

MERCANTILE BANK CORP

Form 10-Q

August 08, 2008

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

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

**For the quarterly period ended June 30, 2008**

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

**For the transition period from to**

**Commission File No. 000-26719  
MERCANTILE BANK CORPORATION**  
(Exact name of registrant as specified in its charter)

Michigan  
(State or other jurisdiction of  
incorporation or organization)

38-3360865  
(IRS Employer Identification No.)

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

(Address of principal executive offices) (Zip Code)

**(616) 406-3000**

(Registrant's telephone number, including area code)

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

Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

Yes  No

At August 8, 2008, there were 8,530,146 shares of Common Stock outstanding.

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CONSOLIDATED BALANCE SHEETS**

	June 30, 2008 (Unaudited)	December 31, 2007
<b>ASSETS</b>		
Cash and due from banks	\$ 37,632,000	\$ 29,138,000
Short term investments	137,000	292,000
Total cash and cash equivalents	37,769,000	29,430,000
Securities available for sale	129,013,000	136,673,000
Securities held to maturity (fair value of \$64,022,007 at June 30, 2008 and \$66,440,000 at December 31, 2007)	63,787,000	65,330,000
Federal Home Loan Bank stock	14,973,000	9,733,000
Loans and leases	1,840,793,000	1,799,880,000
Allowance for loan and lease losses	(31,881,000)	(25,814,000)
Loans and leases, net	1,808,912,000	1,774,066,000
Premises and equipment, net	33,557,000	34,351,000
Bank owned life insurance policies	41,004,000	39,118,000
Accrued interest receivable	8,317,000	9,957,000
Other assets	26,022,000	22,745,000
Total assets	\$ 2,163,354,000	\$ 2,121,403,000
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits		
Noninterest-bearing	\$ 131,107,000	\$ 133,056,000
Interest-bearing	1,413,597,000	1,458,125,000
Total deposits	1,544,704,000	1,591,181,000
Securities sold under agreements to repurchase	82,300,000	97,465,000
Federal funds purchased	16,000,000	13,800,000
Federal Home Loan Bank advances	285,000,000	180,000,000
Subordinated debentures	32,990,000	32,990,000
Other borrowed money	14,245,000	4,013,000
Accrued expenses and other liabilities	20,402,000	23,799,000
Total liabilities	1,995,641,000	1,943,248,000

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Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized, none issued	0	0
Common stock, no par value: 20,000,000 shares authorized; 8,530,512 shares outstanding at June 30, 2008 and 8,527,197 shares outstanding at December 31, 2007	172,640,000	172,938,000
Retained earnings (deficit)	(2,672,000)	4,948,000
Accumulated other comprehensive income (loss)	(2,255,000)	269,000
Total shareholders' equity	167,713,000	178,155,000
Total liabilities and shareholders' equity	\$ 2,163,354,000	\$ 2,121,403,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended June 30, 2008 (Unaudited)	Three Months Ended June 30, 2007 (Unaudited)	Six Months Ended June 30, 2008 (Unaudited)	Six Months Ended June 30, 2007 (Unaudited)
Interest income				
Loans and leases, including fees	\$ 26,483,000	\$ 33,513,000	\$ 55,546,000	\$ 66,935,000
Securities, taxable	1,906,000	1,792,000	3,993,000	3,591,000
Securities, tax-exempt	718,000	693,000	1,433,000	1,400,000
Federal funds sold	31,000	82,000	117,000	175,000
Short term investments	1,000	4,000	5,000	8,000
<b>Total interest income</b>	<b>29,139,000</b>	<b>36,084,000</b>	<b>61,094,000</b>	<b>72,109,000</b>
Interest expense				
Deposits	14,861,000	19,179,000	31,964,000	38,004,000
Short term borrowings	472,000	866,000	1,023,000	1,698,000
Federal Home Loan Bank advances	2,666,000	1,390,000	4,995,000	2,584,000
Long term borrowings	548,000	701,000	1,137,000	1,391,000
<b>Total interest expense</b>	<b>18,547,000</b>	<b>22,136,000</b>	<b>39,119,000</b>	<b>43,677,000</b>
<b>Net interest income</b>	<b>10,592,000</b>	<b>13,948,000</b>	<b>21,975,000</b>	<b>28,432,000</b>
Provision for loan and lease losses	6,200,000	2,350,000	15,300,000	3,370,000
<b>Net interest income after provision for loan and lease losses</b>	<b>4,392,000</b>	<b>11,598,000</b>	<b>6,675,000</b>	<b>25,062,000</b>
Noninterest income				
Services charges on accounts	480,000	393,000	984,000	782,000
Earnings on bank owned life insurance policies	418,000	309,000	853,000	606,000
Mortgage banking activities	174,000	103,000	413,000	214,000
Other income	686,000	616,000	1,398,000	1,227,000
<b>Total noninterest income</b>	<b>1,758,000</b>	<b>1,421,000</b>	<b>3,648,000</b>	<b>2,829,000</b>
Noninterest expense				
Salaries and benefits	5,673,000	6,521,000	11,447,000	11,905,000
Occupancy	958,000	814,000	1,932,000	1,581,000
Furniture and equipment depreciation, rent, and maintenance	480,000	501,000	1,020,000	994,000

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Nonperforming asset costs	1,056,000	145,000	1,542,000	242,000
Other expense	2,610,000	2,058,000	5,165,000	4,056,000
Total noninterest expenses	10,777,000	10,039,000	21,106,000	18,778,000
<b>Income (loss) before federal income tax expense (benefit)</b>	(4,627,000)	2,980,000	(10,783,000)	9,113,000
Federal income tax expense (benefit)	(2,015,000)	759,000	(4,433,000)	2,609,000
<b>Net income (loss)</b>	\$ (2,612,000)	\$ 2,221,000	\$ (6,350,000)	\$ 6,504,000
Basic earnings (loss) per share	\$ (0.31)	\$ 0.26	\$ (0.75)	\$ 0.77
Diluted earnings (loss) per share	\$ (0.31)	\$ 0.26	\$ (0.75)	\$ 0.77
Cash dividends per share	\$ 0.08	\$ 0.14	\$ 0.23	\$ 0.27
Average basic shares outstanding	8,469,097	8,455,891	8,467,122	8,446,419
Average diluted shares outstanding	8,469,097	8,503,138	8,467,122	8,494,276

See accompanying notes to consolidated financial statements.



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

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders Equity
<b>Balance, January 1, 2008</b>	\$ 172,938,000	\$ 4,948,000	\$ 269,000	\$ 178,155,000
Employee stock purchase plan, 4,529 shares	40,000			40,000
Dividend reinvestment plan, 2,841 shares	30,000			30,000
Stock option exercises, 2,000 shares	16,000			16,000
Stock tendered for stock option exercises, 1,123 shares	(16,000)			(16,000)
Stock-based compensation expense	310,000			310,000
Cash dividends (\$0.23 per share)	(678,000)	(1,270,000)		(1,948,000)
Comprehensive income:				
Net loss for the period from January 1, 2008 through June 30, 2008		(6,350,000)		(6,350,000)
Change in net unrealized gain (loss) on securities available for sale, net of reclassifications and tax effect			(2,028,000)	(2,028,000)
Change in net fair value of interest rate swaps, net of reclassifications and tax effect			(496,000)	(496,000)
Total comprehensive loss				(8,874,000)
<b>Balance, June 30, 2008</b>	\$ 172,640,000	\$ (2,672,000)	\$ (2,255,000)	\$ 167,713,000

See accompanying notes to consolidated financial statements.

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

	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders Equity
<b>Balance, January 1, 2007</b>	\$ 161,223,000	\$ 11,794,000	\$ (1,102,000)	\$ 171,915,000
Payment of 5% stock dividend, 401,023 shares	11,131,000	(11,135,000)		(4,000)
Employee stock purchase plan, 1,601 shares	47,000			47,000
Dividend reinvestment plan, 1,492 shares	44,000			44,000
Stock option exercises, 48,135 shares	591,000			591,000
Stock tendered for stock option exercises, 17,132 shares	(561,000)			(561,000)
Stock-based compensation expense	169,000			169,000
Cash dividends (\$0.27 per share)		(2,308,000)		(2,308,000)
Comprehensive income:				
Net income for the period from January 1, 2007 through June 30, 2007		6,504,000		6,504,000
Change in net unrealized gain (loss) on securities available for sale, net of reclassifications and tax effect			(1,866,000)	(1,866,000)
Total comprehensive income				4,638,000
<b>Balance, June 30, 2007</b>	\$ 172,644,000	\$ 4,855,000	\$ (2,968,000)	\$ 174,531,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended June 30, 2008 (Unaudited)	Three Months Ended June 30, 2007 (Unaudited)	Six Months Ended June 30, 2008 (Unaudited)	Six Months Ended June 30, 2007 (Unaudited)
<b>Cash flows from operating activities</b>				
Net income (loss)	\$ (2,612,000)	\$ 2,221,000	\$ (6,350,000)	\$ 6,504,000
Adjustments to reconcile net income (loss) to net cash from operating activities				
Depreciation and amortization	689,000	778,000	1,215,000	1,488,000
Provision for loan and lease losses	6,200,000	2,350,000	15,300,000	3,370,000
Stock-based compensation expense	155,000	85,000	310,000	169,000
Proceeds from sale of mortgage loans held for sale	11,019,000	3,918,000	28,974,000	9,813,000
Origination of mortgage loans held for sale	(10,888,000)	(3,825,000)	(28,644,000)	(9,654,000)
Net gain on sales of mortgage loans held for sale	(131,000)	(93,000)	(330,000)	(159,000)
Earnings on bank owned life insurance	(418,000)	(309,000)	(853,000)	(606,000)
Net change in:				
Accrued interest receivable	815,000	1,026,000	1,640,000	316,000
Other assets	43,000	(3,200,000)	(1,221,000)	(2,116,000)
Accrued expenses and other liabilities	(441,000)	821,000	(3,397,000)	2,377,000
Net cash from operating activities	4,431,000	3,772,000	6,644,000	11,502,000
<b>Cash flows from investing activities</b>				
Loan and lease originations and payments, net	(51,795,000)	(29,532,000)	(51,863,000)	(35,228,000)
Purchases of:				
Securities available for sale	(7,146,000)	(4,948,000)	(53,260,000)	(8,457,000)
Securities held to maturity	0	(1,810,000)	0	(2,407,000)
Federal Home Loan Bank stock	(2,743,000)	(25,000)	(5,240,000)	(25,000)
Proceeds from:				
Maturities, calls and repayments of available for sale securities	8,355,000	1,832,000	58,220,000	3,375,000
Maturities, calls and repayments of held to maturity securities	1,535,000	2,505,000	1,535,000	2,660,000
Purchases of premises and equipment, net	(55,000)	(1,182,000)	(576,000)	(2,561,000)
Purchases of bank owned life insurance	(1,033,000)	(866,000)	(1,033,000)	(866,000)
Net cash for investing activities	(52,882,000)	(34,026,000)	(52,217,000)	(43,509,000)
<b>Cash flows from financing activities</b>				
Net decrease in deposits	(10,046,000)	(47,147,000)	(46,477,000)	(7,893,000)

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Net increase (decrease) in securities sold under agreements to repurchase	(884,000)	6,942,000	(15,165,000)	(485,000)
Net increase (decrease) in federal funds purchased	200,000	9,100,000	2,200,000	(700,000)
Proceeds from Federal Home Loan Bank advances	85,000,000	65,000,000	155,000,000	90,000,000
Maturities of Federal Home Loan Bank advances	(30,000,000)	(20,000,000)	(50,000,000)	(50,000,000)
Net increase in other borrowed money	10,159,000	173,000	10,232,000	337,000
Employee stock purchase plan	17,000	22,000	40,000	47,000
Dividend reinvestment plan	12,000	22,000	30,000	44,000
Stock option exercises, net	0	0	0	30,000
Payment of cash dividends	(678,000)	(1,183,000)	(1,948,000)	(2,308,000)
Cash paid in lieu of fractional shares on stock dividend	0	0	0	(4,000)
Net cash from financing activities	53,780,000	12,929,000	53,912,000	29,068,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Three Months Ended June 30, 2008 (Unaudited)	Three Months Ended June 30, 2007 (Unaudited)	Six Months Ended June 30, 2008 (Unaudited)	Six Months Ended June 30, 2007 (Unaudited)
Net change in cash and cash equivalents	5,329,000	(17,325,000)	8,339,000	(2,939,000)
Cash and cash equivalents at beginning of period	32,440,000	65,766,000	29,430,000	51,380,000
<b>Cash and cash equivalents at end of period</b>	<b>\$ 37,769,000</b>	<b>\$ 48,441,000</b>	<b>\$ 37,769,000</b>	<b>\$ 48,441,000</b>
Supplemental disclosures of cash flow information				
Cash paid during the period for:				
Interest	\$ 20,365,000	\$ 22,298,000	\$ 43,659,000	\$ 42,953,000
Federal income tax	0	3,820,000	0	3,820,000
Transfers from loans and leases to foreclosed assets	1,036,000	1,140,000	1,717,000	2,699,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**1. SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation:** The unaudited financial statements for the three and six months ended June 30, 2008 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ( our bank ), our bank s three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ), and Mercantile Insurance Center, Inc. ( our insurance center ). 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 periods ended June 30, 2008 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, 2007.

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. In accordance with FASB Interpretation No. 46, 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 weighted average common shares outstanding during the period exclusive of unvested restricted shares outstanding. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under stock options and restricted shares and are determined using the treasury stock method. Stock-based awards for 322,165 shares of common stock for the three and six month periods ended June 30, 2008 and 112,514 shares of common stock for the three and six month periods ended June 30, 2007 were antidilutive and were not included in determining diluted earnings per share.

**Stock Dividend:** All per share amounts and average shares outstanding have been adjusted for all periods presented to reflect the 5% stock dividend distributed on May 4, 2007. The Statement of Changes in Shareholders Equity reflects a transfer from retained earnings to common stock for the value of the shares distributed. The impact of the 2007 stock dividend was previously reported as a \$14,948,000 increase to common stock and a \$14,952,000 decrease to retained earnings in our quarterly reports on Form 10-Q in 2007. These financial statements properly reflect this stock dividend as an \$11,131,000 increase to common stock and an \$11,135,000 decrease to retained earnings. Management determined this difference was not material and did not require restatement of previously filed quarterly reports on Form 10-Q.

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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, increased by the provision for loan and lease losses and recoveries, and decreased by charge-offs. Management estimates the allowance balance required based on past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, and economic conditions. 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 management's judgment, should be charged-off. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is likely.

A loan or lease is impaired when full payment under the loan or lease terms is not expected. Impairment is evaluated in aggregate for smaller-balance loans of similar nature such as residential mortgage, consumer and credit card loans, and on an individual loan basis for other loans. If a loan or lease is impaired, a portion of the allowance is allocated so that the loan or lease is reported, net, at the present value of estimated future cash flows using the loan's or lease's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans and leases are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship.

**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. Our current derivatives consist of interest rate swap agreements, which are used as part of our asset liability management to help manage interest rate risk. We do not use derivatives for trading purposes.

Changes in the fair value of derivatives that are designated as a hedge of the variability of cash flows to be received on various loans and are effective are reported in other comprehensive income. They are later reclassified into earnings in the same periods during which the hedged transaction affects earnings and are included in the line item in which the hedged cash flows are recorded (e.g., interest income related to our current interest rate swaps). 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.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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

**Adoption of New Accounting Standards:** In December 2007, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 141(R), *Business Combinations*, to further enhance the accounting and financial reporting related to business combinations. SFAS No. 141(R) establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Therefore, the effects of the adoption of SFAS No. 141(R) will depend upon the extent and magnitude of acquisitions after December 31, 2008.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. SFAS No. 157 does not require any new fair value measurements and was originally effective beginning January 1, 2008. In February 2008, the FASB issued FASB Staff Position ( FSP ) FAS 157-2. FSP FAS 157-2 allows entities to electively defer the effective date of SFAS No. 157 until January 1, 2009 for nonfinancial assets and nonfinancial liabilities except those recognized or disclosed at fair value on an annual or more frequently recurring basis. We will apply the fair value measurement and disclosure provisions of SFAS No. 157 to nonfinancial assets and liabilities effective January 1, 2009. The application of such is not expected to be material to our results of operations or financial position. See Note 10 for a discussion regarding the January 1, 2008 implementation of SFAS No. 157 relating to our financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Liabilities*. SFAS No. 159 permits entities to choose to measure eligible items at fair value at specified election dates. For items for which the fair value option has been elected, unrealized gains and losses are to be reported in earnings at each subsequent reporting date. The fair value option is irrevocable unless a new election date occurs, may be applied instrument by instrument, with a few exceptions, and applies only to entire instruments and not to portions of instruments. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting. SFAS No. 159 was effective beginning January 1, 2008. Through June 30, 2008, we have not elected the fair value option for any of our financial assets or liabilities.

In March 2008, the FASB issued SFAS No. 161, *Disclosures About Derivative Instruments and Hedging Activities – an Amendment of FASB Statement No. 133*. SFAS No. 161 expands disclosure requirements regarding an entity's derivative instruments and hedging activities. Expanded qualitative disclosures that will be required under SFAS No. 161 include: (1) how and why an entity uses derivative instruments; (2) how derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and related interpretations; and (3) how derivative instruments and related hedged items affect an entity's financial statements. SFAS No. 161 is effective beginning January 1, 2009. We do not expect SFAS No. 161 to have a material effect on our derivative disclosures upon adoption.





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MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

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

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS No. 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. generally accepted accounting principles ( GAAP ). SFAS No. 162 directs the GAAP hierarchy to the entity, not the independent auditors, as the entity that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS No. 162 is effective 60 days following the Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board amendments to remove the GAAP hierarchy from the auditing standards. We do not expect SFAS No. 162 to have a material effect on our consolidated results of operations or financial position upon adoption.

**2. LOANS AND LEASES**

Our total loans and leases at June 30, 2008 were \$1,840.8 million compared to \$1,799.9 million at December 31, 2007, an increase of \$40.9 million, or 2.3%. The components of our outstanding balances at June 30, 2008 and December 31, 2007, and the percentage change in loans and leases from the end of 2007 to the end of the second quarter 2008 are as follows:

	June 30, 2008		December 31, 2007		Percent Increase/ (Decrease)
	Balance	%	Balance	%	
Real Estate:					
Construction and land development	\$ 266,014,000	14.5%	\$ 263,868,000	14.7%	0.8%
Secured by 1-4 family properties	130,160,000	7.1	135,517,000	7.5	(4.0)
Secured by multi-family properties	52,325,000	2.8	51,951,000	2.9	0.7
Secured by nonresidential properties	880,689,000	47.8	855,872,000	47.6	2.9
Commercial	504,055,000	27.4	484,645,000	26.9	4.0
Leases	2,654,000	0.1	2,865,000	0.1	(7.4)
Consumer	4,896,000	0.3	5,162,000	0.3	(5.2)
<b>Total loans and leases</b>	<b>\$ 1,840,793,000</b>	<b>100.0%</b>	<b>\$ 1,799,880,000</b>	<b>100.0%</b>	<b>2.3%</b>

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

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

	Three months ended		Six months ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
Beginning balance	\$ 29,957,000	\$ 21,654,000	\$ 25,814,000	\$ 21,411,000
Charge-offs	(4,431,000)	(1,358,000)	(9,568,000)	(2,492,000)
Recoveries	155,000	154,000	335,000	511,000
Provision for loan and lease losses	6,200,000	2,350,000	15,300,000	3,370,000
Balance at June 30	\$ 31,881,000	\$ 22,800,000	\$ 31,881,000	\$ 22,800,000

**4. PREMISES AND EQUIPMENT NET**

Premises and equipment are comprised of the following:

	June 30, 2008	December 31, 2007
Land and improvements	\$ 8,538,000	\$ 8,534,000
Buildings and leasehold improvements	24,884,000	24,559,000
Furniture and equipment	12,402,000	12,164,000
	45,824,000	45,257,000
Less: accumulated depreciation	12,267,000	10,906,000
Premises and equipment, net	\$ 33,557,000	\$ 34,351,000

Depreciation expense totaled \$0.7 million during the second quarter of 2008 and 2007. Depreciation expense totaled \$1.4 million during the first six months of 2008, compared to \$1.3 million during the first six months of 2007.

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**5. DEPOSITS**

Our total deposits at June 30, 2008 were \$1,544.7 million compared to \$1,591.2 million at December 31, 2007, a decrease of \$46.5 million, or 2.9%. The components of our outstanding balances at June 30, 2008 and December 31, 2007, and percentage change in deposits from the end of 2007 to the end of the second quarter 2008 are as follows:

	June 30, 2008		December 31, 2007		Percent Increase/ (Decrease)
	Balance	%	Balance	%	
Noninterest-bearing demand	\$ 131,107,000	8.5	\$ 133,056,000	8.4%	(1.5)%
Interest-bearing checking	43,338,000	2.8	44,491,000	2.8	(2.6)
Money market	13,788,000	0.9	11,872,000	0.7	16.1
Savings	64,703,000	4.2	80,750,000	5.1	(19.9)
Time, under \$100,000	48,081,000	3.1	52,675,000	3.3	(8.7)
Time, \$100,000 and over	285,766,000	18.5	343,296,000	21.6	(16.8)
	586,783,000	38.0	666,140,000	41.9	(11.9)
Out-of-area time, under \$100,000	135,704,000	8.8	100,703,000	6.3	34.8
Out-of-area time, \$100,000 and over	822,217,000	53.2	824,338,000	51.8	(0.3)
	957,921,000	62.0	925,041,000	58.1	3.6
Total deposits	\$ 1,544,704,000	100.0%	\$ 1,591,181,000	100.0%	(2.9)%

**6. SHORT-TERM BORROWINGS**

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

	Six Months	Twelve Months
	Ended June 30, 2008	Ended December 31, 2007
Outstanding balance at end of period	\$ 82,300,000	\$ 97,465,000
Average interest rate at end of period	1.93%	2.94%
Average balance during the period	\$ 87,445,000	\$ 88,685,000
Average interest rate during the period	2.12%	3.67%
Maximum month end balance during the period	\$ 84,146,000	\$ 102,881,000

Securities sold under agreements to repurchase ( repurchase agreements ) generally have original maturities of less than one year. Repurchase agreements are treated as financings and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the agreements are recorded as assets of our bank and are held in safekeeping by correspondent banks. Repurchase agreements are offered principally to certain large deposit

customers. Repurchase agreements were secured by securities with a market value of \$95.0 million and \$108.1 million as of June 30, 2008 and December 31, 2007, respectively.

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**7. FEDERAL HOME LOAN BANK ADVANCES**

Our outstanding balances at June 30, 2008 totaled \$285.0 million and mature at varying dates from July 2008 through June 2012, with fixed rates of interest from 2.95% to 5.34% and averaging 3.94%. At December 31, 2007, outstanding balances totaled \$180.0 million with maturities ranging from January 2008 through January 2012 and fixed rates of interest from 4.01% to 5.34% and averaging 4.71%.

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, 2008 totaled \$322.3 million, with availability approximating \$27.1 million.

Maturities of FHLB advances currently outstanding during the next five years are:

2008	\$30,000,000
2009	65,000,000
2010	65,000,000
2011	85,000,000
2012	40,000,000

**8. COMMITMENTS AND OFF-BALANCE-SHEET RISK**

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

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on management's credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. The balance of the liability account was \$0.5 million as of June 30, 2008 and December 31, 2007.

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**8. COMMITMENTS AND OFF-BALANCE-SHEET RISK** (Continued)

A summary of the contractual amounts of our financial instruments with off-balance-sheet risk at June 30, 2008 and December 31, 2007 follows:

	June 30, 2008	December 31, 2007
Commercial unused lines of credit	\$ 348,157,000	\$ 377,493,000
Unused lines of credit secured by 1-4 family residential properties	32,521,000	33,083,000
Credit card unused lines of credit	9,304,000	9,035,000
Other consumer unused lines of credit	4,696,000	6,910,000
Commitments to make loans	68,610,000	66,196,000
Standby letters of credit	81,592,000	81,292,000
Total loan and lease commitments	\$ 544,880,000	\$ 574,009,000

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, 2008, the total notional amount of the underlying interest rate swap agreements was \$38.8 million, with a net fair value from our commercial loan customers perspective of negative \$0.3 million. We made no payments during the first six months of 2008 in regards to the risk participation agreements, and have accrued no liability for such potential payments. These risk participation agreements are considered financial guarantees in accordance with FASB Interpretation No. 45 and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

**9. 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.

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**9. HEDGING ACTIVITIES** (Continued)

Summary information about interest rate swaps at June 30, 2008 follows. There were no interest rate swaps in effect as of December 31, 2007.

Notional amounts	\$275,000,000
Weighted average pay rates	5.00%
Weighted average receive rates	5.33%
Weighted average maturity	13.8 Months
Net fair value (after-tax)	\$ (496,000)

Our interest rate swaps qualify as a cash flow hedge that converts the variable rate cash inflows on certain of our prime-based commercial loans to a fixed rate of interest. The interest rate swaps pay interest to us at stated fixed rates and require that we make interest payments based on the average prime rates.

The net after-tax derivative loss included in accumulated other comprehensive income (loss) at June 30, 2008 is projected to be reclassified into interest income in conjunction with the recognition of interest payments on the related commercial loans through the stated maturity dates of the various interest rate swaps, with approximately \$361,000 of net after-tax loss expected to be recognized in interest income over the next twelve months. During the first six months of 2008, a net after-tax derivative gain of \$34,000 was reclassified from other accumulated comprehensive income (loss) as an increase in interest income.

Retrospective hedge effectiveness for our cash flow hedges is determined using a dollar offset ratio on a quarterly basis. There were no components of our derivative instruments that were excluded from the assessment of hedge effectiveness. There were no ineffective gains or losses associated with cash flow hedges during the first six months of 2008.

**10. FAIR VALUES**

As discussed in Note 1, effective January 1, 2008, we implemented SFAS No. 157 relating to our financial assets and liabilities. SFAS No. 157 establishes a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following three levels:

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.



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**10. FAIR VALUES** (Continued)

The following is a description of our valuation methodologies used to measure and disclose the fair values of our financial assets and liabilities 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 1 securities include U.S. Government Agency bonds and mortgage-backed securities issued or guaranteed by U.S. Government Agencies that are traded by dealers or brokers in active over-the-counter markets. We have no Level 2 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.

*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, 2008, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the \$1.3 million of such loans at cost so they are not included in the nonrecurring table below.

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

*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.

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**10. FAIR VALUES** (Continued)*Assets and Liabilities Measured at Fair Value on a Recurring Basis*

The balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2008 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	\$ 129,013,000	\$ 129,013,000	\$ 0	\$ 0
Derivatives	(763,000)	0	(763,000)	0
<b>Total</b>	<b>\$ 128,250,000</b>	<b>\$ 129,013,000</b>	<b>\$ (763,000)</b>	<b>\$ 0</b>

We had no assets or liabilities measured at Level 3 during the first six months of 2008.

*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, 2008 and related gains (losses) for the three and six months ended June 30, 2008 are as follows:

	Total	Quoted Price in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Gains (Losses) Three Months Ended June 30, 2008	Six Months Ended June 30, 2008
Impaired loans <sup>(1)</sup>	\$ 31,600,000	\$ 0	\$ 31,600,000	\$ 0	\$ (6,114,000)	\$ (9,828,000)
<b>Total</b>	<b>\$ 31,600,000</b>	<b>\$ 0</b>	<b>\$ 31,600,000</b>	<b>\$ 0</b>	<b>\$ (6,114,000)</b>	<b>\$ (9,828,000)</b>

<sup>(1)</sup> Represents carrying value and related write-downs for which

adjustments are  
based on the  
estimated value  
of the property.

*Nonfinancial Assets and Liabilities Subject to FSP FAS 157-b Deferral Provisions*

We will apply the fair value measurement and disclosure provisions of SFAS No. 157 effective on January 1, 2009 to nonfinancial assets and liabilities measured on a nonrecurring basis. We measure the fair value of the following on a nonrecurring basis: (1) long-lived assets and (2) foreclosed and repossessed assets.

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**11. 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 not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to being closely monitored by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At June 30, 2008 and December 31, 2007, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

Our actual capital levels and minimum required levels were (dollars in thousands):

	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, 2008						
Total capital (to risk weighted assets)						
Consolidated	\$ 228,050	11.0%	\$ 166,461	8.0%	\$ NA	NA
Bank	224,720	10.8	166,133	8.0	207,666	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	201,968	9.7	83,231	4.0	NA	NA
Bank	198,689	9.6	83,067	4.0	124,600	6.0
Tier 1 capital (to average assets)						
Consolidated	201,968	9.5	85,030	4.0	NA	NA
Bank	198,689	9.4	84,881	4.0	106,101	5.0

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**11. 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, 2007						
Total capital (to risk weighted assets)						
Consolidated	\$ 235,700	11.4%	\$ 165,562	8.0%	\$ NA	NA
Bank	232,435	11.3	165,292	8.0	206,615	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	209,886	10.1	82,781	4.0	NA	NA
Bank	206,621	10.0	82,646	4.0	123,969	6.0
Tier 1 capital (to average assets)						
Consolidated	209,886	10.0	84,169	4.0	NA	NA
Bank	206,621	9.8	84,061	4.0	105,076	5.0

Our consolidated capital levels as of June 30, 2008 and December 31, 2007 include the \$32.0 million in trust preferred securities issued by the trust subject to certain limitations. Federal Reserve guidelines limit the amount of trust preferred securities which can be included in our Tier 1 capital to 25% of total Tier 1 capital. As of June 30, 2008 and December 31, 2007, all \$32.0 million of the trust preferred securities were included as Tier 1 capital.

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. We have paid two cash dividends on our common stock during 2008. On January 8, 2008, we declared a \$0.15 per share cash dividend on our common stock, which was paid on March 10, 2008 to record holders as of February 8, 2008. On April 8, 2008, we declared an \$0.08 per share cash dividend on our common stock, which was paid on June 10, 2008 to record holders as of May 9, 2008. On July 10, 2008, we declared a \$0.04 per share cash dividend on our common stock, which is payable on September 10, 2008 to record holders as of August 8, 2008. Because of a retained deficit at the time of declaration, the cash dividends during the second and third quarters are recorded as a reduction of our common stock account.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation**  
**Forward-Looking Statements**

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

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulations; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2007. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

**Introduction**

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, Mercantile Bank of Michigan ( our bank ), our bank's three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ) and Mercantile Insurance Center, Inc. ( our insurance center ), at June 30, 2008 to December 31, 2007 and the results of operations for the three and six months ended June 30, 2008 and June 30, 2007. 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**

Generally accepted accounting principles are complex and require management to apply significant judgment to various accounting, reporting and disclosure matters. Management must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a complete discussion of our significant accounting policies, see footnotes to our Consolidated Financial Statements included on pages F-37 through F-42 in our Form 10-K for the fiscal year ended December 31, 2007 (Commission file number 000-26719). Below is a discussion of our allowance for loan and lease losses policy. This policy is critical because it is 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. Management has reviewed the application of this policy with the Audit Committee of our Board of Directors.

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**Allowance for Loan and Lease Losses:** The allowance for loan and lease losses ( allowance ) is a valuation allowance for probable incurred credit losses, increased by the provision for loan and lease losses and recoveries, and decreased by charge-offs. Management estimates the allowance balance required based on past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, and economic conditions. 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 management's judgment, should be charged-off. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is likely. A loan or lease is impaired when full payment under the loan or lease terms is not expected. Impairment is evaluated in aggregate for smaller-balance loans of similar nature such as residential mortgage, consumer and credit card loans, and on an individual loan basis for other loans. If a loan or lease is impaired, a portion of the allowance is allocated so that the loan or lease is reported, net, at the present value of estimated future cash flows using the loan's or lease's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans and leases are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship.

**Financial Condition**

During the first six months of 2008, our assets increased from \$2,121.4 million on December 31, 2007, to \$2,163.4 million on June 30, 2008. This represents an increase in total assets of \$42.0 million, or 2.0%. The asset growth was comprised primarily of a \$34.8 million increase in net loans and an \$8.3 million increase in cash and cash equivalents. The growth in total assets was primarily funded by a \$105.0 million increase in Federal Home Loan Bank advances, which in part offset a \$46.5 million decrease in deposits and a \$15.2 million decrease in securities sold under agreements to repurchase ( repurchase agreements ).

Commercial loans and leases increased by \$46.5 million during the first six months of 2008, and at June 30, 2008 totaled \$1,705.7 million, or 92.7% of the total loan and lease portfolio. The growth in our commercial loan and lease portfolio has slowed over the past several quarters, especially in comparison to our strong growth since our inception about 10 years ago, primarily reflecting the competitive pricing and underwriting environments within our markets. These competitive pressures have negatively impacted the volume of loans we have booked and accelerated the level of loan payoffs. Despite these competitive pressures, we remain committed to our traditionally high standards of underwriting and believe the long term benefits of this conservative posture outweigh the likely short-term negative impact to our net interest income and overall earnings performance. Our recent commercial loan and lease growth has also been negatively impacted by our decision to request that certain commercial loan relationships seek financing elsewhere, as well as an elevated level of net loan charge-offs.

The continued significant concentration of the loan and lease portfolio in commercial loans and leases is consistent with our stated strategy of focusing a substantial amount of our efforts on wholesale banking. Corporate and business lending is an area of expertise of our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least 10 years' experience. Of each of the loan categories that we originate, commercial loans and leases are most efficiently originated and managed; thus limiting overhead costs by necessitating the attention of fewer full-time employees. Our commercial lending business generates the greatest amount of local deposits and is our primary source of demand deposits.

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

Residential	Vacant Land	\$	20,932,000
Residential	Land Development		57,728,000
Residential	Construction		27,113,000
Commercial	Vacant Land		29,655,000
Commercial	Land Development		29,364,000
Commercial	Construction NonOwner Occupied		87,586,000
Commercial	Construction Owner Occupied		14,053,000
Commercial	NonOwner Occupied		556,722,000
Commercial	Owner Occupied		369,566,000
Total			\$ 1,192,719,000

Residential mortgage loans and consumer loans decreased an aggregate \$5.6 million during the first six months of 2008. As of June 30, 2008, residential mortgage and consumer loans totaled a combined \$135.1 million, or 7.3% of the total loan and lease portfolio. Although we plan to increase our non-commercial loan portfolios in future periods, we expect the commercial sector of our lending efforts and resultant assets to remain the dominant loan portfolio category given our wholesale banking strategy.

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans and leases to provide appropriate loan and lease portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and leases and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans and leases, which exhibit characteristics (financial or otherwise) that could cause the loans and leases to become nonperforming or require restructuring in the future, are included on the internal watch list. Senior management reviews this list regularly.

The level of net loan and lease charge-offs and nonperforming assets increased throughout 2007. Although we were never directly involved in the underwriting of or the investing in subprime residential real estate loans, the apparent substantial and rapid collapse of this line of business during 2007 throughout the United States had a significant negative impact on the residential real estate development lending portion of our business. The resulting decline in real estate prices and slowdown in sales stretched the cash flow of our local developers and eroded the value of our underlying collateral, causing elevated levels of nonperforming assets and net loan and lease charge-offs.



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

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

During the second quarter of 2008, we found that the financial condition of some of our borrowers and guarantors had become increasingly strained, as real estate remains unsold or insufficiently leased and liquid sources of repayment are exhausted or significantly depleted. Recently completed evaluations and appraisals continue to often reflect substantial declines from the original estimated values, and in some cases even in comparison to property value estimates made within the past several quarters. Although the level of our nonperforming assets increased and our net loan and lease charge-offs remained at elevated levels during the second quarter of 2008, our accruing loans that were 30 to 89 days delinquent at June 30, 2008 were at their lowest level in several years, and the total balance of our internal watch list has remained relatively unchanged over the past several months, which are positive signs that we may be nearing the peak in asset quality issues.

As of June 30, 2008, nonperforming assets totaled \$46.6 million, or 2.16% of total assets, an increase from the \$35.7 million, or 1.68% of total assets, as of December 31, 2007, and from the \$24.0 million, or 1.14% of total assets, as of June 30, 2007. As of June 30, 2008, nonperforming loans secured by real estate, combined with foreclosed properties, totaled \$38.6 million, or about 83% of total nonperforming assets. Nonperforming loans and foreclosed properties associated with the development of residential real estate totaled \$14.7 million, with another \$3.2 million in nonperforming loans secured by, and foreclosed properties consisting of, residential properties. Net loan and lease charge-offs during the second quarter of 2008 totaled \$4.3 million, or an annualized 0.95% of average total loans and leases. Net loan and lease charge-offs during the first six months of 2008 totaled \$9.2 million, or an annualized 1.03% of average total loans and leases. This compares to net loan and lease charge-offs of \$1.2 million, or an annualized 0.28% during the second quarter of 2007, and \$2.0 million, or an annualized 0.23% during the first six months of 2007.

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The following table provides a breakdown of nonperforming assets as of June 30, 2008 and net loan and lease charge-offs during the first six months of 2008 by property type:

		Nonperforming Loans	Foreclosed Properties	Net Loan & Lease Charge-Offs
Residential	Land Development	\$ 10,718,000	\$ 1,652,000	\$ 1,265,000
Residential	Construction	2,355,000	0	289,000
Residential	Owner Occupied / Rental	2,492,000	716,000	1,354,000
Commercial	Land Development	3,471,000	0	584,000
Commercial	Construction	0	0	0
Commercial	Owner Occupied	6,269,000	754,000	513,000
Commercial	NonOwner Occupied	10,008,000	166,000	2,970,000
Commercial	NonReal Estate	7,983,000	24,000	2,232,000
Consumer	NonReal Estate	1,000	10,000	25,000
Total		\$ 43,297,000	\$ 3,322,000	\$ 9,232,000

Securities decreased \$4.0 million during the first six months of 2008, totaling \$207.8 million as of June 30, 2008. Proceeds from called U.S. Government Agency bonds totaled \$54.0 million during the first six months of 2008, with another \$4.2 million received from principal paydowns on mortgage-backed securities. A vast majority of the proceeds were invested back into the securities portfolio, with \$34.0 million invested in U.S. Government Agency bonds and \$19.3 million invested in mortgage-backed securities. FHLB of Indianapolis stock increased \$5.2 million during the first six months of 2008, supporting the increased level of FHLB advances during the same time period. Our securities portfolio continues to consist primarily of U.S. Government Agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government Agencies, investment-grade tax-exempt municipal securities and FHLB of Indianapolis stock.

Cash and cash equivalents increased \$8.3 million during the first six months of 2008, totaling \$37.8 million on June 30, 2008. Cash and due from bank balances were up \$8.5 million, while short-term investments were down \$0.2 million. Our commercial lending and wholesale funding focus results in relatively large day-to-day fluctuations of our cash and cash equivalent balances. The average cash and cash equivalents during the first six months of 2008 equaled \$30.2 million, which includes an average balance of federal funds sold of \$8.1 million. We were in a federal funds purchased position as of June 30, 2008 and December 31, 2007.

Premises and equipment at June 30, 2008 equaled \$33.6 million, a decrease of \$0.8 million over the past six months. Purchases of premises and equipment during the first six months of 2008 totaled \$0.6 million. Depreciation expense during the first six months of 2008 equaled \$1.4 million.

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Deposits decreased \$46.5 million during the first six months of 2008, totaling \$1,544.7 million at June 30, 2008. Local deposits decreased \$79.4 million, while out-of-area deposits increased \$32.9 million. As a percent of total deposits, local deposits equaled 38.0% on June 30, 2008, compared to 41.9% as of December 31, 2007. Noninterest-bearing demand deposits, comprising 8.5% of total deposits, decreased \$1.9 million during the first six months of 2008. Savings deposits (4.2% of total deposits) decreased \$16.0 million, interest-bearing checking deposits (2.8% of total deposits) decreased \$1.2 million and money market deposit accounts (0.9% of total deposits) increased \$1.9 million during the first six months of 2008. Local certificates of deposit, comprising 21.6% of total deposits, decreased \$62.1 million during the first six months of 2008. The decline in total local deposits is primarily seasonal in nature, with many deposit customers using funds for business-related purposes. It also appears that the struggling Michigan economy is resulting in some of our business customers having lower deposit totals than normal, especially municipal governmental units.

Out-of-area deposits increased \$32.9 million during the first six months of 2008, totaling \$957.9 million as of June 30, 2008. Out-of-area deposits consist primarily of certificates of deposit obtained from depositors located outside our market area and placed by deposit brokers for a fee, but also include certificates of deposit obtained from the deposit owners directly. The owners of out-of-area deposits include individuals, businesses, and municipal governmental units located throughout the United States. Notwithstanding our decision to increase the use of FHLB advances due to lower interest rates offered on FHLB advance products in comparison to the relatively higher interest rate environment in the brokered deposit markets, out-of-area deposits increased during the first six months of 2008 due to loan growth and the reduction in local deposits and repurchase agreements.

Repurchase agreements decreased \$15.2 million during the first six months of 2008, totaling \$82.3 million as of June 30, 2008. As part of our sweep account program, collected funds from certain business noninterest-bearing checking accounts are invested into over-night interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. Like the decline in total local deposits, the decline in repurchase agreements during the first six months of 2008 is primarily seasonal in nature.

Federal funds purchased increased by \$2.2 million during the first six months of 2008, equaling \$16.0 million as of June 30, 2008. Our average federal funds purchased position during the first six months of 2008 was \$6.7 million. FHLB advances increased \$105.0 million during the first six months of 2008, totaling \$285.0 million as of June 30, 2008. The FHLB advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans and 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, 2008 totaled \$322.3 million, with availability approximating \$27.1 million. FHLB advances, along with out-of-area deposits, are the primary components of our wholesale funding program.

**Liquidity**

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

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Our liquidity strategy is to fund asset growth with deposits, repurchase agreements and FHLB advances and to maintain an adequate level of short- and medium-term investments to meet typical daily loan and deposit activity. Although deposit and repurchase agreement growth from customers located in our market areas has generally consistently increased, this growth has not been sufficient to meet our historical substantial loan growth and provide monies for additional investing activities. To assist in providing the additional needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of certificates of deposit from customers outside of our market areas and advances from the FHLB, totaled \$1,268.9 million, or 65.5% of combined deposits and borrowed funds as of June 30, 2008. As of December 31, 2007, wholesale funds totaled \$1,118.8 million, or 59.4% of combined deposits and borrowed funds.

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

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

As a member of the FHLB of Indianapolis, our bank has access to FHLB borrowing programs. At June 30, 2008, advances from the FHLB totaled \$285.0 million, an increase of \$105.0 million from the \$180.0 million outstanding at December 31, 2007. Based on available collateral at June 30, 2008, our bank could borrow an additional \$27.1 million. Our bank has the ability to borrow money on a daily basis through correspondent banks via established unsecured federal funds purchased lines, totaling \$20.0 million as of June 30, 2008. The average balance of federal funds purchased during the first six months of 2008 equaled \$6.7 million, compared to an \$8.1 million average federal funds sold position during the same time period.

In addition to typical loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. As of June 30, 2008, our bank had a total of \$463.3 million in unfunded loan commitments and \$81.6 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$394.7 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$68.6 million were for loan commitments expected to close and become funded within the next twelve months. We monitor fluctuations in loan balances and commitment levels and include such data in managing our overall liquidity.

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We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, changes in economic or market conditions, earnings problems, declining capital levels or situations beyond our control could cause either short or long term liquidity challenges. While we believe it is unlikely that a funding crisis of any significant degree is likely to materialize, we have developed a comprehensive contingency funding plan that provides a framework for meeting both temporary and longer-term liquidity disruptions. Depending upon the particular circumstances of a liquidity situation, possible strategies may include obtaining funds via one or a combination of the following sources of funds: established lines of credit at correspondent banks and the FHLB of Indianapolis, brokered certificate of deposit market, wholesale securities repurchase markets, issuance of term debt, sale of assets, or sale of common stock or other securities.

**Capital Resources**

Shareholders' equity is a noninterest-bearing source of funds that generally provides support for asset growth. Shareholders' equity decreased by \$10.5 million during the first six months of 2008, from \$178.2 million on December 31, 2007, to \$167.7 million at June 30, 2008. The decrease is primarily attributable to the net loss of \$6.4 million recorded during the first six months of 2008, the payment of cash dividends totaling \$1.9 million and the \$2.5 million mark-to-market adjustments for available for sale securities and our interest rate swaps.

We are subject to regulatory capital requirements primarily administered by federal bank regulatory agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on our financial statements. The capital ratios of the company and our bank as of June 30, 2008 and December 31, 2007 are disclosed under Note 11 of the Notes to Consolidated Financial Statements.

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. We have paid two cash dividends on our common stock during 2008. On January 8, 2008, we declared a \$0.15 per share cash dividend on our common stock, which was paid on March 10, 2008 to record holders as of February 8, 2008. On April 8, 2008, we declared an \$0.08 per share cash dividend on our common stock, which was paid on June 10, 2008 to record holders as of May 9, 2008. On July 10, 2008, we declared a \$0.04 per share cash dividend on our common stock, which is payable on September 10, 2008 to record holders as of August 8, 2008. While we want to maximize shareholder value, which includes the return of capital through cash dividends, given the current economic environment and its impact on our financial performance, we believe it was prudent to pay a reduced cash dividend during the second and third quarters of 2008.

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**Results of Operations**

We recorded a net loss for the second quarter of 2008 of \$2.6 million (\$0.31 per basic and diluted share), compared with net income of \$2.2 million (\$0.26 per basic and diluted share) recorded during the second quarter of 2007. We recorded a net loss for the first six months of 2008 of \$6.4 million (\$0.75 per basic and diluted share), compared with net income of \$6.5 million (\$0.77 per basic and diluted share) recorded during the first six months of 2007. Net income for the second quarter of 2007 and the first six months of 2007 includes a one-time \$1.2 million (\$0.8 million after-tax) expense associated with the financial retirement package for former Chairman and Chief Executive Officer, Gerald Johnson Jr., which was recorded during the second quarter of 2007 in conjunction with Mr. Johnson's retirement effective June 30, 2007. Excluding this one-time expense, net income for the second quarter of 2007 was \$3.0 million (\$0.36 per basic and diluted share), while net income for the first six months of 2007 was \$7.3 million (\$0.86 per basic and diluted share).

The decline in net income during the second quarter and first six months of 2008 is primarily the result of significantly lower net interest income and a substantially higher provision for loan and lease losses. With our near term asset sensitive position, whereby we have a higher magnitude of assets subject to repricing when compared to the level of liabilities subject to repricing, we have experienced a decline in the level of net interest income which has more than offset growth in earning assets. The higher provision expense depicts the deteriorating quality of certain of our commercial loans, reflecting the negative impact of local, state and national economies on our borrowers' cash flows and the reduction of collateral values.

Interest income during the second quarter of 2008 was \$29.1 million, a decrease of 19.2% from the \$36.1 million earned during the second quarter of 2007. Interest income during the first six months of 2008 was \$61.1 million, a decrease of 15.3% from the \$72.1 million earned during the first six months of 2007. The reduction in interest income is primarily attributable to a declining interest rate environment and an increase in nonperforming assets, which more than offset growth in earning assets. During the second quarter of 2008, earning assets averaged \$2,029.5 million, \$64.2 million higher than average earning assets of \$1,965.3 million during the second quarter of 2007. Average loans were up \$57.9 million and average securities increased \$6.2 million. During the first six months of 2008, earning assets averaged \$2,022.4 million, \$63.0 million higher than average earning assets of \$1,959.4 million during the same time period in 2007. Average loans were up \$55.0 million and average securities increased \$6.4 million. Negatively impacting interest income was the decreased yield on earning assets. During the second quarter of 2008 and 2007, earning assets had an average yield (tax equivalent-adjusted basis) of 5.82% and 7.43%, respectively. During the first six months of 2008 and 2007, earning assets had an average yield of 6.12% and 7.48%, respectively. With approximately 60% of our total loans and leases tied to Prime or LIBOR rates, our earning asset yield has been substantially impacted by the steep reduction in market interest rates since late third quarter of 2007. Between mid-September 2007 and late April 2008, the Federal Open Market Committee ( FOMC ) lowered the targeted federal funds rate by a total of 325 basis points. The resulting similar decline in the Prime and LIBOR rates, combined with an increased level of nonperforming assets, a very competitive loan and deposit environment and a flat to inverted yield curve over an extended period of time, has significantly negatively impacted our yield on earning assets and level of interest income.

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Interest expense during the second quarter of 2008 was \$18.5 million, a decrease of 16.2% from the \$22.1 million expensed during the second quarter of 2007. Interest expense during the first six months of 2008 was \$39.1 million, a decrease of 10.4% from the \$43.7 million expensed during the first six months of 2007. The reduction in interest expense is primarily attributable to a declining interest rate environment, which more than offset an increase in interest-bearing liabilities necessitated by asset growth. During the second quarter of 2008, interest-bearing liabilities averaged \$1,822.8 million, \$63.7 million higher than average interest-bearing liabilities of \$1,759.1 million during the second quarter of 2007. Average interest-bearing deposits were down \$105.6 million, while average FHLB advances were up \$153.1 million and average short-term borrowings increased \$8.2 million. During the first six months of 2008, interest-bearing liabilities averaged \$1,814.7 million, \$60.4 million higher than average interest-bearing liabilities of \$1,754.3 million during the same time period in 2007. Average interest-bearing deposits were down \$84.5 million, while average FHLB advances were up \$132.6 million and average short-term borrowings increased \$8.0 million. A decline in the cost of interest-bearing liabilities provided for a reduction of interest expense. During the second quarter of 2008 and 2007, interest-bearing liabilities had an average rate of 4.08% and 5.05%, respectively. During the first six months of 2008 and 2007, interest-bearing liabilities had an average rate of 4.32% and 5.02%, respectively. The lower weighted average cost of interest-bearing liabilities is primarily due to the decline in market interest rates.

Net interest income during the second quarter of 2008 was \$10.6 million, a decrease of 24.1% from the \$13.9 million earned during the second quarter of 2007. Net interest income during the first six months of 2008 was \$22.0 million, a decrease of 22.7% from the \$28.4 million earned during the same time period in 2007. The decrease in net interest income was primarily due to a decline in the net interest margin, which more than offset the positive impact from growth in earning assets. The net interest margin during the second quarter of 2008 was 2.15%, compared to 2.91% during the second quarter of 2007. During the first six months of 2008, the net interest margin was 2.24%, compared to 2.99% during the same time period in 2007. The decline in our net interest margin during both time periods primarily reflects our yield on earnings assets declining at a far greater rate than the reduction in our cost of funds. Although current deposit and borrowing rates have declined similarly to the reduction in the Prime and LIBOR rates, our relatively high reliance on fixed rate certificates of deposit and FHLB advances results in a lagged reduction in our cost of funds in comparison to the reduction in our yield on earning assets.

Given the multitude of factors that impact the net interest margin, such as FOMC interest rate decisions, corresponding changes in interest rates for deposits and borrowed funds, shape of the yield curve, loan and deposit competitive environment, changes in balance sheet structure, level of nonperforming assets, customer behavior, and potential changes in interest rate risk management strategies, it is difficult to predict future net interest margins. However, under the current interest rate environment whereby it appears the FOMC will keep rates unchanged for at least the remainder of 2008, our net interest margin should begin to significantly improve as we move through the second part of 2008 and into 2009. While we expect our asset yield to remain relatively steady, we have about \$465 million in relatively high-rate wholesale funds scheduled to mature during the remainder of 2008 and another \$515 million maturing during 2009. These maturing funds carry an average interest rate of about 4.50%, compared to current interest rates ranging from 2.50% to 4.00% depending on the type and term of wholesale funding instrument.

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The following table sets forth certain information relating to our consolidated average interest-earning assets and interest-bearing liabilities and reflects the average yield on assets and average cost of liabilities for the second quarter of 2008 and 2007. Such yields and costs are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the period presented. Tax-exempt securities interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 35%. Securities interest income was increased by \$300,000 in the second quarter of 2008 and 2007 for this adjustment.

	Average Balance	Quarters ended June 30,		Average Balance (dollars in thousands)	2007 Interest	Average Rate
		2008 Interest	Average Rate			
<b>ASSETS</b>						
Loans and leases	\$ 1,812,898	\$ 26,483	5.86%	\$ 1,755,033	\$ 33,513	7.66%
Securities	209,892	2,924	5.57	203,715	2,785	5.47
Federal funds sold	6,352	31	1.93	6,227	82	5.20
Short term investments	352	1	1.12	370	4	4.75
Total interest-earning assets	2,029,494	29,439	5.82	1,965,345	36,384	7.43
Allowance for loan losses	(32,030)			(22,329)		
Other assets	128,285			132,201		
Total assets	\$ 2,125,749			\$ 2,075,217		
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>						
Interest-bearing deposits	\$ 1,421,444	\$ 14,861	4.19%	\$ 1,527,074	\$ 19,179	5.04%
Short-term borrowings	95,545	472	1.98	87,321	866	3.98
FHLB advances	261,264	2,666	4.04	108,187	1,390	5.08
Long-term borrowings	44,594	548	4.86	36,517	701	7.59
Total interest-bearing liabilities	1,822,847	18,547	4.08	1,759,099	22,136	5.05
Noninterest-bearing deposits	110,409			116,448		
Other liabilities	20,591			24,236		
Shareholders equity	171,902			175,434		
Total liabilities and shareholders equity	\$ 2,125,749			\$ 2,075,217		
Net interest income		\$ 10,892			\$ 14,248	
Net interest rate spread			1.74%			2.38%



Net interest rate margin on average assets	2.06%	2.75%
Net interest margin on earning assets	2.15%	2.91%

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Provisions for loan and lease losses during the second quarter of 2008 were \$6.2 million, compared to \$2.4 million during the second quarter of 2007. Provisions for loan and lease losses during the first six months of 2008 were \$15.3 million, compared to \$3.4 million that was expensed during the same time period in 2007. The increased provisions primarily reflect a higher volume of net loan and lease charge-offs and the need to increase the loan loss reserve to account for identified weaknesses in parts of our loan and lease portfolio primarily as a result of continuing decline in local, state and national economies. We are witnessing the impact of the declining economic environment not only on residential real estate development that we saw throughout 2007, but now on other sectors as well. Our real estate collateral values, both residential and commercial, have deteriorated and the cash flow of some of our borrowers is increasingly strained. As a result, during the first six months of 2008, and especially during the first quarter of 2008, we downgraded numerous commercial loan relationships, which in turn necessitated the sizeable provision for loan and lease losses.

Net loan and lease charge-offs of \$4.3 million were recorded during the second quarter of 2008, compared to \$1.2 million during the second quarter of 2007. During the first six months of 2008, net loan and lease charge-offs totaled \$9.2 million, compared to \$2.0 million during the same time period in 2007. Of the \$9.2 million in net loan and lease charge-offs during the first six months of 2008, \$4.1 million was comprised of commercial real estate loans, \$2.9 million was comprised of loans secured by residential properties and \$2.2 million was comprised of commercial loans secured by collateral other than real estate, such as equipment, inventory and accounts receivable. The allowance, as a percentage of total loans and leases outstanding, was 1.73% as of June 30, 2008, compared to 1.43% as of December 31, 2007 and 1.28% as of June 30, 2007.

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

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

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## MERCANTILE BANK CORPORATION

Noninterest income during the second quarter of 2008 was \$1.76 million, an increase of 23.7% over the \$1.42 million earned during the second quarter of 2007. Noninterest income during the first six months of 2008 was \$3.65 million, an increase of 29.0% over the \$2.83 million earned during the same time period in 2007. Service charge income on deposits and repurchase agreements increased \$202,000 (25.8%), and income from mortgage banking activities increased \$199,000 (92.8%) during the first six months of 2008 when compared to the first six months of 2007, the former primarily reflecting a decrease in the earnings credit rate and improved collection of overdraft service charges, with the latter primarily reflecting a higher volume of refinance activity due to the lower interest rate environment. Earnings on bank owned life insurance policies increased \$247,000 (40.8%) during the first six months of 2008 when compared to the same time period in 2007, primarily resulting from increased investments and improved yields. We recorded increased fee income in virtually all other major fee income categories during both time periods.

Noninterest expense during the second quarter of 2008 was \$10.8 million, an increase of 7.4% over the \$10.0 million expensed during the second quarter of 2007. Noninterest expense during the first six months of 2008 was \$21.1 million, an increase of 12.4% over the \$18.8 million expensed during the same time period in 2007. Employee salary and benefit expenses were \$0.8 million lower during the second quarter of 2008 than the level expensed during the second quarter of 2007, and were \$0.5 million lower during the first six months of 2008 than the level expensed during the first six months of 2007. The salary and benefit expenses for the second quarter of 2007 and the first six months of 2007 include a one-time \$1.2 million expense associated with the financial retirement package for former Chairman and Chief Executive Officer, Gerald Johnson Jr., in conjunction with Mr. Johnson's retirement effective June 30, 2007. If this expense is excluded, our employee salary and benefit expenses were up \$0.4 million during the second quarter of 2008 over the level expensed in the second quarter of 2007, and up \$0.7 million during the first six months of 2008 when compared to the same time period in 2007. The adjusted increases during both time periods primarily reflect the hiring of additional staff related to our expansion in Oakland County in late 2007 and annual pay raises. We recorded an increase of \$0.4 million in occupancy and furniture and equipment costs during the first six months of 2008 when compared to the same time period in 2007, in large part due to the opening of our new facility in Lansing during the second quarter of 2007 and the Oakland County expansion. Costs associated with the administration and resolution of problem assets, including legal costs, property tax payments, appraisals and write-downs on foreclosed properties, totaled \$1.5 million during the first six months of 2008, compared to \$0.2 million during the same time period in 2007. Write-downs on foreclosed properties comprised \$0.9 million of the \$1.5 million expensed during the first six months of 2008.

Due to our loss before federal income tax expense, we recorded a federal income tax benefit during the second quarter and first six months of 2008. During the second quarter of 2008, we recorded a loss before federal income tax of \$4.6 million and a federal income tax benefit of \$2.0 million, compared to net income before federal income tax of \$3.0 million and federal income tax expense of \$0.8 million during the second quarter of 2007. During the first six months of 2008, we recorded a loss before federal income tax of \$10.8 million and a federal income tax benefit of \$4.4 million, compared to net income before federal income tax of \$9.1 million and federal income tax expense of \$2.6 million during the same time period in 2007. Our effective tax rate during the second quarter of 2008 was (43.5%), compared to 25.5% during the second quarter of 2007. Our effective tax rate during the first six months of 2008 was (41.1%), compared to 28.6% during the same time period in 2007. The differences in effective tax rates primarily reflect the significant difference in income before federal income tax expense (benefit), and the relationship of tax-exempt income to income (loss) before federal income tax expense (benefit).

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## MERCANTILE BANK CORPORATION

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

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

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, we assess the existing and potential future effects of changes in interest rates on our financial condition, including capital adequacy, earnings, liquidity and asset quality. Our interest rate risk policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within policy parameters. During the first six months of 2008, we entered into interest rate swaps to convert the variable rate cash flows on certain of our prime-based commercial loans to a fixed rate of interest. Further discussion of our use of, and the accounting for, interest rate swaps is included in Notes 1 and 9 to the Consolidated Financial Statements.

We use two interest rate risk measurement techniques. The first, which is commonly referred to as GAP analysis, measures the difference between the dollar amounts of interest sensitive assets and liabilities that will be refinanced or repriced during a given time period. A significant repricing gap could result in a negative impact to our net interest margin during periods of changing market interest rates. The following table depicts our GAP position as of June 30, 2008 (dollars in thousands):

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## MERCANTILE BANK CORPORATION

	Within Three Months	Three to Twelve Months	One to Five Years	After Five Years	Total
<b>Assets:</b>					
Commercial loans and leases <sup>(1)</sup>	\$ 976,935	\$ 67,643	\$ 600,458	\$ 60,701	\$ 1,705,737
Residential real estate loans	54,347	7,634	55,936	12,243	130,160
Consumer loans	1,382	686	2,258	570	4,896
Investment securities <sup>(2)</sup>	16,089	1,689	36,065	153,930	207,773
Short term investments	137	0	0	0	137
Allowance for loan and lease losses	0	0	0	0	(31,881)
Other assets	0	0	0	0	146,532
<b>Total assets</b>	<b>1,048,890</b>	<b>77,652</b>	<b>694,717</b>	<b>227,444</b>	<b>2,163,354</b>
<b>Liabilities:</b>					
Interest-bearing checking	43,338	0	0	0	43,338
Savings	64,703	0	0	0	64,703
Money market accounts	13,788	0	0	0	13,788
Time deposits < \$100,000	44,293	92,378	47,114	0	183,785
Time deposits \$100,000 and over	341,073	595,413	171,497	0	1,107,983
Short term borrowings	98,300	0	0	0	98,300
FHLB advances	5,000	65,000	215,000	0	285,000
Long term borrowings	37,235	0	10,000	0	47,235
Noninterest-bearing checking	0	0	0	0	131,107
Other liabilities	0	0	0	0	20,402
<b>Total liabilities</b>	<b>647,730</b>	<b>752,791</b>	<b>443,611</b>	<b>0</b>	<b>1,995,641</b>
Shareholders' equity	0	0	0	0	167,713
<b>Total sources of funds</b>	<b>647,730</b>	<b>752,791</b>	<b>443,611</b>	<b>0</b>	<b>2,163,354</b>
<b>Net asset (liability) GAP</b>	<b>\$ 401,160</b>	<b>\$ (675,139)</b>	<b>\$ 251,106</b>	<b>\$ 227,444</b>	
<b>Cumulative GAP</b>	<b>\$ 401,160</b>	<b>\$ (273,979)</b>	<b>\$ (22,873)</b>	<b>\$ 204,571</b>	
<b>Percent of cumulative GAP to total assets</b>	<b>18.5%</b>	<b>(12.7)%</b>	<b>(1.1)%</b>	<b>9.5%</b>	

(1) Floating rate  
loans that are  
currently at  
interest rate

floors are treated as fixed rate loans and are reflected using maturity date and not next repricing date.

- (2) Mortgage-backed securities are categorized by expected final maturities based upon prepayment trends as of June 30, 2008.

The second interest rate risk measurement we use is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, serves as our primary interest rate risk measurement technique. The simulation model assesses the direction and magnitude of variations in net interest income resulting from potential changes in market interest rates. Key assumptions in the model include prepayment speeds on various loan and investment assets; cash flows and maturities of interest-sensitive assets and liabilities; and changes in market conditions impacting loan and deposit volume and pricing. These assumptions are inherently uncertain, subject to fluctuation and revision in a dynamic environment; therefore, the model cannot precisely estimate net interest income or exactly predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to the timing, magnitude, and frequency of interest rate changes and changes in market conditions and the company's strategies, among other factors.

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## MERCANTILE BANK CORPORATION

We conducted multiple simulations as of June 30, 2008, whereby it was assumed that changes in market interest rates occurred ranging from up 200 basis points to down 200 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on our net interest income over the next twelve months, which are well within our policy parameters established to manage and monitor interest rate risk.

Interest Rate Scenario	Dollar Change In Net Interest Income	Percent Change In Net Interest Income
Interest rates down 200 basis points	\$ 1,734,000	3.8%
Interest rates down 100 basis points	3,710,000	8.1
No change in interest rates	5,351,000	11.7
Interest rates up 100 basis points	7,090,000	15.5
Interest rates up 200 basis points	8,801,000	19.2

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

During the past three quarters, we have experienced a significant reduction in our net interest income due to the substantial decline in the interest rate environment, resulting from our near term asset sensitive position whereby we have had a higher magnitude of assets reprice when compared to the level of liabilities that have repriced. During the remainder of 2008 and into 2009, we have a high volume of fixed rate certificates of deposit and FHLB advances scheduled to mature that were obtained during periods of higher interest rate environments. As these instruments mature and are replaced with similar instruments at much lower interest rates, we anticipate a significant reduction in interest expense and a substantial improvement in net interest income in future periods.

**Item 4. Controls and Procedures**

As of June 30, 2008, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of June 30, 2008. There have been no significant changes in our internal controls over financial reporting during the quarter ended June 30, 2008 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

There have been no material changes in our risk factors from those previously disclosed in our annual report on Form 10-K for the year ended December 31, 2007.

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

Most of our employees are eligible to participate in our Mercantile Bank of Michigan 401(k) Plan. Participants may elect to make contributions to the plan, and each plan year we provide for each eligible participant a limited matching contribution. Participants may elect to have contributions invested in our common stock or other specified investments. From approximately December 14, 2007 through July 10, 2008, our employees who elected to do so, purchased in the aggregate approximately 108,747 shares of our common stock pursuant to the plan for approximately \$1.2 million in aggregate amount. All of the shares were acquired by the plan in the open market, and none were purchased from us. Purchases were made at the market price at the time of the purchase, and the shares were allocated to the accounts of the participants. We received no portion of the purchase price for the shares. The shares of our common stock purchased by participants pursuant to the plan are generally registered by us and the plan on a Form S-8 registration statement under the Securities Act of 1933. However, during the period from approximately December 14, 2007 through July 10, 2008 there were not enough shares registered to cover the purchases of our common stock that were made under the plan. On July 10, 2008, we and the plan filed an S-8 registration statement registering an additional 500,000 shares for the plan. Of the additional 500,000 shares, up to 391,253 of the shares will be available for purchase under the plan on and after July 10, 2008; with the remaining 108,747 shares being attributed to prior purchases under the plan.

**Item 3. Defaults upon Senior Securities.**

Not applicable.

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

At our Annual Meeting held on April 24, 2008, our shareholders voted to elect five directors, Betty S. Burton, David M. Cassard, Peter A. Cordes, David M. Hecht and Merle J. Prins, each for a three year term expiring at the Annual Meeting of the shareholders of the company in 2011. The results of the election were as follows:

Nominee	Votes For	Votes Withheld	Abstentions	Broker Non-Votes
Betty S. Burton	7,414,930	480,388	0	0
David M. Cassard	7,395,844	499,475	0	0
Peter A. Cordes	7,491,157	404,162	0	0
David M. Hecht	7,646,842	248,477	0	0
Merle J. Prins	7,614,435	280,884	0	0



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The terms of office of the following directors (who were not up for election) continued after the Annual Meeting: Edward J. Clark, C. John Gill, Doyle A. Hayes, Susan K. Jones, Lawrence W. Larsen, Calvin D. Murdock, Michael H. Price, Timothy O. Schad, Dale J. Visser and Donald Williams, Sr.

Also at our Annual Meeting held on April 24, 2008, our shareholders voted to approve an amendment to our Articles of Incorporation to provide for an annual election of all directors. Previously, our Board of Directors was divided into three classes, and members were elected to serve for staggered three-year terms. The amendment provides for the phased-in elimination of the classification of our Board and the annual election of all directors. The directors elected at the 2009 annual meeting and at later annual meetings will be elected to one-year terms. The amendment did not shorten the existing term of any director elected prior to the 2009 annual meeting. The results of the vote were as follows:

Votes For	Votes Against	Abstentions	Broker Non-Votes
7,680,982	200,990	13,347	0

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits**

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

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on August 8, 2008.

MERCANTILE BANK CORPORATION

By: /s/ Michael H. Price

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

By: /s/ Charles E. Christmas

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

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