MERCANTILE BANK CORP
Form 10-Q
August 05, 2016

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, 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 August 5, 2016, there were 16,279,351 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)

	June 30, 2016	December 31, 2015
ASSETS		
Cash and due from banks	$60,087,000	$42,829,000
Interest-earning deposits	46,896,000	46,463,000
Federal funds sold	0	599,000
Total cash and cash equivalents	106,983,000	89,891,000
Securities available for sale	323,452,000	346,992,000
Federal Home Loan Bank stock	8,026,000	7,567,000
Loans	2,379,940,000	2,277,727,000
Allowance for loan losses	(17,110,000)	(15,681,000)
Loans, net	2,362,830,000	2,262,046,000
Premises and equipment, net	45,558,000	46,862,000
Bank owned life insurance	66,537,000	58,971,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	11,228,000	12,631,000
Other assets	25,849,000	29,123,000
Total assets	$2,999,936,000	$2,903,556,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$733,573,000	$674,568,000
Interest-bearing	1,546,145,000	1,600,814,000
Total deposits	2,279,718,000	2,275,382,000
Securities sold under agreements to repurchase	136,690,000	154,771,000
Federal Home Loan Bank advances	178,000,000	68,000,000

Subordinated debentures	44,494,000	55,154,000
Accrued interest and other liabilities	16,457,000	16,445,000
Total liabilities	2,655,359,000	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; 16,271,061 shares outstanding at June 30, 2016 and 16,358,711 shares outstanding at December 31, 2015	303,336,000	304,819,000
Retained earnings	38,553,000	27,722,000
Accumulated other comprehensive income	2,688,000	1,263,000
Total shareholders’ equity	344,577,000	333,804,000
Total liabilities and shareholders’ equity	$2,999,936,000	$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 June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Interest income				
Loans, including fees	$26,887,000	$25,587,000	$53,666,000	$50,898,000
Securities, taxable	2,657,000	1,489,000	4,173,000	3,174,000
Securities, tax-exempt	540,000	523,000	1,077,000	1,060,000
Other interest-earning assets	63,000	64,000	120,000	120,000
Total interest income	30,147,000	27,663,000	59,036,000	55,252,000
Interest expense				
Deposits	1,819,000	1,775,000	3,685,000	3,675,000
Short-term borrowings	47,000	39,000	91,000	76,000
Federal Home Loan Bank advances	575,000	151,000	925,000	303,000
Subordinated debentures and other borrowings	606,000	657,000	1,353,000	1,308,000
Total interest expense	3,047,000	2,622,000	6,054,000	5,362,000
Net interest income	27,100,000	25,041,000	52,982,000	49,890,000
Provision for loan losses	1,100,000	(600,000)	1,700,000	(1,000,000)
Net interest income after provision for loan losses	26,000,000	25,641,000	51,282,000	50,890,000
Noninterest income				
Services charges on deposit and sweep accounts	1,090,000	812,000	2,038,000	1,582,000
Credit and debit card income	1,080,000	1,079,000	2,095,000	2,291,000
Mortgage banking activities	744,000	999,000	1,342,000	1,687,000
Earnings on bank owned life insurance	298,000	262,000	584,000	548,000
Gain on trust preferred securities repurchase	0	0	2,970,000	0
Other income	852,000	869,000	2,121,000	1,607,000
Total noninterest income	4,064,000	4,021,000	11,150,000	7,715,000

Noninterest expense				
Salaries and benefits	10,801,000	11,074,000	21,796,000	21,158,000
Occupancy	1,480,000	1,479,000	3,084,000	3,052,000
Furniture and equipment	522,000	596,000	1,047,000	1,220,000
Data processing costs	1,970,000	1,872,000	3,962,000	3,642,000
FDIC insurance costs	365,000	483,000	757,000	960,000
Other expense	4,055,000	4,846,000	8,415,000	9,559,000
Total noninterest expenses	19,193,000	20,350,000	39,061,000	39,591,000
Income before federal income tax expense	10,871,000	9,312,000	23,371,000	19,014,000
Federal income tax expense	3,437,000	2,754,000	7,388,000	5,810,000
Net income	$7,434,000	$6,558,000	$15,983,000	$13,204,000
Basic earnings per share	$0.46	$0.39	$0.98	$0.78
Diluted earnings per share	$0.46	$0.39	$0.98	$0.78
Cash dividends per share	$0.16	$0.14	$0.32	$0.28
Average basic shares outstanding	16,240,966	16,767,393	16,266,311	16,852,002
Average diluted shares outstanding	16,268,839	16,803,846	16,293,250	16,887,702

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, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Net income	$7,434,000	$6,558,000	$15,983,000	$13,204,000
Other comprehensive income (loss):				
Unrealized holding gains (losses) on securities available for sale	299,000	(2,722,000)	2,218,000	165,000
Fair value of interest rate swap	(4,000)	71,000	(25,000)	(126,000)
	295,000	(2,651,000)	2,193,000	39,000
Tax effect of unrealized holding gains (losses) on securities available for sale	(105,000)	981,000	(777,000)	(30,000)
Tax effect of fair value of interest rate swap	1,000	(25,000)	9,000	44,000
	(104,000)	956,000	(768,000)	14,000
Other comprehensive income (loss), net of tax	191,000	(1,695,000)	1,425,000	53,000
Comprehensive income	$7,625,000	$4,863,000	$17,408,000	$13,257,000

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 (Deficit)	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 (773 shares)		18			18
Dividend reinvestment plan (38,195 shares)		909			909
Stock option exercises (31,249 shares)		379			379
Stock grants to directors for retainer fees (13,000 shares)		327			327
Stock-based compensation expense		616			616
Share repurchase program (167,878 shares)		(3,732)			(3,732)
Cash dividends ($0.32 per common share)			(5,152)		(5,152)
Net income for the six months ended June 30, 2016			15,983		15,983
Change in net unrealized holding gain on securities available for sale, net of tax effect				1,441	1,441
Change in fair value of interest rate swap, net of tax effect				(16)	(16)
Balances, June 30, 2016	$ 0	$ 303,336	$ 38,553	$ 2,688	$ 344,577

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 (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2015	$ 0	$ 317,904	$ 10,218	$ 16	$ 328,138
Employee stock purchase plan (1,110 shares)		23			23
Dividend reinvestment plan (13,788 shares)		283			283
Stock option exercises (26,375 shares)		275			275
Stock grants to directors for retainer fees (20,094 shares)		402			402
Stock-based compensation expense		359			359
Share repurchase program (463,060 shares)		(9,110)			(9,110)
Cash dividends ($0.28 per common share)			(4,656)		(4,656)
Net income for the six months ended June 30, 2015			13,204		13,204
Change in net unrealized holding gain on securities available for sale, net of tax effect				135	135
Change in fair value of interest rate swap, net of tax effect				(82)	(82)
Balances, June 30, 2015	$ 0	$ 310,136	$ 18,766	$ 69	$ 328,971

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, 2016	Six Months Ended June 30, 2015
Cash flows from operating activities		
Net income	$15,983,000	$13,204,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	4,275,000	5,588,000
Accretion of acquired loans	(2,251,000)	(2,910,000)
Provision for loan losses	1,700,000	(1,000,000)
Stock-based compensation expense	616,000	359,000
Stock grants to directors for retainer fee	327,000	402,000
Proceeds from sales of mortgage loans held for sale	46,441,000	57,735,000
Origination of mortgage loans held for sale	(46,715,000)	(56,853,000)
Net gain from sales of mortgage loans held for sale	(1,290,000)	(1,706,000)
Gain on trust preferred securities repurchase	(2,970,000)	0
Net gain from sales and valuation write-down of foreclosed assets	(322,000)	(71,000)
Net gain from sales and valuation write-down of former bank premises	(10,000)	0
Net (gain) loss from sales of fixed assets	171,000	(10,000)
Net (gain) loss from sales of available for sale securities	1,000	(5,000)
Earnings on bank owned life insurance	(584,000)	(548,000)
Net change in:		
Accrued interest receivable	568,000	212,000
Other assets	(120,000)	(188,000)
Accrued interest and other liabilities	(13,000)	896,000
Net cash from operating activities	15,807,000	15,105,000
Cash flows from investing activities		
Loan originations and payments, net	(99,276,000)	(82,399,000)
Purchases of securities available for sale	(60,873,000)	(4,868,000)
Proceeds from maturities, calls and repayments of securities available for sale	86,872,000	62,135,000
Proceeds from sales of securities available for sale	264,000	665,000
Proceeds from sales of foreclosed assets	1,371,000	1,131,000
Proceeds from sales of former bank premises	46,000	0

Proceeds from FHLB stock redemption	0	6,132,000
Purchases of FHLB stock	(459,000)	0
Purchases of bank owned life insurance	(7,000,000)	0
Net purchases of premises and equipment	(307,000)	(589,000)
Net cash for investing activities	(79,362,000)	(17,793,000)

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
Cash flows from financing activities		
Net decrease in time deposits	(17,540,000)	(84,451,000)
Net increase in all other deposits	21,876,000	87,505,000
Net decrease in securities sold under agreements to repurchase	(18,081,000)	(15,488,000)
Maturities of Federal Home Loan Bank advances	0	(6,000,000)
Proceeds from Federal Home Loan Bank advances	110,000,000	0
Proceeds from stock option exercises	379,000	275,000
Employee stock purchase plan	18,000	23,000
Dividend reinvestment plan	909,000	283,000
Repurchase of common stock shares	(3,732,000)	(9,110,000)
Repurchase of trust preferred securities	(8,030,000)	0
Payment of cash dividends to common shareholders	(5,152,000)	(4,656,000)
Net cash from (for) financing activities	80,647,000	(31,619,000)
Net change in cash and cash equivalents	17,092,000	(34,307,000)
Cash and cash equivalents at beginning of period	89,891,000	172,738,000
Cash and cash equivalents at end of period	$106,983,000	$138,431,000
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	$6,016,000	$5,564,000
Federal income tax	6,700,000	5,700,000
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	236,000	1,098,000
Transfers from bank premises to other real estate owned	371,000	0

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, 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 June 30, 2016 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2015.

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

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

Approximately 150,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2016. In addition, stock options for approximately 92,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 2016. Stock options for approximately 7,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2016.

Approximately 100,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2015. In addition, stock options for approximately 108,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 2015. Stock options for approximately 91,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2015.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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, 2016 and December 31, 2015, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of $2.9 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 $597 million as of June 30, 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.

(Continued)

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)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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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

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard will replace the current "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans, and expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. This ASU is effective for interim and annual reporting periods beginning after December 15, 2019, and early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements.

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	Gross	Gross	Fair

	Cost	Unrealized Gains	Unrealized Losses	Value
June 30, 2016				
U.S. Government agency debt obligations	$132,085,000	$895,000	$(38,000)	$132,942,000
Mortgage-backed securities	56,616,000	979,000	(50,000)	57,545,000
Municipal general obligation bonds	119,878,000	2,602,000	(94,000)	122,386,000
Municipal revenue bonds	8,498,000	95,000	0	8,593,000
Other investments	1,962,000	24,000	0	1,986,000
	$319,039,000	$4,595,000	$(182,000)	$323,452,000
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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

Securities with unrealized losses at June 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Vaule	Unrealized Loss
June 30, 2016						
U.S. Government agency debt obligations	$3,991,000	$ 9,000	$2,958,000	$ 29,000	$6,949,000	$ 38,000
Mortgage-backed securities	3,212,000	16,000	9,899,000	34,000	13,111,000	50,000
Municipal general obligation bonds	850,000	5,000	9,042,000	89,000	9,892,000	94,000
Municipal revenue bonds	557,000	0	0	0	557,000	0
Other investments	0	0	0	0	0	0
	$8,610,000	$ 30,000	$21,899,000	$ 152,000	$30,509,000	$ 182,000

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2015						
U.S. Government agency debt obligations	$0	$ 0	$76,496,000	$1,552,000	$76,496,000	$1,552,000
Mortgage-backed securities	18,025,000	69,000	34,660,000	235,000	52,685,000	304,000
Municipal general obligation bonds	1,981,000	4,000	30,134,000	201,000	32,115,000	205,000
Municipal revenue bonds	0	0	1,134,000	3,000	1,134,000	3,000

Other investments	1,446,000	5,000	0	0	1,446,000	5,000
	$21,452,000	$ 78,000	$142,424,000	$1,991,000	$163,876,000	$2,069,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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2. SECURITIES (Continued)

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

At June 30, 2016, 93 debt securities with fair values totaling $30.5 million have unrealized losses aggregating $0.2 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, 2016, by maturity, are shown in the following table. The contractual maturity is utilized for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

	Weighted Average	Amortized Cost	Fair Value

	Yield			
Due in 2016	1.44	%	$32,582,000	$32,601,000
Due in 2017 through 2021	1.83		119,275,000	120,413,000
Due in 2022 through 2026	3.10		55,510,000	56,994,000
Due in 2027 and beyond	3.27		53,094,000	53,913,000
Mortgage-backed securities	1.76		56,616,000	57,545,000
Other investments	3.06		1,962,000	1,986,000
	2.24	%	$319,039,000	$323,452,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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2. SECURITIES (Continued)

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of $107 million and $106 million at June 30, 2016 and December 31, 2015, respectively, with estimated market values of $109 million and $107 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of $21.5 million and $24.0 million at June 30, 2016 and December 31, 2015, respectively, with estimated market values of $21.8 million and $24.1 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was $137 million and $155 million at June 30, 2016, and December 31, 2015, respectively. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Our total loans at June 30, 2016 were $2.38 billion compared to $2.28 billion at December 31, 2015, an increase of $102 million, or 4.5%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at June 30, 2016 and December 31, 2015, and the percentage change in loans from the end of 2015 to the end of the second quarter of 2016, are as follows:

	June 30, 2016 Balance	%	December 31, 2015 Balance	%	Percent Increase (Decrease)
Originated loans					
Commercial:					
Commercial and industrial	$653,135,000	36.3 %	$577,872,000	35.7 %	13.0 %
Vacant land, land development, and residential construction	30,232,000	1.7	30,138,000	1.9	0.3
Real estate – owner occupied	338,909,000	18.8	330,798,000	20.5	2.5
Real estate – non-owner occupied	603,236,000	33.5	520,754,000	32.2	15.8
Real estate – multi-family and residential rental	39,233,000	2.2	33,954,000	2.1	15.5
Total commercial	1,664,745,000	92.5	1,493,516,000	92.4	11.5
Retail:					
Home equity and other	69,396,000	3.9	67,816,000	4.2	2.3
1-4 family mortgages	65,813,000	3.6	55,255,000	3.4	19.1
Total retail	135,209,000	7.5	123,071,000	7.6	9.9
Total originated loans	$1,799,954,000	100.0%	$1,616,587,000	100.0%	11.3 %

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	June 30, 2016 Balance	%	December 31, 2015 Balance	%	Percent Increase (Decrease)
Acquired loans					
Commercial:					
Commercial and industrial	$97,001,000	16.7 %	$118,431,000	17.9 %	(18.1)%
Vacant land, land development, and residential construction	10,297,000	1.8	14,982,000	2.3	(31.3)
Real estate – owner occupied	99,889,000	17.2	115,121,000	17.4	(13.2)
Real estate – non-owner occupied	113,694,000	19.6	123,597,000	18.7	(8.0)
Real estate – multi-family and residential rental	74,129,000	12.8	81,049,000	12.3	(8.5)
Total commercial	395,010,000	68.1	453,180,000	68.6	(12.8)
Retail:					
Home equity and other	61,671,000	10.6	72,830,000	11.0	(15.3)
1-4 family mortgages	123,305,000	21.3	135,130,000	20.4	(8.7)
Total retail	184,976,000	31.9	207,960,000	31.4	(11.1)
Total acquired loans	$579,986,000	100.0%	$661,140,000	100.0%	(12.3%)

	June 30, 2016 Balance	%	December 31, 2015 Balance	%	Percent Increase (Decrease)
Total loans					
Commercial:					
Commercial and industrial	$750,136,000	31.5 %	$696,303,000	30.6 %	7.7 %
Vacant land, land development, and residential construction	40,529,000	1.7	45,120,000	2.0	(10.2)
Real estate – owner occupied	438,798,000	18.4	445,919,000	19.6	(1.6)
Real estate – non-owner occupied	716,930,000	30.1	644,351,000	28.3	11.3

Real estate – multi-family and residential rental	113,362,000	4.8	115,003,000	5.0	(1.4)
Total commercial	2,059,755,000	86.5	1,946,696,000	85.5	5.8
Retail:					
Home equity and other	131,067,000	5.5	140,646,000	6.2	(6.8)
1-4 family mortgages	189,118,000	8.0	190,385,000	8.3	(0.7)
Total retail	320,185,000	13.5	331,031,000	14.5	(3.3)
Total loans	$2,379,940,000	100.0%	$2,277,727,000	100.0%	4.5 %

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The total contractually required payments due on and carrying value of acquired impaired loans were $19.2 million and $8.8 million, respectively, as of June 30, 2016. The total contractually required payments due on and carrying value of acquired impaired loans were $24.6 million and $13.1 million, respectively, as of December 31, 2015. Changes in the accretable yield for acquired impaired loans for the three and six months ended June 30, 2016 and June 30, 2015 were as follows:

Balance at March 31, 2016	$6,319,000
Additions	0
Accretion income	(674,000)
Net reclassification from nonaccretable to accretable	1,193,000
Reductions (1)	(236,000)
Balance at June 30, 2016	$6,602,000

Balance at December 31, 2015	$5,193,000
Additions	21,000
Accretion income	(1,354,000)
Net reclassification from nonaccretable to accretable	3,565,000
Reductions (1)	(823,000)
Balance at June 30, 2016	$6,602,000

Balance at March 31, 2015	$5,241,000
Additions	0
Accretion income	(681,000)
Net reclassification from nonaccretable to accretable	708,000
Reductions (1)	(153,000)
Balance at June 30, 2015	$5,115,000

Balance at December 31, 2014	$4,998,000
Additions	0
Accretion income	(1,327,000)
Net reclassification from nonaccretable to accretable	1,649,000
Reductions (1)	(205,000)
Balance at June 30, 2015	$5,115,000

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Nonperforming originated loans as of June 30, 2016 and December 31, 2015 were as follows:

	June 30, 2016	December 31, 2015
Loans past due 90 days or more still accruing interest	$0	$0
Nonaccrual loans	2,042,000	1,954,000
Total nonperforming originated loans	$2,042,000	$1,954,000

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

	June 30, 2016	December 31, 2015
Loans past due 90 days or more still accruing interest	$0	$5,000
Nonaccrual loans	3,126,000	3,485,000
Total nonperforming acquired loans	$3,126,000	$3,490,000

The recorded principal balance of nonperforming loans was as follows:

	June 30, 2016	December 31, 2015
Commercial:		
Commercial and industrial	$819,000	$458,000
Vacant land, land development, and residential construction	125,000	155,000
Real estate – owner occupied	1,465,000	1,797,000
Real estate – non-owner occupied	51,000	79,000
Real estate – multi-family and residential rental	114,000	157,000
Total commercial	2,574,000	2,646,000
Retail:		
Home equity and other	616,000	771,000
1-4 family mortgages	1,978,000	2,027,000
Total retail	2,594,000	2,798,000
Total nonperforming loans	$5,168,000	$5,444,000

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

An age analysis of past due loans is as follows as of June 30, 2016:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Originated loans							
Commercial:							
Commercial and industrial	$1,000	$0	$0	$1,000	$653,134,000	$653,135,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	30,232,000	30,232,000	0
Real estate – owner occupied	0	197,000	0	197,000	338,712,000	338,909,000	0
Real estate – non-owner occupied	0	0	0	0	603,236,000	603,236,000	0
Real estate – multi-family and residential rental	0	0	0	0	39,233,000	39,233,000	0
Total commercial	1,000	197,000	0	198,000	1,664,547,000	1,664,745,000	0
Retail:							
Home equity and other	129,000	21,000	11,000	161,000	69,235,000	69,396,000	0
1-4 family mortgages	97,000	0	403,000	500,000	65,313,000	65,813,000	0
Total retail	226,000	21,000	414,000	661,000	134,548,000	135,209,000	0
Total past due loans	$227,000	$218,000	$414,000	$859,000	$1,799,095,000	$1,799,954,000	$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Acquired loans							
Commercial:							
Commercial and industrial	$14,000	$0	$350,000	$364,000	$96,637,000	$97,001,000	$ 0
Vacant land, land development, and residential construction	29,000	0	0	29,000	10,268,000	10,297,000	0
Real estate – owner occupied	243,000	50,000	398,000	691,000	99,198,000	99,889,000	0
Real estate – non-owner occupied	159,000	0	419,000	578,000	113,116,000	113,694,000	0
Real estate – multi-family and residential rental	164,000	42,000	80,000	286,000	73,843,000	74,129,000	0
Total commercial	609,000	92,000	1,247,000	1,948,000	393,062,000	395,010,000	0
Retail:							
Home equity and other	568,000	43,000	11,000	622,000	61,049,000	61,671,000	0
1-4 family mortgages	1,188,000	261,000	344,000	1,793,000	121,512,000	123,305,000	0
Total retail	1,756,000	304,000	355,000	2,415,000	182,561,000	184,976,000	0
Total past due loans	$2,365,000	$396,000	$1,602,000	$4,363,000	$575,623,000	$579,986,000	$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

An age analysis of past due loans is as follows as of December 31, 2015:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Originated loans							
Commercial:							
Commercial and industrial	$0	$0	$0	$0	$577,872,000	$577,872,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	30,138,000	30,138,000	0
Real estate – owner occupied	432,000	0	9,000	441,000	330,357,000	330,798,000	0
Real estate – non-owner occupied	0	0	0	0	520,754,000	520,754,000	0
Real estate – multi-family and residential rental	0	0	0	0	33,954,000	33,954,000	0
Total commercial	432,000	0	9,000	441,000	1,493,075,000	1,493,516,000	0
Retail:							
Home equity and other	186,000	108,000	0	294,000	67,522,000	67,816,000	0
1-4 family mortgages	107,000	95,000	356,000	558,000	54,697,000	55,255,000	0
Total retail	293,000	203,000	356,000	852,000	122,219,000	123,071,000	0

Total past due loans	$725,000	$203,000	$365,000	$1,293,000	$1,615,294,000	$1,616,587,000	$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Acquired Loans							
Commercial:							
Commercial and industrial	$0	$5,000	$541,000	$546,000	$117,885,000	$118,431,000	$ 0
Vacant land, land development, and residential construction	27,000	0	0	27,000	14,955,000	14,982,000	0
Real estate – owner occupied	323,000	425,000	1,142,000	1,890,000	113,231,000	115,121,000	0
Real estate – non-owner occupied	53,000	703,000	79,000	835,000	122,762,000	123,597,000	0
Real estate – multi-family and residential rental	223,000	54,000	0	277,000	80,772,000	81,049,000	0
Total commercial	626,000	1,187,000	1,762,000	3,575,000	449,605,000	453,180,000	0
Retail:							
Home equity and other	395,000	44,000	28,000	467,000	72,363,000	72,830,000	5,000
1-4 family mortgages	960,000	354,000	416,000	1,730,000	133,400,000	135,130,000	0
Total retail	1,355,000	398,000	444,000	2,197,000	205,763,000	207,960,000	5,000
Total past due loans	$1,981,000	$1,585,000	$2,206,000	$5,772,000	$655,368,000	$661,140,000	$ 5,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired originated loans as of June 30, 2016, and average originated impaired loans for the three and six months ended June 30, 2016, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded					
Commercial:					
Commercial and industrial	$2,147,000	$2,146,000		$2,017,000	$ 1,845,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	348,000	251,000		160,000	275,000
Real estate – non-owner occupied	5,623,000	5,623,000		5,641,000	5,660,000
Real estate – multi-family and residential rental	0	0		0	0
Total commercial	8,118,000	8,020,000		7,818,000	7,780,000
Retail:					
Home equity and other	129,000	120,000		65,000	45,000
1-4 family mortgages	1,324,000	668,000		621,000	633,000
Total retail	1,453,000	788,000		686,000	678,000
Total with no related allowance recorded	$9,571,000	$8,808,000		$8,504,000	$ 8,458,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded					
Commercial:					
Commercial and industrial	$249,000	$199,000	$47,000	$217,000	$246,000
Vacant land, land development and residential construction	2,002,000	1,625,000	72,000	1,633,000	1,640,000
Real estate – owner occupied	5,930,000	1,378,000	235,000	1,339,000	1,331,000
Real estate – non-owner occupied	4,704,000	4,704,000	180,000	4,729,000	4,766,000
Real estate – multi-family and residential rental	979,000	979,000	293,000	993,000	1,004,000
Total commercial	13,864,000	8,885,000	827,000	8,911,000	8,987,000
Retail:					
Home equity and other	550,000	512,000	137,000	491,000	515,000
1-4 family mortgages	205,000	163,000	72,000	145,000	139,000
Total retail	755,000	675,000	209,000	636,000	654,000
Total with an allowance recorded	$14,619,000	$9,560,000	$1,036,000	$9,547,000	$9,641,000
Total impaired loans:					
Commercial	$21,982,000	$16,905,000	$827,000	$16,729,000	$16,767,000
Retail	2,208,000	1,463,000	209,000	1,322,000	1,332,000
Total impaired loans	$24,190,000	$18,368,000	$1,036,000	$18,051,000	$18,099,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of June 30, 2016, and average impaired acquired loans for the three and six months ended June 30, 2016, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded					
Commercial:					
Commercial and industrial	$1,694,000	$1,681,000		$1,556,000	$1,535,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	1,314,000	1,300,000		1,485,000	1,640,000
Real estate – non-owner occupied	811,000	811,000		792,000	821,000
Real estate – multi-family and residential rental	295,000	295,000		289,000	327,000
Total commercial	4,114,000	4,087,000		4,122,000	4,323,000
Retail:					
Home equity and other	367,000	365,000		321,000	317,000
1-4 family mortgages	1,305,000	1,305,000		1,290,000	1,376,000
Total retail	1,672,000	1,670,000		1,611,000	1,693,000
Total with no related allowance recorded	$5,786,000	$5,757,000		$5,733,000	$6,016,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded					
Commercial:					
Commercial and industrial	$356,000	$356,000	$ 101,000	$367,000	$ 370,000
Vacant land, land development and residential construction	0	0	0	0	0
Real estate – owner occupied	49,000	49,000	4,000	50,000	50,000
Real estate – non-owner occupied	0	0	0	0	0
Real estate – multi-family and residential rental	20,000	20,000	1,000	20,000	21,000
Total commercial	425,000	425,000	106,000	437,000	441,000
Retail:					
Home equity and other	0	0	0	0	0
1-4 family mortgages	174,000	174,000	5,000	87,000	116,000
Total retail	174,000	174,000	5,000	87,000	116,000
Total with an allowance recorded	$599,000	$599,000	$ 111,000	$524,000	$ 557,000
Total impaired loans:					
Commercial	$4,539,000	$4,512,000	$ 106,000	$4,559,000	$ 4,764,000
Retail	1,846,000	1,844,000	5,000	1,698,000	1,809,000
Total impaired loans	$6,385,000	$6,356,000	$ 111,000	$6,257,000	$ 6,573,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired originated loans as of December 31, 2015, and average impaired originated loans for the three and six months ended June 30, 2015, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded					
Commercial:					
Commercial and industrial	$1,509,000	$1,501,000		$1,930,000	$1,674,000
Vacant land, land development and residential construction	0	0		98,000	135,000
Real estate – owner occupied	712,000	505,000		1,062,000	1,342,000
Real estate – non-owner occupied	5,696,000	5,696,000		2,937,000	2,362,000
Real estate – multi-family and residential rental	0	0		306,000	309,000
Total commercial	7,917,000	7,702,000		6,333,000	5,822,000
Retail:					
Home equity and other	14,000	5,000		189,000	190,000
1-4 family mortgages	1,328,000	657,000		615,000	597,000
Total retail	1,342,000	662,000		804,000	787,000
Total with no related allowance recorded	$9,259,000	$8,364,000		$7,137,000	$6,609,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded					
Commercial:					
Commercial and industrial	$352,000	$305,000	$165,000	$2,812,000	$3,617,000
Vacant land, land development and residential construction	2,017,000	1,655,000	245,000	2,092,000	2,061,000
Real estate – owner occupied	5,867,000	1,314,000	242,000	8,806,000	11,095,000
Real estate – non-owner occupied	4,841,000	4,841,000	201,000	10,319,000	12,195,000
Real estate – multi-family and residential rental	1,028,000	1,028,000	365,000	1,321,000	1,338,000
Total commercial	14,105,000	9,143,000	1,218,000	25,350,000	30,306,000
Retail:					
Home equity and other	600,000	562,000	209,000	165,000	138,000
1-4 family mortgages	165,000	128,000	47,000	217,000	811,000
Total retail	765,000	690,000	256,000	382,000	949,000
Total with an allowance recorded	$14,870,000	$9,833,000	$1,474,000	$25,732,000	$31,255,000
Total impaired loans:					
Commercial	$22,022,000	$16,845,000	$1,218,000	$31,683,000	$36,128,000
Retail	2,107,000	1,352,000	256,000	1,186,000	1,736,000
Total impaired loans	$24,129,000	$18,197,000	$1,474,000	$32,869,000	$37,864,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of December 31, 2015, and average impaired acquired loans for the three and six months ended June 30, 2015, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded					
Commercial:					
Commercial and industrial	$1,528,000	$1,494,000		$1,244,000	$1,356,000
Vacant land, land development and residential construction	0	0		0	0
Real estate – owner occupied	2,233,000	1,952,000		317,000	249,000
Real estate – non-owner occupied	880,000	880,000		427,000	393,000
Real estate – multi-family and residential rental	452,000	404,000		2,037,000	1,520,000
Total commercial	5,093,000	4,730,000		4,025,000	3,518,000
Retail:					
Home equity and other	471,000	310,000		365,000	456,000
1-4 family mortgages	1,804,000	1,548,000		801,000	823,000
Total retail	2,275,000	1,858,000		1,166,000	1,279,000
Total with no related allowance recorded	$7,368,000	$6,588,000		$5,191,000	$4,797,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Second Quarter Average Recorded Principal Balance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded					
Commercial:					
Commercial and industrial	$383,000	$376,000	$102,000	$97,000	$65,000
Vacant land, land development and residential construction	0	0	0	0	0
Real estate – owner occupied	51,000	51,000	4,000	1,256,000	1,338,000
Real estate – non-owner occupied	0	0	0	0	0
Real estate – multi-family and residential rental	23,000	23,000	0	28,000	19,000
Total commercial	457,000	450,000	106,000	1,381,000	1,422,000
Retail:					
Home equity and other	0	0	0	0	0
1-4 family mortgages	175,000	175,000	6,000	283,000	189,000
Total retail	175,000	175,000	6,000	283,000	189,000
Total with an allowance recorded	$632,000	$625,000	$112,000	$1,664,000	$1,611,000
Total impaired loans:					
Commercial	$5,550,000	$5,180,000	$106,000	$5,406,000	$4,940,000
Retail	2,450,000	2,033,000	6,000	1,449,000	1,468,000
Total impaired loans	$8,000,000	$7,213,000	$112,000	$6,855,000	$6,408,000

Impaired loans for which no allocation of the allowance for loan losses has been made generally reflect situations whereby the loans have been charged-down to estimated collateral value. Interest income recognized on accruing troubled debt restructurings totaled $0.2 million and $0.4 million during the second quarter of 2016 and 2015, respectively, and $0.5 million and $0.8 million during the first six months of 2016 and 2015, respectively. No interest income was recognized on nonaccrual loans during the second quarter and first six months of 2016 or during the respective 2015 periods.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

Credit quality indicators were as follows as of June 30, 2016:

Originated loans

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

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

Internal credit risk grade groupings:					
Grades 1 – 4	$455,134,000	$ 19,014,000	$237,652,000	$491,928,000	$ 20,438,000
Grades 5 – 7	197,701,000	11,093,000	99,961,000	111,308,000	17,816,000
Grades 8 – 9	300,000	125,000	1,296,000	0	979,000
Total commercial	$653,135,000	$ 30,232,000	$338,909,000	$603,236,000	$ 39,233,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	$69,396,000	$65,813,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Acquired loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$50,716,000	$ 2,322,000	$41,217,000	$70,569,000	$42,729,000
Grades 5 – 7	43,819,000	7,648,000	55,364,000	41,431,000	30,692,000
Grades 8 – 9	2,466,000	327,000	3,308,000	1,694,000	708,000
Total commercial	$97,001,000	$ 10,297,000	$99,889,000	$113,694,000	$74,129,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail	Retail

	Home Equity and Other	1-4 Family Mortgages
Total retail	$61,671,000	$123,305,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit quality indicators were as follows as of December 31, 2015:

Originated loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$417,120,000	$ 18,118,000	$230,629,000	$400,350,000	$ 19,121,000
Grades 5 – 7	160,454,000	10,365,000	98,332,000	120,404,000	13,806,000
Grades 8 – 9	298,000	1,655,000	1,837,000	0	1,027,000
Total commercial	$577,872,000	$ 30,138,000	$330,798,000	$520,754,000	$ 33,954,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	$67,816,000	$55,255,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Acquired loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$ 67,978,000	$ 3,095,000	$ 45,807,000	$ 71,197,000	$ 44,763,000
Grades 5 – 7	47,589,000	11,364,000	63,563,000	50,066,000	35,288,000
Grades 8 – 9	2,864,000	523,000	5,751,000	2,334,000	998,000
Total commercial	$ 118,431,000	$ 14,982,000	$ 115,121,000	$ 123,597,000	$ 81,049,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	$72,830,000	$135,130,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

All commercial loans are graded using the following criteria:

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses and the recorded investments in originated loans as of and during the three and six months ended June 30, 2016 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2016	$13,924,000	$1,834,000	$214,000	$15,972,000
Provision for loan losses	842,000	296,000	20,000	1,158,000
Charge-offs	(166,000)	(231,000)	0	(397,000)
Recoveries	129,000	14,000	0	143,000
Ending balance	$14,729,000	$1,913,000	$234,000	$16,876,000
Allowance for loan losses:				
Balance at December 31, 2015	$13,672,000	$1,421,000	$140,000	$15,233,000
Provision for loan losses	936,000	799,000	94,000	1,829,000
Charge-offs	(255,000)	(617,000)	0	(872,000)
Recoveries	376,000	310,000	0	686,000
Ending balance	$14,729,000	$1,913,000	$234,000	$16,876,000
Ending balance: individually evaluated for impairment	$827,000	$209,000	$0	$1,036,000
Ending balance: collectively evaluated for impairment	$13,902,000	$1,704,000	$234,000	$15,840,000
Total loans:				
Ending balance	$1,664,745,000	$135,209,000		$1,799,954,000

Ending balance: individually evaluated for impairment	$16,905,000	$1,463,000	$18,368,000
Ending balance: collectively evaluated for impairment	$1,647,840,000	$133,746,000	$1,781,586,000

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses for acquired loans during the three and six months ended June 30, 2016 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2016	$ 266,000	$ 24,000	$ 0	$ 290,000
Provision for loan losses	(57,000)	(1,000)	0	(58,000)
Charge-offs	0	0	0	0
Recoveries	2,000	0	0	2,000
Ending balance	$ 211,000	$ 23,000	$ 0	$ 234,000
Allowance for loan losses:				
Balance at December 31, 2015	$ 420,000	$ 28,000	$ 0	$ 448,000
Provision for loan losses	(167,000)	38,000	0	(129,000)
Charge-offs	0	0	0	0
Recoveries	(42,000)	(43,000)	0	(85,000)
Ending balance	$ 211,000	$ 23,000	$ 0	$ 234,000

The negative loan recoveries reflected for acquired loans during the first six months of 2016 resulted from reversals of prior-period recoveries associated with certain purchased credit impaired (“PCI”) loans that were subject to pre-acquisition charge-offs. Post-acquisition payments received on these PCI loans were previously reported as loan loss recoveries in prior periods; during the first quarter of 2016, these recoveries were reversed and reported as recovery income if associated with specifically reviewed PCI loans or retained gains if associated with PCI-pooled loans.

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses and the recorded investments in originated loans as of and during the three and six months ended June 30, 2015 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2015	$18,977,000	$1,235,000	$ 39,000	$20,251,000
Provision for loan losses	(1,151,000)	513,000	(5,000)	(643,000)
Charge-offs	(4,199,000)	(154,000)	0	(4,353,000)
Recoveries	365,000	120,000	0	485,000
Ending balance	$13,992,000	$1,714,000	$ 34,000	$15,740,000
Allowance for loan losses:				
Balance at December 31, 2014	$17,736,000	$1,487,000	$ 76,000	$19,299,000
Provision for loan losses	(1,651,000)	592,000	(42,000)	(1,101,000)
Charge-offs	(4,277,000)	(517,000)	0	(4,794,000)
Recoveries	2,184,000	152,000	0	2,336,000
Ending balance	$13,992,000	$1,714,000	$ 34,000	$15,740,000
Ending balance: individually evaluated for impairment	$2,146,000	$178,000	$ 0	$2,324,000
Ending balance: collectively evaluated for impairment	$11,846,000	$1,536,000	$ 34,000	$13,416,000
Total loans:				
Ending balance	$1,322,388,000	$107,235,000		$1,429,623,000

Ending balance: individually evaluated for impairment	$19,108,000	$1,180,000	$20,288,000
Ending balance: collectively evaluated for impairment	$1,303,280,000	$106,055,000	$1,409,335,000

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses for acquired loans during the three and six months ended June 30, 2015 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Balance at March 31, 2015	$ 622,000	$ 177,000	$ 0	$ 799,000
Provision for loan losses	(31,000)	74,000	0	43,000
Charge-offs	(30,000)	0	0	(30,000)
Recoveries	0	9,000	0	9,000
Ending balance	$ 561,000	$ 260,000	$ 0	$ 821,000
Allowance for loan losses:				
Balance at December 31, 2014	$ 681,000	$ 61,000	$ 0	$ 742,000
Provision for loan losses	(90,000)	191,000	0	101,000
Charge-offs	(31,000)	(7,000)	0	(38,000)
Recoveries	1,000	15,000	0	16,000
Ending balance	$ 561,000	$ 260,000	$ 0	$ 821,000

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

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

Loans modified as troubled debt restructurings during the three months ended June 30, 2016 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Originated loans			
Commercial:			
Commercial and industrial	0	$ 0	$ 0
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	1	167,000	167,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	1	167,000	167,000
Retail:			
Home equity and other	2	184,000	184,000
1-4 family mortgages	1	33,000	40,000
Total originated retail	3	217,000	224,000
Total originated loans	4	$ 384,000	$ 391,000
Acquired loans			
Commercial:			
Commercial and industrial	0	$ 0	$ 0
Vacant land, land development and residential construction	0	0	0

Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	1	60,000	60,000
Real estate – multi-family and residential rental	1	7,000	7,000
Total acquired commercial	2	67,000	67,000
Retail:			
Home equity and other	1	25,000	25,000
1-4 family mortgages	0	0	0
Total acquired retail	1	25,000	25,000
Total acquired loans	3	$ 92,000	$ 92,000

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(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the six months ended June 30, 2016 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Originated loans			
Commercial:			
Commercial and industrial	1	$ 20,000	$ 20,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	1	167,000	167,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	2	187,000	187,000
Retail:			
Home equity and other	2	184,000	184,000
1-4 family mortgages	1	33,000	40,000
Total originated retail	3	217,000	224,000
Total originated loans	5	$ 404,000	$ 411,000
Acquired loans			
Commercial:			
Commercial and industrial	0	$ 0	$ 0
Vacant land, land development and residential construction	0	0	0

Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	1	60,000	60,000
Real estate – multi-family and residential rental	1	7,000	7,000
Total acquired commercial	2	67,000	67,000
Retail:			
Home equity and other	2	51,000	51,000
1-4 family mortgages	1	19,000	19,000
Total acquired retail	3	70,000	70,000
Total acquired loans	5	$ 137,000	$ 137,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the three months ended June 30, 2015 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Originated loans			
Commercial:			
Commercial and industrial	4	$ 1,308,000	$ 1,308,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	4	1,308,000	1,308,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total originated retail	0	0	0
Total originated loans	4	$ 1,308,000	$ 1,308,000
Acquired loans			
Commercial:			
Commercial and industrial	2	$ 286,000	$ 286,000
Vacant land, land development and residential construction	0	0	0

Real estate – owner occupied	3	119,000	119,000
Real estate – non-owner occupied	1	302,000	302,000
Real estate – multi-family and residential rental	3	265,000	265,000
Total acquired commercial	9	972,000	972,000
Retail:			
Home equity and other	1	161,000	161,000
1-4 family mortgages	0	0	0
Total acquired retail	1	161,000	161,000
Total acquired loans	10	$ 1,133,000	$ 1,133,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Loans modified as troubled debt restructurings during the six months ended June 30, 2015 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Originated loans			
Commercial:			
Commercial and industrial	10	$ 1,876,000	$ 1,901,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	10	1,876,000	1,901,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	0	0	0
Total originated retail	0	0	0
Total originated loans	10	$ 1,876,000	$ 1,901,000
Acquired loans			
Commercial:			
Commercial and industrial	2	$ 286,000	$ 286,000
Vacant land, land development and residential construction	0	0	0

Real estate – owner occupied	5	169,000	169,000
Real estate – non-owner occupied	1	302,000	302,000
Real estate – multi-family and residential rental	3	265,000	265,000
Total acquired commercial	11	1,022,000	1,022,000
Retail:			
Home equity and other	1	161,000	161,000
1-4 family mortgages	0	0	0
Total acquired retail	1	161,000	161,000
Total acquired loans	12	$ 1,183,000	$ 1,183,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2016 (amounts as of period end):

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

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2016 (amounts as of period end):

	Number of	Recorded

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

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2016 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	1	22,000
Total commercial	1	22,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$ 22,000

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2016 (amounts as of period end):

	Number of	Recorded

	Contracts	Principal Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	1	22,000
Total commercial	1	22,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$ 22,000

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2015 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	$0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	1,182,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	1,182,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$1,182,000

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2015 (amounts as of period end):

	Number of	Recorded

	Contracts	Principal Balance
Commercial:		
Commercial and industrial	0	$0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	1,182,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	1,182,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$1,182,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended June 30, 2015 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	18,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	18,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$ 18,000

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2015 (amounts as of period end):

	Number of	Recorded

	Contracts	Principal Balance
Commercial:		
Commercial and industrial	0	$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	18,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	18,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$ 18,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the three months ended June 30, 2016 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 1,946,000	$ 2,062,000	$ 1,369,000	$ 10,529,000	$ 469,000
Charge-Offs	0	0	0	0	0
Payments	0	(26,000)	(35,000)	(94,000)	(8,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	157,000	0	97,000	0	0
Ending Balance	$ 2,103,000	$ 2,036,000	$ 1,431,000	$ 10,435,000	$ 461,000

Retail Retail

	Home Equity and Other	1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 146,000	$ 126,000
Charge-Offs	0	0
Payments	(1,000)	(3,000)
Transfers to ORE	0	0
Net Additions/Deletions	184,000	40,000
Ending Balance	$ 329,000	$ 163,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the three months ended June 30, 2016 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 1,687,000	$ 0	$ 1,455,000	$ 637,000	$ 278,000
Charge-Offs	0	0	0	0	0
Payments	(43,000)	0	(172,000)	(12,000)	(11,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	0	0	0	56,000	7,000
Ending Balance	$ 1,644,000	$ 0	$ 1,283,000	$ 681,000	$ 274,000

Retail Home Equity	Retail 1-4 Family

	and Other	Mortgages
Retail Loan Portfolio:		
Beginning Balance	$161,000	$335,000
Charge-Offs	0	0
Payments	(7,000)	(2,000)
Transfers to ORE	0	0
Net Additions/Deletions	26,000	0
Ending Balance	$180,000	$333,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the six months ended June 30, 2016 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 2,028,000	$ 2,086,000	$ 1,400,000	$ 10,657,000	$ 476,000
Charge-Offs	0	0	0	0	0
Payments	(101,000)	(50,000)	(66,000)	(222,000)	(15,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	176,000	0	97,000	0	0
Ending Balance	$ 2,103,000	$ 2,036,000	$ 1,431,000	$ 10,435,000	$ 461,000

Retail

Retail

	Home Equity and Other	1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$146,000	$128,000
Charge-Offs	0	0
Payments	(1,000)	(5,000)
Transfers to ORE	0	0
Net Additions/Deletions	184,000	40,000
Ending Balance	$329,000	$163,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the six months ended June 30, 2016 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 1,686,000	$ 0	$ 1,652,000	$ 647,000	$ 331,000
Charge-Offs	(48,000)	0	0	0	0
Payments	(43,000)	0	(369,000)	(22,000)	(64,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	49,000	0	0	56,000	7,000
Ending Balance	$ 1,644,000	$ 0	$ 1,283,000	$ 681,000	$ 274,000

	Retail Home	Retail

	Equity and Other	1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$141,000	$316,000
Charge-Offs	0	0
Payments	(14,000)	(3,000)
Transfers to ORE	0	0
Net Additions/Deletions	53,000	20,000
Ending Balance	$180,000	$333,000

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the three months ended June 30, 2015 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 6,556,000	$ 2,654,000	$ 16,966,000	$ 16,063,000	$ 498,000
Charge-Offs	0	0	(4,198,000)	0	0
Payments	(5,380,000)	(22,000)	(10,550,000)	(4,981,000)	(7,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	1,266,000	0	0	0	0
Ending Balance	$ 2,442,000	$ 2,632,000	$ 2,218,000	$ 11,082,000	$ 491,000

Retail Home Equity and Other	Retail 1-4 Family Mortgages

Retail Loan Portfolio:		
Beginning Balance	$ 0	$ 302,000
Charge-Offs	0	(23,000)
Payments	0	(9,000)
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	$ 0	$ 270,000

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the three months ended June 30, 2015 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 1,519,000	$ 0	$ 1,492,000	$ 62,000	$ 333,000
Charge-Offs	0	0	(31,000)	0	0
Payments	(275,000)	0	(292,000)	0	(6,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	277,000	0	181,000	299,000	253,000
Ending Balance	$ 1,521,000	$ 0	$ 1,350,000	$ 361,000	$ 580,000

	Retail Home	Retail

	Equity and Other	1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 0	$ 177,000
Charge-Offs	0	0
Payments	0	0
Transfers to ORE	0	0
Net Additions/Deletions	152,000	0
Ending Balance	$ 152,000	$ 177,000

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the six months ended June 30, 2015 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 7,026,000	$ 2,680,000	$ 17,160,000	$ 17,439,000	$ 505,000
Charge-Offs	0	0	(4,198,000)	0	0
Payments	(6,535,000)	(48,000)	(10,744,000)	(6,357,000)	(14,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	1,951,000	0	0	0	0
Ending Balance	$ 2,442,000	$ 2,632,000	$ 2,218,000	$ 11,082,000	$ 491,000

Retail

	Retail Home Equity and Other	1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 0	$1,967,000
Charge-Offs	0	(148,000)
Payments	0	(1,549,000)
Transfers to ORE	0	0
Net Additions/Deletions	0	0
Ending Balance	$ 0	$270,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the six months ended June 30, 2015 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 1,439,000	$ 0	$ 1,569,000	$ 64,000	$ 381,000
Charge-Offs	0	0	(31,000)	0	0
Payments	(275,000)	0	(471,000)	(2,000)	(54,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	357,000	0	283,000	299,000	253,000
Ending Balance	$ 1,521,000	$ 0	$ 1,350,000	$ 361,000	$ 580,000

	Retail Home	Retail

	Equity and Other	1-4 Family Mortgages
Retail Loan Portfolio:		
Beginning Balance	$ 26,000	$ 178,000
Charge-Offs	0	0
Payments	(26,000)	(1,000)
Transfers to ORE	0	0
Net Additions/Deletions	152,000	0
Ending Balance	$ 152,000	$ 177,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

	June 30, 2016	December 31, 2015
Commercial:		
Commercial and industrial	$131,000	$221,000
Vacant land, land development, and residential construction	43,000	186,000
Real estate – owner occupied	108,000	115,000
Real estate – non-owner occupied	180,000	201,000
Real estate – multi-family and residential rental	294,000	365,000
Total commercial	756,000	1,088,000
Retail:		
Home equity and other	48,000	14,000
1-4 family mortgages	5,000	6,000
Total retail	53,000	20,000
Total related allowance	$809,000	$1,108,000

In general, our policy dictates that a renewal or modification of an 8- or 9-rated commercial loan meets the criteria of a troubled debt restructuring, although we review and consider all renewed and modified loans as part of our troubled debt restructuring assessment procedures. Loan relationships rated 8 contain significant financial weaknesses, resulting in a distinct possibility of loss, while relationships rated 9 reflect vital financial weaknesses, resulting in a highly questionable ability on our part to collect principal; we believe borrowers warranting such ratings would have difficulty obtaining financing from other market participants. Thus, due to the lack of comparable market rates for loans with similar risk characteristics, we believe 8- or 9-rated loans renewed or modified were done so at below market rates. Loans that are identified as troubled debt restructurings are considered impaired and are individually evaluated for impairment when assessing these credits in our allowance for loan losses calculation.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. PREMISES AND EQUIPMENT, NET

Premises and equipment are comprised of the following:

	June 30, 2016	December 31, 2015
Land and improvements	$16,438,000	$16,529,000
Buildings	39,422,000	39,394,000
Furniture and equipment	17,072,000	16,978,000
	72,932,000	72,901,000
Less: accumulated depreciation	27,374,000	26,039,000
Premises and equipment, net	$45,558,000	$46,862,000

Depreciation expense totaled $0.7 million during the second quarter of 2016, compared to $0.8 million during the second quarter of 2015. Depreciation expense totaled $1.4 million during the first six months of 2016, compared to $1.5 million during the first six months of 2015.

5. DEPOSITS

Our total deposits at June 30, 2016 totaled $2.28 billion, an increase of $4.3 million, or 0.2%, from December 31, 2015. The components of our outstanding balances at June 30, 2016 and December 31, 2015, and percentage change in deposits from the end of 2015 to the end of the second quarter of 2016, are as follows:

	June 30, 2016		December 31, 2015		Percent Increase (Decrease)
	Balance	%	Balance	%	
Noninterest-bearing demand	$733,573,000	32.2 %	$674,568,000	29.6 %	8.7 %
Interest-bearing checking	326,752,000	14.3	403,354,000	17.7	(19.0)
Money market	305,217,000	13.4	274,395,000	12.1	11.2
Savings	341,445,000	15.0	332,794,000	14.6	2.6
Time, under $100,000	146,477,000	6.4	155,655,000	6.9	(5.9)
Time, $100,000 and over	329,601,000	14.5	313,247,000	13.8	5.2
	2,183,065,000	95.8	2,154,013,000	94.7	1.3
Out-of-area time, under $100,000	0	0.0	149,000	< 0.1	NA
Out-of-area time, $100,000 and over	96,653,000	4.2	121,220,000	5.3	(20.3)
	96,653,000	4.2	121,369,000	5.3	(20.4)
Total deposits	$2,279,718,000	100.0%	$2,275,382,000	100.0%	0.2 %

Total time deposits of more than $250,000 totaled $209 million and $180 million at June 30, 2016 and December 31, 2015, respectively.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

6. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase ("repurchase agreements") are offered principally to certain large deposit customers. Information relating to our repurchase agreements follows:

	Six Months Ended June 30, 2016	Twelve Months Ended December 31, 2015
Outstanding balance at end of period	$136,690,000	$154,771,000
Average interest rate at end of period	0.14 %	0.11 %
Average daily balance during the period	$153,578,000	$146,826,000
Average interest rate during the period	0.12 %	0.11