MERCANTILE BANK CORP
Form 10-Q
April 30, 2014

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2014

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

SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

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

310 Leonard Street, NW, Grand Rapids, MI 49504

(Address of principal executive offices) (Zip Code)

(616) 406-3000

(Registrant's telephone number, including area code)

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

YesX 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).

YesX 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 NoX

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

MERCANTILE BANK CORPORATION

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MERCANTILE BANK CORPORATION

PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

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

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

See accompanying notes to condensed consolidated financial statements.

1.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

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

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

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

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

See accompanying notes to condensed consolidated financial statements.

3.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

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

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

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

See accompanying notes to condensed consolidated financial statements.

5.

MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

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

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

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three months ended March 31, 2014 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ("our bank") and our bank's two subsidiaries, Mercantile Bank Real Estate Co., LLC ("our real estate company") and Mercantile Insurance Center, Inc. ("our insurance center"). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended March 31, 2014 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2013.

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

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

Approximately 63,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2014. In addition, stock options for approximately 6,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2014. Stock options for approximately 55,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2014.

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

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1.SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES

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

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

(Continued)

11.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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2. SECURITIES (Continued)

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

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

(Continued)

12.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. **SECURITIES** (Continued)

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

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

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

Weighted Average Yield	Amortized Cost	Fair Value

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

(Continued)

13.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

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

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

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

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

(Continued)

14.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

The recorded principal balance of nonaccrual loans was as follows:

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

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

(Continued)

15.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

(Continued)

16.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

	Commercial and Industrial	Commercial Vacant Land, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$197,051,000	$7,993,000	$161,357,000	$232,226,000	$15,411,000
Grades 5 – 7	90,776,000	24,946,000	99,484,000	124,526,000	19,167,000
Grades 8 – 9	1,182,000	4,251,000	3,458,000	21,282,000	1,108,000
Total commercial	$289,009,000	$37,190,000	$264,299,000	$378,034,000	$35,686,000

Retail credit exposure – credit risk profiled by collateral type:

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

Retail credit exposure – credit risk profiled by collateral type:

Retail	Retail 1-4 Family

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

All commercial loans are graded using the following criteria:

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

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

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

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

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

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

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

	Number of	Recorded Principal

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for loans categorized as troubled debt restructurings during the three months ended March 31, 2014 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$ 1,656,000	$ 4,501,000	$ 1,816,000	$ 22,311,000	$ 2,620,000
Charge-Offs	0	0	(11,000)	0	(420,000)
Payments	(266,000)	(3,149,000)	(49,000)	(1,001,000)	(1,468,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	14,000	2,898,000	0	319,000	0
Ending Balance	$ 1,404,000	$ 4,250,000	$ 1,756,000	$ 21,629,000	$ 732,000

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

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

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Activity for loans categorized as troubled debt restructurings during the three months ended March 31, 2013 is as follows:

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Familyand Residential Rental
Commercial Loan Portfolio:					
Beginning Balance	$2,720,000	$ 3,071,000	$4,116,000	$37,672,000	$ 3,027,000
Charge-Offs	(35,000)	(695,000)	0	(711,000)	(15,000)
Payments	(514,000)	(49,000)	(61,000)	(3,211,000)	(54,000)
Transfers to ORE	(74,000)	0	(363,000)	(803,000)	0
Net Additions/Deletions	1,171,000	0	187,000	2,057,000	0
Ending Balance	$3,268,000	$ 2,327,000	$3,879,000	$35,004,000	$ 2,958,000

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

Ending Balance	$ 0	$ 152,000

(Continued)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. PREMISES AND EQUIPMENT, NET

Premises and equipment are comprised of the following:

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

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

5. DEPOSITS

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

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

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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6. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

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

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

Repurchase agreements generally have original maturities of less than one year. Repurchase agreements are treated as financings and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the agreements are recorded as assets of our bank and are held in safekeeping by a correspondent bank. Repurchase agreements are secured by securities with an aggregate market value equal to the aggregate outstanding balance.

7. FEDERAL HOME LOAN BANK ADVANCES

Federal Home Loan Bank advances totaled $45.0 million at March 31, 2014 and December 31, 2013, and mature at varying dates from March 2017 through September 2017, with fixed rates of interest from 1.22% to 1.51% and averaging 1.34%. Each advance is payable at its maturity date and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of March 31, 2014 totaled about $179 million, with availability approximating $129 million.

Maturities of currently outstanding FHLB advances are as follows:

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

8. COMMITMENTS AND OFF-BALANCE SHEET RISK

Our bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Loan commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are conditional commitments issued by our bank to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on our credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and is generally recorded as a liability. There was no reserve or liability balance for these instruments as of March 31, 2014 and December 31, 2013.

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

	March 31, 2014	December 31, 2013
Commercial unused lines of credit	$263,387,000	$257,937,000
Unused lines of credit secured by 1 – 4 family residential properties	22,994,000	23,429,000
Credit card unused lines of credit	8,929,000	9,013,000
Other consumer unused lines of credit	4,819,000	5,695,000
Commitments to make loans	200,374,000	58,799,000

Standby letters of credit	19,379,000	19,670,000
	$519,882,000	$374,543,000

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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8. <u>COMMITMENTS AND OFF-BALANCE SHEET RISK</u> (Continued)

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of March 31, 2014, the total notional amount of the underlying interest rate swap agreements was $17.8 million, with a net fair value from our commercial loan customers’ perspective of negative $2.5 million. These risk participation agreements are considered financial guarantees in accordance with applicable accounting guidance and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

9. <u>HEDGING ACTIVITIES</u>

Our interest rate risk policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using net interest income simulation. Our policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within the policy parameters. To help mitigate the negative impact to our net interest income in an increasing interest rate environment resulting from our cost of funds likely increasing at a higher rate than the yield on our assets, we may periodically enter into derivative financial instruments.

In February 2012, we entered into an interest rate swap agreement with a correspondent bank to hedge the floating rate on our subordinated debentures, which became effective in January 2013 and matures in January 2018. Our $32.0 million of subordinated debentures have a rate equal to the 90-Day Libor Rate plus a fixed spread of 218 basis points, and are subject to repricing quarterly. The interest rate swap agreement provides for us to pay our correspondent bank a fixed rate, while our correspondent bank will pay us the 90-Day Libor Rate on a $32.0 million notional amount. The quarterly re-set dates for the floating rate on the interest rate swap agreement are the same as the re-set dates for the floating rate on the subordinated debentures. The interest rate swap agreement does qualify for hedge accounting; therefore, monthly fluctuations in the present value of the interest rate swap agreement, net of tax effect, are recorded to other comprehensive income. As of March 31, 2014 and December 31, 2013, the present value of the interest rate swap agreement was recorded as a liability in the amount of $0.2 million and $0.3 million, respectively.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

10. FAIR VALUES OF FINANCIAL INSTRUMENTS

The carrying amounts, estimated fair values and level within the fair value hierarchy of financial instruments were as follows as of March 31, 2014 and December 31, 2013 (dollars in thousands):

	Level in Fair Value Hierarchy	March 31, 2014		December 31, 2013	
		Carrying Values	Fair Values	Carrying Values	Fair Values
Financial assets:					
Cash	Level 1	$1,699	$1,699	$1,464	$1,464
Cash equivalents	Level 2	108,248	108,248	145,501	145,501
Securities available for sale	(1)	141,097	141,097	131,178	131,178
FHLB stock	(2)	11,961	11,961	11,961	11,961
Loans, net	Level 3	1,045,842	1,045,151	1,030,422	1,027,300
Bank owned life insurance	Level 2	51,667	51,667	51,377	51,377
Accrued interest receivable	Level 2	3,861	3,861	3,649	3,649
Financial liabilities:					
Deposits	Level 2	1,108,251	1,110,957	1,118,911	1,120,576
Repurchase agreements	Level 2	63,165	63,165	69,305	69,305
FHLB advances	Level 2	45,000	45,035	45,000	45,139
Subordinated debentures	Level 2	32,990	32,959	32,990	32,974
Accrued interest payable	Level 2	1,431	1,431	2,041	2,041
Interest rate swap	(1)	250	250	264	264

(1) See Note 11 for a description of the fair value hierarchy as well as a disclosure of levels for classes of financial assets and liabilities.

(2) It is not practical to determine the fair value of FHLB stock due to transferability restrictions.

Carrying amount is the estimated fair value for cash and cash equivalents, accrued interest receivable and payable, bank owned life insurance, noninterest checking deposits, securities sold under agreements to repurchase, and variable rate loans and deposits that reprice frequently and fully. Security fair values are based on market prices or dealer quotes, and if no such information is available, on the rate and term of the security and information about the issuer. For fixed rate loans and deposits and for variable rate loans and deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of subordinated debentures and Federal Home Loan Bank advances is based on current rates for similar financing. Fair value of the interest rate swap is determined primarily utilizing market-consensus forecasted yield curves. Fair value of off-balance sheet items is estimated to be nominal.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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11. FAIR VALUES

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. The price of the principal (or most advantageous) market used to measure the fair value of the asset or liability is not adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

We are required to use valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability based on market data obtained from independent sources, or unobservable, meaning those that reflect our own assumptions about the assumptions market participants would use in pricing the asset or liability based on the best information available in the circumstances. In that regard, we utilize a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that we have the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be derived from or corroborated by observable market data by correlation or other means.

Level 3: Significant unobservable inputs that reflect our own assumptions about the assumptions that market participants would use in pricing an asset or liability.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. FAIR VALUES (Continued)

The following is a description of our valuation methodologies used to measure and disclose the fair values of our financial assets and liabilities that are recorded at fair value on a recurring or nonrecurring basis:

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies, municipal general obligation and revenue bonds and mutual funds. We have no Level 1 or 3 securities available for sale.

Derivatives. The interest rate swap is measured at fair value on a recurring basis. We measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves, and accordingly, the interest rate swap agreement is classified as Level 2.

Mortgage loans held for sale. Mortgage loans held for sale are carried at the lower of aggregate cost or fair value and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of March 31, 2014 and December 31, 2013, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of $1.7 million and $1.1 million, respectively.

Loans. We do not record loans at fair value on a recurring basis. However, from time to time, we record nonrecurring fair value adjustments to collateral dependent loans to reflect partial write-downs or specific reserves that are based on the observable market price or current estimated value of the collateral. These loans are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge-off.

Foreclosed Assets. At time of foreclosure or repossession, foreclosed and repossessed assets are adjusted to fair value less costs to sell upon transfer of the loans to foreclosed and repossessed assets, establishing a new cost basis. We subsequently adjust estimated fair value of foreclosed assets on a nonrecurring basis to reflect write-downs based on revised fair value estimates.

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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11. FAIR VALUES (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The balances of assets and liabilities measured at fair value on a recurring basis as of March 31, 2014 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	$ 109,294,000	$ 0	$ 109,294,000	$ 0
Mortgage-backed securities	12,615,000	0	12,615,000	0
Municipal general obligation bonds	16,899,000	0	16,899,000	0
Municipal revenue bonds	919,000	0	919,000	0
Mutual funds	1,370,000	0	1,370,000	0
Interest rate swap	(250,000)	0	(250,000)	0
Total	$ 140,847,000	$ 0	$ 140,847,000	$ 0

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first three months of 2014.

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2013 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	$98,477,000	$ 0	$98,477,000	$ 0
Mortgage-backed securities	13,558,000	0	13,558,000	0
Municipal general obligation bonds	16,872,000	0	16,872,000	0
Municipal revenue bonds	916,000	0	916,000	0
Mutual funds	1,355,000	0	1,355,000	0
Interest rate swap	(264,000)	0	(264,000)	0
Total	$130,914,000	$ 0	$130,914,000	$ 0

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2013.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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11. FAIR VALUES (Continued)

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of March 31, 2014 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans [1]	$21,152,000	$ 0	$ 0	$21,152,000
Foreclosed assets [1]	2,350,000	0	0	2,350,000
Total	$23,502,000	$ 0	$ 0	$23,502,000

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2013 are as follows:

Quoted Prices in Active Markets for Identical	Significant Other Observable	Significant Unobservable

	Total	Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)
Impaired loans [1]	$23,405,000	$ 0	$ 0	$23,405,000
Foreclosed assets [1]	2,851,000	0	0	2,851,000
Total	$26,256,000	$ 0	$ 0	$26,256,000

[1] Represents carrying value and related write-downs for which adjustments are based on the estimated value of the property or other assets.

12. <u>REGULATORY MATTERS</u>

We are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on our financial statements.

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

12. REGULATORY MATTERS (Continued)

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At March 31, 2014 and December 31, 2013, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since March 31, 2014 that we believe have changed our bank's categorization. Our actual capital levels (dollars in thousands) and the minimum levels required to be categorized as adequately and well capitalized were:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2014						
Total capital (to risk weighted assets)						
Consolidated	$198,667	16.2%	$98,218	8.0 %	$NA	NA
Bank	196,418	16.0	98,168	8.0	122,710	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	183,251	14.9	49,109	4.0	NA	NA
Bank	181,010	14.8	49,084	4.0	73,626	6.0
Tier 1 capital (to average assets)						
Consolidated	183,251	13.0	56,409	4.0	NA	NA
Bank	181,010	12.8	56,414	4.0	70,518	5.0

December 31, 2013						
Total capital (to risk weighted assets)						
Consolidated	$193,925	15.9 %	$97,498	8.0 %	$NA	NA
Bank	190,493	15.7	97,329	8.0	121,662	10.0 %
Tier 1 capital (to risk weighted assets)						
Consolidated	178,598	14.7	48,749	4.0	NA	NA
Bank	175,192	14.4	48,665	4.0	72,997	6.0
Tier 1 capital (to average assets)						
Consolidated	178,598	12.5	57,006	4.0	NA	NA
Bank	175,192	12.3	56,860	4.0	71,075	5.0

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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12. REGULATORY MATTERS (Continued)

Our consolidated capital levels as of March 31, 2014 and December 31, 2013 include $32.0 million of trust preferred securities issued by the trust in September 2004 and December 2004 subject to certain limitations. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in our Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than $15.0 billion. As of March 31, 2014 and December 31, 2013, all $32.0 million of the trust preferred securities were included in our consolidated Tier 1 capital.

Our and our bank’s ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. On January 16, 2014, our Board of Directors declared a cash dividend on our common stock in the amount of $0.12 per share that was paid on March 10, 2014 to shareholders of record as of February 10, 2014.

13. BUSINESS COMBINATION

On August 14, 2013, Mercantile Bank Corporation (“Mercantile”) and Firstbank Corporation (“Firstbank”) entered into an Agreement and Plan of Merger (the “merger agreement”). Under the terms of the merger agreement, Firstbank will be merged with and into Mercantile, with Mercantile as the surviving corporation. Both Mercantile and Firstbank shareholders approved the merger effective December 12, 2013. Approval of the Board of Governors of the Federal Reserve System is required to complete the merger. Approval has not yet been obtained. Mercantile and Firstbank have each agreed to take actions in order to obtain regulatory clearance required to consummate the merger. On April 14, 2014, we filed an updated election to become a financial holding company with the Federal Reserve Bank of Chicago. We anticipate the election will become effective upon consummation of the planned merger with Firstbank.

MERCANTILE BANK CORPORATION

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward Looking Statements

This report contains forward-looking statements that are based on management's beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and our company. Words such as "anticipates," "believes," "estimates," "expects," "forecasts," "intends," "is likely," "plans," "projects," and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions ("Future Factors") that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. We undertake no obligation to update, amend, or clarify forward looking-statements, whether as a result of new information, future events (whether anticipated or unanticipated), or otherwise.

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2013 or in this report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

Introduction

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, including 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 company"), at March 31, 2014 and December 31, 2013 and the results of operations for the three months ended March 31, 2014 and March 31, 2013. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to "us," "we," "our" or "the company" include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

Critical Accounting Policies

Accounting principles generally accepted in the United States of America are complex and require us to apply significant judgment to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a discussion of our significant accounting policies, see Note 1 of the Notes to our Consolidated Financial Statements included on pages F-48 through F-53 in our Form 10-K for the fiscal year ended December 31, 2013 (Commission file number 000-26719). Our allowance for loan losses policy and accounting for income taxes are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements, and actual results may differ from those estimates. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

MERCANTILE BANK CORPORATION

Allowance for Loan Losses: The allowance for loan losses (“allowance”) is maintained at a level we believe is adequate to absorb probable incurred losses identified and inherent in the loan portfolio. Our evaluation of the adequacy of the allowance is an estimate based on past loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations and estimated collateral values, guidance from bank regulatory agencies, and assessments of the impact of current and anticipated economic conditions on the loan portfolio. 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. Loan losses are charged against the allowance when we believe the uncollectability of a loan is likely. The balance of the allowance represents our best estimate, but significant downturns in circumstances relating to loan quality or economic conditions could result in a requirement for an increased allowance in the future. Likewise, an upturn in loan quality or improved economic conditions may result in a decline in the required allowance in the future. In either instance, unanticipated changes could have a significant impact on the allowance and operating results.

The allowance is increased through a provision charged to operating expense. Uncollectable loans are charged-off through the allowance. Recoveries of loans previously charged-off are added to the allowance. A loan is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement. Impairment is evaluated in aggregate for smaller-balance loans of similar nature such as residential mortgage, consumer and credit card loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan’s existing rate or at the fair value of collateral if repayment is expected solely from the collateral. The timing of obtaining outside appraisals varies, generally depending on the nature and complexity of the property being evaluated, general breadth of activity within the marketplace and the age of the most recent appraisal. For collateral dependent impaired loans, in most cases we obtain and use the “as is” value as indicated in the appraisal report, adjusting for any expected selling costs. In certain circumstances, we may internally update outside appraisals based on recent information impacting a particular or similar property, or due to identifiable trends (e.g., recent sales of similar properties) within our markets. The expected future cash flows exclude potential cash flows from certain guarantors. To the extent these guarantors provide repayments, a recovery would be recorded upon receipt. Loans are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship. Our policy for recognizing income on impaired loans is to accrue interest unless a loan is placed on nonaccrual status. We put loans into nonaccrual status when the full collection of principal and interest is not expected.

Income Tax Accounting: Current income tax assets and liabilities are established for the amount of taxes payable or refundable for the current year. In the preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome may be uncertain. We periodically review and evaluate the status of our tax positions and make adjustments as necessary. Deferred income tax assets and liabilities are also established for the future tax consequences of events that have been recognized in our financial statements or tax returns. A deferred income tax asset or liability is recognized for the estimated future tax effects attributable to temporary differences that can be carried forward (used) in future years. The valuation of our net deferred income tax asset is considered critical as it requires us to make estimates based on provisions of the enacted tax laws. The assessment of the realizability of the net deferred income tax asset involves the use of estimates, assumptions, interpretations and judgments concerning accounting pronouncements, federal and state tax codes and the extent of future taxable income. There can be no assurance that future events, such as court decisions, positions of federal and state tax authorities, and the extent of future taxable income will not differ from our current assessment, the impact of which could be significant to the consolidated results of operations and reported earnings.

Accounting guidance requires that we assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In making such judgments, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors which may impact future operating results. Significant weight is given to evidence that can be objectively verified. During 2011, we returned to pre-tax profitability for four consecutive quarters. Additionally, we experienced lower provision expense, continued declines in nonperforming assets and problem asset administration costs, a higher net interest margin, a further strengthening of our regulatory capital ratios and additional reductions in wholesale funding. This positive evidence allowed us to conclude that, as of December 31, 2011, it was more likely than not that we returned to sustainable profitability in amounts sufficient to allow for realization of our deferred tax assets in future years. Consequently, we reversed the valuation allowance that we had previously determined necessary to carry against our entire net deferred tax asset starting on December 31, 2009.

Merger Agreement

On August 14, 2013, Mercantile Bank Corporation ("Mercantile") and Firstbank Corporation ("Firstbank"), a Michigan corporation, entered into an Agreement and Plan of Merger (the "merger agreement"). Under the terms of the merger agreement, Firstbank will be merged with and into Mercantile, with Mercantile as the surviving corporation. Both Mercantile and Firstbank shareholders approved the merger effective December 12, 2013.

Upon completion of the merger, Firstbank shareholders will receive one share of Mercantile common stock for each share of Firstbank common stock that they own. Each right of any kind to receive Firstbank common stock or benefits measured by the value of a number of shares of Firstbank common stock granted under the Firstbank stock plans will be converted into an award with respect to a number of shares of Mercantile common stock equal to the aggregate number of shares of Firstbank common stock subject to such award. Firstbank restricted stock and unvested stock options will become fully vested as of the effective time of the merger. The exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the effective time of the merger. Based on the closing price of Mercantile common stock on the Nasdaq Stock Market on August 14, 2013, the last trading day before public announcement of the merger agreement, the exchange ratio represented approximately $18.77 in value for each share of Firstbank common stock. Mercantile shareholders will continue to own their existing Mercantile shares.

Based on the estimated number of shares of Mercantile and Firstbank common stock that will be outstanding immediately prior to the effective time of the merger, we estimate that, upon the closing, former Mercantile shareholders will own approximately 52% of the combined company following the merger and former Firstbank shareholders will own approximately 48% of the combined company following the merger.

As part of the merger, Mercantile’s Board of Directors expects to declare and pay a special cash dividend of $2.00 per share to Mercantile shareholders prior to the effective time of the merger, subject to the satisfaction of the closing conditions set forth in the merger agreement.

Approval of the Board of Governors of the Federal Reserve System (“FRB”) is required to complete the merger. An application was filed with the FRB on September 17, 2013. Approval has not yet been obtained. Mercantile and Firstbank have each agreed to take actions in order to obtain regulatory clearance required to consummate the merger. On April 14, 2014, we filed an updated election to become a financial holding company with the Federal Reserve Bank of Chicago. We anticipate the election will become effective upon consummation of the planned merger with Firstbank.

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The obligations of Mercantile and Firstbank to complete the merger are subject to the satisfaction of certain remaining conditions, which include, among others: (i) obtaining the consents, authorizations, approvals, or exemptions required under the Bank Holding Company Act, the FDI Act, and the Michigan Banking Code; (ii) the absence of any injunction, decree, order, statute, rule or regulation by a court or other governmental entity that makes unlawful or prohibits the consummation of the merger; and (iii) the authorization for the listing on Nasdaq of the shares of Mercantile common stock to be issued in connection with the merger and upon conversion of the Firstbank restricted stock and the shares of Mercantile common stock reserved for issuance pursuant to Mercantile stock options, subject to official notice of issuance.

Mercantile and Firstbank have each made customary representations, warranties and covenants in the merger agreement, including, among others, covenants to conduct their business in the ordinary course between the execution of the merger agreement and the completion of the merger, and covenants not to engage in certain kinds of transactions during that period.

The merger agreement generally precludes Mercantile and Firstbank from soliciting or engaging in discussions or negotiations with a third party with respect to an acquisition proposal. However, if Mercantile or Firstbank receives an unsolicited acquisition proposal from a third party and Mercantile’s or Firstbank’s Board of Directors, as applicable, among other things, determines in good faith (after consultation with its legal and financial advisors) that such unsolicited proposal is a superior proposal, then Mercantile or Firstbank, as applicable, may furnish non-public information to and enter into discussions with, and only with, that third party regarding such acquisition proposal.

Mercantile and Firstbank may mutually agree to terminate the merger agreement at any time, notwithstanding approval of the merger agreement by shareholders. Either company may also terminate the merger agreement if the merger is not consummated by June 30, 2014, subject to certain exceptions. In addition, either company may terminate the agreement to enter into a definitive agreement with respect to a superior proposal, subject to certain conditions and the payment of a termination fee.

Generally, all fees and expenses incurred in connection with the merger agreement and the transactions contemplated by the merger agreement will be paid by the party incurring those expenses. Subject to specific exceptions, Mercantile or Firstbank may be required to pay a termination fee of $7.9 million and/or expense reimbursement up to $2.0 million.

The merger will be accounted for using the acquisition method of accounting, with Mercantile treated as the acquirer for accounting purposes.

The merger agreement was filed as exhibit 2.1 to our Form 8-K filed August 15, 2013 to provide security holders with information regarding its terms. On February 20, 2014, Mercantile and Firstbank entered into a first amendment to the merger agreement, a copy of which was attached as exhibit 10.1 to our Form 8-K filed on February 21, 2014. The amendment extends the date on which the merger agreement becomes terminable from March 31, 2014 to June 30, 2014. Mercantile and Firstbank currently expect the effective time of the merger to occur before the extended termination date. However, the merger is subject to various regulatory clearances and the satisfaction or waiver of other conditions as described in the merger agreement, some of which are outside the control of Mercantile and Firstbank, and the merger could be completed at a later time through further extension(s) of the merger agreement or not at all.

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The merger agreement and first amendment are not intended to provide any other factual information about Mercantile, Firstbank or their respective subsidiaries and affiliates. The merger agreement contains representations and warranties by each of the parties to the merger agreement. These representations and warranties were made solely for the benefit of the other party to the merger agreement and (i) are not intended to be treated as categorical statements of fact, but rather as a way of allocating risk to one of the parties if those statements prove to be inaccurate, (ii) may have been qualified in the merger agreement by confidential disclosure schedules that were delivered to the other party in connection with the signing of the merger agreement, which disclosure schedules may contain information that modifies, qualifies and creates exceptions to the representations, warranties and covenants set forth in the merger agreement, (iii) may be subject to standards of materiality applicable to the parties that differ from what might be viewed as material to investors, (iv) were made only as of the date of the merger agreement or such other date or dates as may be specified in the merger agreement or the amendment. Moreover, information concerning the subject matter of the representations, warranties and covenants may change after the date of the merger agreement, which subsequent information may or may not be fully reflected in public disclosures by Mercantile or Firstbank. Accordingly, the representations, warranties and covenants or any descriptions should not be relied upon as characterizations of the actual state of facts or condition of Mercantile or Firstbank.

Mercantile's Board of Directors and Mercantile's shareholders approved an amendment to the Mercantile articles of incorporation which increases the number of authorized shares of common stock from 20 million to 40 million. Although this proposal was approved by Mercantile shareholders, if the merger is not completed the amendment will not become effective.

Financial Overview

Our operating performance and financial condition continued to improve through the first quarter of 2014. In prior years, especially during the period of 2008 through 2010, our earnings performance was negatively impacted by substantial provisions to the allowance and problem asset administration costs. During that period, ongoing state, regional and national economic struggles negatively impacted some of our borrowers' cash flows and underlying collateral values, leading to increased nonperforming assets, higher loan charge-offs and increased overall credit risk within our loan portfolio. We worked with our borrowers to develop constructive dialogue to strengthen our relationships and enhance our ability to resolve complex issues. As a result of those efforts and improved economic conditions, we have experienced significant improvement in our asset quality since the early stages of 2011, resulting in substantially lower provisions to the allowance and problem asset administration costs. While we have increased our sales efforts to grow the commercial loan portfolio, we remain vigilant as to the administration and quality of our loan portfolio.

Our asset quality metrics remain on an improving trend, and we are optimistic that the positive trend will continue. In aggregate dollar amounts, nonperforming asset levels have declined over 92% since the peak level at March 31, 2010, and at March 31, 2014, were at the lowest level since year-end 2006. Progress in the stabilization of economic and real estate market conditions has resulted in numerous loan rating upgrades and significantly lower volumes of loan rating downgrades, which when combined with increasing recoveries of prior loan charge-offs and reversals of specific reserves, have provided for a substantially lower provision expense.

Financial Condition

Our total assets declined $13.5 million during the first three months of 2014, and totaled $1.41 billion as of March 31, 2014. Total loans increased $13.6 million and securities available for sale were up $9.9 million, while federal funds sold decreased $45.6 million and total deposits declined $10.7 million during the first quarter of 2014.

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Our loan portfolio is primarily comprised of commercial loans. Commercial loans increased $17.5 million during the first three months of 2014, and at March 31, 2014 totaled $1.00 billion, or 94.1% of the loan portfolio. The $17.5 million net increase includes about $46 million in new commercial term loans to existing and new borrowers. Non-owner occupied commercial real estate ("CRE") loans increased $14.0 million, commercial and industrial loans were up $2.6 million, owner occupied CRE loans increased $2.4 million and vacant land, land development and residential construction loans were up $0.5 million. Only the multi-family and residential rental segment of our commercial loan portfolio experienced a reduction during the quarter, declining $2.0 million.

Starting in early 2012, with a pruned commercial loan portfolio, an improved earnings performance and financial condition, and stabilized economic conditions, we significantly enhanced our commercial loan sales efforts. We are very pleased with the approximately $450 million in new commercial loan fundings since the beginning of 2012, and our current pipeline reports indicate continued strong commercial loan funding opportunities in future periods. As of March 31, 2014, availability of existing construction and development loans totaled over $50 million, with most of those funds expected to be drawn over the next twelve months. In addition, we have made additional lending commitments totaling about $200 million, a majority of which we expect to be accepted and funded over the next 12 to 18 months. Our commercial lenders also report over $200 million in additional opportunities they are currently discussing with potential new borrowers.

We continue to experience significant commercial loan principal paydowns and payoffs. A majority of these principal paydowns and payoffs received thus far have been welcomed, such as on stressed loan relationships; however, we have also experienced instances where well-performing relationships have been refinanced at other financial institutions and other situations where the borrower has sold the underlying asset, paying off the loan. In many of those cases where the loans were refinanced elsewhere, we believed the terms and conditions of the new lending arrangements were too aggressive, generally reflecting the very competitive banking environment in our markets. We remain committed to prudent underwriting standards that provide for an appropriate yield and risk relationship. In addition, we continue to receive accelerated principal paydowns from certain borrowers who have elevated deposit balances generally resulting from profitable operations and an apparent unwillingness to expand their businesses and/or replace equipment primarily due to economic- and tax-related uncertainties. Usage of existing commercial lines of credit has remained relatively steady.

The commercial loan portfolio represents loans to businesses generally located within our markets. Approximately 71% of the commercial loan portfolio is primarily secured by real estate properties, with the remaining generally secured by other business assets such as accounts receivable, inventory and equipment. The continued concentration of the loan portfolio in commercial loans is consistent with our strategy of focusing a substantial amount of our efforts on commercial banking. Corporate and business lending is an area of expertise for our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least ten years' experience. Of each of the loan categories that we originate, commercial loans are most efficiently originated and managed, thus limiting overhead costs by necessitating the attention of fewer employees. Our commercial lending business generates the largest portion of local deposits and is our primary source of noninterest-bearing checking accounts.

Residential mortgage loans and consumer loans decreased in aggregate $4.0 million during the first three months of 2014, and at March 31, 2014, totaled $62.6 million, or 5.9% of total loans. Although the residential mortgage loan and consumer loan portfolios may increase in future periods, we expect the commercial sector of the lending efforts and resultant assets to remain the dominant loan portfolio category.

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The following table summarizes our loan portfolio:

	3/31/14	12/31/13	9/30/13	6/30/13	3/31/13
Commercial:					
Commercial & Industrial	$289,009,000	$286,373,000	$286,887,000	$279,300,000	$272,890,000
Land Development & Construction	37,190,000	36,741,000	40,741,000	42,170,000	45,174,000
Owner Occupied Commercial RE	264,299,000	261,877,000	258,656,000	253,172,000	253,089,000
Non-Owner Occupied Commercial RE	378,034,000	364,066,000	368,301,000	357,452,000	327,776,000
Multi-Family & Residential Rental	35,686,000	37,639,000	53,178,000	53,522,000	50,035,000
Total Commercial	1,004,218,000	986,696,000	1,007,763,000	985,616,000	948,964,000
Retail:					
1-4 Family Mortgages	30,800,000	31,467,000	36,575,000	35,709,000	35,735,000
Home Equity & Other Consumer Loans	31,778,000	35,080,000	31,149,000	37,337,000	38,257,000
Total Retail	62,578,000	66,547,000	67,724,000	73,046,000	73,992,000
Total	$1,066,796,000	$1,053,243,000	$1,075,487,000	$1,058,662,000	$1,022,956,000

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans to provide effective loan portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans, which exhibit characteristics (financial or otherwise) that could cause the loans to become nonperforming or require restructuring in the future, are included on an internal watch list. Senior management and the Board of Directors review this list regularly. Market value estimates of collateral on impaired loans, as well as on foreclosed and repossessed assets, are reviewed periodically; however, we have a process in place to monitor whether value estimates at each quarter-end are reflective of current market conditions. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside and internal valuations based on identifiable trends within our markets, such as recent sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address distressed market conditions.

Our asset quality continued to improve during the first three months of 2014, and has now been on an improving trend for about four years. Nonperforming assets, comprised of nonaccrual loans and foreclosed properties, totaled $8.7 million as of March 31, 2014, compared to $9.6 million as of December 31, 2013. The volume of nonperforming assets has generally been on a declining trend since the peak of $117.6 million on March 31, 2010, and is currently at its lowest level since year-end 2006.

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The level of nonperforming assets had begun to increase during 2007, with ongoing and significant increases during 2008 and 2009. The increases primarily reflected the impact of poor economic conditions and the resulting negative impact on many of our commercial borrowers’ operating results and financial condition, but were also indicative of our aggressive posture and conservative loan administration practices in regards to measuring borrower financial strength and assigning loan grades on the entire commercial loan portfolio, and developing workout strategies for financially-troubled borrowers. Since 2009, the level of additions to the nonperforming asset category has declined significantly, while the level of interest in, and sales of, foreclosed properties and assets securing nonperforming loans has increased substantially. We believe that our loan administration strategies, combined with a stabilization of economic conditions, have provided for significant improvement in our asset quality and have given us optimism that the momentum will continue in future periods.

The substantial and rapid collapse of the residential real estate market that began in 2007 had a significant negative impact on the residential real estate development lending portion of our business. The resulting decline in real estate prices and slowdown in sales stretched the cash flow of our local developers and eroded the value of our underlying collateral, which caused elevated levels of nonperforming assets and net loan charge-offs. From the period of 2007 through most of 2011, we witnessed stressed economic conditions in Michigan and throughout the country. The resulting decline in business revenue negatively impacted the cash flows of many of our borrowers, some to the point where loan payments became past due. In addition, real estate prices had fallen significantly, thereby exposing us to larger-than-typical losses