FARMERS & MERCHANTS BANCORP INC
Form 10-Q
November 02, 2007

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2007

OR

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from ________ to ________

Commission File Number 0-14492

FARMERS & MERCHANTS BANCORP, INC.
(Exact name of registrant as specified in its charter)

OHIO (State or other jurisdiction of incorporation or organization)	34-1469491 (I.R.S Employer Identification No.)
307-11 North Defiance Street, Archbold, Ohio (Address of principal executive offices)	43502 (Zip Code)

(419) 446-2501
Registrant's telephone number, including area code

(Former name, former address and former fiscal year, if changed since last report.)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer [ ]   Accelerated filer [X]   Non-accelerated filer [ ]

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

Indicate the number of shares of each of the issuers classes of common stock, as of the latest practicable date:

Common Stock, No Par Value	5,062,302
Class	Outstanding as of October 31, 2007

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.
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ITEM 1 FINANCIAL STATEMENTS

FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(in thousands of dollars)

	September 30, 2007	Dec 31, 200
ASSETS:		
Cash and due from banks	$ 17,241	$ 23,583
Interest bearing deposits with banks	486	311
Federal funds sold	967	13,353
Investment Securities:		
U.S. Treasury	215	388
U.S. Government	120,920	122,231
State & political obligations	41,418	45,495
All others	4,063	4,063
Loans and leases (Net of reserve for loan losses of $5,499 and $5,594 respectively)	501,104	498,580
Bank premises and equipment-net	14,742	14,189
Accrued interest and other assets	19,066	14,903
TOTAL ASSETS	$720,222	$737,096
LIABILITIES AND SHAREHOLDERS' EQUITY LIABILITIES:		
Deposits:		
Noninterest bearing	$ 49,728	$ 60,211
Interest bearing	495,912	525,198
Federal funds purchased and securities sold under agreement to repurchase	41,941	34,818
Other borrowed money	37,293	23,233
Accrued interest and other liabilities	5,701	5,904
Total Liabilities	630,575	649,364
SHAREHOLDERS' EQUITY:		
Common stock, no par value - authorized 6,500,000 shares; issued 5,200,000 shares	12,677	12,677
Treasury Stock - 120,478 shares 2007, 36,180 shares 2006	(3,091)	(1,060)
Unearned Stock Awards 17,820 for 2007 and 9,820 for 2006		
Undivided profits	80,412	77,089
Accumulated other comprehensive income (expense)	(351)	(974)
Total Shareholders' Equity	89,647	87,732
LIABILITIES AND SHAREHOLDERS' EQUITY	$720,222	$737,096

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See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2006 Balance Sheet has been derived from the audited financial statements of that date.

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FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(in thousands of dollars, except per share data)

	Three Months Ended		Ni
	September 30, 2007	September 30, 2006	Septembe 2007
INTEREST INCOME:			
Loans and leases	$ 9,501	$ 9,035	$ 28
Investment Securities:			
U.S. Treasury securities	3	19	
Securities of U.S. Government agencies	1,389	1,045	4
Obligations of states and political subdivisions	405	515	1
Other	66	57	
Federal funds	14	57	
Deposits in banks	6	3	
Total Interest Income	11,384	10,731	34
INTEREST EXPENSE:			
Deposits	4,702	4,126	13
Borrowed funds	875	711	2
Total Interest Expense	5,577	4,837	16
NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES	5,807	5,894	18
PROVISION FOR LOAN LOSSES	309	652	
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	5,498	5,242	17
OTHER INCOME:			
Service charges	808	977	2
Other	720	651	2
Net securities gains (losses)	--	(1)	
	1,528	1,627	4
OTHER EXPENSES:			
Salaries and wages	1,928	2,093	6
Pension and other employee benefits	694	599	2
Occupancy expense (net)	186	192	
Other operating expenses	1,891	1,079	5
	4,699	3,963	14

INCOME BEFORE FEDERAL INCOME TAX	2,327	2,906	7
FEDERAL INCOME TAXES	623	789	2
NET INCOME	1,704	2,117	5
OTHER COMPREHENSIVE INCOME (NET OF TAX):			
Unrealized gains (losses) on securities	1,282	1,331	
COMPREHENSIVE INCOME (EXPENSE)	$ 2,986	$ 3,448	$ 6
NET INCOME PER SHARE	$ 0.33	$ 0.41	$
Based upon average weighted shares outstanding of:	5,093,169	5,185,883	5,120
DIVIDENDS DECLARED	$ 0.16	$ 0.15	$

No disclosure of diluted earnings per share is required as shares are antidiluted as of quarter end.

See Notes to Condensed Consolidated Unaudited Financial Statements.

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FARMERS & MERCHANTS BANCORP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands of dollars)

	Nine Months Ended	
	September 30, 2007	September 30, 2
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 5,774	$ 6,104
Adjustments to Reconcile Net Income to Net		
Cash Provided by Operating Activities:		
Depreciation and amortization	894	839
Premium amortization	228	535
Discount amortization	(129)	(211)
Provision for loan losses	444	617
(Gain) Loss on sale of fixed assets	(30)	26
(Gain) Loss on sale of investment securities	--	9
Changes in Operating Assets and Liabilities:		
Accrued interest receivable and other assets	(1,342)	1,061
Accrued interest payable and other liabilities	(386)	(517)
Net Cash Provided by Operating Activities	5,453	8,463
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(1,417)	(305)
Proceeds from sale of fixed assets	--	--
Proceeds from maturities of investment securities:	41,711	37,457
Proceeds from sale of investment securities:	--	19,006
Purchase of investment securities	(35,302)	(19,336)
Purchase of Bank Owned Life Insurance	(3,000)	--
Net (increase) decrease in loans and leases	(2,968)	(32,700)

Net Cash Provided (Used) by Investing Activities	(976)	4,122
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposits	(39,769)	(19,675)
Net change in short-term borrowings	7,123	9,686
Increase in long-term borrowings	--	--
Payments on long-term borrowings	14,060	(5,989)
Purchase of Treasury stock	(2,031)	(454)
Payments of dividends	(2,413)	(2,272)
Net Cash Provided (Used) by Financing Activities	(23,030)	(18,704)
Net change in cash and cash equivalents	(18,553)	(6,119)
Cash and cash equivalents - Beginning of year	37,247	22,589
CASH AND CASH EQUIVALENTS - END OF THE YEAR	$ 18,694	$ 16,470
RECONCILIATION OF CASH AND CASH EQUIVALENTS:		
Cash and cash due from banks	$ 17,241	$ 15,652
Interest bearing deposits	486	306
Federal funds sold	967	512
	$ 18,694	$ 16,470

See Notes to Condensed Consolidated Unaudited Financial Statements.

FARMERS & MERCHANTS BANCORP, INC.

Notes to Condensed Consolidated Unaudited Financial Statements

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2007 are not necessarily indicative of the results that are expected for the year ended December 31, 2007. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2006.

The Company's Board of Directors declared a 4 for 1 stock split effective May 12, 2006. Therefore, all references in the financial statements and other disclosures related to the number of shares and per share amounts of the Company's stock have been retroactively restated to reflect the increased number of shares outstanding.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities

Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as "intend," "believe," "expect," "anticipate," "should," "planned," "estimated," and "potential." Such forward-looking statements are based on current expectations, but may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the industries in which it operates. At times the application of these principles requires Management to make assumptions estimates and judgments that affect the amounts reported in the financial statements. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL) and the valuation

of its Mortgage Servicing Rights as the accounting areas that requires the most subjective or complex judgments, and as such have the highest possibility of being subject to revision as as new information becomes available.

The ALLL represents management's estimate of credit losses inherent in the Bank's loan portfolio at the report date. The estimate is composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion.

Farmers & Merchants Bancorp, Inc. was incorporated on February 25, 1985, under the laws of the State of Ohio. Farmers & Merchants Bancorp, Inc., and its subsidiaries The Farmers & Merchants State Bank and Farmers & Merchants Life Insurance Company are engaged in commercial banking and life and disability insurance, respectively. The executive offices of Farmers & Merchants Bancorp, Inc. are located at 307-11 North Defiance Street, Archbold, Ohio 43502.

LIQUIDITY, CAPITAL RESOURCES AND MATERIAL CHANGES IN FINANCIAL CONDITION

In comparing the balance sheet of September 30, 2007 to that of December 31, 2006, a shifting has occurred in almost all areas. Loans show modest growth, of around $2.5 million for the year, losing much of the momentum in growth that had occurred in the first quarter. As the more expensive interest bearing deposits of rate shoppers left the Bank, those funds were replaced by movements in Federal Funds sold (decreased approximately $12.4 million), investments (decreased by $5.5 million) and on the liability side of the balance sheet, Federal Funds purchased and securities sold under agreement to repurchase (increased $7 million) and other borrowed money (increased $14 million).

Liquidity remains adequate and capital continued to grow even with the additional purchase of treasury stock. The Company had discontinued stock repurchase activity for most of the quarter prior to the announcement of the execution on September 7, 2007 of a definitive agreement for the purchase of Knisely Bank. For the year, slightly over $2 million in shares have been purchased. The Company may continue to repurchase its stock through the end of the year. Overall, asset size has decreased $16.87 million as compared to year end 2006.

Loan demand remains sluggish and competition is intense. The local economics of our communities appears to be leveling out though the Bank has yet to see a change in loan demand. The Bank plans on opening its new branch in Perrysburg in November and looks for the new market to help spur growth opportunities. Training has begun in earnest on improving the sales culture of the Bank with an emphasis on determining our customers needs and wants. As the new skills are implemented, growth opportunities should materialize. This is an on-going process and will take the Bank a couple of years to properly train every employee. The training has begun with the customer contact personnel first.

Loan quality continues to remain strong overall. However, a slight deterioration has occurred with respect to loans past due over 30 days. Past dues ended slightly higher at the end of September at 1.98%. Unlike much of what is heard in the market with residential real estate, the increase in the past dues was caused within the commercial portfolio. One of those issues has already been resolved in the start of the fourth quarter which will bring the ratio back in line with the 1% guideline.

The Knisely Bank merger will provide growth in assets of around $45 to $50 million in 2007 if closed before year end, leaving the Bank well positioned heading into the new year for increased profitability. It also brings additional opportunity for growth in new markets. The Bank will enter the Indiana market with two well established offices, in the communities of Butler and Auburn. The Knisely Bank has been in business for 125 years. This is the Bank's first acquisition in its 110 years of operations.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

MATERIAL CHANGES IN RESULTS OF OPERATIONS

Loan income for the third quarter of 2007 was $.5 million over the same period for 2006. For the nine month period ended, September 30, 2007, an additional $2.7 million in loan interest income was generated. This is partially due to the slight growth in loans and has yet to be fully impacted by the latest rate drop. The Bank has held most of its investment portfolio in agencies for better yields over treasuries and tax equivalent municipal yields. Lower income in Federal Funds Sold is due to the balance sheet shift discussed earlier.

Overall, interest income for the nine months ended September 30, 2007 shows improvement over the same period for 2006 by almost 9.5% or $3 million. During the same nine month period, interest expense grew by approximately 20% or $2.7 million. Increases in interest expense occurred in both deposits and borrowed funds. Net interest income, therefore increased slightly in the nine month comparison to last year. For the quarter, however, net interest income decreased compared to last year.

With loan growth at a minimum, existing provisions were adequate for the loan portfolio growth factor. Other factors influencing the calcualtion of the ALLL include the local economy, the overall credit quality of the loan portfolio and by analyzing specific accounts. Additional funding was required during the third quarter for a specific commercial account allocation. This issue has since been resolved and may result in the fourth quarter allocation being lowered as the credit quality of the remainder of the loan portfolio has had minimal fluctuation.

Other non-interest income has been lagging behind the same nine months ended of a year ago. Service charge income, which includes overdraft privilege fees has decreased significantly with respect to both the quarter and nine month period comparisons. In comparing nine months, overdraft income is down $280 thousand and is attributed to changes in customer behavior as the number of accounts has remained fairly constant. Other non-interest income has improved decreasing the overall loss of noninterest income. The improvement in other non-interest income is not due to one product or service but rather a slight increase in all.

Salaries and expenses show a decrease in both the quarterly and nine months comparisons. This has been due to the decrease in the number of employees which has been accomplished through attrition. As the Bank gears up for the opening of the new branch, new employees will be added which will make this decrease smaller or disappear. Also noteworthy is the increase in the pension and other benefits. These increases are being driven by higher medical costs as the bank is partially self-insured. The Bank's share of claim expense is higher by over $285 thousand year to date. Medical costs continue to be a concern due to the rising cost of premiums and claims. The Bank has experienced more claim costs with fewer employees involved.

Other operating expenses are in line when comparing the nine months ended for each year, but the quarter ended September 30, 2007 shows a large increase as compared to September 2006. 2006's fluctuation was due to a refinement in the ALLL methodology dealing with unfunded loans. To provide comparison for the September 2007 quarter, the quarterly expense is actually lower than September 2005's $1.976 million.

In summary, net income is behind last year's nine months ended which is impacted by the quarter's numbers being down. With asset size similar on an average basis, the issue comes back to the medical expenses and the refinement in ALLL methodology shown in the provision for loan loss and other operating expenses. The additional expense of the new locations will continue to negatively impact earnings to some degree in the fourth quarter but should begin to enhance earnings at some point in 2008.

The company continues to be well-capitalized as the capital ratios below show:

Primary Ratio	13.34%
Tier I Leverage Ratio	12.55%
Risk Based Capital Tier 1	16.26%
Total Risk Based Capital	17.28%
Stockholders' Equity/Total Assets	12.45%

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ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of the Company's interest rate risk arises from the instruments, positions and transactions entered into for purposes, other than trading, such as lending, investing and securing sources of funds. Interest rate risk occurs when interest bearing assets and liabilities reprice at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework for the Company. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. The Company employs a sensitivity analysis in the form of a net interest rate shock as shown in the table following.

Interest Rate Shock on Net Interest Margin				Interest Rate Shock on Net Interest Income	
Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total ($000)	% Change to Flat Rate
3.28%	-14.849%	Rising	3.000%	19,699	-9.628%
3.48%	-9.863%	Rising	2.000%	20,403	-6.396%
3.67%	-4.913%	Rising	1.000%	21,103	-3.186%
3.86%	0.000%	Flat	0.000%	21,797	0.000%
3.98%	3.073%	Falling	-1.000%	22,100	1.391%
4.04%	4.715%	Falling	-2.000%	21,937	0.641%
4.07%	5.605%	Falling	-3.000%	21,564	-1.069%

As the balance sheet mix changes, the predicted net interest margin improves as compared to March and June 2007's interest rate shock table. The net interest margin represents the forecasted twelve month margin. A portion of the improvement in the predicted flat rate is due to the drop in rates that occurred in September. The shock report has consistently shown an improvement in a falling rate environment. The report for September shows an increase in the base or flat rate of 33 basis points over June's with the Federal Funds rate having dropped 50 basis points. This is consistant with the model predictions as June showed improvement to take place in the net interest margin should rates fall.

It must be remembered that the shock report is based on a twelve month time span. How the margin will be impacted in the fourth quarter is still dependent on when pricing opportunities arise from maturities and repricing schedules. The Bank continues to remain focused on gaining more relationships per customer as a way to help control the cost of funds. Promotions continue to focus on special incentives or rewards being based on a multiple deposit account relationship with each customer. As higher priced certificate of deposits left the bank during the most recent quarter, cheaper borrowings from the Federal Home Loan Bank were used to replace the funds. This strategy was implemented to keep the cost of funds in check as forty percent of the CD portfolio matured in the third quarter. The margin would be better had the Federal Fund rate drop occurred at the beginning of the quarter rather than near the end of September.

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ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2007, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2007. There have been no significant changes in the Company's internal controls that occurred for the quarter ended September 30, 2007.

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PART II

ITEM 1 LEGAL PROCEEDINGS

None

ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2006.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	(d) Maxim that may ye the Pl
7/1/2007 to 7/31/2007				
8/1/2007				

to 8/31/2007			
9/1/2007 to 9/30/2007	35,000	$20.84	35,000
Total	35,000	$20.84	35,000 (1)

(1) The Company purchased these shares in the market pursuant to a stock repurchase program publicly announced on October 20, 2006. On that date, the Board of Directors authorized the repurchase of 250,000 common shares between October 20, 2006 and December 31, 2007.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None

ITEM 5 OTHER INFORMATION

ITEM 6 EXHIBITS

2.0 Agreement of Merger and Plan of Reorganization dated as of Septmeber 7, 2007 by and among the Registrant, The Farmers & Merchants State Bank, Knisely Financial Corp and Knisely Bank (incorporated by reference to Registrant's Current Report on Form 8-K filed with the Commission on September 10, 2007.)

3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on August 1, 2006)

3.2 Code of Regulations of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)

31.1 Rule 13-a-14(a) Certification -CEO

31.2 Rule 13-a-14(a) Certification -CFO

32.1 Section 1350 Certification - CEO

32.2 Section 1350 Certification - CFO

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Farmers & Merchants Bancorp, Inc.,

Date: October 31, 2007	By: /s/ Paul S. Siebenmorgen ------------------------------------ Paul S. Siebenmorgen President and CEO
Date: October 31, 2007	By: /s/ Barbara J. Britenriker ------------------------------------ Barbara J. Britenriker Exec. Vice-President and CFO