MERCANTILE BANK CORP
Form 10-Q
November 08, 2012
Table of Contents

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2012

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

For the transition period from to .

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

Michigan	**38-3360865**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

310 Leonard Street, NW, Grand Rapids, MI 49504

(Address of principal executive offices) (Zip Code)

(616) 406-3000

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	x

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

At November 8, 2012, there were 8,638,591 shares of Common Stock outstanding.

Table of Contents

MERCANTILE BANK CORPORATION

INDEX

Table of Contents

MERCANTILE BANK CORPORATION

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS

	September 30, 2012 (Unaudited)	December 31, 2011 (Audited)
ASSETS		
Cash and due from banks	$ 15,311,000	$ 12,402,000
Interest-bearing deposit balances	10,672,000	9,641,000
Federal funds sold	78,012,000	54,329,000
Total cash and cash equivalents	103,995,000	76,372,000
Securities available for sale	135,660,000	172,992,000
Federal Home Loan Bank stock	11,961,000	11,961,000
Loans	1,035,288,000	1,072,422,000
Allowance for loan losses	(27,762,000)	(36,532,000)
Loans, net	1,007,526,000	1,035,890,000
Premises and equipment, net	26,100,000	26,802,000
Bank owned life insurance	49,690,000	48,520,000
Accrued interest receivable	3,939,000	4,403,000
Other real estate owned and repossessed assets	11,160,000	15,282,000
Net deferred tax asset	22,801,000	26,013,000
Other assets	15,532,000	14,994,000
Total assets	$ 1,388,364,000	$ 1,433,229,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest-bearing	$ 166,890,000	$ 147,031,000
Interest-bearing	940,676,000	965,044,000
Total deposits	1,107,566,000	1,112,075,000
Securities sold under agreements to repurchase	60,031,000	72,569,000
Federal Home Loan Bank advances	35,000,000	45,000,000
Subordinated debentures	32,990,000	32,990,000
Other borrowed money	1,433,000	1,434,000
Accrued interest and other liabilities	6,786,000	4,162,000
Total liabilities	1,243,806,000	1,268,230,000

Shareholders equity		
Preferred stock, no par value; 1,000,000 shares authorized; 0 shares outstanding at September 30, 2012 and 21,000 shares outstanding at December 31, 2011	0	20,331,000
Common stock, no par value; 20,000,000 shares authorized; 8,635,070 shares outstanding at September 30, 2012 and 8,605,391 shares outstanding at December 31, 2011	166,728,000	172,841,000
Common stock warrant	0	1,138,000
Retained earnings (deficit)	(24,183,000)	(32,639,000)
Accumulated other comprehensive income	2,013,000	3,328,000
Total shareholders equity	144,558,000	164,999,000
Total liabilities and shareholders equity	$ 1,388,364,000	$ 1,433,229,000

See accompanying notes to consolidated financial statements.

1.

Table of Contents

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended Sept 30, 2012	Three Months Ended Sept 30, 2011	Nine Months Ended Sept 30, 2012	Nine Months Ended Sept 30, 2011
Interest income				
Loans, including fees	$ 13,386,000	$ 14,951,000	$ 40,653,000	$ 47,854,000
Securities, taxable	1,009,000	1,588,000	3,351,000	5,285,000
Securities, tax-exempt	319,000	439,000	1,109,000	1,368,000
Federal funds sold	46,000	60,000	116,000	138,000
Interest-bearing deposit balances	8,000	6,000	22,000	18,000
Total interest income	14,768,000	17,044,000	45,251,000	54,663,000
Interest expense				
Deposits	2,728,000	4,040,000	8,581,000	13,007,000
Short-term borrowings	39,000	73,000	130,000	350,000
Federal Home Loan Bank advances	183,000	410,000	871,000	1,622,000
Other borrowings	234,000	226,000	705,000	782,000
Total interest expense	3,184,000	4,749,000	10,287,000	15,761,000
Net interest income	11,584,000	12,295,000	34,964,000	38,902,000
Provision for loan losses	(400,000)	1,100,000	(3,400,000)	5,000,000
Net interest income after provision for loan losses	11,984,000	11,195,000	38,364,000	33,902,000
Noninterest income				
Services charges on accounts	378,000	405,000	1,142,000	1,228,000
Earnings on bank owned life insurance	378,000	452,000	1,170,000	1,340,000
Mortgage banking activities	447,000	195,000	1,021,000	453,000
Rental income from other real estate owned	270,000	208,000	806,000	599,000
Other income	584,000	544,000	1,792,000	1,639,000
Total noninterest income	2,057,000	1,804,000	5,931,000	5,259,000
Noninterest expense				
Salaries and benefits	4,849,000	4,636,000	14,394,000	13,371,000
Occupancy	598,000	707,000	1,947,000	2,116,000
Furniture and equipment depreciation, rent and maintenance	282,000	305,000	888,000	912,000
Nonperforming asset costs	1,576,000	1,589,000	4,931,000	6,637,000
FDIC insurance costs	294,000	639,000	894,000	2,274,000
Other expense	2,586,000	2,099,000	7,389,000	6,689,000
Total noninterest expenses	10,185,000	9,975,000	30,443,000	31,999,000

Income before federal income tax expense	3,856,000	3,024,000	13,852,000	7,162,000
Federal income tax expense	1,240,000	0	4,365,000	0
Net income	2,616,000	3,024,000	9,487,000	7,162,000
Preferred stock dividends and accretion	0	342,000	1,030,000	1,011,000
Net income attributable to common shares	$ 2,616,000	$ 2,682,000	$ 8,457,000	$ 6,151,000

See accompanying notes to consolidated financial statements.

2.

Table of Contents

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)

(Unaudited)

	Three Months Ended Sept 30, 2012	Three Months Ended Sept 30, 2011	Nine Months Ended Sept 30, 2012	Nine Months Ended Sept 30, 2011
Basic earnings per share	$ 0.30	$ 0.31	$ 0.98	$ 0.72
Diluted earnings per share	$ 0.30	$ 0.30	$ 0.95	$ 0.69
Cash dividends per share	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Average basic shares outstanding	8,622,719	8,604,263	8,612,831	8,602,654
Average diluted shares outstanding	8,653,751	8,868,122	8,896,728	8,875,025

See accompanying notes to consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended Sept 30, 2012	Three Months Ended Sept 30, 2011	Nine Months Ended Sept 30, 2012	Nine Months Ended Sept 30, 2011
Net income	$ 2,616,000	$ 3,024,000	$ 9,487,000	$ 7,162,000
Other comprehensive income:				
Change in net unrealized gain on securities available for sale, net of tax effect	(124,000)	3,037,000	(596,000)	4,300,000
Change in fair value of interest rate swap, net of tax effect	(298,000)	0	(719,000)	0
Other comprehensive income	(422,000)	3,037,000	(1,315,000)	4,300,000
Comprehensive income	$ 2,194,000	$ 6,061,000	$ 8,172,000	$ 11,462,000

See accompanying notes to consolidated financial statements.

4.

Table of Contents

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS EQUITY

(Unaudited)

($ in thousands)	Preferred Stock	Common Stock	Common Stock Warrant	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income	Total Shareholders Equity
Balances, January 1, 2012	$ 20,331	$ 172,841	$ 1,138	$ (32,639)	$ 3,328	$ 164,999
Repurchase of preferred stock	(21,000)					(21,000)
Preferred stock dividends				(362)		(362)
Accretion of preferred stock	669			(669)		0
Repurchase of common stock warrant		(6,327)	(1,138)			(7,465)
Employee stock purchase plan (1,743 shares)		29				29
Stock option exercises (47,007 shares)		488				488
Stock tendered for stock option exercises (18,718 shares)		(317)				(317)
Stock-based compensation expense		14				14
Net income for the period from January 1, 2012 through September 30, 2012				9,487		9,487
Change in net unrealized gain on securities available for sale, net of tax effect					(596)	(596)
Change in fair value of interest rate swap, net of tax effect					(719)	(719)
Balances, September 30, 2012	$ 0	$ 166,728	$ 0	$ (24,183)	$ 2,013	$ 144,558

See accompanying notes to consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS EQUITY (Continued)

(Unaudited)

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

See accompanying notes to consolidated financial statements.

6.

Table of Contents

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended Sept 30, 2012	Nine Months Ended Sept 30, 2011
Cash flows from operating activities		
Net income	$ 9,487,000	$ 7,162,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	1,669,000	1,694,000
Provision for loan losses	(3,400,000)	5,000,000
Stock-based compensation expense	14,000	66,000
Proceeds from sales of mortgage loans held for sale	57,233,000	29,603,000
Origination of mortgage loans held for sale	(62,347,000)	(31,349,000)
Net gain from sales of mortgage loans held for sale	(853,000)	(338,000)
Net loss from sale and valuation write-down of foreclosed assets	1,817,000	1,318,000
Earnings on bank owned life insurance	(1,170,000)	(1,340,000)
Net change in:		
Accrued interest receivable	464,000	1,055,000
Other assets	2,638,000	2,599,000
Accrued expenses and other liabilities	1,652,000	173,000
Net cash from operating activities	7,204,000	15,643,000
Cash flows from investing activities		
Loan originations and payments, net	27,283,000	149,809,000
Purchases of:		
Securities available for sale	(45,973,000)	(3,072,000)
Proceeds from:		
Maturities, calls and repayments of available for sale securities	82,580,000	55,179,000
Redemption of Federal Home Loan Bank stock	0	2,384,000
Proceeds from sales of foreclosed assets	12,753,000	7,921,000
Purchases of premises and equipment, net	(415,000)	(222,000)
Net cash from investing activities	76,228,000	211,999,000
Cash flows from financing activities		
Net decrease in time deposits	(43,811,000)	(133,202,000)
Net increase in all other deposits	39,302,000	44,703,000
Net decrease in securities sold under agreements to repurchase	(12,538,000)	(47,639,000)
Proceeds from Federal Home Loan Bank advances	20,000,000	0
Maturities and prepayments of Federal Home Loan Bank advances	(30,000,000)	(20,000,000)
Maturities of wholesale repurchase agreements	0	(10,000,000)
Net decrease in other borrowed money	(1,000)	(90,000)
Repurchase of preferred stock	(21,000,000)	0
Repurchase of common stock warrant	(7,465,000)	0
Proceeds from stock option exercises, net of cashless exercises	171,000	55,000
Employee stock purchase plan	29,000	30,000
Dividend reinvestment plan	0	6,000

Payment of cash dividends on preferred stock	(496,000)	0
Net cash for financing activities	(55,809,000)	(166,137,000)

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Nine Months Ended Sept 30, 2012	Nine Months Ended Sept 30, 2011
Net change in cash and cash equivalents	27,623,000	61,505,000
Cash and cash equivalents at beginning of period	76,372,000	64,198,000
Cash and cash equivalents at end of period	$ 103,995,000	$ 125,703,000
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Interest	$ 11,157,000	$ 15,503,000
Federal income tax	0	0
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	10,448,000	9,851,000
Preferred stock cash dividend accrued	0	1,488,000

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited condensed consolidated financial statements include the results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan (our bank) and our bank s three subsidiaries, Mercantile Bank Mortgage Company, LLC (our mortgage company), Mercantile Bank Real Estate Co., LLC (our real estate company), and Mercantile Insurance Center, Inc. (our insurance center). These condensed consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended September 30, 2012 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, 2011.

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

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and our common stock warrant through the date we repurchased the warrant as disclosed in Note 12, 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 38,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2012. In addition, stock options for approximately 26,000 and 21,000 shares of common stock were included in determining diluted earnings per share for the three and nine months ended September 30, 2012, respectively. Also, our stock warrant for approximately 616,000 shares of common stock was included in determining diluted earnings per share for the three and nine months ended September 30, 2012 taking into account our full repurchase of said stock warrant on July 3, 2012. Stock options for approximately 137,000 and 142,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2012.

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

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

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

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Derivatives: Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Used as part of our asset and liability management to help manage interest rate risk, our derivatives have historically consisted of interest rate swap agreements that qualified for hedge accounting. In February 2012, we entered into an interest rate swap agreement that does qualify for hedge accounting. However, in June 2011, we simultaneously purchased and sold an interest rate cap, a structure commonly referred to as a cap corridor , which does not qualify for hedge accounting. The current outstanding interest rate swap agreement and cap corridor are 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.

If designated as a hedge, we formally document the relationship between 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.

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income*, to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The ASU eliminates the option to present components of other comprehensive income as part of the Statement of Changes in Shareholders Equity. Instead, all changes in shareholders equity must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the single continuous statement approach, the statement should present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present the components of net income and total net income followed consecutively by a second statement that should present the components of other comprehensive income, a total for other comprehensive income and a total for comprehensive income. Also known as recycling, companies will also be required to display reclassification adjustments and their effect on net income and other comprehensive income in the statement(s) in which they appear. The ASU does not change certain other current requirements including items that constitute net income and other comprehensive income. The ASU is to be applied retrospectively and became effective January 1, 2012. Beginning with the March 31, 2012 Form 10-Q, we have included the Consolidated Statements of Comprehensive Income.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2012				
U.S. Government agency debt obligations	$ 69,413,000	$ 1,395,000	$ (79,000)	$ 70,729,000
Mortgage-backed securities	23,004,000	2,280,000	0	25,284,000
Michigan Strategic Fund bonds	11,255,000	0	0	11,255,000
Municipal general obligation bonds	22,985,000	1,131,000	0	24,116,000
Municipal revenue bonds	2,748,000	122,000	0	2,870,000
Mutual funds	1,338,000	68,000	0	1,406,000
	$ 130,743,000	$ 4,996,000	$ (79,000)	$ 135,660,000
December 31, 2011				
U.S. Government agency debt obligations	$ 86,783,000	$ 1,872,000	$ (59,000)	$ 88,596,000
Mortgage-backed securities	31,851,000	2,759,000	0	34,610,000
Michigan Strategic Fund bonds	16,700,000	0	0	16,700,000
Municipal general obligation bonds	26,212,000	1,097,000	0	27,309,000
Municipal revenue bonds	4,300,000	123,000	0	4,423,000
Mutual funds	1,312,000	42,000	0	1,354,000
	$ 167,158,000	$ 5,893,000	$ (59,000)	$ 172,992,000

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

Securities with unrealized losses at September 30, 2012 and December 31, 2011, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2012						
U.S. Government agency debt obligations	$ 8,905,000	$ (79,000)	$ 0	$ 0	$ 8,905,000	$ (79,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Municipal general obligation bonds	0	0	0	0	0	0
Municipal revenue bonds	0	0	0	0	0	0
Mutual funds	0	0	0	0	0	0
	$ 8,905,000	$ (79,000)	$ 0	$ 0	$ 8,905,000	$ (79,000)
December 31, 2011						
U.S. Government agency debt obligations	$ 9,765,000	$ (33,000)	$ 9,526,000	$ (26,000)	$ 19,291,000	$ (59,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Municipal general obligation bonds	0	0	0	0	0	0
Municipal revenue bonds	0	0	0	0	0	0
Mutual funds	0	0	0	0	0	0
	$ 9,765,000	$ (33,000)	$ 9,526,000	$ (26,000)	$ 19,291,000	$ (59,000)

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

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

At September 30, 2012, six debt securities with a fair value totaling $8.9 million have unrealized losses with aggregate depreciation of $0.1 million, or 0.06% from the amortized cost basis of total securities. At September 30, 2012, 204 debt securities and a mutual fund with a fair value totaling $106.5 million have unrealized gains with aggregate appreciation of $5.0 million, or 3.8% from the amortized cost basis of total securities. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no declines are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at September 30, 2012, by contractual maturity, are shown below. The contractual maturity is utilized below for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

The maturities of securities and their weighted average yields at September 30, 2012 are also shown in the following table. The yields for municipal securities are included at their tax equivalent yield.

	Weighted Average Yield	Amortized Cost	Fair Value
Due in 2012	6.85%	$ 1,007,000	$ 1,017,000
Due in 2013 through 2017	5.03	6,809,000	7,075,000
Due in 2018 through 2022	3.58	24,837,000	25,266,000
Due in 2023 and beyond	4.42	62,493,000	64,357,000
Mortgage-backed securities	5.17	23,004,000	25,284,000
Michigan Strategic Fund bonds	1.75	11,255,000	11,255,000
Mutual funds	2.31	1,338,000	1,406,000
	4.21%	$ 130,743,000	$ 135,660,000

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. **SECURITIES** (Continued)

At September 30, 2012, and December 31, 2011, the amortized cost of securities issued by the State of Michigan and all its political subdivisions totaled $25.7 million and $30.5 million, respectively, with estimated market values of $27.0 million and $31.7 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements and letters of credit issued on behalf of our customers was $74.8 million and $109.0 million at September 30, 2012 and December 31, 2011, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

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

Our total loans at September 30, 2012 were $1.04 billion compared to $1.07 billion at December 31, 2011, a decline of $37.1 million, or 3.5%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at September 30, 2012 and December 31, 2011, and the percentage change in loans from the end of 2011 to the end of the third quarter of 2012, are as follows:

	September 30, 2012		December 31, 2011		Percent
	Balance	%	Balance	%	Increase (Decrease)
Commercial:					
Commercial and industrial	$ 271,814,000	26.3%	$ 260,613,000	24.3%	4.3%
Vacant land, land development, and residential construction	56,622,000	5.5	61,959,000	5.8	(8.6)
Real estate owner occupied	276,185,000	26.6	271,869,000	25.3	1.6
Real estate non-owner occupied	299,356,000	28.9	334,165,000	31.2	(10.4)
Real estate multi-family and residential rental	53,434,000	5.2	68,299,000	6.4	(21.8)
Total commercial	957,411,000	92.5	996,905,000	93.0	(4.0)
Retail:					
Home equity and other	39,423,000	3.8	42,336,000	3.9	(6.9)
1-4 family mortgages	38,454,000	3.7	33,181,000	3.1	15.9
Total retail	77,877,000	7.5	75,517,000	7.0	3.1
Total loans	$ 1,035,288,000	100.0%	$ 1,072,422,000	100.0%	(3.5)%

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Nonperforming loans as of September 30, 2012 and December 31, 2011 were as follows:

	September 30, 2012	December 31, 2011
Loans past due 90 days or more still accruing interest	$ 0	$ 0
Nonaccrual loans	24,782,000	45,074,000
Total nonperforming loans	$ 24,782,000	$ 45,074,000

As discussed in the Troubled Debt Restructurings section of our Significant Accounting Policies, troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans whereas accruing troubled debt restructurings are generally excluded from nonperforming loans. At September 30, 2012 and December 31, 2011, there were no accruing troubled debt restructurings included in nonperforming loans.

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

	September 30, 2012	December 31, 2011
Commercial:		
Commercial and industrial	$ 3,870,000	$ 5,916,000
Vacant land, land development, and residential construction	2,850,000	3,448,000
Real estate owner occupied	3,074,000	6,635,000
Real estate non-owner occupied	11,157,000	24,169,000
Real estate multi-family and residential rental	1,754,000	2,532,000
Total commercial	22,705,000	42,700,000
Retail:		
Home equity and other	733,000	1,013,000
1-4 family mortgages	1,344,000	1,361,000
Total retail	2,077,000	2,374,000
Total nonaccrual loans	$ 24,782,000	$ 45,074,000

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of September 30, 2012:

	30 59 Days Past Due	60 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	$ 90,000	$ 0	$ 1,659,000	$ 1,749,000	$ 270,065,000	$ 271,814,000	$ 0
Vacant land, land development, and residential construction	0	0	1,177,000	1,177,000	55,445,000	56,622,000	0
Real estate owner occupied	0	0	1,633,000	1,633,000	274,552,000	276,185,000	0
Real estate non-owner occupied	0	234,000	3,811,000	4,045,000	295,311,000	299,356,000	0
Real estate multi-family and residential rental	0	170,000	588,000	758,000	52,676,000	53,434,000	0
Total commercial	90,000	404,000	8,868,000	9,362,000	948,049,000	957,411,000	0
Retail:							
Home equity and other	31,000	13,000	0	44,000	39,379,000	39,423,000	0
1-4 family mortgages	48,000	80,000	642,000	770,000	37,684,000	38,454,000	0
Total retail	79,000	93,000	642,000	814,000	77,063,000	77,877,000	0
Total past due loans	$ 169,000	$ 497,000	$ 9,510,000	$ 10,176,000	$ 1,025,112,000	$ 1,035,288,000	$ 0

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of December 31, 2011:

	30 59 Days Past Due	60 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	$ 0	$ 2,037,000	$ 2,284,000	$ 4,321,000	$ 256,292,000	$ 260,613,000	$ 0
Vacant land, land development, and residential construction	0	145,000	2,448,000	2,593,000	59,366,000	61,959,000	0
Real estate owner occupied	85,000	786,000	2,836,000	3,707,000	268,162,000	271,869,000	0
Real estate non-owner occupied	456,000	728,000	9,837,000	11,021,000	323,144,000	334,165,000	0
Real estate multi-family and residential rental	42,000	443,000	957,000	1,442,000	66,857,000	68,299,000	0
Total commercial	583,000	4,139,000	18,362,000	23,084,000	973,821,000	996,905,000	0
Retail:							
Home equity and other	46,000	0	242,000	288,000	42,048,000	42,336,000	0
1-4 family mortgages	274,000	133,000	445,000	852,000	32,329,000	33,181,000	0
Total retail	320,000	133,000	687,000	1,140,000	74,377,000	75,517,000	0
Total past due loans	$ 903,000	$ 4,272,000	$ 19,049,000	$ 24,224,000	$ 1,048,198,000	$ 1,072,422,000	$ 0

(Continued)

19.

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans as of September 30, 2012, and average impaired loans for the three and nine months ended September 30, 2012, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Third Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:					
Commercial:					
Commercial and industrial	$ 4,210,000	$ 3,289,000		$ 3,209,000	$ 3,521,000
Vacant land, land development and residential construction	2,279,000	1,166,000		1,480,000	1,959,000
Real estate owner occupied	4,578,000	3,246,000		3,391,000	3,535,000
Real estate non-owner occupied	7,493,000	4,979,000		5,832,000	6,850,000
Real estate multi-family and residential rental	2,172,000	985,000		918,000	841,000
Total commercial	20,732,000	13,665,000		14,830,000	16,706,000
Retail:					
Home equity and other	580,000	487,000		482,000	603,000
1-4 family mortgages	1,440,000	779,000		715,000	715,000
Total retail	2,020,000	1,266,000		1,197,000	1,318,000
Total with no related allowance recorded	$ 22,752,000	$ 14,931,000		$ 16,027,000	$ 18,024,000

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Third Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:					
Commercial:					
Commercial and industrial	$ 3,278,000	$ 2,785,000	$ 1,358,000	$ 3,528,000	$ 3,406,000
Vacant land, land development and residential construction	3,305,000	3,117,000	1,465,000	2,981,000	3,529,000
Real estate owner occupied	3,233,000	2,813,000	1,326,000	4,120,000	5,235,000
Real estate non-owner occupied	40,590,000	34,521,000	10,061,000	25,220,000	23,085,000
Real estate multi-family and residential rental	4,693,000	4,477,000	1,287,000	4,748,000	8,306,000
Total commercial	55,099,000	47,713,000	15,497,000	40,597,000	43,561,000
Retail:					
Home equity and other	235,000	206,000	206,000	291,000	259,000
1-4 family mortgages	484,000	364,000	99,000	503,000	484,000
Total retail	719,000	570,000	305,000	794,000	743,000
Total with an allowance recorded	$ 55,818,000	$ 48,283,000	$ 15,802,000	$ 41,391,000	$ 44,304,000
Total impaired loans:					
Commercial	$ 75,831,000	$ 61,378,000	$ 15,497,000	$ 55,427,000	$ 60,267,000
Retail	2,739,000	1,836,000	305,000	1,991,000	2,061,000
Total impaired loans	$ 78,570,000	$ 63,214,000	$ 15,802,000	$ 57,418,000	$ 62,328,000

Interest income of $0.4 million and $1.1 million was recognized on impaired loans during the third quarter and first nine months of 2012, respectively.

(Continued)

21.

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans as of December 31, 2011, and average impaired loans for the three and nine months ended September 30, 2011, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Third Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:					
Commercial:					
Commercial and industrial	$ 4,670,000	$ 4,254,000		$ 1,353,000	$ 1,704,000
Vacant land, land development and residential construction	5,308,000	2,755,000		2,278,000	6,387,000
Real estate owner occupied	5,525,000	3,572,000		4,071,000	4,233,000
Real estate non-owner occupied	14,017,000	8,131,000		9,286,000	12,306,000
Real estate multi-family and residential rental	1,309,000	671,000		1,579,000	979,000
Total commercial	30,829,000	19,383,000		18,567,000	25,609,000
Retail:					
Home equity and other	1,000,000	727,000		856,000	503,000
1-4 family mortgages	1,300,000	729,000		363,000	228,000
Total retail	2,300,000	1,456,000		1,219,000	731,000
Total with no related allowance recorded	$ 33,129,000	$ 20,839,000		$ 19,786,000	$ 26,340,000

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Third Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal