

MERCANTILE BANK CORP  
Form 10-Q  
November 04, 2016  
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**U.S. SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 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  Accelerated filer   
Non-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 November 4, 2016, there were 16,302,213 shares of common stock outstanding.

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## MERCANTILE BANK CORPORATION

## PART I --- FINANCIAL INFORMATION

## Item 1. Financial Statements

## CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

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	September 30, 2016	December 31, 2015
<b>ASSETS</b>		
Cash and due from banks	\$55,882,000	\$42,829,000
Interest-earning deposits	85,848,000	46,463,000
Federal funds sold	0	599,000
Total cash and cash equivalents	141,730,000	89,891,000
Securities available for sale	325,443,000	346,992,000
Federal Home Loan Bank stock	8,026,000	7,567,000
Loans	2,406,377,000	2,277,727,000
Allowance for loan losses	(17,526,000 )	(15,681,000 )
Loans, net	2,388,851,000	2,262,046,000
Premises and equipment, net	45,212,000	46,862,000
Bank owned life insurance	66,876,000	58,971,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	10,592,000	12,631,000
Other assets	27,761,000	29,123,000
Total assets	\$3,063,964,000	\$2,903,556,000
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest-bearing	\$731,663,000	\$674,568,000
Interest-bearing	1,597,774,000	1,600,814,000
Total deposits	2,329,437,000	2,275,382,000
Securities sold under agreements to repurchase	146,843,000	154,771,000
Federal Home Loan Bank advances	178,000,000	68,000,000

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Subordinated debentures	44,665,000	55,154,000
Accrued interest and other liabilities	15,548,000	16,445,000
Total liabilities	2,714,493,000	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; 16,296,658 shares outstanding at September 30, 2016 and 16,358,711 shares outstanding at December 31, 2015	304,027,000	304,819,000
Retained earnings	43,655,000	27,722,000
Accumulated other comprehensive income	1,789,000	1,263,000
Total shareholders' equity	349,471,000	333,804,000
Total liabilities and shareholders' equity	\$3,063,964,000	\$2,903,556,000

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See accompanying notes to condensed consolidated financial statements.

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## MERCANTILE BANK CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months	Three Months	Nine Months	Nine Months
	Ended	Ended	Ended	Ended
	Sept 30, 2016	Sept 30, 2015	Sept 30, 2016	Sept 30, 2015
Interest income				
Loans, including fees	\$27,553,000	\$26,565,000	\$81,219,000	\$77,463,000
Securities, taxable	1,488,000	1,382,000	5,661,000	4,556,000
Securities, tax-exempt	545,000	512,000	1,622,000	1,572,000
Other interest-earning assets	120,000	42,000	240,000	161,000
Total interest income	29,706,000	28,501,000	88,742,000	83,752,000
Interest expense				
Deposits	1,924,000	1,969,000	5,608,000	5,642,000
Short-term borrowings	62,000	39,000	154,000	116,000
Federal Home Loan Bank advances	670,000	203,000	1,595,000	506,000
Subordinated debentures and other borrowings	600,000	665,000	1,952,000	1,973,000
Total interest expense	3,256,000	2,876,000	9,309,000	8,237,000
<b>Net interest income</b>	<b>26,450,000</b>	<b>25,625,000</b>	<b>79,433,000</b>	<b>75,515,000</b>
Provision for loan losses	600,000	(500,000 )	2,300,000	(1,500,000 )
<b>Net interest income after provision for loan losses</b>	<b>25,850,000</b>	<b>26,125,000</b>	<b>77,133,000</b>	<b>77,015,000</b>
Noninterest income				
Services charges on deposit and sweep accounts	1,140,000	862,000	3,178,000	2,444,000
Credit and debit card income	1,090,000	1,005,000	3,185,000	3,296,000
Mortgage banking activities	1,236,000	1,073,000	2,578,000	2,784,000
Earnings on bank owned life insurance	349,000	272,000	933,000	820,000
Gain on trust preferred securities repurchase	0	0	2,970,000	0
Other income	1,469,000	1,065,000	3,590,000	2,648,000
Total noninterest income	5,284,000	4,277,000	16,434,000	11,992,000

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Noninterest expense				
Salaries and benefits	11,162,000	10,745,000	32,959,000	31,903,000
Occupancy	1,515,000	1,526,000	4,600,000	4,578,000
Furniture and equipment	531,000	569,000	1,579,000	1,788,000
Data processing costs	1,987,000	1,958,000	5,949,000	5,599,000
FDIC insurance costs	351,000	355,000	1,108,000	1,315,000
Other expense	4,117,000	4,540,000	12,530,000	14,101,000
Total noninterest expenses	19,663,000	19,693,000	58,725,000	59,284,000
<b>Income before federal income tax expense</b>	11,471,000	10,709,000	34,842,000	29,723,000
Federal income tax expense	3,626,000	3,373,000	11,014,000	9,183,000
<b>Net income</b>	\$7,845,000	\$7,336,000	\$23,828,000	\$20,540,000
Basic earnings per share	\$0.48	\$0.45	\$1.46	\$1.23
Diluted earnings per share	\$0.48	\$0.45	\$1.46	\$1.23
Cash dividends per share	\$0.17	\$0.15	\$0.49	\$0.43
Average basic shares outstanding	16,282,804	16,425,933	16,271,848	16,708,444
Average diluted shares outstanding	16,307,350	16,461,794	16,294,093	16,743,625

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See accompanying notes to condensed consolidated financial statements.



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## MERCANTILE BANK CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

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	Three Months Ended Sept 30, 2016	Three Months Ended Sept 30, 2015	Nine Months Ended Sept 30, 2016	Nine Months Ended Sept 30, 2015
<b>Net income</b>	\$7,845,000	\$7,336,000	\$23,828,000	\$20,540,000
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	(1,495,000)	1,230,000	722,000	1,395,000
Fair value of interest rate swap	113,000	(153,000 )	88,000	(279,000 )
	(1,382,000)	1,077,000	810,000	1,116,000
Tax effect of unrealized holding gains (losses) on securities available for sale	523,000	(431,000 )	(253,000 )	(461,000 )
Tax effect of fair value of interest rate swap	(40,000 )	53,000	(31,000 )	98,000
	483,000	(378,000 )	(284,000 )	(363,000 )
<b>Other comprehensive income (loss), net of tax</b>	(899,000 )	699,000	526,000	753,000
<b>Comprehensive income</b>	\$6,946,000	\$8,035,000	\$24,354,000	\$21,293,000

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See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION  
 CONDENSED CONSOLIDATED STATEMENTS OF  
 CHANGES IN SHAREHOLDERS' EQUITY  
 (Unaudited)

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

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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)

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(\$ in thousands except per share amounts)	Preferred Common		Retained	Accumulated	Total
	Stock	Stock	Earnings (Deficit)	Other Comprehensive Income (Loss)	Shareholders' Equity
<b>Balances, January 1, 2015</b>	\$ 0	\$317,904	\$10,218	\$ 16	\$ 328,138
Employee stock purchase plan (1,610 shares)		33			33
Dividend reinvestment plan (22,248 shares)		456			456
Stock option exercises (27,375 shares)		281			281
Stock grants to directors for retainer fees (20,094 shares)		402			402
Stock-based compensation expense		525			525
Share repurchase program (765,260 shares)		(15,223 )			(15,223 )
Cash dividends (\$0.43 per common share)			(7,085 )		(7,085 )
Net income for the nine months ended September 30, 2015			20,540		20,540
Change in net unrealized holding gain on securities available for sale, net of tax effect				934	934
Change in fair value of interest rate swap, net of tax effect				(181 )	(181 )
<b>Balances, September 30, 2015</b>	\$ 0	\$304,378	\$23,673	\$ 769	\$ 328,820

See accompanying notes to condensed consolidated financial statements.

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## MERCANTILE BANK CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended Sept 30, 2016	Nine Months Ended Sept 30, 2015
<b>Cash flows from operating activities</b>		
Net income	\$23,828,000	\$20,540,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	6,730,000	8,596,000
Accretion of acquired loans	(3,253,000 )	(4,264,000 )
Provision for loan losses	2,300,000	(1,500,000 )
Stock-based compensation expense	901,000	525,000
Stock grants to directors for retainer fee	327,000	402,000
Proceeds from sales of mortgage loans held for sale	83,440,000	94,608,000
Origination of mortgage loans held for sale	(83,000,000 )	(92,260,000 )
Net gain from sales of mortgage loans held for sale	(2,463,000 )	(2,831,000 )
Gain on trust preferred securities repurchase	(2,970,000 )	0
Net gain from sales and valuation write-down of foreclosed assets	(322,000 )	(104,000 )
Net gain from sales and valuation write-down of former bank premises	(10,000 )	0
Net (gain) loss from sales of fixed assets	174,000	(22,000 )
Net (gain) loss from sales of available for sale securities	1,000	(5,000 )
Earnings on bank owned life insurance	(933,000 )	(820,000 )
Net change in:		
Accrued interest receivable	(228,000 )	(321,000 )
Other assets	(1,554,000 )	(1,731,000 )
Accrued interest and other liabilities	(809,000 )	4,754,000
Net cash from operating activities	22,159,000	25,567,000
<b>Cash flows from investing activities</b>		
Loan originations and payments, net	(124,126,000)	(127,390,000)
Purchases of securities available for sale	(130,414,000)	(8,266,000 )
Proceeds from maturities, calls and repayments of securities available for sale	152,781,000	72,277,000
Proceeds from sales of securities available for sale	264,000	665,000
Proceeds from sales of foreclosed assets	1,458,000	1,431,000
Proceeds from sales of former bank premises	45,000	0
Proceeds from FHLB stock redemption	0	6,132,000

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Purchases of FHLB stock	(459,000	)	0
Purchases of bank owned life insurance	(7,000,000	)	0
Net purchases of premises and equipment	(1,051,000	)	(932,000 )
Net cash for investing activities	(108,502,000)		(56,083,000 )

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See accompanying notes to condensed consolidated financial statements.

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## MERCANTILE BANK CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

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	Nine Months	Nine Months
	Ended	Ended
	Sept 30, 2016	Sept 30, 2015
<b>Cash flows from financing activities</b>		
Net increase (decrease) in time deposits	17,823,000	(118,950,000)
Net increase in all other deposits	36,232,000	97,535,000
Net decrease in securities sold under agreements to repurchase	(7,928,000 )	(9,420,000 )
Maturities of Federal Home Loan Bank advances	0	(6,000,000 )
Proceeds from Federal Home Loan Bank advances	110,000,000	20,000,000
Proceeds from stock option exercises	606,000	281,000
Employee stock purchase plan	27,000	33,000
Dividend reinvestment plan	1,079,000	456,000
Repurchase of common stock shares	(3,732,000 )	(15,223,000 )
Repurchase of trust preferred securities	(8,030,000 )	0
Payment of cash dividends to common shareholders	(7,895,000 )	(7,085,000 )
Net cash from (for) financing activities	138,182,000	(38,373,000 )
Net change in cash and cash equivalents	51,839,000	(68,889,000 )
Cash and cash equivalents at beginning of period	89,891,000	172,738,000
Cash and cash equivalents at end of period	\$ 141,730,000	\$ 103,849,000
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	\$9,218,000	\$8,625,000
Federal income tax	10,950,000	5,700,000
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	297,000	1,604,000
Transfers from bank premises to other real estate owned	371,000	0

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See accompanying notes to condensed consolidated financial statements.





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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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**1. SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation:** The unaudited financial statements for the nine months ended September 30, 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 September 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 148,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2016. In addition, stock options for approximately 79,000

shares of common stock were included in determining diluted earnings per share for the three and nine months ended September 30, 2016. Stock options for approximately 4,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2016.

Approximately 98,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2015. In addition, stock options for approximately 106,000 shares of common stock were included in determining diluted earnings per share for the three and nine months ended September 30, 2015. Stock options for approximately 103,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2015.

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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

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

cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is considered doubtful.

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

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. As of September 30, 2016 and December 31, 2015, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$3.3 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 \$605 million as of September 30, 2016.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

Servicing fee income is recorded for fees earned for 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.

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

other defaulted loans.

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

**Derivatives:** Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Used as part of our asset and liability management to help manage interest rate risk, our derivatives have generally consisted of interest rate swap agreements that qualified for hedge accounting. In February 2012, we entered into an interest rate swap agreement that qualifies for hedge accounting. The current outstanding interest rate swap is discussed in more detail in Note 9. We do not use derivatives for trading purposes.

Changes in the fair value of derivatives that are designated, for accounting purposes, as a hedge of the variability of cash flows to be received on various 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 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Adoption of New Accounting Standards: In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. This ASU establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. This ASU was originally effective for annual and interim periods beginning after December 15, 2016, with 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.

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard will replace the current "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (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.

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

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## MERCANTILE BANK CORPORATION

## NOTES TO CONDENSED 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 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>September 30, 2016</u>				
U.S. Government agency debt obligations	\$ 138,133,000	\$ 391,000	\$(641,000)	\$ 137,883,000
Mortgage-backed securities	51,671,000	956,000	(58,000)	52,569,000
Municipal general obligation bonds	122,293,000	2,357,000	(164,000)	124,486,000
Municipal revenue bonds	8,458,000	70,000	(10,000)	8,518,000
Other investments	1,970,000	17,000	0	1,987,000
	\$ 322,525,000	\$ 3,791,000	\$(873,000)	\$ 325,443,000
<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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Securities with unrealized losses at September 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
<u>September 30, 2016</u>						
U.S. Government agency debt obligations	\$52,728,000	\$ 633,000	\$1,992,000	\$ 8,000	\$54,720,000	\$ 641,000
Mortgage-backed securities	787,000	3,000	15,064,000	55,000	15,851,000	58,000
Municipal general obligation bonds	14,524,000	86,000	6,644,000	78,000	21,168,000	164,000
Municipal revenue bonds	1,502,000	10,000	0	0	1,502,000	10,000
Other investments	0	0	0	0	0	0
	\$69,541,000	\$ 732,000	\$23,700,000	\$ 141,000	\$93,241,000	\$ 873,000

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## MERCANTILE BANK CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES** (Continued)

	Less than 12 Months		12 Months or More		Total	
	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
	Value	Loss	Value	Loss	Value	Loss
<u>December 31, 2015</u>						
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
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

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, 2016, 153 debt securities with fair values totaling \$93.2 million have unrealized losses aggregating \$0.9 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.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES** (Continued)

The amortized cost and fair value of debt securities at September 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 Average Yield	Amortized Cost	Fair Value
Due in 2016	2.07	% \$14,095,000	\$14,030,000
Due in 2017 through 2021	1.83	116,939,000	117,856,000
Due in 2022 through 2026	2.78	69,857,000	70,885,000
Due in 2027 and beyond	2.86	67,993,000	68,116,000
Mortgage-backed securities	1.77	51,671,000	52,569,000
Other investments	4.60	1,970,000	1,987,000
	2.27	% \$322,525,000	\$325,443,000

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of \$110 million and \$106 million at September 30, 2016 and December 31, 2015, respectively, with estimated market values of \$112 million and \$107 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$20.7 million and \$24.0 million at September 30, 2016 and December 31, 2015, respectively, with estimated market values of \$20.9 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 \$147 million and \$155 million at September 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

The fair value estimates for acquired loans are based on expected prepayments and the amount and timing of discounted expected principal, interest and other cash flows. Credit discounts representing the principal losses expected over the life of the loan are also a component of the initial fair value. In determining the merger date fair value of acquired impaired loans, and in subsequent accounting, we have generally aggregated acquired commercial and consumer loans into pools of loans with common risk characteristics.

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

Our total loans at September 30, 2016 were \$2.41 billion compared to \$2.28 billion at December 31, 2015, an increase of \$129 million, or 5.6%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at September 30, 2016 and December 31, 2015, and the percentage change in loans from the end of 2015 to the end of the third quarter of 2016, are as follows:

	September 30, 2016	December 31, 2015	Percent
	Balance	Balance	Increase (Decrease)
<b><u>Originated loans</u></b>			

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Commercial:								
Commercial and industrial	\$667,051,000	35.6	%	\$577,872,000	35.7	%	15.4	%
Vacant land, land development, and residential construction	28,003,000	1.5		30,138,000	1.9		(7.1)	)
Real estate – owner occupied	346,323,000	18.5		330,798,000	20.5		4.7	
Real estate – non-owner occupied	638,090,000	34.1		520,754,000	32.2		22.5	
Real estate – multi-family and residential rental	46,239,000	2.4		33,954,000	2.1		36.2	
Total commercial	1,725,706,000	92.1		1,493,516,000	92.4		15.5	
Retail:								
Home equity and other	72,680,000	3.9		67,816,000	4.2		7.2	
1-4 family mortgages	74,835,000	4.0		55,255,000	3.4		35.4	
Total retail	147,515,000	7.9		123,071,000	7.6		19.9	
Total originated loans	\$1,873,221,000	100.0%		\$1,616,587,000	100.0%		15.9	%

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## MERCANTILE BANK CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

	September 30, 2016		December 31, 2015		Percent
	Balance	%	Balance	%	Increase (Decrease)
<b><u>Acquired loans</u></b>					
Commercial:					
Commercial and industrial	\$83,279,000	15.6 %	\$118,431,000	17.9 %	(29.7% )
Vacant land, land development, and residential construction	9,452,000	1.8	14,982,000	2.3	(36.9 )
Real estate – owner occupied	94,381,000	17.7	115,121,000	17.4	(18.0 )
Real estate – non-owner occupied	103,354,000	19.4	123,597,000	18.7	(16.4 )
Real estate – multi-family and residential rental	71,864,000	13.5	81,049,000	12.3	(11.3 )
Total commercial	362,330,000	68.0	453,180,000	68.6	(20.0 )
Retail:					
Home equity and other	54,946,000	10.3	72,830,000	11.0	(24.6 )
1-4 family mortgages	115,880,000	21.7	135,130,000	20.4	(14.2 )
Total retail	170,826,000	32.0	207,960,000	31.4	(17.9 )
Total acquired loans	\$533,156,000	100.0%	\$661,140,000	100.0%	(19.4% )

	September 30, 2016		December 31, 2015		Percent
	Balance	%	Balance	%	Increase (Decrease)
<b><u>Total loans</u></b>					
Commercial:					
Commercial and industrial	\$750,330,000	31.2 %	\$696,303,000	30.6 %	7.8 %
Vacant land, land development, and residential construction	37,455,000	1.6	45,120,000	2.0	(17.0 )
Real estate – owner occupied	440,704,000	18.3	445,919,000	19.6	(1.2 )
Real estate – non-owner occupied	741,444,000	30.8	644,351,000	28.3	15.1



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Real estate – multi-family and residential rental	118,103,000	4.9	115,003,000	5.0	2.7
Total commercial	2,088,036,000	86.8	1,946,696,000	85.5	7.3
Retail:					
Home equity and other	127,626,000	5.3	140,646,000	6.2	(9.3 )
1-4 family mortgages	190,715,000	7.9	190,385,000	8.3	0.2
Total retail	318,341,000	13.2	331,031,000	14.5	(3.8 )
Total loans	\$2,406,377,000	100.0%	\$2,277,727,000	100.0%	5.6 %

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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 \$16.5 million and \$7.0 million, respectively, as of September 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 accretable yield for acquired impaired loans for the three and nine months ended September 30, 2016 and September 30, 2015 were as follows:

Balance at June 30, 2016	\$6,602,000
Additions	224,000
Accretion income	(638,000 )
Net reclassification from nonaccretable to accretable	1,000,000
Reductions (1)	(407,000 )
Balance at September 30, 2016	\$6,781,000
Balance at December 31, 2015	\$5,193,000
Additions	245,000
Accretion income	(1,992,000)
Net reclassification from nonaccretable to accretable	4,565,000
Reductions (1)	(1,230,000)
Balance at September 30, 2016	\$6,781,000
Balance at June 30, 2015	\$5,115,000
Additions	16,000
Accretion income	(653,000 )
Net reclassification from nonaccretable to accretable	1,520,000
Reductions (1)	(548,000 )
Balance at September 30, 2015	\$5,450,000

Balance at December 31, 2014	\$4,998,000
Additions	16,000
Accretion income	(1,980,000)
Net reclassification from nonaccretable to accretable	3,166,000
Reductions (1)	(750,000 )
Balance at September 30, 2015	\$5,450,000

(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 September 30, 2016 and December 31, 2015 were as follows:

	September 30,  2016	December 31,  2015
Loans past due 90 days or more still accruing interest	\$0	\$0
Nonaccrual loans	1,696,000	1,954,000
Total nonperforming originated loans	\$1,696,000	\$1,954,000

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

	September 30,  2016	December 31,  2015
Loans past due 90 days or more still accruing interest	\$0	\$5,000
Nonaccrual loans	2,973,000	3,485,000
Total nonperforming acquired loans	\$2,973,000	\$3,490,000

The recorded principal balance of nonperforming loans was as follows:

	September 30,	December 31,
	2016	2015
Commercial:		
Commercial and industrial	\$382,000	\$458,000
Vacant land, land development, and residential construction	110,000	155,000
Real estate – owner occupied	801,000	1,797,000
Real estate – non-owner occupied	673,000	79,000
Real estate – multi-family and residential rental	169,000	157,000
Total commercial	2,135,000	2,646,000
Retail:		
Home equity and other	654,000	771,000
1-4 family mortgages	1,880,000	2,027,000
Total retail	2,534,000	2,798,000
Total nonperforming loans	\$4,669,000	\$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 September 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
<b>Originated loans</b>							
<b>Commercial:</b>							
Commercial and industrial	\$28,000	\$0	\$0	\$28,000	\$667,023,000	\$667,051,000	\$ 0
Vacant land, land development, and residential construction	0	0	0	0	28,003,000	28,003,000	0
Real estate – owner occupied	0	0	0	0	346,323,000	346,323,000	0
Real estate – non-owner occupied	0	0	0	0	638,090,000	638,090,000	0
Real estate – multi-family and residential rental	0	0	0	0	46,239,000	46,239,000	0
Total commercial	28,000	0	0	28,000	1,725,678,000	1,725,706,000	0
<b>Retail:</b>							
Home equity and other	38,000	4,000	8,000	50,000	72,630,000	72,680,000	0
1-4 family mortgages	252,000	0	262,000	514,000	74,321,000	74,835,000	0
Total retail	290,000	4,000	270,000	564,000	146,951,000	147,515,000	0
Total past due loans	\$318,000	\$4,000	\$270,000	\$592,000	\$1,872,629,000	\$1,873,221,000	\$ 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
<b><u>Acquired loans</u></b>							
Commercial:							
Commercial and industrial	\$64,000	\$0	\$16,000	\$80,000	\$83,199,000	\$83,279,000	\$ 0
Vacant land, land development, and residential construction	0	0	0	0	9,452,000	9,452,000	0
Real estate – owner occupied	125,000	0	179,000	304,000	94,077,000	94,381,000	0
Real estate – non-owner occupied	0	507,000	222,000	729,000	102,625,000	103,354,000	0
Real estate – multi-family and residential rental	0	0	156,000	156,000	71,708,000	71,864,000	0
Total commercial	189,000	507,000	573,000	1,269,000	361,061,000	362,330,000	0
Retail:							
Home equity and other	242,000	89,000	40,000	371,000	54,575,000	54,946,000	0
1-4 family mortgages	1,081,000	130,000	477,000	1,688,000	114,192,000	115,880,000	0
Total retail	1,323,000	219,000	517,000	2,059,000	168,767,000	170,826,000	0
Total past due loans	\$1,512,000	\$726,000	\$1,090,000	\$3,328,000	\$529,828,000	\$533,156,000	\$ 0



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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
<b><u>Originated loans</u></b>							
<b>Commercial:</b>							
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
<b>Retail:</b>							
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
<b><u>Acquired Loans</u></b>							
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

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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 September 30, 2016, and average originated impaired loans for the three and nine months ended September 30, 2016, 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
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$1,472,000	\$1,472,000		\$1,809,000	\$1,752,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	503,000	404,000		327,000	307,000
Real estate – non-owner occupied	5,610,000	5,610,000		5,616,000	5,647,000
Real estate – multi-family and residential rental	0	0		0	0
Total commercial	7,585,000	7,486,000		7,752,000	7,706,000
Retail:					
Home equity and other	122,000	116,000		118,000	63,000
1-4 family mortgages	1,191,000	567,000		618,000	616,000
Total retail	1,313,000	683,000		736,000	679,000
Total with no related allowance recorded	\$8,898,000	\$8,169,000		\$8,488,000	\$8,385,000

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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	Third Quarter Average	Year-To-Date Average
	Contractual	Principal	Allowance	Recorded	Recorded
	Balance	Balance		Principal	Principal
				Balance	Balance
<u>With an allowance recorded</u>					
Commercial:					
Commercial and industrial	\$222,000	\$171,000	\$38,000	\$185,000	\$227,000
Vacant land, land development and residential construction	1,493,000	1,109,000	44,000	1,367,000	1,507,000
Real estate – owner occupied	5,907,000	1,354,000	232,000	1,366,000	1,337,000
Real estate – non-owner occupied	4,635,000	4,635,000	177,000	4,670,000	4,734,000
Real estate – multi-family and residential rental	953,000	953,000	263,000	966,000	992,000
Total commercial	13,210,000	8,222,000	754,000	8,554,000	8,797,000
Retail:					
Home equity and other	632,000	590,000	217,000	551,000	534,000
1-4 family mortgages	205,000	160,000	69,000	162,000	144,000
Total retail	837,000	750,000	286,000	713,000	678,000
Total with an allowance recorded	\$14,047,000	\$8,972,000	\$1,040,000	\$9,267,000	\$9,475,000
Total impaired loans:					
Commercial	\$20,795,000	\$15,708,000	\$754,000	\$16,306,000	\$16,503,000
Retail	2,150,000	1,433,000	286,000	1,449,000	1,357,000
Total impaired loans	\$22,945,000	\$17,141,000	\$1,040,000	\$17,755,000	\$17,860,000



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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 September 30, 2016, and average impaired acquired loans for the three and nine months ended September 30, 2016, 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
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$1,000,000	\$973,000		\$1,327,000	\$1,395,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	809,000	741,000		1,021,000	1,416,000
Real estate – non-owner occupied	1,112,000	1,111,000		961,000	894,000
Real estate – multi-family and residential rental	485,000	360,000		327,000	335,000
Total commercial	3,406,000	3,185,000		3,636,000	4,040,000
Retail:					
Home equity and other	497,000	329,000		347,000	320,000
1-4 family mortgages	1,697,000	1,309,000		1,307,000	1,359,000
Total retail	2,194,000	1,638,000		1,654,000	1,679,000
Total with no related allowance recorded	\$5,600,000	\$4,823,000		\$5,290,000	\$5,719,000

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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	Third 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	\$331,000	\$98,000	\$343,000	\$361,000
Vacant land, land development and residential construction	0	0	0	0	0
Real estate – owner occupied	49,000	49,000	4,000	49,000	49,000
Real estate – non-owner occupied	0	0	0	0	0
Real estate – multi-family and residential rental	2,000	2,000	1,000	11,000	16,000
Total commercial	403,000	382,000	103,000	403,000	426,000
Retail:					
Home equity and other	0	0	0	0	0
1-4 family mortgages	173,000	173,000	5,000	174,000	131,000
Total retail	173,000	173,000	5,000	174,000	131,000
Total with an allowance recorded	\$576,000	\$555,000	\$108,000	\$577,000	\$557,000
Total impaired loans:					
Commercial	\$3,809,000	\$3,567,000	\$103,000	\$4,039,000	\$4,466,000
Retail	2,367,000	1,811,000	5,000	1,828,000	1,810,000
Total impaired loans	\$6,176,000	\$5,378,000	\$108,000	\$5,867,000	\$6,276,000

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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 nine months ended September 30, 2015, 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
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$1,509,000	\$1,501,000		\$1,908,000	\$1,729,000
Vacant land, land development and residential construction	0	0		0	101,000
Real estate – owner occupied	712,000	505,000		113,000	1,032,000
Real estate – non-owner occupied	5,696,000	5,696,000		5,747,000	3,204,000
Real estate – multi-family and residential rental	0	0		151,000	232,000
Total commercial	7,917,000	7,702,000		7,919,000	6,298,000
Retail:					
Home equity and other	14,000	5,000		189,000	190,000
1-4 family mortgages	1,328,000	657,000		716,000	631,000
Total retail	1,342,000	662,000		905,000	821,000
Total with no related allowance recorded	\$9,259,000	\$8,364,000		\$8,824,000	\$7,119,000

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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	Third 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	\$ 436,000	\$ 2,816,000
Vacant land, land development and residential construction	2,017,000	1,655,000	245,000	2,052,000	2,026,000
Real estate – owner occupied	5,867,000	1,314,000	242,000	1,959,000	8,778,000
Real estate – non-owner occupied	4,841,000	4,841,000	201,000	4,926,000	10,371,000
Real estate – multi-family and residential rental	1,028,000	1,028,000	365,000	1,179,000	1,266,000
Total commercial	14,105,000	9,143,000	1,218,000	10,552,000	25,257,000
Retail:					
Home equity and other	600,000	562,000	209,000	160,000	143,000
1-4 family mortgages	165,000	128,000	47,000	131,000	641,000
Total retail	765,000	690,000	256,000	291,000	784,000
Total with an allowance recorded	\$ 14,870,000	\$ 9,833,000	\$ 1,474,000	\$ 10,843,000	\$ 26,041,000
Total impaired loans:					
Commercial	\$ 22,022,000	\$ 16,845,000	\$ 1,218,000	\$ 18,471,000	\$ 31,555,000
Retail	2,107,000	1,352,000	256,000	1,196,000	1,605,000
Total impaired loans	\$ 24,129,000	\$ 18,197,000	\$ 1,474,000	\$ 19,667,000	\$ 33,160,000



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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 nine months ended September 30, 2015, 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
<u>With no related allowance recorded</u>					
Commercial:					
Commercial and industrial	\$1,528,000	\$1,494,000		\$1,596,000	\$1,432,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	2,233,000	1,952,000		910,000	535,000
Real estate – non-owner occupied	880,000	880,000		656,000	487,000
Real estate – multi-family and residential rental	452,000	404,000		2,885,000	1,799,000
Total commercial	5,093,000	4,730,000		6,047,000	4,253,000
Retail:					
Home equity and other	471,000	310,000		342,000	423,000
1-4 family mortgages	1,804,000	1,548,000		816,000	855,000
Total retail	2,275,000	1,858,000		1,158,000	1,278,000
Total with no related allowance recorded	\$7,368,000	\$6,588,000		\$7,205,000	\$5,531,000

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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	Third 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	\$73,000	\$65,000
Vacant land, land development and residential construction	0	0	0	0	0
Real estate – owner occupied	51,000	51,000	4,000	568,000	1,016,000
Real estate – non-owner occupied	0	0	0	0	0
Real estate – multi-family and residential rental	23,000	23,000	0	26,000	20,000
Total commercial	457,000	450,000	106,000	667,000	1,101,000
Retail:					
Home equity and other	0	0	0	0	0
1-4 family mortgages	175,000	175,000	6,000	229,000	185,000
Total retail	175,000	175,000	6,000	229,000	185,000
Total with an allowance recorded	\$632,000	\$625,000	\$112,000	\$896,000	\$1,286,000
Total impaired loans:					
Commercial	\$5,550,000	\$5,180,000	\$106,000	\$6,714,000	\$5,354,000
Retail	2,450,000	2,033,000	6,000	1,387,000	1,463,000
Total impaired loans	\$8,000,000	\$7,213,000	\$112,000	\$8,101,000	\$6,817,000

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 \$0.3 million during the third quarter of 2016 and 2015, and \$0.8 million and \$1.0 million during the first nine months of 2016 and 2015, respectively. No interest income was recognized on nonaccrual loans during the third quarter and first nine 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 September 30, 2016:

**Originated loans**

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

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

Internal credit risk grade groupings:

Grades 1 – 4	\$476,862,000	\$ 18,294,000	\$237,640,000	\$530,972,000	\$28,478,000
Grades 5 – 7	190,018,000	9,599,000	107,614,000	107,118,000	16,807,000
Grades 8 – 9	171,000	110,000	1,069,000	0	954,000
Total commercial	\$667,051,000	\$ 28,003,000	\$346,323,000	\$638,090,000	\$46,239,000

Retail credit exposure – credit risk profiled by collateral type:

Retail	Retail
Home Equity	1-4 Family
and Other	Mortgages
Total retail	\$72,680,000
	\$74,835,000

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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 Vacant Land, Land Development, and Industrial 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	\$43,682,000	\$ 2,183,000	\$40,534,000	\$62,371,000	\$ 40,803,000
Grades 5 – 7	38,201,000	7,114,000	51,972,000	39,544,000	30,470,000
Grades 8 – 9	1,396,000	155,000	1,875,000	1,439,000	591,000
Total commercial	\$83,279,000	\$ 9,452,000	\$94,381,000	\$103,354,000	\$ 71,864,000

Retail credit exposure – credit risk profiled by collateral type:



Retail	Retail
Home Equity	1-4 Family
and Other	Mortgages

Total retail \$54,946,000 \$115,880,000

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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)

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**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 nine months ended September 30, 2016 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at June 30, 2016	\$ 14,729,000	\$ 1,913,000	\$ 234,000	\$ 16,876,000
Provision for loan losses	493,000	329,000	(252,000 )	570,000
Charge-offs	(1,000 )	(290,000 )	0	(291,000 )
Recoveries	78,000	101,000	0	179,000
Ending balance	\$ 15,299,000	\$ 2,053,000	\$ (18,000 )	\$ 17,334,000
Allowance for loan losses:				
Balance at December 31, 2015	\$ 13,672,000	\$ 1,421,000	\$ 140,000	\$ 15,233,000
Provision for loan losses	1,429,000	1,128,000	(158,000 )	2,399,000
Charge-offs	(256,000 )	(907,000 )	0	(1,163,000 )
Recoveries	454,000	411,000	0	865,000
Ending balance	\$ 15,299,000	\$ 2,053,000	\$ (18,000 )	\$ 17,334,000
Ending balance: individually evaluated for impairment	\$ 754,000	\$ 286,000	\$ 0	\$ 1,040,000
Ending balance: collectively evaluated for impairment	\$ 14,545,000	\$ 1,767,000	\$ (18,000 )	\$ 16,294,000
Total loans:				
Ending balance	\$ 1,725,706,000	\$ 147,515,000		\$ 1,873,221,000



Ending balance: individually evaluated for impairment	\$ 15,708,000	\$ 1,433,000	\$ 17,141,000
Ending balance: collectively evaluated for impairment	\$ 1,709,998,000	\$ 146,082,000	\$ 1,856,080,000

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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 nine months ended September 30, 2016 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at June 30, 2016	\$ 211,000	\$ 23,000	\$ 0	\$ 234,000
Provision for loan losses	(39,000 )	69,000	0	30,000
Charge-offs	0	(72,000 )	0	(72,000 )
Recoveries	0	0	0	0
Ending balance	\$ 172,000	\$ 20,000	\$ 0	\$ 192,000
Allowance for loan losses:				
Balance at December 31, 2015	\$ 420,000	\$ 28,000	\$ 0	\$ 448,000
Provision for loan losses	(206,000 )	107,000	0	(99,000 )
Charge-offs	0	(72,000 )	0	(72,000 )
Recoveries	(42,000 )	(43,000 )	0	(85,000 )
Ending balance	\$ 172,000	\$ 20,000	\$ 0	\$ 192,000

The negative loan recoveries reflected for acquired loans during the first nine 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 nine months ended September 30, 2015 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at June 30, 2015	\$ 13,992,000	\$ 1,714,000	\$ 34,000	\$ 15,740,000
Provision for loan losses	9,000	(13,000 )	(89,000 )	(93,000 )
Charge-offs	0	(46,000 )	0	(46,000 )
Recoveries	200,000	36,000	0	236,000
Ending balance	\$ 14,201,000	\$ 1,691,000	\$ (55,000 )	\$ 15,837,000
Allowance for loan losses:				
Balance at December 31, 2014	\$ 17,736,000	\$ 1,487,000	\$ 76,000	\$ 19,299,000
Provision for loan losses	(1,641,000 )	578,000	(131,000 )	(1,194,000 )
Charge-offs	(4,276,000 )	(563,000 )	0	(4,839,000 )
Recoveries	2,382,000	189,000	0	2,571,000
Ending balance	\$ 14,201,000	\$ 1,691,000	\$ (55,000 )	\$ 15,837,000
Ending balance: individually evaluated for impairment	\$ 1,657,000	\$ 170,000	\$ 0	\$ 1,827,000
Ending balance: collectively evaluated for impairment	\$ 12,544,000	\$ 1,521,000	\$ (55,000 )	\$ 14,010,000
Total loans:				
Ending balance	\$ 1,402,320,000	\$ 117,390,000		\$ 1,519,710,000

Ending balance: individually evaluated for impairment	\$ 17,835,000	\$ 1,212,000	\$ 19,047,000
Ending balance: collectively evaluated for impairment	\$ 1,384,485,000	\$ 116,178,000	\$ 1,500,663,000

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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 nine months ended September 30, 2015 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at June 30, 2015	\$ 561,000	\$ 260,000	\$ 0	\$ 821,000
Provision for loan losses	(389,000 )	(18,000 )	0	(407,000)
Charge-offs	(87,000 )	(49,000 )	0	(136,000)
Recoveries	0	4,000	0	4,000
Ending balance	\$ 85,000	\$ 197,000	\$ 0	\$ 282,000
Allowance for loan losses:				
Balance at December 31, 2014	\$ 681,000	\$ 61,000	\$ 0	\$ 742,000
Provision for loan losses	(479,000 )	173,000	0	(306,000)
Charge-offs	(118,000 )	(56,000 )	0	(174,000)
Recoveries	1,000	19,000	0	20,000
Ending balance	\$ 85,000	\$ 197,000	\$ 0	\$ 282,000

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 September 30, 2016 were as follows:

	Number of Contracts	Pre- Modification Recorded Principal Balance	Post- Modification Recorded Principal Balance
<b><u>Originated loans</u></b>			
Commercial:			
Commercial and industrial	0	\$ 0	\$ 0
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	0	0	0
Retail:			
Home equity and other	1	56,000	56,000
1-4 family mortgages	0	0	0
Total originated retail	1	56,000	56,000
Total originated loans	1	\$ 56,000	\$ 56,000
<b><u>Acquired loans</u></b>			
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	1	44,000	44,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total acquired commercial	1	44,000	44,000
Retail:			
Home equity and other	1	3,000	3,000
1-4 family mortgages	0	0	0
Total acquired retail	1	3,000	3,000
Total acquired loans	2	\$ 47,000	\$ 47,000

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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 nine months ended September 30, 2016 were as follows:

		Pre-	Post-
	Number	Modification	Modification
	of	Recorded	Recorded
	Contracts	Principal	Principal
		Balance	Balance
<b><u>Originated loans</u></b>			
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	3	240,000	240,000
1-4 family mortgages	1	33,000	40,000
Total originated retail	4	273,000	280,000
Total originated loans	6	\$ 460,000	\$ 467,000
<b><u>Acquired loans</u></b>			
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	1	44,000	44,000
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	3	111,000	111,000
Retail:			
Home equity and other	3	54,000	54,000
1-4 family mortgages	1	19,000	19,000
Total acquired retail	4	73,000	73,000
Total acquired loans	7	\$ 184,000	\$ 184,000

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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 September 30, 2015 were as follows:

		Pre-	Post-
	Number	Modification	Modification
	of	Recorded	Recorded
	Contracts	Principal	Principal
		Balance	Balance
<b><u>Originated loans</u></b>			
Commercial:			
Commercial and industrial	0	\$ 0	\$ 0
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	0	0	0
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total originated retail	0	0	0
Total originated loans	0	\$ 0	\$ 0
<b><u>Acquired loans</u></b>			
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	237,000	237,000
Real estate – multi-family and residential rental	0	0	0
Total acquired commercial	1	237,000	237,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total acquired retail	0	0	0
Total acquired loans	1	\$ 237,000	\$ 237,000

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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 nine months ended September 30, 2015 were as follows:

		Pre- Modification Recorded Principal Balance	Post- Modification Recorded Principal Balance
	Number of Contracts		
<b><u>Originated loans</u></b>			
Commercial:			
Commercial and industrial	9	\$ 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	9	1,876,000	1,901,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgagess	0	0	0
Total originated retail	0	0	0
Total originated loans	9	\$ 1,876,000	\$ 1,901,000
<b><u>Acquired loans</u></b>			
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	66,000	66,000
Real estate – non-owner occupied	4	655,000	655,000
Real estate – multi-family and residential rental	2	202,000	202,000
Total acquired commercial	11	1,209,000	1,209,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total acquired retail	0	0	0
Total acquired loans	11	\$ 1,209,000	\$ 1,209,000

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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 September 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 nine months ended September 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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(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 September 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 acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the nine months ended September 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

## 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 September 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	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 nine months ended September 30, 2015 (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

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(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 September 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 nine months ended September 30, 2015 (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	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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## 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 September 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	\$ 2,103,000	\$ 2,036,000	\$ 1,431,000	\$ 10,435,000	\$ 461,000
Charge-Offs	0	0	0	0	0
Payments	(230,000 )	(526,000 )	(37,000 )	(91,000 )	(7,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	0	0	0	0	0
Ending Balance	\$ 1,873,000	\$ 1,510,000	\$ 1,394,000	\$ 10,344,000	\$ 454,000

Retail	Retail
Home Equity	1-4 Family



	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$329,000	\$163,000
Charge-Offs	0	0
Payments	(1,000 )	(3,000 )
Transfers to ORE	0	0
Net Additions/Deletions	59,000	0
Ending Balance	\$387,000	\$160,000

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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 September 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	\$ 1,644,000	\$ 0	\$ 1,283,000	\$ 681,000	\$ 274,000
Charge-Offs	0	0	0	0	0
Payments	(397,000 )	0	(747,000 )	(24,000 )	(35,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	0	0	41,000	0	0
Ending Balance	\$ 1,247,000	\$ 0	\$ 577,000	\$ 657,000	\$ 239,000

Retail	Retail
Home Equity	1-4 Family
	Mortgages

	and	
	Other	
Retail Loan Portfolio:		
Beginning Balance	\$ 180,000	\$ 333,000
Charge-Offs	0	0
Payments	(7,000 )	(4,000 )
Transfers to ORE	0	0
Net Additions/Deletions	3,000	0
Ending Balance	\$ 176,000	\$ 329,000

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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 nine months ended September 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	(175,000 )	(576,000 )	(103,000 )	(313,000 )	(22,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	20,000	0	97,000	0	0
Ending Balance	\$ 1,873,000	\$ 1,510,000	\$ 1,394,000	\$ 10,344,000	\$ 454,000

Retail      Retail  
  
Home      1-4  
Equity      Family  
  
Mortgages

	and	
	Other	
Retail Loan Portfolio:		
Beginning Balance	\$ 146,000	\$ 128,000
Charge-Offs	0	0
Payments	(1,000 )	(8,000 )
Transfers to ORE	0	0
Net Additions/Deletions	242,000	40,000
Ending Balance	\$ 387,000	\$ 160,000

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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 nine months ended September 30, 2016 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	\$ 1,686,000	\$ 0	\$ 1,652,000	\$ 647,000	\$ 331,000
Charge-Offs	(48,000 )	0	0	0	0
Payments	(391,000 )	0	(1,116,000)	(46,000 )	(99,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	0	0	41,000	56,000	7,000
Ending Balance	\$ 1,247,000	\$ 0	\$ 577,000	\$ 657,000	\$ 239,000

Retail	Retail
Home	
	1-4
Equity	Family

	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$ 141,000	\$ 316,000
Charge-Offs	0	0
Payments	(20,000 )	(6,000 )
Transfers to ORE	0	0
Net Additions/Deletions	55,000	19,000
Ending Balance	\$ 176,000	\$ 329,000

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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 September 30, 2015 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	\$ 2,442,000	\$ 2,632,000	\$ 2,218,000	\$ 11,082,000	\$ 491,000
Charge-Offs	0	0	0	0	0
Payments	(56,000 )	(272,000 )	(291,000 )	(324,000 )	(7,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	(302,000 )	0	0	0	0
Ending Balance	\$ 2,084,000	\$ 2,360,000	\$ 1,927,000	\$ 10,758,000	\$ 484,000

Retail    Retail  
Home  
1-4  
Equity    Family



	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$ 0	\$ 270,000
Charge-Offs	0	0
Payments	0	(3,000 )
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	\$ 0	\$ 267,000

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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 September 30, 2015 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	\$ 1,521,000	\$ 0	\$ 1,350,000	\$ 361,000	\$ 580,000
Charge-Offs	0	0	0	0	(42,000 )
Payments	(324,000 )	0	(77,000 )	(5,000 )	(274,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	0	0	0	236,000	0
Ending Balance	\$ 1,197,000	\$ 0	\$ 1,273,000	\$ 592,000	\$ 264,000

Retail	Retail
Home	
	1-4
Equity	Family

	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$ 152,000	\$ 177,000
Charge-Offs	0	0
Payments	(5,000 )	(1,000 )
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	\$ 147,000	\$ 176,000

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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 nine months ended September 30, 2015 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	\$7,026,000	\$ 2,680,000	\$17,160,000	\$17,439,000	\$ 505,000
Charge-Offs	0	0	(4,198,000 )	0	0
Payments	(6,591,000)	(320,000 )	(11,035,000)	(6,681,000 )	(21,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	1,649,000	0	0	0	0
Ending Balance	\$2,084,000	\$ 2,360,000	\$1,927,000	\$10,758,000	\$ 484,000

Retail    Retail  
Home

Equity 1-4 Family

and Mortgages  
Other

Retail Loan Portfolio:

Beginning Balance	\$ 0	\$1,967,000
Charge-Offs	0	(148,000 )
Payments	0	(1,552,000)
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	\$ 0	\$267,000

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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 nine months ended September 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	0	0	(42,000 )
Payments	(597,000 )	0	(296,000 )	(6,000 )	(329,000 )
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	355,000	0	0	534,000	254,000
Ending Balance	\$ 1,197,000	\$ 0	\$ 1,273,000	\$ 592,000	\$ 264,000

Retail	Retail
Home	
	1-4
Equity	Family

	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	\$26,000	\$178,000
Charge-Offs	0	0
Payments	(32,000 )	(2,000 )
Transfers to ORE	0	0
Net Additions/Deletions	153,000	0
Ending Balance	\$147,000	\$176,000

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## MERCANTILE BANK CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

	September 30,	December 31,
	2016	2015
Commercial:		
Commercial and industrial	\$ 120,000	\$ 221,000
Vacant land, land development, and residential construction	30,000	186,000
Real estate – owner occupied	105,000	115,000
Real estate – non-owner occupied	177,000	201,000
Real estate – multi-family and residential rental	264,000	365,000
Total commercial	696,000	1,088,000
Retail:		
Home equity and other	50,000	14,000
1-4 family mortgages	5,000	6,000
Total retail	55,000	20,000
Total related allowance	\$ 751,000	\$ 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:

	September 30,	December 31,
	2016	2015
Land and improvements	\$ 16,634,000	\$ 16,529,000
Buildings	39,510,000	39,394,000
Furniture and equipment	17,089,000	16,978,000
	73,233,000	72,901,000
Less: accumulated depreciation	28,021,000	26,039,000
Premises and equipment, net	\$45,212,000	\$46,862,000

Depreciation expense totaled \$0.7 million during the third quarter of 2016 and 2015. Depreciation expense totaled \$2.2 million during the first nine months of 2016, compared to \$2.3 million during the first nine months of 2015.

**5. DEPOSITS**

Our total deposits at September 30, 2016 totaled \$2.33 billion, an increase of \$54.1 million, or 2.4%, from December 31, 2015. The components of our outstanding balances at September 30, 2016 and December 31, 2015, and percentage change in deposits from the end of 2015 to the end of the third quarter of 2016, are as follows:

	September 30, 2016		December 31, 2015		Percent	
	Balance	%	Balance	%	Increase (Decrease)	
Noninterest-bearing demand	\$731,663,000	31.4	% \$674,568,000	29.6	% 8.5	%
Interest-bearing checking	379,934,000	16.3	403,354,000	17.7	(5.8)	)
Money market	270,248,000	11.6	274,395,000	12.1	(1.5)	)
Savings	339,498,000	14.6	332,794,000	14.6	2.0	)
Time, under \$100,000	152,315,000	6.5	155,655,000	6.9	(2.1)	)
Time, \$100,000 and over	364,387,000	15.7	313,247,000	13.8	16.3	)
	2,238,045,000	96.1	2,154,013,000	94.7	3.9	)
Out-of-area time, under \$100,000	0	0.0	149,000	< 0.1	NA	)
Out-of-area time, \$100,000 and over	91,392,000	3.9	121,220,000	5.3	(24.6)	)
	91,392,000	3.9	121,369,000	5.3	(24.7)	)
Total deposits	\$2,329,437,000	100.0%	\$2,275,382,000	100.0%	2.4	%

Total time deposits of more than \$250,000 totaled \$227 million and \$180 million at September 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:

	Nine Months Ended  September 30,  2016	Twelve Months Ended  December 31, 2015
Outstanding balance at end of period	\$ 146,843,000	\$ 154,771,000
Average interest rate at end of period	0.16 %	0.11 %
Average daily balance during the period	\$ 151,691,000	\$ 146,826,000
Average interest rate during the period	0.13 %	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 September 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 September 30, 2016 totaled about \$545 million, with availability based on collateral approximating \$367 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 September 30, 2016 and December 31, 2015.

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

	September 30,  2016	December 31,  2015
Commercial unused lines of credit	\$537,850,000	\$522,658,000

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Unused lines of credit secured by 1 – 4 family residential properties	59,137,000	61,905,000
Credit card unused lines of credit	19,360,000	15,612,000
Other consumer unused lines of credit	6,799,000	8,583,000
Commitments to make loans	119,339,000	178,034,000
Standby letters of credit	24,871,000	34,946,000
	\$767,356,000	\$821,738,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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**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 September 30, 2016, the total notional amount of the underlying interest rate swap agreements was \$14.0 million, with a net fair value from our commercial loan customers' perspective of negative \$2.4 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 September 30, 2016 and December 31, 2015, the fair value of the interest rate swap agreement was recorded as a liability in the amount of \$0.2 million and \$0.3 million, respectively.

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 September 30, 2016 and December 31, 2015 (dollars in thousands):

	Level in	September 30, 2016		December 31, 2015	
	Fair Value	Carrying	Fair	Carrying	Fair
	Hierarchy	Values	Values	Values	Values
Financial assets:					
Cash	Level 1	\$10,815	\$10,815	\$12,496	\$12,496
Cash equivalents	Level 2	130,915	130,915	77,395	77,395
Securities available for sale	(1)	325,443	325,443	346,992	346,992
FHLBI stock	(2)	8,026	8,026	7,567	7,567
Loans, net	Level 3	2,385,513	2,382,258	2,260,730	2,259,710
Loans held for sale	Level 2	3,338	3,338	1,316	1,316
Bank owned life insurance	Level 2	66,876	66,876	58,971	58,971
Accrued interest receivable	Level 2	8,064	8,064	7,836	7,836
Financial liabilities:					
Deposits	Level 2	2,329,437	2,267,226	2,275,382	2,208,724
Repurchase agreements	Level 2	146,843	146,843	154,771	154,771
FHLBI advances	Level 2	178,000	180,481	68,000	68,858
Subordinated debentures	Level 2	44,665	44,782	55,154	55,760
Accrued interest payable	Level 2	1,570	1,570	1,479	1,479
Interest rate swap	(1)	165	165	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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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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 September 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 September 30, 2016 and December 31, 2015, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$3.3 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 September 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	\$ 137,883,000	\$ 0	\$ 137,883,000	\$ 0
Mortgage-backed securities	52,569,000	0	52,569,000	0
Municipal general obligation bonds	124,486,000	0	118,017,000	6,469,000
Municipal revenue bonds	8,518,000	0	8,518,000	0
Other investments	1,987,000	0	1,987,000	0
Interest rate swap	(165,000 )	0	(165,000 )	0
Total	\$325,278,000	\$ 0	\$318,809,000	\$ 6,469,000



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

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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 September 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 <sup>(1)</sup>	\$8,324,000	\$ 0	\$ 0	\$ 8,324,000
Foreclosed assets <sup>(1)</sup>	790,000	0	0	790,000
Total	\$9,114,000	\$ 0	\$ 0	\$ 9,114,000

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 2)	(Level 3)
		Assets		
		(Level		
		1)		
Impaired loans <sup>(1)</sup>	\$ 8,970,000	\$ 0	\$ 0	\$ 8,970,000
Foreclosed assets <sup>(1)</sup>	1,293,000	0	0	1,293,000
Total	\$ 10,263,000	\$ 0	\$ 0	\$ 10,263,000

<sup>(1)</sup> 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 September 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 September 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:

				Minimum Required	
				to be Well Capitalized Under	
Actual		Minimum Required for Capital Adequacy Purposes		Prompt Corrective Action Regulations	
Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>September 30, 2016</u>					

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Total capital (to risk weighted assets)							
Consolidated	\$354,580	13.1 %	\$217,441	8.0 %	\$NA	NA	
Bank	355,706	13.1	217,213	8.0	271,516	10.0 %	
Tier 1 capital (to risk weighted assets)							
Consolidated	337,054	12.4	163,081	6.0	NA	NA	
Bank	338,180	12.5	162,910	6.0	217,213	8.0	
Common equity tier 1 (to risk weighted assets)							
Consolidated	294,463	10.8	122,311	4.5	NA	NA	
Bank	338,180	12.5	122,182	4.5	176,485	6.5	
Tier 1 capital (to average assets)							
Consolidated	337,054	11.3	119,485	4.0	NA	NA	
Bank	338,180	11.3	119,440	4.0	149,300	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 September 30, 2016 and December 31, 2015 include \$42.6 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 September 30, 2016 and December 31, 2015, all \$42.6 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)

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**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 was paid on September 21, 2016 to shareholders of record as of September 9, 2016. On October 13, 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 December 21, 2016 to shareholders of record as of December 9, 2016. Also on October 13, 2016, our Board of Directors declared a special cash dividend on our common stock in the amount of \$0.50 per share that will be paid on December 21, 2016 to shareholders of record as of December 9, 2016. On a pro forma basis as of September 30, 2016, the payment of the \$0.50 special cash dividend, that will be funded via a cash dividend from our bank, has a 25 to 30 basis point negative impact on our and our bank’s regulatory capital ratios reflected above.



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 nine 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

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**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 September 30, 2016 and December 31, 2015 and the results of operations for the three months and nine months ended September 30, 2016 and September 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

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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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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

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**Financial Overview**

We reported net income of \$7.8 million for the third quarter of 2016, and net income of \$23.8 million for the first nine months of 2016. On a diluted earnings per share basis, we earned \$0.48 per share during the third quarter and \$1.46 per share during the first nine months of 2016. Our earnings performance during 2016 reflects a 7% increase in diluted earnings per share during the third quarter when compared to the third quarter of 2015, and a 19% increase in diluted earnings per share during the first nine months of the year when compared to the same time period in 2015. Our net interest income during the first nine months of 2016 was positively impacted by calls on U.S. Government Agency bonds that had been purchased at a discounted price. Accelerated discount accretion totaled \$2.2 million (\$0.09 per diluted share) during the first nine 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 0.19% of total loans as of September 30, 2016. Gross loan charge-offs equaled \$0.4 million during the third quarter of 2016, and totaled \$1.2 million for the first nine months of the year, while recoveries of prior period loan charge-offs equaled \$0.2 million and \$0.8 million during the respective time periods. Net loan charge-offs, as a percent of average total loans, equaled an annualized 0.03% during the third quarter and first nine months of 2016. 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 \$131 million during the third quarter of 2016, bringing the year-to-date total to about \$429 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 \$26.4 million and \$129 million during the third quarter and first nine 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 September 30, 2016, we had \$113 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 real estate non-owner occupied loans and commercial and industrial loans both equaling 31%, commercial real estate owner occupied loans comprising 18% and residential mortgage and consumer loans aggregating 13% of total loans at September 30, 2016. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans equaled 57% at September 30, 2016.

We recorded a provision expense of \$0.6 million during the third quarter of 2016, bringing total provision expense for the first nine months of 2016 to \$2.3 million. During 2015, we recorded a negative provision expense of \$0.5 million



during the third quarter and \$1.5 million during the first nine 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 September 30, 2016, noninterest-bearing checking accounts comprised 28% of total funds, interest-bearing checking and sweep accounts combined for 20%, savings deposits and money market accounts aggregated to 23% and local time deposits accounted for 19%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank of Indianapolis (“FHLBI”) advances, represented 10% of total funds.

### **Financial Condition**

Our total assets increased \$160 million during the first nine months of 2016, and totaled \$3.06 billion as of September 30, 2016. Total loans increased \$129 million, while securities available for sale declined \$21.5 million and cash and cash equivalents increased \$51.8 million. Total deposits increased \$54.1 million, while FHLBI advances were up \$110 million and securities sold under agreements to repurchase (“sweep accounts”) were down \$7.9 million during the first nine 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.

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MERCANTILE BANK CORPORATION

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Commercial loans increased \$141 million during the first nine months of 2016, and at September 30, 2016 totaled \$2.09 billion, or 86.8% 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 nine months of 2016 primarily reflects new commercial term loans to existing and new borrowers. Commercial and industrial loans were up \$54.0 million, non-owner occupied commercial real estate (“CRE”) loans increased \$97.1 million, owner occupied CRE loans decreased \$5.2 million, multi-family and residential rental loans were up \$3.1 million and vacant land, land development and residential construction loans declined \$7.7 million. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans equaled 57.0% as of September 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 \$1.6 billion in new commercial term loan fundings since the beginning of 2012, including about \$429 million during the first nine months of 2016. As of September 30, 2016, availability on existing construction and development loans totaled \$113 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 \$119 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 increased \$0.3 million during the first nine months of 2016, and at September 30, 2016 totaled \$191 million, or 7.9% of total loans. Home equity and other consumer loans declined \$13.0 million during the first nine months of 2016, and at September 30, 2016, totaled \$128 million, or 5.3% of total loans. One-to-four family mortgage loans and home equity and other consumer loans equated to 8.3% and 6.2% of total

loans as of December 31, 2015, respectively.

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

	9/30/16	6/30/16	3/31/16	12/31/15	9/30/15
Commercial:					
Commercial & Industrial	\$750,330,000	\$750,136,000	\$714,612,000	\$696,303,000	\$643,118,000
Land Development & Construction	37,455,000	40,529,000	39,630,000	45,120,000	47,734,000
Owner Occupied Commercial RE	440,704,000	438,798,000	441,662,000	445,919,000	427,016,000
Non-Owner Occupied Commercial RE	741,444,000	716,930,000	666,013,000	644,351,000	636,227,000
Multi-Family & Residential Rental	118,103,000	113,362,000	112,533,000	115,003,000	123,525,000
Total Commercial	2,088,036,000	2,059,755,000	1,974,450,000	1,946,696,000	1,877,620,000
Retail:					
1-4 Family Mortgages	190,715,000	189,118,000	185,535,000	190,385,000	193,003,000
Home Equity & Other Consumer Loans	127,626,000	131,067,000	135,683,000	140,646,000	146,765,000
	318,341,000	320,185,000	321,218,000	331,031,000	339,768,000
Total	\$2,406,377,000	\$2,379,940,000	\$2,295,668,000	\$2,277,727,000	\$2,317,388,000

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 \$5.5 million (0.2% of total assets) as of September 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

	9/30/16	6/30/16	3/31/16	12/31/15	9/30/15
Residential Real Estate:					
Land Development	\$23,000	\$42,000	\$30,000	\$23,000	\$25,000
Construction	0	319,000	0	0	0
Owner Occupied / Rental	2,661,000	2,638,000	2,484,000	2,917,000	2,588,000
	2,684,000	2,999,000	2,514,000	2,940,000	2,613,000
Commercial Real Estate:					
Land Development	110,000	125,000	140,000	155,000	170,000
Construction	0	0	0	0	0
Owner Occupied	1,109,000	1,786,000	1,970,000	2,131,000	2,602,000
Non-Owner Occupied	673,000	51,000	51,000	108,000	2,539,000
	1,892,000	1,962,000	2,161,000	2,394,000	5,311,000
Non-Real Estate:					
Commercial Assets	65,000	165,000	137,000	69,000	271,000
Consumer Assets	28,000	42,000	30,000	41,000	19,000
	93,000	207,000	167,000	110,000	290,000
Total	\$4,669,000	\$5,168,000	\$4,842,000	\$5,444,000	\$8,214,000

## OTHER REAL ESTATE OWNED &amp; REPOSSESSED ASSETS

	9/30/16	6/30/16	3/31/16	12/31/15	9/30/15
Residential Real Estate:					
Land Development	\$0	\$0	\$0	\$0	\$353,000
Construction	0	0	0	0	0
Owner Occupied / Rental	284,000	255,000	471,000	598,000	1,126,000
	284,000	255,000	471,000	598,000	1,479,000
Commercial Real Estate:					
Land Development	0	0	0	0	0

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Construction	0	0	0	0	0
Owner Occupied	488,000	477,000	907,000	612,000	139,000
Non-Owner Occupied	18,000	83,000	100,000	83,000	654,000
	506,000	560,000	1,007,000	695,000	793,000
Non-Real Estate:					
Commercial Assets	0	0	0	0	0
Consumer Assets	0	0	0	0	0
	0	0	0	0	0
Total	\$790,000	\$815,000	\$1,478,000	\$1,293,000	\$2,272,000

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## MERCANTILE BANK CORPORATION

The following tables provide a reconciliation of nonperforming assets:

## NONPERFORMING LOANS RECONCILIATION

	3rd Qtr 2016	2nd Qtr 2016	1st Qtr 2016	4th Qtr 2015	3rd Qtr 2015
Beginning balance	\$5,168,000	\$4,842,000	\$5,444,000	\$8,214,000	\$8,103,000
Additions, net of transfers to ORE	1,111,000	1,082,000	528,000	902,000	743,000
Returns to performing status	0	0	0	(43,000 )	0
Principal payments	(1,509,000)	(495,000 )	(774,000 )	(3,457,000)	(567,000 )
Loan charge-offs	(101,000 )	(261,000 )	(356,000 )	(172,000 )	(65,000 )
Total	\$4,669,000	\$5,168,000	\$4,842,000	\$5,444,000	\$8,214,000

## OTHER REAL ESTATE OWNED &amp; REPOSSESSED ASSETS RECONCILIATION

	3rd Qtr 2016	2nd Qtr 2016	1st Qtr 2016	4th Qtr 2015	3rd Qtr 2015
Beginning balance	\$815,000	\$1,478,000	\$1,293,000	\$2,272,000	\$2,033,000
Additions	61,000	14,000	595,000	676,000	581,000
Sale proceeds	(76,000 )	(642,000 )	(402,000 )	(1,300,000)	(319,000 )
Valuation write-downs	(10,000 )	(35,000 )	(8,000 )	(355,000 )	(23,000 )
Total	\$790,000	\$815,000	\$1,478,000	\$1,293,000	\$2,272,000

Gross loan charge-offs equaled \$0.4 million during the third quarter of 2016, and totaled \$1.2 million for the first nine months of the year, while recoveries of prior period loan charge-offs equaled \$0.2 million and \$0.8 million during the respective time periods. Net loan charge-offs, as a percent of average total loans, equaled an annualized 0.03% during the third quarter and first nine months of 2016. 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 loans. Our migration analysis takes into account various time periods, with most weight placed on the time frame from December 31, 2010 through September 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 \$17.3 million as of September 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 September 30, 2016 and December 31, 2015, equaling \$0.2 million and \$0.5 million, respectively. The allowance equaled 375% of nonperforming loans as of September 30, 2016, compared to 288% as of December 31, 2015. The increase in this ratio during the first nine 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 September 30, 2016, the allowance for originated loans was comprised of \$16.3 million in general reserves relating to non-impaired loans, \$0.4 million in specific reserve allocations relating to nonaccrual loans, and \$0.6 million in specific reserves on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$19.3 million at September 30, 2016, consisting of \$1.6 million that are on nonaccrual status and \$17.7 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 \$0.9 million as of September 30, 2016 had been subject to previous partial charge-offs aggregating \$4.8 million. Those partial charge-offs were recorded as follows: less than \$0.1 million in 2016, 2013 and 2012, \$4.2 million in 2015, \$0.4 million in 2011 and \$0.2 million in 2010. As of September 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:

	9/30/16	6/30/16	3/31/16	12/31/15	9/30/15
Performing	\$17,717,000	\$19,403,000	\$19,087,000	\$19,336,000	\$18,743,000
Nonperforming	1,630,000	1,950,000	2,112,000	2,358,000	2,786,000
Total	\$19,347,000	\$21,353,000	\$21,199,000	\$21,694,000	\$21,529,000

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 \$21.5 million during the first nine months of 2016, totaling \$325 million as of September 30, 2016. Purchases during the first nine months of 2016, consisting almost exclusively of U.S. Government Agency bonds and municipal bonds, totaled \$130 million. Proceeds from matured and called U.S. Government agency bonds and municipal bonds during the first nine months of 2016 totaled \$123 million and \$15.5 million, respectively, with another \$14.4 million from principal paydowns on mortgage-backed securities. In addition, proceeds from the sale of a municipal bond totaled \$0.3 million. At September 30, 2016, the portfolio was primarily comprised of U.S. Government agency bonds (42%), municipal bonds (41%) and U.S. Government agency issued or guaranteed mortgage-backed securities (16%). 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 September 30, 2016

totaled \$325 million, including a net unrealized gain of \$2.9 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 September 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.

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.

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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 nine months of 2016, the average balance of these funds equaled \$61.1 million, or 2.2% 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 \$45.2 million at September 30, 2016, a decrease of \$1.7 million during the first nine months of 2016. Purchases during the first nine months of 2016 totaled \$0.9 million, while depreciation expense aggregated to \$2.2 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 September 30, 2016, compared to \$1.3 million as of December 31, 2015. Sale proceeds during the first nine months of 2016 totaled \$1.2 million, while transfers in from the loan portfolio and bank premises totaled \$0.7 million. Valuation write-downs totaled less than \$0.1 million. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on some impaired lending relationships, we believe the overall strong quality of our loan portfolio will limit any overall increase in, and average balance of, this particular nonperforming asset category in future periods.

Total deposits increased \$54.1 million during the first nine months of 2016, totaling \$2.33 billion at September 30, 2016. Out-of-area deposits decreased \$30.0 million during the first nine months of 2016, and as a percent of total deposits, equaled 3.9% as of September 30, 2016, compared to 5.3% as of December 31, 2015.

Noninterest-bearing checking accounts increased \$57.1 million during the first nine months of 2016, generally due to deposit account openings as part of recently established commercial lending relationships and transfers from business-related interest-bearing checking accounts to new noninterest-bearing checking accounts. Interest-bearing checking accounts decreased \$23.4 million, a large portion of which reflects transfers noted above. Money market deposit accounts decreased \$4.1 million and savings deposits grew \$6.7 million during the first nine months of 2016. Local time deposits increased \$47.8 million, in large part reflecting a 13-month special offered during the third quarter.

Sweep accounts decreased \$7.9 million during the first nine months of 2016, totaling \$147 million as of September 30, 2016. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts and savings deposits into over-night interest-bearing repurchase agreements. Such sweep accounts are not deposit accounts and are not afforded federal deposit insurance, and are accounted for as secured borrowings.

FHLBI advances increased \$110 million during the first nine months of 2016, reflecting new advances obtained primarily during the second quarter. The additional funds were primarily used to replace maturing brokered deposits and help fund net loan growth. As of September 30, 2016, FHLBI advances totaled \$178 million. The FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit as of September 30, 2016 totaled about \$545 million, with availability approximating \$367 million.

### **Liquidity**

Liquidity is measured by our ability to raise funds through deposits, borrowed funds, and capital, or cash flow from the repayment of loans and securities. These funds are used to fund loans, meet deposit withdrawals, maintain reserve requirements and operate our company. Liquidity is primarily achieved through local and out-of-area deposits and liquid assets such as securities available for sale, matured and called securities, federal funds sold and interest-bearing balances. Asset and liability management is the process of managing our balance sheet to achieve a mix of earning assets and liabilities that maximizes profitability, while providing adequate liquidity.

To assist in providing needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of deposits from customers outside of our market areas and advances from the FHLBI, totaled \$269 million, or 10.1% of combined deposits and borrowed funds, as of September 30, 2016, compared to \$189 million, or 7.6% of combined deposits and borrowed funds, as of December 31, 2015. The increase in wholesale funds primarily reflects new FHLBI advances obtained during the second quarter to assist in funding strong net loan growth.

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Sweep accounts decreased \$7.9 million during the first nine months of 2016, totaling \$147 million as of September 30, 2016. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts and savings deposits into over-night interest-bearing repurchase agreements. Such sweep accounts are not deposit accounts and are not afforded federal deposit insurance, and are accounted for as secured borrowings. Information regarding our repurchase agreements as of September 30, 2016 and during the first nine months of 2016 is as follows:

Outstanding balance at September 30, 2016	\$146,843,000	
Weighted average interest rate at September 30, 2016	0.16	%
Maximum daily balance nine months ended September 30, 2016	\$175,088,000	
Average daily balance for nine months ended September 30, 2016	\$151,691,000	
Weighted average interest rate for nine months ended September 30, 2016	0.13	%

As a member of FHLBI, we have access to FHLBI advance borrowing programs. FHLBI advances increased \$110 million during the first nine months of 2016, reflecting new advances obtained primarily during the second quarter. The additional funds were primarily used to replace maturing brokered deposits and help fund net loan growth. As of September 30, 2016, FHLBI advances totaled \$178 million. Our borrowing line of credit as of September 30, 2016 totaled about \$545 million, with availability approximating \$367 million.

We also have the ability to borrow up to \$30.0 million on a daily basis through a correspondent bank using an established unsecured federal funds purchased line of credit. We did not access this line of credit during the first nine months of 2016; in fact, we have not accessed any federal funds purchased lines of credit since January of 2010. In contrast, our interest-bearing deposit balance with the Federal Reserve Bank of Chicago averaged \$58.8 million during the first nine months of 2016. We also have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using certain municipal bonds as collateral, we could have borrowed up to \$25.2 million as of September 30, 2016. We did not utilize this line of credit during the first nine months of 2016 or at any time during the previous seven fiscal years, and do not plan to access this line of credit in future periods.

The following table reflects, as of September, 2016, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

One Year	One to	Three to	Over
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	or Less	Three Years	Five Years	Five Years	Total
Deposits without a stated maturity	\$1,721,343,000	\$0	\$0	\$0	\$1,721,343,000
Certificates of deposit	391,074,000	148,789,000	68,231,000	0	608,094,000
Short-term borrowings	146,843,000	0	0	0	146,843,000
Federal Home Loan Bank advances	48,000,000	30,000,000	50,000,000	50,000,000	178,000,000
Subordinated debentures	0	0	0	44,665,000	44,665,000
Other borrowed money	0	0	0	3,408,000	3,408,000
Property leases	413,000	630,000	200,000	0	1,243,000

In addition to normal loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. As of September 30, 2016, we had a total of \$742 million in unfunded loan commitments and \$24.9 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$623 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$119 million were for loan commitments generally expected to close and become funded within the next 12 to 18 months. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

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We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, changes in economic or market conditions, a reduction in earnings performance, declining capital levels or situations beyond our control could cause liquidity challenges. While we believe it is unlikely that a funding crisis of any significant degree is likely to materialize, we have developed a comprehensive contingency funding plan that provides a framework for meeting liquidity disruptions.

**Capital Resources**

Shareholders' equity was \$349 million at September 30, 2016, compared to \$334 million at December 31, 2015. The \$15.7 million increase during the first nine months of 2016 primarily reflects the positive impact of net income totaling \$23.8 million and the negative impacts of cash dividends on common shares totaling \$7.9 million and our share repurchase program aggregating \$3.7 million. Also positively impacting shareholders' equity during the first nine months of 2016 was an increase in the net unrealized gain on securities available for sale of \$0.5 million.

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 nine months of 2016, we purchased approximately 168,000 shares of common stock at an average price of \$22.23, totaling \$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 \$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.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. The Federal Reserve Board and the Federal Deposit Insurance Corporation approved final rules, commonly referred to as "BASEL III," implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks. Under the final rules, which became effective January 1, 2015, minimum requirements have increased for both the quantity and quality of capital held by us and our bank. The final rules included a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, required a minimum ratio of Total Capital to risk-weighted assets of 8.0% and required a minimum Tier 1 leverage ratio of 4.0%. A new capital conservation buffer, comprised of common equity Tier 1 capital, was also established above the regulatory minimum capital requirements. This capital conservation buffer is being phased-in beginning January 1, 2016 at 0.625% of risk-weighted assets and will increase each subsequent year by an additional 0.625% until reaching its final level of 2.5% on January 1, 2019. Strict

eligibility criteria for regulatory capital instruments were also implemented under the final rules. The final rules also revised the definition and calculation of Tier 1 capital, Total Capital and risk-weighted assets.

As of September 30, 2016, our bank's total risk-based capital ratio was 13.1%, with our bank's total regulatory capital equaling \$356 million, or approximately \$84 million in excess of the 10.0% minimum which is among the requirements to be categorized as "well capitalized." On October 13, 2016, our Board of Directors approved a \$0.50 per share special cash dividend on our common stock that will be paid on December 21, 2016 to shareholders of record as of December 9, 2016. On a pro forma basis as of September 30, 2016, the special cash dividend, which will be funded via a cash dividend from our bank to us, has a 25 to 30 basis point impact on our regulatory capital ratios. Our and our bank's capital ratios as of September 30, 2016 and December 31, 2015 are disclosed in Note 12 of the Notes to Condensed Consolidated Financial Statements.

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**Results of Operations**

We recorded net income of \$7.8 million (\$0.48 per basic and diluted share) for the third quarter of 2016, compared to net income of \$7.3 million (\$0.45 per basic and diluted share) recorded during the third quarter of 2015. We recorded net income of \$23.8 million (\$1.46 per basic and diluted share) for the first nine months of 2016, compared to net income of \$20.5 million (\$1.23 per basic and diluted share) recorded during the first nine months of 2015. The repurchase of \$11.0 million in trust preferred securities at a 27% discount during the first quarter of 2016 increased net income during the first nine months of 2016 by approximately \$1.8 million, or \$0.11 per basic and diluted share.

The improved earnings performance in the third quarter and first nine months of 2016 compared to the respective 2015 periods primarily resulted from increased noninterest income and net interest income, which more than offset increased provision expense. The increased noninterest income during the third quarter of 2016 mainly resulted from the reimbursement of certain medical insurance premiums assessed in prior years and increased service charges on accounts and mortgage banking activity income. The increased noninterest income during the first nine months of 2016 primarily reflected the recording of a pre-tax gain associated with the trust preferred securities repurchase transaction in January of 2016 and higher service charges on accounts. The increased net interest income in the third quarter of 2016 resulted from an increase in earning assets, which more than offset a decreased net interest margin, while the increased net interest income during the first nine months of 2016 primarily resulted from an increase in earning assets and an improved net interest margin. The higher provision expense in the current-year periods mainly resulted from ongoing loan growth and increased allocations related to environmental factors.

Interest income during the third quarter of 2016 was \$29.7 million, an increase of \$1.2 million, or 4.2%, from the \$28.5 million earned during the third quarter of 2015. The increase resulted from growth in average earning assets, which more than offset a lower yield on average earning assets. The yield on average earning assets was 4.22% during the third quarter of 2016, compared to 4.30% during the third quarter of 2015. The decreased yield primarily resulted from a lower yield on loans, which more than offset a higher yield on securities and a reallocation of earning assets. The yield on loans, which equaled 4.57% and 4.79%, respectively, during the third quarter of 2016 and the prior-year third quarter, generally declined over the past nine quarters, consistent with the industry and primarily due to the ongoing low interest rate environment and competitive pressures; however, the negative impact of the lower loan yield on the yield on average earning assets was somewhat offset by the aforementioned reallocation of earning assets. Capitalizing on an opportunity stemming from the 2014 merger with Firstbank, the earning asset mix was reallocated by reinvesting cash flows from monthly paydowns on lower-yielding mortgage-backed securities and matured and called U.S. Government Agency bonds into the higher-yielding loan portfolio. Average loans represented approximately 85% of average earning assets during the third quarter of 2016, up from about 83% during the prior-year third quarter. The reallocation strategy was completed during the second quarter of 2016 as securities

reached the desired level. Accretion of acquired loans amounted to \$1.0 million during the third quarter of 2016, compared to \$1.4 million during the third quarter of 2015. The yield on securities was 2.71% during the third quarter of 2016, up from 2.16% during the third quarter of 2015 primarily due to an increased level of discount accretion related to called U.S. Government Agency bonds. Accelerated unaccreted discount totaling \$0.4 million was recorded as interest income during the third quarter of 2016; no accelerated accretion was recorded during the third quarter of 2015. Average earning assets equaled \$2.81 billion during the third quarter of 2016, up \$169 million, or 6.4%, from the level of \$2.64 billion during the third quarter of 2015.

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Interest income during the first nine months of 2016 was \$88.7 million, an increase of \$5.0 million, or 6.0%, from the \$83.7 million earned during the first nine months of 2015. The increase primarily resulted from growth in, and an increased yield on, average earning assets. Average earning assets equaled \$2.74 billion during the first nine months of 2016, up \$94.8 million, or 3.6%, from the level of \$2.64 billion during the first nine months of 2015. The yield on average earning assets was 4.34% during the first nine months of 2016, compared to 4.26% during the first nine months of 2015. The higher yield primarily resulted from an increased yield on securities and a change in earning asset mix, which more than offset a decreased yield on loans. The yield on securities was 3.07% during the first nine months of 2016, up from 2.16% during the first nine months of 2015 primarily due to an increased level of discount accretion related to called U.S. Government Agency bonds. Accelerated unaccreted discount totaling \$2.2 million was recorded as interest income during the first nine months of 2016, compared to only a nominal amount during the respective 2015 period. Higher-yielding average loans represented about 85% of average earning assets during the first nine months of 2016, compared to about 82% during the first nine months of 2015; the shift in earning assets reflected the previously discussed reallocation of earning assets strategy that ended during the second quarter of 2016. The yield on loans equaled 4.63% during the first nine months of 2016, compared to 4.80% during the respective 2015 period; the decreased yield primarily reflects the ongoing low interest rate environment and competitive pressures. Accretion of acquired loans totaled \$3.3 million during the first nine months of 2016, compared to \$4.3 million during the first nine months of 2015.

Interest expense during the third quarter of 2016 was \$3.3 million, an increase of \$0.4 million, or 13.2%, from the \$2.9 million expensed during the third quarter of 2015. The increase during the 2016 period is primarily attributable to a higher weighted average cost of, and an increase in average balance of, interest-bearing liabilities. The increase in the weighted average cost of interest-bearing liabilities from 0.60% in the third quarter of 2015 to 0.66% in the current-year third quarter primarily reflects a change in interest-bearing liability mix and a higher cost of certificates of deposit, which more than offset decreases in the costs of certain interest-bearing non-certificate of deposit account categories. Higher-costing average FHLBI advances represented 9.1% of average interest-bearing liabilities during the third quarter of 2016, compared to 2.9% during the prior-year third quarter. Longer-term FHLBI advances totaling \$110 million were obtained during the first half of 2016 to meet loan funding and other liquidity needs. The higher cost of certificates of deposit was expected in light of purchase accounting amortization entries, which were associated with fair value measurements recorded on the merger date, ending in July of 2015. A \$0.2 million reduction in interest expense on certificates of deposit related to purchase accounting entries was recorded during the third quarter of 2015; no reduction in interest expense was recorded during the third quarter of 2016. The increased rates paid on certificates of deposit also contributed to the higher cost. The cost of interest-bearing non-certificate of deposit accounts decreased from 0.15% during the third quarter of 2015 to 0.10% during the third quarter of 2016 in light of rates being lowered during the latter part of 2015. Average interest-bearing liabilities were \$1.95 billion during the third quarter of 2016, up \$29.7 million, or 1.5%, from the \$1.92 billion average during the third quarter of 2015.

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Interest expense during the first nine months of 2016 was \$9.3 million, an increase of \$1.1 million, or 13.0%, from the \$8.2 million expensed during the first nine months of 2015. The increase during the 2016 period is primarily attributable to a higher weighted average cost of interest-bearing liabilities, which more than offset the positive impact of a decrease in the volume of average interest-bearing liabilities. The weighted average cost of interest-bearing liabilities was 0.65% during the first nine months of 2016, up from 0.57% during the first nine months of 2015 mainly due to an increased cost of certificates of deposit, which more than offset decreases in the costs of certain interest-bearing non-certificate of deposit account categories. As noted previously, the higher cost of certificates of deposit was expected in light of purchase accounting amortization entries ending in July of 2015. A \$1.4 million reduction in interest expense on certificates of deposit related to purchase accounting entries was recorded during the first nine months of 2015; no reduction in interest expense was recorded during the respective 2016 period. The higher cost was also attributable to increased rates paid on certificates of deposit and FHLBI advances. The cost of interest-bearing non-certificate of deposit accounts decreased from 0.17% during the first nine months of 2015 to 0.10% during the first nine months of 2016 in light of rates being lowered during the latter part of 2015. Average interest-bearing liabilities were \$1.91 billion during the first nine months of 2016, down \$31.1 million, or 1.6%, from the \$1.94 billion average during the first nine months of 2015.

Net interest income during the third quarter of 2016 was \$26.4 million, an increase of \$0.8 million, or 3.2%, from the \$25.6 million earned during the second quarter of 2015. The increase was due to growth in earning assets, which more than offset a lower net interest margin. The net interest margin decreased from 3.87% in the third quarter of 2015 to 3.76% in the current-year third quarter due to a decreased yield on average earning assets and an increased cost of funds. The decreased yield on average earning assets from 4.30% during the third quarter of 2015 to 4.22% during the third quarter of 2016 mainly resulted from a lower yield on loans, which more than offset a higher yield on securities and a reallocation of earning assets. The cost of funds was 0.46% in the third quarter of 2016, compared to 0.43% in the prior-year third quarter; the higher cost of funds primarily resulted from the previously discussed change in average interest-bearing liability mix and increased cost of certificates of deposit.

Net interest income during the first nine months of 2016 was \$79.4 million, an increase of \$3.9 million, or 5.2%, from the \$75.5 million earned during the first nine months of 2015. The increase was primarily due to a higher net interest margin and growth in average earning assets. The net interest margin improved from 3.84% during the first nine months of 2015 to 3.89% during the respective 2016 period due to an increased yield on average earning assets. The increase in the yield on average earning assets from 4.26% during the first nine months of 2015 to 4.34% during the first nine months of 2016 primarily resulted from an increased yield on securities and a change in earning asset mix, which more than offset a decreased yield on loans. The cost of funds was 0.45% during the first nine months of 2016, compared to 0.42% during the first nine months of 2015; the higher cost of funds primarily resulted from the previously discussed increased cost of certificates of deposit.



The net interest margin remained relatively stable over the past nine quarters, ranging from 3.76% to 4.01%. The yield on loans generally declined over the same time period, consistent with the industry and primarily due to the ongoing low interest rate environment and competitive pressures. The negative impact of the lower loan yield has been largely offset by assets shifting out of the lower-yielding securities portfolio and into the higher-yielding loan portfolio. As noted previously, the reallocation of earning assets strategy was completed in the second quarter of 2016.

The following table sets forth certain information relating to our consolidated average interest-earning assets and interest-bearing liabilities and reflects the average yield on assets and average cost of liabilities for the third quarter of 2016 and 2015. Such yields and costs are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the period presented. Tax-exempt securities interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 35%. Securities interest income was increased by \$198,000 and \$145,000 in the third quarter of 2016 and 2015, respectively, for this non-GAAP, but industry standard, adjustment. This adjustment equated to a three basis point increase in our net interest margin during the third quarter of 2016, and a two basis point increase in our net interest margin during the third quarter of 2015.

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	Quarters ended September 30,					
	2 0 1 6			2 0 1 5		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
	(dollars in thousands)					
<b>ASSETS</b>						
Loans	\$2,391,620	\$27,553	4.57 %	\$2,201,124	\$26,565	4.79 %
Investment securities	328,993	2,231	2.71	378,286	2,039	2.16
Other interest-earning assets	91,590	120	0.51	64,027	42	0.25
Total interest - earning assets	2,812,203	29,904	4.22	2,643,437	28,646	4.30
Allowance for loan losses	(17,375 )			(16,655 )		
Other assets	245,496			249,889		
Total assets	\$3,040,324			\$2,876,671		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>						
Interest-bearing deposits	\$1,572,424	\$1,924	0.49 %	\$1,653,441	\$1,969	0.47 %
Short-term borrowings	147,960	62	0.17	148,362	39	0.11
Federal Home Loan Bank advances	178,000	670	1.47	56,261	203	1.41
Other borrowings	48,013	600	4.89	58,641		