MERCANTILE BANK CORP
Form 10-Q
May 06, 2016
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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2016

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

SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

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

310 Leonard Street, NW, Grand Rapids, MI 49504

(Address of principal executive offices) (Zip Code)

(616) 406-3000

(Registrant's telephone number, including area code)

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

Yes 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 29, 2016, there were 16,240,246 shares of common stock outstanding.

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MERCANTILE BANK CORPORATION

PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$38,367,000	$42,829,000
Interest-earning deposits	62,814,000	46,463,000
Federal funds sold	0	599,000
Total cash and cash equivalents	101,181,000	89,891,000
Securities available for sale	343,805,000	346,992,000
Federal Home Loan Bank stock	7,567,000	7,567,000
Loans	2,295,668,000	2,277,727,000
Allowance for loan losses	(16,262,000)	(15,681,000)
Loans, net	2,279,406,000	2,262,046,000
Premises and equipment, net	45,963,000	46,862,000
Bank owned life insurance	59,248,000	58,971,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	11,916,000	12,631,000
Other assets	27,497,000	29,123,000
Total assets	$2,926,056,000	$2,903,556,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$678,100,000	$674,568,000
Interest-bearing	1,587,022,000	1,600,814,000
Total deposits	2,265,122,000	2,275,382,000
Securities sold under agreements to repurchase	162,312,000	154,771,000
Federal Home Loan Bank advances	98,000,000	68,000,000
Subordinated debentures	44,324,000	55,154,000

Accrued interest and other liabilities	17,745,000	16,445,000
Total liabilities	2,587,503,000	2,569,752,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; none issued	0	0
Common stock, no par value; 40,000,000 shares authorized; 16,232,234 shares outstanding at March 31, 2016 and 16,358,711 shares outstanding at December 31, 2015	302,360,000	304,819,000
Retained earnings	33,697,000	27,722,000
Accumulated other comprehensive income	2,496,000	1,263,000
Total shareholders’ equity	338,553,000	333,804,000
Total liabilities and shareholders’ equity	$2,926,056,000	$2,903,556,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended March 31, 2016	Three Months Ended March 31, 2015
Interest income		
Loans, including fees	$26,779,000	$25,311,000
Securities, taxable	1,516,000	1,686,000
Securities, tax-exempt	537,000	537,000
Other interest-earning assets	57,000	55,000
Total interest income	28,889,000	27,589,000
Interest expense		
Deposits	1,866,000	1,899,000
Short-term borrowings	44,000	38,000
Federal Home Loan Bank advances	350,000	152,000
Subordinated debentures and other borrowings	747,000	651,000
Total interest expense	3,007,000	2,740,000
Net interest income	25,882,000	24,849,000
Provision for loan losses	600,000	(400,000)
Net interest income after provision for loan losses	25,282,000	25,249,000
Noninterest income		
Service charges on deposit and sweep accounts	948,000	770,000
Credit and debit card income	1,015,000	1,213,000
Gain on trust preferred securities repurchase	2,970,000	0
Mortgage banking income	598,000	688,000
Earnings on bank owned life insurance	286,000	287,000
Other income	1,269,000	736,000
Total noninterest income	7,086,000	3,694,000
Noninterest expense		
Salaries and benefits	10,995,000	10,084,000
Occupancy	1,604,000	1,573,000
Furniture and equipment depreciation, rent and maintenance	525,000	624,000
Data processing costs	1,992,000	1,770,000

FDIC insurance costs	392,000	477,000
Other expense	4,360,000	4,713,000
Total noninterest expenses	19,868,000	19,241,000
Income before federal income tax expense	12,500,000	9,702,000
Federal income tax expense	3,951,000	3,056,000
Net income	$8,549,000	$6,646,000
Basic earnings per share	$0.52	$0.39
Diluted earnings per share	$0.52	$0.39
Cash dividends per share	$0.16	$0.14
Average basic shares outstanding	16,291,654	16,937,630
Average diluted shares outstanding	16,325,475	16,978,591

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, 2016	Three Months Ended March 31, 2015
Net income	$8,549,000	$6,646,000
Other comprehensive income (loss):		
Unrealized holding gains on securities available for sale	1,919,000	2,873,000
Fair value of interest rate swap	(21,000)	(197,000)
	1,898,000	2,676,000
Tax effect of unrealized holding gains (losses) on securities available for sale	(672,000)	(997,000)
Tax effect of fair value of interest rate swap	7,000	69,000
	(665,000)	(928,000)
Other comprehensive income, net of tax effect	1,233,000	1,748,000
Comprehensive income	$9,782,000	$8,394,000

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 except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2016	$ 0	$ 304,819	$ 27,722	$ 1,263	$ 333,804
Employee stock purchase plan (364 shares)		8			8
Dividend reinvestment plan (17,876 shares)		411			411
Stock option exercises (4,700 shares)		50			50
Stock-based compensation expense		330			330
Share repurchase program (147,656 shares)		(3,258)			(3,258)
Cash dividends ($0.16 per common share)			(2,574)		(2,574)
Net income for the three months ended March 31, 2016			8,549		8,549
Change in net unrealized holding gain on securities available for sale, net of tax effect				1,247	1,247
Change in fair value of interest rate swap, net of tax effect				(14)	(14)
Balances, March 31, 2016	$ 0	$ 302,360	$ 33,697	$ 2,496	$ 338,553

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 except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2015	$ 0	$317,904	$10,218	$ 16	$ 328,138
Employee stock purchase plan (543 shares)		10			10
Dividend reinvestment plan (7,172 shares)		140			140
Stock option exercises (13,500 shares)		132			132
Stock grants to directors for retainer fees (5,994 shares)		123			123
Stock-based compensation expense		212			212
Share repurchase program (103,981 shares)		(1,984)			(1,984)
Cash dividends ($0.14 per common share)			(2,377)		(2,377)
Net income for the three months ended March 31, 2015			6,646		6,646
Change in net unrealized holding gain on securities available for sale, net of tax effect				1,876	1,876
Change in fair value of interest rate swap, net of tax effect				(128)	(128)
Balances, March 31, 2015	$ 0	$316,537	$14,487	$ 1,764	$ 332,788

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2016			Three Months Ended March 31, 2015		
Cash flows from operating activities						
Net income	$	8,549,000		$	6,646,000	
Adjustments to reconcile net income to net cash from operating activities						
Depreciation and amortization		2,767,000			2,833,000	
Accretion of acquired loans		(1,316,000	)		(1,416,000	)
Provision for loan losses		600,000			(400,000	)
Stock-based compensation expense		330,000			212,000	
Stock grants to directors for retainer fees		0			123,000	
Proceeds from sales of mortgage loans held for sale		19,465,000			23,970,000	
Origination of mortgage loans held for sale		(18,150,000	)		(25,123,000	)
Net gain from sales of mortgage loans held for sale		(543,000	)		(703,000	)
Gain on trust preferred securities repurchase		(2,970,000	)		0	
Net gain from sales and valuation write-down of foreclosed assets		(164,000	)		(1,000	)
Net (gain) loss from sales and write-downs of fixed assets		140,000			(20,000	)
Net (gain) loss from sales of available for sale securities		1,000			(5,000	)
Earnings on bank owned life insurance		(286,000	)		(287,000	)

Net change in:		
Accrued interest receivable	(366,000)	(713,000)
Other assets	732,000	1,150,000
Accrued interest and other liabilities	1,278,000	1,540,000
Net cash from operating activities	10,067,000	7,806,000
Cash flows from investing activities		
Loan originations and payments, net	(18,011,000)	(27,224,000)
Purchases of securities available for sale	(17,873,000)	(1,800,000)
Proceeds from maturities, calls and repayments of securities available for sale	22,337,000	22,371,000
Proceeds from sales of securities available for sale	264,000	665,000
Proceeds from sales of foreclosed assets	574,000	754,000
Net sales (purchases) of premises and equipment	44,000	(288,000)
Net cash for investing activities	(12,665,000)	(5,522,000)
Cash flows from financing activities		
Net decrease in time deposits	(24,764,000)	(40,457,000)
Net increase in all other deposits	14,504,000	43,654,000
Net increase (decrease) in securities sold under agreements to repurchase	7,541,000	(19,350,000)
Maturities of Federal Home Loan Bank advances	0	(6,000,000)
Proceeds from Federal Home Loan Bank advances	30,000,000	0
Proceeds from stock option exercises	50,000	132,000
Employee stock purchase plan	8,000	10,000
Dividend reinvestment plan	411,000	140,000
	(3,258,000)	(1,984,000)

Repurchase of common stock shares				
Repurchase of trust preferred securities		(8,030,000)		0
Payment of cash dividends to common shareholders		(2,574,000)		(2,377,000)
Net cash from (for) financing activities		13,888,000		(26,232,000)
Net change in cash and cash equivalents		11,290,000		(23,948,000)
Cash and cash equivalents at beginning of period		89,891,000		172,738,000
Cash and cash equivalents at end of period	$	101,181,000	$	148,790,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Three Months Ended March 31, 2016	Three Months Ended March 31, 2015
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	$3,063,000	$2,903,000
Federal income tax	250,000	950,000
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	595,000	422,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three months ended March 31, 2016 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ("our bank") and our bank's two subsidiaries, Mercantile Bank Real Estate Co., LLC ("our real estate company") and Mercantile Insurance Center, Inc. ("our insurance center"). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended March 31, 2016 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2015.

We have five separate business trusts that were formed to issue trust preferred securities. Subordinated debentures were issued to the trusts in return for the proceeds raised from the issuance of the trust preferred securities. The trusts are not consolidated, but instead we report the subordinated debentures issued to the trusts as a liability.

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and are determined using the treasury stock method. Our unvested restricted shares, which contain non-forfeitable rights to dividends whether paid or accrued (i.e., participating securities), are included in the number of shares outstanding for both basic and diluted earnings per share calculations. In the event of a net loss, our unvested restricted shares are excluded from the calculation of both basic and diluted earnings per share.

Approximately 150,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2016. In addition, stock options for approximately 118,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2016. Stock options for approximately 10,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2016.

Approximately 101,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2015. In addition, stock options for approximately 121,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2015. Stock options for approximately 118,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2015.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Securities: Debt securities classified as held to maturity are carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities are classified as available for sale when they might be sold prior to maturity. Equity securities with readily determinable fair values are classified as available for sale. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. Federal Home Loan Bank stock is carried at cost.

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

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

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

Interest income on commercial loans and mortgage loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer and credit card loans are typically charged off no later than when they are 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is considered doubtful.

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

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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 March 31, 2016 and December 31, 2015, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of $0.5 million and $1.3 million, respectively. Loans held for sale are reported as part of our total loans on the balance sheet.

Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold, which is reduced by the cost allocated to the servicing right. We generally lock in the sale price to the purchaser of the loan at the same time we make a rate commitment to the borrower. These mortgage banking activities are not designated as hedges and are carried at fair value. The net gain or loss on mortgage banking derivatives is included in the gain on sale of loans. Mortgage loans serviced for others totaled approximately $600 million as of March 31, 2016.

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

Servicing fee income is recorded for fees earned for serving mortgage loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. Amortization of mortgage loan servicing rights is netted against mortgage loan servicing income and recorded in mortgage banking activities in the income statement.

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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.

Goodwill and Core Deposit Intangible: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. The quantitative test is a two-step process consisting of comparing the carrying value of the reporting unit to an estimate of its fair value. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2014 and 2015, we elected to perform a qualitative assessment for our annual impairment test and concluded it is more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required.

The core deposit intangible that arose from the Firstbank Corporation acquisition was initially measured at fair value and is being amortized into noninterest expense over a ten-year period using the sum-of-the-years-digits methodology.

Adoption of New Accounting Standards: In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. This ASU establishes a comprehensive revenue recognition standard for virtually all industries under U.S.

GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. This ASU was originally effective for annual and interim periods beginning after December 15, 2016, with three transition methods available – full retrospective, retrospective and cumulative effect approach. In August 2015, the FASB issued ASU 2015-14, *Revenue from Contracts with Customers – Deferral of Effective Date*, which delays the implementation of this guidance by one year. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1.SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2016				
U.S. Government agency debt obligations	$141,400,000	$2,076,000	$(580,000)	$142,896,000
Mortgage-backed securities	61,744,000	828,000	(111,000)	62,461,000
Municipal general obligation bonds	125,794,000	1,948,000	(148,000)	127,594,000
Municipal revenue bonds	8,798,000	87,000	0	8,885,000
Other investments	1,954,000	15,000	0	1,969,000
	$339,690,000	$4,954,000	$(839,000)	$343,805,000
December 31, 2015				
U.S. Government agency debt obligations	$146,660,000	$1,932,000	$(1,552,000)	$147,040,000
Mortgage-backed securities	66,670,000	708,000	(304,000)	67,074,000
Municipal general obligation bonds	120,679,000	1,549,000	(205,000)	122,023,000
Municipal revenue bonds	8,841,000	76,000	(3,000)	8,914,000
Other investments	1,946,000	0	(5,000)	1,941,000
	$344,796,000	$4,265,000	$(2,069,000)	$346,992,000

Securities with unrealized losses at March 31, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
March 31, 2016						
U.S. Government agency debt obligations	$7,046,000	$114,000	$42,601,000	$466,000	$49,647,000	$580,000
Mortgage-backed securities	7,942,000	36,000	17,055,000	75,000	24,997,000	111,000
Municipal general obligation bonds	3,054,000	22,000	10,551,000	126,000	13,605,000	148,000
Municipal revenue bonds	0	0	121,000	< 1,000	121,000	< 1,000
Other investments	0	0	0	0	0	0
	$18,042,000	$172,000	$70,328,000	$667,000	$88,370,000	$839,000