MERCANTILE BANK CORP
Form 10-Q
May 09, 2011

**U.S. SECURITIES AND EXCHANGE COMMISSION**
**Washington, DC 20549**
**FORM 10-Q**

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

**For the quarterly period ended March 31, 2011**

o **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 þ No o

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 o No o

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 o | Accelerated filer o | Non-accelerated filer o (Do not check if a smaller reporting company) | Smaller reporting company þ |

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

Yes o No þ

At May 9, 2011, there were 8,605,046 shares of Common Stock outstanding.

MERCANTILE BANK CORPORATION
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MERCANTILE BANK CORPORATION
PART I FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS

| | March 31, 2011 (Unaudited) | December 31, 2010 (Audited) |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $ 11,277,000 | $ 6,674,000 |
| Short-term investments | 9,543,000 | 9,600,000 |
| Federal funds sold | 56,068,000 | 47,924,000 |
| Total cash and cash equivalents | 76,888,000 | 64,198,000 |
| Securities available for sale | 207,321,000 | 220,830,000 |
| Federal Home Loan Bank stock | 14,345,000 | 14,345,000 |
| Loans | 1,206,886,000 | 1,262,630,000 |
| Allowance for loan losses | (42,118,000) | (45,368,000) |
| Loans, net | 1,164,768,000 | 1,217,262,000 |
| Premises and equipment, net | 27,518,000 | 27,873,000 |
| Bank owned life insurance | 47,182,000 | 46,743,000 |
| Accrued interest receivable | 5,885,000 | 5,942,000 |
| Other real estate owned and repossessed assets | 15,884,000 | 16,675,000 |
| Other assets | 17,144,000 | 18,553,000 |
| Total assets | $ 1,576,935,000 | $ 1,632,421,000 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Deposits | | |
| Noninterest-bearing | $ 136,025,000 | $ 112,944,000 |
| Interest-bearing | 1,117,619,000 | 1,160,888,000 |
| Total deposits | 1,253,644,000 | 1,273,832,000 |
| Securities sold under agreements to repurchase | 80,821,000 | 116,979,000 |
| Federal Home Loan Bank advances | 65,000,000 | 65,000,000 |
| Subordinated debentures | 32,990,000 | 32,990,000 |
| Other borrowed money | 11,733,000 | 11,804,000 |
| Accrued interest and other liabilities | 5,933,000 | 5,880,000 |
| Total liabilities | 1,450,121,000 | 1,506,485,000 |
| Shareholders equity | | |

| | | |
|---|---|---|
| Preferred stock, no par value; 1,000,000 shares authorized; 21,000 shares outstanding at March 31, 2011 and December 31, 2010 | 20,138,000 | 20,077,000 |
| Common stock, no par value; 20,000,000 shares authorized; 8,601,117 shares outstanding at March 31, 2011 and 8,597,993 shares outstanding at December 31, 2010 | 172,732,000 | 172,677,000 |
| Common stock warrant | 1,138,000 | 1,138,000 |
| Retained earnings (deficit) | (67,693,000) | (68,781,000) |
| Accumulated other comprehensive income | 499,000 | 825,000 |
| Total shareholders equity | 126,814,000 | 125,936,000 |
| Total liabilities and shareholders equity | $ 1,576,935,000 | $ 1,632,421,000 |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|---|---|
| Interest income | | |
| Loans, including fees | $ 16,732,000 | $ 20,406,000 |
| Securities, taxable | 1,916,000 | 1,983,000 |
| Securities, tax-exempt | 475,000 | 760,000 |
| Federal funds sold | 30,000 | 31,000 |
| Short-term investments | 6,000 | 9,000 |
| Total interest income | 19,159,000 | 23,189,000 |
| Interest expense | | |
| Deposits | 4,634,000 | 6,497,000 |
| Short-term borrowings | 161,000 | 344,000 |
| Federal Home Loan Bank advances | 606,000 | 1,696,000 |
| Other borrowings | 309,000 | 346,000 |
| Total interest expense | 5,710,000 | 8,883,000 |
| **Net interest income** | 13,449,000 | 14,306,000 |
| Provision for loan losses | 2,200,000 | 8,400,000 |
| **Net interest income after provision for loan losses** | 11,249,000 | 5,906,000 |
| Noninterest income | | |
| Service charges on accounts | 422,000 | 466,000 |
| Earnings on bank owned life insurance | 439,000 | 411,000 |
| Rental income from other real estate owned | 186,000 | 401,000 |
| Mortgage banking activities | 132,000 | 100,000 |
| Net gain on sales of securities | 0 | 476,000 |
| Gain on sales of commercial loans | 0 | 220,000 |
| Other income | 573,000 | 581,000 |
| Total noninterest income | 1,752,000 | 2,655,000 |
| Noninterest expense | | |
| Salaries and benefits | 4,371,000 | 4,665,000 |
| Occupancy | 701,000 | 750,000 |
| Furniture and equipment depreciation, rent and maintenance | 303,000 | 409,000 |
| Nonperforming asset costs | 3,098,000 | 2,504,000 |

| | | |
|---|---|---|
| FDIC insurance costs | 916,000 | 1,186,000 |
| Other expense | 2,192,000 | 2,120,000 |
| Total noninterest expenses | 11,581,000 | 11,634,000 |
| **Income (loss) before federal income tax expense (benefit)** | 1,420,000 | (3,073,000) |
| Federal income tax expense (benefit) | 0 | (430,000) |
| Net income (loss) | 1,420,000 | (2,643,000) |
| Preferred stock dividends and accretion | 332,000 | 320,000 |
| **Net income (loss) attributable to common shares** | $ 1,088,000 | $ (2,963,000) |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)
(Unaudited)

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|---|---|
| Basic earnings (loss) per share | $ 0.13 | $ (0.35) |
| Diluted earnings (loss) per share | $ 0.12 | $ (0.35) |
| Cash dividends per share | $ 0.00 | $ 0.01 |
| Average basic shares outstanding | 8,599,166 | 8,501,671 |
| Average diluted shares outstanding | 8,884,675 | 8,501,671 |

See accompanying notes to consolidated financial statements.

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

| ($ in thousands) | Preferred Stock | Common Stock | Common Stock Warrant | Retained Earnings (Deficit) | Accumulated Other Comprehensive Income (Loss) | Total Shareholders Equity |
|---|---|---|---|---|---|---|
| **Balances, January 1, 2011** | $ 20,077 | $ 172,677 | $ 1,138 | $ (68,781) | $ 825 | $ 125,936 |
| Accretion of preferred stock | 61 | | | (61) | | 0 |
| Employee stock purchase plan (1,059 shares) | | 11 | | | | 11 |
| Stock option exercises (3,500 shares) | | 22 | | | | 22 |
| Dividend reinvestment plan (10 shares) | | 0 | | | | 0 |
| Stock-based compensation expense | | 22 | | | | 22 |
| Preferred stock dividends | | | | (271) | | (271) |
| Comprehensive income (loss): | | | | | | |
| Net income for the period from January 1, 2011 through March 31, 2011 | | | | 1,420 | | 1,420 |
| Change in net unrealized gain on securities available for sale, net of reclassifications and tax effect | | | | | (326) | (326) |
| Total comprehensive income | | | | | | 1,094 |
| | $ 20,138 | $ 172,732 | $ 1,138 | $ (67,693) | $ 499 | $ 126,814 |

**Balances, March 31, 2011**

See accompanying notes to consolidated financial statements.

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

| ($ in thousands) | Preferred Stock | Common Stock | Common Stock Warrant | Retained Earnings (Deficit) | Accumulated Other Comprehensive Income (Loss) | Total Shareholders Equity |
|---|---|---|---|---|---|---|
| **Balances, January 1, 2010** | $ 19,839 | $ 172,438 | $ 1,138 | $ (54,170) | $ 859 | $ 140,104 |
| Accretion of preferred stock | 57 | | | (57) | | 0 |
| Employee stock purchase plan (3,003 shares) | | 12 | | | | 12 |
| Dividend reinvestment plan (687 shares) | | 2 | | | | 2 |
| Stock-based compensation expense | | 126 | | | | 126 |
| Cash dividends ($0.01 per common share) | | (85) | | | | (85) |
| Preferred stock dividends | | | | (264) | | (264) |
| Comprehensive income (loss): | | | | | | |
| Net loss for the period from January 1, 2010 through March 31, 2010 | | | | (2,643) | | (2,643) |
| Change in net unrealized gain on securities available for sale, net of reclassifications and tax effect | | | | | 758 | 758 |
| Net unrealized gain on securities transferred from held to maturity to available for sale, net of tax effect | | | | | 274 | 274 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Reclassification of unrealized gain on interest rate swaps, net of tax effect | | | | | (64) | (64) |
| Total comprehensive loss | | | | | | (1,675) |
| **Balances, March 31, 2010** | $ 19,896 | $ 172,493 | $ 1,138 | $ (57,134) | $ 1,827 | $ 138,220 |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income (loss) | $ 1,420,000 | $ (2,643,000) |
| Adjustments to reconcile net income (loss) to net cash from operating activities | | |
| Depreciation and amortization | 575,000 | 615,000 |
| Provision for loan losses | 2,200,000 | 8,400,000 |
| Stock-based compensation expense | 22,000 | 126,000 |
| Proceeds from sales of mortgage loans held for sale | 9,703,000 | 7,297,000 |
| Origination of mortgage loans held for sale | (7,503,000) | (5,326,000) |
| Net gain from sales of mortgage loans held for sale | (91,000) | (58,000) |
| Gain on sales of commercial loans | 0 | (220,000) |
| Net gain on sale of held to maturity securities | 0 | (476,000) |
| Net loss on sale and valuation write-down of foreclosed assets | 574,000 | 817,000 |
| Recognition of unrealized gain on interest rate swaps | 0 | (99,000) |
| Earnings on bank owned life insurance | (439,000) | (411,000) |
| Net change in: | | |
| Accrued interest receivable | 57,000 | 31,000 |
| Other assets | 1,387,000 | 466,000 |
| Accrued expenses and other liabilities | (218,000) | (1,186,000) |
| Net cash from operating activities | 7,687,000 | 7,333,000 |
| **Cash flows from investing activities** | | |
| Loan originations and payments, net | 46,215,000 | 26,602,000 |
| Purchases of: | | |
| Securities available for sale | (2,002,000) | (7,525,000) |
| Proceeds from: | | |
| Maturities, calls and repayments of available for sale securities | 15,043,000 | 17,958,000 |
| Sales of held to maturity securities | 0 | 20,452,000 |
| Proceeds from sales of commercial loans | 0 | 5,519,000 |
| Proceeds from sales of foreclosed assets | 2,187,000 | 4,923,000 |
| Purchases of premises and equipment, net | (56,000) | (14,000) |
| Net cash from investing activities | 61,387,000 | 67,915,000 |
| **Cash flows from financing activities** | | |
| Net decrease in time deposits | (39,542,000) | (64,396,000) |
| Net increase in all other deposits | 19,354,000 | 82,978,000 |
| Net decrease in securities sold under agreements to repurchase | (36,158,000) | (1,136,000) |
| Net decrease in federal funds purchased | 0 | (2,600,000) |
| Maturities of Federal Home Loan Bank advances | 0 | (15,000,000) |
| Net decrease in other borrowed money | (71,000) | (61,000) |

| | | |
|---|---|---|
| Proceeds from stock option exercises | 22,000 | 0 |
| Employee stock purchase plan | 11,000 | 12,000 |
| Dividend reinvestment plan | 0 | 2,000 |
| Payment of cash dividends on preferred stock | 0 | (264,000) |
| Payment of cash dividends on common shares | 0 | (85,000) |
| Net cash for financing activities | (56,384,000) | (550,000) |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(Unaudited)

| | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
|---|---|---|
| Net change in cash and cash equivalents | 12,690,000 | 74,698,000 |
| Cash and cash equivalents at beginning of period | 64,198,000 | 21,735,000 |
| Cash and cash equivalents at end of period | $ 76,888,000 | $ 96,433,000 |
| Supplemental disclosures of cash flow information | | |
| Cash paid during the period for: | | |
| Interest | $ 6,057,000 | $ 10,536,000 |
| Federal income tax | 0 | 0 |
| Noncash financing and investing activities: | | |
| Transfers from loans to foreclosed assets | 1,970,000 | 2,228,000 |
| Preferred stock cash dividend accrued | 937,000 | 131,000 |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

## 1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three months ended March 31, 2011 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 three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ), and Mercantile Insurance Center, Inc. ( our insurance center ). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended March 31, 2011 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, 2010.

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

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and our common stock warrant, 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 73,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2011. In addition, stock options and a stock warrant for approximately 53,000 and 616,000 shares of common stock, respectively, were included in determining diluted earnings per share for the three months ended March 31, 2011. Stock options for approximately 205,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2011.

Due to our prior year net loss, approximately 88,000 unvested restricted shares were not included in determining both basic and diluted earnings per share for the three months ended March 31, 2010. In addition, stock options and a stock warrant for approximately 292,000 and 616,000 shares of common stock, respectively, were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2010. Weighted average diluted common shares outstanding equals the weighted average common shares outstanding during the three months ended March 31, 2010 due to the net loss recorded during that time period.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

Troubled Debt Restructurings: A loan is accounted for as a troubled debt restructuring if we, for economic or legal reasons related to the borrower s financial condition, grant a significant concession to the borrower 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 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 generally remain categorized as nonperforming loans until a six-month payment history has been maintained.

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. Historically, our derivatives have consisted of interest rate swap agreements, which are used as part of our asset and liability management to help manage interest rate risk. We do not use derivatives for trading purposes.

Changes in the fair value of derivatives that are designated 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 noninterest income or expense.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

**1. <u>SIGNIFICANT ACCOUNTING POLICIES</u>** (Continued)

If designated as a hedge, we formally document the relationship between derivatives as hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions. This documentation includes linking cash flow hedges to specific assets 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 derivatives as a hedge is no longer appropriate or intended.

<u>Adoption of New Accounting Standards</u>: In January 2010, the Financial Accounting Standards Board ( FASB ) issued ASU 2010-06, *Improving Disclosure about Fair Value Measurements*. This ASU requires new disclosures on the amount and reason for transfers in and out of Level 1 and Level 2 recurring fair value measurements. The ASU also requires disclosure of activities (i.e., on a gross basis), including purchases, sales, issuances, and settlements, in the reconciliation of Level 3 recurring fair value measurements. The ASU clarifies existing disclosure requirements on levels of disaggregation and disclosures about inputs and valuation techniques. The new disclosure regarding Level 1 and Level 2 recurring fair value measurements and clarification of existing disclosures were effective beginning January 1, 2010. Upon adoption of those portions of the ASU in our 2010 first quarter, we began providing the required disclosures as currently presented in Note 10. The disclosures about the reconciliation of information in Level 3 recurring fair value measurements are required beginning January 1, 2011. There was no effect on our fair value disclosures presented in Note 10 upon adoption of the final portion of the ASU in our 2011 first quarter, as we currently have no Level 3 recurring fair value measurements.

In July 2010, the FASB issued ASU 2010-20, *Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. In order to provide greater transparency, this ASU requires significant new disclosures on a disaggregated basis about the allowance for credit losses (i.e., allowance for loan losses for banks) and the credit quality of financing receivables (i.e., loans for banks). Under the ASU, a rollforward schedule of the allowance for loan losses, with the ending allowance balance further disaggregated on the basis of the impairment method, along with the related ending loan balance and significant purchases and sales of loans during the period are to be disclosed by portfolio segment. Additional disclosures are required by class of loan, including credit quality, aging of past due loans, nonaccrual status and impairment information. Disclosure of the nature and extent of troubled debt restructurings ( TDR ) that occurred during the period and their effect on the allowance for loan losses as well as the effect on the allowance of TDRs that occurred within the prior twelve months and that defaulted during the current reporting period will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the loan portfolio s risk and performance. The majority of disclosures required as of the end of a reporting period were effective as of December 31, 2010. Upon adoption of those portions of the ASU on December 31, 2010, we began providing the required end of period disclosures as currently presented in Note 3. The disclosures about activity are effective January 1, 2011. Upon adoption of the final portion of the ASU in our 2011 first quarter, we began providing the required activity disclosures, with the exception of the new TDR related disclosures, as currently presented in Note 3. In January 2011, the FASB issued ASU 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, which temporarily deferred the effective date for disclosures related to TDRs.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

In April 2011, the FASB issued ASU 2011-2, *A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring*, to clarify when a loan modification or restructuring is considered a TDR. When performing this evaluation under the ASU, a creditor must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty, and (2) the lender has granted a concession to the borrower. The ASU amends current guidance to include indicators that a lender should consider in determining whether a borrower is experiencing financial difficulties. It further clarifies that a borrower could be experiencing financial difficulty even if it is not currently in default but default is probable in the foreseeable future. With respect to whether the lender has granted a concession to the borrower, the ASU indicates (1) a borrower s inability to access funds at a market interest rate for debt with similar risk characteristics as the restructured debt indicates that the modification was executed at a below-market rate and therefore may indicate a concession was granted, (2) a modification that permanently or temporarily increases a loan s contractual interest rate does not preclude it from being considered a concession because the rate may still be below the market interest rate for new debt with similar risk characteristics, and (3) a modification that results in a delay in payment that is insignificant is not considered to be a concession. The ASU also clarifies that a creditor is precluded from using the borrower s effective interest rate test when performing this evaluation. For TDR identification and disclosure purposes, the guidance is effective for our 2011 third quarter and is to be applied retrospectively to modifications occurring on or after January 1, 2011 that remain outstanding at September 30, 2011. The effect, if any, of the change in the method of calculating impairment will be reflected in our 2011 third quarter. The ASU requires disclosure of the total recorded investment and allowance for loan losses for newly identified TDRs, based on the new guidance, as of September 30, 2011. Beginning in our 2011 third quarter, we are also required to disclose the previously deferred TDR activity related disclosures required by ASU 2010-20. Although early adoption of this ASU is permitted, we plan to adopt the new guidance in our 2011 third quarter. We do not expect the adoption of this ASU to have a material effect on our results of operations or financial position.

In April 2011, the FASB issued ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*, to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets on substantially the agreed upon terms. This ASU eliminates consideration of the transferor s ability to fulfill its contractual rights and obligations from the criteria, as well as related implementation guidance (i.e., that it possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets), in determining effective control, even in the event of default by the transferee. Other criteria applicable to the assessment of effective control are not changed by this new guidance. This ASU is effective January 1, 2012. We do not expect the adoption of this new ASU to have a material effect on our results of operations or financial position.

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**2. SECURITIES**

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| March 31, 2011 | | | | |
| U.S. Government agency debt obligations | $ 112,641,000 | $ 1,344,000 | $ (2,540,000) | $ 111,445,000 |
| Mortgage-backed securities | 40,390,000 | 2,585,000 | 0 | 42,975,000 |
| Michigan Strategic Fund bonds | 18,105,000 | 0 | 0 | 18,105,000 |
| Municipal general obligation bonds | 28,591,000 | 344,000 | (293,000) | 28,642,000 |
| Municipal revenue bonds | 4,838,000 | 54,000 | (10,000) | 4,882,000 |
| Mutual funds | 1,274,000 | 0 | (2,000) | 1,272,000 |
| | $ 205,839,000 | $ 4,327,000 | $ (2,845,000) | $ 207,321,000 |
| December 31, 2010 | | | | |
| U.S. Government agency debt obligations | $ 121,633,000 | $ 1,704,000 | $ (1,775,000) | $ 121,562,000 |
| Mortgage-backed securities | 44,340,000 | 2,601,000 | 0 | 46,941,000 |
| Michigan Strategic Fund bonds | 18,175,000 | 0 | 0 | 18,175,000 |
| Municipal general obligation bonds | 28,594,000 | 227,000 | (779,000) | 28,042,000 |
| Municipal revenue bonds | 4,841,000 | 46,000 | (44,000) | 4,843,000 |
| Mutual funds | 1,264,000 | 3,000 | 0 | 1,267,000 |
| | $ 218,847,000 | $ 4,581,000 | $ (2,598,000) | $ 220,830,000 |

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**2. SECURITIES** (Continued)

Securities with unrealized losses at March 31, 2011 and December 31, 2010, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| March 31, 2011 | | | | | | |
| U.S. Government agency debt obligations | $ 62,684,000 | $ (2,540,000) | $ 0 | $ 0 | $ 62,684,000 | $ (2,540,000) |
| Mortgage-backed securities | 0 | 0 | 0 | 0 | 0 | 0 |
| Michigan Strategic Fund bonds | 0 | 0 | 0 | 0 | 0 | 0 |
| Municipal general obligation bonds | 3,227,000 | (64,000) | 6,290,000 | (229,000) | 9,517,000 | (293,000) |
| Municipal revenue bonds | 516,000 | (4,000) | 234,000 | (6,000) | 750,000 | (10,000) |
| Mutual funds | 1,272,000 | (2,000) | 0 | 0 | 1,272,000 | (2,000) |
| | $ 67,699,000 | $ (2,610,000) | $ 6,524,000 | $ (235,000) | $ 74,223,000 | $ (2,845,000) |
| December 31, 2010 | | | | | | |
| U.S. Government agency debt obligations | $ 56,588,000 | $ (1,775,000) | $ 0 | $ 0 | $ 56,588,000 | $ (1,775,000) |
| Mortgage-backed securities | 0 | 0 | 0 | 0 | 0 | 0 |
| Michigan Strategic Fund bonds | 0 | 0 | 0 | 0 | 0 | 0 |
| Municipal general obligation bonds | 7,847,000 | (299,000) | 6,497,000 | (480,000) | 14,344,000 | (779,000) |
| Municipal revenue bonds | 811,000 | (25,000) | 805,000 | (19,000) | 1,616,000 | (44,000) |
| Mutual funds | 0 | 0 | 0 | 0 | 0 | 0 |
| | $ 65,246,000 | $ (2,099,000) | $ 7,302,000 | $ (499,000) | $ 72,548,000 | $ (2,598,000) |

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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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 March 31, 2011, 76 debt securities and a mutual fund with a fair value totaling $74.2 million have unrealized losses with aggregate depreciation of $2.8 million, or 1.4% from the amortized cost basis of total securities. At March 31, 2011, 194 debt securities with a fair value totaling $115.0 million have unrealized gains with aggregate appreciation of $4.3 million, or 2.1% from the amortized cost basis of total securities. 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 declines are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at March 31, 2011, by contractual maturity, are shown below. The contractual maturity is utilized below 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 fees. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**2. SECURITIES** (Continued)

The maturities of securities and their weighted average yields at March 31, 2011 are also shown in the following table. The yields for municipal securities are shown at their tax equivalent yield.

| | Weighted Average Yield | Amortized Cost | Fair Value |
|---|---|---|---|
| Due in 2011 | 6.89% | $ 500,000 | $ 501,000 |
| Due in 2012 through 2016 | 5.79 | 5,534,000 | 5,892,000 |
| Due in 2017 through 2021 | 4.28 | 28,802,000 | 28,623,000 |
| Due in 2022 and beyond | 4.70 | 111,234,000 | 109,953,000 |
| Mortgage-backed securities | 5.14 | 40,390,000 | 42,975,000 |
| Michigan Strategic Fund bonds | 3.04 | 18,105,000 | 18,105,000 |
| Mutual funds | 3.10 | 1,274,000 | 1,272,000 |
| | 4.61% | $ 205,839,000 | $ 207,321,000 |

At March 31, 2011, and December 31, 2010, the amortized cost of securities issued by the State of Michigan and all its political subdivisions totaled $33.4 million, with an estimated market value of $33.5 million and $32.9 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements, other deposits, and letters of credit issued on behalf of our customers was $152.0 million and $166.9 million at March 31, 2011 and December 31, 2010, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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## 3. LOANS AND ALLOWANCE FOR LOAN LOSSES

Our total loans at March 31, 2011 were $1.21 billion compared to $1.26 billion at December 31, 2010, a decrease of $55.7 million, or 4.4%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at March 31, 2011 and December 31, 2010, and the percentage change in loans from the end of 2010 to the end of the first quarter of 2011, are as follows:

| | March 31, 2011 | | December 31, 2010 | | Percent Increase |
|---|---|---|---|---|---|
| | Balance | % | Balance | % | (Decrease) |
| Commercial: | | | | | |
| Commercial and industrial | $ 280,467,000 | 23.2% | $ 288,515,000 | 22.8% | (2.8)% |
| Vacant land, land development, and residential construction | 80,904,000 | 6.7 | 83,786,000 | 6.6 | (3.4) |
| Real estate owner occupied | 270,856,000 | 22.4 | 277,377,000 | 22.0 | (2.4) |
| Real estate non-owner occupied | 419,603,000 | 34.8 | 449,104,000 | 35.6 | (6.6) |
| Real estate multi-family and residential rental | 74,549,000 | 6.2 | 77,188,000 | 6.1 | (3.4) |
| Total commercial | 1,126,379,000 | 93.3 | 1,175,970,000 | 93.1 | (4.2) |
| Retail: | | | | | |
| Home equity and other | 47,602,000 | 4.0 | 51,186,000 | 4.1 | (7.0) |
| 1-4 family mortgages | 32,905,000 | 2.7 | 35,474,000 | 2.8 | (7.2) |
| Total retail | 80,507,000 | 6.7 | 86,660,000 | 6.9 | (7.1) |
| Total loans | $ 1,206,886,000 | 100.0% | $ 1,262,630,000 | 100.0% | (4.4)% |

Nonperforming loans as of March 31, 2011 and December 31, 2010 were as follows:

| | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Loans past due 90 days or more still accruing interest | $ 0 | $ 766,000 |
| Nonaccrual loans, including troubled debt restructurings | 55,444,000 | 63,915,000 |
| Troubled debt restructurings, accruing interest | 4,761,000 | 4,763,000 |
| Total nonperforming loans | $ 60,205,000 | $ 69,444,000 |

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**3. LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

The recorded principal balance of nonaccrual loans, including troubled debt restructurings, was as follows:

| | March 31, 2011 | December 31, 2010 |
|---|---|---|
| Commercial: | | |
| Commercial and industrial | $ 6,677,000 | $ 10,128,000 |
| Vacant land, land development, and residential construction | 12,071,000 | 12,441,000 |
| Real estate owner occupied | 8,408,000 | 10,172,000 |
| Real estate non-owner occupied | 20,491,000 | 22,609,000 |
| Real estate multi-family and residential rental | 4,439,000 | 4,686,000 |
| Total commercial | 52,086,000 | 60,036,000 |
| Retail: | | |
| Home equity and other | 2,075,000 | 2,425,000 |
| 1-4 family mortgages | 1,283,000 | 1,454,000 |
| Total retail | 3,358,000 | 3,879,000 |
| Total nonaccrual loans | $ 55,444,000 | $ 63,915,000 |

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

An age analysis of past due loans is as follows as of March 31, 2011:

| | 30 59 Days Past Due | 60 89 Days Past Due | Greater Than 89 Days Past Due | Total Past Due | Current | Total Loans | Recorded Balance > 89 Days and Accruing |
|---|---|---|---|---|---|---|---|
| Commercial: | | | | | | | |
| Commercial and industrial | $ 608,000 | $ 1,001,000 | $ 3,310,000 | $ 4,919,000 | $ 275,548,000 | $ 280,467,000 | $ 0 |
| Vacant land, land development, and residential construction | 7,959,000 | 0 | 2,993,000 | 10,952,000 | 69,952,000 | 80,904,000 | 0 |
| Real estate owner occupied | 96,000 | 1,332,000 | 4,628,000 | 6,056,000 | 264,800,000 | 270,856,000 | 0 |
| Real estate non-owner occupied | 0 | 0 | 13,704,000 | 13,704,000 | 405,899,000 | 419,603,000 | 0 |
| Real estate multi-family and residential rental | 323,000 | 91,000 | 2,818,000 | 3,232,000 | 71,317,000 | 74,549,000 | 0 |
| Total commercial | 8,986,000 | 2,424,000 | 27,453,000 | 38,863,000 | 1,087,516,000 | 1,126,379,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 488,000 | 9,000 | 710,000 | 1,207,000 | 46,395,000 | 47,602,000 | 0 |
| 1-4 family mortgages | 0 | 5,000 | 822,000 | 827,000 | 32,078,000 | 32,905,000 | 0 |
| Total retail | 488,000 | 14,000 | 1,532,000 | 2,034,000 | 78,473,000 | 80,507,000 | 0 |
| Total past due loans | $ 9,474,000 | $ 2,438,000 | $ 28,985,000 | $ 40,897,000 | $ 1,165,989,000 | $ 1,206,886,000 | $ 0 |

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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**3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u>** (Continued)

An age analysis of past due loans is as follows as of December 31, 2010:

| | 30 59 Days Past Due | 60 89 Days | Greater Than 89 Days | Total | Total | Recorded Balance > 89 Days and |
|---|---|---|---|---|---|---|