MERCANTILE BANK CORP
Form 10-Q
April 30, 2014
U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

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

310 Leonard Street, NW, Grand Rapids, MI 49504

(Address of principal executive offices) (Zip Code)

(616) 406-3000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

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

Yes X No

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

Large accelerated filer ___ Accelerated filer X
Non-accelerated filer ___ Smaller reporting company ___

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

Yes No X

At April 30, 2014, there were 8,738,608 shares of common stock outstanding.

MERCANTILE BANK CORPORATION

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MERCANTILE BANK CORPORATION

PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

	March 31, 2014 (Unaudited)	December 31, 2013 (Audited)
ASSETS		
Cash and due from banks	$25,823,000	$17,149,000
Interest-bearing deposits	6,295,000	6,389,000
Federal funds sold	77,829,000	123,427,000
Total cash and cash equivalents	109,947,000	146,965,000
Securities available for sale	141,097,000	131,178,000
Federal Home Loan Bank stock	11,961,000	11,961,000
Loans	1,066,796,000	1,053,243,000
Allowance for loan losses	(20,954,000)	(22,821,000)
Loans, net	1,045,842,000	1,030,422,000
Premises and equipment, net	24,867,000	24,898,000
Bank owned life insurance	51,667,000	51,377,000
Accrued interest receivable	3,861,000	3,649,000
Other real estate owned and repossessed assets	2,350,000	2,851,000
Net deferred tax asset	15,768,000	17,754,000
Other assets	6,155,000	5,911,000
Total assets	$1,413,515,000	$1,426,966,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$230,709,000	$224,580,000
Interest-bearing	877,542,000	894,331,000
Total deposits	1,108,251,000	1,118,911,000
Securities sold under agreements to repurchase	63,165,000	69,305,000
Federal Home Loan Bank advances	45,000,000	45,000,000
Subordinated debentures	32,990,000	32,990,000
Accrued interest and other liabilities	6,420,000	7,435,000

Total liabilities	1,255,826,000	1,273,641,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; none issued	0	0
Common stock, no par value; 20,000,000 shares authorized; 8,738,608 shares outstanding at March 31, 2014 and 8,739,108 shares outstanding at December 31, 2013	162,076,000	162,999,000
Retained earnings (deficit)	(521,000)	(4,101,000)
Accumulated other comprehensive income (loss)	(3,866,000)	(5,573,000)
Total shareholders' equity	157,689,000	153,325,000
Total liabilities and shareholders' equity	$1,413,515,000	$1,426,966,000

See accompanying notes to condensed consolidated financial statements.

1.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Interest income		
Loans, including fees	$12,099,000	$12,846,000
Securities, taxable	1,234,000	1,007,000
Securities, tax-exempt	183,000	295,000
Federal funds sold	68,000	54,000
Interest-bearing balances	4,000	7,000
Total interest income	13,588,000	14,209,000
Interest expense		
Deposits	2,035,000	2,320,000
Short-term borrowings	22,000	20,000
Federal Home Loan Bank advances	150,000	118,000
Subordinated debentures and other borrowings	317,000	297,000
Total interest expense	2,524,000	2,755,000
Net interest income	11,064,000	11,454,000
Provision for loan losses	(1,900,000)	(1,500,000)
Net interest income after provision for loan losses	12,964,000	12,954,000
Noninterest income		
Service charges on deposit and sweep accounts	365,000	374,000
Earnings on bank owned life insurance	290,000	338,000
Mortgage banking activities	63,000	252,000
Rental income from other real estate owned	56,000	199,000
Other income	732,000	664,000
Total noninterest income	1,506,000	1,827,000
Noninterest expense		

Salaries and benefits	5,230,000	4,857,000
Occupancy	712,000	658,000
Furniture and equipment depreciation, rent and maintenance	247,000	256,000
FDIC insurance costs	177,000	245,000
Problem asset costs	(20,000)	131,000
Merger-related costs	377,000	14,000
Other expense	2,484,000	2,423,000
Total noninterest expenses	9,207,000	8,584,000
Income before federal income tax expense	5,263,000	6,197,000
Federal income tax expense	1,683,000	1,797,000
Net income	$3,580,000	$4,400,000
Basic earnings per share	$0.41	$0.51
Diluted earnings per share	$0.41	$0.50
Cash dividends per share	$0.12	$0.10
Average basic shares outstanding	8,738,836	8,705,677
Average diluted shares outstanding	8,741,121	8,718,601

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Net income	$3,580,000	$4,400,000
Other comprehensive income (loss):		
Unrealized holding gains (losses) on securities available for sale	2,604,000	(1,002,000)
Fair value of interest rate swap	14,000	114,000
	2,618,000	(888,000)
Tax effect of unrealized holding gains (losses) on securities available for sale	(906,000)	351,000
Tax effect of fair value of interest rate swap	(5,000)	(40,000)
	(911,000)	311,000
Other comprehensive income (loss), net of tax effect	1,707,000	(577,000)
Comprehensive income	$5,287,000	$3,823,000

See accompanying notes to condensed consolidated financial statements.

3.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

($ in thousands)	Preferred Stock	Common Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2014	$ 0	$ 162,999	$ (4,101)	$ (5,573)	$ 153,325
Stock-based compensation expense		118			118
Cash dividends ($0.12 per common share)		(1,041)			(1,041)
Net income for the three months ended March 31, 2014			3,580		3,580
Change in net unrealized holding gain on securities available for sale, net of tax effect				1,698	1,698
Change in fair value of interest rate swap, net of tax effect				9	9
Balances, March 31, 2014	$ 0	$ 162,076	$ (521)	$ (3,866)	$ 157,689

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

($ in thousands)	Preferred Stock	Common Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2013	$ 0	$166,074	$(21,134)	$ 1,650	$ 146,590
Employee stock purchase plan (532 shares)		9			9
Dividend reinvestment plan (929 shares)		16			16
Stock-based compensation expense		118			118
Cash dividends ($0.10 per common share)		(864)			(864)
Net income for the three months ended March 31, 2013			4,400		4,400
Change in net unrealized holding gain on securities available for sale, net of tax effect				(651)	(651)
Change in fair value of interest rate swap, net of tax effect				74	74
Balances, March 31, 2013	$ 0	$165,353	$(16,734)	$ 1,073	$ 149,692

See accompanying notes to condensed consolidated financial statements.

5.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2014	Three Months Ended March 31, 2013
Cash flows from operating activities		
Net income	$3,580,000	$4,400,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	512,000	553,000
Provision for loan losses	(1,900,000)	(1,500,000)
Stock-based compensation expense	118,000	118,000
Proceeds from sales of mortgage loans held for sale	4,450,000	16,260,000
Origination of mortgage loans held for sale	(4,979,000)	(15,393,000)
Net gain from sales of mortgage loans held for sale	(52,000)	(202,000)
Net gain from sale and valuation write-down of foreclosed assets	(276,000)	(528,000)
Earnings on bank owned life insurance	(290,000)	(338,000)
Net change in:		
Accrued interest receivable	(212,000)	(25,000)
Other assets	611,000	2,159,000
Accrued expenses and other liabilities	(1,060,000)	(2,205,000)
Net cash from operating activities	502,000	3,299,000
Cash flows from investing activities		
Loan originations and payments, net	(12,939,000)	14,779,000
Purchases of securities available for sale	(11,672,000)	(14,984,000)
Proceeds from maturities, calls and repayments of securities available for sale	4,407,000	12,314,000
Proceeds from sales of foreclosed assets	777,000	2,639,000
Purchases of premises and equipment	(311,000)	(80,000)
Net cash from (for) investing activities	(19,738,000)	14,668,000
Cash flows from financing activities		
Net decrease in time deposits	(14,142,000)	(43,116,000)
Net increase in all other deposits	3,482,000	702,000
Net increase (decrease) in securities sold under agreements to repurchase	(6,140,000)	3,979,000
Net increase in other borrowed money	59,000	81,000
Employee stock purchase plan	0	9,000
Dividend reinvestment plan	0	16,000

Payment of cash dividends to common shareholders	(1,041,000)	(864,000)
Net cash for financing activities	(17,782,000)	(39,193,000)
Net change in cash and cash equivalents	(37,018,000)	(21,226,000)
Cash and cash equivalents at beginning of period	146,965,000	136,003,000
Cash and cash equivalents at end of period	$109,947,000	$114,777,000
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	$3,134,000	$3,339,000
Federal income tax	0	0
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	0	1,647,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three months ended March 31, 2014 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 March 31, 2014 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, 2013.

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

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and 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 63,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2014. In addition, stock options for approximately 6,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2014. Stock options for approximately 55,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2014.

Approximately 65,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2013. In addition, stock options for approximately 21,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2013. Stock options for approximately 132,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2013.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

Changes in the fair value of derivatives that are designated, for accounting purposes, as a hedge of the variability of cash flows to be received on various loans and are effective are reported in other comprehensive income. They are later reclassified into earnings in the same periods during which the hedged transaction affects earnings and are included in the line item in which the hedged cash flows are recorded. If hedge accounting does not apply, changes in the fair value of derivatives are recognized immediately in current earnings as interest income or expense.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

If designated as a hedge, we formally document the relationship between derivatives as hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions. This documentation includes linking cash flow hedges to specific assets and liabilities on the balance sheet. If designated as a hedge, we also formally assess, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in cash flows of the hedged items. Ineffective hedge gains and losses are recognized immediately in current earnings as noninterest income or expense. We discontinue hedge accounting when we determine the derivative is no longer effective in offsetting changes in the cash flows of the hedged item, the derivative is settled or terminates, or treatment of the derivative as a hedge is no longer appropriate or intended.

Adoption of New Accounting Standards: In January of 2014, the FASB issued ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.* This ASU clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The ASU also requires additional related interim and annual disclosures. The guidance in this ASU is effective for annual and interim periods beginning after December 15, 2014. The implementation of ASU 2014-04 should not have a material impact on our financial position or results of operations.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2014				
U.S. Government agency debt obligations	$116,492,000	$430,000	$(7,628,000)	$109,294,000
Mortgage-backed securities	11,544,000	1,071,000	0	12,615,000
Municipal general obligation bonds	16,488,000	411,000	0	16,899,000
Municipal revenue bonds	877,000	42,000	0	919,000
Mutual funds	1,393,000	0	(23,000)	1,370,000
	$146,794,000	$1,954,000	$(7,651,000)	$141,097,000
December 31, 2013				
U.S. Government agency debt obligations	$108,279,000	$263,000	$(10,065,000)	$98,477,000
Mortgage-backed securities	12,456,000	1,102,000	0	13,558,000
Municipal general obligation bonds	16,488,000	388,000	(4,000)	16,872,000
Municipal revenue bonds	878,000	38,000	0	916,000
Mutual funds	1,386,000	0	(31,000)	1,355,000
	$139,487,000	$1,791,000	$(10,100,000)	$131,178,000

(Continued)

11.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. **SECURITIES** (Continued)

Securities with unrealized losses at March 31, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
March 31, 2014						
U.S. Government agency debt obligations	$44,172,000	$(2,532,000)	$42,828,000	$(5,096,000)	$87,000,000	$(7,628,000)
Mortgage-backed securities	0	0	0	0	0	0
Municipal general obligation bonds	0	0	0	0	0	0
Municipal revenue bonds	0	0	0	0	0	0
Mutual funds	1,370,000	(23,000)	0	0	1,370,000	(23,000)
	$45,542,000	$(2,555,000)	$42,828,000	$(5,096,000)	$88,370,000	$(7,651,000)
December 31, 2013						
U.S. Government agency debt obligations	$57,117,000	$(5,798,000)	$29,679,000	$(4,267,000)	$86,796,000	$(10,065,000)
Mortgage-backed securities	0	0	0	0	0	0
Municipal general obligation bonds	295,000	(4,000)	0	0	295,000	(4,000)
Municipal revenue bonds	0	0	0	0	0	0
Mutual funds	1,355,000	(31,000)	0	0	1,355,000	(31,000)
	$58,767,000	$(5,833,000)	$29,679,000	$(4,267,000)	$88,446,000	$(10,100,000)

(Continued)

12.

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 March 31, 2014, 63 debt securities and one mutual fund with fair values totaling $88.4 million have unrealized losses aggregating $7.7 million. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no unrealized losses are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at March 31, 2014, by maturity, are shown in the following table. The contractual maturity is utilized for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

Weighted Average Yield	Amortized Cost	Fair Value

Due in 2014	5.44 %	$1,770,000	$1,801,000
Due in 2015 through 2019	6.31	1,018,000	1,040,000
Due in 2020 through 2024	3.44	44,432,000	43,437,000
Due in 2025 and beyond	3.63	86,637,000	80,834,000
Mortgage-backed securities	5.14	11,544,000	12,615,000
Mutual funds	2.11	1,393,000	1,370,000
	3.73 %	$146,794,000	$141,097,000

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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2. SECURITIES (Continued)

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of $17.4 million and estimated market value of $17.8 million at March 31, 2014 and December 31, 2013. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was $105.2 million and $94.4 million at March 31, 2014 and December 31, 2013, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

Our total loans at March 31, 2014 were $1.07 billion compared to $1.05 billion at December 31, 2013, an increase of $13.6 million, or 1.3%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at March 31, 2014 and December 31, 2013, and the percentage change in loans from the end of 2013 to the end of the first quarter of 2014, are as follows:

	March 31, 2014		December 31, 2013		Percent Increase (Decrease)
	Balance	%	Balance	%	
Commercial:					
Commercial and industrial	$289,009,000	27.1 %	$286,373,000	27.2 %	0.9 %
Vacant land, land development, and residential construction	37,190,000	3.5	36,741,000	3.5	1.2
Real estate – owner occupied	264,299,000	24.8	261,877,000	24.9	0.9

Real estate – non-owner occupied	378,034,000	35.4	364,066,000	34.6	3.8	
Real estate – multi-family and residential rental	35,686,000	3.3	37,639,000	3.5	(5.2	)
Total commercial	1,004,218,000	94.1	986,696,000	93.7	1.8	
Retail:						
Home equity and other	31,778,000	3.0	35,080,000	3.3	(9.4	)
1-4 family mortgages	30,800,000	2.9	31,467,000	3.0	(2.1	)
Total retail	62,578,000	5.9	66,547,000	6.3	(6.0	)
Total loans	$1,066,796,000	100.0%	$1,053,243,000	100.0%	1.3	%

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. **<u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u>** (Continued)

Nonperforming loans as of March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014	December 31, 2013
Loans past due 90 days or more still accruing interest	$0	$0
Nonaccrual loans	6,342,000	6,718,000
Total nonperforming loans	$6,342,000	$6,718,000

The recorded principal balance of nonaccrual loans was as follows:

	March 31, 2014	December 31, 2013
Commercial:		
Commercial and industrial	$919,000	$1,501,000
Vacant land, land development, and residential construction	361,000	785,000
Real estate – owner occupied	684,000	389,000
Real estate – non-owner occupied	335,000	168,000
Real estate – multi-family and residential rental	492,000	208,000
Total commercial	2,791,000	3,051,000
Retail:		
Home equity and other	762,000	788,000
1-4 family mortgages	2,789,000	2,879,000

Total retail	3,551,000	3,667,000
Total nonaccrual loans	$6,342,000	$6,718,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of March 31, 2014:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	$ 0	$ 0	$121,000	$121,000	$288,888,000	$289,009,000	$ 0
Vacant land, land development, and residential construction	0	0	95,000	95,000	37,095,000	37,190,000	0
Real estate – owner occupied	0	0	0	0	264,299,000	264,299,000	0
Real estate – non-owner occupied	0	0	0	0	378,034,000	378,034,000	0
Real estate – multi-family and residential rental	0	0	0	0	35,686,000	35,686,000	0
Total commercial	0	0	216,000	216,000	1,004,002,000	1,004,218,000	0
Retail:							
Home equity and other	0	0	0	0	31,778,000	31,778,000	0
1-4 family mortgages	0	0	391,000	391,000	30,409,000	30,800,000	0
Total retail	0	0	391,000	391,000	62,187,000	62,578,000	0
Total past due loans	$ 0	$ 0	$607,000	$607,000	$1,066,189,000	$1,066,796,000	$ 0

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of December 31, 2013:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Commercial:							
Commercial and industrial	$0	$0	$309,000	$309,000	$286,064,000	$286,373,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	36,741,000	36,741,000	0
Real estate – owner occupied	65,000	0	50,000	115,000	261,762,000	261,877,000	0
Real estate – non-owner occupied	0	0	0	0	364,066,000	364,066,000	0
Real estate – multi-family and residential rental	0	0	64,000	64,000	37,575,000	37,639,000	0
Total commercial	65,000	0	423,000	488,000	986,208,000	986,696,000	0
Retail:							
Home equity and other	14,000	0	0	14,000	35,066,000	35,080,000	0
1-4 family mortgages	21,000	44,000	375,000	440,000	31,027,000	31,467,000	0
Total retail	35,000	44,000	375,000	454,000	66,093,000	66,547,000	0
Total past due loans	$100,000	$44,000	$798,000	$942,000	$1,052,301,000	$1,053,243,000	$ 0

(Continued)

17.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans as of March 31, 2014, and average impaired loans for the three months ended March 31, 2014, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$1,693,000	$205,000		$ 358,000
Vacant land, land development and residential construction	459,000	343,000		353,000
Real estate – owner occupied	1,165,000	684,000		735,000
Real estate – non-owner occupied	1,831,000	1,761,000		1,247,000
Real estate – multi-family and residential rental	41,000	1,000		1,000
Total commercial	5,189,000	2,994,000		2,694,000
Retail:				
Home equity and other	707,000	649,000		555,000
1-4 family mortgages	1,190,000	611,000		629,000
Total retail	1,897,000	1,260,000		1,184,000
Total with no related allowance recorded	$7,086,000	$4,254,000		$ 3,878,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$1,006,000	$953,000	$451,000	$1,197,000
Vacant land, land development and residential construction	4,213,000	3,908,000	728,000	4,023,000
Real estate – owner occupied	1,488,000	1,488,000	455,000	1,500,000
Real estate – non-owner occupied	19,470,000	19,451,000	7,370,000	20,262,000
Real estate – multi-family and residential rental	1,207,000	1,089,000	504,000	1,886,000
Total commercial	27,384,000	26,889,000	9,508,000	28,868,000
Retail:				
Home equity and other	118,000	92,000	92,000	190,000
1-4 family mortgages	2,237,000	2,160,000	879,000	2,196,000
Total retail	2,355,000	2,252,000	971,000	2,386,000
Total with an allowance recorded	$29,739,000	$29,141,000	$10,479,000	$31,254,000
Total impaired loans:				
Commercial	$32,573,000	$29,883,000	$9,508,000	$31,562,000
Retail	4,252,000	3,512,000	971,000	3,570,000
Total impaired loans	$36,825,000	$33,395,000	$10,479,000	$35,132,000

Interest income of $0.5 million was recognized on impaired loans during the first quarter of 2014.

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired loans were as follows as of December 31, 2013:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$2,229,000	$511,000		$ 1,205,000
Vacant land, land development and residential construction	475,000	362,000		991,000
Real estate – owner occupied	1,270,000	785,000		1,084,000
Real estate – non-owner occupied	895,000	733,000		4,049,000
Real estate – multi-family and residential rental	41,000	1,000		390,000
Total commercial	4,910,000	2,392,000		7,719,000
Retail:				
Home equity and other	507,000	461,000		471,000
1-4 family mortgages	1,272,000	647,000		727,000
Total retail	1,779,000	1,108,000		1,198,000
Total with no related allowance recorded	$6,689,000	$3,500,000		$ 8,917,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$1,517,000	$1,440,000	$792,000	$1,880,000
Vacant land, land development and residential construction	4,436,000	4,139,000	844,000	3,354,000
Real estate – owner occupied	1,513,000	1,513,000	528,000	2,550,000
Real estate – non-owner occupied	21,088,000	21,072,000	7,969,000	28,388,000
Real estate – multi-family and residential rental	3,219,000	2,684,000	1,127,000	2,915,000
Total commercial	31,773,000	30,848,000	11,260,000	39,087,000
Retail:				
Home equity and other	320,000	289,000	96,000	329,000
1-4 family mortgages	2,274,000	2,231,000	1,030,000	1,628,000
Total retail	2,594,000	2,520,000	1,126,000	1,957,000
Total with an allowance recorded	$34,367,000	$33,368,000	$12,386,000	$41,044,000
Total impaired loans:				
Commercial	$36,683,000	$33,240,000	$11,260,000	$46,806,000
Retail	4,373,000	3,628,000	1,126,000	3,155,000
Total impaired loans	$41,056,000	$36,868,000	$12,386,000	$49,961,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

Credit Quality Indicators. We utilize a comprehensive grading system for our commercial loans. All commercial loans are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, operating performance, financial condition, collateral, industry condition and management. All commercial loans are graded at inception and reviewed and, if appropriate, re-graded at various intervals thereafter. The risk assessment for retail loans is primarily based on the type of collateral and payment activity.

Loans by credit quality indicators were as follows as of March 31, 2014:

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

	Commercial and Industrial	Commercial Vacant Land, 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	$197,051,000	$7,993,000	$161,357,000	$232,226,000	$15,411,000
Grades 5 – 7	90,776,000	24,946,000	99,484,000	124,526,000	19,167,000
Grades 8 – 9	1,182,000	4,251,000	3,458,000	21,282,000	1,108,000
Total commercial	$289,009,000	$37,190,000	$264,299,000	$378,034,000	$35,686,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	$31,778,000	$30,800,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Loans by credit quality indicators were as follows as of December 31, 2013:

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 - and Residential Multi-Family Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$208,151,000	$6,973,000	$156,230,000	$219,325,000	$15,465,000
Grades 5 – 7	76,237,000	25,535,000	103,066,000	122,717,000	19,469,000
Grades 8 – 9	1,985,000	4,233,000	2,581,000	22,024,000	2,705,000
Total commercial	$286,373,000	$36,741,000	$261,877,000	$364,066,000	$37,639,000

Retail credit exposure – credit risk profiled by collateral type:

Retail	Retail 1-4 Family

	Home Equity and Other	Mortgages
Total retail	$35,080,000	$31,467,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

All commercial loans are graded using the following criteria:

Grade 1.	Excellent credit rating that contain very little, if any, risk of loss.
Grade 2.	Strong sources of repayment and have low repayment risk.
Grade 3.	Good sources of repayment and have limited repayment risk.
Grade 4.	Adequate sources of repayment and acceptable repayment risk; however, characteristics are present that render the credit more vulnerable to a negative event.
Grade 5.	Marginally acceptable sources of repayment and exhibit defined weaknesses and negative characteristics.
Grade 6.	Well defined weaknesses which may include negative current cash flow, high leverage, or operating losses. Generally, if the credit does not stabilize or if further deterioration is observed in the near term, the loan will likely be downgraded and placed on the Watch List (i.e., list of lending relationships that receive increased scrutiny and review by the Board of Directors and senior management).
Grade 7.	Defined weaknesses or negative trends that merit close monitoring through Watch List status.
Grade 8.	Inadequately protected by current sound net worth, paying capacity of the obligor, or pledged collateral, resulting in a distinct possibility of loss requiring close monitoring through Watch List status.
Grade 9.	Vital weaknesses exist where collection of principal is highly questionable.

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

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

Activity in the allowance for loan losses and the recorded investments in loans as of and during the three months ended March 31, 2014 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$20,455,000	$2,358,000	$ 8,000	$22,821,000
Provision for loan losses	(1,454,000)	(434,000)	(12,000)	(1,900,000)
Charge-offs	(586,000)	(2,000)	0	(588,000)
Recoveries	586,000	35,000	0	621,000
Ending balance	$19,001,000	$1,957,000	$ (4,000)	$20,954,000
Ending balance: individually evaluated for impairment	$9,508,000	$971,000	$ 0	$10,479,000
Ending balance: collectively evaluated for impairment	$9,493,000	$986,000	$ (4,000)	$10,475,000
Total loans:				
Ending balance	$1,004,218,000	$62,578,000		$1,066,796,000
Ending balance: individually evaluated for impairment	$29,883,000	$3,512,000		$33,395,000
Ending balance: collectively evaluated for impairment	$974,335,000	$59,066,000		$1,033,401,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

Activity in the allowance for loan losses and the recorded investments in loans as of and during the three months ended March 31, 2013 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$26,043,000	$2,645,000	$ (11,000)	$28,677,000
Provision for loan losses	(1,164,000)	(363,000)	27,000	(1,500,000)
Charge-offs	(2,412,000)	(3,000)	0	(2,415,000)
Recoveries	1,250,000	23,000	0	1,273,000
Ending balance	$23,717,000	$2,302,000	$ 16,000	$26,035,000
Ending balance: individually evaluated for impairment	$14,616,000	$277,000	$ 0	$14,893,000
Ending balance: collectively evaluated for impairment	$9,101,000	$2,025,000	$ 16,000	$11,142,000
Total loans:				
Ending balance	$948,964,000	$73,992,000		$1,022,956,000
Ending balance: individually evaluated for impairment	$49,636,000	$2,064,000		$51,700,000
Ending balance: collectively evaluated for impairment	$899,328,000	$71,928,000		$971,256,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

Loans modified as troubled debt restructurings during the three months ended March 31, 2014 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Commercial:			
Commercial and industrial	1	$ 14,000	$ 14,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	2	354,000	323,000
Real estate – multi-family and residential rental	0	0	0
Total commercial	3	368,000	337,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total retail	0	0	0
Total	3	$ 368,000	$ 337,000

Loans modified as troubled debt restructurings during the three months ended March 31, 2013 were as follows:

	Number of	Pre-Modification Recorded Principal	Post-Modification Recorded Principal

	Contracts	Balance	Balance
Commercial:			
Commercial and industrial	1	$ 875,000	$ 875,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	2	2,068,000	2,068,000
Real estate – multi-family and residential rental	0	0	0
Total commercial	3	2,943,000	2,943,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total retail	0	0	0
Total	3	$ 2,943,000	$ 2,943,000

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

The following loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended March 31, 2014 (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 loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended March 31, 2013 (amounts as of period end):

	Number of	Recorded Principal

	Contracts	Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	44,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	44,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$ 44,000

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for loans categorized as troubled debt restructurings during the three months ended March 31, 2014 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	$ 1,656,000	$ 4,501,000	$ 1,816,000	$ 22,311,000	$ 2,620,000
Charge-Offs	0	0	(11,000)	0	(420,000)
Payments	(266,000)	(3,149,000)	(49,000)	(1,001,000)	(1,468,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	14,000	2,898,000	0	319,000	0
Ending Balance	$ 1,404,000	$ 4,250,000	$ 1,756,000	$ 21,629,000	$ 732,000

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 0	$ 2,191,000
Charge-Offs	0	0
Payments	0	(69,000)
Transfers to ORE	0	0

Net Additions/Deletions	0	0
Ending Balance	$ 0	$2,122,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

Activity for loans categorized as troubled debt restructurings during the three months ended March 31, 2013 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-Familyand Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$2,720,000	$3,071,000	$4,116,000	$37,672,000	$3,027,000
Charge-Offs	(35,000)	(695,000)	0	(711,000)	(15,000)
Payments	(514,000)	(49,000)	(61,000)	(3,211,000)	(54,000)
Transfers to ORE	(74,000)	0	(363,000)	(803,000)	0
Net Additions/Deletions	1,171,000	0	187,000	2,057,000	0
Ending Balance	$3,268,000	$2,327,000	$3,879,000	$35,004,000	$2,958,000

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 0	$154,000
Charge-Offs	0	0
Payments	0	(2,000)
Transfers to ORE	0	0
Net Additions/Deletions	0	0

Ending Balance	$ 0	$ 152,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

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

	March 31, 2014	December 31, 2013
Commercial:		
Commercial and industrial	$95,000	$187,000
Vacant land, land development, and residential construction	695,000	798,000
Real estate – owner occupied	455,000	528,000
Real estate – non-owner occupied	7,236,000	7,828,000
Real estate – multi-family and residential rental	304,000	1,010,000
Total commercial	8,785,000	10,351,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	32,000	0
Total retail	32,000	0
Total related allowance	$8,817,000	$10,351,000

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)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. PREMISES AND EQUIPMENT, NET

Premises and equipment are comprised of the following:

	March 31, 2014	December 31, 2013
Land and improvements	$8,556,000	$8,556,000
Buildings	24,742,000	24,733,000
Furniture and equipment	13,001,000	12,718,000
	46,299,000	46,007,000
Less: accumulated depreciation	21,432,000	21,109,000
Premises and equipment, net	$24,867,000	$24,898,000

Depreciation expense totaled $0.3 million during the first quarter of 2014 and 2013.

5. DEPOSITS

Our total deposits at March 31, 2014 totaled $1.11 billion compared to $1.12 billion at December 31, 2013, a decrease of $10.7 million, or 1.0%. The components of our outstanding balances at March 31, 2014 and December 31, 2013, and percentage change in deposits from the end of 2013 to the end of the first quarter of 2014, are as follows:

	March 31, 2014		December 31, 2013		Percent Increase
	Balance	%	Balance	%	(Decrease)

Noninterest-bearing checking	$230,709,000	20.8 %	$224,580,000	20.1 %	2.7 %
Interest-bearing checking	189,971,000	17.1	197,388,000	17.6	(3.8)
Money market	135,931,000	12.3	133,369,000	11.9	1.9
Savings	54,815,000	5.0	52,606,000	4.7	4.2
Time, under $100,000	42,261,000	3.8	43,251,000	3.9	(2.3)
Time, $100,000 and over	263,998,000	23.8	254,600,000	22.8	3.7
	917,685,000	82.8	905,794,000	81.0	1.3
Out-of-area time, under $100,000	3,645,000	0.3	4,078,000	0.4	(10.6)
Out-of-area time, $100,000 and over	186,921,000	16.9	209,039,000	18.6	(10.6)
	190,566,000	17.2	213,117,000	19.0	(10.6)
Total deposits	$1,108,251,000	100.0%	$1,118,911,000	100.0%	(1.0)%

(Continued)

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:

	Three Months Ended March 31, 2014	Twelve Months Ended December 31, 2013
Outstanding balance at end of period	$63,165,000	$69,305,000
Average interest rate at end of period	0.13 %	0.12 %
Average daily balance during the period	$76,412,000	$65,939,000
Average interest rate during the period	0.12 %	0.12 %
Maximum daily balance during the period	$91,303,000	$78,960,000

Repurchase agreements generally have original maturities of less than one year. 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 ADVANCES

Federal Home Loan Bank advances totaled $45.0 million at March 31, 2014 and December 31, 2013, and mature at varying dates from March 2017 through September 2017, with fixed rates of interest from 1.22% to 1.51% and averaging 1.34%. 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 March 31, 2014 totaled about $179 million, with availability approximating $129 million.

Maturities of currently outstanding FHLB advances are as follows:

2014	$0
2015	0
2016	0
2017	45,000,000
2018	0

(Continued)

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 March 31, 2014 and December 31, 2013.

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at March 31, 2014 and December 31, 2013 follows:

	March 31, 2014	December 31, 2013
Commercial unused lines of credit	$263,387,000	$257,937,000
Unused lines of credit secured by 1 – 4 family residential properties	22,994,000	23,429,000