

MERCANTILE BANK CORP

Form 10-Q

November 06, 2009

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

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

**For the quarterly period ended September 30, 2009**

**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

(State or other jurisdiction of  
incorporation or organization)

38-3360865

(IRS Employer Identification No.)

**310 Leonard Street, NW, Grand Rapids, MI 49504**

(Address of principal executive offices) (Zip Code)

**(616) 406-3000**

(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  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. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting  
company

(Do not check if a smaller  
reporting company)

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

Yes  No

At November 6, 2009, there were 8,590,946 shares of Common Stock outstanding.

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CONSOLIDATED BALANCE SHEETS

|  | September 30,<br>2009<br>(Unaudited) | December 31,<br>2008 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Cash and due from banks  | \$ 14,445,000                        | \$ 16,754,000        |
| Short-term investments   | 1,804,000                            | 100,000              |
| Federal funds sold   | 50,426,000                           | 8,950,000            |
| Total cash and cash equivalents  | 66,675,000                           | 25,804,000           |
| Securities available for sale  | 160,880,000                          | 162,669,000          |
| Securities held to maturity (fair value of \$64,055,000 at September 30, 2009 and \$65,381,000 at December 31, 2008) | 61,927,000                           | 64,437,000           |
| Federal Home Loan Bank stock   | 15,681,000                           | 15,681,000           |
| Loans and leases   | 1,614,226,000                        | 1,856,915,000        |
| Allowance for loan and lease losses  | (33,443,000)                         | (27,108,000)         |
| Loans and leases, net  | 1,580,783,000                        | 1,829,807,000        |
| Premises and equipment, net  | 30,247,000                           | 32,334,000           |
| Bank owned life insurance policies   | 44,490,000                           | 42,462,000           |
| Accrued interest receivable  | 8,069,000                            | 8,513,000            |
| Other assets   | 48,598,000                           | 26,303,000           |
| Total assets   | \$ 2,017,350,000                     | \$ 2,208,010,000     |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                                      |                      |
| Deposits   |                                      |                      |
| Noninterest-bearing  | \$ 108,509,000                       | \$ 110,712,000       |
| Interest-bearing   | 1,342,459,000                        | 1,488,863,000        |
| Total deposits   | 1,450,968,000                        | 1,599,575,000        |
| Securities sold under agreements to repurchase   | 102,847,000                          | 94,413,000           |
| Federal Home Loan Bank advances  | 225,000,000                          | 270,000,000          |
| Subordinated debentures  | 32,990,000                           | 32,990,000           |
| Other borrowed money   | 16,867,000                           | 19,528,000           |
| Accrued expenses and other liabilities   | 11,387,000                           | 17,132,000           |
| Total liabilities  | 1,840,059,000                        | 2,033,638,000        |
| Shareholders equity  |                                      |                      |

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|  |                  |                  |
|--|------------------|------------------|
| Preferred stock, no par value; 1,000,000 shares authorized; 21,000 shares outstanding at September 30, 2009  | 19,782,000       | 0                |
| Common stock, no par value: 20,000,000 shares authorized; 8,590,946 shares outstanding at September 30, 2009 and 8,593,432 shares outstanding at December 31, 2008 | 172,362,000      | 172,353,000      |
| Common stock warrants  | 1,138,000        | 0                |
| Retained earnings (deficit)  | (17,764,000)     | (1,281,000)      |
| Accumulated other comprehensive income   | 1,773,000        | 3,300,000        |
| Total shareholders' equity   | 177,291,000      | 174,372,000      |
| Total liabilities and shareholders' equity   | \$ 2,017,350,000 | \$ 2,208,010,000 |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME

|  | Three<br>Months<br>Ended<br>Sept 30, 2009<br>(Unaudited) | Three<br>Months<br>Ended<br>Sept 30, 2008<br>(Unaudited) | Nine Months<br>Ended<br>Sept 30, 2009<br>(Unaudited) | Nine Months<br>Ended<br>Sept 30, 2008<br>(Unaudited) |
|--|--|--|--|--|
| Interest income  |  |  |  |  |
| Loans and leases, including fees                                     | \$ 23,185,000  | \$ 27,161,000  | \$ 72,450,000  | \$ 82,707,000  |
| Securities, taxable  | 1,865,000  | 1,932,000  | 5,690,000  | 5,925,000  |
| Securities, tax-exempt   | 820,000  | 709,000  | 2,515,000  | 2,142,000  |
| Federal funds sold   | 22,000   | 40,000   | 108,000  | 157,000  |
| Short-term investments   | 1,000  | 1,000  | 17,000   | 6,000  |
| <b>Total interest income</b>   | <b>25,893,000</b>  | <b>29,843,000</b>  | <b>80,780,000</b>                                    | <b>90,937,000</b>                                    |
| Interest expense   |  |  |  |  |
| Deposits   | 9,357,000  | 14,180,000   | 33,419,000   | 46,144,000   |
| Short-term borrowings  | 471,000  | 483,000  | 1,385,000  | 1,506,000  |
| Federal Home Loan Bank advances                                      | 2,113,000  | 2,839,000  | 6,860,000  | 7,834,000  |
| Other borrowings   | 385,000  | 613,000  | 1,294,000  | 1,750,000  |
| <b>Total interest expense</b>  | <b>12,326,000</b>  | <b>18,115,000</b>  | <b>42,958,000</b>                                    | <b>57,234,000</b>                                    |
| <b>Net interest income</b>   | <b>13,567,000</b>  | <b>11,728,000</b>  | <b>37,822,000</b>                                    | <b>33,703,000</b>                                    |
| Provision for loan and lease losses                                  | 11,800,000   | 1,900,000  | 33,700,000   | 17,200,000   |
| <b>Net interest income after provision for loan and lease losses</b> | <b>1,767,000</b>   | <b>9,828,000</b>   | <b>4,122,000</b>                                     | <b>16,503,000</b>                                    |
| Noninterest income   |  |  |  |  |
| Services charges on accounts   | 488,000  | 488,000  | 1,500,000  | 1,472,000  |
| Mortgage banking activities  | 167,000  | 103,000  | 939,000  | 516,000  |
| Earnings on bank owned life insurance policies                       | 379,000  | 455,000  | 1,020,000  | 1,308,000  |
| Other income   | 676,000  | 771,000  | 2,146,000  | 2,169,000  |
| <b>Total noninterest income</b>                                      | <b>1,710,000</b>   | <b>1,817,000</b>   | <b>5,605,000</b>                                     | <b>5,465,000</b>                                     |
| Noninterest expense  |  |  |  |  |
| Salaries and benefits  | 4,798,000  | 5,584,000  | 15,597,000   | 17,031,000   |
| Occupancy  | 855,000  | 967,000  | 2,659,000  | 2,899,000  |
| Furniture and equipment depreciation, rent and maintenance           | 486,000  | 482,000  | 1,419,000  | 1,502,000  |
| Nonperforming asset costs  | 2,903,000  | 804,000  | 5,005,000  | 2,345,000  |

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|  |                |              |                 |                |
|--|----------------|--------------|-----------------|----------------|
| FDIC insurance costs   | 1,220,000      | 446,000      | 3,650,000       | 1,040,000      |
| Branch consolidation costs                                       | 158,000        | 0            | 1,308,000       | 0              |
| Other expense  | 2,097,000      | 2,230,000    | 6,015,000       | 6,802,000      |
| Total noninterest expenses                                       | 12,517,000     | 10,513,000   | 35,653,000      | 31,619,000     |
| <b>Income (loss) before federal income tax expense (benefit)</b> | (9,040,000)    | 1,132,000    | (25,926,000)    | (9,651,000)    |
| Federal income tax expense (benefit)                             | (3,754,000)    | 53,000       | (9,926,000)     | (4,380,000)    |
| Net income (loss)  | (5,286,000)    | 1,079,000    | (16,000,000)    | (5,271,000)    |
| Preferred stock dividends and accretion                          | 320,000        | 0            | 483,000         | 0              |
| <b>Net income (loss) available to common shareholders</b>        | \$ (5,606,000) | \$ 1,079,000 | \$ (16,483,000) | \$ (5,271,000) |
| Basic earnings (loss) per share                                  | \$ (0.66)      | \$ 0.13      | \$ (1.94)       | \$ (0.62)      |
| Diluted earnings (loss) per share                                | \$ (0.66)      | \$ 0.13      | \$ (1.94)       | \$ (0.62)      |
| Cash dividends per common share                                  | \$ 0.01        | \$ 0.04      | \$ 0.06         | \$ 0.27        |
| Average basic shares outstanding                                 | 8,492,946      | 8,529,514    | 8,487,362       | 8,468,951      |
| Average diluted shares outstanding                               | 8,492,946      | 8,529,514    | 8,487,362       | 8,468,951      |

See accompanying notes to consolidated financial statements.



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

| (\$ in thousands)   | Preferred<br>Stock | Common<br>Stock | Common<br>Stock<br>Warrants | Retained<br>Earnings<br>(Deficit) | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders<br>Equity |
|---|--------------------|-----------------|-----------------------------|-----------------------------------|---|---------------------------------|
| <b>Balances, January 1,<br/>2009</b>  | \$ 0               | \$ 172,353      | \$ 0                        | \$ (1,281)                        | \$ 3,300  | \$ 174,372                      |
| Preferred stock issued, net   | 19,696             |                 |                             |                                   |   | 19,696                          |
| Accretion of preferred<br>stock   | 86                 |                 |                             | (86)                              |   | 0                               |
| Common stock warrants<br>issued   |                    |                 | 1,138                       |                                   |   | 1,138                           |
| Employee stock purchase<br>plan<br>(10,208 shares)                                  |                    | 43              |                             |                                   |   | 43                              |
| Dividend reinvestment<br>plan<br>(2,496 shares)                                     |                    | 9               |                             |                                   |   | 9                               |
| Stock-based compensation<br>expense   |                    | 466             |                             |                                   |   | 466                             |
| Cash dividends<br>(\$0.06 per common share)   |                    | (509)           |                             |                                   |   | (509)                           |
| Preferred stock dividends   |                    |                 |                             | (397)                             |   | (397)                           |
| Comprehensive income<br>(loss):   |                    |                 |                             |                                   |   |                                 |
| Net loss for the period<br>from January 1, 2009<br>through September 30,<br>2009    |                    |                 |                             | (16,000)                          |   | (16,000)                        |
| Change in net unrealized<br>gain (loss) on securities<br>available for sale, net of |                    |                 |                             |                                   | (520)   | (520)                           |

reclassifications and tax  
effect

Reclassification of  
unrealized gain on interest  
rate swaps, net of tax  
effect

(1,007) (1,007)

Total comprehensive loss

(17,527)

**Balances, September 30,  
2009**

\$ 19,782 \$ 172,362 \$ 1,138 \$(17,764) \$ 1,773 \$ 177,291

See accompanying notes to consolidated financial statements.

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

| (\$ in thousands)  | Preferred | Common     | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Shareholders |
|--|-----------|------------|-----------------|----------------------|---|-----------------------|
|  | Stock     | Stock      | Warrants        | (Deficit)            | (Loss)  | Equity                |
| <b>Balances, January 1, 2008</b>   | \$ 0      | \$ 172,938 | \$ 0            | \$ 4,948             | \$ 269  | \$ 178,155            |
| Employee stock purchase plan<br>(7,307 shares)   |           | 60         |                 |                      |   | 60                    |
| Dividend reinvestment plan<br>(3,361 shares)   |           | 34         |                 |                      |   | 34                    |
| Stock option exercises<br>(2,000 shares)   |           | 16         |                 |                      |   | 16                    |
| Stock tendered for stock<br>option exercises (1,123<br>shares)   |           | (16)       |                 |                      |   | (16)                  |
| Stock-based compensation<br>expense  |           | 465        |                 |                      |   | 465                   |
| Cash dividends<br>(\$0.27 per common share)  |           | (1,017)    |                 | (1,270)              |   | (2,287)               |
| Comprehensive income<br>(loss):  |           |            |                 |                      |   |                       |
| Net loss for the period from<br>January 1, 2008 through<br>September 30, 2008  |           |            |                 | (5,271)              |   | (5,271)               |
| Change in net unrealized<br>gain (loss) on securities<br>available for sale, net of<br>reclassifications and tax<br>effect |           |            |                 |                      | (424)   | (424)                 |
| Change in net fair value of<br>interest rate swaps, net of<br>reclassifications and tax<br>effect                          |           |            |                 |                      | 616   | 616                   |

Total comprehensive loss (5,079)

**Balances, September 30,  
2008**

\$ 0 \$ 172,480 \$ 0 \$ (1,593) \$ 461 \$ 171,348

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | Nine Months<br>Ended<br>September 30,<br>2009<br>(Unaudited) | Nine Months<br>Ended<br>September 30,<br>2008<br>(Unaudited) |
|--|--|--|
| <b>Cash flows from operating activities</b>                                      |  |  |
| Net income (loss)  | \$ (16,000,000)  | \$ (5,271,000)   |
| Adjustments to reconcile net income (loss) to net cash from operating activities |  |  |
| Depreciation and amortization  | 2,172,000  | 2,005,000  |
| Provision for loan and lease losses  | 33,700,000   | 17,200,000   |
| Stock-based compensation expense   | 466,000  | 465,000  |
| Proceeds from sales of mortgage loans held for sale                              | 64,808,000   | 35,118,000   |
| Origination of mortgage loans held for sale                                      | (64,774,000)   | (34,714,000)   |
| Net gain on sales of mortgage loans held for sale                                | (713,000)  | (404,000)  |
| Net loss on sale and write-down of foreclosed assets                             | 2,231,000  | 951,000  |
| Recognition of unrealized gain on interest rate swaps                            | (1,550,000)  | 0  |
| Earnings on bank owned life insurance policies                                   | (1,020,000)  | (1,308,000)  |
| Net change in:   |  |  |
| Accrued interest receivable  | 444,000  | 913,000  |
| Other assets   | (9,442,000)  | (5,943,000)  |
| Accrued expenses and other liabilities   | (5,879,000)  | (6,870,000)  |
| Net cash from operating activities   | 4,443,000  | 2,142,000  |
| <b>Cash flows from investing activities</b>                                      |  |  |
| Loan and lease originations and payments, net                                    | 185,931,000  | (89,450,000)   |
| Proceeds from the sales of commercial loans                                      | 11,633,000   | 0  |
| Purchases of:  |  |  |
| Securities available for sale  | (39,984,000)   | (67,967,000)   |
| Securities held to maturity  | (1,025,000)  | (226,000)  |
| Federal Home Loan Bank stock   | 0  | (5,948,000)  |
| Proceeds from:   |  |  |
| Maturities, calls and repayments of available for sale securities                | 41,286,000   | 60,426,000   |
| Maturities, calls and repayments of held to maturity securities                  | 3,520,000  | 1,535,000  |
| Proceeds from the sale of foreclosed assets                                      | 3,824,000  | 4,897,000  |
| Purchases of premises and equipment, net   | (29,000)   | (645,000)  |
| Purchases of bank owned life insurance   | (1,008,000)  | (1,033,000)  |
| Net cash from (for) investing activities   | 204,148,000  | (98,411,000)   |
| <b>Cash flows from financing activities</b>                                      |  |  |
| Net increase (decrease) in time deposits   | (161,088,000)  | 28,073,000   |
| Net increase (decrease) in all other deposits                                    | 12,481,000   | (43,541,000)   |
| Net increase in securities sold under agreements to repurchase                   | 8,434,000  | 8,521,000  |

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|  |               |              |
|--|---------------|--------------|
| Net decrease in federal funds purchased                                  | 0             | (13,800,000) |
| Proceeds from Federal Home Loan Bank advances                            | 5,000,000     | 186,500,000  |
| Maturities of Federal Home Loan Bank advances                            | (50,000,000)  | (81,500,000) |
| Net increase (decrease) in other borrowed money                          | (2,661,000)   | 15,380,000   |
| Proceeds from issuance of preferred stock and common stock warrants, net | 20,834,000    | 0            |
| Employee stock purchase plan   | 43,000        | 60,000       |
| Dividend reinvestment plan   | 9,000         | 34,000       |
| Payment of cash dividends on preferred stock                             | (263,000)     | 0            |
| Payment of cash dividends to common shareholders                         | (509,000)     | (2,287,000)  |
| Net cash from (for) financing activities                                 | (167,720,000) | 97,440,000   |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|  | Nine Months<br>Ended<br>September 30,<br>2009<br>(Unaudited) | Nine Months<br>Ended<br>September 30,<br>2008<br>(Unaudited) |
|--|--|--|
| Net change in cash and cash equivalents              | 40,871,000   | 1,171,000  |
| Cash and cash equivalents at beginning of period     | 25,804,000   | 29,430,000   |
| <b>Cash and cash equivalents at end of period</b>    | <b>\$ 66,675,000</b>   | <b>\$ 30,601,000</b>   |
| Supplemental disclosures of cash flow information    |  |  |
| Cash paid during the period for:                     |  |  |
| Interest   | \$ 49,634,000  | \$ 63,503,000  |
| Federal income tax                                   | 0  | 0  |
| Noncash financing and investing activities:          |  |  |
| Transfers from loans and leases to foreclosed assets | 18,439,000   | 5,028,000  |
| Preferred stock cash dividend accrued                | 134,000  | 0  |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation:** The unaudited financial statements for the three and nine months ended September 30, 2009 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ( our bank ) and our bank s three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ), and Mercantile Insurance Center, Inc. ( our insurance center ). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended September 30, 2009 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, 2008.

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.

We have evaluated subsequent events through November 6, 2009, the date the financial statements were issued.

**Earnings Per Share:** Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and our common stock warrants, and are determined using the treasury stock method. Our unvested stock awards, which contain non-forfeitable rights to dividends whether paid or unpaid, are also 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 stock awards are excluded from the calculation of both basic and diluted earnings per share.

Due to our net loss, approximately 95,000 unvested restricted shares were not included in determining both basic and diluted earnings per share for the three months and nine months ended September 30, 2009. Approximately 57,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended September 30, 2008, but were not included in determining both basic and diluted earnings per share for the nine months ended September 30, 2008 due to the net loss recorded during that period. In addition, stock options and stock warrants for approximately 298,000 and 616,000 shares of common stock, respectively, were antidilutive and were not included in determining diluted earnings per share for the three and nine months ended September 30, 2009. Stock options for approximately 263,000 and 319,000 shares of common stock were antidilutive and were not included in determining diluted earnings per share for the three and nine months ended September 30, 2008, respectively. Weighted average diluted common shares outstanding equals the weighted average common shares outstanding during the three and nine month periods ended September 30, 2009 and the nine month period ended September 30, 2008 due to the net losses recorded during those time periods.



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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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

Allowance for Loan and Lease Losses: The allowance for loan and lease losses ( allowance ) is a valuation allowance for probable incurred credit losses. Loan and lease losses are charged against the allowance when we believe the uncollectibility of a loan or lease is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required based on past loan and lease 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 and leases, but the entire allowance is available for any loan or lease that, in our judgment, should be charged-off.

A loan or lease is impaired when, based on current information and events, it is probable we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status, collateral value and the probability of collecting 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 or lease 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 loans and leases and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. We do not separately identify individual residential and consumer loans for impairment disclosures.

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. During 2008, our derivatives consisted of interest rate swap agreements, which were used as part of our asset liability management to help manage interest rate risk. We do not use derivatives for trading purposes.

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

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**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 on the balance sheet. If designated as a hedge, we also formally assess, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in cash flows of the hedged items. Ineffective hedge gains and losses are recognized immediately in current earnings as noninterest income or expense. We discontinue hedge accounting when we determine the derivative is no longer effective in offsetting changes in the cash flows of the hedged item, the derivative is settled or terminates, or treatment of the derivatives as a hedge is no longer appropriate or intended.

Adoption of New Accounting Standards: In June 2009, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2009-01, *Topic 105 Generally Accepted Accounting Principles FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (formerly Statement No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162*). ASU No. 2009-01 establishes the FASB Accounting Standards Codification ( Codification ) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with generally accepted accounting principles in the United States ( U.S. GAAP ). All guidance contained in the Codification carries an equal level of authority. The Codification does not change current U.S. GAAP but is intended to simplify user access to all authoritative U.S. GAAP by providing all of the authoritative literature related to a particular topic in one place. All existing accounting standard documents are superseded and all other accounting literature not included in the Codification is considered nonauthoritative. The Codification is effective for interim or annual reporting periods ending after September 15, 2009. We made the appropriate changes to U.S. GAAP references in our financial statements.

In December 2007, the FASB issued a new standard now codified in Accounting Standards Codification ( ASC ) 805, *Business Combinations* (formerly Statement No. 141(R), *Business Combinations*), to further enhance the accounting and financial reporting related to business combinations. This standard establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This standard applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Therefore, the effects of the adoption of this standard will depend upon the extent and magnitude of acquisitions after December 31, 2008. The adoption of this standard has had no impact on our results of operations or financial position.

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

In September 2006, the FASB issued a new standard now codified in ASC 820, *Fair Value Measurements and Disclosures* (formerly Statement No. 157, *Fair Value Measurements*), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This standard applies to other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. The standard does not require any new fair value measurements and was originally effective beginning January 1, 2008, but was subsequently deferred until January 1, 2009 for nonfinancial assets and nonfinancial liabilities except those items recognized or disclosed at fair value on an annual or more frequently recurring basis. We applied the fair value measurement and disclosure provisions of the new standard to nonfinancial assets and nonfinancial liabilities effective January 1, 2009. The application of the new standard was not material to our results of operations or financial position, although it did result in additional disclosures included in Note 11 relating to nonfinancial assets.

In March 2008, the FASB issued a new standard now codified in ASC 815, *Derivatives and Hedging* (formerly Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activities - an Amendment of FASB Statement No. 133*). This standard expands disclosure requirements regarding an entity's derivative instruments and hedging activities. Expanded qualitative disclosures that are required under this standard include: (1) how and why an entity uses derivative instruments; (2) how derivative instruments and related hedged items are accounted for under ASC 815; and (3) how derivative instruments and related hedged items affect an entity's financial statements. This standard was adopted January 1, 2009 and did not have an effect on our disclosures as we have had no derivative instruments outstanding during the current year.

In early April 2009, the FASB issued the following additional guidance now codified in the ASC's listed below (formerly listed as the FSPs below), that is intended to provide additional guidance and require additional disclosures relating to fair value measurements and other-than-temporary impairment ( OTTI ) on an interim and/or annual basis:

FSP No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, codified in ASC 820, *Fair Value Measurements and Disclosures*. This guidance provides additional direction for estimating fair value when the volume and level of activity for the asset or liability have significantly decreased as well as guidance on identifying circumstances that indicate a transaction is not orderly. Our adoption of this new standard during the quarter ended June 30, 2009 had no impact on our results of operations or financial position, although additional disclosures were required.

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

FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, codified in ASC 320, *Investments - Debt and Equity Securities*. This guidance, which applies to debt securities, is intended to provide greater clarity to investors about the credit and noncredit components of an OTTI event and to more effectively communicate when an OTTI event has occurred. It defines the credit component of an OTTI charge as the difference between the present value of the cash flows expected to be collected and the amortized cost basis of the debt security. When an entity does not intend to sell the security and it is more likely than not that the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an OTTI charge in earnings and the remaining portion in other comprehensive income. In addition, it requires additional disclosures about investment securities on an interim basis. Our adoption of this guidance during the quarter ended June 30, 2009 had no impact on our results of operations or financial position, although additional disclosures were required.

FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments*, codified in ASC 825, *Financial Instruments*. This guidance requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies in addition to annual reporting periods. It also requires disclosure of the method(s) and significant assumptions used to estimate the fair value of financial instruments and changes in method(s) and significant assumptions, if any, during the period. Our adoption of this guidance during the quarter ended June 30, 2009 had no impact on our results of operations or financial position, although additional disclosures were required.

In June 2008, the FASB issued new guidance now codified in ASC 260, *Earnings Per Share* (formerly FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*). This guidance provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities and are required to be included in the computation of earnings per share pursuant to the two-class method described in ASC 260. The two-class method of computing earnings per share includes an earnings allocation formula that determines earnings per share for common stock and any participating securities according to dividends declared, whether paid or unpaid, and participation rights in undistributed earnings. All prior period earnings per share data presented is required to be adjusted retrospectively to conform with the provisions of this new guidance. Adoption of this guidance had no impact on our third quarter or year-to-date 2009 or 2008 earnings per share.

In May 2009, the FASB issued a new standard now codified in ASC 855, *Subsequent Events* (formerly SFAS No. 165, *Subsequent Events*), which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date. It is effective for interim or annual financial periods ending after June 15, 2009. The adoption of this standard did not have any impact on our results of operations or financial position.

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

In June 2009, the FASB issued Statement No. 166, *Accounting for Transfers of Financial Assets*, an amendment of FASB Statement No. 140 ( Statement No. 166 ). Statement No. 166 amends the guidance on accounting for transfers of financial assets, including securitization transactions, where entities have continued exposure to risks related to transferred financial assets. Statement No. 166 also expands the disclosure requirements for such transactions. Statement No. 166 is currently not included in the Codification. It is effective as of the beginning of the first annual reporting period that begins after November 15, 2009. We are currently evaluating the impact of this standard on our financial statements.

**2. SECURITIES**

The amortized cost, 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<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value  |
|---|-------------------|------------------------------|-------------------------------|----------------|
| September 30, 2009                      |                   |                              |                               |                |
| U.S. Government agency debt obligations | \$ 70,966,000     | \$ 638,000                   | \$ (983,000)                  | \$ 70,621,000  |
| Mortgage-backed securities              | 65,476,000        | 2,680,000                    | (4,000)                       | 68,152,000     |
| Michigan Strategic Fund bonds           | 20,685,000        | 0                            | 0                             | 20,685,000     |
| Mutual funds                            | 1,414,000         | 8,000                        | 0                             | 1,422,000      |
|   | \$ 158,541,000    | \$ 3,326,000                 | \$ (987,000)                  | \$ 160,880,000 |
| December 31, 2008                       |                   |                              |                               |                |
| U.S. Government agency debt obligations | \$ 61,511,000     | \$ 1,264,000                 | \$ (393,000)                  | \$ 62,382,000  |
| Mortgage-backed securities              | 74,702,000        | 2,324,000                    | 0                             | 77,026,000     |
| Michigan Strategic Fund bonds           | 22,105,000        | 0                            | 0                             | 22,105,000     |
| Mutual fund                             | 1,175,000         | 0                            | (19,000)                      | 1,156,000      |
|   | \$ 159,493,000    | \$ 3,588,000                 | \$ (412,000)                  | \$ 162,669,000 |

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**2. SECURITIES** (Continued)

The carrying amount, unrecognized gains and losses, and fair value of securities held to maturity were as follows:

|                                    | Carrying<br>Amount | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|------------------------------------|--------------------|------------------------------|-------------------------------|---------------|
| September 30, 2009                 |                    |                              |                               |               |
| Municipal general obligation bonds | \$ 52,490,000      | \$ 1,838,000                 | \$ (18,000)                   | \$ 54,310,000 |
| Municipal revenue bonds            | 9,437,000          | 314,000                      | (6,000)                       | 9,745,000     |
|                                    | \$ 61,927,000      | \$ 2,152,000                 | \$ (24,000)                   | \$ 64,055,000 |
| December 31, 2008                  |                    |                              |                               |               |
| Municipal general obligation bonds | \$ 56,893,000      | \$ 1,133,000                 | \$ (351,000)                  | \$ 57,675,000 |
| Municipal revenue bonds            | 7,544,000          | 175,000                      | (13,000)                      | 7,706,000     |
|                                    | \$ 64,437,000      | \$ 1,308,000                 | \$ (364,000)                  | \$ 65,381,000 |

Securities with unrealized losses at September 30, 2009 and December 31, 2008, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

| Description of Securities                  | Less than 12 Months |                    | 12 Months or More |                    | Total         |                    |
|--|---------------------|--------------------|-------------------|--------------------|---------------|--------------------|
|  | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| September 30, 2009                         |                     |                    |                   |                    |               |                    |
| U.S. Government agency<br>debt obligations | \$ 21,758,000       | \$ (810,000)       | \$ 9,815,000      | \$ (173,000)       | \$ 31,573,000 | \$ (983,000)       |
| Mortgage-backed<br>securities              | 1,217,000           | (4,000)            | 0                 | 0                  | 1,217,000     | (4,000)            |
| Michigan Strategic Fund<br>bonds           | 0                   | 0                  | 0                 | 0                  | 0             | 0                  |
| Mutual funds                               | 0                   | 0                  | 0                 | 0                  | 0             | 0                  |
| Municipal general<br>obligation bonds      | 0                   | 0                  | 610,000           | (18,000)           | 610,000       | (18,000)           |
| Municipal revenue bonds                    | 234,000             | (6,000)            | 0                 | 0                  | 234,000       | (6,000)            |
|  | \$ 23,209,000       | \$ (820,000)       | \$ 10,425,000     | \$ (191,000)       | \$ 33,634,000 | \$ (1,011,000)     |

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**2. SECURITIES** (Continued)

| Description of Securities               | Less than 12 Months |                 | 12 Months or More |                 | Total         |                 |
|---|---------------------|-----------------|-------------------|-----------------|---------------|-----------------|
|   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value    | Unrealized Loss |
| December 31, 2008                       |                     |                 |                   |                 |               |                 |
| U.S. Government agency debt obligations | \$ 20,588,000       | \$ (387,000)    | \$ 1,994,000      | \$ (6,000)      | \$ 22,582,000 | \$ (393,000)    |
| Mortgage-backed securities              | 0                   | 0               | 0                 | 0               | 0             | 0               |
| Michigan Strategic Fund bonds           | 0                   | 0               | 0                 | 0               | 0             | 0               |
| Mutual fund                             | 0                   | 0               | 1,156,000         | (19,000)        | 1,156,000     | (19,000)        |
| Municipal general obligation bonds      | 3,547,000           | (76,000)        | 10,852,000        | (275,000)       | 14,399,000    | (351,000)       |
| Municipal revenue bonds                 | 307,000             | (1,000)         | 794,000           | (12,000)        | 1,101,000     | (13,000)        |
|   | \$ 24,442,000       | \$ (464,000)    | \$ 14,796,000     | \$ (312,000)    | \$ 39,238,000 | \$ (776,000)    |

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. Effective in the second quarter of 2009, with the adoption of new fair value guidance (see Note 1), 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.

There were eight U.S. Government agency debt obligations and three municipal general obligation bonds in a continuous loss position for 12 months or more at September 30, 2009. At September 30, 2009, 29 debt securities with a fair value totaling \$33.6 million have unrealized losses with aggregate depreciation of \$1.0 million, or 0.5% from the amortized cost basis of total securities. At September 30, 2009, 326 debt securities and a mutual fund with a fair value totaling \$167.4 million have unrealized gains with aggregate appreciation of \$5.5 million, or 2.5% from the amortized cost basis of total securities. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not have to sell our debt securities before recovery of the cost basis, no declines are deemed to be other-than-temporary.

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**2. SECURITIES** (Continued)

The amortized cost and fair values of debt securities at September 30, 2009, by contractual maturity, are shown below. The contractual maturity is utilized below for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

The maturities of securities and their weighted average yields at September 30, 2009 are also shown in the following table. The yields for municipal securities are shown at their tax equivalent yield.

|                                  | Weighted<br>Average<br>Yield | Held-to-Maturity   |               | Weighted<br>Average<br>Yield | Available-for-Sale |                |
|----------------------------------|------------------------------|--------------------|---------------|------------------------------|--------------------|----------------|
|                                  |                              | Carrying<br>Amount | Fair<br>Value |                              | Amortized<br>Cost  | Fair<br>Value  |
| Due in 2009                      | 6.38%                        | \$ 1,185,000       | \$ 1,189,000  | NA                           | \$ 0               | \$ 0           |
| Due in 2010 through<br>2014      | 6.66                         | 12,324,000         | 12,822,000    | 4.86%                        | 5,979,000          | 6,370,000      |
| Due in 2015 through<br>2019      | 6.48                         | 14,601,000         | 15,128,000    | 4.90                         | 12,484,000         | 12,588,000     |
| Due in 2020 and beyond           | 6.36                         | 33,817,000         | 34,916,000    | 5.09                         | 52,503,000         | 51,663,000     |
| Mortgage-backed<br>securities    | NA                           | 0                  | 0             | 5.14                         | 65,476,000         | 68,152,000     |
| Michigan Strategic<br>Fund bonds | NA                           | 0                  | 0             | 3.06                         | 20,685,000         | 20,685,000     |
| Mutual funds                     | NA                           | 0                  | 0             | 3.22                         | 1,414,000          | 1,422,000      |
|                                  | 6.45%                        | \$ 61,927,000      | \$ 64,055,000 | 4.81%                        | \$ 158,541,000     | \$ 160,880,000 |

During the first nine months of 2009 and the years ended December 31, 2008, and 2007, there were no securities sold.

At September 30, 2009, and December 31, 2008, the amortized cost of securities issued by the State of Michigan and all its political subdivisions totaled \$61.9 million and \$64.4 million, with an estimated market value of \$64.1 million and \$65.4 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders' equity.

The carrying value of securities that are pledged to secure repurchase agreements and other deposits was \$132.7 million and \$124.2 million at September 30, 2009, and December 31, 2008, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold, or redeemed by, the issuer.



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**3. LOANS AND LEASES**

Our total loans and leases at September 30, 2009 were \$1,614.2 million compared to \$1,856.9 million at December 31, 2008, a decrease of \$242.7 million, or 13.1%. The components of our outstanding balances at September 30, 2009 and December 31, 2008, and the percentage change in loans and leases from the end of 2008 to the end of the third quarter 2009, are as follows:

|                                      | September 30, 2009 |        | December 31, 2008 |        | Percent Increase (Decrease) |
|--------------------------------------|--------------------|--------|-------------------|--------|-----------------------------|
|                                      | Balance            | %      | Balance           | %      |                             |
| Real Estate:                         |                    |        |                   |        |                             |
| Construction and land development    | \$ 200,911,000     | 12.4%  | \$ 263,392,000    | 14.1%  | (23.7)%                     |
| Secured by 1-4 family properties     | 131,159,000        | 8.2    | 140,776,000       | 7.6    | (6.8)                       |
| Secured by multi-family properties   | 48,968,000         | 3.0    | 47,365,000        | 2.6    | 3.4                         |
| Secured by nonresidential properties | 831,424,000        | 51.5   | 881,350,000       | 47.5   | (5.7)                       |
| Commercial                           | 394,574,000        | 24.4   | 516,201,000       | 27.8   | (23.6)                      |
| Leases                               | 1,190,000          | 0.1    | 1,985,000         | 0.1    | (40.1)                      |
| Consumer                             | 6,000,000          | 0.4    | 5,846,000         | 0.3    | 2.6                         |
| Total loans and leases               | \$ 1,614,226,000   | 100.0% | \$ 1,856,915,000  | 100.0% | (13.1)%                     |

**4. ALLOWANCE FOR LOAN AND LEASE LOSSES**

The following is a summary of the change in our allowance for loan and lease losses account for the three and nine months ended September 30:

|                                     | Three months ended |                    | Nine months ended  |                    |
|-------------------------------------|--------------------|--------------------|--------------------|--------------------|
|                                     | September 30, 2009 | September 30, 2008 | September 30, 2009 | September 30, 2008 |
| Beginning balance                   | \$ 32,605,000      | \$ 31,881,000      | \$ 27,108,000      | \$ 25,814,000      |
| Charge-offs                         | (11,545,000)       | (4,462,000)        | (28,396,000)       | (14,030,000)       |
| Recoveries                          | 583,000            | 192,000            | 1,031,000          | 527,000            |
| Provision for loan and lease losses | 11,800,000         | 1,900,000          | 33,700,000         | 17,200,000         |
| Balance at September 30             | \$ 33,443,000      | \$ 29,511,000      | \$ 33,443,000      | \$ 29,511,000      |

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**5. PREMISES AND EQUIPMENT NET**

Premises and equipment are comprised of the following:

|                                      | September 30,<br>2009 | December 31,<br>2008 |
|--------------------------------------|-----------------------|----------------------|
| Land and improvements                | \$ 8,531,000          | \$ 8,538,000         |
| Buildings and leasehold improvements | 24,515,000            | 24,888,000           |
| Furniture and equipment              | 12,519,000            | 12,484,000           |
|                                      | 45,565,000            | 45,910,000           |
| Less: accumulated depreciation       | 15,318,000            | 13,576,000           |
| <br>Premises and equipment, net      | <br>\$ 30,247,000     | <br>\$ 32,334,000    |

Depreciation expense totaled \$0.6 million during the third quarter of 2009, compared to \$0.7 million during the third quarter of 2008. Depreciation expense totaled \$2.0 million during the first nine months of 2009 and 2008.

**6. DEPOSITS**

Our total deposits at September 30, 2009 were \$1,451.0 million compared to \$1,599.6 million at December 31, 2008, a decrease of \$148.6 million, or 9.3%. The components of our outstanding balances at September 30, 2009 and December 31, 2008, and percentage change in deposits from the end of 2008 to the end of the third quarter 2009, are as follows:

|                                      | September 30, 2009   |            | December 31, 2008    |            | Percent<br>Increase<br>(Decrease) |
|--------------------------------------|----------------------|------------|----------------------|------------|-----------------------------------|
|                                      | Balance              | %          | Balance              | %          |                                   |
| Noninterest-bearing demand           | \$ 108,509,000       | 7.5%       | \$ 110,712,000       | 6.9%       | (2.0)%                            |
| Interest-bearing checking            | 67,033,000           | 4.6        | 50,248,000           | 3.1        | 33.4                              |
| Money market                         | 31,169,000           | 2.1        | 24,886,000           | 1.6        | 25.2                              |
| Savings                              | 41,559,000           | 2.9        | 49,943,000           | 3.1        | (16.8)                            |
| Time, under \$100,000                | 103,726,000          | 7.1        | 49,991,000           | 3.1        | 107.5                             |
| Time, \$100,000 and over             | 304,013,000          | 21.0       | 184,573,000          | 11.6       | 64.7                              |
|                                      | 656,009,000          | 45.2       | 470,353,000          | 29.4       | 39.5                              |
| Out-of-area time, under \$100,000    | 71,295,000           | 4.9        | 128,948,000          | 8.1        | (44.7)                            |
| Out-of-area time, \$100,000 and over | 723,664,000          | 49.9       | 1,000,274,000        | 62.5       | (27.7)                            |
|                                      | 794,959,000          | 54.8       | 1,129,222,000        | 70.6       | (29.6)                            |
| <br>Total deposits                   | <br>\$ 1,450,968,000 | <br>100.0% | <br>\$ 1,599,575,000 | <br>100.0% | <br>(9.3)%                        |



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**7. SHORT-TERM BORROWINGS**

Information relating to our securities sold under agreements to repurchase follows:

|   | Nine Months<br>Ended<br>September 30,<br>2009 | Twelve Months<br>Ended<br>December 31, 2008 |
|---|---|---|
| Outstanding balance at end of period        | \$ 102,847,000                                | \$ 94,413,000                               |
| Average interest rate at end of period      | 1.89%   | 1.96%                                       |
| Average balance during the period           | \$ 94,703,000                                 | \$ 93,149,000                               |
| Average interest rate during the period     | 1.95%   | 2.04%                                       |
| Maximum month end balance during the period | \$ 109,585,000                                | \$ 105,986,000                              |

Securities sold under agreements to repurchase ( 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 correspondent banks. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements were secured by securities with a market value of \$115.3 million and \$106.5 million as of September 30, 2009 and December 31, 2008, respectively.

**8. FEDERAL HOME LOAN BANK ADVANCES**

Our outstanding balances at September 30, 2009 totaled \$225.0 million and mature at varying dates from October 2009 through January 2014, with fixed rates of interest from 2.95% to 4.71% and averaging 3.57%. At December 31, 2008, outstanding balances totaled \$270.0 million with maturities ranging from January 2009 through December 2013 and fixed rates of interest from 2.95% to 5.30% and averaging 3.79%.

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 September 30, 2009 totaled about \$296.0 million, with availability approximating \$63.0 million.

Maturities of FHLB advances currently outstanding during the next 60 months are:

|      |              |
|------|--------------|
| 2009 | \$20,000,000 |
| 2010 | 65,000,000   |
| 2011 | 85,000,000   |
| 2012 | 40,000,000   |
| 2013 | 10,000,000   |
| 2014 | 5,000,000    |

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**9. 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 our 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 management's credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. The balance of the liability account was \$0.0 million as of September 30, 2009 and \$0.5 million as of December 31, 2008.

A summary of the contractual amounts of our financial instruments with off-balance-sheet risk at September 30, 2009 and December 31, 2008 follows:

|   | September 30,<br>2009 | December 31,<br>2008 |
|---|-----------------------|----------------------|
| Commercial unused lines of credit                                   | \$ 214,399,000        | \$ 323,785,000       |
| Unused lines of credit secured by 1-4 family residential properties | 24,801,000            | 30,658,000           |
| Credit card unused lines of credit                                  | 8,755,000             | 9,413,000            |
| Other consumer unused lines of credit                               | 4,008,000             | 4,881,000            |
| Commitments to extend credit  | 6,763,000             | 10,959,000           |
| Standby letters of credit   | 40,064,000            | 51,439,000           |
| <br>  |                       |                      |
| Total loan and lease commitments                                    | \$ 298,790,000        | \$ 431,135,000       |

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**9. COMMITMENTS AND OFF-BALANCE-SHEET RISK** (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 September 30, 2009, the total notional amount of the underlying interest rate swap agreements was \$56.3 million, with a net fair value from our commercial loan customers perspective of negative \$5.0 million. Payments made during 2008 and the first nine months of 2009 in regards to the risk participation agreements totaled \$236,000; however, we believe the affected customer will reimburse us for such payments and therefore have recorded no valuation allowance for our receivable from this customer and have accrued no liability for potential future payments. 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.

**10. HEDGING ACTIVITIES**

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.

A majority of our assets are comprised of commercial loans on which the interest rates are variable, while a majority of our liabilities are comprised of fixed rate certificates of deposit and FHLB advances. Due to this repricing mismatch, we may periodically enter into derivative financial instruments to mitigate the exposure in cash flows resulting from changes in interest rates.

During 2008, we entered into several interest rate swaps with an aggregate notional amount of \$275.0 million. The interest rate swaps qualified as cash flow hedges that converted the variable rate cash inflows on certain of our prime-based commercial loans to a fixed rate of interest. The interest rate swaps paid interest to us at stated fixed rates and required that we make interest payments based on the average of the Wall Street Journal Prime Rate.

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**10. HEDGING ACTIVITIES** (Continued)

On October 30, 2008, we terminated all of our interest rate swaps. The termination coincided with our decision to not lower our prime rate in association with the Federal Open Market Committee's reduction of the targeted federal funds rate by 50 basis points on October 29, 2008. Virtually all of our prime rate-based commercial floating rate loans are tied to the Mercantile Bank Prime Rate, while our interest rate swaps utilized the Wall Street Journal Prime Rate. The resulting difference negatively impacted the effectiveness of our interest rate swaps, so we believed it was prudent to terminate them. The aggregate fair value of the interest rate swaps on October 30, 2008 was \$2.4 million, which is being accreted into interest income on loans and leases based on the original term of the interest rate swaps. The remaining accretion at September 30, 2009 is as follows: \$250,000 during the fourth quarter of 2009; and \$100,000 during the first quarter of 2010. During the first nine months of 2009, \$1.5 million was accreted into interest income on loans and leases.

**11. FAIR VALUES MEASUREMENTS**

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.

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**11. FAIR VALUES MEASUREMENTS** (Continued)

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.

The following is a description of our valuation methodologies used to measure and disclose the fair values of our financial assets and liabilities 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 and mortgage-backed securities issued or guaranteed by U.S. Government Agencies. We have no Level 1 or 3 securities available for sale.

*Securities held to maturity.* Securities held to maturity are carried at amortized cost when we have the positive intent and ability to hold them to maturity. 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 have to sell our debt securities before recovery of their cost basis. The fair value of held to maturity securities, as disclosed in the accompanying consolidated financial statements, is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models.

*Mortgage loans held for sale.* Mortgage loans held for sale are carried at the lower of 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 September 30, 2009, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the \$1.2 million of such loans at cost so they are not included in the nonrecurring table below.

*Loans and leases.* We do not record loans and leases at fair value on a recurring basis. However, from time to time, we record nonrecurring fair value adjustments to collateral dependent loans and leases 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 and leases are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge-off. At time of foreclosure or repossession, foreclosed and repossessed assets are adjusted to fair value less costs to sell upon transfer of the loans and leases to foreclosed and repossessed assets, establishing a new cost basis. At that time, they are reported in our fair value disclosures in the nonrecurring table below.

*Derivatives.* For interest rate swaps, we measure fair value utilizing models that use primarily market observable inputs, such as yield curves and option volatilities, and accordingly, are classified as Level 2. We had no interest rate swaps contracts outstanding as of September 30, 2009 or December 31, 2008.



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**11. FAIR VALUES MEASUREMENTS** (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 September 30, 2009 are as follows:

|                               | Total          | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------|----------------|---|---|--|
| Securities available for sale | \$ 160,880,000 | \$ 0  | \$ 160,880,000  | \$ 0   |
| Total                         | \$ 160,880,000 | \$ 0  | \$ 160,880,000  | \$ 0   |

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 are as follows:

|                               | Total          | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------|----------------|---|---|--|
| Securities available for sale | \$ 162,669,000 | \$ 0  | \$ 162,669,000  | \$ 0   |
| Total                         | \$ 162,669,000 | \$ 0  | \$ 162,669,000  | \$ 0   |

We had no assets or liabilities measured at Levels 1 or 3 on a recurring basis as of December 31, 2008 or during the first nine months of 2009.

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**11. FAIR VALUES MEASUREMENTS** (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 September 30, 2009 are as follows:

|                                  | Total                | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|----------------------------------|----------------------|---|---|--|
| Impaired loans <sup>(1)</sup>    | \$ 54,289,000        | \$ 0  | \$ 54,289,000   | \$ 0   |
| Foreclosed assets <sup>(1)</sup> | 19,523,000           | 0   | 19,523,000  | 0  |
| <b>Total</b>                     | <b>\$ 73,812,000</b> | <b>\$ 0</b>   | <b>\$ 73,812,000</b>                                      | <b>\$ 0</b>  |

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2008 are as follows:

|                               | Total                | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-------------------------------|----------------------|---|---|--|
| Impaired loans <sup>(1)</sup> | \$ 37,197,000        | \$ 0  | \$ 37,197,000   | \$ 0   |
| <b>Total</b>                  | <b>\$ 37,197,000</b> | <b>\$ 0</b>   | <b>\$ 37,197,000</b>                                      | <b>\$ 0</b>  |

<sup>(1)</sup> Represents carrying value and related write-downs for which adjustments are based on the estimated value of the property or other assets.



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**12. FAIR VALUES OF FINANCIAL INSTRUMENTS**

Carrying amount and estimated fair values of financial instruments were as follows as of September 30, 2009 and December 31, 2008:

|  | September 30, 2009 |                | December 31, 2008  |                |
|--|--------------------|----------------|--------------------|----------------|
|  | Carrying<br>Values | Fair<br>Values | Carrying<br>Values | Fair<br>Values |
| <b>Financial assets</b>                        |                    |                |                    |                |
| Cash and cash equivalents                      | \$ 66,675,000      | \$ 66,675,000  | \$ 25,804,000      | \$ 25,804,000  |
| Securities available for sale                  | 160,880,000        | 160,880,000    | 162,669,000        | 162,669,000    |
| Securities held to maturity                    | 61,927,000         | 64,055,000     | 64,437,000         | 65,381,000     |
| Federal Home Loan Bank stock                   | 15,681,000         | 15,681,000     | 15,681,000         | 15,681,000     |
| Loans, net                                     | 1,580,783,000      | 1,598,754,000  | 1,829,807,000      | 1,872,141,000  |
| Bank owned life insurance policies             | 44,490,000         | 44,490,000     | 42,462,000         | 42,462,000     |
| Accrued interest receivable                    | 8,069,000          | 8,069,000      | 8,513,000          | 8,513,000      |
| <b>Financial liabilities</b>                   |                    |                |                    |                |
| Deposits                                       | 1,450,968,000      | 1,459,040,000  | 1,599,575,000      | 1,610,953,000  |
| Securities sold under agreements to repurchase | 102,847,000        | 102,847,000    | 94,413,000         | 94,413,000     |
| Federal Home Loan Bank advances                | 225,000,000        | 227,378,000    | 270,000,000        | 274,847,000    |
| Subordinated debentures                        | 32,990,000         | 32,849,000     | 32,990,000         | 31,100,000     |
| Accrued interest payable                       | 8,570,000          | 8,570,000      | 15,245,000         | 15,245,000     |

Carrying amount is the estimated fair value for cash and cash equivalents, Federal Home Loan Bank stock, accrued interest receivable and payable, bank owned life insurance policies, demand 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 off balance sheet items is estimated to be nominal.

Current accounting pronouncements require disclosure of the estimated fair value of financial instruments as disclosed in Note 11. Given the current market conditions, a portion of our loan portfolio is not readily marketable and market prices do not exist. We have not attempted to market our loans to potential buyers, if any exist, to determine the fair value of those instruments. Since negotiated prices in illiquid markets depend upon the then present motivations of the buyer and seller, it is reasonable to assume that actual sales prices could vary widely from any estimate of fair value made without the benefit of negotiations. Additionally, changes in market interest rates can dramatically impact the value of financial instruments in a short period of time. Accordingly, the fair value measurements for loans included in the table above are unlikely to represent the instruments liquidation values.

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**13. REGULATORY MATTERS**

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.

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 being closely monitored 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 September 30, 2009 and December 31, 2008, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since September 30, 2009 that we believe have changed our bank's categorization. Our actual capital levels (dollars in thousands) and minimum required levels were:

|  | Actual    |       | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Regulations |       |
|--|-----------|-------|--|-------|--|-------|
|  | Amount    | Ratio | Amount   | Ratio | Amount   | Ratio |
| September 30, 2009                       |           |       |  |       |  |       |
| Total capital (to risk weighted assets)  |           |       |  |       |  |       |
| Consolidated                             | \$220,198 | 12.0% | \$147,068  | 8.0%  | \$NA   | NA    |
| Bank                                     | 215,299   | 11.7  | 146,661  | 8.0   | 183,326  | 10.0% |
| Tier 1 capital (to risk weighted assets) |           |       |  |       |  |       |
| Consolidated                             | 197,089   | 10.7  | 73,534   | 4.0   | NA   | NA    |
| Bank                                     | 192,253   | 10.5  | 73,331   | 4.0   | 109,996  | 6.0   |
| Tier 1 capital (to average assets)       |           |       |  |       |  |       |
| Consolidated                             | 197,089   | 9.7   | 81,278   | 4.0   | NA   | NA    |
| Bank                                     | 192,253   | 9.5   | 81,087   | 4.0   | 101,359  | 5.0   |

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**13. REGULATORY MATTERS** (Continued)

|   | Actual     |       | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Regulations |       |
|---|------------|-------|--|-------|--|-------|
|   | Amount     | Ratio | Amount   | Ratio | Amount   | Ratio |
| December 31, 2008                           |            |       |  |       |  |       |
| Total capital (to risk<br>weighted assets)  |            |       |  |       |  |       |
| Consolidated                                | \$ 229,307 | 10.9% | \$ 167,836   | 8.0%  | \$NA   | NA    |
| Bank  | 226,034    | 10.8  | 167,480  | 8.0   | 209,350  | 10.0% |
| Tier 1 capital (to risk<br>weighted assets) |            |       |  |       |  |       |
| Consolidated                                | 203,072    | 9.7   | 83,918   | 4.0   | NA   | NA    |
| Bank  | 199,853    | 9.6   | 83,740   | 4.0   | 125,610  | 6.0   |
| Tier 1 capital (to average<br>assets)       |            |       |  |       |  |       |
| Consolidated                                | 203,072    | 9.2   | 88,577   | 4.0   | NA   | NA    |
| Bank  | 199,853    | 9.0   | 88,413   | 4.0   | 110,516  | 5.0   |

Our consolidated capital levels as of September 30, 2009 and December 31, 2008 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. As of September 30, 2009 and December 31, 2008, all \$32.0 million of the trust preferred securities were included as Tier 1 capital.

Our consolidated and bank capital levels as of September 30, 2009 were negatively impacted by our net deferred tax asset not qualifying for inclusion in the Tier 1 capital. In determining the amount of net deferred tax asset that does qualify, an analysis of historical taxable income as well as projected taxable income for the next twelve months is performed at each quarter-end. At September 30, 2009, it was determined that \$10.4 million and \$10.2 million of our consolidated and bank net deferred tax asset did not qualify for inclusion in Tier 1 capital, respectively. At December 31, 2008, all of our consolidated and bank net deferred tax asset qualified for inclusion in Tier 1 capital.

Our and our bank's ability to pay cash and stock dividends on our common stock is subject to limitations under various laws and regulations and to prudent and sound banking practices. On January 8, 2009, we declared a \$0.04 per share cash dividend on our common stock, which was paid on March 10, 2009 to record holders as of February 10, 2009. On April 9, 2009, we declared a \$0.01 per share cash dividend on our common stock, which was paid on June 10, 2009 to record holders as of May 8, 2009. On July 16, 2009, we declared a \$0.01 per share cash dividend on our common stock, which was paid on September 10, 2009 to record holders as of August 10, 2009. On October 15, 2009, we declared a \$0.01 per share cash dividend on our common stock, which is payable on December 10, 2009 to record holders as of November 10, 2009. Because we had a retained deficit at the time of the declarations, the cash dividends were recorded as a reduction of our common stock account.

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**14. U.S. TREASURY CAPITAL PURCHASE PROGRAM PARTICIPATION**

On May 15, 2009, we completed the sale of \$21.0 million of preferred stock to the United States Treasury Department ( Treasury ) under the Treasury s Capital Purchase Program. The program is designed to attract broad participation by healthy banking institutions to help stabilize the financial system and increase lending for the benefit of the U.S. economy. Under the terms of the sale, the Treasury received 21,000 shares of fixed rate cumulative perpetual preferred stock with a liquidation value of \$1,000 per share and a warrant to purchase 616,438 shares of our common stock, no par value, in exchange for \$21.0 million. The preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5.00% for the first five years, and 9.00% thereafter. Subject to regulatory approval, we are generally permitted to redeem the preferred shares at par plus unpaid dividends. The common stock warrant has a 10-year term and was immediately exercisable upon its issuance, with an exercise price equal to \$5.11 per share. The Treasury has agreed not to exercise voting power with respect to any shares of common stock issued upon exercise of the warrant, while it holds the shares.

We allocated the \$21.0 million in proceeds to the preferred stock and the common stock warrant based on their relative fair values. To determine the fair value of the preferred stock, we used a discounted cash flow model that assumed redemption of the preferred stock at the end of year 5. The discount rate utilized was 12.00% and the estimated fair value was determined to be \$15.5 million. The fair value of the common stock warrant was estimated to be \$0.9 million using the Black-Scholes option pricing model with the following assumptions: expected dividend yield of 1.00%; risk-free interest rate of 1.99%; expected life of five years; expected volatility of 53.00%; and a weighted average fair value of \$3.92.

The aggregate fair value for both the preferred stock and the common stock warrant was determined to be \$16.4 million, with 94.6% of this aggregate attributable to the preferred stock and 5.4% attributable to the common stock warrants. Therefore, the \$21.0 million issuance was allocated with \$19.9 million being assigned to the preferred stock and \$1.1 million being assigned to the common stock warrants.

The sum of the \$1.1 million difference between the \$21.0 million face value of the preferred stock and the \$19.9 million allocated to it upon issuance and \$0.2 million of direct costs associated with the transaction, or \$1.3 million, was recorded as a discount on the preferred stock. The \$1.3 million discount will be accreted, using the effective interest method, as a reduction in net income available to common shareholders over the next five years at approximately \$0.2 million to \$0.3 million per year.

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## 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 various 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 regulations; 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, 2008 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, Mercantile Bank of Michigan ( our bank ), our bank's three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ) and Mercantile Insurance Center, Inc. ( our insurance center ), at September 30, 2009 to December 31, 2008 and the results of operations for the three and nine months ended September 30, 2009 and September 30, 2008. 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 complete discussion of our significant accounting policies, see footnotes to our Consolidated Financial Statements included on pages F-39 through F-44 in our Form 10-K for the fiscal year ended December 31, 2008 (Commission file number 000-26719). Our allowance for loan and lease 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.



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## MERCANTILE BANK CORPORATION

**Allowance for Loan and Lease Losses:** The allowance for loan and lease losses ( allowance ) is maintained at a level we believe is adequate to absorb probable incurred losses identified and inherent in the loan and lease portfolio. Our evaluation of the adequacy of the allowance is an estimate based on past loan and lease loss experience, the nature and volume of the loan and lease portfolio, information about specific borrower situations and estimated collateral values and assessments of the impact of current and anticipated economic conditions on the loan and lease portfolio.

Allocations of the allowance may be made for specific loans or leases, but the entire allowance is available for any loan or lease that, in our judgment, should be charged-off. Loan and lease losses are charged against the allowance when we believe the uncollectibility of a loan or lease balance is likely. The balance of the allowance represents our best estimate, but significant downturns in circumstances relating to loan and lease quality or economic conditions could result in a requirement for an increased allowance in the future. Likewise, an upturn in loan and lease 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 operating earnings.

The allowance is increased through a provision charged to operating expense. Uncollectible loans and leases are charged-off through the allowance. Recoveries of loans and leases previously charged-off are added to the allowance. A loan or lease 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 or lease 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 or lease is impaired, a portion of the allowance is allocated so that the loan or lease is reported, net, at the present value of estimated future cash flows using the loan's or lease's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans and leases 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 or lease is placed on nonaccrual status. We put loans or leases into nonaccrual status when the full collection of principal and interest is not expected.

**Income Tax Accounting:** ASC 740, *Income Taxes*, requires that companies assess whether a valuation allowance should be established against deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. Accordingly, we reviewed our deferred tax assets and determined that no valuation allowance was necessary at September 30, 2009.

In making decisions regarding any valuation allowance, 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. Our significant negative evidence is our operating loss for 2008 and the first nine months of 2009, which puts us in a cumulative pre-tax loss position over the last three years, combined with a challenging economic environment and uncertainty in the timing of a meaningful economic recovery. Our positive evidence includes our: 1) history of strong earnings performance prior to 2008; 2) aggressive nature in identifying, administering and accounting for problem assets; 3) well capitalized regulatory capital position; 4) rapidly improving net interest margin; 5) substantial decline in wholesale funding reliance which in large part is due to a significant increase in local deposits; 6) decisions made that have led to reduced salary, benefit, occupancy, furniture and equipments costs; and 7) cautiously optimistic expectations regarding future taxable income.

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Future realization of our deferred tax assets is highly dependent upon our forecasts of taxable income. While such forecasts cannot be guaranteed, we believe they have been developed in a conservative manner in regards to net interest margin expectations and the impact of potential further credit deterioration on provisions to our allowance. We expect our regulatory capital ratios to remain well above required minimums, thus ensuring our economic viability and ability to realize our deferred tax assets. The deferred tax assets will be analyzed quarterly for changes affecting realizability, and there can be no assurance that a valuation allowance will not be necessary in future periods.

**Financial Overview**

Our earnings performance has been negatively impacted by substantial provisions to the allowance. Ongoing state, regional and national economic struggles have 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 continue to work with our borrowers to develop constructive dialogue to strengthen our relationships and enhance our ability to resolve complex issues; however, with the environment for the banking industry likely to remain stressed until economic conditions improve, credit quality will continue to be our major concern. We will remain vigilant in the identification and administration of problem assets, but provisions to the allowance will likely remain above historical levels, dampening future earnings performance.

Our earnings performance also reflects positive steps we have taken to not only partially mitigate the impact of deteriorating asset quality in the near term, but to benefit us on a longer term basis as well. First, our net interest margin has been expanding throughout 2009 as we replace maturing high-rate deposits with lower-cost funds, while at the same time our commercial loan pricing initiatives have offset the negative impact of an increase in nonaccrual loans. Despite a substantial reduction in total loans, our net interest income has increased due to the higher net interest margin, and we expect our net interest margin to improve further over the next few quarters. Next, our regulatory capital ratios have also increased, as the sale of preferred stock under the Treasury's Capital Purchase Program and the reduction of loans outstanding have more than offset the impact of recording a net loss. In addition, we have seen strong increases in local deposits, reflecting the successful implementation of various initiatives, campaigns and product enhancements. The local deposit growth, combined with the reduction of loans outstanding, has provided for a substantial reduction of, and reliance on, wholesale funds. Lastly, we are starting to see the positive effect of our branch consolidation and other overhead cost reduction initiatives, as we continue to make strides to reduce controllable noninterest expense.

**Financial Condition**

During the first nine months of 2009, our total assets decreased from \$2,208.0 million on December 31, 2008, to \$2,017.4 million on September 30, 2009. This represents a decrease in total assets of \$190.6 million, or 8.6%. The decline in total assets was comprised primarily of a \$242.7 million decrease in total loans and leases and a reduction of \$4.3 million in securities, partially offset by a \$40.9 million increase in cash and cash equivalents. The reduction in total assets provided for a \$148.6 million decline in deposits and a decrease of \$45.0 million in Federal Home Loan Bank advances, partially offset by an \$8.4 million increase in securities sold under agreements to repurchase ( repurchase agreements ).

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## MERCANTILE BANK CORPORATION

Commercial loans and leases decreased by \$233.2 million during the first nine months of 2009, and at September 30, 2009 totaled \$1,477.1 million, or 91.5% of the total loan and lease portfolio. This decline reflects the slowdown in business activity in our markets and the impact of a concerted effort on our part to reduce exposure to certain non-owner occupied commercial real estate ( CRE ) and automotive-related businesses. The biggest decline occurred in the commercial and industrial ( C&I ) loan portfolio, where usage of commercial lines of credit was reduced by about \$105.0 million, in large part reflecting the slowdown in business activity and a corresponding reduction in accounts receivable and inventory financings. We would expect to see an increase in commercial line of credit usage when economic conditions improve. Our systematic approach to reducing our exposure to certain CRE lending will be pro-longed, given the nature of CRE lending and the current depressed economic conditions; however, we believe that such a reduction is in our best interest when taking into account the increased inherent credit risk, relatively low loan rates and nominal deposit balances associated with targeted borrowing relationships.

The commercial loan and lease portfolio represents loans to businesses generally located within our market areas. Approximately 73% of the commercial loan and lease 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 significant concentration of the loan and lease portfolio in commercial loans and leases is consistent with our stated strategy of focusing a substantial amount of our efforts on wholesale 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 and leases are most efficiently originated and managed, thus limiting overhead costs by necessitating the attention of fewer employees. Our commercial lending business generates a significant portion of local deposits and is our primary source of demand deposits.

The following table summarizes our loans secured by real estate, excluding residential mortgage loans representing permanent financing of owner occupied dwellings and home equity lines of credit, at September 30, 2009 and December 31, 2008:

|   | September 30,<br>2009 | December 31,<br>2008 |
|---|-----------------------|----------------------|
| Residential Vacant Land                   | \$ 20,630,000         | \$ 21,374,000        |
| Residential Land Development              | 33,862,000            | 54,055,000           |
| Residential Construction                  | 9,446,000             | 16,839,000           |
| Commercial Vacant Land                    | 25,564,000            | 29,269,000           |
| Commercial Land Development               | 22,412,000            | 24,629,000           |
| Commercial Construction NonOwner Occupied | 79,339,000            | 102,464,000          |
| Commercial Construction Owner Occupied    | 5,456,000             | 9,344,000            |
| Commercial NonOwner Occupied              | 528,727,000           | 558,360,000          |
| Commercial Owner Occupied                 | 349,335,000           | 370,099,000          |
| <br>                                      |                       |                      |
| Total                                     | \$ 1,074,771,000      | \$ 1,186,433,000     |

Residential mortgage loans and consumer loans decreased an aggregate \$9.5 million during the first nine months of 2009. As of September 30, 2009, residential mortgage loans and consumer loans totaled a combined \$137.2 million, or 8.5% of the total loan and lease portfolio. Although residential mortgage loan and consumer loan portfolios may increase in future periods, we expect the commercial sector of our lending efforts and resultant assets to remain the dominant loan portfolio category given our wholesale banking strategy.

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## MERCANTILE BANK CORPORATION

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans and leases to provide appropriate loan and lease 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 leases and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans and leases, which exhibit characteristics (financial or otherwise) that could cause the loans and leases to become nonperforming or require restructuring in the future, are included on the internal watch list. Senior management reviews 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 ensure 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 also adjust both 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. The levels of net loan and lease charge-offs and nonperforming assets have increased since early 2007. Although we were never directly involved in the underwriting of or the investing in subprime residential real estate loans, the apparent substantial and rapid collapse of this line of business during 2007 throughout the United States 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 has 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 and lease charge-offs. Since that time, we have witnessed rapidly deteriorating economic conditions in Michigan and throughout the country. The resulting decline in business revenue has negatively impacted the cash flows of many of our borrowers, some to the point where loan payments have become past due or will likely become delinquent in future periods. In addition, real estate prices have fallen significantly, thereby exposing us to larger-than-typical losses in those instances where the sale of collateral is the primary source of repayment. It is likely that net loan and lease charge-offs and nonperforming assets will remain elevated in comparison to our historical levels until economic conditions improve.

As of December 31, 2007, nonperforming assets totaled \$35.7 million, or 1.68% of total assets, an increase from the \$9.6 million, or 0.46% of total assets, as of December 31, 2006. As of December 31, 2007, nonperforming loans secured by real estate, combined with foreclosed properties, totaled \$28.6 million, or about 80% of total nonperforming assets. Nonperforming loans and foreclosed properties associated with the development of residential real estate totaled \$11.1 million, with another \$3.2 million in nonperforming loans secured by, and foreclosed properties consisting of, residential properties. Net loan and lease charge-offs during 2007 totaled \$6.7 million, or 0.38% of average total loans and leases. Net loan and lease charge-offs during the fourth quarter of 2007 totaled \$3.9 million, or about 58%, of the total net loan and lease charge-offs for all of 2007. During 2006, net loan and lease charge-offs totaled \$4.9 million, or 0.29% of average total loans and leases.

Throughout most of 2008, we experienced deterioration in a number of commercial loan relationships which previously had been performing fairly well. Analysis of certain commercial borrowers revealed a reduced capability on the part of these borrowers to make required payments as indicated by factors such as delinquent loan payments, diminished cash flow, deteriorating financial performance, or past due property taxes, and in the case of commercial and residential development projects slow absorption or sales trends. In addition, commercial real estate serves as the primary collateral source for many of these borrowing relationships and updated evaluations and appraisals in many cases reflected significant declines from the original estimated values.

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During the fourth quarter of 2008 and the first nine months of 2009, we saw a continuation of the stresses caused by the weakening and poor economic conditions, especially in the CRE markets and automotive-related borrowing relationships in our C&I portfolio. High vacancy rates or slow absorption has resulted in inadequate cash flow generated from some real estate projects we have financed, and has required guarantors to provide personal funds to make full contractual loan payments and pay other operating costs. In some cases, the guarantors' cash and other liquid reserves have become seriously diminished. In other cases, sale of the collateral, either by the borrower or us, is our primary source of repayment.

As of September 30, 2009, nonperforming assets totaled \$110.8 million, or 5.5% of total assets, an increase from the \$57.4 million, or 2.6% of total assets, as of December 31, 2008, and from the \$47.8 million, or 2.2% of total assets, as of September 30, 2008. As of September 30, 2009, nonperforming loans secured by CRE, combined with foreclosed properties, totaled \$62.8 million. Nonperforming loans and foreclosed properties associated with the development of residential real estate totaled \$26.7 million, with another \$6.8 million in nonperforming loans secured by, and foreclosed properties consisting of, residential properties. Nonperforming C&I loans and repossessed assets totaled \$14.5 million. Net loan and lease charge-offs during the first nine months of 2009 totaled \$27.4 million, or an annualized 2.1% of average total loans and leases, compared to \$13.5 million, or an annualized 1.0% of average total loans and leases, during the first nine months of 2008.

The following table provides a breakdown of nonperforming assets as of September 30, 2009 and net loan and lease charge-offs during the first nine months of 2009 by property type:

|             |                         | Nonperforming<br>Loans | Foreclosed<br>Assets | Net Loan &<br>Lease<br>Charge-Offs |
|-------------|-------------------------|------------------------|----------------------|------------------------------------|
| Residential | Land Development        | \$ 9,056,000           | \$ 4,589,000         | \$ 2,151,000                       |
| Residential | Construction            | 11,942,000             | 1,079,000            | 4,317,000                          |
| Residential | Owner Occupied / Rental | 5,988,000              | 842,000              | 2,701,000                          |
| Commercial  | Land Development        | 3,700,000              | 921,000              | 74,000                             |
| Commercial  | Construction            | 228,000                | 0                    | 0                                  |
| Commercial  | Owner Occupied          | 20,265,000             | 1,164,000            | 1,922,000                          |
| Commercial  | NonOwner Occupied       | 25,932,000             | 10,541,000           | 6,398,000                          |
| Commercial  | NonReal Estate          | 14,131,000             | 379,000              | 9,625,000                          |
| Consumer    | NonReal Estate          | 0                      | 8,000                | 178,000                            |
| Total       |                         | \$ 91,242,000          | \$ 19,523,000        | \$ 27,366,000                      |

Securities decreased \$4.3 million during the first nine months of 2009, totaling \$238.5 million as of September 30, 2009. Proceeds from called U.S. Government Agency bonds totaled \$26.6 million during the first nine months of 2009, with another \$13.2 million received from principal paydowns on mortgage-backed securities. In addition, \$3.5 million was received from the matured and called tax-exempt municipal general obligation bonds. A majority of the proceeds were invested back into the securities portfolio, with \$35.8 million invested in U.S. Government Agency bonds, \$3.9 million invested in mortgage-backed securities and \$1.0 million invested in tax-exempt municipal general obligation bonds. At September 30, 2009, the securities portfolio was comprised of U.S. Government Agency bonds (30%), U.S. Government Agency issued or guaranteed mortgage-backed securities (28%), tax-exempt municipal general obligations and revenue bonds (26%), Michigan Strategic Fund bonds (9%), Federal Home Loan Bank stock (7%) and mutual funds (less than 1%).

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Market values on our U.S. Government Agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government Agencies and tax-exempt municipal securities are determined on a monthly basis with the assistance of a third party vendor. Evaluated pricing models that vary by type of security and incorporate available market data are utilized. Standard inputs include issuer and type of security, benchmark yields, reported trades, broker/dealer quotes and issuer spreads. The market value of other securities is estimated at carrying value as those financial instruments are generally bought and sold at par value. We believe our valuation methodology provides for a reasonable estimation of market value, and that it is consistent with fair value accounting requirements.

Cash and cash equivalents increased \$40.9 million during the first nine months of 2009, totaling \$66.7 million on September 30, 2009. The federal funds sold balance was up \$41.5 million and short-term investments were up \$1.7 million, while cash and due from bank balances were down \$2.3 million. Given market conditions, we believe it is prudent to maintain relatively high balances of short-term liquid funds. During the first nine months of 2009, our average federal funds sold balance was about \$57.0 million.

Premises and equipment at September 30, 2009 equaled \$30.2 million, a decrease of \$2.1 million over the past nine months. Purchases of premises and equipment during the first nine months of 2009 were nominal, while depreciation expense totaled \$2.0 million.

Deposits decreased \$148.6 million during the first nine months of 2009, totaling \$1,451.0 million at September 30, 2009. Local deposits increased \$185.7 million, while out-of-area deposits decreased \$334.3 million. As a percent of total deposits, local deposits equaled 45.2% on September 30, 2009, an increase from 29.4% as of December 31, 2008. Noninterest-bearing demand deposits, comprising 7.5% of total deposits, decreased \$2.2 million during the first nine months of 2009. Savings deposits (2.9% of total deposits) decreased \$8.4 million, interest-bearing checking deposits (4.6% of total deposits) increased \$16.8 million and money market deposit accounts (2.1% of total deposits) increased \$6.3 million during the first nine months of 2009. Local certificates of deposit, comprising 28.1% of total deposits, increased \$173.2 million during the first nine months of 2009.

The increase in local deposits reflects various programs and initiatives we have implemented during 2009. During the first quarter, we ran a local one-year certificate of deposit campaign to attract new deposits and cross-sell other bank products. We opened over 1,500 certificates of deposit totaling over \$60.0 million, with many new customers coming to the bank and a majority of the funds coming from other financial institutions. Our sales force has been working diligently to cross-sell these new customers, and we are currently in the midst of a direct mailing program designed specifically to appeal to them which will assist us in retaining the deposits at maturity and providing us additional cross-sell opportunities. We have also created several initiatives within our commercial lending function, such as: inclusion of local deposit growth goals as part of our commercial lenders' job performance standards; an emphasis to all sales employees on garnering personal deposits of the business owners, officers and employees; mandating minimum corporate deposit balances on existing commercial loan relationships at time of renewal and new commercial loan customers as part of the loan commitment; and the requirement of property tax escrow accounts on certain commercial loan relationships. Additionally, we have had strong success with our executive banking product, which provides for a relatively high-rate interest-bearing checking account and an increase in certificate of deposit rate offerings if the customer maintains their primary noninterest-bearing checking account with us. We also remain committed to providing our customers with the latest in technological advances that provide improved information, convenience and timeliness, and to that end have launched several new offerings during 2009. Lastly, certificates of deposit from municipal governmental units have increased about \$45.0 million during the first nine months of 2009.

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Out-of-area deposits decreased \$334.3 million during the first nine months of 2009, totaling \$795.0 million as of September 30, 2009. Out-of-area deposits consist primarily of certificates of deposit obtained from depositors located outside our market areas and placed by deposit brokers for a fee, but also include certificates of deposit obtained from the deposit owners directly. The owners of out-of-area deposits include individuals, businesses, and municipal governmental units located throughout the United States. The decline in out-of-area deposits during the first nine months of 2009 primarily reflects the influx of cash resulting from the reduction in total loans and leases and from the increase in local deposits.

Repurchase agreements increased \$8.4 million during the first nine months of 2009, totaling \$102.8 million as of September 30, 2009. As part of our sweep account program, collected funds from certain business noninterest-bearing checking accounts are invested into over-night interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance.

FHLB advances decreased \$45.0 million during the first nine months of 2009, totaling \$225.0 million as of September 30, 2009. The FHLB 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 September 30, 2009 totaled about \$296.0 million, with availability approximating \$63.0 million. FHLB advances, along with out-of-area deposits, are the primary components of our wholesale funding program.

**Liquidity**

Liquidity is measured by our ability to raise funds through deposits, borrowed funds, capital or cash flow from the repayment of loans and securities. These monies are used to fund loans, meet deposit withdrawals and operate our company. Liquidity is primarily achieved through the growth of local and out-of-area deposits, advances from the FHLB and federal funds purchased, as well as liquid assets such as securities available for sale, matured and called securities, and federal funds sold. Asset and liability management is the process of managing our balance sheet to achieve a mix of earning assets and liabilities that maximizes profitability, while providing adequate liquidity.

In general, our liquidity strategy is to fund asset growth with deposits, repurchase agreements and FHLB advances and to maintain an adequate level of short- and medium-term investments to meet typical daily loan and deposit activity. Although deposit and repurchase agreement growth from customers located in our market areas has generally consistently increased, this growth has not been sufficient to meet our historical substantial loan growth and provide monies for additional investing activities. To assist in providing the additional needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, comprised primarily of certificates of deposit from customers outside of our market areas and advances from the FHLB, totaled \$1,035.0 million, or 57.7% of combined deposits and borrowed funds as of September 30, 2009. As of December 31, 2008, wholesale funds totaled \$1,414.2 million, or 71.5% of combined deposits and borrowed funds. The decline in wholesale funds reflects the combined impact of an increase in local deposits and a reduction of total loans outstanding.

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Although local deposits have historically generally increased as new business, municipal governmental unit and individual deposit relationships are established and as existing customers maintain or increase balances in their accounts, the relatively high reliance on wholesale funds will likely remain. As part of our interest rate risk management strategy, a majority of our wholesale funds have a fixed interest rate that mature within one year, reflecting that a majority of our loans and leases have a floating rate tied to either Mercantile Bank Prime Rate or LIBOR rates. While this strategy increases inherent liquidity risk, we believe the increased liquidity risk is sufficiently mitigated by the benefits derived from an interest rate risk management standpoint. In addition, we have developed a comprehensive contingency funding plan which we believe further mitigates the increased liquidity risk.

Wholesale funds are generally a lower all-in cost source of funds when compared to the interest rates that would have to be offered in our local markets to generate a commensurate level of funds. Interest rates paid on new out-of-area deposits and FHLB advances have historically been similar to interest rates paid on new certificates of deposit issued to local customers. In addition, the overhead costs associated with wholesale funds are considerably less than the overhead costs that would be incurred to attract and administer a similar level of local deposits, especially if the estimated costs of a required expanded branching network were taken into account. We believe the relatively low overhead costs reflecting our limited branch network mitigate our high reliance on wholesale funds and resulting relatively low net interest margin.

As a member of the FHLB of Indianapolis, our bank has access to the FHLB advance borrowing programs. Advances totaled \$225.0 million at September 30, 2009, compared to \$270.0 million outstanding at December 31, 2008. Based on available collateral at September 30, 2009, our bank could borrow an additional \$63.0 million. Our bank also has the ability to borrow up to \$30.0 million on a daily basis through a correspondent bank using an established unsecured federal funds purchased line of credit. The average balance of federal funds purchased during the first nine months of 2009 equaled only \$0.1 million, compared to a \$57.0 million average federal funds sold position during the same time period. Given volatile market conditions, during the latter part of 2008 we made the decision to operate with a higher than normal balance of federal funds sold, and we expect to continue to maintain a higher than historical level of federal funds sold until market conditions return to more normalized levels. As a result, we expect the use of our federal funds purchased line of credit, in at least the near future, will be minimal.

Our bank has an established line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using a substantial majority of our tax-exempt municipal securities as collateral, at September 30, 2009 we could have borrowed up to about \$50.0 million for terms of 1 to 28 days, or up to about \$42.0 million for terms of 29 to 90 days. We do not plan to regularly access this line of credit.

In addition to typical loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. As of September 30, 2009, our bank had a total of \$258.7 million in unfunded loan commitments and \$40.1 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$251.9 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$6.8 million were for loan commitments expected to close within the next several months. The level of commitments to make loans has declined significantly when compared to historical levels, primarily reflecting poor economic conditions. We monitor fluctuations in loan balances and commitment levels and include such data in managing our overall liquidity.



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We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, changes in economic or market conditions, reduction in earnings performance, declining capital levels or situations beyond our control could cause either short or long term liquidity challenges. We have developed a comprehensive contingency funding plan that provides a framework for meeting both temporary and longer-term liquidity disruptions. Depending upon the particular circumstances of a liquidity situation, possible strategies may include obtaining funds via one or a combination of the following sources of funds: established lines of credit at a correspondent bank, the FHLB and the Federal Reserve Bank of Chicago, brokered certificate of deposit market, wholesale securities repurchase markets, issuance of term debt, common or preferred stock, or sale of securities or other assets.

**Capital Resources**

Shareholders' equity is a noninterest-bearing source of funds that generally provides support for asset growth and the absorption of operating losses. Shareholders' equity was \$177.3 million at September 30, 2009, compared to \$174.4 million on December 31, 2008. The \$2.9 million increase during the first nine months of 2009 is primarily attributable to the sale of \$21.0 million of preferred stock to the United States Treasury Department under the Capital Purchase Program (see Note 14), which offset the net loss attributable to common shares of \$16.5 million recorded during the first nine months of 2009, the payment of cash dividends on common stock totaling \$0.5 million and the aggregate \$1.5 million adjustment for the market value of available for sale securities and the reclassification of unrealized gain on interest rate swaps.

We and our bank are subject to regulatory capital requirements administered by federal and state banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. Our and our bank's capital ratios as of September 30, 2009 and December 31, 2008 are disclosed in Note 13 of the Notes to Consolidated Financial Statements.

Our and our bank's ability to pay cash and stock dividends to common shareholders is subject to limitations under various laws and regulations and to prudent and sound banking practices. We have paid three cash dividends on our common stock during 2009. On January 8, 2009, we declared a \$0.04 per share cash dividend on our common stock which was paid on March 10, 2009 to record holders as of February 10, 2009. On April 9, 2009, we declared a \$0.01 per share cash dividend on our common stock which was paid on June 10, 2009 to record holders as of May 8, 2009. On July 16, 2009, we declared a \$0.01 per share cash dividend on our common stock which was paid on September 10, 2009 to record holders as of August 10, 2009. On October 15, 2009, we declared a \$0.01 per share cash dividend on our common stock which will be paid on December 10, 2009 to record holders as of November 10, 2009. While we want to maximize shareholder value, which includes the return of capital through cash dividends, given the current economic environment and its impact on our financial performance, we believe it is prudent to pay a reduced cash dividend in 2009 when compared to previous years.

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MERCANTILE BANK CORPORATION

**Results of Operations**

We recorded a net loss attributable to common shares for the third quarter of 2009 of \$5.6 million (\$0.66 per basic and diluted share), compared with net income of \$1.1 million (\$0.13 per basic and diluted share) recorded during the third quarter of 2008. We recorded a net loss attributable to common shares for the first nine months of 2009 of \$16.5 million (\$1.94 per basic and diluted share), compared with a net loss of \$5.3 million (\$0.62 per basic and diluted share) recorded during the first nine months of 2008. The net losses attributable to common shares for the third quarter of 2009 and the first nine months of 2009 include \$0.2 million (\$0.1 million after-tax) and \$1.3 million (\$0.85 million after-tax) in expenses associated with the consolidation of the mid- and eastern-Michigan regions of our banking activities, respectively. The nine-month 2009 net loss attributable to common shares also includes a \$0.9 million (\$0.62 million after-tax) charge for the bank industry-wide FDIC special assessment. Excluding the impact of these one-time charges from ongoing operations, the third quarter net loss attributable to common shares was \$5.5 million (\$0.65 per basic and diluted share), and the nine-month 2009 net loss attributable to common shares was \$15.0 million (\$1.77 per basic and diluted share).

The decline in earnings performance during the third quarter of 2009 and the first nine months of 2009 in comparison to the respective 2008 timeframes is primarily the result of a substantially higher provision for loan and lease losses, which more than offset increased net interest income. The elevated provision for loan and lease losses reflects continuing deterioration in the quality of the loan portfolio, most notably in the CRE and C&I segments. The continuing decline in the state and national economies has significantly hampered certain commercial borrowers' cash flows and negatively impacted real estate values, resulting in increasing levels of nonperforming CRE and C&I loans. The increase in net interest income is the result of an improved net interest margin, which has been positively impacted by a substantial reduction in our cost of funds.

Interest income during the third quarter of 2009 was \$25.9 million, a decrease of 13.2% from the \$29.8 million earned during the third quarter of 2008. Interest income during the first nine months of 2009 was \$80.8 million, a decrease of 11.2% from the \$90.9 million earned during the first nine months of 2008. The reduction in interest income during the third quarter of 2009 compared to the third quarter of 2008 is attributable to a decreased level of average earning assets and a declining yield on earning assets, primarily resulting from a decreased interest rate environment, an increased level of nonperforming assets and an increased percentage of low-yielding federal funds sold to total earning assets. These factors, with the exception of a decreased level of average earning assets, also negatively impacted interest income during the nine-month 2009 time period compared with the respective 2008 time period.

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During the third quarter of 2009, earning assets averaged \$1,935.6 million, \$138.2 million lower than average earning assets of \$2,073.8 million during the third quarter of 2008. Average loans and leases decreased \$189.3 million, which more than offset increases in average federal funds sold of \$25.5 million, average securities of \$23.9 million, and average short-term investments of \$1.7 million. During the first nine months of 2009, earning assets averaged \$2,046.2 million, \$6.6 million higher than average earning assets of \$2,039.6 million during the same time period in 2008. Average federal funds sold were up \$48.8 million, average securities were up \$26.0 million, and average short-term investments, consisting mainly of certificates of deposit, were up \$7.4 million, while average loans and leases were down \$75.6 million. During the third quarter of 2009 and 2008, earning assets had an average yield (tax equivalent-adjusted basis) of 5.37% and 5.77%, respectively. During the first nine months of 2009 and 2008, earning assets had an average yield of 5.34% and 6.00%, respectively. With approximately 60% of our total loans and leases tied to Prime or LIBOR rates, our earning asset yield has been substantially impacted by the steep reduction in market interest rates since late third quarter of 2007. Between mid-September 2007 and early-October 2008, the Federal Open Market Committee ( FOMC ) lowered the targeted federal funds rate by a total of 375 basis points. The resulting similar decline in the Prime and LIBOR rates, combined with an increased level of nonperforming assets, has significantly lowered our yield on earning assets and level of interest income. Although the FOMC lowered the targeted federal funds rate by another 50 basis points in late October 2008 and an additional 75 basis points in mid-December 2008, we kept the Mercantile Bank Prime Rate unchanged at 4.50% in an effort to shield interest income from further erosion. Virtually all of our prime-based commercial floating rate loans are tied to the Mercantile Bank Prime Rate. A higher level of nonperforming assets has also negatively impacted the yield on earning assets, increasing from 2.17% of total assets at September 30, 2008, to 5.49% at September 30, 2009. A significant increase in average federal funds sold during the first nine months of 2009 also had an adverse effect on earning asset yield. Interest expense during the third quarter of 2009 was \$12.3 million, a decrease of 32.0% from the \$18.1 million expensed during the third quarter of 2008. Interest expense during the first nine months of 2009 was \$43.0 million, a decrease of 24.9% from the \$57.2 million expensed during the first nine months of 2008. The reduction in interest expense during the third quarter of 2009 compared to the respective 2008 timeframe is primarily attributable to a declining interest rate environment and a decrease in average interest-bearing liabilities, while the reduction in interest expense for the nine-month 2009 time period compared to the same 2008 time period resulted from the declining interest rate environment.

During the third quarter of 2009, interest-bearing liabilities averaged \$1,733.5 million, \$142.8 million lower than average interest-bearing liabilities of \$1,876.3 million during the third quarter of 2008. Average interest-bearing deposits were down \$85.0 million, average FHLB advances were down \$55.4 million, average other borrowings were down \$2.3 million, and average short-term borrowings, consisting primarily of securities sold under agreements to repurchase, were down \$0.1 million. During the first nine months of 2009, interest-bearing liabilities averaged \$1,842.4 million, \$7.0 million higher than average interest-bearing liabilities of \$1,835.4 million during the same time period in 2008. Average other borrowings were up \$5.8 million and average interest-bearing deposits were up \$5.5 million, while average FHLB advances were down \$3.7 million and average short-term borrowings were down \$0.6 million. A decline in the average cost of interest-bearing liabilities, combined with the reduction in average interest-bearing liabilities, resulted in the reduction of interest expense during the third quarter of 2009 compared to the same time period in 2008. During the third quarter of 2009 and 2008, interest-bearing liabilities had an average rate of 2.82% and 3.83%, respectively. During the first nine months of 2009 and 2008, interest-bearing liabilities had an average rate of 3.12% and 4.15%, respectively. The lower weighted average cost of interest-bearing liabilities is primarily due to the decline in market interest rates.

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## MERCANTILE BANK CORPORATION

Net interest income during the third quarter of 2009 was \$13.6 million, an increase of 15.7% from the \$11.7 million earned during the third quarter of 2008. Net interest income during the first nine months of 2009 was \$37.8 million, an increase of 12.2% from the \$33.7 million earned during the same time period in 2008. The increase in net interest income during the third quarter of 2009 compared to the respective 2008 timeframe was due to an improved net interest margin, while the increase during the first nine months of 2009 compared to the respective 2008 timeframe was due to an improved net interest margin and, to a much lesser extent, growth in earning assets. The net interest margin during the third quarter of 2009 was 2.85%, compared to 2.30% during the third quarter of 2008. During the first nine months of 2009, the net interest margin was 2.53%, compared to 2.26% during the same time period in 2008. Although our yield on assets declined during both time periods primarily due to an increased level of nonperforming assets and a declining interest rate environment, our cost of funds declined at a far greater rate, resulting in the improved net interest margin. The cost of funds primarily decreased as a result of higher-costing matured wholesale funds, consisting of certificates of deposit and FHLB advances, being replaced by lower-costing funds.

Given the multitude of factors that impact the net interest margin, it is difficult to predict future net interest margins. However, in light of the current stable interest rate environment, our net interest margin during the remainder of 2009 and into 2010 should benefit from a continued reduction in our cost of funds and the loan pricing initiatives instituted in 2008 and 2009. With respect to our cost of funds, we have about \$300 million in wholesale funds at an average rate of 2.85% scheduled to mature during the fourth quarter of 2009, as well as about \$175 million at an average rate of 2.75% and about \$100 million at an average rate of 2.40% maturing in the first and second quarters of 2010, respectively. Current rates on wholesale instruments generally range from 0.40% to 2.50%, depending on the type of product and term, and during the third quarter of 2009 averaged 1.15%. While a continued reduction in our cost of funds will positively impact our net interest margin, the impact of asset quality on the net interest margin is difficult to predict.

The following table sets forth certain information relating to our consolidated average interest-earning assets and interest-bearing liabilities and reflects the average yield on assets and average cost of liabilities for the second quarter of 2009 and 2008. Such yields and costs are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the period presented. Tax-exempt securities interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 35%. Securities interest income was increased by \$314,000 and \$300,000 in the third quarter of 2009 and 2008, respectively, for this adjustment.

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## MERCANTILE BANK CORPORATION

Quarters ended September 30,

|   | 2009                   |           | 2008            |                    | Average   |       |
|---|------------------------|-----------|-----------------|--------------------|-----------|-------|
|   | Average<br>Balance     | Interest  | Average<br>Rate | Average<br>Balance | Interest  | Rate  |
|   | (dollars in thousands) |           |                 |                    |           |       |
| <b>ASSETS</b>                                 |                        |           |                 |                    |           |       |
| Loans and leases                              | \$ 1,663,510           | \$ 23,185 | 5.53%           | \$ 1,852,848       | \$ 27,161 | 5.82% |
| Securities                                    | 236,281                | 2,999     | 5.08            | 212,341            | 2,941     | 5.54  |
| Federal funds sold                            | 33,785                 | 22        | 0.25            | 8,319              | 40        | 1.90  |
| Short-term investments                        | 2,061                  | 1         | 0.27            | 279                | 1         | 1.00  |
| Total interest-earning assets                 | 1,935,637              | 26,207    | 5.37            | 2,073,787          | 30,143    | 5.77  |
| Allowance for loan losses                     | (34,959)               |           |                 | (32,358)           |           |       |
| Other assets                                  | 141,677                |           |                 | 131,430            |           |       |
| Total assets                                  | \$ 2,042,355           |           |                 | \$ 2,172,859       |           |       |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>    |                        |           |                 |                    |           |       |
| Interest-bearing deposits                     | \$ 1,355,485           | \$ 9,357  | 2.74%           | \$ 1,440,508       | \$ 14,180 | 3.91% |
| Short-term borrowings                         | 97,795                 | 471       | 1.91            | 97,833             | 483       | 1.96  |
| FHLB advances                                 | 230,381                | 2,113     | 3.59            | 285,777            | 2,839     | 3.89  |
| Other borrowings                              | 49,843                 | 385       | 3.02            | 52,222             | 613       | 4.59  |
| Total interest-bearing liabilities            | 1,733,504              | 12,326    | 2.82            | 1,876,340          | 18,115    | 3.83  |
| Noninterest-bearing deposits                  | 113,779                |           |                 | 110,036            |           |       |
| Other liabilities                             | 13,672                 |           |                 | 17,242             |           |       |
| Shareholders equity                           | 181,400                |           |                 | 169,241            |           |       |
| Total liabilities and shareholders equity     | \$ 2,042,355           |           |                 | \$ 2,172,859       |           |       |
| Net interest income                           |                        | \$ 13,881 |                 |                    | \$ 12,028 |       |
| Net interest rate spread                      |                        |           | 2.55%           |                    |           | 1.94% |
| Net interest rate margin on average assets    |                        |           | 2.70%           |                    |           | 2.20% |
| Net interest margin on average earning assets |                        |           | 2.85%           |                    |           | 2.30% |

Provisions for loan and lease losses during the third quarter of 2009 were \$11.8 million, compared to \$1.9 million during the third quarter of 2008. Provisions for loan and lease losses during the first nine months of 2009 were \$33.7 million, compared to \$17.2 million that was expensed during the same time period in 2008. The increased provisions primarily reflect a higher volume of net loan and lease charge-offs and additional deterioration in the quality of our loan and lease portfolio, stemming from the continuing declines in the Michigan, regional, and national economies. The economic downturn, which in 2007 and early 2008 had a significant impact on our residential real estate development loan portfolio, had an adverse effect on the quality of other portfolio sectors as well throughout 2008 and into 2009. A majority of the provision expense during the first nine months of 2009 related to CRE and C&I loans.

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Net loan and lease charge-offs of \$11.0 million were recorded during the third quarter of 2009, compared to \$4.3 million during the third quarter of 2008. During the first nine months of 2009, net loan and lease charge-offs totaled \$27.4 million, compared to \$13.5 million during the same time period in 2008. Of the \$11.5 million in gross loans and leases charged-off during the third quarter of 2009, \$3.8 million, or approximately 33%, represents the elimination of specific reserves that were established in earlier periods. The remaining \$7.7 million, while in part covered through general reserve allocations via our loan grading system, is included in the \$11.8 million provision that was expensed during the third quarter of 2009. Provision expense during the first nine months of 2009 allocated to CRE loans totaled \$15.0 million, with another \$9.8 million allocated to C&I loans. The allowance, as a percentage of total loans and leases outstanding, was 2.07% as of September 30, 2009, compared to 1.46% as of December 31, 2008 and 1.58% as of September 30, 2008.

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at adequate levels. Through the loan and lease review and credit departments, we attempt to allocate specific portions of the allowance based on specifically identifiable problem loans and leases. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Reserve Analysis, composition of the loan and lease portfolio, third party analysis of the loan and lease administration processes and loan and lease portfolio and general economic conditions. In addition, the historically strong commercial loan growth and expansions into new markets are taken into account.

The Reserve Analysis, used since our inception and completed monthly, applies reserve allocation factors to outstanding loan and lease balances to calculate an overall allowance dollar amount. For commercial loans and leases, which continue to comprise a vast majority of our loan and lease portfolio, reserve allocation factors are based upon the loan ratings as determined by our standardized grade paradigms. For retail loans, reserve allocation factors are based upon the type of credit. Adjustments for specific loan relationships, including impaired loans and leases, are made on a case-by-case basis. The reserve allocation factors are primarily based on recent levels and historical trends of net loan and lease charge-offs and non-performing assets, the comparison of the recent levels and historical trends of net loan charge-offs and nonperforming assets with a customized peer group consisting of ten similarly-sized publicly traded banking organizations conducting business in the states of Michigan, Illinois, Indiana or Ohio, the review and consideration of our loan migration analysis and the experience of senior management making similar loans and leases over a period of many years. We regularly review the Reserve Analysis and make adjustments based upon identifiable trends and experience.

Noninterest income during the third quarter of 2009 was \$1.71 million, a decrease of 5.9% from the \$1.82 million earned during the third quarter of 2008. Noninterest income during the first nine months of 2009 was \$5.61 million, an increase of 2.6% over the \$5.47 million earned during the same time period in 2008. Income from mortgage banking activities increased \$423,000, or 82.0%, during the first nine months of 2009, reflecting a higher volume of refinancing activity due to the lower interest rate environment, while rental income on foreclosed properties, included in other income, increased \$261,000, or 294.9%.

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Noninterest expense during the third quarter of 2009 was \$12.5 million, an increase of 19.1% over the \$10.5 million expensed during the third quarter of 2008. Noninterest expense during the first nine months of 2009 was \$35.7 million, an increase of 12.8% over the \$31.6 million expensed during the same time period in 2008. Overhead costs during the third quarter of 2009 include a \$0.2 million charge for the branch consolidation, and overhead costs for the first nine months of 2009 include a \$1.3 million charge for the branch consolidation and a \$0.9 million charge for the bank industry-wide FDIC special assessment. The one-time charges related to the branch consolidation were fully expensed during the second and third quarters of 2009; we expect the branch consolidation to result in a \$200,000 per month reduction in overhead costs beginning in the fourth quarter. Excluding these one-time charges, noninterest expense during the third quarter of 2009 totaled \$12.4 million, or \$1.8 million higher than the third quarter of 2008; for the first nine months of 2009, noninterest expense equaled \$33.5 million, or \$1.9 million higher than the first nine months of 2008.

Controllable operating expenses, including salaries and benefits (excluding a \$0.5 million one-time charge for severance payments included in the branch consolidation line for the first nine months of 2009), occupancy, and furniture and equipment costs, declined \$0.9 million in the third quarter of 2009 and \$1.8 million in the first nine months of 2009 when compared to the respective 2008 timeframes. Salary and benefit costs were down \$0.8 million in the third quarter of 2009 and \$1.4 million, exclusive of the \$0.5 million one-time charge taken in the second quarter, in the first nine months of 2009, primarily resulting from a reduction in full-time equivalent employees from 307 at the end of the third quarter of 2008 to 265 as of September 30, 2009. FDIC insurance assessments equaled \$1.2 million in the third quarter of 2009, up \$0.8 million from the amount expensed in the third quarter of 2008, and \$2.8 million, excluding the one-time special assessment, in the first nine months of 2009, up \$1.7 million from the same time period in 2008. Costs associated with the administration and resolution of problem assets, including legal costs, property tax payments, appraisals and write-downs on foreclosed properties, totaled \$2.9 million in the third quarter of 2009 and \$5.0 million in the first nine months of 2009, compared to \$0.8 million and \$2.3 million in the respective 2008 timeframes.

Due to our loss before federal income tax benefit, we recorded a federal income tax benefit during the third quarter and first nine months of 2009. During the third quarter of 2009, we recorded a loss before federal income tax benefit of \$9.0 million and a federal income tax benefit of \$3.8 million, compared to income before federal income tax expense of \$1.1 million and federal income tax expense of \$0.1 million during the third quarter of 2008. During the first nine months of 2009, we recorded a loss before federal income tax benefit of \$25.9 million and a federal income tax benefit of \$9.9 million, compared to a loss before federal income tax benefit of \$9.7 million and a federal income tax benefit of \$4.4 million during the same time period in 2008. Our effective tax rate during the third quarter of 2009 was (41.5%), compared to 4.7% during the third quarter of 2008. Our effective tax rate during the first nine months of 2009 was (38.3%), compared to (45.4%) during the same time period in 2008.

ASC 740, *Income Taxes*, requires that companies assess whether a valuation allowance should be established against deferred tax assets based on the consideration of all available evidence using a more likely than not standard. Accordingly, we reviewed our deferred tax assets and determined that no valuation allowance was necessary at September 30, 2009.



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In making decisions regarding any valuation allowance, 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. Our significant negative evidence is our operating loss for 2008 and the first nine months of 2009, which puts us in a cumulative pre-tax loss position over the last three years, combined with a challenging economic environment and uncertainty in the timing of a meaningful economic recovery. Our positive evidence includes our: 1) history of strong earnings performance prior to 2008; 2) aggressive nature in identifying, administering and accounting for problem assets; 3) well capitalized regulatory capital position; 4) rapidly improving net interest margin; 5) substantial decline in wholesale funding reliance which in large part is due to a significant increase in local deposits; 6) decisions made that have lead to reduced salary, benefit, occupancy, furniture and equipments costs; and 7) cautiously optimistic expectations regarding future taxable income.

Future realization of our deferred tax assets is highly dependent upon our forecasts of taxable income. While such forecasts cannot be guaranteed, we believe they have been developed in a conservative manner in regards to net interest margin expectations and the impact of potential further credit deterioration on provisions to our allowance. We expect our regulatory capital ratios to remain well above required minimums, thus ensuring our economic viability and ability to realize our deferred tax assets. The deferred tax assets will be analyzed quarterly for changes affecting realizability, and there can be no assurance that a valuation allowance will not be necessary in future periods.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. We have only limited agricultural-related loan assets and therefore have no significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates is assumed to be insignificant. Interest rate risk is the exposure of our financial condition to adverse movements in interest rates. We derive our income primarily from the excess of interest collected on our interest-earning assets over the interest paid on our interest-bearing liabilities. The rates of interest we earn on our assets and owe on our liabilities generally are established contractually for a period of time. Since market interest rates change over time, we are exposed to lower profitability if we cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excessive levels of interest rate risk could pose a significant threat to our earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to our safety and soundness.

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, we assess the existing and potential future effects of changes in interest rates on our financial condition, including capital adequacy, earnings, liquidity and asset quality. Our interest rate risk policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within policy parameters. During the first six months of 2008, we entered into interest rate swaps to convert the variable rate cash flows on certain of our prime-based commercial loans to a fixed rate of interest. Further discussion of our use of, and the accounting for, interest rate swaps is included in Notes 1 and 10 to the Consolidated Financial Statements.

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We use two interest rate risk measurement techniques. The first, which is commonly referred to as GAP analysis, measures the difference between the dollar amounts of interest sensitive assets and liabilities that will be refinanced or repriced during a given time period. A significant repricing gap could result in a negative impact to our net interest margin during periods of changing market interest rates. The following table depicts our GAP position as of September 30, 2009 (dollars in thousands):

|  | Within<br>Three<br>Months | Three to<br>Twelve<br>Months | One to<br>Five<br>Years | After<br>Five<br>Years | Total            |
|--|---------------------------|------------------------------|-------------------------|------------------------|------------------|
| <b>Assets:</b>                                       |                           |                              |                         |                        |                  |
| Commercial loans and leases <sup>(1)</sup>           | \$ 524,005                | \$ 269,701                   | \$ 641,526              | \$ 41,835              | \$ 1,477,067     |
| Residential real estate loans                        | 52,746                    | 12,028                       | 52,643                  | 13,742                 | 131,159          |
| Consumer loans                                       | 1,674                     | 1,459                        | 2,662                   | 205                    | 6,000            |
| Investment securities <sup>(2)</sup>                 | 38,974                    | 6,772                        | 50,809                  | 141,933                | 238,488          |
| Short-term investments                               | 52,230                    | 0                            | 0                       | 0                      | 52,230           |
| Allowance for loan and lease<br>losses               | 0                         | 0                            | 0                       | 0                      | (33,443)         |
| Other assets   | 0                         | 0                            | 0                       | 0                      | 145,849          |
| <b>Total assets</b>                                  | <b>669,629</b>            | <b>289,960</b>               | <b>747,640</b>          | <b>197,715</b>         | <b>2,017,350</b> |
| <b>Liabilities:</b>                                  |                           |                              |                         |                        |                  |
| Interest-bearing checking                            | 67,033                    | 0                            | 0                       | 0                      | 67,033           |
| Savings  | 41,559                    | 0                            | 0                       | 0                      | 41,559           |
| Money market accounts                                | 31,169                    | 0                            | 0                       | 0                      | 31,169           |
| Time deposits < \$100,000                            | 28,795                    | 107,832                      | 38,394                  | 0                      | 175,021          |
| Time deposits \$100,000 and over                     | 415,978                   | 425,634                      | 186,065                 | 0                      | 1,027,677        |
| Short-term borrowings                                | 102,847                   | 0                            | 0                       | 0                      | 102,847          |
| FHLB advances  | 20,000                    | 45,000                       | 160,000                 | 0                      | 225,000          |
| Other borrowings                                     | 34,857                    | 5,000                        | 10,000                  | 0                      | 49,857           |
| Noninterest-bearing checking                         | 0                         | 0                            | 0                       | 0                      | 108,509          |
| Other liabilities                                    | 0                         | 0                            | 0                       | 0                      | 11,387           |
| <b>Total liabilities</b>                             | <b>742,238</b>            | <b>583,466</b>               | <b>394,459</b>          | <b>0</b>               | <b>1,840,059</b> |
| Shareholders' equity                                 | 0                         | 0                            | 0                       | 0                      | 177,291          |
| <b>Total sources of funds</b>                        | <b>742,238</b>            | <b>583,466</b>               | <b>394,459</b>          | <b>0</b>               | <b>2,017,350</b> |
| <b>Net asset (liability) GAP</b>                     | <b>\$ (72,609)</b>        | <b>\$ (293,506)</b>          | <b>\$ 353,181</b>       | <b>\$ 197,715</b>      |                  |
| <b>Cumulative GAP</b>                                | <b>\$ (72,609)</b>        | <b>\$ (366,115)</b>          | <b>\$ (12,934)</b>      | <b>\$ 184,781</b>      |                  |
| <b>Percent of cumulative GAP to total<br/>assets</b> | <b>(3.6)%</b>             | <b>(18.1)%</b>               | <b>(0.6)%</b>           | <b>9.2%</b>            |                  |

- (1) Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not next repricing date.
- (2) Mortgage-backed securities are categorized by expected final maturities based upon prepayment trends as of September 30, 2009.

The second interest rate risk measurement we use is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, serves as our primary interest rate risk measurement technique. The simulation model assesses the direction and magnitude of variations in net interest income resulting from potential changes in market interest rates. Key assumptions in the model include prepayment speeds on various loan and investment assets; cash flows and maturities of interest-sensitive assets and liabilities; and changes in market conditions impacting loan and deposit volume and pricing.

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These assumptions are inherently uncertain, subject to fluctuation and revision in a dynamic environment; therefore, the model cannot precisely estimate net interest income or exactly predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to the timing, magnitude, and frequency of interest rate changes and changes in market conditions and the company's strategies, among other factors.

We conducted multiple simulations as of September 30, 2009, in which it was assumed that changes in market interest rates occurred ranging from up 200 basis points to down 200 basis points in equal quarterly instalments over the next twelve months in comparison to estimated net interest income based on our balance sheet, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of September 30, 2009.

The resulting estimates are within our policy parameters established to manage and monitor interest rate risk.

|                                      | Dollar Change In<br>Net Interest<br>Income | Percent Change<br>In<br>Net Interest<br>Income |
|--------------------------------------|--|--|
| Interest Rate Scenario               |  |  |
| Interest rates down 200 basis points | \$ 2,812,000                               | 5.6%   |
| Interest rates down 100 basis points | 2,928,000                                  | 5.8  |
| No change in interest rates          | 3,101,000                                  | 6.1  |
| Interest rates up 100 basis points   | 2,129,000                                  | 4.2  |
| Interest rates up 200 basis points   | 3,140,000                                  | 6.2  |

The resulting estimates have been significantly impacted by the current interest rate and economic environment, as adjustments have been made to critical model inputs with regards to traditional interest rate relationships. This is especially important as it relates to floating rate commercial loans and brokered certificates of deposit, which comprise a substantial portion of our balance sheet. As of September 30, 2009, the Mercantile Bank Prime Rate is 4.50% as compared to the Wall Street Journal Prime Rate of 3.25%. Historically, the two indices have been equal; however, we elected not to reduce the Mercantile Bank Prime Rate in late October and mid-December of 2008 when the Wall Street Journal Prime Rate declined by 50 and 75 basis points, respectively. In conducting our simulations at September 30, 2009, we have made the assumption that the Mercantile Bank Prime Rate will remain unchanged until the Wall Street Journal Prime Rate exceeds the Mercantile Bank Prime Rate, at which time the two indices will remain equal in the increasing interest rate scenarios. We have also made similar assumptions in regards to our local deposit rates, which in general have not been reduced since the separation of the Mercantile and Wall Street Journal Prime Rate indices. Also, brokered certificate of deposit rates have substantially decreased over the past several months, with part of the decline attributable to a significant imbalance whereby the supply of available funds far outweighs the demand from banks looking to raise funds. As a result, we have substantially limited further reductions in brokered certificate of deposit rates in the declining interest rate scenarios.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; level of nonperforming assets; economic and competitive conditions; potential changes in lending, investing and deposit gathering strategies; client preferences; and other factors.

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MERCANTILE BANK CORPORATION

**Item 4. Controls and Procedures**

As of September 30, 2009, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2009. There have been no significant changes in our internal controls over financial reporting during the quarter ended September 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we may be involved in various legal proceedings that are incidental to our business. In our opinion, we are not a party to any current legal proceedings that are material to our financial condition, either individually or in the aggregate.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those previously disclosed in our annual report on Form 10-K for the year ended December 31, 2008.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

We have made no unregistered sales of equity securities during the quarter ended September 30, 2009.

We have made no purchases of our equity securities during the quarter ended September 30, 2009.

We are presently participating in the Treasury's Capital Purchase Program. Under the program we sold preferred stock and a warrant for common stock to the Treasury for \$21.0 million on May 15, 2009. An agreement we signed in connection with the program provides that we may not, without the Treasury's consent, increase our dividend rate per share of common stock or, with certain exceptions, repurchase any shares of our common stock. Our quarterly dividend on our common stock, as of May 15, 2009, was \$0.01 per share. These restrictions remain in effect until the earlier of (i) May 15, 2012, or (ii) such time as all of the preferred stock that we sold to the Treasury has been redeemed by us, or transferred by the Treasury to third parties that are not affiliated with the Treasury.

**Item 3. Defaults upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable.

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits**

| EXHIBIT NO. | EXHIBIT DESCRIPTION   |
|-------------|---|
| 3.1         | Our Articles of Incorporation are incorporated by reference to exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2009   |
| 3.2         | Our Amended and Restated Bylaws dated as of January 16, 2003 are incorporated by reference to Exhibit 3.2 of our Registration Statement on Form S-3 (Commission File No. 333-103376) that became effective on February 21, 2003 |
| 31          | Rule 13a-14(a) Certifications   |
| 32.1        | Section 1350 Chief Executive Officer Certification  |
| 32.2        | Section 1350 Chief Financial Officer Certification  |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 6, 2009.

MERCANTILE BANK CORPORATION

By: /s/ Michael H. Price

Michael H. Price  
Chairman of the Board, President and Chief Executive  
Officer  
(Principal Executive Officer)

By: /s/ Charles E. Christmas

Charles E. Christmas  
Senior Vice President, Chief Financial Officer and  
Treasurer  
(Principal Financial and Accounting Officer)

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