MERCANTILE BANK CORP
Form 10-Q
August 08, 2014
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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 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 August 8, 2014, there were 16,851,320 shares of common stock outstanding.

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MERCANTILE BANK CORPORATION

PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

	June 30, 2014 (Unaudited)	December 31, 2013 (Audited)
ASSETS		
Cash and due from banks	$58,730,000	$17,149,000
Interest-bearing deposits	48,150,000	6,389,000
Federal funds sold	11,973,000	123,427,000
Total cash and cash equivalents	118,853,000	146,965,000
Securities available for sale	475,275,000	131,178,000
Federal Home Loan Bank stock	19,226,000	11,961,000
Loans	2,073,482,000	1,053,243,000
Allowance for loan losses	(20,856,000)	(22,821,000)
Loans, net	2,052,626,000	1,030,422,000
Premises and equipment, net	49,003,000	24,898,000
Bank owned life insurance	55,693,000	51,377,000
Goodwill	50,870,000	0
Core deposit intangible	17,213,000	0
Net deferred tax asset	9,238,000	17,754,000
Accrued interest receivable	7,711,000	3,649,000
Other real estate owned and repossessed assets	2,878,000	2,851,000
Other assets	20,696,000	5,911,000
Total assets	$2,879,282,000	$1,426,966,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$515,646,000	$224,580,000
Interest-bearing	1,787,615,000	894,331,000
Total deposits	2,303,261,000	1,118,911,000
Securities sold under agreements to repurchase	124,108,000	69,305,000
Federal Home Loan Bank advances	57,044,000	45,000,000

Subordinated debentures	54,131,000	32,990,000
Other borrowed money	14,348,000	1,620,000
Accrued interest and other liabilities	10,252,000	5,815,000
Total liabilities	2,563,144,000	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; 40,000,000 shares authorized; 16,839,175 shares outstanding at June 30, 2014 and 8,739,108 shares outstanding at December 31, 2013	318,452,000	162,999,000
Retained earnings (deficit)	673,000	(4,101,000)
Accumulated other comprehensive income (loss)	(2,987,000)	(5,573,000)
Total shareholders' equity	316,138,000	153,325,000
Total liabilities and shareholders' equity	$2,879,282,000	$1,426,966,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended June 30, 2014 (Unaudited)	Three Months Ended June 30, 2013 (Unaudited)	Six Months Ended June 30, 2014 (Unaudited)	Six Months Ended June 30, 2013 (Unaudited)
Interest income				
Loans, including fees	$16,657,000	$12,687,000	$28,756,000	$25,533,000
Securities, taxable	1,393,000	1,007,000	2,627,000	2,014,000
Securities, tax-exempt	374,000	257,000	557,000	552,000
Federal funds sold	41,000	35,000	109,000	89,000
Interest-bearing deposits	17,000	6,000	21,000	13,000
Total interest income	18,482,000	13,992,000	32,070,000	28,201,000
Interest expense				
Deposits	2,272,000	2,223,000	4,307,000	4,543,000
Short-term borrowings	27,000	19,000	49,000	39,000
Federal Home Loan Bank advances	156,000	119,000	306,000	238,000
Other borrowings	474,000	319,000	791,000	615,000
Total interest expense	2,929,000	2,680,000	5,453,000	5,435,000
Net interest income	15,553,000	11,312,000	26,617,000	22,766,000
Provision for loan losses	(700,000)	(1,500,000)	(2,600,000)	(3,000,000)
Net interest income after provision for loan losses	16,253,000	12,812,000	29,217,000	25,766,000
Noninterest income				
Services charges on accounts	522,000	384,000	887,000	758,000
Earnings on bank owned life insurance	282,000	350,000	581,000	688,000
Mortgage banking activities	349,000	225,000	412,000	477,000
Rental income from other real estate owned	43,000	156,000	99,000	355,000
Other income	1,092,000	657,000	1,815,000	1,321,000
Total noninterest income	2,288,000	1,772,000	3,794,000	3,599,000
Noninterest expense				
Salaries and benefits	7,037,000	4,981,000	12,267,000	9,838,000

Occupancy	914,000	624,000	1,626,000	1,282,000
Furniture and equipment	368,000	256,000	615,000	512,000
FDIC insurance costs	224,000	175,000	401,000	420,000
Problem asset costs	(36,000)	279,000	(56,000)	410,000
Merger-related costs	3,453,000	46,000	3,830,000	60,000
Other expense	4,106,000	2,452,000	6,590,000	4,875,000
Total noninterest expenses	16,066,000	8,813,000	25,273,000	17,397,000
Income before federal income tax expense	2,475,000	5,771,000	7,738,000	11,968,000
Federal income tax expense	966,000	1,755,000	2,649,000	3,552,000
Net income	$1,509,000	$4,016,000	$5,089,000	$8,416,000
Basic earnings per share	$0.13	$0.46	$0.50	$0.97
Diluted earnings per share	$0.13	$0.46	$0.50	$0.97
Cash dividends per share	$2.12	$0.11	$2.24	$0.21
Average basic shares outstanding	$11,406,908	$8,705,667	$10,080,242	$8,705,673
Average diluted shares outstanding	$11,435,867	$8,718,649	$10,094,725	$8,718,627

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 June 30, 2014 (Unaudited)	Three Months Ended June 30, 2013 (Unaudited)	Six Months Ended June 30, 2014 (Unaudited)	Six Months Ended June 30, 2013 (Unaudited)
Net income	$1,509,000	$4,016,000	$5,089,000	$8,416,000
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	1,537,000	(3,787,000)	4,148,000	(4,789,000)
Fair value of interest rate swap	(140,000)	763,000	(126,000)	797,000
	1,397,000	(3,024,000)	4,022,000	(3,992,000)
Tax effect of unrealized holding gains (losses) on securities available for sale	(568,000)	1,325,000	(1,481,000)	1,676,000
Tax effect of fair value of interest rate swap	49,000	(266,000)	45,000	(226,000)
	(519,000)	1,059,000	(1,436,000)	1,450,000
Other comprehensive income (loss), net of tax	878,000	(1,965,000)	2,586,000	(2,542,000)
Comprehensive income	$2,387,000	$2,051,000	$7,675,000	$5,874,000

See accompanying notes to condensed consolidated financial statements.

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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 option exercises (5,920 shares)		75			75
Stock grants to directors for retainer fees (7,375 shares)		155			155
Stock-based compensation expense		351			351
Cash dividends ($2.24 per common share)		(20,102)	(315)		(20,417)
Common stock issued in connection with Firstbank merger (8,087,272 shares)		173,310			173,310
Stock options issued to replace existing Firstbank options at merger date		1,664			1,664
Net income for the six months ended June 30, 2014			5,089		5,089
Change in net unrealized holding gain on securities available for sale, net of tax effect				2,667	2,667
Change in fair value of interest rate swap, net of tax effect				(81)	(81)
Balances, June 30, 2014	$ 0	$ 318,452	$ 673	$ (2,987)	$ 316,138

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

($ 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 (1,098 shares)		19			19
Dividend reinvestment plan (1,954 shares)		33			33
Stock-based compensation expense		236			236
Cash dividends ($0.21 per common share)		(1,814)			(1,814)
Net income for the six months ended June 30, 2013			8,416		8,416
Change in net unrealized holding gain on securities available for sale, net of tax effect				(3,113)	(3,113)
Change in fair value of interest rate swap, net of tax effect				571	571
Balances, June 30, 2013	$ 0	$164,548	$(12,718)	$ (892)	$ 150,938

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Cash flows from operating activities		
Net income	$5,089,000	$8,416,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	1,967,000	1,086,000
Accretion of acquired loans	(512,000)	0
Provision for loan losses	(2,600,000)	(3,000,000)
Stock-based compensation expense	351,000	236,000
Proceeds from sales of mortgage loans held for sale	16,958,000	29,298,000
Origination of mortgage loans held for sale	(16,525,000)	(28,383,000)
Net gain from sales of mortgage loans held for sale	(383,000)	(395,000)
Net gain from sale and valuation write-down of foreclosed assets	(605,000)	(895,000)
Earnings on bank owned life insurance	(581,000)	(688,000)
Net change in:		
Accrued interest receivable	312,000	214,000
Other assets	(1,678,000)	11,930,000
Accrued interest and other liabilities	(5,844,000)	(1,368,000)
Net cash from (for) operating activities	(4,051,000)	16,451,000
Cash flows from investing activities		
Cash received in merger	91,806,000	0
Loan originations and payments, net	(75,655,000)	(20,433,000)
Purchases of securities available for sale	(11,679,000)	(28,973,000)
Proceeds from maturities, calls and repayments of securities available for sale	22,800,000	28,538,000
Proceeds from sales of securities available for sale	0	3,905,000
Proceeds from sales of foreclosed assets	1,940,000	5,659,000
Purchases of premises and equipment	(874,000)	(134,000)
Net cash from (for) investing activities	28,338,000	(11,438,000)
Cash flows from financing activities		
Net decrease in time deposits	(15,516,000)	(51,608,000)
Net decrease in all other deposits	(29,743,000)	(22,281,000)
Net increase (decrease) in securities sold under agreements to repurchase	319,000	(7,437,000)
Net increase in other borrowed money	12,728,000	49,000
Proceeds from stock option exercises	75,000	0

Employee stock purchase plan	0	19,000
Dividend reinvestment plan	0	33,000
Stock grants to directors for retainer fee	155,000	0
Payment of cash dividends to common shareholders	(20,417,000)	(1,814,000)
Net cash for financing activities	(52,399,000)	(83,039,000)
Net change in cash and cash equivalents	(28,112,000)	(78,026,000)
Cash and cash equivalents at beginning of period	146,965,000	136,003,000
Cash and cash equivalents at end of period	$118,853,000	$57,977,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	$5,336,000	$6,068,000
Federal income tax	1,400,000	0
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	175,000	1,710,000

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 six months ended June 30, 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 June 30, 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 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.

Stock options for approximately 159,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 2014. Stock options for approximately 177,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2014.

Approximately 64,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2013. In addition, stock options for approximately 21,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 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 and six months ended June 30, 2013.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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.

Investments: Investments are presented at fair value as required by accounting principles. Our investment portfolio is classified as available for sale, as such: adjustments to the fair value are reported as a change in equity. If a security is deemed to be other than temporarily impaired, the adjustment to fair value is recorded through the income statement.

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 and the related unrealized holding gain or loss (the difference between the fair value and amortized cost of the securities so classified) is reported in other comprehensive income. Other securities such as Federal Home Loan Bank stock are carried at cost. Interest income includes amortization of purchase premium or accretion of purchase discount. Premiums and discounts on securities are amortized or accreted on the level-yield method. Gains and losses on sales are recorded on the trade date and are determined using the specific identification method.

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.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 June 30, 2014 and December 31, 2013, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of $1.9 million and $1.1 million, respectively.

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 $593.0 million as of June 30, 2014.

Mortgage Banking Activities: 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. Impairment is evaluated quarterly based on the fair value of the servicing rights, using groupings of the underlying loans as to interest rates, types of loans, loan size, term and other factors. Any temporary impairment of a grouping is reported as a valuation allowance which is recovered when impairment no longer exists. Other-than-temporary impairments are recorded as a direct write-down to the carrying value of the servicing assets.

Servicing fee income is recorded for fees earned for servicing 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 servicing rights is netted against loan servicing income in the income statement.

<u>Derivatives</u>: 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 11. 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.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. <u>SIGNIFICANT ACCOUNTING POLICIES</u> (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.

<u>Goodwill and</u> <u>Core Deposit Intangible</u>: 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.

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.

<u>Adoption of New Accounting Standards:</u> 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 adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

In 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 is effective for annual and interim periods beginning after December 15, 2016 with three transition methods available – full retrospective, retrospective and cumulative effect approach. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

In June 2014, the FASB issued ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. This ASU requires two accounting changes. First, repurchase-to-maturity transactions will be accounted for as secured borrowing transactions on the balance sheet, rather than sales. Second, for repurchase financing arrangements, the ASU requires separate accounting for a transfer of a financial asset executed contemporaneously with (or in contemplation of) a repurchase agreement with the same counterparty, which also will generally result in secured borrowing accounting for the repurchase agreement. The ASU also introduces new disclosures to increase transparency about the types of collateral pledged for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings. The ASU also requires a transferor to disclose information about transactions accounted for as a sale in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets through an agreement with the transferee. The accounting changes and disclosure for certain transactions accounted for as a sale are effective for the first interim or annual period beginning after December 15, 2014. The disclosure for transactions accounted for as secured borrowings is required for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

2. BUSINESS COMBINATION

We completed the merger of Firstbank Corporation ("Firstbank"), a Michigan corporation with approximately $1.5 billion in total assets and 46 branch locations, into Mercantile Bank Corporation as of June 1, 2014 ("Merger Date"). The results of operations due to the Firstbank transaction have been included in Mercantile's financial results since the Merger Date. All of Firstbank's common stock was converted into the right to receive one share of Mercantile common stock for each share of Firstbank common stock. The conversion of Firstbank's common stock into Mercantile's common stock resulted in Mercantile issuing 8,087,272 shares of its common stock. The merger provided an expanded geographic footprint for the Company and increased the size of the balance sheet wherein the combined companies can realize economies of scale and other operating efficiencies. In conjunction with the completion of the merger, Mercantile assumed the obligations of Firstbank Capital Trust I, Firstbank Capital Trust II, Firstbank Capital Trust III and Firstbank Capital Trust IV.

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2. BUSINESS COMBINATION (Continued)

The Firstbank transaction was accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at estimated fair value on the Merger Date. Preliminary goodwill of $50.9 million was calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created from combining the two banking organizations as well as the economies of scale expected from combining the operations of the two companies. None of the goodwill is deductible for income tax purposes as the merger is accounted for as a tax-free exchange.

The following table provides the purchase price calculation as of the Merger Date and the identifiable assets purchased and the liabilities assumed at their estimated fair values. These fair value measurements are provisional based on third-party valuations that are currently under review and are subject to refinement for up to one year after the Merger Date based on additional information that may be obtained by us that existed as of the Merger Date.

Purchase Price:

Mercantile common shares issued for Firstbank common shares	8,087,272
Price per share, based on Mercantile closing price on May 30, 2014	$21.43
Value of common stock issued	173,310,000
Replacement stock options	1,664,000
Total purchase price	$174,974,000

Preliminary Statement of Net Assets Acquired at Fair Value:

Assets	
Cash and cash equivalents	$91,806,000
Securities	358,599,000
Total loans	943,662,000
Premises and equipment	24,049,000
Core deposit intangible	17,478,000

Mortgage servicing rights	7,389,000	
Other assets	8,500,000	
Total Assets	$1,451,483,000	
Liabilities		
Deposits	$1,229,609,000	
Borrowings	87,615,000	
Other liabilities	10,155,000	
Total Liabilities	$1,327,379,000	
Net Identifiable Assets Acquired		$124,104,000
Goodwill		$50,870,000

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2. BUSINESS COMBINATION (Continued)

The fair value of mortgage servicing rights was $7.4 million at the Acquisition Date. During the month of June 2014, new servicing rights amounting to less than $0.1 million and amortization expense of $0.1 million were recorded.

Firstbank's results of operations prior to the Merger Date are not included in our consolidated statements of income or consolidated statements of comprehensive income. The operations of the former Firstbank organization provided approximately $4.5 million in net interest income for the period from the Merger Date to June 30, 2014.

We recorded merger-related expenses of $3.5 million and $3.8 million during the three month and six month periods ended June 30, 2014, respectively. Such expenses were generally for professional services, costs related to termination of existing contractual arrangements for various services, retention and severance compensation costs, marketing and promotional expenses, travel costs, and printing and supplies costs. Virtually all of Mercantile and Firstbank's operating systems are now integrated.

The following table provides the unaudited pro forma information for the results of operations for the three and six month periods ended June 30, 2014 and 2013, as if the acquisition had occurred on January 1 of each year. These adjustments reflect the impact of certain purchase accounting fair value measurements, primarily comprised of Firstbank's loan and deposit portfolios. In addition, the $3.8 million in merger-related expenses noted earlier are included in each period presented. We expect to achieve further operating cost savings and other business synergies as a result of the merger which are not reflected in the pro forma amounts. These unaudited pro forma results are presented for illustrative purposes only and are not intended to represent or be indicative of the actual results of operations of the combined banking organization that would have been achieved had the merger occurred at the beginning of each period presented, nor are they intended to represent or be indicative of future results of operations.

	Three months ended June 30,	Six months ended June 30,

	2014	2013	2014	2013
Net interest income	$15,453,000	$11,212,000	$26,417,000	$22,566,000
Noninterest expense	17,160,000	13,407,000	26,862,000	22,786,000
Net income	863,000	900,000	4,186,000	5,043,000
Net income per diluted share	0.05	0.05	0.25	0.30

In most instances, determining the fair value of the acquired assets and assumed liabilities required us to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of those determinations relates to the valuation of acquired loans. For such loans, the excess of cash flows expected at acquisition over the estimated fair value is recognized as interest income over the remaining lives of the loans. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition reflects the impact of estimated credit losses and other factors, such as prepayments. In accordance with the applicable accounting guidance for business combinations, there was no carry-over of Firstbank’s previously established allowance for loan losses.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. BUSINESS COMBINATION (Continued)

The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 (“acquired impaired”), and loans that do not meet this criteria, which are accounted for under ASC 310-20 (“acquired non-impaired”). In addition, the loans are further categorized into different loan pools based primarily on the type and purpose of the loan.

The provisional fair value of loans at the Acquisition Date is presented in the following table:

	Acquired Impaired	Acquired Non-Impaired	Acquired Total Loans
Commercial Loans:			
Commercial & industrial	$878,000	$163,316,000	$164,194,000
Commercial real estate	12,973,000	378,016,000	390,989,000
Construction & development	1,289,000	33,726,000	35,015,000
Total Commercial Loans	$15,140,000	$575,058,000	$590,198,000
Consumer Loans:			
Residential mortgages	$9,694,000	$216,653,000	$226,347,000
Instalment	167,000	61,657,000	61,824,000
Home equity lines	288,000	52,054,000	52,342,000
Construction	76,000	12,875,000	12,951,000
Total Consumer Loans	$10,225,000	$343,239,000	$353,464,000
Total Loans	$25,365,000	$918,297,000	$943,662,000

The following table presents data on acquired impaired loans at the Acquisition Date:

Acquired

	Impaired
Contractual required payments	$44,936,000
Nonaccretable difference	17,057,000
Expected cash flows	27,879,000
Accretable yield	2,514,000
Carrying balance	$25,365,000

The nonaccretable difference includes $10.4 million in principal cash flows not expected to be collected, $2.8 million of pre-acquisition charge-offs and $3.9 million of future interest not expected to be collected. The unpaid principal balance of acquired performing loans was $926.4 million at the Acquisition Date, and the unaccreted discount on such loans was $8.1 million.

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MERCANTILE BANK CORPORATION

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(Unaudited)

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2. BUSINESS COMBINATION (Continued)

We also assumed obligations under junior subordinated debentures with an aggregate balance of $36.1 million and an aggregate fair value of $21.1 million as of the Acquisition Date, payable to four unconsolidated trusts (Firstbank Capital Trust I, Firstbank Capital Trust II, Firstbank Capital Trust III, and Firstbank Capital Trust IV) that have issued trust preferred securities. The junior subordinated debentures are the sole assets of each trust. Interest rates on all trust preferred securities issued by the trusts are tied to the 90 Day Libor rate with spreads ranging from 135 basis points to 199 basis points, and reset quarterly. The trust preferred securities have maturity dates ranging from October, 2034 to July, 2037, and are callable by us in whole or in part quarterly. The junior subordinated debentures are unsecured obligations of Mercantile, who has guaranteed that interest payments on the junior subordinated debentures made to the trust will be distributed by the trust to the holders of the trust preferred securities. The trust preferred securities currently fully qualify as Tier 1 Capital, and under current risk-based capital guidelines, will remain fully qualified as Tier 1 Capital until maturity unless called by us at an earlier date.

3. 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
June 30, 2014				
U.S. Government agency debt obligations	$219,141,000	$731,000	$(6,166,000)	$213,706,000
Mortgage-backed securities	107,145,000	1,249,000	(222,000)	108,172,000
Municipal general obligation bonds	139,996,000	894,000	(721,000)	140,169,000
Municipal revenue bonds	11,244,000	115,000	(35,000)	11,324,000
Other Investments	1,909,000	0	(5,000)	1,904,000

	$479,435,000	$2,989,000	$(7,149,000)	$475,275,000
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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. SECURITIES (Continued)

Securities with unrealized losses at June 30, 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
June 30, 2014						
U.S. Government agency debt obligations	$90,627,000	$(373,000)	$69,159,000	$(5,793,000)	$159,786,000	$(6,166,000)
Mortgage-backed securities	64,108,000	(222,000)	0	0	64,108,000	(222,000)
Municipal general obligation bonds	92,461,000	(721,000)	0	0	92,461,000	(721,000)
Municipal revenue bonds	7,775,000	(35,000)	0	0	7,775,000	(35,000)
Other Investments	0	0	1,395,000	(5,000)	1,395,000	(5,000)
	$254,971,000	$(1,351,000)	$70,554,000	$(5,798,000)	$325,525,000	$(7,149,000)
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)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. 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 June 30, 2014, 452 debt securities and one mutual fund with fair values totaling $325.5 million have unrealized losses aggregating $7.1 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 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 June 30, 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	0.86%	$	20,435,000	$	20,538,000
Due in 2015 through 2019	1.25		178,246,000		182,962,000
Due in 2020 through 2024	2.95		78,336,000		88,647,000
Due in 2025 and beyond	3.63		89,198,000		73,052,000
Mortgage-backed securities	1.73		103,209,000		108,172,000
Other Investments	1.55		1,909,000		1,904,000
	2.07%	$	471,333,000	$	475,275,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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3. **SECURITIES** (Continued)

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of $114.8 million and $17.4 million at June 30, 2014 and December 31, 2013, respectively, with estimated market values of $115.2 million and $17.8 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of $36.4 million and estimated market value of $36.3 million at June 30, 2014. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, did not exceed 10% of shareholders’ equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was $272.6 million and $94.4 million at June 30, 2014 and December 31, 2013, respectively. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

4. **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 (See Note 2 – Business Combination for further information). These loans were recorded at estimated fair value at the Acquisition 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 Acquisition Date and are accounted for in pools. No acquired loans were modified as troubled debt restructurings after the Acquisition Date.

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 Acquisition 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The difference between the fair value of an acquired non-impaired loan and contractual amounts due at the Acquisition 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 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.

We evaluate quarterly the remaining contractual required payments receivable and estimate cash flows expected to be collected over the life 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 Acquisition 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 Acquisition 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 June 30, 2014 were $2.07 billion compared to $1.05 billion at December 31, 2013, an increase of $1.02 billion, or 96.9%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at June 30, 2014 and December 31, 2013, and the percentage change in loans from the end of 2013 to the end of the second quarter of 2014, are as follows:

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(Unaudited)

4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	June 30, 2014 Balance	%	December 31, 2013 Balance	%	Percent Increase (Decrease)
Originated loans					
Commercial:					
Commercial and industrial	$342,375,000	29.9 %	$286,373,000	27.2 %	19.6 %
Vacant land, land development, and residential construction	32,214,000	2.8	36,741,000	3.5	(12.3)
Real estate – owner occupied	264,596,000	23.1	261,877,000	24.9	1.0
Real estate – non-owner occupied	399,855,000	34.9	364,066,000	34.6	9.8
Real estate – multi-family and residential rental	37,569,000	3.3	37,639,000	3.5	(0.2)
Total commercial	1,076,609,000	94.0	986,696,000	93.7	9.1
Retail:					
Home equity and other	35,151,000	3.1	35,080,000	3.3	0.2
1-4 family mortgages	33,337,000	2.9	31,467,000	3.0	5.9
Total retail	68,488,000	6.0	66,547,000	6.3	2.9
Total originated loans	$1,145,097,000	100.0%	$1,053,243,000	100.0%	8.7 %

	June 30, 2014 Balance	%	December 31, 2013 Balance	%	Percent Increase (Decrease)
Acquired loans					
Commercial:					
Commercial and industrial	$273,684,000	29.5 %	$0	NA	NM
Vacant land, land development, and residential construction	21,091,000	2.3	0	NA	NM
Real estate – owner occupied	119,818,000	12.9	0	NA	NM
Real estate – non-owner occupied	149,434,000	16.1	0	NA	NM

Real estate – multi-family and residential rental	47,099,000	5.1	0	NA	NM
Total commercial	611,126,000	65.8	0	NA	NM
Retail:					
Home equity and other	134,557,000	14.5	0	NA	NM
1-4 family mortgages	182,702,000	19.7	0	NA	NM
Total retail	317,259,000	34.2	0	NA	NM
Total acquired loans	$928,385,000	100.0%	$0	NA	NM

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	June 30, 2014 Balance	%	December 31, 2013 Balance	%	Percent Increase (Decrease)
Total loans					
Commercial:					
Commercial and industrial	$616,059,000	29.7 %	$286,373,000	27.2 %	115.1 %
Vacant land, land development, and residential construction	53,305,000	2.6	36,741,000	3.5	45.1
Real estate – owner occupied	384,414,000	18.5	261,877,000	24.9	46.8
Real estate – non-owner occupied	549,289,000	26.5	364,066,000	34.6	50.9
Real estate – multi-family and residential rental	84,668,000	4.1	37,639,000	3.5	124.9
Total commercial	1,687,735,000	81.4	986,696,000	93.7	71.0
Retail:					
Home equity and other	169,708,000	8.2	35,080,000	3.3	383.8
1-4 family mortgages	216,039,000	10.4	31,467,000	3.0	586.6
Total retail	385,747,000	18.6	66,547,000	6.3	479.7
Total loans	$2,073,482,000	100.0%	$1,053,243,000	100.0%	96.9 %

The total outstanding balance and carrying value of acquired impaired loans was $42.6 million and $26.1 million, respectively, as of June 30, 2014. Changes in the accretable yield for acquired impaired loans for the three and six months ended June 30, 2014 were as follows:

Balance at January 1, 2014	$0
Additions	2,514,000
Accretion	(103,000)
Net reclassification from nonaccretable to accretable	0

Disposals	0
Ending balance	$2,411,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Nonperforming originated loans as of June 30, 2014 and December 31, 2013 were as follows:

	June 30, 2014	December 31, 2013
Loans past due 90 days or more still accruing interest	$0	$0
Nonaccrual loans	5,741,000	6,718,000
Total nonperforming originated loans	$5,741,000	$6,718,000

The recorded principal balance of nonaccrual loans was as follows:

	June 30, 2014	December 31, 2013
Commercial:		
Commercial and industrial	$824,000	$1,501,000
Vacant land, land development, and residential construction	235,000	785,000
Real estate – owner occupied	640,000	389,000
Real estate – non-owner occupied	129,000	168,000
Real estate – multi-family and residential rental	470,000	208,000
Total commercial	2,298,000	3,051,000
Retail:		
Home equity and other	772,000	788,000
1-4 family mortgages	2,671,000	2,879,000
Total retail	3,443,000	3,667,000

Total nonaccrual loans	$5,741,000	$6,718,000

Acquired impaired loans are not subject to individual evaluation for impairment and are not reported as nonperforming loans based on acquired impaired loan accounting. Acquired non-impaired loans are placed on nonaccrual status and reported as nonperforming or past due using the same criteria applied to the originated loan portfolio.

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of June 30, 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
Originated loans							
Commercial:							
Commercial and industrial	$0	$ 0	$121,000	$121,000	$342,254,000	$342,375,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	32,214,000	32,214,000	0
Real estate – owner occupied	35,000	0	90,000	125,000	264,471,000	264,596,000	0
Real estate – non-owner occupied	0	0	0	0	399,855,000	399,855,000	0
Real estate – multi-family and residential rental	0	0	0	0	37,569,000	37,569,000	0
Total commercial	35,000	0	211,000	246,000	1,076,363,000	1,076,609,000	0
Retail:							
Home equity and other	2,000	0	0	2,000	35,149,000	35,151,000	0
1-4 family mortgages	0	0	347,000	347,000	32,990,000	33,337,000	0
Total retail	2,000	0	347,000	349,000	68,139,000	68,488,000	0
Total past due loans	$37,000	$ 0	$558,000	$595,000	$1,144,502,000	$1,145,097,000	$ 0

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. 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
Acquired loans							
Commercial:							
Commercial and industrial	$587,000	$19,000	$1,202,000	$1,808,000	$271,876,000	$273,684,000	$ 0
Vacant land, land development, and residential construction	0	0	748,000	748,000	20,343,000	21,091,000	0
Real estate – owner occupied	363,000	0	949,000	1,312,000	118,506,000	119,818,000	0
Real estate – non-owner occupied	65,000	1,347,000	1,436,000	2,848,000	146,586,000	149,434,000	0
Real estate – multi-family and residential rental	0	0	0	0	47,099,000	47,099,000	0
Total commercial	1,015,000	1,366,000	4,335,000	6,716,000	604,410,000	611,126,000	0
Retail:							
Home equity and other	681,000	142,000	12,000	835,000	133,722,000	134,557,000	0
1-4 family mortgages	1,796,000	115,000	860,000	2,771,000	179,931,000	182,702,000	0
Total retail	2,477,000						