allocations relating to nonaccrual loans, and \$0.7 million in specific reserves on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$21.4 million at June 30, 2016, consisting of \$2.0 million that are on nonaccrual status and \$19.4 million that are on accrual status. The latter, while considered and accounted for as impaired loans in accordance with accounting guidelines, is not included in our nonperforming loan totals. Impaired loans with an aggregate carrying value of \$1.0 million as of June 30, 2016 had been subject to previous partial charge-offs aggregating \$4.9 million. Those partial charge-offs were recorded as follows: less than \$0.1 million in 2016, 2013 and 2012, \$4.3 million in 2015, \$0.4 million in 2011 and \$0.2 million in 2010. As of June 30, 2016, there were no specific reserves allocated to impaired loans that had been subject to a previous partial charge-off.

The following table provides a breakdown of our originated and acquired loans categorized as troubled debt restructurings:

	6/30/16	3/31/16	12/31/15	9/30/15	6/30/15
Performing	\$19,403,000	\$19,087,000	\$19,336,000	\$18,743,000	\$20,031,000
Nonperforming	1,950,000	2,112,000	2,358,000	2,786,000	3,245,000
Total	\$21,353,000	\$21,199,000	\$21,694,000	\$21,529,000	\$23,276,000

Although we believe the allowance is adequate to absorb loan losses in our originated loan portfolio as they arise, there can be no assurance that we will not sustain loan losses in any given period that could be substantial in relation to, or greater than, the size of the allowance.

Securities available for sale decreased \$23.5 million during the first six months of 2016, totaling \$323 million as of June 30, 2016. Purchases during the first six months of 2016, consisting almost exclusively of U.S. Government Agency bonds and municipal bonds, totaled \$60.9 million. Proceeds from matured and called U.S. Government agency bonds and municipal bonds during the first six months of 2016 totaled \$63.2 million and \$14.1 million, respectively, with another \$9.6 million from principal paydowns on mortgage-backed securities. In addition, proceeds from the sale of a municipal bond totaled \$0.3 million. At June 30, 2016, the portfolio was primarily comprised of U.S. Government agency bonds (41%), municipal bonds (40%) and U.S. Government agency issued or guaranteed mortgage-backed securities (18%). All of our securities are currently designated as available for sale, and are therefore stated at fair value. The fair value of securities designated as available for sale at June 30, 2016 totaled \$323 million,

including a net unrealized gain of \$4.4 million. We maintain the securities portfolio at levels to provide adequate pledging and secondary liquidity for our daily operations. In addition, the securities portfolio serves a primary interest rate risk management function. We expect purchases during the remainder of 2016 to generally consist of U.S. Government Agency bonds and municipal bonds, with the securities portfolio maintained at about 11% of total assets.

FHLBI stock totaled \$8.0 million as of June 30, 2016, compared to \$7.6 million as of December 31, 2015. The \$0.4 million increase reflects additional stock purchased during the second quarter resulting from increases in our total FHLBI advances outstanding. Our investment in FHLBI stock is necessary to engage in their advance and other financing programs. We have regularly received quarterly cash dividends, and we expect a cash dividend will continue to be paid in future quarterly periods.

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Market values on our U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies and municipal bonds are generally determined on a monthly basis with the assistance of a third party vendor. Evaluated pricing models that vary by type of security and incorporate available market data are utilized. Standard inputs include issuer and type of security, benchmark yields, reported trades, broker/dealer quotes and issuer spreads. The market value of certain non-rated securities issued by relatively small municipalities generally located within our markets is estimated at carrying value. We believe our valuation methodology provides for a reasonable estimation of market value, and that it is consistent with the requirements of accounting guidelines.

Interest-bearing balances, primarily consisting of excess funds deposited at the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate sensitivity. During the first six months of 2016, the average balance of these funds equaled \$45.7 million, or 1.7% of average earning assets. We expect the level of these funds to average approximately 1% to 2% of average earning assets in future quarters.

Net premises and equipment equaled \$45.6 million at June 30, 2016, a decrease of \$1.3 million during the first six months of 2016. Purchases during the first six months of 2016 totaled \$0.5 million, while depreciation expense aggregated to \$1.4 million and \$0.4 million was moved to foreclosed and repossessed assets in association with the closure of three branch offices. Foreclosed and repossessed assets equaled \$0.8 million as of June 30, 2016, compared to \$1.3 million as of December 31, 2015. Sale proceeds during the first six month