MERCANTILE BANK CORP
Form 10-Q
August 09, 2010

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

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

For the quarterly period ended June 30, 2010

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

For the transition period from __________ to __________.

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

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

310 Leonard Street, NW, Grand Rapids, MI 49504
(Address of principal executive offices) (Zip Code)

(616) 406-3000
(Registrant s telephone number, including area code)

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

Yes þ No o

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

Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

Yes o No þ

At August 9, 2010, there were 8,594,307 shares of Common Stock outstanding.

MERCANTILE BANK CORPORATION

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MERCANTILE BANK CORPORATION
PART I FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED BALANCE SHEETS

	June 30, 2010 (Unaudited)	December 31, 2009 (Audited)
ASSETS		
Cash and due from banks	$ 16,521,000	$ 18,896,000
Short-term investments	9,470,000	1,471,000
Federal funds sold	53,892,000	1,368,000
Total cash and cash equivalents	79,883,000	21,735,000
Securities available for sale	217,117,000	182,492,000
Securities held to maturity (fair value of $60,271,000 at December 31, 2009)	0	59,211,000
Federal Home Loan Bank stock	15,681,000	15,681,000
Loans and leases	1,410,710,000	1,539,818,000
Allowance for loan and lease losses	(47,738,000)	(47,878,000)
Loans and leases, net	1,362,972,000	1,491,940,000
Premises and equipment, net	28,636,000	29,684,000
Bank owned life insurance	45,890,000	45,024,000
Accrued interest receivable	6,278,000	7,088,000
Other real estate owned and repossessed assets	23,020,000	26,608,000
Other assets	24,585,000	26,745,000
Total assets	$ 1,804,062,000	$ 1,906,208,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Deposits		
Noninterest-bearing	$ 126,572,000	$ 121,157,000
Interest-bearing	1,213,588,000	1,280,470,000
Total deposits	1,340,160,000	1,401,627,000
Securities sold under agreements to repurchase	108,271,000	99,755,000
Federal funds purchased	0	2,600,000
Federal Home Loan Bank advances	160,000,000	205,000,000
Subordinated debentures	32,990,000	32,990,000
Other borrowed money	16,836,000	16,890,000
Accrued expenses and other liabilities	6,762,000	7,242,000

Total liabilities	1,665,019,000	1,766,104,000
Shareholders equity		
Preferred stock, no par value; 1,000,000 shares authorized; 21,000 shares outstanding at June 30, 2010 and December 31, 2009	19,955,000	19,839,000
Common stock, no par value: 20,000,000 shares authorized; 8,594,307 shares outstanding at June 30, 2010 and 8,592,514 shares outstanding at December 31, 2009	172,631,000	172,438,000
Common stock warrant	1,138,000	1,138,000
Retained earnings (deficit)	(57,818,000)	(54,170,000)
Accumulated other comprehensive income	3,137,000	859,000
Total shareholders equity	139,043,000	140,104,000
Total liabilities and shareholders equity	$ 1,804,062,000	$ 1,906,208,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended June 30, 2010 (Unaudited)	Three Months Ended June 30, 2009 (Unaudited)	Six Months Ended June 30, 2010 (Unaudited)	Six Months Ended June 30, 2009 (Unaudited)
Interest income				
Loans and leases, including fees	$ 20,066,000	$ 24,080,000	$ 40,471,000	$ 49,265,000
Securities, taxable	2,039,000	1,889,000	4,022,000	3,825,000
Securities, tax-exempt	544,000	855,000	1,304,000	1,695,000
Federal funds sold	37,000	39,000	69,000	86,000
Short-term investments	10,000	3,000	19,000	16,000
Total interest income	22,696,000	26,866,000	45,885,000	54,887,000
Interest expense				
Deposits	5,992,000	11,220,000	12,489,000	24,061,000
Short-term borrowings	353,000	475,000	697,000	915,000
Federal Home Loan Bank advances	1,576,000	2,295,000	3,272,000	4,747,000
Other borrowings	354,000	426,000	700,000	909,000
Total interest expense	8,275,000	14,416,000	17,158,000	30,632,000
Net interest income	14,421,000	12,450,000	28,727,000	24,255,000
Provision for loan and lease losses	6,200,000	11,500,000	14,600,000	21,900,000
Net interest income after provision for loan and lease losses	8,221,000	950,000	14,127,000	2,355,000
Noninterest income				
Services charges on accounts	447,000	500,000	913,000	1,012,000
Earnings on bank owned life insurance	454,000	296,000	865,000	641,000
Rental income from other real estate owned	390,000	60,000	791,000	193,000
Mortgage banking activities	130,000	403,000	230,000	772,000
Net gain on sales of securities	0	0	476,000	0
Gain on sales of commercial loans	5,000	0	225,000	0
Other income	570,000	604,000	1,151,000	1,277,000
Total noninterest income	1,996,000	1,863,000	4,651,000	3,895,000
Noninterest expense				

Salaries and benefits	4,559,000	5,247,000	9,225,000	10,799,000
Occupancy	723,000	883,000	1,473,000	1,804,000
Furniture and equipment depreciation, rent and maintenance	396,000	466,000	805,000	933,000
Nonperforming asset costs	2,460,000	1,119,000	4,964,000	2,101,000
FDIC insurance costs	1,167,000	1,796,000	2,353,000	2,430,000
Branch consolidation costs	0	1,150,000	0	1,150,000
Other expense	2,137,000	1,703,000	4,256,000	3,919,000
Total noninterest expenses	11,442,000	12,364,000	23,076,000	23,136,000
Income (loss) before federal income tax expense (benefit)	(1,225,000)	(9,551,000)	(4,298,000)	(16,886,000)
Federal income tax expense (benefit)	(862,000)	(3,326,000)	(1,292,000)	(6,172,000)
Net income (loss)	(363,000)	(6,225,000)	(3,006,000)	(10,714,000)
Preferred stock dividends and accretion	321,000	163,000	641,000	163,000
Net income (loss) available to common shareholders	$ (684,000)	$ (6,388,000)	$ (3,647,000)	$ (10,877,000)

See accompanying notes to consolidated financial statements.

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

	Three Months Ended June 30, 2010 (Unaudited)	Three Months Ended June 30, 2009 (Unaudited)	Six Months Ended June 30, 2010 (Unaudited)	Six Months Ended June 30, 2009 (Unaudited)
Basic earnings (loss) per share	$ (0.08)	$ (0.75)	$ (0.43)	$ (1.28)
Diluted earnings (loss) per share	$ (0.08)	$ (0.75)	$ (0.43)	$ (1.28)
Cash dividends per share	$ 0.00	$ 0.01	$ 0.01	$ 0.05
Average basic shares outstanding	8,505,086	8,487,747	8,503,388	8,484,524
Average diluted shares outstanding	8,505,086	8,487,747	8,503,388	8,484,524

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 Stock	Common Stock	Common Stock Warrant	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Balances, January 1, 2010	$ 19,839	$ 172,438	$ 1,138	$ (54,170)	$ 859	$ 140,104
Accretion of preferred stock	116			(116)		0
Employee stock purchase plan (5,086 shares)		23				23
Dividend reinvestment plan (687 shares)		3				3
Stock-based compensation expense		252				252
Cash dividends ($0.01 per common share)		(85)				(85)
Preferred stock dividends				(526)		(526)
Comprehensive income (loss):						
Net loss for the period from January 1, 2010 through June 30, 2010				(3,006)		(3,006)
Change in net unrealized gain on securities available for sale, net of reclassifications and tax effect					2,068	2,068
Net unrealized gain on securities transferred from held to maturity to available for sale, net of tax effect					274	274

Reclassification of unrealized gain on interest rate swaps, net of tax effect					(64)	(64)
Total comprehensive loss						(728)
Balances, June 30, 2010	$ 19,955	$ 172,631	$ 1,138	$ (57,818)	$ 3,137	$ 139,043

See accompanying notes to consolidated financial statements.

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

($ in thousands)	Preferred Stock	Common Stock	Common Stock Warrant	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total Shareholders Equity
Balances, January 1, 2009	$ 0	$ 172,353	$ 0	$ (1,281)	$ 3,300	$ 174,372
Preferred stock issued, net	19,696					19,696
Accretion of preferred stock	29			(29)		0
Common stock warrant issued			1,138			1,138
Employee stock purchase plan (6,979 shares)		30				30
Dividend reinvestment plan (2,212 shares)		8				8
Stock-based compensation expense		310				310
Cash dividends ($0.05 per common share)		(424)				(424)
Preferred stock dividends				(134)		(134)
Comprehensive income (loss):						
Net loss for the period from January 1, 2009 through June 30, 2009				(10,714)		(10,714)
Change in net unrealized gain (loss) on securities available for sale, net of reclassifications and tax effect					(1,748)	(1,748)
					(842)	(842)

Reclassification of unrealized gain on interest rate swaps, net of tax effect						
Total comprehensive loss						(13,304)
Balances June 30, 2009	$ 19,725	$ 172,277	$ 1,138	$ (12,158)	$ 710	$ 181,692

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities		
Net income (loss)	$ (3,006,000)	$ (10,714,000)
Adjustments to reconcile net income (loss) to net cash from operating activities		
Depreciation and amortization	1,306,000	1,472,000
Provision for loan and lease losses	14,600,000	21,900,000
Stock-based compensation expense	252,000	310,000
Proceeds from sales of mortgage loans held for sale	14,497,000	54,068,000
Origination of mortgage loans held for sale	(13,215,000)	(56,279,000)
Net gain from sales of mortgage loans held for sale	(147,000)	(608,000)
Gain from sale of commercial loans	(225,000)	0
Net gain from sale of held to maturity securities	(476,000)	0
Net loss from sale and valuation write-down of foreclosed assets	1,523,000	544,000
Recognition of unrealized gain on interest rate swaps	(99,000)	(1,296,000)
Earnings on bank owned life insurance	(865,000)	(641,000)
Net change in:		
Accrued interest receivable	810,000	780,000
Other assets	599,000	(6,397,000)
Accrued expenses and other liabilities	(480,000)	(644,000)
Net cash from operating activities	15,074,000	2,495,000
Cash flows from investing activities		
Loan and lease originations and payments, net	101,912,000	127,948,000
Purchases of:		
Securities available for sale	(37,516,000)	(31,790,000)
Securities held to maturity	0	(1,024,000)
Proceeds from:		
Maturities, calls and repayments of available for sale securities	45,836,000	33,088,000
Maturities, calls and repayments of held to maturity securities	0	3,520,000
Sales of held to maturity securities	20,452,000	0
Proceeds from sales of commercial loans	5,648,000	0
Proceeds from sales of foreclosed assets	7,962,000	1,887,000
Purchases of premises and equipment, net	(30,000)	(26,000)
Net cash from investing activities	144,264,000	133,603,000
Cash flows from financing activities		
Net decrease in time deposits	(152,027,000)	(130,246,000)
Net increase in all other deposits	90,560,000	9,304,000
Net increase in securities sold under agreements to repurchase	8,516,000	15,172,000

Net decrease in federal funds purchased	(2,600,000)	0
Proceeds from Federal Home Loan Bank advances	0	5,000,000
Maturities of Federal Home Loan Bank advances	(45,000,000)	(40,000,000)
Net decrease in other borrowed money	(54,000)	(2,678,000)
Proceeds from issuance of preferred stock and common stock warrant, net	0	20,834,000
Employee stock purchase plan	23,000	30,000
Dividend reinvestment plan	3,000	8,000
Payment of cash dividends on preferred stock	(526,000)	0
Payment of cash dividends on common shares	(85,000)	(424,000)
Net cash for financing activities	(101,190,000)	(123,000,000)

See accompanying notes to consolidated financial statements.

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

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Net change in cash and cash equivalents	58,148,000	13,098,000
Cash and cash equivalents at beginning of period	21,735,000	25,804,000
Cash and cash equivalents at end of period	$ 79,883,000	$ 38,902,000
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Interest	$ 18,631,000	$ 33,867,000
Federal income tax	0	0
Noncash financing and investing activities:		
Transfers from loans and leases to foreclosed assets	5,898,000	6,859,000
Preferred stock cash dividend accrued	134,000	134,000

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. **SIGNIFICANT ACCOUNTING POLICIES**

Basis of Presentation: The unaudited financial statements for the six months ended June 30, 2010 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 June 30, 2010 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, 2009.

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

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

Due to our net loss, approximately 88,000 unvested restricted shares were not included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2010, and approximately 98,000 unvested restricted shares were not included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2009. In addition, stock options and a stock warrant for approximately 285,000 and 616,000 shares of common stock, respectively, were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2010, and stock options and a stock warrant for approximately 319,000 and 616,000 shares of common stock, respectively, were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2009. Weighted average diluted common shares outstanding equals the weighted average common shares outstanding during the three and six month periods ended June 30, 2010 and 2009 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 uncollectability of a loan or lease is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required using 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.

Troubled Debt Restructurings: A loan or lease is accounted for as a troubled debt restructuring if we, for economic or legal reasons related to the borrower s financial condition, grant a significant concession to the borrower that we would not otherwise consider. A troubled debt restructuring may involve the receipt of assets from the debtor in partial or full satisfaction of the loan or lease, or a modification of terms such as a reduction of the stated interest rate or balance of the loan or lease, a reduction of accrued interest, an extension of the maturity date at a stated interest rate lower than the current market rate for a new loan with similar risk, or some combination of these concessions. Troubled debt restructurings generally remain categorized as nonperforming loans and leases until a six-month payment history has been maintained.

Derivatives: Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Historically, our derivatives have consisted of interest rate swap agreements, which are used as part of our asset and liability management to help manage interest rate risk. We do not use derivatives for trading purposes.

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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.

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 December 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) ASU 2009-16, *Accounting for Transfers of Financial Assets* (formerly Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*). This ASU 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. This ASU also expands the disclosure requirements for such transactions. It is effective as of the beginning of the first annual reporting period that begins after November 15, 2009. The adoption of this ASU on January 1, 2010 had no impact on our results of operations or financial position.

In January 2010, the FASB issued ASU 2010-06, *Improving Disclosure about Fair Value Measurements*. This ASU requires new disclosures on the amount and reason for transfers in and out of Level 1 and Level 2 recurring fair value measurements. The ASU also requires disclosure of activities (i.e., on a gross basis), including purchases, sales, issuances, and settlements, in the reconciliation of Level 3 fair value recurring measurements. The ASU clarifies existing disclosure requirements on levels of disaggregation and disclosures about inputs and valuation techniques. The new disclosures regarding Level 1 and Level 2 fair value measurements and clarification of existing disclosures are effective for periods beginning after December 15, 2009. The disclosures about the reconciliation of information in Level 3 recurring fair value measurements are required for periods beginning after December 15, 2010. Upon adoption of the applicable portions of this ASU on January 1, 2010, we provided the required disclosures as presented in Note 12. For those additional disclosures required for fiscal years beginning after December 15, 2010, we anticipate first including those disclosures in our financial statements for the period ending March 31, 2011.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

In July 2010, the FASB issued ASU 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. In order to provide greater transparency, this ASU requires significant new disclosures on a disaggregated basis about the allowance for credit losses (e.g., allowance for loan and lease losses for banks) and the credit quality of financing receivables (e.g., loans and leases for banks). Under the ASU, a rollforward schedule of the allowance for loan and lease losses, with the ending allowance balance further disaggregated on the basis of the impairment method, along with the related ending loan and lease balance and significant purchases and sales of loans and leases during the period are to be disclosed by portfolio segment (e.g., commercial loans, retail loans). Additional disclosures are required by class of loan and lease (e.g., commercial real estate, construction and development, residential, consumer), including credit quality, aging of past due loans, nonaccrual status and impairment information. Disclosure of the nature and extent of troubled debt restructurings that occurred during the period and their effect on the allowance for loan and lease losses as well as the effect on the allowance of troubled debt restructurings that occurred within the prior 12 months that defaulted during the current reporting period will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the loan and lease portfolio s risk and performance. The majority of the disclosures, required as of the end of a reporting period, are effective for interim and annual periods ending after December 15, 2010 and will be first included in our annual financial statements for the year ending December 31, 2010. The disclosures about activity that occurred prior to issuance of the ASU (e.g., allowance rollforward and loan modification disclosures) are effective for interim and annual reporting periods beginning after December 15, 2010 and will be first disclosed in our financial statements for the interim period ending March 31, 2011. Comparative disclosures for earlier reporting periods ending after initial adoption are required and encouraged for reporting periods ending before initial adoption.

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

2. SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2010				
U.S. Government agency debt obligations	$ 100,731,000	$ 1,577,000	$ (9,000)	$ 102,299,000
Mortgage-backed securities	54,289,000	3,702,000	0	57,991,000
Michigan Strategic Fund bonds	19,695,000	0	0	19,695,000
Municipal general obligation bonds	29,866,000	361,000	(153,000)	30,074,000
Municipal revenue bonds	5,548,000	50,000	(11,000)	5,587,000
Mutual funds	1,448,000	23,000	0	1,471,000
	$ 211,577,000	$ 5,713,000	$ (173,000)	$ 217,117,000
December 31, 2009				
U.S. Government agency debt obligations	$ 96,438,000	$ 490,000	$ (1,384,000)	$ 95,544,000
Mortgage-backed securities	62,171,000	2,811,000	0	64,982,000
Michigan Strategic Fund bonds	20,550,000	0	0	20,550,000
Mutual funds	1,425,000	0	(9,000)	1,416,000
	$ 180,584,000	$ 3,301,000	$ (1,393,000)	$ 182,492,000

The carrying amount, unrecognized gains and losses, and fair value of securities categorized as held to maturity were as follows at December 31, 2009 (none at June 30, 2010):

	Carrying Amount	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2009				
Municipal general obligation bonds	$ 49,892,000	$ 1,000,000	$ (111,000)	$ 50,781,000
Municipal revenue bonds	9,319,000	190,000	(19,000)	9,490,000
	$ 59,211,000	$ 1,190,000	$ (130,000)	$ 60,271,000

After analyzing our current and forecasted federal income tax position, we sold certain tax-exempt municipal bonds with an aggregate book value of $20.0 million in late March of 2010. Immediately subsequent to the sale, we reclassified the remaining tax-exempt municipal bonds with an amortized cost of $39.2 million from held to maturity to available for sale. The net unrealized gain at the date of transfer amounted to $0.4 million and was reported in other comprehensive income net of tax effect.

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2. SECURITIES (Continued)

Securities with unrealized losses at June 30, 2010 and December 31, 2009, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
Description of Securities	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
June 30, 2010						
U.S. Government agency debt obligations	$ 2,743,000	$ (7,000)	$ 999,000	$ (2,000)	$ 3,742,000	$ (9,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Mutual funds	0	0	0	0	0	0
Municipal general obligation bonds	0	0	9,978,000	(153,000)	9,978,000	(153,000)
Municipal revenue bonds	0	0	1,066,000	(11,000)	1,066,000	(11,000)
	$ 2,743,000	$ (7,000)	$ 12,043,000	$ (166,000)	$ 14,786,000	$ (173,000)
December 31, 2009						
U.S. Government agency debt obligations	$ 50,190,000	$ (1,322,000)	$ 7,927,000	$ (62,000)	$ 58,117,000	$ (1,384,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Mutual funds	0	0	1,211,000	(9,000)	1,211,000	(9,000)
Municipal general obligation bonds	738,000	(5,000)	8,638,000	(106,000)	9,376,000	(111,000)
Municipal revenue bonds	228,000	(12,000)	1,073,000	(7,000)	1,301,000	(19,000)
	$ 51,156,000	$ (1,339,000)	$ 18,849,000	$ (184,000)	$ 70,005,000	$ (1,523,000)

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2. SECURITIES (Continued)

We evaluate securities for other-than-temporary impairment at least on a quarterly basis. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability we have to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Effective in the second quarter of 2009, with the adoption of new fair value guidance, 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 33 municipal general obligation bonds, 4 municipal revenue bonds, and 1 U.S. Government agency debt obligation in continuous loss positions for 12 months or more at June 30, 2010. At June 30, 2010, 41 debt securities with a fair value totaling $14.8 million have unrealized losses with aggregate depreciation of $0.2 million, or 0.1% from the amortized cost basis of total securities. At June 30, 2010, 223 debt securities and a mutual fund with a fair value totaling $168.4 million have unrealized gains with aggregate appreciation of $5.7 million, or 2.7% 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.

The amortized cost and fair values of debt securities at June 30, 2010, by contractual maturity, are shown below. The contractual maturity is utilized below for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

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2. SECURITIES (Continued)

The maturities of securities and their weighted average yields at June 30, 2010 are also shown in the following table. The yields for municipal securities are shown at their tax equivalent yield.

	Weighted Average Yield	Amortized Cost	Fair Value
Due in 2010	5.43%	$ 3,333,000	$ 3,354,000
Due in 2011 through 2015	5.98	6,060,000	6,474,000
Due in 2016 through 2020	4.49	19,361,000	19,523,000
Due in 2021 and beyond	5.24	107,391,000	108,609,000
Mortgage-backed securities	5.14	54,289,000	57,991,000
Michigan Strategic Fund bonds	3.07	19,695,000	19,695,000
Mutual funds	3.06	1,448,000	1,471,000
	4.95%	$ 211,577,000	$ 217,117,000

At June 30, 2010, and December 31, 2009, the amortized cost of securities issued by the State of Michigan and all its political subdivisions totaled $35.4 million and $59.2 million, with an estimated market value of $35.7 million and $60.3 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements, other deposits, and letters of credit issued on behalf of our customers was $154.2 million and $158.1 million at June 30, 2010 and December 31, 2009, 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

Our total loans at June 30, 2010 were $1.41 billion compared to $1.54 billion at December 31, 2009, a decrease of $129.1 million, or 8.4%. The components of our outstanding balances at June 30, 2010 and December 31, 2009, and the percentage change in loans from the end of 2009 to the end of the second quarter 2010, are as follows:

	June 30, 2010 Balance	%	December 31, 2009 Balance	%	Percent Increase (Decrease)
Real Estate:					
Construction and land development	$ 152,546,000	10.8%	$ 176,078,000	11.4%	(13.4)%
Secured by 1-4 family properties	119,177,000	8.4	124,805,000	8.1	(4.5)
Secured by multi-family properties	43,557,000	3.1	47,679,000	3.1	(8.6)
Secured by nonresidential properties	771,274,000	54.7	814,058,000	52.9	(5.3)
Commercial	317,940,000	22.5	370,146,000	24.0	(14.1)
Leases	630,000	0.1	1,055,000	0.1	(40.3)
Consumer	5,586,000	0.4	5,997,000	0.4	(6.9)
Total loans and leases	$ 1,410,710,000	100.0%	$ 1,539,818,000	100.0%	(8.4)%

4. ALLOWANCE FOR LOAN AND LEASE LOSSES

The following is a summary of the change in our allowance for loan and lease losses for the six months ended June 30:

	2010	2009
Balance at January 1	$ 47,878,000	$ 27,108,000
Charge-offs	(16,737,000)	(16,851,000)
Recoveries	1,997,000	448,000
Provision for loan and lease losses	14,600,000	21,900,000
Balance at June 30	$ 47,738,000	$ 32,605,000

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MERCANTILE BANK CORPORATION
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5. PREMISES AND EQUIPMENT, NET

Premises and equipment are comprised of the following:

	June 30, 2010	December 31, 2009
Land and improvements	$ 8,531,000	$ 8,531,000
Buildings and leasehold improvements	24,516,000	24,515,000
Furniture and equipment	12,464,000	12,532,000
	45,511,000	45,578,000
Less: accumulated depreciation	16,875,000	15,894,000
Premises and equipment, net	$ 28,636,000	$ 29,684,000

Depreciation expense totaled $0.5 million during the second quarter of 2010, compared to $0.6 million during the second quarter of 2009. Depreciation expense totaled $1.1 million during the first six months of 2010, compared to $1.3 million during the first six months of 2009.

6. DEPOSITS

Our total deposits at June 30, 2010 were $1.34 billion compared to $1.40 billion at December 31, 2009, a decrease of $61.5 million, or 4.4%. The components of our outstanding balances at June 30, 2010 and December 31, 2009, and percentage change in deposits from the end of 2009 to the end of the second quarter 2010, are as follows:

	June 30, 2010		December 31, 2009		Percent Increase
	Balance	%	Balance	%	(Decrease)
Noninterest-bearing demand	$ 126,572,000	9.4%	$ 121,157,000	8.6%	4.5%
Interest-bearing checking	128,293,000	9.6	86,320,000	6.2	48.6
Money market	79,210,000	5.9	32,008,000	2.3	147.5
Savings	34,595,000	2.6	38,625,000	2.8	(10.4)
Time, under $100,000	78,267,000	5.8	105,195,000	7.5	(25.6)
Time, $100,000 and over	234,059,000	17.5	293,455,000	20.9	(20.2)
	680,996,000	50.8	676,760,000	48.3	0.6
Out-of-area time, under $100,000	47,717,000	3.6	62,760,000	4.5	(24.0)
Out-of-area time, $100,000 and over	611,447,000	45.6	662,107,000	47.2	(7.7)
	659,164,000	49.2	724,867,000	51.7	(9.1)
Total deposits	$ 1,340,160,000	100.0%	$ 1,401,627,000	100.0%	(4.4)%

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7. SHORT-TERM BORROWINGS

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

	Six Months Ended June 30, 2010	Twelve Months Ended December 31, 2009
Outstanding balance at end of period	$ 108,271,000	$ 99,755,000
Average interest rate at end of period	1.41%	1.41%
Average balance during the period	$ 100,110,000	$ 98,409,000
Average interest rate during the period	1.40%	1.87%
Maximum month end balance during the period	$ 108,705,000	$ 111,692,000

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 a correspondent bank. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements are secured by securities with an aggregate market value equal to the aggregate outstanding balance.

8. FEDERAL HOME LOAN BANK ADVANCES

Our outstanding balances at June 30, 2010 totaled $160.0 million and mature at varying dates from December 2010 through January 2014, with fixed rates of interest from 2.97% to 4.42% and averaging 3.52%. At December 31, 2009, outstanding balances totaled $205.0 million with maturities ranging from January 2010 through January 2014 and fixed rates of interest from 2.95% to 4.42% and averaging 3.50%.

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 June 30, 2010 totaled about $220.0 million, with availability approximating $56.0 million.

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

2010	$20,000,000
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 its customers. These financial instruments include commitments to extend credit and standby letters of credit. Loan commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are conditional commitments issued by our bank to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank s maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on our credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. The balance of the liability was $0 as of June 30, 2010 and December 31, 2009.

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at June 30, 2010 and December 31, 2009 follows:

	June 30, 2010	December 31, 2009
Commercial unused lines of credit	$ 172,889,000	$ 205,018,000
Unused lines of credit secured by 1 4 family residential properties	25,214,000	24,916,000
Credit card unused lines of credit	8,253,000	8,565,000
Other consumer unused lines of credit	3,518,000	4,526,000
Commitments to extend credit	11,191,000	7,701,000
Standby letters of credit	27,573,000	36,512,000
	$ 248,638,000	$ 287,238,000

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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 June 30, 2010, the total notional amount of the underlying interest rate swap agreements was $52.1 million, with a net fair value from our commercial loan customers perspective of negative $5.7 million. Payments made in regards to the risk participation agreements total $460,000; however, we believe the affected customer will reimburse us for such payments and therefore we have accrued 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 has been accreted into interest income on loans and leases based on the original term of the interest rate swaps. As of June 30, 2010, we had fully accreted the $2.4 million into interest income, including $0.1 million during the first six months of 2010.

11. FAIR VALUES OF FINANCIAL INSTRUMENTS

Carrying amount and estimated fair values of financial instruments were as follows as of June 30, 2010 and December 31, 2009:

	June 30, 2010		December 31, 2009	
	Carrying Values	Fair Values	Carrying Values	Fair Values
Financial assets				
Cash and cash equivalents	$ 79,883,000	$ 79,883,000	$ 21,735,000	$ 21,735,000
Securities available for sale	217,117,000	217,117,000	182,492,000	182,492,000
Securities held to maturity	0	0	59,211,000	60,271,000
Federal Home Loan Bank stock	15,681,000	15,681,000	15,681,000	15,681,000
Loans, net	1,362,972,000	1,372,716,000	1,491,940,000	1,501,860,000
Bank owned life insurance	45,890,000	45,890,000	45,024,000	45,024,000
Accrued interest receivable	6,278,000	6,278,000	7,088,000	7,088,000
Financial liabilities				
Deposits	1,340,160,000	1,347,542,000	1,401,627,000	1,407,310,000
Securities sold under agreements to repurchase	108,271,000	108,271,000	99,755,000	99,755,000
Federal funds purchased	0	0	2,600,000	2,600,000
Federal Home Loan Bank advances	160,000,000	164,360,000	205,000,000	208,435,000
Subordinated debentures	32,990,000	33,917,000	32,990,000	32,971,000
Accrued interest payable	4,686,000	4,686,000	6,158,000	6,158,000

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11. FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)

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, 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 12. Given 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.

12. FAIR VALUES

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. The price of the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be 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.

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12. FAIR VALUES (Continued)

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

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

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

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

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, mortgage-backed securities issued or guaranteed by U.S. Government agencies, municipal general obligation and revenue bonds, Michigan Strategic Fund bonds and mutual funds. We have no Level 1 or 3 securities.

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. 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.

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12. FAIR VALUES (Continued)

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 June 30, 2010 and December 31, 2009, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the $1.4 million and $0.9 million, respectively, 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.

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

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 June 30, 2010 or December 31, 2009.

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 June 30, 2010 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. Government agency debt obligations	$ 102,299,000	$ 0	$ 102,299,000	$ 0
Mortgage-backed securities	57,991,000	0	57,991,000	0
Michigan Strategic Fund bonds	19,695,000	0	19,695,000	0
Municipal general obligation bonds	30,074,000	0	30,074,000	0
Municipal revenue bonds	5,587,000	0	5,587,000	0
Mutual funds	1,471,000	0	1,471,000	0
Total	$ 217,117,000	$ 0	$ 217,117,000	$ 0

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first six months of 2010.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

12. FAIR VALUES (Continued)

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2009 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale	$ 182,492,000	$ 0	$ 182,492,000	$ 0
Total	$ 182,492,000	$ 0	$ 182,492,000	$ 0

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 June 30, 2010 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans [1]	$ 51,935,000	$ 0	$ 0	$ 51,935,000
Foreclosed assets [1]	23,020,000	0	0	23,020,000
Total	$ 74,955,000	$ 0	$ 0	$ 74,955,000

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2009 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans [1]	$ 41,456,000	$ 0	$ 0	$ 41,456,000

Foreclosed assets [1]	26,608,000	0	0	26,608,000
Total	$ 68,064,000	$ 0	$ 0	$ 68,064,000

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

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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 close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At June 30, 2010 and December 31, 2009, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since June 30, 2010 that we believe has changed our bank s categorization.

Our actual capital levels (dollars in thousands) and the minimum levels required to be categorized as adequately and well capitalized were:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
June 30, 2010						
Total capital (to risk weighted assets)						
Consolidated	$ 187,957	11.9%	$ 126,117	8.0%	$ NA	NA
Bank	186,655	11.9	125,998	8.0	157,498	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	167,905	10.7	63,059	4.0	NA	NA
Bank	166,622	10.6	62,999	4.0	94,499	6.0
Tier 1 capital (to average assets)						
Consolidated	167,905	9.0	74,487	4.0	NA	NA
Bank	166,622	9.0	74,446	4.0	93,057	5.0

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

13. REGULATORY MATTERS (Continued)

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2009						
Total capital (to risk weighted assets)						
Consolidated	$ 193,157	11.2%	$ 138,169	8.0%	$ NA	NA
Bank	191,146	11.1	138,051	8.0	172,563	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	171,244	9.9	69,085	4.0	NA	NA
Bank	169,251	9.8	69,026	4.0	103,538	6.0
Tier 1 capital (to average assets)						
Consolidated	171,244	8.6	79,325	4.0	NA	NA
Bank	169,251	8.6	79,119	4.0	98,899	5.0

Our consolidated capital levels as of June 30, 2010 and December 31, 2009 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 June 30, 2010 and December 31, 2009, all $32.0 million of the trust preferred securities were included as Tier 1 capital.

On July 9, 2010, we announced via a Form 8-K filed with the SEC that we are deferring regularly scheduled quarterly interest payments on our subordinated debentures beginning with the quarterly interest payment scheduled to be paid on July 18, 2010. The deferral of interest payments on the subordinated debentures results in the deferral of distributions on our trust preferred securities. We also announced that we are deferring regularly scheduled quarterly dividend payments on our preferred stock beginning with the quarterly dividend payment scheduled to be paid on August 15, 2010. We have not determined the duration of the deferral period.

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MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

13. REGULATORY MATTERS (Continued)

Our and our bank s ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. On January 14, 2010, we declared a $0.01 per share cash dividend on our common stock, which was paid on March 10, 2010 to record holders as of February 10, 2010. Because we had a retained deficit at the time of the declaration, the cash dividend was recorded as a reduction of our common stock account. In April 2010, we suspended future payments of cash dividends on our common stock until economic conditions and our financial performance improve. In addition, we are precluded from paying dividends on our common stock and preferred stock because, under the terms of our subordinated debentures, we cannot pay dividends during periods when we have deferred the payment of interest on our subordinated debentures; and, as indicated above in this Note 13, we are now deferring such interest payments. Also, pursuant to our articles of incorporation, we are precluded from paying dividends on our common stock while any dividends accrued on our preferred stock have not been declared and paid. Because, as indicated above in this Note 13, we have suspended the payment of dividends on our preferred stock, we are precluded from paying dividends on our common stock.

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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 vari words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions (Future Factors) that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. We undertake no obligation to update, amend, or clarify forward looking-statements, whether as a result of new information, future events (whether anticipated or unanticipated), or otherwise.

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2009 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 company), at June 30, 2010 to December 31, 2009 and the results of operations for the three and six months ended June 30, 2010 and June 30, 2009. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to us, we, our or the company include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

Critical Accounting Policies

Accounting principles generally accepted in the United States of America are complex and require us to apply significant judgment to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a discussion of our significant accounting policies, see footnotes to our Consolidated Financial Statements included on pages F-42 through F-49 in our Form 10-K for the fiscal year ended December 31, 2009 (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 agaie #D9D9D9 ;border-right:1pt none #D9D9D9 ;background-color: #CCEEFF;padding:0pt;">

Carbon Steel

$

1,461.2

$

1,285.5

Aluminum

550.2

483.1

Stainless Steel

403.2

347.3

Alloy

169.0

145.3

Toll processing and logistics

101.1

87.2

Other and eliminations

72.4

70.9

Total

$

2,757.1

$

2,419.3

Metal Sales

Metal product sales represented approximately 94% of our first quarter of 2018 revenues. We have minimal contract sales with our customers as we primarily sell our inventories in the “spot market” under fixed price sales orders. The contracts with our customers generally have only one performance obligation. Control of the metal products we sell transfers to our customers upon delivery for orders with FOB destination terms or upon shipment for orders with FOB shipping point terms. Shipping and handling charges to our customers are included in net sales. We account for all shipping and handling of our products as fulfillment activities and not as a promised good or service. Costs incurred in connection with the shipping and handling of our products are typically included in operating expenses whether we use a third-party carrier or our own trucks. Shipment and delivery of our orders generally occur on the same day due to the close proximity of our customers and our metals service center locations.

Toll Processing and Logistics

Toll processing services relate to the processing of customer-owned metal. Logistics services primarily include transportation services for metal we toll-process. Revenue for these services is recognized over time as the toll processing or logistics services are performed. These services are generally short-term in nature with the service being performed in less than one day.

Seasonality

Some of our customers are in seasonal businesses, especially customers in the construction industry and related businesses. However, our overall operations have not shown any material seasonal trends as a result of our geographic, product and customer diversity. Typically, revenues in the months of July, November and December have been lower than in other months because of a reduced number of working days for shipments of our products, resulting from holidays observed by the Company as well as vacation and extended holiday closures at some of our customers.

5. Goodwill

The change in the carrying amount of goodwill is as follows:

	(in millions)
Balance at January 1, 2018	$ 1,842.6
Acquisition	9.1
Effect of foreign currency translation	(1.3)
Balance at March 31, 2018	$ 1,850.4

We had no accumulated impairment losses related to goodwill at March 31, 2018.

The goodwill recorded from our acquisition of DuBose is tax deductible.

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6. Intangible Assets, net

Intangible assets, net consisted of the following:

	Weighted Average Amortizable Life in Years	March 31, 2018 Gross Carrying Amount (in millions)	March 31, 2018 Accumulated Amortization	December 31, 2017 Gross Carrying Amount	December 31, 2017 Accumulated Amortization
Intangible assets subject to amortization:					
Covenants not to compete	4.8	$ 0.8	$ (0.4)	$ 0.8	$ (0.4)
Customer lists/relationships	14.5	752.6	(402.4)	745.0	(391.3)
Software	10.0	8.1	(8.1)	8.1	(8.1)
Other	5.7	7.6	(6.6)	6.3	(5.9)
		769.1	(417.5)	760.2	(405.7)
Intangible assets not subject to amortization:					
Trade names		763.9	—	757.6	—
		$ 1,533.0	$ (417.5)	$ 1,517.8	$ (405.7)

Intangible assets recorded in connection with our acquisition of DuBose were $15.7 million as of March 31, 2018 (see Note 3—“Acquisitions”). A total of $6.6 million was allocated to the trade names acquired, which are not subject to amortization.

We recognized amortization expense for intangible assets of $11.8 million and $13.4 million for the first quarters of 2018 and 2017, respectively. Foreign currency translation losses related to intangible assets, net, were $0.9 million for the first quarter of 2018.

The following is a summary of estimated aggregate amortization expense for the remaining nine months of 2018 and each of the succeeding five years:

	(in millions)
2018 (remaining nine months)	$ 35.7
2019	47.5
2020	47.5

2021	43.4
2022	35.2
2023	29.1

7. Debt

Debt consisted of the following:

	March 31, 2018	December 31, 2017
	(in millions)	
Unsecured revolving credit facility due September 30, 2021	$ 690.0	$ 538.0
Unsecured term loan due from June 29, 2018 to September 30, 2021	555.0	562.5
Senior unsecured notes due April 15, 2023	500.0	500.0
Senior unsecured notes due November 15, 2036	250.0	250.0
Other notes and revolving credit facilities	65.7	64.0
Total	2,060.7	1,914.5
Less: unamortized discount and debt issuance costs	(12.4)	(13.1)
Less: amounts due within one year and short-term borrowings	(101.2)	(92.0)
Total long-term debt	$ 1,947.1	$ 1,809.4

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Unsecured Credit Facility

On September 30, 2016, we entered into a $2.1 billion unsecured five-year credit agreement (“Credit Agreement”) comprised of a $1.5 billion unsecured revolving credit facility and a $600.0 million unsecured term loan, with an option to increase the revolving credit facility up to an additional $500.0 million at our request, subject to approval of the lenders and certain other customary conditions. The term loan due September 30, 2021 amortizes in quarterly installments, with an annual amortization of 5% through September 2018 and 10% thereafter until June 2021, with the balance to be paid at maturity. Interest on borrowings from the revolving credit facility and term loan at March 31, 2018 was at variable rates based on LIBOR plus 1.25% or the bank prime rate plus 0.25% and included a commitment fee at an annual rate of 0.15% on the unused portion of the revolving credit facility. The applicable margins over LIBOR and base rate borrowings, along with commitment fees, are subject to adjustment every quarter based on our leverage ratio, as defined in the Credit Agreement. All borrowings under the Credit Agreement may be prepaid without penalty.

Weighted average interest rates on borrowings outstanding on the revolving credit facility were 3.37% and 2.96% as of March 31, 2018 and December 31, 2017, respectively. Weighted average interest rates on borrowings outstanding on the term loan were 3.13% and 2.82% as of March 31, 2018 and December 31, 2017, respectively. As of March 31, 2018, we had $690.0 million of outstanding borrowings, $52.9 million of letters of credit issued and $757.1 million available for borrowing on the revolving credit facility.

Senior Unsecured Notes

On November 20, 2006, we entered into an indenture (the “2006 Indenture”), for the issuance of $600.0 million of unsecured debt securities. The total debt issued was comprised of two tranches, (a) $350.0 million aggregate principal amount of senior unsecured notes bearing interest at the rate of 6.20% per annum, which matured and were repaid on November 15, 2016 and (b) $250.0 million aggregate principal amount of senior unsecured notes bearing interest at the rate of 6.85% per annum, maturing on November 15, 2036.

On April 12, 2013, we entered into an indenture (the “2013 Indenture” and, together with the 2006 Indenture, the “Indentures”), for the issuance of $500.0 million aggregate principal amount of senior unsecured notes at the rate of 4.50% per annum, maturing on April 15, 2023.

Under the Indentures, the notes are senior unsecured obligations and rank equally in right of payment with all of our existing and future unsecured and unsubordinated obligations.

The senior unsecured notes include provisions that require us to make an offer to repurchase the notes at a price equal to 101% of their principal amount plus accrued and unpaid interest in the event of both a change in control and a downgrade of our credit rating.

Other Notes and Revolving Credit Facilities

Revolving credit facilities with a combined credit limit of approximately $66.5 million are in place for operations in Asia and Europe with combined outstanding balances of $55.6 million and $53.9 million as of March 31, 2018 and December 31, 2017, respectively.

Various industrial revenue bonds had combined outstanding balances of $10.1 million as of March 31, 2018 and December 31, 2017, and have maturities through 2027.

Covenants

The Credit Agreement and the Indentures include customary representations, warranties, covenants, acceleration, indemnity and events of default provisions. The covenants under the Credit Agreement include, among other things, two financial statement covenants that require us to maintain an interest coverage ratio and a maximum leverage ratio.

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8. Income Taxes

Our effective income tax rates for the first quarters of 2018 and 2017 were 24.0% and 32.7%, respectively. Our first quarter of 2018 effective income tax rate was favorably impacted by Tax Reform, which included significant changes to the taxation of U.S. corporations, including a reduction of the U.S. federal statutory rate from 35% to 21% effective January 1, 2018. Based on our preliminary assessment of the impact of Tax Reform, we recognized a one-time, provisional net tax benefit of $207.3 million in the fourth quarter of 2017, primarily related to the remeasurement of deferred tax assets and liabilities at the lowered federal statutory tax rate, which was partially offset by repatriation and related liabilities. Given the substantial changes to the Internal Revenue Code as a result of Tax Reform, our estimated financial impacts from Tax Reform are subject to further analysis, interpretation and clarification of the new law, which could result in changes to our estimates in future quarters in 2018. We did not make an adjustment during the first quarter of 2018 to our provisional estimate recognized in 2017. State income taxes offset by the effects of company-owned life insurance policies mainly accounted for the difference between our effective income tax rate and the federal statutory rate for the first quarter of 2018.

9. Equity

Common Stock and Share Repurchase Plan

On October 20, 2015, our Board of Directors increased the number of shares authorized to be repurchased under our share repurchase plan by 7.5 million shares and extended the duration of the plan through December 31, 2018. We repurchase shares through open market purchases under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). Since initiating the share repurchase plan in 1994, we have repurchased approximately 23.1 million shares at an average cost of $32.94 per share. As of March 31, 2018, we had authorization under the plan to purchase approximately 7.5 million shares, or about 10% of our current outstanding shares. Repurchased and subsequently retired shares are restored to the status of authorized but unissued shares.

Common stock and additional paid-in capital activity included the following:

	Three Months Ended March 31, 2018		
	Shares	Amount	Weighted Average Exercise Price

	(in millions, except share and per share amounts)		
Stock-based compensation(1)	269,433	$ 1.0	
Stock options exercised	48,275	2.8	$ 57.91
Share repurchases(2)	(592,564)	(50.0)	
Total	(274,856)	$ (46.2)	

(1) Stock-based compensation expense of $6.4 million reduced by $5.4 million of payments we made to tax authorities on our employees' behalf for shares withheld related to net share settlements.
(2) Includes 8,120 shares for $0.7 million pending settlement at March 31, 2018.

Dividends

On April 25, 2018, our Board of Directors declared the 2018 second quarter cash dividend of $0.50 per share. The dividend is payable on June 15, 2018 to stockholders of record as of May 25, 2018.

During the first quarters of 2018 and 2017, we declared and paid quarterly dividends of $0.50 and $0.45 per share, or $36.5 million and $32.8 million in total, respectively. During the first quarters of 2018 and 2017, we paid $2.0 million and $0.9 million in dividend equivalents with respect to vested restricted stock units ("RSUs"), respectively.

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Stock-Based Compensation

We make annual grants of long-term incentive awards to officers and key employees in the forms of service-based and performance-based RSUs that generally have 3-year vesting periods. The performance-based RSU awards are subject to both service and performance goal criteria. We also make annual grants of stock to the non-employee members of the Board of Directors that include dividend rights and vest immediately upon grant. The fair value of the RSUs and stock grants is determined based on the closing stock price of our common stock on the grant date.

A summary of the status of our unvested service-based and performance-based RSUs as of March 31, 2018 and changes during the quarter then ended is as follows:

Unvested Shares	Shares	Weighted Average Grant Date Fair Value
Unvested at January 1, 2018	924,575	$ 74.09
Granted(1)	474,715	84.26
Vested	(3,032)	71.59
Cancelled or forfeited	(10,018)	73.84
Unvested at March 31, 2018	1,386,240	$ 77.58
Shares reserved for future grants (all plans)	1,379,291	

(1) 474,715 RSUs, including 178,970 performance-based RSUs, were granted in March 2018.

Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss included the following:

	Foreign Currency Translation Loss	Pension and Postretirement Benefit Adjustments, Net of Tax	Accumulated Other Comprehensive Loss
	(in millions)		
Balance as of January 1, 2018	$ (51.1)	$ (20.5)	$ (71.6)
Current-period change	(2.9)	—	(2.9)

Balance as of March 31, 2018	$	(54.0)	$	(20.5)	$	(74.5)

Foreign currency translation adjustments have not been adjusted for income taxes. Pension and postretirement benefit adjustments are net of taxes of $13.6 million as of March 31, 2018 and December 31, 2017.

10. Commitments and Contingencies

Environmental Contingencies

We are currently involved with an environmental remediation project related to activities at former manufacturing operations of Earle M. Jorgensen Company (“EMJ”), our wholly owned subsidiary, which operations were sold many years prior to our acquisition of EMJ in 2006. Although the potential cleanup costs could be significant, EMJ maintained insurance policies during the time it owned the manufacturing operations that have covered costs incurred to date, and are expected to continue to cover the majority of the related costs. We do not expect that this obligation will have a material adverse impact on our consolidated financial position, results of operations or cash flows.

Legal Matters

From time to time, we are named as a defendant in legal actions. Generally, these actions arise out of our normal course of business. We are not currently a party to any pending legal proceedings other than routine litigation incidental

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to the business. We expect that these matters will be resolved without having a material adverse effect on our results of operations, financial condition or cash flows. We maintain general liability insurance against risks arising out of our normal course of business.

11. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Three Months Ended March 31,	
	2018	2017
	(in millions, except share and per share amounts)	
Numerator:		
Net income attributable to Reliance	$ 169.0	$ 111.7
Denominator:		
Weighted average shares outstanding	72,818,336	72,841,878
Dilutive effect of stock-based awards	632,029	573,487
Weighted average diluted shares outstanding	73,450,365	73,415,365
Earnings per share attributable to Reliance stockholders:		
Diluted	$ 2.30	$ 1.52
Basic	$ 2.32	$ 1.53

Potentially dilutive securities whose effect would have been antidilutive were not significant for the first quarters of 2018 and 2017.

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RELIANCE STEEL & ALUMINUM CO.

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

This report contains certain statements that are, or may be deemed to be, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Our forward-looking statements may include, but are not limited to, discussions of our industry, our end markets, our business strategies and our expectations concerning future demand and our results of operations, margins, profitability, impairment charges, taxes, liquidity, litigation matters and capital resources. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “could,” “would,” “expect,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential” and “continue,” the negative of these terms, and similar expressions. statements contained in this report, other than statements of historical fact, are forward-looking statements. These forward-looking statements are based on management’s estimates, projections and assumptions as of the date of such statements.

Forward-looking statements involve known and unknown risks and uncertainties and are not guarantees of future performance. Actual outcomes and results may differ materially from what is expressed or forecasted in these forward-looking statements as a result of various important factors, including, but not limited to, those disclosed in this report and in other reports we have filed with the Securities and Exchange Commission (the “SEC”). As a result, these statements speak only as of the date that they were made, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as may be required by law. Important risks and uncertainties about our business can be found in Item 1A “Risk Factors” of our Annual Report on Form 10-K for the year ended December 31, 2017 filed with the SEC.

Overview

We had strong operational execution in the first quarter of 2018 resulting in our highest net sales and gross profit in our history. Net sales for the first quarter of 2018 were $2.76 billion, up 14.0% from $2.42 billion for the first quarter of 2017. The positive pricing and demand fundamentals experienced in the fourth quarter of 2017 continued through the first quarter of 2018, with pricing momentum building throughout the quarter. Our gross profit margin in the first quarter of 2018 was 29.7%, which exceeded our estimated range of 27% to 29% and drove record quarterly gross profit dollars of $819.9 million. Pricing levels were significantly higher in the first quarter of 2018 compared to the first quarter of 2017 for nearly every product we sell, which had a favorable impact on our revenues and earnings. We achieved several successes in the first quarter of 2018:

- Net sales of $2.76 billion and 1.6 million tons sold, both the highest in our history;

- Gross profit was $819.9 million, the highest in our history;

- Our gross profit margin was 29.7%, above our estimated range of 27% to 29%;

- Pre-tax income of $225.2 million, the third highest in our history, surpassed only by pre-tax income levels during two quarters in 2008; and

- Our earnings per diluted share of $2.30 were the second highest in our history, surpassed only by the fourth quarter of 2017 which benefited from the impact of tax reform.

Our same-store tons sold increased 3.5% in the first quarter of 2018 compared to the first quarter of 2017, exceeding the industry increase reported by the Metals Service Center Institute ("MSCI") of 2.6% during the same period. We believe our strong performance is attributable to our focus on small orders requiring high levels of quality and service on a just-in-time basis, as well as our significant investments in value-added processing equipment over the past few years. Our increase in tons sold is also attributable to anticipated Section 232 of the Trade Expansion Act of 1962 ("Section 232") actions, which created concern about metal availability and resulted in a limited amount of pre-buying activity from certain of our customers.

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Our same-store average selling price per ton sold in the first quarter of 2018 increased 10.0% compared to the first quarter of 2017. Our same-store average selling price per ton sold has increased sequentially in each of the past eight quarters, with the most significant price increases for certain carbon and stainless steel products. In the first quarter of 2018, pricing increased rapidly due to strong demand and accelerated Section 232 activity which drove higher metal pricing on nearly every product we sell.

Our S,G&A expense as a percent of sales of 18.8% in the first quarter of 2018 decreased from 19.7% in the first quarter of 2017 due to higher metals pricing and record tons sold that increased our sales levels.

We generated cash flow from operations of $13.3 million in the first quarter of 2018, up from $20.7 million used in operations in the first quarter of 2017 due to our strong gross profit margin coupled with the higher pricing and demand environment. We typically use cash from operations to build our working capital during the first half of the year, however, our strong earnings generated cash flow from operations in the first quarter of 2018. As of March 31, 2018, our net debt-to-total capital ratio was 28.6%, up from 27.2% as of December 31, 2017. We believe we have sufficient liquidity as of March 31, 2018, with approximately $757.1 million available for borrowing on our revolving credit facility.

In the first quarter of 2018, we completed one acquisition, invested $41.8 million in capital expenditures, and continued our stockholder return activities with an 11.1% increase in our regular quarterly dividend rate and $50.0 million of common stock repurchases.

We believe that our exposure to diverse end markets, broad product base and wide geographic footprint will continue to mitigate earnings volatility compared to many of our competitors.

We will continue to focus on working capital management and maximizing profitability of our existing businesses, as well as executing our proven growth strategies and stockholder return activities.

Acquisitions

On March 1, 2018, we acquired DuBose National Energy Services, Inc. (“DuBose Energy”) and its affiliate, DuBose National Energy Fasteners & Machined Parts, Inc. (“DuBose Fasteners” and, together with DuBose Energy, “DuBose”). DuBose was founded in 1990 and is headquartered in Clinton, North Carolina. DuBose specializes in fabrication, supply and distribution of metal and metal products to the nuclear industry, including utilities, component

manufacturers and contractors. DuBose’s net sales during the period from March 1, 2018 to March 31, 2018 were $2.3 million.

On October 2, 2017, through our wholly owned subsidiary Diamond Manufacturing Company, we acquired Ferguson Perforating Company (“Ferguson”). Ferguson, headquartered in Providence, Rhode Island, specializes in manufacturing highly engineered and complex perforated metal parts for diverse end markets including industrial machinery, automotive, aerospace, sugar producers and consumer electronics manufacturers. Ferguson’s net sales were $9.5 million for the first quarter of 2018.

We funded our 2018 and 2017 acquisitions with borrowings on our revolving credit facility and cash on hand.

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Three Months Ended March 31, 2018 Compared to Three Months Ended March 31, 2017

The following table sets forth certain income statement data for the first quarters of 2018 and 2017, respectively (dollars are shown in millions and certain amounts may not calculate due to rounding):

	Three Months Ended March 31,					
	2018			2017		
	$	% of Net Sales		$	% of Net Sales	
Net sales	$ 2,757.1	100.0	%	$ 2,419.3	100.0	%
Cost of sales (exclusive of depreciation and amortization expense shown below)	1,937.2	70.3		1,697.7	70.2	
Gross profit (1)	819.9	29.7		721.6	29.8	
Warehouse, delivery, selling, general and administrative expense ("S,G&A")	519.4	18.8		476.2	19.7	
Depreciation expense	42.3	1.5		41.8	1.7	
Amortization expense	11.8	0.4		13.4	0.6	
Operating income	$ 246.4	8.9	%	$ 190.2	7.9	%

(1) Gross profit, calculated as net sales less cost of sales, and gross profit margin, calculated as gross profit divided by net sales, are non-GAAP financial measures as they exclude depreciation and amortization expense associated with the corresponding sales. About half of our orders are basic distribution with no processing services performed. For the remainder of our sales orders, we perform "first-stage" processing, which is generally not labor intensive as we are simply cutting the metal to size. Because of this, the amount of related labor and overhead, including depreciation and amortization, is not significant and is excluded from our cost of sales. Therefore, our cost of sales is substantially comprised of the cost of the material we sell. We use gross profit and gross profit margin as shown above as measures of operating performance. Gross profit and gross profit margin are important operating and financial measures, as their fluctuations can have a significant impact on our earnings. Gross profit and gross profit margin, as presented, are not necessarily comparable with similarly titled measures for other companies.

Net Sales

	Three Months Ended March 31,		Dollar	Percentage	
	2018	2017	Change	Change	
	(in millions)				
Net sales	$ 2,757.1	$ 2,419.3	$ 337.8	14.0	%
Net sales, same-store	$ 2,745.2	$ 2,419.3	$ 325.9	13.5	%

Tons	Percentage

	Three Months Ended March 31,				
	2018	2017	Change	Change	
	(in thousands)				
Tons sold	1,595.7	1,540.4	55.3	3.6	%
Tons sold, same-store	1,593.7	1,540.4	53.3	3.5	%

	Three Months Ended March 31,		Price	Percentage	
	2018	2017	Change	Change	
Average selling price per ton sold	$ 1,724	$ 1,563	$ 161	10.3	%
Average selling price per ton sold, same-store	$ 1,719	$ 1,563	$ 156	10.0	%

Tons sold and average selling price per ton sold amounts exclude our toll processing sales (as we process the metal for a fee, without taking ownership of the metal). Same-store amounts exclude the results of our 2018 and 2017 acquisitions.

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Our consolidated net sales increased in the first quarter of 2018 compared to the first quarter of 2017 due to record tons sold and higher metals prices. Prices for nearly every product we sell improved in the first quarter of 2018 compared to the first quarter of 2017. Our same-store average selling price per ton sold has increased sequentially in the past eight quarters. Accelerated Section 232 activity favorably impacted both tons sold and metal prices.

The automotive (that we serve primarily through our toll processing operations in the U.S. and Mexico) and aerospace end markets continued to perform well for us in the first quarter of 2018. Heavy industry demand was up from the low levels we experienced in the first quarter of 2017. Non-residential construction demand, including infrastructure, grew at a steady rate, although it remains at significantly reduced demand levels from its peak levels experienced in 2006. Demand for the products we sell to the energy (oil and gas) end market continued to gradually improve in the first quarter of 2018 compared to 2017, but remains significantly lower than the recent peak in 2014. In the first quarter of 2018, our same-store tons sold increased 3.5% compared to the first quarter of 2017, exceeding the industry increase reported by the MSCI of 2.6% during the same period.

Since we primarily purchase and sell our inventories in the “spot” market, the changes in our average selling prices generally fluctuate in accordance with the changes in the costs of the various metals we purchase. The mix of products sold can also have an impact on our average selling prices.

Our same-store average selling price per ton sold in the first quarter of 2018 increased 10.0% compared to the first quarter of 2017 given increased mill pricing for most products we sell. As carbon steel sales represent approximately 52% of our sales dollars, changes in carbon steel prices have the most significant impact on changes in our overall average selling price per ton sold. Our major commodity selling prices changed year-over-year as follows:

	Average Selling Price per Ton Sold (percentage change)		Same-store Average Selling Price per Ton Sold	
Carbon steel	10.5	%	10.4	%
Aluminum	7.3	%	7.2	%
Stainless steel	7.6	%	7.0	%
Alloy	10.1	%	9.6	%

Cost of Sales

Three Months Ended March 31,					
2018		2017			
	% of		% of	Dollar	Percentage

	$	Net Sales	$	Net Sales	Change	Change
	(dollars in millions)					
Cost of sales	$ 1,937.2	70.3 %	$ 1,697.7	70.2 %	$ 239.5	14.1 %

The increase in cost of sales in the first quarter of 2018 compared to the first quarter of 2017 is mainly due to higher tons sold and a higher average cost per ton sold. See “Net Sales” above for trends in both demand and costs of our products.

Also, our last-in, first-out (“LIFO”) method inventory valuation reserve adjustment, which is included in cost of sales and, in effect, reflects cost of sales at current replacement costs, resulted in a charge, or expense, of $25.0 million in the first quarter of 2018 compared to a charge, or expense, of $10.0 million in the first quarter of 2017.

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Gross Profit

	Three Months Ended March 31, 2018		2017			
	$	% of Net Sales	$	% of Net Sales	Dollar Change	Percentage Change
	(dollars in millions)					
Gross profit	$ 819.9	29.7 %	$ 721.6	29.8 %	$ 98.3	13.6 %

Our gross profit was higher in the first quarter of 2018 compared to the first quarter of 2017 due to higher tons sold and higher metals prices. Our first quarter of 2018 gross profit of $819.9 million was the highest in our history. See "Net Sales" and "Cost of Sales" above for further discussion on product pricing trends and our LIFO inventory valuation reserve adjustments, respectively.

Expenses

	Three Months Ended March 31, 2018		2017			
	$	% of Net Sales	$	% of Net Sales	Dollar Change	Percentage Change
	(dollars in millions)					
S,G&A expense	$ 519.4	18.8 %	$ 476.2	19.7 %	$ 43.2	9.1 %
S,G&A expense, same-store	$ 514.3	18.7 %	$ 476.2	19.7 %	$ 38.1	8.0 %
Depreciation & amortization expense	$ 54.1	2.0 %	$ 55.2	2.3 %	$ (1.1)	(2.0) %

Same-store amounts exclude the results of our 2018 and 2017 acquisitions.

Our S,G&A expense increased due to increases in certain warehouse and delivery expenses due to improved shipping volumes and increases in profit-based compensation, as a result of higher levels of profitability, as well as significant increases in freight expenses from rising fuel prices. Our S,G&A expense as a percentage of sales decreased mainly due to our higher sales levels, as a result of higher average selling prices and higher tons sold.

Operating Income

	Three Months Ended March 31,						
	2018		2017				
	$	% of Net Sales	$	% of Net Sales	Dollar Change	Percentage Change	
	(dollars in millions)						
Operating income	$ 246.4	8.9 %	$ 190.2	7.9 %	$ 56.2	29.5 %	

Our operating income was higher in the first quarter of 2018 compared to the first quarter of 2017 due to higher gross profit dollars from both higher average selling prices and higher tons sold. Our operating income margin increased mainly due to the decline in our S,G,&A expense as a percentage of sales due to our higher sales levels. See “Net Sales” above for trends in both demand and costs of our products and “Expenses” for trends in our operating expenses.

Income Tax Rate

Our effective income tax rates for the first quarters of 2018 and 2017 were 24.0% and 32.7%, respectively. During the first quarter of 2018, our effective income tax rate was favorably impacted by the Tax Cuts and Jobs Act of 2017 (“Tax Reform”), which included significant changes to the taxation of U.S. corporations, including a reduction of the U.S. federal statutory rate from 35% to 21% effective January 1, 2018. Based on our preliminary assessment of the impact of Tax Reform, we recognized a one-time, provisional net tax benefit of $207.3 million in the fourth quarter of 2017, primarily

related to the remeasurement of deferred tax assets and liabilities at the lowered federal statutory tax rate, which was partially offset by repatriation and related liabilities. Given the substantial changes to the Internal Revenue Code as a result of Tax Reform, our estimated financial impacts from Tax Reform are subject to further analysis, interpretation and clarification of the new law, which could result in changes to our estimates in future quarters in 2018. We did not make an adjustment during the first quarter of 2018 to our provisional estimate recognized in 2017. State income taxes offset by the effects of company-owned life insurance policies mainly accounted for the difference between our effective income tax rate and the federal statutory rate for the first quarter of 2018.

Net Income

	Three Months Ended March 31,							
	2018			2017				
	$	% of Net Sales		$	% of Net Sales		Dollar Change	Percentage Change	
	(dollars in millions)								
Net income attributable to Reliance	$ 169.0	6.1	%	$ 111.7	4.6	%	$ 57.3	51.3	%

The increases in our net income and net income as a percentage of sales were primarily the result of higher operating income and a lower effective income tax rate.

Liquidity and Capital Resources

Operating Activities

Net cash generated by operating activities was $13.3 million in the first quarter of 2018 compared to net cash used in operating activities of $20.7 million in the first quarter of 2017. Our increased operating cash flow was due to our significantly higher profitability, which was offset by increased working capital requirements (primarily accounts receivable and inventory less accounts payable) due to higher metal prices and increased shipping volumes. To manage our working capital, we focus on our days sales outstanding and on our inventory turnover rate, as receivables and inventory are the two most significant elements of our working capital. At March 31, 2018 and March 31, 2017, our days sales outstanding rate was 42.2 days. Our inventory turn rate (based on tons) during the first quarter of 2018 was 4.5 times (or 2.7 months on hand), compared to 4.7 times (or 2.6 months on hand) in the first quarter of 2017.

Investing Activities

Net cash used in investing activities of $77.3 million in the first quarter of 2018 increased from $32.0 million in the first quarter of 2017 due to $39.6 million used to fund an acquisition in the first quarter of 2018. Capital expenditures were $41.8 million in the first quarter of 2018 compared to $34.1 million in the first quarter of 2017. The majority of our 2018 and 2017 capital expenditures related to organic growth initiatives.

Financing Activities

Net cash provided by financing activities of $54.9 million in the first quarter of 2018 decreased slightly from $60.4 million in the first quarter of 2017. Net debt borrowings in the first quarter of 2018 were $145.3 million compared to $93.1 million in the first quarter of 2017. We used cash of $49.3 million to repurchase shares of our common stock in the first quarter of 2018. We paid dividends and dividend equivalents of $38.5 million during the first quarter of 2018, an increase of $4.8 million from the first quarter of 2017, due to an increase in our regular quarterly dividend rate in February 2018.

On April 25, 2018, our Board of Directors declared the 2018 second quarter cash dividend of $0.50 per share. We have increased our dividend 25 times since our IPO in 1994, with the most recent increase of 11.1% from $0.45 per share to $0.50 per share effective in the first quarter of 2018. We have never reduced or suspended our dividend and have paid regular quarterly dividends to our stockholders for 59 consecutive years.

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On October 20, 2015, our Board of Directors increased the number of shares authorized to be repurchased under our share repurchase plan by 7.5 million shares and extended the duration of the plan through December 31, 2018. During the first quarter of 2018, we repurchased 592,564 shares of our common stock at an average cost of $84.38 per share for a total of $50.0 million, including 8,120 shares for $0.7 million pending settlement at March 31, 2018. Since initiating the share repurchase plan in 1994, we have repurchased approximately 23.1 million shares at an average cost of $32.94 per share. As of March 31, 2018, we had authorization under the plan to purchase approximately 7.5 million shares, or about 10% of our current outstanding shares. We expect to continue opportunistically repurchasing shares of our common stock going forward.

Liquidity

Our primary sources of liquidity are funds generated from operations and our $1.5 billion revolving credit facility. Our total outstanding debt at March 31, 2018 was $2.06 billion, up from $1.91 billion at December 31, 2017. As of March 31, 2018, we had $690.0 million of outstanding borrowings, $52.9 million of letters of credit issued and $757.1 million available for borrowing on our revolving credit facility.

As of March 31, 2018, our net debt-to-total capital ratio (net debt-to-total capital is calculated as total debt, net of cash, divided by Reliance stockholders' equity plus total debt, net of cash) was 28.6%, up from 27.2% as of December 31, 2017.

On September 30, 2016, we entered into a $2.1 billion unsecured five-year credit agreement ("Credit Agreement") comprised of a $1.5 billion unsecured revolving credit facility and a $600.0 million unsecured term loan, with an option to increase the revolving credit facility up to an additional $500.0 million at our request, subject to approval of the lenders and certain other customary conditions. We intend to use the revolving credit facility for working capital and general corporate purposes, including, but not limited to, capital expenditures, dividend payments, repayment of debt, share repurchases, internal growth initiatives and acquisitions. The $600.0 million term loan due September 30, 2021 amortizes in quarterly installments, with an annual amortization of 5% through September 2018 and 10% thereafter until June 2021, with the balance to be paid at maturity. All borrowings under the Credit Agreement may be prepaid without penalty.

Revolving credit facilities with a combined credit limit of approximately $66.5 million are in place for operations in Asia and Europe with combined outstanding balances of $55.6 million and $53.9 million as of March 31, 2018 and December 31, 2017, respectively.

Tax Cuts and Jobs Act of 2017

Tax Reform enacted in December 2017 had a favorable impact on our profitability and cash flows in the first quarter of 2018 compared to the first quarter of 2017 through a reduction in our effective income tax rate. In 2017, we recognized a one-time, provisional net tax benefit of $207.3 million, primarily related to the remeasurement of deferred tax assets and liabilities at the lowered federal statutory tax rate, which was partially offset by repatriation and related liabilities.

Capital Resources

On November 20, 2006, we entered into an indenture (the “2006 Indenture”), for the issuance of $600.0 million of unsecured debt securities. The total debt issued was comprised of two tranches, (a) $350.0 million aggregate principal amount of senior unsecured notes bearing interest at the rate of 6.20% per annum, which matured and were repaid on November 15, 2016 and (b) $250.0 million aggregate principal amount of senior unsecured notes bearing interest at the rate of 6.85% per annum, maturing on November 15, 2036.

On April 12, 2013, we entered into an indenture (the “2013 Indenture” and, together with the 2006 Indenture, the “Indentures”), for the issuance of $500.0 million aggregate principal amount of senior unsecured notes at the rate of 4.50% per annum, maturing on April 15, 2023.

Under the Indentures, the notes are senior unsecured obligations and rank equally in right of payment with all of our existing and future unsecured and unsubordinated obligations.

The senior unsecured notes include provisions that require us to make an offer to repurchase the notes at a price equal to 101% of their principal amount plus accrued and unpaid interest in the event of both a change in control and a downgrade of our credit rating.

Various industrial revenue bonds had combined outstanding balances of $10.1 million as of March 31, 2018 and December 31, 2017, and have maturities through 2027.

As of March 31, 2018, we had $237.7 million of debt obligations coming due before our $1.5 billion revolving credit facility expires on September 30, 2021. We believe that we will continue to have sufficient liquidity to fund our future operating needs and to repay our debt obligations as they become due. In addition to funds generated from operations and funds available under our revolving credit facility, we expect to be able to access the capital markets to raise funds, if desired. We believe our investment grade credit rating enhances our ability to effectively raise capital, if needed. We expect to continue our acquisition and other growth activities along with our stockholder return activities in the future and anticipate that we will be able to fund such activities as they arise.

Covenants

The Credit Agreement and the Indentures include customary representations, warranties, covenants, acceleration, indemnity and events of default provisions. The covenants under the Credit Agreement include, among other things, two financial statement covenants that require us to maintain a minimum interest coverage ratio and a maximum leverage ratio. Our interest coverage ratio for the twelve-month period ended March 31, 2018 was approximately 9.8 times compared to the debt covenant minimum requirement of 3.0 times (interest coverage ratio is calculated as earnings before interest and taxes (EBIT), as defined in the Credit Agreement, divided by interest expense). Our leverage ratio as of March 31, 2018, calculated in accordance with the terms of the Credit Agreement, was 30.7% compared to the debt covenant maximum amount of 60% (leverage ratio is calculated as total debt, inclusive of capital lease obligations and outstanding letters of credit, divided by Reliance stockholders' equity plus total debt).

We were in compliance with all financial covenants in our Credit Agreement at March 31, 2018.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or variable interest entities, which are typically

established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

As of March 31, 2018 and December 31, 2017, we were contingently liable under standby letters of credit in the aggregate amount of $42.7 million and $43.1 million, respectively. The letters of credit relate to insurance policies and construction projects.

Contractual Obligations and Other Commitments

We had no material changes in commitments for capital expenditures, operating lease obligations or purchase obligations as of March 31, 2018, as compared to those disclosed in our table of contractual obligations included in our Annual Report on Form 10-K for the year ended December 31, 2017.

Inflation

Our operations have not been, and we do not expect them to be, materially affected by general inflation. Historically, we have been successful in adjusting prices to our customers to reflect changes in metal prices.

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Seasonality

Some of our customers are in seasonal businesses, especially customers in the construction industry and related businesses. However, our overall operations have not shown any material seasonal trends as a result of our geographic, product and customer diversity. Typically, revenues in the months of July, November and December have been lower than in other months because of a reduced number of working days for shipments of our products, resulting from holidays observed by the Company as well as vacation and extended holiday closures at some of our customers. Reduced shipping days also have a significant impact on our profitability. We cannot predict whether period-to-period fluctuations will be consistent with historical patterns. Results of any one or more quarters are therefore not necessarily indicative of annual results.

Goodwill and Other Intangible Assets

Goodwill, which represents the excess of cost over the fair value of net assets acquired, amounted to $1.85 billion at March 31, 2018, or approximately 23% of total assets, or 39% of Reliance stockholders' equity. Additionally, other intangible assets, net amounted to $1.12 billion at March 31, 2018, or approximately 14% of total assets, or 23% of Reliance stockholders' equity. Goodwill and other intangible assets deemed to have indefinite lives are not amortized but are subject to annual impairment tests. Other intangible assets with finite useful lives continue to be amortized over their estimated useful lives. We review the recoverability of our long-lived assets whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable.

Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses our Unaudited Consolidated Financial Statements, which have been prepared in accordance with U.S. GAAP. When we prepare these consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of our accounting policies require that we make subjective judgments, including estimates that involve matters that are inherently uncertain. Our most critical accounting estimates include those related to goodwill and intangible assets and long-lived assets. We base our estimates and judgments on historical experience and on various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for our judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Our actual results may differ from these estimates under different assumptions or conditions.

See “Critical Accounting Policies and Estimates” in our Annual Report on Form 10-K for the year ended December 31, 2017 for further information regarding the accounting policies that we believe to be critical accounting policies and that affect our more significant judgments and estimates used in preparing our consolidated financial statements. We do not believe that the new accounting guidance implemented in 2018 changed our critical accounting policies.

New Accounting Guidance

See Note 2—“Impact of Recently Issued Accounting Guidance” to our Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q for disclosure on new accounting guidance issued or implemented.

Item 3. Quantitative And Qualitative Disclosures About Market Risk

In the ordinary course of business, we are exposed to various market risk factors, including fluctuations in interest rates, changes in general economic conditions, domestic and foreign competition, foreign currency exchange rates and metals pricing, demand and availability. There have been no significant changes in our market risk exposures since December 31, 2017. See Item 7A “Quantitative and Qualitative Disclosures About Market Risk” in our Annual Report on Form 10-K for the year ended December 31, 2017 for further discussion on quantitative and qualitative disclosures about market risk.

Item 4. Controls And Procedures

Under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer and Chief Financial Officer, the Company carried out an evaluation of the effectiveness of the design and operation of the Company’s disclosure controls and procedures pursuant to and as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that, as of the end of the period covered in this report, the Company’s disclosure controls and procedures are effective.

There have been no changes in the Company’s internal control over financial reporting during the quarter ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

The information contained under the heading “Legal Matters” in Note 10—“Commitments and Contingencies” to our Unaudited Consolidated Financial Statements included in this Quarterly Report on Form 10-Q is incorporated by reference into this Item 1.

Item 1A. Risk Factors

Except as set forth below, there have been no material changes to the risk factors disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Excess capacity and over-production by foreign metal producers could increase the level of metal imports into the U.S., resulting in lower domestic prices, which would adversely affect our sales, margins and profitability.

Global metal-making capacity exceeds demand for metal products in some regions around the world. Rather than reducing employment by rationalizing capacity with consumption, we believe metal manufacturers in these countries (often with government assistance or subsidies in various forms) have periodically exported metal at prices which may not reflect their costs of production or capital. Excessive imports of metal into the U.S. have exerted, and may continue to exert, downward pressure on U.S. metal prices.

On March 1, 2018, the President of the United States announced a plan to indefinitely impose a 25 percent tariff on certain imported steel products and a 10 percent tariff on certain imported aluminum products under Section 232 of the Trade Expansion Act of 1962. Application of the tariffs commenced March 23, 2018, with temporary or long-term exemptions for a number of countries and subject to a product exemption process. We expect that these tariffs, while in effect, will discourage metal imports from non-exempt countries. However, we do not yet have sufficient information to evaluate in detail the possible impact of these tariffs on our operations or financial results. When these or other tariffs or duties expire or if others are further relaxed or repealed, or if relatively higher U.S. metal prices make it attractive for foreign metal producers to export their products to the U.S., despite the presence of duties or tariffs, the resurgence of substantial imports of foreign steel could create downward pressure on U.S. metal prices which could have a material adverse effect on our potential earnings and future results of operations.

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

Share repurchase activity during the three months ended March 31, 2018 was as follows:

Period	Total Number of Shares Purchased	Average Price Paid Per Share ($)	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Shares That May Yet Be Purchased Under the Plan(1)
January 1 - January 31, 2018	-	-	-	8,091,976
February 1 - February 28, 2018	-	-	-	8,091,976
March 1 - March 31, 2018	592,564	84.38	592,564	7,499,412
Total	592,564		592,564	

(1) On October 20, 2015, our Board of Directors amended our share repurchase plan increasing by 7,500,000 shares the total number of shares authorized to be repurchased and extending the program through December 31, 2018. Our share repurchase plan does not obligate us to acquire any specific number of shares. Under the share repurchase plan, shares may be repurchased in the open market or privately negotiated transactions, including plans complying with Rule 10b5-1 under the Exchange Act.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.	Description
31.1*	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2*	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32**	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS*	XBRL Instance Document.
101.SCH*	XBRL Taxonomy Extension Schema Document.
101.CAL*	XBRL Taxonomy Calculation Linkbase Document.
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB*	XBRL Taxonomy Label Linkbase Document.

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Exhibit No.	Description
101.PRE*	XBRL Taxonomy Presentation Linkbase Document.

* Filed herewith.

** Furnished herewith.

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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.

	RELIANCE STEEL & ALUMINUM CO. (Registrant)	
Dated: May 2, 2018	By:	/s/ Gregg J. Mollins Gregg J. Mollins President and Chief Executive Officer (Principal Executive Officer)
	By:	/s/ Karla R. Lewis Karla R. Lewis Senior Executive Vice President and Chief Financial Officer (Principal Financial Officer; Principal

Accounting
Officer)

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