

MERCANTILE BANK CORP

Form 10-Q

November 06, 2017

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2017

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

(State or other jurisdiction of incorporation or organization)

38-3360865

(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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Yes No

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 6, 2017, there were 16,491,790 shares of common stock outstanding.

Table of Contents

MERCANTILE BANK CORPORATION

INDEX

| PART | | <u>Page</u> |
|------|---|-------------|
| I. | <u>Financial Information</u> | <u>No.</u> |
| | <u>Item 1. Financial Statements</u> | |
| | <u>Condensed Consolidated Balance Sheets (Unaudited) – September 30, 2017 and December 31, 2016</u> | 1 |
| | <u>Condensed Consolidated Statements of Income (Unaudited) - Three and Nine Months Ended September 30, 2017 and September 30, 2016</u> | 2 |
| | <u>Condensed Consolidated Statements of Comprehensive Income (Unaudited) - Three and Nine Months Ended September 30, 2017 and September 30, 2016</u> | 3 |
| | <u>Condensed Consolidated Statements of Changes in Shareholders' Equity (Unaudited) – Nine Months Ended September 30, 2017 and September 30, 2016</u> | 4 |
| | <u>Condensed Consolidated Statements of Cash Flows (Unaudited) – Nine Months Ended September 30, 2017 and September 30, 2016</u> | 6 |
| | <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u> | 8 |
| | <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 71 |
| | <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 89 |
| | <u>Item 4. Controls and Procedures</u> | 91 |
| PART | <u>Other Information</u> | |
| II. | | |
| | <u>Item 1. Legal Proceedings</u> | 92 |
| | <u>Item 1A. Risk Factors</u> | 92 |
| | <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 92 |
| | <u>Item 3. Defaults Upon Senior Securities</u> | 92 |
| | <u>Item 4. Mine Safety Disclosures</u> | 92 |

| | |
|----------------------------------|----|
| <u>Item 5. Other Information</u> | 92 |
| <u>Item 6. Exhibits</u> | 92 |
| <u>Signatures</u> | 93 |

Table of Contents

MERCANTILE BANK CORPORATION

PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

| | September 30, 2017 | December 31, 2016 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$53,941,000 | \$50,200,000 |
| Interest-earning deposits | 123,110,000 | 133,396,000 |
| Total cash and cash equivalents | 177,051,000 | 183,596,000 |
| Securities available for sale | 330,090,000 | 328,060,000 |
| Federal Home Loan Bank stock | 11,036,000 | 8,026,000 |
| Loans | 2,554,272,000 | 2,378,620,000 |
| Allowance for loan losses | (19,193,000) | (17,961,000) |
| Loans, net | 2,535,079,000 | 2,360,659,000 |
| Premises and equipment, net | 45,606,000 | 45,456,000 |
| Bank owned life insurance | 66,858,000 | 67,198,000 |
| Goodwill | 49,473,000 | 49,473,000 |
| Core deposit intangible | 8,156,000 | 9,957,000 |
| Other assets | 31,306,000 | 30,146,000 |
| Total assets | \$3,254,655,000 | \$3,082,571,000 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest-bearing | \$826,038,000 | \$810,600,000 |
| Interest-bearing | 1,663,005,000 | 1,564,385,000 |
| Total deposits | 2,489,043,000 | 2,374,985,000 |
| Securities sold under agreements to repurchase | 122,280,000 | 131,710,000 |
| Federal Home Loan Bank advances | 220,000,000 | 175,000,000 |
| Subordinated debentures | 45,347,000 | 44,835,000 |
| Accrued interest and other liabilities | 15,439,000 | 15,230,000 |

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| | | |
|--|-----------------|-----------------|
| Total liabilities | 2,892,109,000 | 2,741,760,000 |
| 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; 16,490,279 shares issued and outstanding at September 30, 2017 and 16,416,695 shares issued and outstanding at December 31, 2016 | 309,033,000 | 305,488,000 |
| Retained earnings | 55,258,000 | 40,904,000 |
| Accumulated other comprehensive loss | (1,745,000) | (5,581,000) |
| Total shareholders' equity | 362,546,000 | 340,811,000 |
| Total liabilities and shareholders' equity | \$3,254,655,000 | \$3,082,571,000 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

| | Three Months Ended Sept 30, 2017 | Three Months Ended Sept 30, 2016 | Nine Months Ended Sept 30, 2017 | Nine Months Ended Sept 30, 2016 |
|--|--|--|---|---|
| Interest income | | | | |
| Loans, including fees | \$30,746,000 | \$27,553,000 | \$86,406,000 | \$81,219,000 |
| Securities, taxable | 1,322,000 | 1,488,000 | 3,885,000 | 5,661,000 |
| Securities, tax-exempt | 584,000 | 545,000 | 1,709,000 | 1,622,000 |
| Other interest-earning assets | 382,000 | 120,000 | 641,000 | 240,000 |
| Total interest income | 33,034,000 | 29,706,000 | 92,641,000 | 88,742,000 |
| Interest expense | | | | |
| Deposits | 2,652,000 | 1,924,000 | 6,543,000 | 5,608,000 |
| Short-term borrowings | 45,000 | 62,000 | 142,000 | 154,000 |
| Federal Home Loan Bank advances | 1,033,000 | 670,000 | 2,690,000 | 1,595,000 |
| Subordinated debentures and other borrowings | 660,000 | 600,000 | 1,920,000 | 1,952,000 |
| Total interest expense | 4,390,000 | 3,256,000 | 11,295,000 | 9,309,000 |
| Net interest income | 28,644,000 | 26,450,000 | 81,346,000 | 79,433,000 |
| Provision for loan losses | 1,000,000 | 600,000 | 2,350,000 | 2,300,000 |
| Net interest income after provision for loan losses | 27,644,000 | 25,850,000 | 78,996,000 | 77,133,000 |
| Noninterest income | | | | |
| Services charges on deposit and sweep accounts | 1,076,000 | 1,140,000 | 3,148,000 | 3,178,000 |
| Credit and debit card income | 1,215,000 | 1,090,000 | 3,497,000 | 3,185,000 |
| Mortgage banking income | 1,326,000 | 1,236,000 | 3,233,000 | 2,578,000 |
| Earnings on bank owned life insurance | 328,000 | 349,000 | 2,394,000 | 933,000 |
| Gain on trust preferred securities repurchase | 0 | 0 | 0 | 2,970,000 |
| Other income | 660,000 | 1,469,000 | 2,226,000 | 3,590,000 |
| Total noninterest income | 4,605,000 | 5,284,000 | 14,498,000 | 16,434,000 |
| Noninterest expense | | | | |

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| | | | | |
|--|--------------------|--------------------|---------------------|---------------------|
| Salaries and benefits | 11,636,000 | 11,162,000 | 33,796,000 | 32,959,000 |
| Occupancy | 1,598,000 | 1,515,000 | 4,707,000 | 4,600,000 |
| Furniture and equipment depreciation, rent and maintenance | 543,000 | 531,000 | 1,625,000 | 1,579,000 |
| Data processing costs | 2,071,000 | 1,987,000 | 6,155,000 | 5,949,000 |
| FDIC insurance costs | 250,000 | 351,000 | 708,000 | 1,108,000 |
| Other expense | 4,112,000 | 4,117,000 | 12,877,000 | 12,530,000 |
| Total noninterest expenses | 20,210,000 | 19,663,000 | 59,868,000 | 58,725,000 |
| Income before federal income tax expense | 12,039,000 | 11,471,000 | 33,626,000 | 34,842,000 |
| Federal income tax expense | 3,702,000 | 3,626,000 | 10,331,000 | 11,014,000 |
| Net income | \$8,337,000 | \$7,845,000 | \$23,295,000 | \$23,828,000 |
| Basic earnings per share | \$0.51 | \$0.48 | \$1.41 | \$1.46 |
| Diluted earnings per share | \$0.51 | \$0.48 | \$1.41 | \$1.46 |
| Cash dividends per share | \$0.19 | \$0.17 | \$0.55 | \$0.49 |
| Average basic shares outstanding | 16,483,492 | 16,282,804 | 16,463,245 | 16,271,848 |
| Average diluted shares outstanding | 16,494,540 | 16,307,350 | 16,474,534 | 16,294,093 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| | Three Months | Three Months | Nine Months | Nine Months |
|--|------------------|------------------|------------------|------------------|
| | Ended | Ended | Ended | Ended |
| | Sept 30, 2017 | Sept 30, 2016 | Sept 30, 2017 | Sept 30, 2016 |
| Net income | \$8,337,000 | \$7,845,000 | \$23,295,000 | \$23,828,000 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding gains (losses) on securities available for sale | (1,381,000) | (1,495,000) | 5,833,000 | 722,000 |
| Fair value of interest rate swap | 13,000 | 113,000 | 69,000 | 88,000 |
| Total other comprehensive income | (1,368,000) | (1,382,000) | 5,902,000 | 810,000 |
| Tax effect of unrealized holding gains (losses) on securities available for sale | 484,000 | 523,000 | (2,042,000) | (253,000) |
| Tax effect of fair value of interest rate swap | (5,000) | (40,000) | (24,000) | (31,000) |
| Total tax effect of other comprehensive income | 479,000 | 483,000 | (2,066,000) | (284,000) |
| Other comprehensive income (loss), net of tax | (889,000) | (899,000) | 3,836,000 | 526,000 |
| Comprehensive income | \$7,448,000 | \$6,946,000 | \$27,131,000 | \$24,354,000 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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

| (\$ in thousands except per share amounts) | Preferred Common | | Retained Earnings | Accumulated | Total Shareholders' Equity |
|--|------------------|-----------|----------------------|--|----------------------------------|
| | Stock | Stock | | Other Comprehensive Income (Loss) | |
| Balances, January 1, 2017 | \$ 0 | \$305,488 | \$40,904 | \$ (5,581) | \$ 340,811 |
| Employee stock purchase plan (1,053 shares) | | 36 | | | 36 |
| Dividend reinvestment plan (43,938 shares) | | 1,426 | | | 1,426 |
| Stock option exercises (25,075 shares) | | 289 | | | 289 |
| Stock grants to directors for retainer fees (11,712 shares) | | 363 | | | 363 |
| Stock-based compensation expense | | 1,431 | | | 1,431 |
| Cash dividends (\$0.55 per common share) | | | (8,941) | | (8,941) |
| Net income for the nine months ended September 30, 2017 | | | 23,295 | | 23,295 |
| Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect | | | | 3,791 | 3,791 |
| Change in fair value of interest rate swap, net of tax effect | | | | 45 | 45 |
| Balances, September 30, 2017 | \$ 0 | \$309,033 | \$55,258 | \$ (1,745) | \$ 362,546 |

See accompanying notes to condensed consolidated financial statements.

4

Table of Contents

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

| (\$ in thousands except per share amounts) | Preferred Common | | Retained Earnings | Accumulated | Total Shareholders' Equity |
|--|------------------|-----------|----------------------|--|----------------------------------|
| | Stock | Stock | | Other Comprehensive Income (Loss) | |
| Balances, January 1, 2016 | \$ 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/(loss) 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 |
| Balances, September 30, 2016 | \$ 0 | \$304,027 | \$43,655 | \$ 1,789 | \$ 349,471 |

See accompanying notes to condensed consolidated financial statements.

5

Table of Contents

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| | Nine Months Ended Sept 30, 2017 | Nine Months Ended Sept 30, 2016 |
|---|---------------------------------------|---------------------------------------|
| Cash flows from operating activities | | |
| Net income | \$23,295,000 | \$23,828,000 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Depreciation and amortization | 7,820,000 | 6,730,000 |
| Accretion of acquired loans | (1,867,000) | (3,253,000) |
| Provision for loan losses | 2,350,000 | 2,300,000 |
| Stock-based compensation expense | 1,431,000 | 901,000 |
| Stock grants to directors for retainer fee | 363,000 | 327,000 |
| Proceeds from sales of mortgage loans held for sale | 81,368,000 | 83,440,000 |
| Origination of mortgage loans held for sale | (81,570,000) | (83,000,000) |
| Net gain from sales of mortgage loans held for sale | (2,875,000) | (2,463,000) |
| Gain on trust preferred securities repurchase | 0 | (2,970,000) |
| Net gain from sales and valuation write-down of foreclosed assets | (199,000) | (322,000) |
| Net (gain) loss from sales and valuation write-down of former bank premises | 123,000 | (10,000) |
| Net loss from sales of fixed assets | 67,000 | 174,000 |
| Net (gain) loss from sales of available for sale securities | (36,000) | 1,000 |
| Earnings on bank owned life insurance | (2,394,000) | (933,000) |
| Net change in: | | |
| Accrued interest receivable | (1,404,000) | (228,000) |
| Other assets | (1,987,000) | (1,554,000) |
| Accrued interest and other liabilities | 278,000 | (809,000) |
| Net cash from operating activities | 24,763,000 | 22,159,000 |
| Cash flows from investing activities | | |
| Loan originations and payments, net | (172,665,000) | (124,126,000) |
| Purchases of securities available for sale | (50,276,000) | (130,414,000) |
| Proceeds from maturities, calls and repayments of securities available for sale | 46,177,000 | 152,781,000 |
| Proceeds from sales of securities available for sale | 6,706,000 | 264,000 |
| Proceeds from sales of foreclosed assets | 772,000 | 1,458,000 |
| Proceeds from sales of former bank premises | 22,000 | 45,000 |
| Purchases of Federal Home Loan Bank stock | (3,010,000) | (459,000) |
| Proceeds from bank owned life insurance cash value release and death benefits | 2,720,000 | 0 |

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| | | |
|---|---------------|---------------|
| Purchases of bank owned life insurance | 0 | (7,000,000) |
| Net purchases of premises and equipment | (4,192,000) | (1,051,000) |
| Net cash for investing activities | (173,746,000) | (108,502,000) |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

| | Nine Months | Nine Months |
|--|----------------|----------------|
| | Ended | Ended |
| | Sept 30, 2017 | Sept 30, 2016 |
| Cash flows from financing activities | | |
| Net increase (decrease) in time deposits | (49,466,000) | 17,823,000 |
| Net increase in all other deposits | 163,524,000 | 36,232,000 |
| Net decrease in securities sold under agreements to repurchase | (9,430,000) | (7,928,000) |
| Maturities of Federal Home Loan Bank advances | (45,000,000) | 0 |
| Proceeds from Federal Home Loan Bank advances | 90,000,000 | 110,000,000 |
| Proceeds from stock option exercises | 289,000 | 606,000 |
| Employee stock purchase plan | 36,000 | 27,000 |
| Dividend reinvestment plan | 1,426,000 | 1,079,000 |
| Repurchase of common stock shares | 0 | (3,732,000) |
| Repurchase of trust preferred securities | 0 | (8,030,000) |
| Payment of cash dividends to common shareholders | (8,941,000) | (7,895,000) |
| Net cash from financing activities | 142,438,000 | 138,182,000 |
| Net change in cash and cash equivalents | (6,545,000) | 51,839,000 |
| Cash and cash equivalents at beginning of period | 183,596,000 | 89,891,000 |
| Cash and cash equivalents at end of period | \$ 177,051,000 | \$ 141,730,000 |
| Supplemental disclosures of cash flows information | | |
| Cash paid during the period for: | | |
| Interest | \$ 11,064,000 | \$ 9,218,000 |
| Federal income tax | 10,275,000 | 10,950,000 |
| Noncash financing and investing activities: | | |
| Transfers from loans to foreclosed assets | 839,000 | 297,000 |
| Transfers from bank premises to other real estate owned | 1,737,000 | 371,000 |

See accompanying notes to condensed consolidated financial statements.

7

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the nine months ended September 30, 2017 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, 2017 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, 2016.

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 220,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2017. In addition, stock options for approximately 28,000 shares of common stock were included in determining diluted earnings per share for the three and nine months ended September 30, 2017. Stock options for approximately 7,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2017.

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.

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.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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, 2017 and December 31, 2016, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$4.1 million and \$1.0 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 \$611 million as of September 30, 2017.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 servicing 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.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivatives: Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Used as part of our asset and liability management to help manage interest rate risk, our derivatives have 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 assets and liabilities 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 2015 and 2016, 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.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 two transition methods available – full 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. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance will not have an impact on interest income. We are completing an overall assessment of revenue streams and review of related contracts potentially affected by the ASU. In addition, we are evaluating the ASU's expanded disclosure requirements. We plan to adopt this ASU on January 1, 2018 utilizing the modified retrospective approach with a cumulative effect adjustment to opening retained earnings, if such adjustment is applicable.

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.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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 did not 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: (i) financial assets subject to credit losses and measured at amortized cost, and (ii) 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.

In January 2017, the FASB issued ASU No. 2017-04, *Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. This ASU simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under this ASU, an entity should perform the Step 1 annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying value. If the carrying amount exceeds the fair value, an entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, not to exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. This ASU is effective January 1, 2020 and early adoption is permitted. The ASU should be applied prospectively. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

In March 2017, the FASB issued ASU No. 2017-08, *Premium Amortization on Purchased Callable Debt Securities*. This ASU requires the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. Previously, entities were allowed to amortize to contractual maturity or to call date. This ASU is effective for annual reporting periods beginning after December 15, 2018, and early adoption is permitted. We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements.

2. SECURITIES

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|----------------|
| <u>September 30, 2017</u> | | | | |
| U.S. Government agency debt obligations | \$ 165,551,000 | \$ 208,000 | \$ (4,591,000) | \$ 161,168,000 |
| Mortgage-backed securities | 39,304,000 | 405,000 | (214,000) | 39,495,000 |
| Municipal general obligation bonds | 121,803,000 | 1,750,000 | (243,000) | 123,310,000 |
| Municipal revenue bonds | 4,099,000 | 51,000 | (16,000) | 4,134,000 |
| Other investments | 2,002,000 | 0 | (19,000) | 1,983,000 |

\$332,759,000 \$2,414,000 \$(5,083,000) \$330,090,000

December 31, 2016

| | | | | |
|---|----------------|------------|---------------|----------------|
| U.S. Government agency debt obligations | \$ 159,271,000 | \$ 106,000 | \$(7,337,000) | \$ 152,040,000 |
| Mortgage-backed securities | 47,329,000 | 486,000 | (423,000) | 47,392,000 |
| Municipal general obligation bonds | 120,284,000 | 312,000 | (1,549,000) | 119,047,000 |
| Municipal revenue bonds | 7,699,000 | 23,000 | (91,000) | 7,631,000 |
| Other investments | 1,979,000 | 0 | (29,000) | 1,950,000 |
| | \$336,562,000 | \$927,000 | \$(9,429,000) | \$328,060,000 |

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

Securities with unrealized losses at September 30, 2017 and December 31, 2016, 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, 2017</u> | | | | | | |
| U.S. Government agency debt obligations | \$81,981,000 | \$2,496,000 | \$47,265,000 | \$2,095,000 | \$129,246,000 | \$4,591,000 |
| Mortgage-backed securities | 21,482,000 | 121,000 | 9,416,000 | 93,000 | 30,898,000 | 214,000 |
| Municipal general obligation bonds | 10,280,000 | 90,000 | 8,436,000 | 153,000 | 18,716,000 | 243,000 |
| Municipal revenue bonds | 0 | 0 | 1,101,000 | 16,000 | 1,101,000 | 16,000 |
| Other investments | 1,502,000 | 19,000 | 0 | 0 | 1,502,000 | 19,000 |
| | \$115,245,000 | \$2,726,000 | \$66,218,000 | \$2,357,000 | \$181,463,000 | \$5,083,000 |

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|-------------|-------------------|------------|---------------|-------------|
| | Fair | Unrealized | Fair | Unrealized | Fair | Unrealized |
| | Value | Loss | Value | Loss | Value | Loss |
| <u>December 31, 2016</u> | | | | | | |
| U.S. Government agency debt obligations | \$110,160,000 | \$7,172,000 | \$5,073,000 | \$165,000 | \$115,233,000 | \$7,337,000 |
| Mortgage-backed securities | 3,670,000 | 4,000 | 37,072,000 | 419,000 | 40,742,000 | 423,000 |
| Municipal general obligation bonds | 65,895,000 | 1,360,000 | 27,734,000 | 189,000 | 93,629,000 | 1,549,000 |
| Municipal revenue bonds | 1,921,000 | 90,000 | 206,000 | 1,000 | 2,127,000 | 91,000 |

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| | | | | | | |
|-------------------|---------------|-------------|--------------|-----------|---------------|-------------|
| Other investments | 1,479,000 | 29,000 | 0 | 0 | 1,479,000 | 29,000 |
| | \$183,125,000 | \$8,655,000 | \$70,085,000 | \$774,000 | \$253,210,000 | \$9,429,000 |

(Continued)

15

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

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

At September 30, 2017, 195 debt securities and one mutual fund with fair values totaling \$181 million have unrealized losses aggregating \$5.1 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 the unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no unrealized losses are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at September 30, 2017, by maturity, are shown in the following table. The contractual maturity is utilized for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

| | | |
|----------|-----------|-------|
| Weighted | Amortized | Fair |
| Average | Cost | Value |

Yield

| | | | |
|-------------------------------------|--------|---------------|---------------|
| Due in 2017 | 1.51 % | \$3,307,000 | \$3,307,000 |
| Due in 2018 through 2022 | 2.20 | 95,857,000 | 96,451,000 |
| Due in 2023 through 2027 | 2.71 | 99,198,000 | 98,217,000 |
| Due in 2028 and beyond | 2.94 | 93,091,000 | 90,637,000 |
| Mortgage-backed securities | 2.06 | 39,304,000 | 39,495,000 |
| Other investments | 2.03 | 2,002,000 | 1,983,000 |
| Total available for sale securities | 2.53 % | \$332,759,000 | \$330,090,000 |

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of \$113 million at September 30, 2017 and \$109 million at December 31, 2016, with estimated market values of \$114 million and \$107 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$13.4 million and \$19.5 million at September 30, 2017 and December 31, 2016, respectively, with estimated market values of \$13.6 million and \$19.5 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.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was \$122 million and \$132 million at September 30, 2017 and December 31, 2016, respectively. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

The fair value estimates for acquired loans are based on expected prepayments and the amount and timing of discounted expected principal, interest and other cash flows. Credit discounts representing the principal losses

expected over the life of the loan are also a component of the initial fair value. In determining the merger date fair value of acquired impaired loans, and in subsequent accounting, we have generally aggregated acquired commercial and consumer loans into pools of loans with common risk characteristics.

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.

(Continued)

Table of Contents

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, 2017 were \$2.55 billion compared to \$2.38 billion at December 31, 2016, an increase of \$176 million, or 7.4%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at September 30, 2017 and December 31, 2016, and the percentage change in loans from the end of 2016 to the end of the third quarter of 2017, are as follows:

| | September 30, 2017 | | December 31, 2016 | | Percent |
|--------------------------------|--------------------|---|-------------------|---|------------------------|
| | Balance | % | Balance | % | Increase (Decrease) |
| <u>Originated loans</u> | | | | | |
| Commercial: | | | | | |

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| | | | | | | | | |
|---|-----------------|--------|---|-----------------|--------|---|--------|---|
| Commercial and industrial | \$710,699,000 | 33.3 | % | \$636,771,000 | 33.8 | % | 11.6 | % |
| Vacant land, land development, and residential construction | 21,272,000 | 1.0 | | 26,519,000 | 1.4 | | (19.8) |) |
| Real estate – owner occupied | 411,367,000 | 19.3 | | 363,509,000 | 19.3 | | 13.2 | |
| Real estate – non-owner occupied | 721,304,000 | 33.8 | | 652,054,000 | 34.6 | | 10.6 | |
| Real estate – multi-family and residential rental | 58,356,000 | 2.7 | | 50,045,000 | 2.6 | | 16.6 | |
| Total commercial | 1,922,998,000 | 90.1 | | 1,728,898,000 | 91.7 | | 11.2 | |
| Retail: | | | | | | | | |
| Home equity and other | 69,325,000 | 3.3 | | 69,831,000 | 3.7 | | (0.7) |) |
| 1-4 family mortgages | 141,443,000 | 6.6 | | 85,819,000 | 4.6 | | 64.8 | |
| Total retail | 210,768,000 | 9.9 | | 155,650,000 | 8.3 | | 35.4 | |
| Total originated loans | \$2,133,766,000 | 100.0% | | \$1,884,548,000 | 100.0% | | 13.2 | % |

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

| | September 30, 2017 | | December 31, 2016 | | Percent |
|---|--------------------|--------|-------------------|--------|------------------------|
| | Balance | % | Balance | % | Increase (Decrease) |
| <u>Acquired loans</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$65,864,000 | 15.7 % | \$77,132,000 | 15.6 % | (14.6%) |
| Vacant land, land development, and residential construction | 7,303,000 | 1.7 | 8,309,000 | 1.7 | (12.1) |
| Real estate – owner occupied | 73,980,000 | 17.6 | 86,955,000 | 17.6 | (14.9) |
| Real estate – non-owner occupied | 83,863,000 | 19.9 | 96,215,000 | 19.5 | (12.8) |
| Real estate – multi-family and residential rental | 60,814,000 | 14.5 | 67,838,000 | 13.7 | (10.4) |
| Total commercial | 291,824,000 | 69.4 | 336,449,000 | 68.1 | (13.3) |
| Retail: | | | | | |
| Home equity and other | 34,051,000 | 8.1 | 48,216,000 | 9.8 | (29.4) |
| 1-4 family mortgages | 94,631,000 | 22.5 | 109,407,000 | 22.1 | (13.5) |
| Total retail | 128,682,000 | 30.6 | 157,623,000 | 31.9 | (18.4) |
| Total acquired loans | \$420,506,000 | 100.0% | \$494,072,000 | 100.0% | (14.9%) |

| | September 30, 2017 | | December 31, 2016 | | Percent |
|---|--------------------|--------|-------------------|--------|------------------------|
| | Balance | % | Balance | % | Increase (Decrease) |
| <u>Total loans</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$776,563,000 | 30.4 % | \$713,903,000 | 30.0 % | 8.8 % |
| Vacant land, land development, and residential construction | 28,575,000 | 1.1 | 34,828,000 | 1.5 | (18.0) |
| Real estate – owner occupied | 485,347,000 | 19.0 | 450,464,000 | 18.9 | 7.7 |
| Real estate – non-owner occupied | 805,167,000 | 31.5 | 748,269,000 | 31.5 | 7.6 |
| Real estate – multi-family and residential rental | 119,170,000 | 4.7 | 117,883,000 | 4.9 | 1.1 |

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| | | | | | | |
|-----------------------|-----------------|--------|-----------------|--------|-------|---|
| Total commercial | 2,214,822,000 | 86.7 | 2,065,347,000 | 86.8 | 7.2 | |
| Retail: | | | | | | |
| Home equity and other | 103,376,000 | 4.0 | 118,047,000 | 5.0 | (12.4 |) |
| 1-4 family mortgages | 236,074,000 | 9.3 | 195,226,000 | 8.2 | 20.9 | |
| Total retail | 339,450,000 | 13.3 | 313,273,000 | 13.2 | 8.4 | |
| Total loans | \$2,554,272,000 | 100.0% | \$2,378,620,000 | 100.0% | 7.4 | % |

(Continued)

Table of Contents

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 \$12.4 million and \$5.3 million, respectively, as of September 30, 2017. The total contractually required payments due on and carrying value of acquired impaired loans were \$15.5 million and \$6.2 million, respectively, as of December 31, 2016. Changes in the accretible yield for acquired impaired loans for the three and nine months ended September 30, 2017 and September 30, 2016 were as follows:

| | |
|---|-------------|
| Balance at June 30, 2017 | \$1,658,000 |
| Additions | 2,000 |
| Accretion income | (141,000) |
| Net reclassification from nonaccretible to accretible | 83,000 |
| Reductions (1) | (23,000) |
| Balance at September 30, 2017 | \$1,579,000 |
| Balance at December 31, 2016 | \$1,726,000 |
| Additions | 223,000 |
| Accretion income | (429,000) |
| Net reclassification from nonaccretible to accretible | 330,000 |
| Reductions (1) | (271,000) |
| Balance at September 30, 2017 | \$1,579,000 |
| Balance at June 30, 2016 | \$6,602,000 |
| Additions | 224,000 |
| Accretion income | (638,000) |
| Net reclassification from nonaccretible to accretible | 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 |

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

(Continued)

20

Table of Contents

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, 2017 and December 31, 2016 were as follows:

| | September 30, 2017 | December 31, 2016 |
|--|------------------------------|-----------------------------|
| Loans past due 90 days or more still accruing interest | \$0 | \$0 |
| Nonaccrual loans | 4,696,000 | 3,328,000 |
| Total nonperforming originated loans | \$4,696,000 | \$3,328,000 |

Nonperforming acquired loans as of September 30, 2017 and December 31, 2016 were as follows:

| | September 30, 2017 | December 31, 2016 |
|--|------------------------------|-----------------------------|
| Loans past due 90 days or more still accruing interest | \$0 | \$0 |
| Nonaccrual loans | 3,535,000 | 2,611,000 |
| Total nonperforming acquired loans | \$3,535,000 | \$2,611,000 |

The recorded principal balance of nonperforming loans was as follows:

| | September 30, 2017 | December 31, 2016 |
|---|--------------------------|-------------------------|
| Commercial: | | |
| Commercial and industrial | \$2,401,000 | \$2,296,000 |
| Vacant land, land development, and residential construction | 50,000 | 95,000 |
| Real estate – owner occupied | 2,309,000 | 285,000 |
| Real estate – non-owner occupied | 45,000 | 488,000 |
| Real estate – multi-family and residential rental | 247,000 | 17,000 |
| Total commercial | 5,052,000 | 3,181,000 |
| Retail: | | |
| Home equity and other | 543,000 | 496,000 |
| 1-4 family mortgages | 2,636,000 | 2,262,000 |
| Total retail | 3,179,000 | 2,758,000 |
| Total nonperforming loans | \$8,231,000 | \$5,939,000 |

Acquired impaired loans are generally 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.

(Continued)

Table of Contents

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, 2017:

| | 30 – 59 Days Past Due | 60 – 89 Days Past Due | Greater Than 89 Days Past Due | Total Past Due | Current | Total Loans | Recorded Balance > 89 Days and Accruing |
|---|--------------------------------|-----------------------------|--|-------------------|-----------------|-----------------|--|
| <u>Originated loans</u> | | | | | | | |
| Commercial: | | | | | | | |
| Commercial and industrial | \$0 | \$0 | \$0 | \$0 | \$710,699,000 | \$710,699,000 | \$ 0 |
| Vacant land, land development, and residential construction | 50,000 | 0 | 0 | 50,000 | 21,222,000 | 21,272,000 | 0 |
| Real estate – owner occupied | 0 | 0 | 0 | 0 | 411,367,000 | 411,367,000 | 0 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 721,304,000 | 721,304,000 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 0 | 58,356,000 | 58,356,000 | 0 |
| Total commercial | 50,000 | 0 | 0 | 50,000 | 1,922,948,000 | 1,922,998,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 35,000 | 111,000 | 0 | 146,000 | 69,179,000 | 69,325,000 | 0 |
| 1-4 family mortgages | 0 | 69,000 | 248,000 | 317,000 | 141,126,000 | 141,443,000 | 0 |
| Total retail | 35,000 | 180,000 | 248,000 | 463,000 | 210,305,000 | 210,768,000 | 0 |
| Total past due loans | \$85,000 | \$180,000 | \$248,000 | \$513,000 | \$2,133,253,000 | \$2,133,766,000 | \$ 0 |

(Continued)

22

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

| | 30 – 59 Days Past Due | 60 – 89 Days Past Due | Greater Than 89 Days Past Due | Total Past Due | Current | Total Loans | Recorded Balance > 89 Days and Accruing |
|---|-----------------------------|-----------------------------|--|-------------------|----------------|----------------|--|
| <u>Acquired loans</u> | | | | | | | |
| Commercial: | | | | | | | |
| Commercial and industrial | \$ 114,000 | \$ 0 | \$ 1,000 | \$ 115,000 | \$ 65,749,000 | \$ 65,864,000 | \$ 0 |
| Vacant land, land development, and residential construction | 0 | 0 | 0 | 0 | 7,303,000 | 7,303,000 | 0 |
| Real estate – owner occupied | 153,000 | 139,000 | 0 | 292,000 | 73,688,000 | 73,980,000 | 0 |
| Real estate – non-owner occupied | 0 | 45,000 | 0 | 45,000 | 83,818,000 | 83,863,000 | 0 |
| Real estate – multi-family and residential rental | 0 | 99,000 | 10,000 | 109,000 | 60,705,000 | 60,814,000 | 0 |
| Total commercial | 267,000 | 283,000 | 11,000 | 561,000 | 291,263,000 | 291,824,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 207,000 | 157,000 | 21,000 | 385,000 | 33,666,000 | 34,051,000 | 0 |
| 1-4 family mortgages | 481,000 | 363,000 | 707,000 | 1,551,000 | 93,080,000 | 94,631,000 | 0 |
| Total retail | 688,000 | 520,000 | 728,000 | 1,936,000 | 126,746,000 | 128,682,000 | 0 |
| Total past due loans | \$ 955,000 | \$ 803,000 | \$ 739,000 | \$ 2,497,000 | \$ 418,009,000 | \$ 420,506,000 | \$ 0 |

(Continued)

Table of Contents

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, 2016:

| | 30 – 59 Days Past Due | 60 – 89 Days Past Due | Greater Than 89 Days Past Due | Total Past Due | Current | Total Loans | Recorded Balance > 89 Days and Accruing |
|---|-----------------------------|-----------------------------|--|-------------------|-----------------|-----------------|--|
| <u>Originated loans</u> | | | | | | | |
| Commercial: | | | | | | | |
| Commercial and industrial | \$0 | \$27,000 | \$0 | \$27,000 | \$636,744,000 | \$636,771,000 | \$ 0 |
| Vacant land, land development, and residential construction | 0 | 0 | 0 | 0 | 26,519,000 | 26,519,000 | 0 |
| Real estate – owner occupied | 0 | 0 | 0 | 0 | 363,509,000 | 363,509,000 | 0 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 652,054,000 | 652,054,000 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 0 | 50,045,000 | 50,045,000 | 0 |
| Total commercial | 0 | 27,000 | 0 | 27,000 | 1,728,871,000 | 1,728,898,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 46,000 | 98,000 | 0 | 144,000 | 69,687,000 | 69,831,000 | 0 |
| 1-4 family mortgages | 758,000 | 122,000 | 337,000 | 1,217,000 | 84,602,000 | 85,819,000 | 0 |
| Total retail | 804,000 | 220,000 | 337,000 | 1,361,000 | 154,289,000 | 155,650,000 | 0 |
| Total past due loans | \$804,000 | \$247,000 | \$337,000 | \$1,388,000 | \$1,883,160,000 | \$1,884,548,000 | \$ 0 |

(Continued)

24

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

| | 30 – 59 Days Past Due | 60 – 89 Days Past Due | Greater Than 89 Days Past Due | Total Past Due | Current | Total Loans | Recorded Balance > 89 Days and Accruing |
|---|-----------------------------|-----------------------------|--|-------------------|---------------|----------------|--|
| <u>Acquired Loans</u> | | | | | | | |
| Commercial: | | | | | | | |
| Commercial and industrial | \$0 | \$11,000 | \$16,000 | \$27,000 | \$77,105,000 | \$77,132,000 | \$ 0 |
| Vacant land, land development, and residential construction | 0 | 0 | 0 | 0 | 8,309,000 | 8,309,000 | 0 |
| Real estate – owner occupied | 62,000 | 0 | 50,000 | 112,000 | 86,843,000 | 86,955,000 | 0 |
| Real estate – non-owner occupied | 0 | 0 | 353,000 | 353,000 | 95,862,000 | 96,215,000 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 17,000 | 17,000 | 67,821,000 | 67,838,000 | 0 |
| Total commercial | 62,000 | 11,000 | 436,000 | 509,000 | 335,940,000 | 336,449,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 258,000 | 26,000 | 45,000 | 329,000 | 47,887,000 | 48,216,000 | 0 |
| 1-4 family mortgages | 1,255,000 | 467,000 | 439,000 | 2,161,000 | 107,246,000 | 109,407,000 | 0 |
| Total retail | 1,513,000 | 493,000 | 484,000 | 2,490,000 | 155,133,000 | 157,623,000 | 0 |
| Total past due loans | \$1,575,000 | \$504,000 | \$920,000 | \$2,999,000 | \$491,073,000 | \$494,072,000 | \$ 0 |

(Continued)

25

Table of Contents

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, 2017, and average originated impaired loans for the three and nine months ended September 30, 2017, 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 | \$83,000 | \$70,000 | | \$56,000 | \$ 823,000 |
| Vacant land, land development and residential construction | 463,000 | 50,000 | | 58,000 | 73,000 |
| Real estate – owner occupied | 224,000 | 214,000 | | 266,000 | 189,000 |
| Real estate – non-owner occupied | 178,000 | 178,000 | | 89,000 | 45,000 |
| Real estate – multi-family and residential rental | 360,000 | 360,000 | | 180,000 | 189,000 |
| Total commercial | 1,308,000 | 872,000 | | 649,000 | 1,319,000 |
| Retail: | | | | | |
| Home equity and other | 849,000 | 776,000 | | 729,000 | 488,000 |
| 1-4 family mortgages | 1,264,000 | 603,000 | | 614,000 | 632,000 |
| Total retail | 2,113,000 | 1,379,000 | | 1,343,000 | 1,120,000 |
| Total with no related allowance recorded | \$3,421,000 | \$2,251,000 | | \$1,992,000 | \$ 2,439,000 |

(Continued)

26

Table of Contents

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 | \$4,066,000 | \$4,030,000 | \$1,252,000 | \$4,100,000 | \$3,395,000 |
| Vacant land, land development and residential construction | 249,000 | 249,000 | 6,000 | 374,000 | 561,000 |
| Real estate – owner occupied | 2,819,000 | 2,807,000 | 530,000 | 2,319,000 | 1,731,000 |
| Real estate – non-owner occupied | 296,000 | 296,000 | 2,000 | 392,000 | 2,569,000 |
| Real estate – multi-family and residential rental | 66,000 | 66,000 | 66,000 | 321,000 | 536,000 |
| Total commercial | 7,496,000 | 7,448,000 | 1,856,000 | 7,506,000 | 8,792,000 |
| Retail: | | | | | |
| Home equity and other | 1,085,000 | 1,066,000 | 723,000 | 1,035,000 | 866,000 |
| 1-4 family mortgages | 165,000 | 112,000 | 15,000 | 113,000 | 125,000 |
| Total retail | 1,250,000 | 1,178,000 | 738,000 | 1,148,000 | 991,000 |
| Total with an allowance recorded | \$8,746,000 | \$8,626,000 | \$2,594,000 | \$8,654,000 | \$9,783,000 |
| Total impaired loans: | | | | | |
| Commercial | \$8,804,000 | \$8,320,000 | \$1,856,000 | \$8,155,000 | \$10,111,000 |
| Retail | 3,363,000 | 2,557,000 | 738,000 | 2,491,000 | 2,111,000 |
| Total impaired loans | \$12,167,000 | \$10,877,000 | \$2,594,000 | \$10,646,000 | \$12,222,000 |

(Continued)

27

Table of Contents

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, 2017, and average impaired acquired loans for the three and nine months ended September 30, 2017, were as follows:

| | Unpaid | Recorded | Related | Third Quarter Average | Year-To-Date Average |
|--|--------------|--------------|-----------|-----------------------------|-------------------------|
| | Contractual | Principal | Allowance | Recorded | Recorded |
| | Principal | Balance | | Principal | Principal |
| | Balance | | | Balance | Balance |
| <u>With no related allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 1,074,000 | \$ 1,057,000 | | \$ 1,196,000 | \$ 1,044,000 |
| Vacant land, land development and residential construction | 29,000 | 29,000 | | 31,000 | 15,000 |
| Real estate – owner occupied | 1,206,000 | 904,000 | | 1,031,000 | 1,091,000 |
| Real estate – non-owner occupied | 989,000 | 988,000 | | 975,000 | 863,000 |
| Real estate – multi-family and residential rental | 1,306,000 | 1,289,000 | | 750,000 | 455,000 |
| Total commercial | 4,604,000 | 4,267,000 | | 3,983,000 | 3,468,000 |
| Retail: | | | | | |
| Home equity and other | 677,000 | 495,000 | | 453,000 | 394,000 |
| 1-4 family mortgages | 2,485,000 | 2,022,000 | | 1,974,000 | 1,818,000 |
| Total retail | 3,162,000 | 2,517,000 | | 2,427,000 | 2,212,000 |
| Total with no related allowance recorded | \$ 7,766,000 | \$ 6,784,000 | | \$ 6,410,000 | \$ 5,680,000 |

(Continued)

28

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

| | Unpaid | Recorded | Related | Third Quarter | Year-To-Date |
|--|--------------|--------------|-----------|------------------|--------------|
| | Contractual | Principal | Allowance | Average | Average |
| | Principal | Balance | | Recorded | Recorded |
| | Balance | | | Principal | Principal |
| | | | | Balance | Balance |
| <u>With an allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 0 | \$ 0 | \$ 0 | \$ 6,000 | \$ 12,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 | 0 | 0 |
| Real estate – owner occupied | 46,000 | 46,000 | 3,000 | 47,000 | 47,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 0 | 0 |
| Total commercial | 46,000 | 46,000 | 3,000 | 53,000 | 59,000 |
| Retail: | | | | | |
| Home equity and other | 0 | 0 | 0 | 0 | 0 |
| 1-4 family mortgages | 170,000 | 170,000 | 3,000 | 170,000 | 171,000 |
| Total retail | 170,000 | 170,000 | 3,000 | 170,000 | 171,000 |
| Total with an allowance recorded | \$ 216,000 | \$ 216,000 | \$ 6,000 | \$ 223,000 | \$ 230,000 |
| Total impaired loans: | | | | | |
| Commercial | \$ 4,650,000 | \$ 4,313,000 | \$ 3,000 | \$ 4,036,000 | \$ 3,527,000 |
| Retail | 3,332,000 | 2,687,000 | 3,000 | 2,597,000 | 2,383,000 |
| Total impaired loans | \$ 7,982,000 | \$ 7,000,000 | \$ 6,000 | \$ 6,633,000 | \$ 5,910,000 |

(Continued)

29

Table of Contents

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, 2016, and average impaired originated loans for the three and nine months ended September 30, 2016, were as follows:

| | Unpaid | Recorded | Related | Third Quarter Average | Year-To-Date Average |
|--|--------------|--------------|-----------|-----------------------------|-------------------------|
| | Contractual | Principal | Allowance | Recorded | Recorded |
| | Principal | Balance | | Principal | Principal |
| | Balance | | | Balance | Balance |
| <u>With no related allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 1,498,000 | \$ 1,498,000 | | \$ 1,809,000 | \$ 1,752,000 |
| Vacant land, land development and residential construction | 487,000 | 95,000 | | 0 | 0 |
| Real estate – owner occupied | 0 | 0 | | 327,000 | 307,000 |
| Real estate – non-owner occupied | 0 | 0 | | 5,616,000 | 5,647,000 |
| Real estate – multi-family and residential rental | 130,000 | 130,000 | | 0 | 0 |
| Total commercial | 2,115,000 | 1,723,000 | | 7,752,000 | 7,706,000 |
| Retail: | | | | | |
| Home equity and other | 114,000 | 114,000 | | 118,000 | 63,000 |
| 1-4 family mortgages | 1,270,000 | 630,000 | | 618,000 | 616,000 |
| Total retail | 1,384,000 | 744,000 | | 736,000 | 679,000 |
| Total with no related allowance recorded | \$ 3,499,000 | \$ 2,467,000 | | \$ 8,488,000 | \$ 8,385,000 |

(Continued)

30

Table of Contents

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 | \$2,405,000 | \$2,382,000 | \$673,000 | \$185,000 | \$227,000 |
| Vacant land, land development and residential construction | 999,000 | 999,000 | 28,000 | 1,367,000 | 1,507,000 |
| Real estate – owner occupied | 906,000 | 906,000 | 97,000 | 1,366,000 | 1,337,000 |
| Real estate – non-owner occupied | 5,020,000 | 5,020,000 | 247,000 | 4,670,000 | 4,734,000 |
| Real estate – multi-family and residential rental | 1,040,000 | 1,040,000 | 258,000 | 966,000 | 992,000 |
| Total commercial | 10,370,000 | 10,347,000 | 1,303,000 | 8,554,000 | 8,797,000 |
| Retail: | | | | | |
| Home equity and other | 434,000 | 412,000 | 203,000 | 551,000 | 534,000 |
| 1-4 family mortgages | 204,000 | 157,000 | 66,000 | 162,000 | 144,000 |
| Total retail | 638,000 | 569,000 | 269,000 | 713,000 | 678,000 |
| Total with an allowance recorded | \$11,008,000 | \$10,916,000 | \$1,572,000 | \$9,267,000 | \$9,475,000 |
| Total impaired loans: | | | | | |
| Commercial | \$12,485,000 | \$12,070,000 | \$1,303,000 | \$16,306,000 | \$16,503,000 |
| Retail | 2,022,000 | 1,313,000 | 269,000 | 1,449,000 | 1,357,000 |
| Total impaired loans | \$14,507,000 | \$13,383,000 | \$1,572,000 | \$17,755,000 | \$17,860,000 |

(Continued)

31

Table of Contents

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, 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 | \$853,000 | \$826,000 | | \$1,327,000 | \$1,395,000 |
| Vacant land, land development and residential construction | 0 | 0 | | 0 | 0 |
| Real estate – owner occupied | 1,281,000 | 1,210,000 | | 1,021,000 | 1,416,000 |
| Real estate – non-owner occupied | 928,000 | 789,000 | | 961,000 | 894,000 |
| Real estate – multi-family and residential rental | 152,000 | 89,000 | | 327,000 | 335,000 |
| Total commercial | 3,214,000 | 2,914,000 | | 3,636,000 | 4,040,000 |
| Retail: | | | | | |
| Home equity and other | 531,000 | 351,000 | | 347,000 | 320,000 |
| 1-4 family mortgages | 2,081,000 | 1,629,000 | | 1,307,000 | 1,359,000 |
| Total retail | 2,612,000 | 1,980,000 | | 1,654,000 | 1,679,000 |
| Total with no related allowance recorded | \$5,826,000 | \$4,894,000 | | \$5,290,000 | \$5,719,000 |

(Continued)

32

Table of Contents

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 | \$ 19,000 | \$ 19,000 | \$ 2,000 | \$ 343,000 | \$ 361,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 | 0 | 0 |
| Real estate – owner occupied | 48,000 | 48,000 | 3,000 | 49,000 | 49,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 11,000 | 16,000 |
| Total commercial | 67,000 | 67,000 | 5,000 | 403,000 | 426,000 |
| Retail: | | | | | |
| Home equity and other | 0 | 0 | 0 | 0 | 0 |
| 1-4 family mortgages | 172,000 | 172,000 | 4,000 | 174,000 | 131,000 |
| Total retail | 172,000 | 172,000 | 4,000 | 174,000 | 131,000 |
| Total with an allowance recorded | \$ 239,000 | \$ 239,000 | \$ 9,000 | \$ 577,000 | \$ 557,000 |
| Total impaired loans: | | | | | |
| Commercial | \$ 3,281,000 | \$ 2,981,000 | \$ 5,000 | \$ 4,039,000 | \$ 4,466,000 |
| Retail | 2,784,000 | 2,152,000 | 4,000 | 1,828,000 | 1,810,000 |
| Total impaired loans | \$ 6,065,000 | \$ 5,133,000 | \$ 9,000 | \$ 5,867,000 | \$ 6,276,000 |

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 \$0.1 million and \$0.3 million during the third quarters of 2017 and 2016, respectively, and \$0.4 million and \$0.8 million during the first nine months of 2017 and 2016, respectively. No interest income was recognized on nonaccrual loans during the third quarter and first nine months of 2017 or during the respective 2016 periods. Lost interest income on nonaccrual loans totaled \$0.1 million during the third quarter of 2017 and \$0.2 million during the first nine months of 2017. Lost interest income on nonaccrual loans totaled \$0.1 million during the third quarter of 2016 and \$0.4 million during the first nine months of 2016.

(Continued)

Table of Contents

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 delinquency.

Credit quality indicators were as follows as of September 30, 2017:

Originated loans

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

| | Commercial | Commercial | Commercial | Commercial | Commercial |
|---------------------------------------|---------------|--------------|---------------|---------------|---------------|
| | Commercial | Vacant Land, | Commercial | Commercial | Commercial |
| | and | Land | Real Estate - | Real Estate - | Real Estate - |
| | Industrial | Development, | Owner | Non-Owner | Multi-Family |
| | | and | Occupied | Occupied | and |
| | | Residential | | | Residential |
| | | Construction | | | Rental |
| Internal credit risk grade groupings: | | | | | |
| Grades 1 – 4 | \$534,639,000 | \$13,017,000 | \$312,650,000 | \$573,763,000 | \$37,127,000 |

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| | | | | | |
|------------------|---------------|---------------|---------------|---------------|---------------|
| Grades 5 – 7 | 171,658,000 | 8,205,000 | 95,973,000 | 147,541,000 | 20,803,000 |
| Grades 8 – 9 | 4,402,000 | 50,000 | 2,744,000 | 0 | 426,000 |
| Total commercial | \$710,699,000 | \$ 21,272,000 | \$411,367,000 | \$721,304,000 | \$ 58,356,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | |
|-------------|------------|
| Retail | Retail |
| Home Equity | 1-4 Family |
| and Other | Mortgages |

Total retail \$69,325,000 \$141,443,000

(Continued)

Table of Contents

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 | \$38,477,000 | \$ 1,536,000 | \$29,429,000 | \$50,688,000 | \$36,523,000 |
| Grades 5 – 7 | 26,315,000 | 4,831,000 | 43,010,000 | 32,161,000 | 22,899,000 |
| Grades 8 – 9 | 1,072,000 | 936,000 | 1,541,000 | 1,014,000 | 1,392,000 |
| Total commercial | \$65,864,000 | \$ 7,303,000 | \$73,980,000 | \$83,863,000 | \$60,814,000 |

Retail credit exposure – credit risk profiled by collateral type:

Retail Retail

| | |
|-----------|------------|
| Home | 1-4 Family |
| Equity | Mortgages |
| and Other | |

Total retail \$34,051,000 \$94,631,000

(Continued)

35

Table of Contents

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, 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 - |
| | Land | Real Estate - | Real Estate - | Real Estate - | Multi-Family |
| | Development, | Owner | Non-Owner | Non-Owner | and |
| | and | Occupied | Occupied | Occupied | Residential |
| | Residential | | | | Rental |
| | Construction | | | | |
| Internal credit risk grade groupings: | | | | | |
| Grades 1 – 4 | \$440,219,000 | \$ 16,378,000 | \$238,890,000 | \$542,294,000 | \$29,793,000 |
| Grades 5 – 7 | 190,170,000 | 10,046,000 | 123,517,000 | 109,304,000 | 19,082,000 |
| Grades 8 – 9 | 6,382,000 | 95,000 | 1,102,000 | 456,000 | 1,170,000 |
| Total commercial | \$636,771,000 | \$ 26,519,000 | \$363,509,000 | \$652,054,000 | \$50,045,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | |
|-------------|------------|
| Retail | Retail |
| Home Equity | 1-4 Family |
| and Other | Mortgages |

Total retail \$69,831,000 \$85,819,000

(Continued)

36

Table of Contents

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 | \$40,911,000 | \$ 1,887,000 | \$36,246,000 | \$57,671,000 | \$39,574,000 |
| Grades 5 – 7 | 35,233,000 | 6,164,000 | 49,255,000 | 37,040,000 | 28,015,000 |
| Grades 8 – 9 | 988,000 | 258,000 | 1,454,000 | 1,504,000 | 249,000 |
| Total commercial | \$77,132,000 | \$ 8,309,000 | \$86,955,000 | \$96,215,000 | \$67,838,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | |
|-------------|------------|
| Retail | Retail |
| Home Equity | 1-4 Family |
| and Other | Mortgages |

Total retail \$48,216,000 \$109,407,000

(Continued)

37

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

All commercial loans are graded using the following criteria:

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

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

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

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

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

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

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

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

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

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

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

(Continued)

38

Table of Contents

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, 2017 are as follows:

| | Commercial Loans | Retail Loans | Unallocated | Total |
|---|---------------------|-----------------|-------------|------------------|
| Allowance for loan losses: | | | | |
| Balance at June 30, 2017 | \$ 15,363,000 | \$ 2,433,000 | \$ 159,000 | \$ 17,955,000 |
| Provision for loan losses | 452,000 | 415,000 | 46,000 | 913,000 |
| Charge-offs | (347,000) |) (320,000) |) 0 | (667,000) |
| Recoveries | 565,000 | 41,000 | 0 | 606,000 |
| Ending balance | \$ 16,033,000 | \$ 2,569,000 | \$ 205,000 | \$ 18,807,000 |
| Allowance for loan losses: | | | | |
| Balance at December 31, 2016 | \$ 16,026,000 | \$ 1,882,000 | \$ (40,000) |) \$ 17,868,000 |
| Provision for loan losses | 600,000 | 1,178,000 | 245,000 | 2,023,000 |
| Charge-offs | (1,579,000) |) (683,000) |) 0 | (2,262,000) |
| Recoveries | 986,000 | 192,000 | 0 | 1,178,000 |
| Ending balance | \$ 16,033,000 | \$ 2,569,000 | \$ 205,000 | \$ 18,807,000 |
| Ending balance: individually evaluated for impairment | \$ 1,856,000 | \$ 738,000 | \$ 0 | \$ 2,594,000 |
| Ending balance: collectively evaluated for impairment | \$ 14,177,000 | \$ 1,831,000 | \$ 205,000 | \$ 16,213,000 |
| Total loans: | | | | |
| Ending balance | \$ 1,922,998,000 | \$ 210,768,000 | | \$ 2,133,766,000 |

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| | | | |
|---|-----------------|---------------|-----------------|
| Ending balance: individually evaluated for impairment | \$8,320,000 | \$2,557,000 | \$10,877,000 |
| Ending balance: collectively evaluated for impairment | \$1,914,678,000 | \$208,211,000 | \$2,122,889,000 |

(Continued)

39

Table of Contents

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, 2017 is as follows:

| | Commercial Loans | Retail Loans | Unallocated | Total |
|------------------------------|---------------------|-----------------|-------------|------------|
| Allowance for loan losses: | | | | |
| Balance at June 30, 2017 | \$ 324,000 | \$ 16,000 | \$ 0 | \$ 340,000 |
| Provision for loan losses | (18,000) | 105,000 | 0 | 87,000 |
| Charge-offs | (1,000) | (41,000) | 0 | (42,000) |
| Recoveries | 1,000 | 0 | 0 | 1,000 |
| Ending balance | \$ 306,000 | \$ 80,000 | \$ 0 | \$ 386,000 |
| Allowance for loan losses: | | | | |
| Balance at December 31, 2016 | \$ 75,000 | \$ 18,000 | \$ 0 | \$ 93,000 |
| Provision for loan losses | 224,000 | 103,000 | 0 | 327,000 |
| Charge-offs | (12,000) | (41,000) | 0 | (53,000) |
| Recoveries | 19,000 | 0 | 0 | 19,000 |
| Ending balance | \$ 306,000 | \$ 80,000 | \$ 0 | \$ 386,000 |

(Continued)

Table of Contents

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 originated loans during the three and nine months ended September 30, 2016 and the recorded investments in originated loans as of December 31, 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:

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| | | | |
|---|------------------|----------------|------------------|
| Ending balance | \$ 1,728,898,000 | \$ 155,650,000 | \$ 1,884,548,000 |
| Ending balance: individually evaluated for impairment | \$ 12,070,000 | \$ 1,313,000 | \$ 13,383,000 |
| Ending balance: collectively evaluated for impairment | \$ 1,716,828,000 | \$ 154,337,000 | \$ 1,871,165,000 |

(Continued)

Table of Contents

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.

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

(Continued)

42

Table of Contents

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, 2017 were as follows:

| | | Pre- | Post- |
|--|-----------|--------------|--------------|
| | Number | Modification | Modification |
| | of | Recorded | Recorded |
| | Contracts | Principal | Principal |
| | | Balance | Balance |
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 3 | \$ 1,362,000 | \$ 1,362,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 2 | 477,000 | 477,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total originated commercial | 5 | 1,839,000 | 1,839,000 |
| Retail: | | | |
| Home equity and other | 1 | 68,000 | 68,000 |
| 1-4 family mortgages | 0 | 0 | 0 |
| Total originated retail | 1 | 68,000 | 68,000 |
| Total originated loans | 6 | \$ 1,907,000 | \$ 1,907,000 |
| <u>Acquired loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 1 | \$ 282,000 | \$ 282,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 0 | 0 | 0 |

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| | | | |
|---|---|--------------|--------------|
| Real estate – non-owner occupied | 1 | 64,000 | 64,000 |
| Real estate – multi-family and residential rental | 1 | 1,064,000 | 1,064,000 |
| Total acquired commercial | 3 | 1,410,000 | 1,410,000 |
| Retail: | | | |
| Home equity and other | 2 | 90,000 | 90,000 |
| 1-4 family mortgages | 1 | 51,000 | 51,000 |
| Total acquired retail | 3 | 141,000 | 141,000 |
| Total acquired loans | 6 | \$ 1,551,000 | \$ 1,551,000 |

(Continued)

43

Table of Contents

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, 2017 were as follows:

| | | Pre- | Post- |
|--|-----------|--------------|--------------|
| | Number | Modification | Modification |
| | of | Recorded | Recorded |
| | Contracts | Principal | Principal |
| | | Balance | Balance |
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 9 | \$ 4,114,000 | \$ 4,293,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 4 | 1,195,000 | 1,195,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total originated commercial | 13 | 5,309,000 | 5,488,000 |
| Retail: | | | |
| Home equity and other | 7 | 657,000 | 658,000 |
| 1-4 family mortgages | 0 | 0 | 0 |
| Total originated retail | 7 | 657,000 | 658,000 |
| Total originated loans | 20 | \$ 5,966,000 | \$ 6,146,000 |
| <u>Acquired loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 2 | \$ 399,000 | \$ 399,000 |
| Vacant land, land development and residential construction | 1 | 38,000 | 38,000 |
| Real estate – owner occupied | 0 | 0 | 0 |

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| | | | |
|---|----|--------------|--------------|
| Real estate – non-owner occupied | 2 | 745,000 | 744,000 |
| Real estate – multi-family and residential rental | 1 | 1,064,000 | 1,064,000 |
| Total acquired commercial | 6 | 2,246,000 | 2,245,000 |
| Retail: | | | |
| Home equity and other | 7 | 256,000 | 258,000 |
| 1-4 family mortgages | 3 | 185,000 | 185,000 |
| Total acquired retail | 10 | 441,000 | 443,000 |
| Total acquired loans | 16 | \$ 2,687,000 | \$ 2,688,000 |

(Continued)

Table of Contents

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 |
|--|---------------------------|--|---|
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 0 | \$ 0 | \$ 0 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 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 |
| <u>Acquired loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 0 | \$ 0 | \$ 0 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| 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 |

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| | | | |
|---------------------------|---|-----------|-----------|
| 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 |

(Continued)

45

Table of Contents

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 |
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 1 | \$ 20,000 | \$ 20,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 1 | 167,000 | 167,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total originated commercial | 2 | 187,000 | 187,000 |
| Retail: | | | |
| Home equity and other | 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 |
| <u>Acquired loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 0 | \$ 0 | \$ 0 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 1 | 44,000 | 44,000 |

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| | | | |
|---|---|------------|------------|
| 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 |

(Continued)

Table of Contents

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, 2017 (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, 2017 (amounts as of period end):

| | Number of | Recorded Principal |
|--|--------------|-----------------------|
|--|--------------|-----------------------|

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| | Contracts | 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 |

(Continued)

Table of Contents

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, 2017 (amounts as of period end):

| | Number of Contracts | Recorded Principal Balance |
|--|---------------------------|----------------------------------|
| Commercial: | | |
| Commercial and industrial | 1 | \$ 114,000 |
| 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 | 1 | 114,000 |
| Retail: | | |
| Home equity and other | 1 | 99,000 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 1 | 99,000 |
| Total | 2 | \$213,000 |

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, 2017 (amounts as of period end):

| | Number of | Recorded Principal |
|--|--------------|-----------------------|
|--|--------------|-----------------------|

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| | Contracts | Balance |
|--|-----------|-----------|
| Commercial: | | |
| Commercial and industrial | 1 | \$114,000 |
| 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 | 1 | 114,000 |
| Retail: | | |
| Home equity and other | 1 | 99,000 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 1 | 99,000 |
| Total | 2 | \$213,000 |

(Continued)

Table of Contents

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 Principal |
|--|--------------|-----------------------|
|--|--------------|-----------------------|

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| | Contracts | 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 |

(Continued)

Table of Contents

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 Principal |
|--|--------------|-----------------------|
|--|--------------|-----------------------|

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| | Contracts | 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 |

(Continued)

50

Table of Contents

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, 2017 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 | \$ 2,775,000 | \$ 934,000 | \$ 1,658,000 | \$ 564,000 | \$ 131,000 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (572,000) | (276,000) | (144,000) | (24,000) | (131,000) |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 858,000 | 0 | 477,000 | 0 | 0 |
| Ending Balance | \$ 3,061,000 | \$ 658,000 | \$ 1,991,000 | \$ 540,000 | \$ 0 |

| | |
|----------------|---------------|
| Retail | Retail |
| Home Equity | 1-4 Family |

| | and Other | Mortgages |
|-------------------------|-------------|------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$1,050,000 | \$ 151,000 |
| Charge-Offs | 0 | 0 |
| Payments | (17,000) | (3,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 69,000 | 0 |
| Ending Balance | \$1,102,000 | \$ 148,000 |

(Continued)

Table of Contents

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, 2017 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 | \$ 992,000 | \$ 33,000 | \$ 980,000 | \$ 914,000 | \$ 63,000 |
| Charge-Offs | 0 | 0 | (227,000) | 0 | 0 |
| Payments | (239,000) | (4,000) | (253,000) | (33,000) | (19,000) |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 280,000 | 0 | 0 | 62,000 | 1,064,000 |
| Ending Balance | \$ 1,033,000 | \$ 29,000 | \$ 500,000 | \$ 943,000 | \$ 1,108,000 |

| | |
|----------------|---------------|
| Retail | Retail |
| Home Equity | 1-4 Family |
| and Other | Mortgages |

Retail Loan Portfolio:

| | | |
|-------------------------|-----------|-----------|
| Beginning Balance | \$202,000 | \$510,000 |
| Charge-Offs | 0 | 0 |
| Payments | (8,000) | (6,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 92,000 | 50,000 |
| Ending Balance | \$286,000 | \$554,000 |

(Continued)

Table of Contents

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, 2017 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 | \$ 1,503,000 | \$ 1,488,000 | \$ 906,000 | \$ 5,110,000 | \$ 716,000 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (1,950,000) | (830,000) | (196,000) | (167,000) | (404,000) |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 3,508,000 | 0 | 1,281,000 | (4,403,000) | (312,000) |
| Ending Balance | \$ 3,061,000 | \$ 658,000 | \$ 1,991,000 | \$ 540,000 | \$ 0 |

| Retail | Retail |
|----------------|---------------|
| Home Equity | 1-4 Family |
| and Other | Mortgages |

Retail Loan Portfolio:

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| | | |
|-------------------------|--------------|------------|
| Beginning Balance | \$ 385,000 | \$ 157,000 |
| Charge-Offs | 0 | 0 |
| Payments | (69,000) | (9,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 786,000 | 0 |
| Ending Balance | \$ 1,102,000 | \$ 148,000 |

(Continued)

53

Table of Contents

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, 2017 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 | \$ 1,125,000 | \$ 0 | \$ 900,000 | \$ 728,000 | \$ 60,000 |
| Charge-Offs | 0 | 0 | (239,000) | 0 | 0 |
| Payments | (518,000) | (4,000) | (161,000) | (218,000) | (16,000) |
| Transfers to ORE | 0 | 0 | 0 | (291,000) | 0 |
| Net Additions/Deletions | 426,000 | 33,000 | 0 | 724,000 | 1,064,000 |
| Ending Balance | \$ 1,033,000 | \$ 29,000 | \$ 500,000 | \$ 943,000 | \$ 1,108,000 |

| | |
|----------------|---------------|
| Retail | Retail |
| Home Equity | 1-4 Family |

| | and Other | Mortgages |
|-------------------------|--------------|-----------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$208,000 | \$326,000 |
| Charge-Offs | (25,000) | 0 |
| Payments | (49,000) | (12,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 152,000 | 240,000 |
| Ending Balance | \$286,000 | \$554,000 |

(Continued)

Table of Contents

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 |

(Continued)

Table of Contents

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 and Other | Mortgages |
|-------------------------|----------------|----------------------------|------------|
| 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 |

(Continued)

Table of Contents

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 Equity | 1-4 Family |

| | and Other | Mortgages |
|-------------------------|--------------|------------|
| 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 |

(Continued)

Table of Contents

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 Equity | 1-4 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 |

(Continued)

Table of Contents

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, 2017 | December 31, 2016 |
|---|------------------------------|-----------------------------|
| Commercial: | | |
| Commercial and industrial | \$ 111,000 | \$9,000 |
| Vacant land, land development, and residential construction | 6,000 | 28,000 |
| Real estate – owner occupied | 157,000 | 100,000 |
| Real estate – non-owner occupied | 2,000 | 247,000 |
| Real estate – multi-family and residential rental | 0 | 258,000 |
| Total commercial | 276,000 | 642,000 |
| Retail: | | |
| Home equity and other | 187,000 | 48,000 |
| 1-4 family mortgages | 3,000 | 4,000 |
| Total retail | 190,000 | 52,000 |
| Total related allowance | \$ 466,000 | \$ 694,000 |

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.

(Continued)

59

Table of Contents

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, |
|--------------------------------|------------------|-----------------|
| | 2017 | 2016 |
| Land and improvements | \$ 17,970,000 | \$ 16,649,000 |
| Buildings | 40,245,000 | 40,327,000 |
| Furniture and equipment | 17,774,000 | 17,195,000 |
| | 75,989,000 | 74,171,000 |
| Less: accumulated depreciation | 30,383,000 | 28,715,000 |
| Premises and equipment, net | \$ 45,606,000 | \$ 45,456,000 |

Depreciation expense totaled \$0.8 million during the third quarter of 2017, compared to \$0.7 million during the third quarter of 2016. Depreciation expense totaled \$2.2 million during the first nine months of 2017 and 2016.

5. DEPOSITS

Our total deposits at September 30, 2017 totaled \$2.49 billion, an increase of \$114 million, or 4.8%, from December 31, 2016. The components of our outstanding balances at September 30, 2017 and December 31, 2016, and percentage change in deposits from the end of 2016 to the end of the third quarter of 2017, are as follows:

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| | September 30, 2017 | | December 31, 2016 | | Percent | |
|--------------------------------------|--------------------|--------|-------------------|--------|------------------------|---|
| | Balance | % | Balance | % | Increase (Decrease) | |
| Noninterest-bearing checking | \$826,038,000 | 33.2 | % \$810,600,000 | 34.1 | % 1.9 | % |
| Interest-bearing checking | 405,223,000 | 16.3 | 377,929,000 | 15.9 | 7.2 | |
| Money market | 404,336,000 | 16.2 | 272,051,000 | 11.5 | 48.6 | |
| Savings | 333,495,000 | 13.4 | 344,988,000 | 14.5 | (3.3 |) |
| Time, under \$100,000 | 151,049,000 | 6.1 | 146,169,000 | 6.2 | 3.3 | |
| Time, \$100,000 and over | 264,247,000 | 10.6 | 347,058,000 | 14.6 | (23.9 |) |
| Total local deposits | 2,384,388,000 | 95.8 | 2,298,795,000 | 96.8 | 3.7 | |
| Out-of-area time, under \$100,000 | 0 | NA | 0 | NA | NA | |
| Out-of-area time, \$100,000 and over | 104,655,000 | 4.2 | 76,190,000 | 3.2 | 37.4 | |
| Total out-of-area deposits | 104,655,000 | 4.2 | 76,190,000 | 3.2 | 37.4 | |
| Total deposits | \$2,489,043,000 | 100.0% | \$2,374,985,000 | 100.0% | 4.8 | % |

Total time deposits of more than \$250,000 totaled \$269 million and \$214 million at September 30, 2017 and December 31, 2016, respectively.

(Continued)

Table of Contents

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, 2017 | Twelve Months Ended December 31, 2016 | | |
|---|--|---|---|---|
| Outstanding balance at end of period | \$ 122,280,000 | \$ 131,710,000 | | |
| Average interest rate at end of period | 0.16 | 0.16 | % | % |
| Average daily balance during the period | \$ 116,947,000 | \$ 149,079,000 | | |
| Average interest rate during the period | 0.16 | 0.14 | % | % |
| Maximum daily balance during the period | \$ 142,459,000 | \$ 175,088,000 | | |

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 \$220 million at September 30, 2017, and mature at varying dates from May 2018 through April 2024, with fixed rates of interest from 1.04% to 2.39% and averaging 1.72%. FHLBI advances totaled \$175 million at December 31, 2016, and were expected to mature at varying dates ranging from March 2017 through April 2023, with fixed rates of interest from 1.04% to 2.11% and averaging 1.48%.

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, 2017 totaled approximately \$650 million, with remaining availability based on collateral approximating \$430 million.

Maturities of currently outstanding FHLBI advances are as follows:

| | |
|------------|------------|
| 2017 | \$0 |
| 2018 | 20,000,000 |
| 2019 | 40,000,000 |
| 2020 | 30,000,000 |
| 2021 | 40,000,000 |
| Thereafter | 90,000,000 |

(Continued)

Table of Contents

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, 2017 and December 31, 2016.

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at September 30, 2017 and December 31, 2016 follows:

| | September 30, 2017 | December 31, 2016 |
|---|------------------------------|--------------------------|
| Commercial unused lines of credit | \$687,396,000 | \$553,345,000 |
| Unused lines of credit secured by 1 – 4 family residential properties | 60,564,000 | 56,275,000 |

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| | | |
|---------------------------------------|---------------|---------------|
| Credit card unused lines of credit | 37,258,000 | 22,689,000 |
| Other consumer unused lines of credit | 15,575,000 | 8,489,000 |
| Commitments to make loans | 130,455,000 | 154,338,000 |
| Standby letters of credit | 26,956,000 | 26,202,000 |
| | \$958,204,000 | \$821,338,000 |

Certain of our commercial loan customers had previously 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 had entered into risk participation agreements with the correspondent banks whereby we agreed 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 did not make the payments. We were not a party to the interest rate swap agreements under these arrangements. As of September 30, 2017, all such interest rate swap agreements had been terminated by our commercial loan customers. These risk participation agreements were considered financial guarantees in accordance with applicable accounting guidance and were therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities were accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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.

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, 2017 and December 31, 2016, the fair value of the interest rate swap agreement was recorded as a liability in the amount of less than \$0.1 million.

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

(Continued)

Table of Contents

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, 2017 and December 31, 2016 (dollars in thousands):

| | Level in Fair Value Hierarchy | September 30, 2017 | | December 31, 2016 | |
|-------------------------------|--|--------------------|----------------|--------------------|----------------|
| | | Carrying Values | Fair Values | Carrying Values | Fair Values |
| Financial assets: | | | | | |
| Cash | Level 1 | \$11,389 | \$11,389 | \$11,493 | \$11,493 |
| Cash equivalents | Level 2 | 165,662 | 165,662 | 172,103 | 172,103 |
| Securities available for sale | (1) | 330,090 | 330,090 | 328,060 | 328,060 |
| FHLBI stock | (2) | 11,036 | 11,036 | 8,026 | 8,026 |
| Loans, net | Level 3 | 2,530,967 | 2,513,324 | 2,359,624 | 2,353,276 |
| Loans held for sale | Level 2 | 4,112 | 4,112 | 1,035 | 1,035 |
| Mortgage servicing rights | Level 2 | 5,195 | 8,076 | 5,544 | 7,997 |
| Accrued interest receivable | Level 2 | 9,118 | 9,118 | 7,714 | 7,714 |
| Financial liabilities: | | | | | |
| Deposits | Level 2 | 2,489,043 | 2,375,476 | 2,374,985 | 2,286,548 |
| Repurchase agreements | Level 2 | 122,280 | 122,280 | 131,710 | 131,710 |
| FHLBI advances | Level 2 | 220,000 | 221,103 | 175,000 | 174,734 |
| Subordinated debentures | Level 2 | 45,347 | 45,390 | 44,835 | 45,220 |
| Accrued interest payable | Level 2 | 1,823 | 1,823 | 1,592 | 1,592 |
| Interest rate swap | (1) | 15 | 15 | 84 | 84 |

(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, 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. The fair value of mortgage servicing rights is estimated using a valuation model that calculates the present value of estimated future net servicing cash flows, taking into consideration expected mortgage loan prepayment rates, discount rates, servicing costs and other economic factors, which are determined based on current market conditions. 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.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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.

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, 2017 or December 31, 2016. We have no Level 1 securities available for sale.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. FAIR VALUES (Continued)

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, 2017 and December 31, 2016, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$4.1 million and \$1.0 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. The fair values of impaired loans are determined using either the sales comparison approach or income approach; respective unobservable inputs for the approaches consist of adjustments for differences between comparable sales and the utilization of appropriate capitalization rates.

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. The fair values of parcels of other real estate owned are determined using either the sales comparison approach or income approach; respective unobservable inputs for the approaches consist of adjustments for differences between comparable sales and the utilization of appropriate capitalization rates.

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, 2017 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 | \$ 161,168,000 | \$ 0 | \$ 161,168,000 | \$ 0 |
| Mortgage-backed securities | 39,495,000 | 0 | 39,495,000 | 0 |
| Municipal general obligation bonds | 123,310,000 | 0 | 118,084,000 | 5,226,000 |
| Municipal revenue bonds | 4,134,000 | 0 | 4,134,000 | 0 |
| Other investments | 1,983,000 | 0 | 1,983,000 | 0 |
| Interest rate swap | (15,000) | 0 | (15,000) | 0 |
| Total | \$ 330,075,000 | \$ 0 | \$ 324,849,000 | \$ 5,226,000 |

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. FAIR VALUES (Continued)

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first nine months of 2017.

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 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 | \$ 152,040,000 | \$ 0 | \$ 152,040,000 | \$ 0 |
| Mortgage-backed securities | 47,392,000 | 0 | 47,392,000 | 0 |
| Municipal general obligation bonds | 119,047,000 | 0 | 112,648,000 | 6,399,000 |
| Municipal revenue bonds | 7,631,000 | 0 | 7,631,000 | 0 |
| Other investments | 1,950,000 | 0 | 1,950,000 | 0 |
| Interest rate swap | (84,000) | 0 | (84,000) | 0 |
| Total | \$327,976,000 | \$ 0 | \$321,577,000 | \$ 6,399,000 |

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

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, 2017 are as follows:

| | | Quoted | | |
|-------------------|-------------|-----------|-------------|--------------|
| | | Prices in | Significant | |
| | | Active | Other | Significant |
| | Total | Markets | Observable | Unobservable |
| | | for | Inputs | Inputs |
| | | Identical | (Level 2) | (Level 3) |
| | | Assets | (Level 2) | (Level 3) |
| | | (Level 1) | | |
| Impaired loans | \$6,915,000 | \$ 0 | \$ 0 | \$ 6,915,000 |
| Foreclosed assets | 2,327,000 | 0 | 0 | 2,327,000 |
| Total | \$9,242,000 | \$ 0 | \$ 0 | \$ 9,242,000 |

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. FAIR VALUES (Continued)

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2016 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 | \$9,896,000 | \$ 0 | \$ 0 | \$ 9,896,000 |
| Foreclosed assets | 469,000 | 0 | 0 | 469,000 |
| Total | \$10,365,000 | \$ 0 | \$ 0 | \$ 10,365,000 |

The carrying values are based on the estimated value of the property or other assets. Fair value estimates of collateral on impaired loans and foreclosed assets are reviewed periodically. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside appraisals and internal evaluations based on identifiable trends within our markets, such as sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address current distressed market conditions. For real estate dependent loans and foreclosed assets, we generally assign a 15% to 25% discount

factor for commercial-related properties, and a 25% to 50% discount factor for residential-related properties. In a vast majority of cases, we assign a 10% discount factor for estimated selling costs.

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.

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, 2017 and December 31, 2016, 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, 2017 that we believe have changed our bank's categorization.

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REGULATORY MATTERS (Continued)

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

| | Actual | | Minimum Required for Capital Adequacy Purposes | | Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations | |
|--|-----------|--------|--|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <u>September 30, 2017</u> | | | | | | |
| Total capital (to risk weighted assets) | | | | | | |
| Consolidated | \$373,280 | 12.7 % | \$235,921 | 8.0 % | NA | NA |
| Bank | 368,143 | 12.5 | 235,709 | 8.0 | 294,636 | 10.0 % |
| Tier 1 capital (to risk weighted assets) | | | | | | |
| Consolidated | 354,087 | 12.0 | 176,941 | 6.0 | NA | NA |
| Bank | 348,949 | 11.8 | 176,782 | 6.0 | 235,709 | 8.0 |
| Common equity tier 1 (to risk weighted assets) | | | | | | |
| Consolidated | 310,814 | 10.5 | 132,706 | 4.5 | NA | NA |
| Bank | 348,949 | 11.8 | 132,587 | 4.5 | 191,514 | 6.5 |
| Tier 1 capital (to average assets) | | | | | | |
| Consolidated | 354,087 | 11.2 | 126,664 | 4.0 | NA | NA |
| Bank | 348,949 | 11.0 | 126,583 | 4.0 | 158,228 | 5.0 |

December 31, 2016

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| | | | | | | | |
|--|-----------|--------|-----------|-------|---------|--------|--|
| Total capital (to risk weighted assets) | | | | | | | |
| Consolidated | \$354,278 | 13.1 % | \$215,819 | 8.0 % | \$NA | NA | |
| Bank | 353,243 | 13.1 | 215,605 | 8.0 | 269,506 | 10.0 % | |
| Tier 1 capital (to risk weighted assets) | | | | | | | |
| Consolidated | 336,316 | 12.5 | 161,864 | 6.0 | NA | NA | |
| Bank | 335,282 | 12.4 | 161,704 | 6.0 | 215,605 | 8.0 | |
| Common equity tier 1 (to risk weighted assets) | | | | | | | |
| Consolidated | 293,555 | 10.9 | 121,398 | 4.5 | NA | NA | |
| Bank | 335,282 | 12.4 | 121,278 | 4.5 | 175,179 | 6.5 | |
| Tier 1 capital (to average assets) | | | | | | | |
| Consolidated | 336,316 | 11.2 | 120,486 | 4.0 | NA | NA | |
| Bank | 335,282 | 11.1 | 120,383 | 4.0 | 150,479 | 5.0 | |

(Continued)

Table of Contents

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REGULATORY MATTERS (Continued)

Our consolidated capital levels as of September 30, 2017 and December 31, 2016 include \$43.3 million and \$42.8 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, 2017 and December 31, 2016, all \$43.3 million and \$42.8 million, respectively, of the trust preferred securities were included in our consolidated Tier 1 capital.

Under the final BASEL III capital rules that became effective on January 1, 2015, there is a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not meet this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in cash dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5% and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. We believe that, as of September 30, 2017, our bank would meet all capital adequacy requirements under the BASEL III capital rules on a fully phased-in basis as if all such requirements were currently in effect.

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 12, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.18 per share that was paid on March 22, 2017 to shareholders of record as of March 10, 2017. On April 13, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.18 per share that was paid on June 21, 2017 to shareholders of record as of June 9, 2017. On July 13, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.19 per share that was paid on September 20, 2017 to shareholders of record as of September 8, 2017. On October 12, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.19 per share that will be paid on

December 20, 2017 to shareholders of record as of December 8, 2017.

On January 30, 2015, we announced that our Board of Directors had authorized a 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 a \$15.0 million expansion of the stock repurchase plan. Since inception, we have purchased a total of 956,419 shares at a total price of \$19.5 million, at an average price per share of \$20.38; no shares were purchased under the authorized plan during the first nine months of 2017. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan, which would also likely be funded from cash dividends paid to us from our bank.

Table of Contents

MERCANTILE BANK CORPORATION

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

Forward Looking Statements

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

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2016 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, 2017 and December 31, 2016 and the results of operations for the three months and nine months ended September 30, 2017 and September 30, 2016. 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-42 through F-49 in our Form 10-K for the fiscal year ended December 31, 2016 (Commission file number 000-26719). Our critical accounting policies 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.

Table of Contents

MERCANTILE BANK CORPORATION

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

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

Income Tax Accounting: Current income tax assets and liabilities are established for the amount of taxes payable or refundable for the current year. In the preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome may be uncertain. We periodically review and evaluate the status of our tax positions and make adjustments as necessary. Deferred income tax assets and liabilities are also established for the future tax consequences of events that have been recognized in our financial statements or tax returns. A deferred income tax asset or liability is recognized for the estimated future tax effects attributable to temporary differences that can be carried forward (used) in future years. The valuation of our net deferred income tax

asset is considered critical as it requires us to make estimates based on provisions of the enacted tax laws. The assessment of the realizability of the net deferred income tax asset involves the use of estimates, assumptions, interpretations and judgments concerning accounting pronouncements, federal and state tax codes and the extent of future taxable income. There can be no assurance that future events, such as court decisions, positions of federal and state tax authorities, and the extent of future taxable income will not differ from our current assessment, the impact of which could be significant to the consolidated results of operations and reported earnings.

Table of Contents

MERCANTILE BANK CORPORATION

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

Securities and Other Financial Instruments: Securities available for sale consist of bonds and notes which might be sold prior to maturity due to changes in interest rates, 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.

Table of Contents

MERCANTILE BANK CORPORATION

Financial Overview

We reported net income of \$8.3 million, or \$0.51 per diluted share, for the third quarter of 2017. During the third quarter of 2016, we earned \$7.8 million, or \$0.48 per diluted share. Net income for the first nine months of 2017 totaled \$23.3 million, or \$1.41 per diluted share, compared to \$23.8 million, or \$1.46 per diluted share, during the first nine months of 2016. Excluding the impacts of certain noncore transactions, including a bank owned life insurance death benefit claim during the first quarter of 2017, the repurchase of trust preferred securities at a large discount during the first quarter of 2016, and accelerated purchase discount accretion on called U.S. Government agency bonds during the first nine months of 2016, diluted earnings per share during the first nine months of 2017 and 2016 equaled \$1.34 and \$1.27, respectively.

The overall quality of our loan portfolio remains strong, with continued low levels of nonperforming assets and net loan charge-offs. Nonperforming assets as a percent of total assets equaled only 32 basis points as of the end of the third quarter of 2017. Of the \$3.3 million net increase in nonperforming assets during the third quarter, nearly one-half is associated with a transfer of a bank-owned facility that is no longer being considered for use in bank operations to the other real estate owned category. We expect to sell the facility within the next six months at a price that approximates its current carrying value. Gross loan charge-offs equaled \$0.7 million during the third quarter of 2017, and totaled \$2.3 million for the first nine months of the year, while recoveries of prior period loan charge-offs equaled \$0.6 million and \$1.2 million during the respective time periods. Net loan charge-offs, as a percent of average total loans, equaled an annualized 0.02% and 0.06% during the third quarter and first nine months of 2017, respectively. 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 \$128 million during the third quarter of 2017, bringing the year-to-date total to approximately \$410 million. We also generally 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 \$27.0 million and \$176 million during the third quarter and first nine months of 2017, respectively. The new loan pipeline remains strong, and at September 30, 2017, we had \$163 million in unfunded loan commitments on commercial construction and development projects that are in the construction phase. We believe our loan portfolio remains well diversified, with commercial real estate non-owner occupied loans comprising 32%, commercial and industrial loans equaling 30%, commercial real estate owner occupied loans comprising 19% and residential mortgage and consumer loans aggregating 13% of total loans at September 30, 2017. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans combined equaled 57% at September 30, 2017.

We recorded a provision for loan losses of \$1.0 million during the third quarter of 2017, in large part driven by an increased allocation relating to our economic conditions environmental factor and commercial loan growth. The provision for loan losses totaled \$2.4 million for the first nine months of 2017, slightly higher than the \$2.3 million expensed during the first nine months of 2016, primarily driven by commercial loan growth.

We believe our funding structure also remains well diversified. As of September 30, 2017, noninterest-bearing checking accounts comprised 29% of total funds, interest-bearing checking and sweep accounts combined for 19%, savings deposits and money market accounts aggregated to 26% and local time deposits accounted for 15%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank of Indianapolis (“FHLBI”) advances, represented 11% of total funds.

Financial Condition

Our total assets increased \$172 million during the first nine months of 2017, and totaled \$3.25 billion as of September 30, 2017. Total loans increased \$176 million and securities available for sale were up \$2.0 million, while cash and cash equivalents decreased \$6.5 million. Total deposits increased \$114 million and FHLBI advances were up \$45.0 million, while securities sold under agreements to repurchase (“sweep accounts”) were down \$9.4 million during the first nine months of 2017. A majority of our deposit growth resulted from increases in noninterest-bearing checking accounts associated with commercial and industrial loan growth and from increases in money market deposit accounts associated with product enhancements. The increase in FHLBI advances generally reflects new advances obtained to fund loan growth.

Table of Contents

MERCANTILE BANK CORPORATION

Commercial loans increased \$149 million during the first nine months of 2017, and at September 30, 2017 totaled \$2.21 billion, or 86.7% of the loan portfolio. As of December 31, 2016, the commercial loan portfolio comprised 86.8% of total loans. The increase in commercial loans during the first nine months of 2017 primarily reflects new commercial term loans to existing and new borrowers. Commercial and industrial loans were up \$62.7 million, non-owner occupied commercial real estate (“CRE”) loans increased \$56.9 million, owner occupied CRE loans grew \$34.9 million, multi-family and residential rental loans grew \$1.3 million and vacant land, land development and residential construction loans declined \$6.3 million. As a percent of total commercial loans, commercial and industrial loans and owner occupied CRE loans combined equaled 57.0% as of September 30, 2017, compared to 56.4% at December 31, 2016.

We are very pleased with the approximately \$1.6 billion in new commercial term loan fundings since the beginning of 2015, including approximately \$410 million during the first nine months of 2017. As of September 30, 2017, availability on existing construction and development loans totaled \$163 million, which we expect to be drawn over the next 12 to 18 months. Our loan pipeline reports indicate continued strong commercial loan funding opportunities in future periods, including approximately \$130 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. Usage of existing commercial lines of credit has remained relatively steady.

One-to-four family mortgage loans increased \$40.8 million during the first nine months of 2017, and at September 30, 2017, totaled \$236 million, or 9.3% of total loans. The increase primarily reflects a strategic initiative to enhance our mortgage banking operations, and generally consists of mortgage loans that have a fixed rate for the initial five to seven year period and then convert to an adjustable rate that is subject to reset annually thereafter. Home equity and other consumer loans declined \$14.7 million during the first nine months of 2017, and at September 30, 2017, totaled \$103 million, or 4.0% of total loans. One-to-four family mortgage loans and home equity and other consumer loans equated to 8.2% and 5.0% of total loans as of December 31, 2016, respectively.

75

Table of Contents

MERCANTILE BANK CORPORATION

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

| | 9/30/17 | 6/30/17 | 3/31/17 | 12/31/16 | 9/30/16 |
|------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Commercial: | | | | | |
| Commercial & Industrial | \$776,563,000 | \$780,816,000 | \$757,220,000 | \$713,903,000 | \$750,330,000 |
| Land Development & Construction | 28,575,000 | 29,027,000 | 31,924,000 | 34,828,000 | 37,455,000 |
| Owner Occupied Commercial RE | 485,347,000 | 491,633,000 | 452,382,000 | 450,464,000 | 440,704,000 |
| Non-Owner Occupied Commercial RE | 805,167,000 | 783,036,000 | 768,565,000 | 748,269,000 | 741,444,000 |
| Multi-Family & Residential Rental | 119,170,000 | 114,081,000 | 113,257,000 | 117,883,000 | 118,103,000 |
| Total Commercial | 2,214,822,000 | 2,198,593,000 | 2,123,348,000 | 2,065,347,000 | 2,088,036,000 |
| Retail: | | | | | |
| 1-4 Family Mortgages | 236,074,000 | 220,697,000 | 205,849,000 | 195,226,000 | 190,715,000 |
| Home Equity & Other Consumer Loans | 103,376,000 | 107,991,000 | 112,117,000 | 118,047,000 | 127,626,000 |
| Total Retail | 339,450,000 | 328,688,000 | 317,966,000 | 313,273,000 | 318,341,000 |
| Total | \$2,554,272,000 | \$2,527,281,000 | \$2,441,314,000 | \$2,378,620,000 | \$2,406,377,000 |

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 other real estate owned, totaled \$10.6 million (0.3% of total assets) as of September 30, 2017, compared to \$6.4 million (0.2% of total assets) as of December 31, 2016. At September 30, 2017, nonperforming loans totaled \$8.2 million and other real estate owned equaled \$2.4 million, the latter of which includes a facility with a carrying value of \$1.6 million that was transferred from fixed assets to other estate owned during the third quarter. This facility, located near our main office, was originally acquired for potential future bank operations; however, we recently decided we no longer need the facility for that purpose. We expect to sell this facility within the next six months at a price that approximates the carrying value. Given the low level of nonperforming loans and accruing loans 30 to 89 days delinquent, combined with the manageable and steady level of watch list credits and what we believe are strong credit administration practices, we remain pleased with the overall quality of the loan portfolio.

Table of Contents

MERCANTILE BANK CORPORATION

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

NONPERFORMING LOANS

| | 9/30/17 | 6/30/17 | 3/31/17 | 12/31/16 | 9/30/16 |
|--------------------------|-------------|-------------|-------------|-------------|-------------|
| Residential Real Estate: | | | | | |
| Land Development | \$0 | \$0 | \$0 | \$16,000 | \$23,000 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied / Rental | 3,403,000 | 3,192,000 | 2,787,000 | 2,739,000 | 2,661,000 |
| | 3,403,000 | 3,192,000 | 2,787,000 | 2,755,000 | 2,684,000 |
| Commercial Real Estate: | | | | | |
| Land Development | 50,000 | 65,000 | 80,000 | 95,000 | 110,000 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied | 2,583,000 | 1,052,000 | 911,000 | 285,000 | 1,109,000 |
| Non-Owner Occupied | 46,000 | 47,000 | 421,000 | 488,000 | 673,000 |
| | 2,679,000 | 1,164,000 | 1,412,000 | 868,000 | 1,892,000 |
| Non-Real Estate: | | | | | |
| Commercial Assets | 2,126,000 | 2,081,000 | 3,076,000 | 2,293,000 | 65,000 |
| Consumer Assets | 23,000 | 13,000 | 17,000 | 23,000 | 28,000 |
| | 2,149,000 | 2,094,000 | 3,093,000 | 2,316,000 | 93,000 |
| Total | \$8,231,000 | \$6,450,000 | \$7,292,000 | \$5,939,000 | \$4,669,000 |

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

| | 9/30/17 | 6/30/17 | 3/31/17 | 12/31/16 | 9/30/16 |
|--------------------------|---------|---------|---------|----------|---------|
| Residential Real Estate: | | | | | |
| Land Development | \$0 | \$0 | \$0 | \$0 | \$0 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied / Rental | 245,000 | 175,000 | 185,000 | 144,000 | 284,000 |
| | 245,000 | 175,000 | 185,000 | 144,000 | 284,000 |
| Commercial Real Estate: | | | | | |
| Land Development | 0 | 0 | 0 | 0 | 0 |
| Construction | 0 | 0 | 0 | 0 | 0 |

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| | | | | | |
|--------------------|-------------|-----------|-----------|-----------|-----------|
| Owner Occupied | 2,044,000 | 261,000 | 310,000 | 325,000 | 488,000 |
| Non-Owner Occupied | 38,000 | 353,000 | 0 | 0 | 18,000 |
| | 2,082,000 | 614,000 | 310,000 | 325,000 | 506,000 |
| Non-Real Estate: | | | | | |
| Commercial Assets | 0 | 0 | 0 | 0 | 0 |
| Consumer Assets | 0 | 0 | 0 | 0 | 0 |
| | 0 | 0 | 0 | 0 | 0 |
| Total | \$2,327,000 | \$789,000 | \$495,000 | \$469,000 | \$790,000 |

Table of Contents

MERCANTILE BANK CORPORATION

The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

| | 3rd Qtr 2017 | 2nd Qtr 2017 | 1st Qtr 2017 | 4th Qtr 2016 | 3rd Qtr 2016 |
|------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Beginning balance | \$6,450,000 | \$7,292,000 | \$5,939,000 | \$4,669,000 | \$5,168,000 |
| Additions, net of transfers to ORE | 3,081,000 | 1,279,000 | 2,890,000 | 2,932,000 | 1,111,000 |
| Returns to performing status | (120,000) | 0 | (113,000) | (13,000) | 0 |
| Principal payments | (1,089,000) | (1,168,000) | (1,289,000) | (1,386,000) | (1,509,000) |
| Loan charge-offs | (91,000) | (953,000) | (135,000) | (263,000) | (101,000) |
| Total | \$8,231,000 | \$6,450,000 | \$7,292,000 | \$5,939,000 | \$4,669,000 |

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS
RECONCILIATION

| | 3rd Qtr 2017 | 2nd Qtr 2017 | 1st Qtr 2017 | 4th Qtr 2016 | 3rd Qtr 2016 |
|-----------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Beginning balance | \$789,000 | \$495,000 | \$469,000 | \$790,000 | \$815,000 |
| Additions | 1,918,000 | 511,000 | 97,000 | 54,000 | 61,000 |
| Sale proceeds | (373,000) | (147,000) | (56,000) | (308,000) | (76,000) |
| Valuation write-downs | (7,000) | (70,000) | (15,000) | (67,000) | (10,000) |
| Total | \$2,327,000 | \$789,000 | \$495,000 | \$469,000 | \$790,000 |

Gross loan charge-offs equaled \$0.7 million during the third quarter of 2017, and totaled \$2.3 million for the first nine months of the year, while recoveries of prior period loan charge-offs equaled \$0.6 million and \$1.2 million during the respective time periods. Net loan charge-offs, as a percent of average total loans, equaled an annualized 0.02% and 0.06% during the third quarter and first nine months of 2017, respectively. Loan charge-offs related to one commercial loan relationship, recorded during the second quarter, accounted for approximately one-half of the gross loan charge-off amount during the first nine months of 2017. 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.

Table of Contents

MERCANTILE BANK CORPORATION

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, 2017. 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. During the third quarter of 2017, we adjusted the economic conditions environmental factor, which resulted in an increased loan loss reserve level of \$0.6 million.

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 \$18.8 million as of September 30, 2017, or 0.9% of total originated loans outstanding, compared to \$17.9 million, or 0.9% of total originated loans outstanding at December 31, 2016. We also had an allowance for acquired loans as of September 30, 2017 and December 31, 2016, equaling \$0.4 million and \$0.1 million, respectively. The allowance equaled 233% of nonperforming loans as of September 30, 2017, compared to 302% as of December 31, 2016.

Table of Contents

MERCANTILE BANK CORPORATION

As of September 30, 2017, the allowance for originated loans was comprised of \$16.2 million in general reserves relating to non-impaired loans, \$2.1 million in specific reserve allocations relating to nonaccrual loans, and \$0.5 million in specific reserves on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$12.0 million at September 30, 2017, consisting of \$2.6 million that are on nonaccrual status and \$9.4 million that are on accrual status. The latter, while considered and accounted for as impaired loans in accordance with accounting guidelines, is not included in our nonperforming loan totals. Impaired loans with an aggregate carrying value of \$0.6 million as of September 30, 2017 had been subject to previous partial charge-offs aggregating \$0.7 million. Those partial charge-offs were recorded as follows: \$0.1 million in 2017, less than \$0.1 million in 2016, 2015, 2013 and 2012, \$0.4 million in 2011 and \$0.2 million in 2010. As of September 30, 2017, 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:

| | 9/30/17 | 6/30/17 | 3/31/17 | 12/31/16 | 9/30/16 |
|---------------|--------------|--------------|--------------|--------------|--------------|
| Performing | \$9,350,000 | \$9,982,000 | \$11,497,000 | \$12,480,000 | \$17,717,000 |
| Nonperforming | 2,603,000 | 975,000 | 731,000 | 1,132,000 | 1,630,000 |
| Total | \$11,953,000 | \$10,957,000 | \$12,228,000 | \$13,612,000 | \$19,347,000 |

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 increased \$2.0 million during the first nine months of 2017, totaling \$330 million as of September 30, 2017. Purchases during the first nine months of 2017, consisting almost exclusively of U.S. Government agency bonds (\$23.7 million), U.S. Government issued or guaranteed mortgage-backed securities (\$7.8 million) and municipal bonds (\$18.8 million), totaled \$50.3 million. Proceeds from matured and called U.S. Government agency bonds and municipal bonds during the first nine months of 2017 totaled \$17.3 million and \$18.4 million, respectively, with another \$10.4 million from principal paydowns on U.S. Government agency issued or guaranteed mortgage-backed securities. In addition, proceeds from the sale of U.S. Government agency issued or guaranteed mortgage-backed securities and municipal bonds totaled \$5.0 million and \$1.7 million, respectively. At September 30, 2017, the portfolio was primarily comprised of U.S. Government agency bonds (49%), municipal bonds (39%) and U.S. Government agency issued or guaranteed mortgage-backed securities (12%). 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, 2017 totaled \$330 million, including a net unrealized loss of \$2.7 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 2017 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 \$11.0 million as of September 30, 2017, compared to \$8.0 million as of December 31, 2016. The \$3.0 million increase reflects additional stock purchased in association with an increase in outstanding advances during the first nine months of 2017. 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.

Table of Contents

MERCANTILE BANK CORPORATION

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

Interest-bearing balances, primarily consisting of excess funds deposited at the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate sensitivity. During the first nine months of 2017, the average balance of these funds equaled \$75.0 million, or 2.6% of average earning assets. We expect the level of these funds to average approximately 1% to 2% of average earning assets in future quarters.

Net premises and equipment equaled \$45.6 million at September 30, 2017, an increase of \$0.1 million during the first nine months of 2017. Net purchases during the first nine months of 2017 totaled \$4.2 million, while depreciation expense aggregated to \$2.2 million. Other real estate owned equaled \$2.3 million as of September 30, 2017, compared to \$0.5 million as of December 31, 2016. During the third quarter of 2017, a facility with a carrying value of \$1.6 million was transferred from fixed assets to other estate owned. This facility, located near our main office, was originally acquired for potential future bank operations; however, we recently decided we no longer need the facility for that purpose. We expect to sell this facility within the next six months at a price that approximates the carrying value. While we expect further transfers from loans to other real estate owned 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 \$114 million during the first nine months of 2017, totaling \$2.49 billion at September 30, 2017. Out-of-area deposits increased \$28.5 million during the first nine months of 2017, and as a percent of total deposits, equaled 4.2% as of September 30, 2017, compared to 3.2% as of December 31, 2016.

Noninterest-bearing checking accounts increased \$15.4 million during the first nine months of 2017, in large part reflecting growth from deposit account openings as part of recently established commercial lending relationships and transfers from closed sweep accounts. Interest-bearing checking accounts increased \$27.3 million, while savings deposits declined \$11.5 million. Money market deposit accounts increased \$132 million, while local time deposits \$100,000 and over declined \$82.8 million, in large part reflecting one depositor transferring their funds from time

deposits to money market accounts. This negotiated transfer was completed at the request of the depositor to ease recordkeeping burdens; although the funds are no longer in time deposit products, we believe the stability of this long-standing deposit relationship is unchanged. In addition, money market deposit accounts increased due to an enhanced high balance money market deposit account product offering. Local time deposits under \$100,000 increased \$4.9 million.

Sweep accounts decreased \$9.4 million during the first nine months of 2017, totaling \$122 million as of September 30, 2017. Total balances in this product have been on a declining trend over the past few years, in large part reflecting customers closing sweep accounts and depositing the funds into stand-alone noninterest-bearing checking accounts. 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 \$45.0 million during the first nine months of 2017, reflecting new advances obtained primarily to fund loan growth. As of September 30, 2017, FHLBI advances totaled \$220 million. The FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio and certain commercial real estate loans. Our borrowing line of credit as of September 30, 2017 totaled approximately \$650 million, with remaining availability approximating \$430 million.

Table of Contents

MERCANTILE BANK CORPORATION

Shareholders' equity was \$363 million at September 30, 2017, compared to \$341 million at December 31, 2016. The \$21.7 million increase during the first nine months of 2017 primarily reflects the positive impact of net income totaling \$23.3 million and the negative impact of cash dividends on common shares totaling \$8.9 million. Also positively impacting shareholder's equity during the first nine months of 2017 was a \$3.8 million after-tax decline in our net unrealized loss on available for sale securities and an aggregate \$1.4 million sale of common stock via our cash dividend reinvestment plan.

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 \$325 million, or 11.5% of combined deposits and borrowed funds, as of September 30, 2017, compared to \$251 million, or 9.4% of combined deposits and borrowed funds, as of December 31, 2016. The increase in wholesale funds primarily reflects new brokered deposits and FHLBI advances obtained during the first nine months of 2017 to assist in funding loan growth.

Sweep accounts decreased \$9.4 million during the first nine months of 2017, totaling \$122 million as of September 30, 2017. Total balances in this product have been on a declining trend over the past few years, in large part reflecting customers closing sweep accounts and depositing the funds into stand-alone noninterest-bearing checking accounts. 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, 2017 and during the first nine months of 2017 is as follows:

| | | |
|--|----------------|---|
| Outstanding balance at September 30, 2017 | \$ 122,280,000 | |
| Weighted average interest rate at September 30, 2017 | 0.16 | % |

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| | |
|---|----------------|
| Maximum daily balance nine months ended September 30, 2017 | \$ 142,459,000 |
| Average daily balance for nine months ended September 30, 2017 | \$ 116,947,000 |
| Weighted average interest rate for nine months ended September 30, 2017 | 0.16 % |

As a member of FHLBI, we have access to FHLBI advance borrowing programs. FHLBI advances increased \$45.0 million during the first nine months of 2017, reflecting new advances primarily obtained to assist in funding loan growth. As of September 30, 2017, FHLBI advances totaled \$220 million, and based on available collateral we could borrow an additional \$430 million.

We also have the ability to borrow up to \$50.0 million on a daily basis through a correspondent bank using an established unsecured federal funds purchased line of credit. To provide temporary liquidity, we accessed this line of credit on two occasions in early 2017, the first instances since January of 2010. In contrast, our interest-bearing deposit balance with the Federal Reserve Bank of Chicago averaged \$72.7 million during the first nine months of 2017. 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 \$20.3 million as of September 30, 2017. We did not utilize this line of credit during the first nine months of 2017 or at any time during the previous eight fiscal years, and do not plan to access this line of credit in future periods.

Table of Contents

MERCANTILE BANK CORPORATION

The following table reflects, as of September 30, 2017, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

| | One Year or Less | One to Three Years | Three to Five Years | Over Five Years | Total |
|------------------------------------|---------------------|-----------------------|------------------------|--------------------|-----------------|
| Deposits without a stated maturity | \$1,969,092,000 | \$0 | \$0 | \$0 | \$1,969,092,000 |
| Time deposits | 287,089,000 | 152,173,000 | 80,689,000 | 0 | 519,951,000 |
| Short-term borrowings | 122,280,000 | 0 | 0 | 0 | 122,280,000 |
| Federal Home Loan Bank advances | 50,000,000 | 40,000,000 | 70,000,000 | 60,000,000 | 220,000,000 |
| Subordinated debentures | 0 | 0 | 0 | 45,347,000 | 45,347,000 |
| Other borrowed money | 0 | 0 | 0 | 3,241,000 | 3,241,000 |
| Property leases | 384,000 | 537,000 | 349,000 | 277,000 | 1,547,000 |

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, 2017, we had a total of \$931 million in unfunded loan commitments and \$27.0 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$801 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$130 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.

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 \$363 million at September 30, 2017, compared to \$341 million at December 31, 2016. The \$21.7 million increase during the first nine months of 2017 primarily reflects the positive impact of net income totaling \$23.3 million and the negative impact of cash dividends on common shares totaling \$8.9 million. Also positively impacting shareholder's equity during the first nine months of 2017 was a \$3.8 million after-tax decline in our net unrealized loss on available for sale securities and an aggregate \$1.4 million sale of common stock via our

cash dividend reinvestment plan.

On January 30, 2015, we announced that our Board of Directors had authorized a 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. Since inception, we have purchased approximately 956,000 shares of common stock at a total price of \$19.5 million, at an average price of \$20.38; no shares were purchased during the first nine months of 2017. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan, which would also likely be funded from cash dividends paid to us from our bank.

Table of Contents

MERCANTILE BANK CORPORATION

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. Under the BASEL III capital rules that became effective on January 1, 2015, there is a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not meet this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in cash dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5% and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. We believe that, as of September 30, 2017, our bank would meet all capital adequacy requirements under the BASEL III capital rules on a fully phased-in basis as if all such requirements were currently in effect.

As of September 30, 2017, our bank's total risk-based capital ratio was 12.5%, compared to 13.1% at December 31, 2016. Our bank's total regulatory capital increased \$14.9 million during the first nine months of 2017, in large part reflecting the net impact of net income totaling \$26.4 million and cash dividends paid to us aggregating \$12.1 million. Our bank's total risk-based capital ratio was also impacted by a \$251 million increase in total risk-weighted assets, primarily resulting from commercial loan growth. As of September 30, 2017, our bank's total regulatory capital equaled \$368 million, or approximately \$74 million in excess of the 10.0% minimum which is among the requirements to be categorized as "well capitalized." Our and our bank's capital ratios as of September 30, 2017 and December 31, 2016 are disclosed in Note 12 of the Notes to Condensed Consolidated Financial Statements.

Results of Operations

We recorded net income of \$8.3 million, or \$0.51 per basic and diluted share, for the third quarter of 2017, compared to net income of \$7.8 million, or \$0.48 per basic and diluted share, for the third quarter of 2016. We recorded net income of \$23.3 million, or \$1.41 per basic and diluted share, for the first nine months of 2017, compared to net income of \$23.8 million, or \$1.46 per basic and diluted share, for the first nine months of 2016.

A bank owned life insurance death benefit claim in the first quarter of 2017 increased reported net income during the first nine months of 2017 by approximately \$1.2 million, or \$0.07 per diluted share, while the repurchase of \$11.0 million in trust preferred securities at a 27% discount in the first quarter of 2016 and recording of accelerated purchase discount accretion on called U.S. Government agency bonds during the first nine months of 2016 increased reported net income during the first nine months of 2016 by approximately \$1.8 million, or \$0.11 per diluted share, and \$1.3 million, or \$0.08 per diluted share, respectively. Excluding the impacts of these noncore transactions, diluted earnings per share during the first nine months of 2017 and 2016 equaled \$1.34 and \$1.27, respectively.

Interest income during the third quarter of 2017 was \$33.0 million, an increase of \$3.3 million, or 11.2%, from the \$29.7 million earned during the third quarter of 2016. The increase in interest income resulted from growth in, and a higher yield on, average earning assets. Average earning assets equaled \$2.99 billion during the third quarter of 2017, up \$178 million, or 6.3%, from the level of \$2.81 billion during the third quarter of 2016; average loans were up \$143 million, average interest-earning deposit balances were up \$25.3 million, and average securities were up \$10.1 million. The yield on average earning assets was 4.41% during the third quarter of 2017, compared to 4.22% during the third quarter of 2016. The higher yield mainly resulted from an increased yield on loans, which equaled 4.81% in the current-year third quarter compared to 4.57% in the prior-year third quarter. The increased yield on loans was primarily due to a higher yield on commercial loans, which equaled 4.82% in the third quarter of 2017 compared to 4.50% in the third quarter of 2016, in large part resulting from increased rates on variable-rate loans stemming from the Federal Open Market Committee (“FOMC”) raising the targeted federal funds rate by 25 basis points in December of 2016, March of 2017, and June of 2017 and an increased level of purchased credit-impaired loan income, which totaled \$1.3 million in the third quarter of 2017 compared to \$0.8 million during the third quarter of 2016.

Table of ContentsMERCANTILE BANK CORPORATION

Interest income during the first nine months of 2017 was \$92.6 million, an increase of \$3.9 million, or 4.4%, from the \$88.7 million earned during the first nine months of 2016. The increase in interest income resulted from a higher level of average earning assets, which more than offset a slightly lower yield on average earning assets. Average earning assets equaled \$2.88 billion during the first nine months of 2017, up \$141 million, or 5.2%, from the level of \$2.74 billion during the respective 2016 period; average loans were up \$130 million, average interest-earning deposit balances were up \$13.9 million and average securities were down \$2.5 million. The yield on average earning assets was 4.32% during the first nine months of 2017, compared to 4.34% during the first nine months of 2016. The lower yield resulted from a decreased yield on securities, which more than offset an increased yield on loans. The yield on securities was 2.43% during the first nine months of 2017, down from 3.07% during the first nine months of 2016 primarily due to a decreased level of accelerated purchase discount accretion related to called U.S. Government agency bonds. Approximately \$2.0 million in accelerated purchase discount accretion was recorded as interest income during the first nine months of 2016, positively impacting the yield on average earning assets by nine basis points; a nominal level of accelerated purchase discount accretion was recorded during the first nine months of 2017. The increase in the yield on loans from 4.63% during the first nine months of 2016 to 4.68% during the first nine months of 2017 mainly resulted from a higher yield on commercial loans, which more than offset a decreased yield on residential mortgage loans. The yield on commercial loans equaled 4.67% during the first nine months of 2017, up from 4.56% during the respective 2016 period as the positive impacts of the three most recent FOMC rate hikes and increased purchased credit-impaired loan income more than offset the negative impact of loans being originated and renewed at lower rates in light of the ongoing relatively low interest rate environment and competitive pressures. The decline in the yield on residential mortgage loans from 5.33% during the first nine months of 2016 to 4.80% during the first nine months of 2017 primarily reflected the booking of adjustable-rate mortgages with initial rates that were generally lower than the existing portfolio's average rate.

Interest expense during the third quarter of 2017 was \$4.4 million, an increase of \$1.1 million, or 34.8%, from the \$3.3 million expensed during the third quarter of 2016. The increase in interest expense is primarily attributable to a higher weighted average cost of interest-bearing liabilities, which equaled 0.85% in the third quarter of 2017 compared to 0.66% in the third quarter of 2016. The increase mainly reflects higher costs of certain non-time deposit account categories, borrowed funds, and time deposits, along with a change in the interest-bearing liability mix. The cost of interest-bearing non-time deposit accounts increased from 0.10% during the third quarter of 2016 to 0.35% during the third quarter of 2017, primarily reflecting one large depositor transferring funds from time deposits into a money market account product at rates higher than the average rate on the money market product at the time of transfer and the offering of a high balance money market account product with a higher rate. The cost of borrowed funds increased from 1.41% during the third quarter of 2016 to 1.75% during the third quarter of 2017 primarily due to a change in borrowing mix and an increased cost of FHLBI advances. Average lower-costing sweep accounts represented 27.3% of average borrowed funds during the third quarter of 2017, down from 39.6% during the prior-year third quarter, while average higher-costing FHLBI advances represented 60.4% and 47.6% of average borrowed funds during the respective periods. The cost of FHLBI advances increased from 1.47% during the third quarter of 2016 to 1.70% during the third quarter of 2017. The cost of time deposits increased from 1.13% during the third quarter of 2016 to 1.26% during the current-year third quarter primarily due to higher costs of public unit certificates of deposit \$100,000 and over and brokered certificates of deposit \$100,000 and over. Average

higher-costing FHLBI advances represented 11.7% of average interest-bearing liabilities during the third quarter of 2017, up from 9.1% during the prior-year third quarter. Longer-term FHLBI advances totaling \$90 million were obtained during the first nine months of 2017 to meet loan funding and other liquidity needs; the advances were longer-term in nature to meet interest rate risk management goals.

Table of ContentsMERCANTILE BANK CORPORATION

Interest expense during the first nine months of 2017 was \$11.3 million, an increase of \$2.0 million, or 21.3%, from the \$9.3 million expensed during the first nine months of 2016. The increase is mainly attributable to a higher weighted average cost of interest-bearing liabilities, which equaled 0.77% during the first nine months of 2017 compared to 0.65% during the respective 2016 period. The increase in the weighted average cost of interest-bearing liabilities primarily reflects higher costs of certain non-time deposit account categories and borrowed funds. The cost of interest-bearing non-time deposit accounts increased from 0.10% during the first nine months of 2016 to 0.24% during the first nine months of 2017, mainly reflecting the aforementioned large depositor transferring funds from time deposits to a money market account and the offering of a high balance money market account. The cost of borrowed funds increased from 1.45% during the first nine months of 2016 to 1.66% during the first nine months of 2017 primarily due to a change in borrowing mix and an increased cost of FHLBI advances. Average lower-costing sweep accounts represented 30.6% of average borrowed funds during the first nine months of 2017, down from 44.6% during the first nine months of 2016, while average higher-costing FHLBI advances represented 56.8% and 41.1% of average borrowed funds during the respective periods. An increase in the cost of time deposits and a change in interest-bearing liability mix also contributed to the higher weighted average cost of interest-bearing liabilities during the first nine months of 2017 compared to the respective 2016 period. The cost of time deposits increased from 1.13% during the first nine months of 2016 to 1.21% during the first nine months of 2017, primarily reflecting higher costs of public unit certificates of deposit \$100,00 and over and brokered certificates of deposit \$100,000 and over. Average higher-costing FHLBI advances represented 11.1% of average interest-bearing liabilities during the first nine months of 2017, up from 7.3% during the respective 2016 period. Longer-term FHLBI advances totaling \$90 million were obtained during the first nine months of 2017 to meet loan funding and other liquidity needs.

Net interest income during the third quarter of 2017 was \$28.6 million, an increase of \$2.2 million, or 8.3%, from the \$26.4 million earned during the third quarter of 2016. The increase was due to growth in average earning assets and a higher net interest margin. The net interest margin increased from 3.76% in the third quarter of 2016 to 3.83% in the current-year third quarter due to an increased yield on average earning assets, primarily reflecting a higher yield on commercial loans. The higher commercial loan yield primarily resulted from increased interest rates on variable-rate commercial loans stemming from the aforementioned three FOMC rate hikes and a higher level of purchased credit-impaired loan income. The cost of funds equaled 0.58% during the third quarter of 2017, up from 0.46% during the prior-year third quarter primarily due to higher costs of certain non-time deposit account categories, borrowed funds, and time deposits, along with a change in interest-bearing liability mix.

Net interest income during the first nine months of 2017 was \$81.3 million, an increase of \$1.9 million, or 2.4%, from the \$79.4 million earned during the first nine months of 2016. The increase was due to an increased level of average earning assets, which more than offset a lower net interest margin. The net interest margin declined from 3.89% during the first nine months of 2016 to 3.80% during the first nine months of 2017 due to a slight decline in the yield on average earning assets and an increased cost of funds. The lower yield on average earning assets resulted from a decreased yield on securities, primarily reflecting a decreased level of accelerated purchase discount accretion on called U.S. Government agency bonds, which more than offset an increased yield on loans, mainly reflecting higher

interest rates on variable-rate commercial loans stemming from the previously-mentioned FOMC rate hikes and a higher level of purchased credit-impaired commercial loan income. The cost of funds equaled 0.52% during the first nine months of 2017, up from 0.45% during the first nine months of 2016 primarily due to higher costs of certain non-time deposit account categories and borrowed funds.

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 2017 and 2016. 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 \$213,000 and \$198,000 in the third quarter of 2017 and 2016, respectively, for this non-GAAP, but industry standard, adjustment. This adjustment equated to a three basis point increase in our net interest margin during both the third quarter of 2017 and the third quarter of 2016.

Table of Contents

MERCANTILE BANK CORPORATION

| | Quarters ended September 30, | | | | | |
|---|------------------------------|----------|---------|-------------|----------|---------|
| | 2 0 1 7 | | Average | 2 0 1 6 | | Average |
| | Balance | Interest | Rate | Balance | Interest | Rate |
| | (dollars in thousands) | | | | | |
| ASSETS | | | | | | |
| Loans | \$2,534,364 | \$30,746 | 4.81 % | \$2,391,620 | \$27,553 | 4.57 % |
| Investment securities | 339,125 | 2,119 | 2.50 | 328,993 | 2,231 | 2.71 |
| Other interest-earning assets | 116,851 | 382 | 1.28 | 91,590 | 120 | 0.51 |
| Total interest - earning assets | 2,990,340 | 33,247 | 4.41 | 2,812,203 | 29,904 | 4.22 |
| Allowance for loan losses | (18,918) | | | (17,375) | | |
| Other assets | 248,631 | | | 245,496 | | |
| Total assets | \$3,220,053 | | | \$3,040,324 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Interest-bearing deposits | \$1,648,235 | \$2,652 | 0.64 % | \$1,572,424 | \$1,924 | 0.49 % |
| Short-term borrowings | 107,355 | 45 | 0.17 | 147,960 | 62 | 0.17 |
| Federal Home Loan Bank advances | 238,043 | 1,033 | 1.70 | 178,000 | 670 | 1.47 |
| Other borrowings | 48,512 | 660 | 5.32 | 48,013 | 600 | 4.89 |
| Total interest-bearing liabilities | 2,042,145 | 4,390 | 0.85 | 1,946,397 | 3,256 | 0.66 |
| Noninterest-bearing deposits | 805,650 | | | 733,600 | | |
| Other liabilities | 13,126 | | | 14,383 | | |
| Shareholders' equity | 359,132 | | | 345,944 | | |
| Total liabilities and shareholders' equity | \$3,220,053 | | | \$3,040,324 | | |
| Net interest income | | \$28,857 | | | \$26,648 | |
| Net interest rate spread | | | 3.56 % | | | 3.56 % |
| Net interest spread on average assets | | | 3.56 % | | | 3.48 % |
| Net interest margin on earning assets | | | 3.83 % | | | 3.76 % |

A loan loss provision expense of \$1.0 million was recorded during the third quarter of 2017, compared to a provision expense of \$0.6 million during the third quarter of 2016. A loan loss provision expense of \$2.4 million was recorded during the first nine months of 2017, compared to a provision expense of \$2.3 million during the first nine months of 2016. The provision expense recorded during the third quarter of 2017 primarily reflects an increased allocation

related to the economic conditions environmental factor. Ongoing loan growth also necessitated a portion of the provision expense incurred during the current-year third quarter and accounted for a substantial portion of the provision expense recorded during the first nine months of 2017 and both 2016 periods.

Table of ContentsMERCANTILE BANK CORPORATION

Net loan charge-offs of \$0.1 million were recorded during the third quarter of 2017, compared to \$0.2 million during the prior-year third quarter. Net loan charge-offs of \$1.1 million were recorded during the first nine months of 2017, compared to \$0.5 million during the same time period in 2016. Net loan charge-offs associated with one commercial loan relationship accounted for approximately 45% of net loan charge-offs during the first nine months of 2017. The allowance for originated loans, as a percentage of total originated loans, was 0.9% as of both September 30, 2017, and September 30, 2016. Our allowance for acquired loans totaled \$0.4 million as of September 30, 2017, compared to \$0.2 million as of September 30, 2016.

Noninterest income during the third quarter of 2017 was \$4.6 million, a decrease of \$0.7 million, or 12.9%, from the \$5.3 million recorded during the prior-year third quarter. Growth in several fee income categories, including credit and debit card fees, mortgage banking activity income, and payroll processing revenue, was more than offset by a decline in other income, which was elevated in the third quarter of 2016 as a result of certain noncore transactions, including the reimbursement of \$0.4 million in medical insurance premiums charged in prior years and \$0.3 million in payments received on purchased commercial credit-impaired loans that had been charged-off prior to the merger and non-pooled purchased commercial credit-impaired loans that went into recovery after the merger. Excluding these noncore transactions, noninterest income increased \$0.1 million, or 1.9%, during the third quarter of 2017 compared to the prior-year third quarter.

Noninterest income during the first nine months of 2017 was \$14.5 million, a decrease of \$1.9 million, or 11.8%, from the \$16.4 million earned during the same time period in 2016. Noninterest income during the first nine months of 2017 included a bank owned life insurance death benefit claim of \$1.4 million, while noninterest income during the first nine months of 2016 included a \$3.0 million gain associated with a trust preferred securities repurchase transaction, \$0.5 million in payments received on purchased commercial credit-impaired loans that had been charged-off prior to the merger and non-pooled purchased commercial credit-impaired loans that went into recovery after the merger, a \$0.4 million reimbursement of certain medical insurance premiums that were charged in prior years, and a \$0.3 million gain related to the sale of an equity investment; excluding these transactions, noninterest income increased \$0.9 million, or 7.5%, in the first nine months of 2017 compared to the respective 2016 period. The increase in core noninterest income primarily reflects higher mortgage banking income resulting from the positive impact of strategic initiatives that were implemented in the latter half of 2016, including the hiring of additional loan originators, introduction of new and enhanced products, loan programs and increased marketing efforts. Increased credit and debit card fees and payroll processing revenue also contributed to the higher level of core noninterest income.

Noninterest expense during the third quarter of 2017 was \$20.2 million, an increase of \$0.5 million, or 2.8%, from the \$19.7 million expensed during the third quarter of 2016. The higher level of expense primarily resulted from expected increases in various operating expenses stemming from recent expansion initiatives and increased salary expense,

mainly reflecting annual employee merit pay increases, the hiring of additional staff, a larger bonus accrual, and greater stock-based compensation expense.

Noninterest expense during the first nine months of 2017 was \$59.9 million, an increase of \$1.2 million, or 1.9%, from the \$58.7 million expensed during the same time period in 2016. The increase was mainly attributable to expected increases in various operating costs associated with recent expansion initiatives and higher salary expense, primarily reflecting annual employee merit pay increases, the hiring of additional staff, and greater stock-based compensation. FDIC insurance premiums during the first nine months of 2017 were \$0.7 million, a decrease of \$0.4 million, or 36.1%, from the \$1.1 million expensed during the first nine months of 2016; the decrease mainly resulted from changes to the deposit insurance assessment calculation that became effective in the third quarter of 2016.

Table of Contents

MERCANTILE BANK CORPORATION

During the third quarter of 2017, we recorded income before federal income tax of \$12.0 million and a federal income tax expense of \$3.7 million. During the third quarter of 2016, we recorded income before federal income tax of \$11.5 million and a federal income tax expense of \$3.6 million. Our effective tax rate was 30.8% during the third quarter of 2017, compared to 31.6% during the respective 2016 period. During the first nine months of 2017, we recorded income before federal income tax of \$33.6 million and a federal income tax expense of \$10.3 million. During the first nine months of 2016, we recorded income before federal income tax of \$34.8 million and a federal income tax expense of \$11.0 million. Our effective tax rate was 30.7% during the first nine months of 2017, compared to 31.6% during the respective 2016 period. The increase in federal income tax expense during the third quarter of 2017 compared to the prior-year third quarter resulted from the higher level of income before federal income tax. The decrease in federal income tax expense during the first nine months of 2017 compared to the respective 2016 period resulted from the lower level of income before federal income tax and the aforementioned nontaxable bank owned life insurance death benefit claim, which positively impacted the effective tax rate.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. We have only limited agricultural-related loan assets and therefore have no significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates is assumed to be insignificant. Interest rate risk is the exposure of our financial condition to adverse movements in interest rates. We derive our income primarily from the excess of interest collected on our interest-earning assets over the interest paid on our interest-bearing liabilities. The rates of interest we earn on our assets and owe on our liabilities generally are established contractually for a period of time. Since market interest rates change over time, we are exposed to lower profitability if we cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excessive levels of interest rate risk could pose a significant threat to our earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to our safety and soundness.

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal control procedures are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, we assess the existing and potential future effects of changes in interest rates on our financial condition, including capital adequacy, earnings, liquidity and asset quality.

We use two interest rate risk measurement techniques. The first, which is commonly referred to as GAP analysis, measures the difference between the dollar amounts of interest sensitive assets and liabilities that will be refinanced or repriced during a given time period. A significant repricing gap could result in a negative impact to our net interest margin during periods of changing market interest rates.

Table of Contents

MERCANTILE BANK CORPORATION

The following table depicts our GAP position as of September 30, 2017:

| | Within Three Months | Three to Twelve Months | One to Five Years | After Five Years | Total |
|---|---------------------------|------------------------------|-------------------------|------------------------|-------------------------|
| Assets: | | | | | |
| Commercial loans (1) | \$ 1,148,781,000 | \$ 73,714,000 | \$ 669,144,000 | \$ 298,102,000 | \$ 2,189,741,000 |
| Residential real estate loans | 62,583,000 | 21,384,000 | 124,613,000 | 119,945,000 | 328,525,000 |
| Consumer loans | 1,762,000 | 1,416,000 | 26,896,000 | 5,932,000 | 36,006,000 |
| Securities (2) | 16,329,000 | 24,809,000 | 99,230,000 | 200,758,000 | 341,126,000 |
| Other interest-bearing assets | 121,360,000 | 500,000 | 1,250,000 | 0 | 123,110,000 |
| Allowance for loan losses | 0 | 0 | 0 | 0 | (19,193,000) |
| Other assets | 0 | 0 | 0 | 0 | 255,340,000 |
| Total assets | 1,350,815,000 | 121,823,000 | 921,133,000 | 624,737,000 | \$ 3,254,655,000 |
| Liabilities: | | | | | |
| Interest-bearing checking | 405,223,000 | 0 | 0 | 0 | 405,223,000 |
| Savings deposits | 333,495,000 | 0 | 0 | 0 | 333,495,000 |
| Money market accounts | 404,336,000 | 0 | 0 | 0 | 404,336,000 |
| Time deposits under \$100,000 | 22,467,000 | 47,619,000 | 80,963,000 | 0 | 151,049,000 |
| Time deposits \$100,000 & over | 47,735,000 | 169,268,000 | 151,899,000 | 0 | 368,902,000 |
| Short-term borrowings | 122,280,000 | 0 | 0 | 0 | 122,280,000 |
| Federal Home Loan Bank advances | 0 | 20,000,000 | 140,000,000 | 60,000,000 | 220,000,000 |
| Other borrowed money | 48,588,000 | 0 | 0 | 0 | 48,588,000 |
| Noninterest-bearing checking | 0 | 0 | 0 | 0 | 826,038,000 |
| Other liabilities | 0 | 0 | 0 | 0 | 12,198,000 |
| Total liabilities | 1,384,124,000 | 236,887,000 | 372,862,000 | 60,000,000 | 2,892,109,000 |
| Shareholders' equity | 0 | 0 | 0 | 0 | 362,546,000 |
| Total liabilities & shareholders' equity | 1,384,124,000 | 236,887,000 | 372,862,000 | 60,000,000 | \$ 3,254,655,000 |
| Net asset (liability) GAP | \$(33,309,000) | \$(115,064,000) | \$ 548,271,000 | \$ 564,737,000 | |
| Cumulative GAP | \$(33,309,000) | \$(148,373,000) | \$ 399,898,000 | \$ 964,635,000 | |

| | | | | | | | | |
|--|------|----|------|----|------|---|------|---|
| Percent of cumulative GAP to total assets | (1.0 |)% | (4.6 |)% | 12.3 | % | 29.6 | % |
|--|------|----|------|----|------|---|------|---|

- (1) Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.
- (2) Mortgage-backed securities are categorized by average life calculations based upon prepayment trends as of September 30, 2017.

The second interest rate risk measurement we use is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, it serves as our primary interest rate risk measurement technique. The simulation model assesses the direction and magnitude of variations in net interest income resulting from potential changes in market interest rates.

Table of Contents

MERCANTILE BANK CORPORATION

Key assumptions in the model include prepayment speeds on various loan and investment assets; cash flows and maturities of interest sensitive assets and liabilities; and changes in market conditions impacting loan and deposit volume and pricing. These assumptions are inherently uncertain, subject to fluctuation and revision in a dynamic environment; therefore, the model cannot precisely estimate net interest income or exactly predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude, and frequency of interest rate changes and changes in market conditions and our strategies, among other factors.

We conducted multiple simulations as of September 30, 2017, in which it was assumed that changes in market interest rates occurred ranging from up 400 basis points to down 400 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on net interest income over the next twelve months in comparison to estimated net interest income based on our balance sheet structure, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of September 30, 2017. The resulting estimates are within our policy parameters established to manage and monitor interest rate risk.

| Interest Rate Scenario | Dollar Change In Net Interest Income | Percent Change In Net Interest Income |
|--------------------------------------|--|---|
| Interest rates down 400 basis points | \$(17,930,000) | (16.5%) |
| Interest rates down 300 basis points | (14,970,000) | (13.8) |
| Interest rates down 200 basis points | (11,240,000) | (10.4) |
| Interest rates down 100 basis points | (5,890,000) | (5.4) |
| No change in interest rates | (360,000) | (0.3) |
| Interest rates up 100 basis points | 1,910,000 | 1.8 |
| Interest rates up 200 basis points | 4,160,000 | 3.8 |
| Interest rates up 300 basis points | 6,420,000 | 5.9 |
| Interest rates up 400 basis points | 8,660,000 | 8.0 |

The resulting estimates have been significantly impacted by the current interest rate and economic environments, as adjustments have been made to critical model inputs with regards to traditional interest rate relationships. This is especially important as it relates to floating rate commercial loans, which comprise a sizable portion of our balance sheet.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; level of nonperforming assets; economic and competitive conditions; potential changes in lending, investing, and deposit gathering strategies; client preferences; and other factors.

Item 4. Controls and Procedures

As of September 30, 2017, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2017.

There have been no changes in our internal control over financial reporting during the quarter ended September 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

MERCANTILE BANK CORPORATION

PART II – OTHER INFORMATION**Item 1. Legal Proceedings.**

From time to time, we may be involved in various legal proceedings that are incidental to our business. In our opinion, we are not a party to any current legal proceedings that are material to our financial condition, either individually or in the aggregate.

Item 1A. Risk Factors.

There have been no material changes in our risk factors from those previously disclosed in our annual report on Form 10-K for the year ended December 31, 2016, and incorporated therein by reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

We made no unregistered sales of equity securities during the quarter ended September 30, 2017.

Issuer Purchases of Equity Securities

We announced on January 30, 2015 that our Board of Directors had authorized a 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 a \$15.0 million expansion of the stock repurchase program. No shares of our common stock were repurchased during the third quarter of 2017.

| Period | (a) Total Number of Shares | (b) Average Price Paid Per | (c) Total Number of Shares Purchased as | (d) Maximum Number of Shares or |
|--------|-------------------------------------|-------------------------------------|---|--|
|--------|-------------------------------------|-------------------------------------|---|--|

| | Purchased | Share | Part of | Approximate |
|------------------|-----------|-------|-----------|---------------|
| | | | Publicly | Dollar |
| | | | Announced | Value that |
| | | | Plans or | May Yet Be |
| | | | Programs | Purchased |
| | | | | Under the |
| | | | | Plans or |
| | | | | Programs |
| July 1 – 31 | 0 | \$ NA | 0 | \$ 15,505,000 |
| August 1 – 31 | 0 | NA | 0 | 15,505,000 |
| September 1 – 30 | 0 | NA | 0 | 15,505,000 |
| Total | 0 | \$ NA | 0 | \$ 15,505,000 |

Item 3. Defaults Upon Senior Securities.

Not applicable.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

Not applicable.

Item 6. Exhibits

The Exhibit Index following the Signature Page hereto is incorporated by reference under this item.

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 6, 2017.

MERCANTILE
BANK
CORPORATION

By: /s/ Robert B.
Kaminski, Jr.

Robert B.
Kaminski, Jr.
President and
Chief Executive
Officer

(Principal
Executive
Officer)

By: /s/
Charles E.
Christmas

Charles E.
Christmas
Executive
Vice
President,
Chief
Financial
Officer and
Treasurer

(Principal
Financial
and

Accounting
Officer)

93

Table of Contents

EXHIBIT INDEX

| <u>Exhibit No.</u> | <u>EXHIBIT DESCRIPTION</u> |
|--------------------|---|
| 2.1 | <u>Agreement and Plan of Merger dated August 14, 2013, incorporated by reference to Exhibit 2.1 to our Current Report on Form 8-K filed August 15, 2013</u> |
| 2.2 | <u>First Amendment to Merger Agreement dated February 20, 2014, incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed February 21, 2014</u> |
| 3.1 | <u>Our Articles of Incorporation are incorporated by reference to Exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2009</u> |
| 3.2 | <u>Our Amended and Restated Bylaws dated as of January 16, 2003 are incorporated by reference to Exhibit 3.2 of our Registration Statement on Form S-3 (Commission File No. 333-103376) that became effective on February 21, 2003</u> |
| 31 | <u>Rule 13a-14(a) Certifications</u> |
| 32.1 | <u>Section 1350 Chief Executive Officer Certification</u> |
| 32.2 | <u>Section 1350 Chief Financial Officer Certification</u> |
| 101 | The following financial information from Mercantile's Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) the Condensed Consolidated Statements of Changes in Shareholders' Equity, (v) the Condensed Consolidated Statements of Cash Flows, and (vi) the Notes to Condensed Consolidated Financial Statements |