

MERCANTILE BANK CORP

Form 10-Q

November 08, 2011

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# U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

## FORM 10-Q

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

For the quarterly period ended September 30, 2011

.. **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)

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**Michigan**  
(State or other jurisdiction of  
incorporation or organization)

**38-3360865**  
(IRS Employer Identification No.)

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

(Address of principal executive offices) (Zip Code)

**(616) 406-3000**

(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

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

Yes ☒ No ☐

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

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐

Smaller reporting company ☒

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

Yes ☐ No ☒

At November 8, 2011, there were 8,604,906 shares of Common Stock outstanding.

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## MERCANTILE BANK CORPORATION

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## CONSOLIDATED BALANCE SHEETS

|                                                                                                                                   | September 30,<br>2011<br>(Unaudited) | December 31,<br>2010<br>(Audited) |
|-----------------------------------------------------------------------------------------------------------------------------------|--------------------------------------|-----------------------------------|
| <b>ASSETS</b>                                                                                                                     |                                      |                                   |
| Cash and due from banks                                                                                                           | \$ 18,890,000                        | \$ 6,674,000                      |
| Interest-bearing deposit balances                                                                                                 | 9,630,000                            | 9,600,000                         |
| Federal funds sold                                                                                                                | 97,183,000                           | 47,924,000                        |
| Total cash and cash equivalents                                                                                                   | 125,703,000                          | 64,198,000                        |
| Securities available for sale                                                                                                     | 173,134,000                          | 220,830,000                       |
| Federal Home Loan Bank stock                                                                                                      | 11,961,000                           | 14,345,000                        |
| Loans                                                                                                                             | 1,094,037,000                        | 1,262,630,000                     |
| Allowance for loan losses                                                                                                         | (39,351,000)                         | (45,368,000)                      |
| Loans, net                                                                                                                        | 1,054,686,000                        | 1,217,262,000                     |
| Premises and equipment, net                                                                                                       | 26,865,000                           | 27,873,000                        |
| Bank owned life insurance                                                                                                         | 48,083,000                           | 46,743,000                        |
| Accrued interest receivable                                                                                                       | 4,887,000                            | 5,942,000                         |
| Other real estate owned and repossessed assets                                                                                    | 17,287,000                           | 16,675,000                        |
| Other assets                                                                                                                      | 15,379,000                           | 18,553,000                        |
| Total assets                                                                                                                      | \$ 1,477,985,000                     | \$ 1,632,421,000                  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                                                       |                                      |                                   |
| Deposits                                                                                                                          |                                      |                                   |
| Noninterest-bearing                                                                                                               | \$ 144,022,000                       | \$ 112,944,000                    |
| Interest-bearing                                                                                                                  | 1,041,311,000                        | 1,160,888,000                     |
| Total deposits                                                                                                                    | 1,185,333,000                        | 1,273,832,000                     |
| Securities sold under agreements to repurchase                                                                                    | 69,340,000                           | 116,979,000                       |
| Federal Home Loan Bank advances                                                                                                   | 45,000,000                           | 65,000,000                        |
| Subordinated debentures                                                                                                           | 32,990,000                           | 32,990,000                        |
| Other borrowed money                                                                                                              | 1,714,000                            | 11,804,000                        |
| Accrued interest and other liabilities                                                                                            | 6,875,000                            | 5,880,000                         |
| Total liabilities                                                                                                                 | 1,341,252,000                        | 1,506,485,000                     |
| Shareholders' equity                                                                                                              |                                      |                                   |
| Preferred stock, no par value; 1,000,000 shares authorized; 21,000 shares outstanding at September 30, 2011 and December 31, 2010 | 20,266,000                           | 20,077,000                        |
|                                                                                                                                   | 172,834,000                          | 172,677,000                       |

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Common stock, no par value; 20,000,000 shares authorized; 8,605,053 shares outstanding at September 30, 2011 and 8,597,993 shares outstanding at December 31, 2010

|                                                |                      |                      |
|------------------------------------------------|----------------------|----------------------|
| Common stock warrant                           | 1,138,000            | 1,138,000            |
| Retained earnings (deficit)                    | (62,630,000)         | (68,781,000)         |
| Accumulated other comprehensive income         | 5,125,000            | 825,000              |
| <br>Total shareholders' equity                 | <br>136,733,000      | <br>125,936,000      |
| <br>Total liabilities and shareholders' equity | <br>\$ 1,477,985,000 | <br>\$ 1,632,421,000 |

See accompanying notes to consolidated financial statements.

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## MERCANTILE BANK CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

|                                                            | Three Months<br>Ended<br>Sept 30, 2011<br>(Unaudited) | Three Months<br>Ended<br>Sept 30, 2010<br>(Unaudited) | Nine Months<br>Ended<br>Sept 30, 2011<br>(Unaudited) | Nine Months<br>Ended<br>Sept 30, 2010<br>(Unaudited) |
|------------------------------------------------------------|-------------------------------------------------------|-------------------------------------------------------|------------------------------------------------------|------------------------------------------------------|
| <b>Interest income</b>                                     |                                                       |                                                       |                                                      |                                                      |
| Loans, including fees                                      | \$ 14,951,000                                         | \$ 19,284,000                                         | \$ 47,854,000                                        | \$ 59,755,000                                        |
| Securities, taxable                                        | 1,588,000                                             | 1,901,000                                             | 5,285,000                                            | 5,923,000                                            |
| Securities, tax-exempt                                     | 439,000                                               | 497,000                                               | 1,368,000                                            | 1,802,000                                            |
| Federal funds sold                                         | 60,000                                                | 41,000                                                | 138,000                                              | 110,000                                              |
| Interest-bearing deposit balances                          | 6,000                                                 | 11,000                                                | 18,000                                               | 29,000                                               |
| <b>Total interest income</b>                               | <b>17,044,000</b>                                     | <b>21,734,000</b>                                     | <b>54,663,000</b>                                    | <b>67,619,000</b>                                    |
| <b>Interest expense</b>                                    |                                                       |                                                       |                                                      |                                                      |
| Deposits                                                   | 4,040,000                                             | 5,636,000                                             | 13,007,000                                           | 18,125,000                                           |
| Short-term borrowings                                      | 73,000                                                | 394,000                                               | 350,000                                              | 1,091,000                                            |
| Federal Home Loan Bank advances                            | 410,000                                               | 1,441,000                                             | 1,622,000                                            | 4,713,000                                            |
| Other borrowings                                           | 226,000                                               | 328,000                                               | 782,000                                              | 1,029,000                                            |
| <b>Total interest expense</b>                              | <b>4,749,000</b>                                      | <b>7,799,000</b>                                      | <b>15,761,000</b>                                    | <b>24,958,000</b>                                    |
| <b>Net interest income</b>                                 | <b>12,295,000</b>                                     | <b>13,935,000</b>                                     | <b>38,902,000</b>                                    | <b>42,661,000</b>                                    |
| Provision for loan losses                                  | 1,100,000                                             | 10,400,000                                            | 5,000,000                                            | 25,000,000                                           |
| <b>Net interest income after provision for loan losses</b> | <b>11,195,000</b>                                     | <b>3,535,000</b>                                      | <b>33,902,000</b>                                    | <b>17,661,000</b>                                    |
| <b>Noninterest income</b>                                  |                                                       |                                                       |                                                      |                                                      |
| Services charges on accounts                               | 405,000                                               | 452,000                                               | 1,228,000                                            | 1,365,000                                            |
| Earnings on bank owned life insurance                      | 452,000                                               | 445,000                                               | 1,340,000                                            | 1,310,000                                            |
| Rental income from other real estate owned                 | 208,000                                               | 362,000                                               | 599,000                                              | 1,153,000                                            |
| Mortgage banking activities                                | 195,000                                               | 346,000                                               | 453,000                                              | 576,000                                              |
| Net gain on sales of securities                            | 0                                                     | 0                                                     | 0                                                    | 476,000                                              |
| Gain on sales of commercial loans                          | 0                                                     | 99,000                                                | 0                                                    | 324,000                                              |
| Other income                                               | 544,000                                               | 585,000                                               | 1,639,000                                            | 1,736,000                                            |
| <b>Total noninterest income</b>                            | <b>1,804,000</b>                                      | <b>2,289,000</b>                                      | <b>5,259,000</b>                                     | <b>6,940,000</b>                                     |
| <b>Noninterest expense</b>                                 |                                                       |                                                       |                                                      |                                                      |
| Salaries and benefits                                      | 4,636,000                                             | 4,649,000                                             | 13,371,000                                           | 13,874,000                                           |
| Occupancy                                                  | 707,000                                               | 696,000                                               | 2,116,000                                            | 2,169,000                                            |
| Furniture and equipment depreciation, rent and maintenance | 305,000                                               | 358,000                                               | 912,000                                              | 1,163,000                                            |
| Nonperforming asset costs                                  | 1,589,000                                             | 2,895,000                                             | 6,637,000                                            | 7,859,000                                            |
| FDIC insurance costs                                       | 639,000                                               | 1,097,000                                             | 2,274,000                                            | 3,450,000                                            |
| Other expense                                              | 2,099,000                                             | 2,204,000                                             | 6,689,000                                            | 6,459,000                                            |
| <b>Total noninterest expenses</b>                          | <b>9,975,000</b>                                      | <b>11,899,000</b>                                     | <b>31,999,000</b>                                    | <b>34,974,000</b>                                    |

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|                                                                  |              |                |              |                |
|------------------------------------------------------------------|--------------|----------------|--------------|----------------|
| <b>Income (loss) before federal income tax expense (benefit)</b> | 3,024,000    | (6,075,000)    | 7,162,000    | (10,373,000)   |
| Federal income tax expense (benefit)                             | 0            | (718,000)      | 0            | (2,010,000)    |
| Net income (loss)                                                | 3,024,000    | (5,357,000)    | 7,162,000    | (8,363,000)    |
| Preferred stock dividends and accretion                          | 342,000      | 325,000        | 1,011,000    | 966,000        |
| <b>Net income (loss) available to common shareholders</b>        | \$ 2,682,000 | \$ (5,682,000) | \$ 6,151,000 | \$ (9,329,000) |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS (Continued)

(Unaudited)

|                                    | Three Months<br>Ended<br>Sept 30, 2011<br>(Unaudited) | Three Months<br>Ended<br>Sept 30, 2010<br>(Unaudited) | Nine Months<br>Ended<br>Sept 30, 2011<br>(Unaudited) | Nine Months<br>Ended<br>Sept 30, 2010<br>(Unaudited) |
|------------------------------------|-------------------------------------------------------|-------------------------------------------------------|------------------------------------------------------|------------------------------------------------------|
| Basic earnings (loss) per share    | \$ 0.31                                               | \$ (0.67)                                             | \$ 0.72                                              | \$ (1.10)                                            |
| Diluted earnings (loss) per share  | \$ 0.30                                               | \$ (0.67)                                             | \$ 0.69                                              | \$ (1.10)                                            |
| Cash dividends per share           | \$ 0.00                                               | \$ 0.00                                               | \$ 0.00                                              | \$ 0.01                                              |
| Average basic shares outstanding   | 8,604,263                                             | 8,507,174                                             | 8,602,654                                            | 8,504,664                                            |
| Average diluted shares outstanding | 8,868,122                                             | 8,507,174                                             | 8,875,025                                            | 8,504,664                                            |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

| (\$ in thousands)                                                                        | Preferred<br>Stock | Common<br>Stock | Common<br>Stock<br>Warrant | Retained<br>Earnings<br>(Deficit) | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
|------------------------------------------------------------------------------------------|--------------------|-----------------|----------------------------|-----------------------------------|-----------------------------------------------------------|----------------------------------|
| <b>Balances, January 1, 2011</b>                                                         | \$ 20,077          | \$ 172,677      | \$ 1,138                   | \$ (68,781)                       | \$ 825                                                    | \$ 125,936                       |
| Accretion of preferred stock                                                             | 189                |                 |                            | (189)                             |                                                           | 0                                |
| Employee stock purchase plan (3,531 shares)                                              |                    | 30              |                            |                                   |                                                           | 30                               |
| Stock option exercises (8,800 shares)                                                    |                    | 55              |                            |                                   |                                                           | 55                               |
| Dividend reinvestment plan (644 shares)                                                  |                    | 6               |                            |                                   |                                                           | 6                                |
| Stock-based compensation expense                                                         |                    | 66              |                            |                                   |                                                           | 66                               |
| Preferred stock dividends                                                                |                    |                 |                            | (822)                             |                                                           | (822)                            |
| Comprehensive income (loss):                                                             |                    |                 |                            |                                   |                                                           |                                  |
| Net income for the period from January 1, 2011 through September 30, 2011                |                    |                 |                            | 7,162                             |                                                           | 7,162                            |
| Change in net unrealized gain on securities available for sale, net of reclassifications |                    |                 |                            |                                   | 4,300                                                     | 4,300                            |
| <b>Total comprehensive income</b>                                                        |                    |                 |                            |                                   |                                                           | <b>11,462</b>                    |
| <b>Balances, September 30, 2011</b>                                                      | \$ 20,266          | \$ 172,834      | \$ 1,138                   | \$ (62,630)                       | \$ 5,125                                                  | \$ 136,733                       |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

| (\$ in thousands)                                                                                            | Preferred<br>Stock | Common<br>Stock | Common<br>Stock<br>Warrant | Retained<br>Earnings<br>(Deficit) | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
|--------------------------------------------------------------------------------------------------------------|--------------------|-----------------|----------------------------|-----------------------------------|-----------------------------------------------------------|----------------------------------|
| <b>Balances, January 1, 2010</b>                                                                             | \$ 19,839          | \$ 172,438      | \$ 1,138                   | \$ (54,170)                       | \$ 859                                                    | \$ 140,104                       |
| Accretion of preferred stock                                                                                 | 177                |                 |                            | (177)                             |                                                           | 0                                |
| Employee stock purchase plan (7,702 shares)                                                                  |                    | 35              |                            |                                   |                                                           | 35                               |
| Dividend reinvestment plan (687 shares)                                                                      |                    | 2               |                            |                                   |                                                           | 2                                |
| Stock-based compensation expense                                                                             |                    | 378             |                            |                                   |                                                           | 378                              |
| Cash dividends (\$0.01 per common share)                                                                     |                    | (85)            |                            |                                   |                                                           | (85)                             |
| Preferred stock dividends                                                                                    |                    |                 |                            | (790)                             |                                                           | (790)                            |
| Comprehensive income (loss):                                                                                 |                    |                 |                            |                                   |                                                           |                                  |
| Net loss for the period from January 1, 2010 through September 30, 2010                                      |                    |                 |                            | (8,363)                           |                                                           | (8,363)                          |
| Change in net unrealized gain on securities available for sale, net of reclassifications and tax effect      |                    |                 |                            |                                   | 3,243                                                     | 3,243                            |
| Net unrealized gain on securities transferred from held to maturity to available for sale, net of tax effect |                    |                 |                            |                                   | 274                                                       | 274                              |
| Reclassification of unrealized gain on interest rate swaps, net of tax effect                                |                    |                 |                            |                                   | (64)                                                      | (64)                             |
| <b>Total comprehensive loss</b>                                                                              |                    |                 |                            |                                   |                                                           | (4,910)                          |
| <b>Balances, September 30, 2010</b>                                                                          | \$ 20,016          | \$ 172,768      | \$ 1,138                   | \$ (63,500)                       | \$ 4,312                                                  | \$ 134,734                       |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

|                                                                                  | Nine Months<br>Ended<br>Sept 30, 2011 | Nine Months<br>Ended<br>Sept 30, 2010 |
|----------------------------------------------------------------------------------|---------------------------------------|---------------------------------------|
| <b>Cash flows from operating activities</b>                                      |                                       |                                       |
| Net income (loss)                                                                | \$ 7,162,000                          | \$ (8,363,000)                        |
| Adjustments to reconcile net income (loss) to net cash from operating activities |                                       |                                       |
| Depreciation and amortization                                                    | 1,694,000                             | 1,875,000                             |
| Provision for loan losses                                                        | 5,000,000                             | 25,000,000                            |
| Stock-based compensation expense                                                 | 66,000                                | 378,000                               |
| Proceeds from sales of mortgage loans held for sale                              | 29,603,000                            | 35,800,000                            |
| Origination of mortgage loans held for sale                                      | (31,349,000)                          | (38,878,000)                          |
| Net gain from sales of mortgage loans held for sale                              | (338,000)                             | (425,000)                             |
| Gain from sale of commercial loans                                               | 0                                     | (324,000)                             |
| Net gain from sale of held to maturity securities                                | 0                                     | (476,000)                             |
| Net loss from sale and valuation write-down of foreclosed assets                 | 1,318,000                             | 3,067,000                             |
| Recognition of unrealized gain on interest rate swaps                            | 0                                     | (99,000)                              |
| Earnings on bank owned life insurance                                            | (1,340,000)                           | (1,310,000)                           |
| Net change in:                                                                   |                                       |                                       |
| Accrued interest receivable                                                      | 1,055,000                             | 945,000                               |
| Other assets                                                                     | 2,599,000                             | 899,000                               |
| Accrued expenses and other liabilities                                           | 173,000                               | (1,784,000)                           |
| Net cash from operating activities                                               | 15,643,000                            | 16,305,000                            |
| <b>Cash flows from investing activities</b>                                      |                                       |                                       |
| Loan originations and payments, net                                              | 149,809,000                           | 170,466,000                           |
| Purchases of:                                                                    |                                       |                                       |
| Securities available for sale                                                    | (3,072,000)                           | (71,526,000)                          |
| Proceeds from:                                                                   |                                       |                                       |
| Maturities, calls and repayments of available for sale securities                | 55,179,000                            | 84,491,000                            |
| Sales of held to maturity securities                                             | 0                                     | 20,452,000                            |
| Redemption of Federal Home Loan Bank stock                                       | 2,384,000                             | 0                                     |
| Proceeds from sales of commercial loans                                          | 0                                     | 7,395,000                             |
| Proceeds from sales of foreclosed assets                                         | 7,921,000                             | 9,271,000                             |
| Purchases of premises and equipment, net                                         | (222,000)                             | (84,000)                              |
| Net cash from investing activities                                               | 211,999,000                           | 220,465,000                           |
| <b>Cash flows from financing activities</b>                                      |                                       |                                       |
| Net decrease in time deposits                                                    | (133,202,000)                         | (190,595,000)                         |
| Net increase in all other deposits                                               | 44,703,000                            | 140,832,000                           |
| Net increase (decrease) in securities sold under agreements to repurchase        | (47,639,000)                          | 16,486,000                            |
| Net decrease in federal funds purchased                                          | 0                                     | (2,600,000)                           |
| Maturities and prepayments of Federal Home Loan Bank advances                    | (20,000,000)                          | (45,000,000)                          |
| Maturities of wholesale repurchase agreements                                    | (10,000,000)                          | (5,000,000)                           |
| Net decrease in other borrowed money                                             | (90,000)                              | (59,000)                              |

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|                                              |               |              |
|----------------------------------------------|---------------|--------------|
| Proceeds from stock option exercises         | 55,000        | 0            |
| Employee stock purchase plan                 | 30,000        | 35,000       |
| Dividend reinvestment plan                   | 6,000         | 2,000        |
| Payment of cash dividends on preferred stock | 0             | (525,000)    |
| Payment of cash dividends on common shares   | 0             | (85,000)     |
| Net cash for financing activities            | (166,137,000) | (86,509,000) |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

|                                                   | Nine Months<br>Ended<br>Sept 30, 2011 | Nine Months<br>Ended<br>Sept 30, 2010 |
|---------------------------------------------------|---------------------------------------|---------------------------------------|
| Net change in cash and cash equivalents           | 61,505,000                            | 150,261,000                           |
| Cash and cash equivalents at beginning of period  | 64,198,000                            | 21,735,000                            |
| Cash and cash equivalents at end of period        | \$ 125,703,000                        | \$ 171,996,000                        |
| Supplemental disclosures of cash flow information |                                       |                                       |
| Cash paid during the period for:                  |                                       |                                       |
| Interest                                          | \$ 15,503,000                         | \$ 26,741,000                         |
| Federal income tax                                | 0                                     | 0                                     |
| Noncash financing and investing activities:       |                                       |                                       |
| Transfers from loans to foreclosed assets         | 9,851,000                             | 7,626,000                             |
| Preferred stock cash dividend accrued             | 1,488,000                             | 398,000                               |

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 nine months ended September 30, 2011 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ( our bank ) and our bank s three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ), and Mercantile Insurance Center, Inc. ( our insurance center ). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended September 30, 2011 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2010.

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

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

Approximately 70,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2011. In addition, stock options and a stock warrant for approximately 48,000 and 616,000 shares of common stock, respectively, were included in determining diluted earnings per share for the three and nine months ended September 30, 2011. Stock options for approximately 197,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2011.

Due to our net loss for the 2010 periods, approximately 87,000 unvested restricted shares were not included in determining both basic and diluted earnings per share for the three and nine months ended September 30, 2010. In addition, stock options and a stock warrant for approximately 283,000 and 616,000 shares of common stock, respectively, were antidilutive and not included in determining diluted earnings per share for the three and nine months ended September 30, 2010. Weighted average diluted common shares outstanding equals the weighted average common shares outstanding during the three and nine months ended September 30, 2010 due to the net loss recorded during those time periods.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

**Derivatives:** Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. Used as part of our asset and liability management to help manage interest rate risk, our derivatives have historically consisted of interest rate swap agreements that qualified for hedge accounting. In June 2011, we simultaneously purchased and sold an interest rate cap, a structure commonly referred to as a "cap corridor", which does not qualify for hedge accounting. We do not use derivatives for trading purposes.

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

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

**Adoption of New Accounting Standards:** In January 2010, the Financial Accounting Standards Board (FASB) issued ASU 2010-06, *Improving Disclosure about Fair Value Measurements*. This ASU requires new disclosures on the amount and reason for transfers in and out of Level 1 and Level 2 recurring fair value measurements. The ASU also requires disclosure of activities (i.e., on a gross basis), including purchases, sales, issuances, and settlements, in the reconciliation of Level 3 recurring fair value measurements. The ASU clarifies existing disclosure requirements on levels of disaggregation and disclosures about inputs and valuation techniques. The new disclosure regarding Level 1 and Level 2 recurring fair value measurements and clarification of existing disclosures were effective beginning January 1, 2010. Upon adoption of those portions of the ASU in our 2010 first quarter, we began providing the required disclosures as currently presented in Note 11. The disclosures about the reconciliation of information in Level 3 recurring fair value measurements were required beginning January 1, 2011. There was no effect on our fair value disclosures presented in Note 11 upon adoption of the final portion of the ASU in our 2011 first quarter, as we currently have no Level 3 recurring fair value measurements.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

In April 2011, the FASB issued ASU 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, to clarify when a loan modification or restructuring is considered a TDR. When performing this evaluation under the ASU, a creditor must use judgment to determine whether (1) the debtor (i.e., the borrower) is experiencing financial difficulty, and (2) the lender has granted a concession to the borrower. The ASU amends current guidance to include indicators that a lender should consider in determining whether a borrower is experiencing financial difficulties. It further clarifies that a borrower could be experiencing financial difficulty even if it is not currently in default but default is probable in the foreseeable future. With respect to whether the lender has granted a concession to the borrower, the ASU indicates (1) a borrower's inability to access funds at a market interest rate for debt with similar risk characteristics as the restructured debt indicates that the modification was executed at a below-market rate and therefore may indicate a concession was granted, (2) a modification that permanently or temporarily increases a loan's contractual interest rate does not preclude it from being considered a concession because the rate may still be below the market interest rate for new debt with similar risk characteristics, and (3) a modification that results in a delay in payment that is insignificant is not considered to be a concession. The ASU also clarifies that a creditor is precluded from using the borrower's effective interest rate test when performing this evaluation. For TDR identification and disclosure purposes, the guidance became effective for our 2011 third quarter and was applied retrospectively to modifications occurring on or after January 1, 2011 that remained outstanding at September 30, 2011. The effect of the change in the method of calculating impairment was reflected in our 2011 third quarter. The ASU requires disclosure of the total recorded investment and allowance for loan losses for newly identified TDRs, based on the new guidance, as of September 30, 2011. Beginning in our 2011 third quarter, we disclosed the previously deferred TDR activity related disclosures required by ASU 2010-20 in Note 3.

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, to align the fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRSs). Many of the amendments in this ASU will not result in a change in requirements but simply clarify existing requirements. The amendments in this ASU that do not change a principle or requirement for measuring fair value or disclosing information about fair value measurements include the following: (1) the ASU permits an exception for measuring fair value when a reporting entity manages its financial instruments on the basis of its net exposure, rather than gross exposure, to those risks; (2) the ASU clarifies that the application of premiums and discounts in a fair value measurement is related to the unit of account for the asset or liability being measured at fair value and specifically prohibits blockage discounts for Level 2 and 3 investments; and (3) the amendments expand fair value measurement disclosures. The more significant new disclosures include: (1) for all Level 3 fair value measurements, quantitative information about significant unobservable inputs used as well as a qualitative discussion about the sensitivity of recurring Level 3 fair value measurements; (2) transfers between Level 1 and Level 2 fair value measurements on a gross basis, including the reasons for those transfers; and (3) the categorization by level of the fair value hierarchy for items that are not measured at fair value in the balance sheet but for which the fair value is required to be disclosed (e.g., held-to-maturity securities and loans). The ASU is to be applied prospectively and is effective January 1, 2012. We do not expect the adoption of this new ASU to have a material effect on our results of operations or financial position.

In June 2011, the FASB issued ASU 2011-05, *Presentation of Comprehensive Income*, to improve the comparability, consistency and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income. The ASU eliminates the option to present components of other comprehensive income as part of the Statement of Changes in Shareholders' Equity. Instead, all changes in shareholders' equity must be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the single continuous statement approach, the statement should present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income. In the two-statement approach, the first statement should present the components of net income and total net income followed consecutively by a second statement that should present the components of other comprehensive income, a total for other comprehensive income and a total for comprehensive income. Also known as recycling, companies will also be required to display reclassification adjustments and their effect on net income and other comprehensive income in the statement(s) in which they appear. The ASU does not change certain other current requirements including items that constitute net income and other comprehensive income. The ASU is to be applied retrospectively and is effective January 1, 2012. We are currently evaluating the two presentation approaches permitted by the ASU. On October 21, 2011, the FASB decided to defer the above-described presentation of reclassification adjustments until further consideration.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES**

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

|                                         | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value  |
|-----------------------------------------|-------------------|------------------------------|-------------------------------|----------------|
| <b><u>September 30, 2011</u></b>        |                   |                              |                               |                |
| U.S. Government agency debt obligations | \$ 82,452,000     | \$ 2,136,000                 | \$ (76,000)                   | \$ 84,512,000  |
| Mortgage-backed securities              | 35,235,000        | 3,232,000                    | 0                             | 38,467,000     |
| Michigan Strategic Fund bonds           | 16,955,000        | 0                            | 0                             | 16,955,000     |
| Municipal general obligation bonds      | 26,614,000        | 848,000                      | (4,000)                       | 27,458,000     |
| Municipal revenue bonds                 | 4,301,000         | 98,000                       | 0                             | 4,399,000      |
| Mutual funds                            | 1,294,000         | 49,000                       | 0                             | 1,343,000      |
|                                         | \$ 166,851,000    | \$ 6,363,000                 | \$ (80,000)                   | \$ 173,134,000 |
| <b><u>December 31, 2010</u></b>         |                   |                              |                               |                |
| U.S. Government agency debt obligations | \$ 121,633,000    | \$ 1,704,000                 | \$ (1,775,000)                | \$ 121,562,000 |
| Mortgage-backed securities              | 44,340,000        | 2,601,000                    | 0                             | 46,941,000     |
| Michigan Strategic Fund bonds           | 18,175,000        | 0                            | 0                             | 18,175,000     |
| Municipal general obligation bonds      | 28,594,000        | 227,000                      | (779,000)                     | 28,042,000     |
| Municipal revenue bonds                 | 4,841,000         | 46,000                       | (44,000)                      | 4,843,000      |
| Mutual funds                            | 1,264,000         | 3,000                        | 0                             | 1,267,000      |
|                                         | \$ 218,847,000    | \$ 4,581,000                 | \$ (2,598,000)                | \$ 220,830,000 |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES (Continued)**

Securities with unrealized losses at September 30, 2011 and December 31, 2010, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

|                                         | Less than 12 Months<br>Fair<br>Value | Unrealized<br>Loss | 12 Months or More<br>Fair<br>Value | Unrealized<br>Loss | Fair<br>Value | Total<br>Unrealized<br>Loss |
|-----------------------------------------|--------------------------------------|--------------------|------------------------------------|--------------------|---------------|-----------------------------|
| <b><u>September 30, 2011</u></b>        |                                      |                    |                                    |                    |               |                             |
| U.S. Government agency debt obligations | \$ 12,585,000                        | \$ (76,000)        | \$ 0                               | \$ 0               | \$ 12,585,000 | \$ (76,000)                 |
| Mortgage-backed securities              | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
| Michigan Strategic Fund bonds           | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
| Municipal general obligation bonds      | 0                                    | 0                  | 589,000                            | (4,000)            | 589,000       | (4,000)                     |
| Municipal revenue bonds                 | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
| Mutual funds                            | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
|                                         | \$ 12,585,000                        | \$ (76,000)        | \$ 589,000                         | \$ (4,000)         | \$ 13,174,000 | \$ (80,000)                 |
| <b><u>December 31, 2010</u></b>         |                                      |                    |                                    |                    |               |                             |
| U.S. Government agency debt obligations | \$ 56,588,000                        | \$ (1,775,000)     | \$ 0                               | \$ 0               | \$ 56,588,000 | \$ (1,775,000)              |
| Mortgage-backed securities              | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
| Michigan Strategic Fund bonds           | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
| Municipal general obligation bonds      | 7,847,000                            | (299,000)          | 6,497,000                          | (480,000)          | 14,344,000    | (779,000)                   |
| Municipal revenue bonds                 | 811,000                              | (25,000)           | 805,000                            | (19,000)           | 1,616,000     | (44,000)                    |
| Mutual funds                            | 0                                    | 0                  | 0                                  | 0                  | 0             | 0                           |
|                                         | \$ 65,246,000                        | \$ (2,099,000)     | \$ 7,302,000                       | \$ (499,000)       | \$ 72,548,000 | \$ (2,598,000)              |

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES** (Continued)

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

At September 30, 2011, 10 debt securities with a fair value totaling \$13.2 million have unrealized losses with aggregate depreciation of \$0.1 million, or 0.04% from the amortized cost basis of total securities. At September 30, 2011, 232 debt securities and a mutual fund with a fair value totaling \$142.0 million have unrealized gains with aggregate appreciation of \$6.4 million, or 3.8% from the amortized cost basis of total securities. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no declines are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at September 30, 2011, by contractual maturity, are shown below. The contractual maturity is utilized below for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment fees. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**2. SECURITIES** (Continued)

The maturities of securities and their weighted average yields at September 30, 2011 are also shown in the following table. The yields for municipal securities are included at their tax equivalent yield.

|                               | Weighted<br>Average<br>Yield | Amortized<br>Cost | Fair<br>Value  |
|-------------------------------|------------------------------|-------------------|----------------|
| Due in 2011                   | NA                           | \$ 0              | \$ 0           |
| Due in 2012 through 2016      | 5.09%                        | 6,589,000         | 6,952,000      |
| Due in 2017 through 2021      | 4.43                         | 18,505,000        | 18,859,000     |
| Due in 2022 and beyond        | 4.75                         | 88,273,000        | 90,558,000     |
| Mortgage-backed securities    | 5.14                         | 35,235,000        | 38,467,000     |
| Michigan Strategic Fund bonds | 2.88                         | 16,955,000        | 16,955,000     |
| Mutual funds                  | 2.94                         | 1,294,000         | 1,343,000      |
|                               | 4.61%                        | \$ 166,851,000    | \$ 173,134,000 |

At September 30, 2011, and December 31, 2010, the amortized cost of securities issued by the State of Michigan and all its political subdivisions totaled \$30.9 million and \$33.4 million, respectively, with an estimated market value of \$31.9 million and \$32.9 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements and letters of credit issued on behalf of our customers was \$94.4 million and \$166.9 million at September 30, 2011 and December 31, 2010, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Our total loans at September 30, 2011 were \$1.09 billion compared to \$1.26 billion at December 31, 2010, a decrease of \$168.6 million, or 13.4%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at September 30, 2011 and December 31, 2010, and the percentage change in loans from the end of 2010 to the end of the third quarter of 2011, are as follows:

|                                                             | September 30, 2011      |               | December 31, 2010       |               | Percent Increase (Decrease) |
|-------------------------------------------------------------|-------------------------|---------------|-------------------------|---------------|-----------------------------|
|                                                             | Balance                 | %             | Balance                 | %             |                             |
| <b>Commercial:</b>                                          |                         |               |                         |               |                             |
| Commercial and industrial                                   | \$ 262,972,000          | 24.0%         | \$ 288,515,000          | 22.8%         | (8.9)%                      |
| Vacant land, land development, and residential construction | 64,039,000              | 5.9           | 83,786,000              | 6.6           | (23.6)                      |
| Real estate owner occupied                                  | 266,749,000             | 24.4          | 277,377,000             | 22.0          | (3.8)                       |
| Real estate non-owner occupied                              | 348,929,000             | 31.9          | 449,104,000             | 35.6          | (22.3)                      |
| Real estate multi-family and residential rental             | 70,284,000              | 6.4           | 77,188,000              | 6.1           | (8.9)                       |
| <b>Total commercial</b>                                     | <b>1,012,973,000</b>    | <b>92.6</b>   | <b>1,175,970,000</b>    | <b>93.1</b>   | <b>(13.9)</b>               |
| <b>Retail:</b>                                              |                         |               |                         |               |                             |
| Home equity and other                                       | 44,751,000              | 4.1           | 51,186,000              | 4.1           | (12.6)                      |
| 1-4 family mortgages                                        | 36,313,000              | 3.3           | 35,474,000              | 2.8           | 2.4                         |
| <b>Total retail</b>                                         | <b>81,064,000</b>       | <b>7.4</b>    | <b>86,660,000</b>       | <b>6.9</b>    | <b>(6.5)</b>                |
| <b>Total loans</b>                                          | <b>\$ 1,094,037,000</b> | <b>100.0%</b> | <b>\$ 1,262,630,000</b> | <b>100.0%</b> | <b>(13.4)%</b>              |

Nonperforming loans as of September 30, 2011 and December 31, 2010 were as follows:

|                                                          | September 30, 2011   | December 31, 2010    |
|----------------------------------------------------------|----------------------|----------------------|
| Loans past due 90 days or more still accruing interest   | \$ 0                 | \$ 766,000           |
| Nonaccrual loans, including troubled debt restructurings | 39,540,000           | 63,915,000           |
| Troubled debt restructurings, accruing interest          | 0                    | 4,763,000            |
| <b>Total nonperforming loans</b>                         | <b>\$ 39,540,000</b> | <b>\$ 69,444,000</b> |

As discussed in the Troubled Debt Restructurings section of our Significant Accounting Policies, troubled debt restructurings can be in either accrual or nonaccrual status. Nonaccrual troubled debt restructurings are included in nonperforming loans whereas accruing troubled debt restructurings are generally excluded from nonperforming loans. At September 30, 2011, there were no accruing troubled debt restructurings included in nonperforming loans. At December 31, 2010, we categorized an accruing troubled debt restructured lending relationship as

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nonperforming due to certain circumstances surrounding this particular relationship. That credit relationship has been paid-off.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

|                                                             | September 30,<br>2011 | December 31,<br>2010 |
|-------------------------------------------------------------|-----------------------|----------------------|
| <b>Commercial:</b>                                          |                       |                      |
| Commercial and industrial                                   | \$ 6,755,000          | \$ 10,128,000        |
| Vacant land, land development, and residential construction | 3,108,000             | 12,441,000           |
| Real estate owner occupied                                  | 7,093,000             | 10,172,000           |
| Real estate non-owner occupied                              | 16,206,000            | 22,609,000           |
| Real estate multi-family and residential rental             | 3,048,000             | 4,686,000            |
| <b>Total commercial</b>                                     | <b>36,210,000</b>     | <b>60,036,000</b>    |
| <b>Retail:</b>                                              |                       |                      |
| Home equity and other                                       | 1,630,000             | 2,425,000            |
| 1-4 family mortgages                                        | 1,700,000             | 1,454,000            |
| <b>Total retail</b>                                         | <b>3,330,000</b>      | <b>3,879,000</b>     |
| <b>Total nonaccrual loans</b>                               | <b>\$ 39,540,000</b>  | <b>\$ 63,915,000</b> |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

An age analysis of past due loans is as follows as of September 30, 2011:

|                                                                | 30 - 59<br>Days<br>Past Due | 60 - 89<br>Days<br>Past Due | Greater<br>Than 89<br>Days<br>Past Due | Total<br>Past Due    | Current                 | Total<br>Loans          | Recorded<br>Balance > 89<br>Days<br>and<br>Accruing |
|----------------------------------------------------------------|-----------------------------|-----------------------------|----------------------------------------|----------------------|-------------------------|-------------------------|-----------------------------------------------------|
| <b>Commercial:</b>                                             |                             |                             |                                        |                      |                         |                         |                                                     |
| Commercial and industrial                                      | \$ 258,000                  | \$ 100,000                  | \$ 2,937,000                           | \$ 3,295,000         | \$ 259,677,000          | \$ 262,972,000          | \$ 0                                                |
| Vacant land, land development,<br>and residential construction | 0                           | 0                           | 2,305,000                              | 2,305,000            | 61,734,000              | 64,039,000              | 0                                                   |
| Real estate owner occupied                                     | 141,000                     | 0                           | 3,127,000                              | 3,268,000            | 263,481,000             | 266,749,000             | 0                                                   |
| Real estate non-owner occupied                                 | 1,246,000                   | 0                           | 10,586,000                             | 11,832,000           | 337,097,000             | 348,929,000             | 0                                                   |
| Real estate multi-family and<br>residential rental             | 166,000                     | 0                           | 1,149,000                              | 1,315,000            | 68,969,000              | 70,284,000              | 0                                                   |
| <b>Total commercial</b>                                        | <b>1,811,000</b>            | <b>100,000</b>              | <b>20,104,000</b>                      | <b>22,015,000</b>    | <b>990,958,000</b>      | <b>1,012,973,000</b>    | <b>0</b>                                            |
| <b>Retail:</b>                                                 |                             |                             |                                        |                      |                         |                         |                                                     |
| Home equity and other                                          | 94,000                      | 0                           | 783,000                                | 877,000              | 43,874,000              | 44,751,000              | 0                                                   |
| 1-4 family mortgages                                           | 0                           | 222,000                     | 650,000                                | 872,000              | 35,441,000              | 36,313,000              | 0                                                   |
| <b>Total retail</b>                                            | <b>94,000</b>               | <b>222,000</b>              | <b>1,433,000</b>                       | <b>1,749,000</b>     | <b>79,315,000</b>       | <b>81,064,000</b>       | <b>0</b>                                            |
| <b>Total past due loans</b>                                    | <b>\$ 1,905,000</b>         | <b>\$ 322,000</b>           | <b>\$ 21,537,000</b>                   | <b>\$ 23,764,000</b> | <b>\$ 1,070,273,000</b> | <b>\$ 1,094,037,000</b> | <b>\$ 0</b>                                         |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

|                                                                | 30 59<br>Days<br>Past Due | 60 89<br>Days<br>Past Due | Greater<br>Than 89<br>Days<br>Past Due | Total<br>Past Due | Current          | Total<br>Loans   | Recorded<br>Balance > 89<br>Days and<br>Accruing |
|----------------------------------------------------------------|---------------------------|---------------------------|----------------------------------------|-------------------|------------------|------------------|--------------------------------------------------|
| Commercial:                                                    |                           |                           |                                        |                   |                  |                  |                                                  |
| Commercial and industrial                                      | \$ 280,000                | \$ 2,074,000              | \$ 1,474,000                           | \$ 3,828,000      | \$ 284,687,000   | \$ 288,515,000   | \$ 19,000                                        |
| Vacant land, land development,<br>and residential construction | 0                         | 453,000                   | 3,586,000                              | 4,039,000         | 79,747,000       | 83,786,000       | 0                                                |
| Real estate owner occupied                                     | 1,194,000                 | 574,000                   | 6,497,000                              | 8,265,000         | 269,112,000      | 277,377,000      | 0                                                |
| Real estate non-owner occupied                                 | 164,000                   | 4,341,000                 | 12,520,000                             | 17,025,000        | 432,079,000      | 449,104,000      | 747,000                                          |
| Real estate multi-family and<br>residential rental             | 672,000                   | 0                         | 2,692,000                              | 3,364,000         | 73,824,000       | 77,188,000       | 0                                                |
| Total commercial                                               | 2,310,000                 | 7,442,000                 | 26,769,000                             | 36,521,000        | 1,139,449,000    | 1,175,970,000    | 766,000                                          |
| Retail:                                                        |                           |                           |                                        |                   |                  |                  |                                                  |
| Home equity and other                                          | 1,024,000                 | 179,000                   | 227,000                                | 1,430,000         | 49,756,000       | 51,186,000       | 0                                                |
| 1-4 family mortgages                                           | 365,000                   | 0                         | 316,000                                | 681,000           | 34,793,000       | 35,474,000       | 0                                                |
| Total retail                                                   | 1,389,000                 | 179,000                   | 543,000                                | 2,111,000         | 84,549,000       | 86,660,000       | 0                                                |
| Total past due loans                                           | \$ 3,699,000              | \$ 7,621,000              | \$ 27,312,000                          | \$ 38,632,000     | \$ 1,223,998,000 | \$ 1,262,630,000 | \$ 766,000                                       |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Impaired loans were as follows as of September 30, 2011:

|                                                            | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Principal<br>Balance | Related<br>Allowance | Third Quarter<br>Average<br>Recorded<br>Principal<br>Balance | Year-To-Date<br>Average<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|-----------------------------------------------|----------------------------------|----------------------|--------------------------------------------------------------|-------------------------------------------------------------|
| With no related allowance recorded:                        |                                               |                                  |                      |                                                              |                                                             |
| Commercial:                                                |                                               |                                  |                      |                                                              |                                                             |
| Commercial and industrial                                  | \$ 1,403,000                                  | \$ 1,274,000                     |                      | \$ 1,353,000                                                 | \$ 1,704,000                                                |
| Vacant land, land development and residential construction | 5,493,000                                     | 2,703,000                        |                      | 2,278,000                                                    | 6,387,000                                                   |
| Real estate owner occupied                                 | 5,437,000                                     | 3,547,000                        |                      | 4,071,000                                                    | 4,233,000                                                   |
| Real estate non-owner occupied                             | 14,652,000                                    | 8,836,000                        |                      | 9,286,000                                                    | 12,306,000                                                  |
| Real estate multi-family and residential rental            | 1,681,000                                     | 905,000                          |                      | 1,579,000                                                    | 979,000                                                     |
| Total commercial                                           | 28,666,000                                    | 17,265,000                       |                      | 18,567,000                                                   | 25,609,000                                                  |
| Retail:                                                    |                                               |                                  |                      |                                                              |                                                             |
| Home equity and other                                      | 867,000                                       | 855,000                          |                      | 856,000                                                      | 503,000                                                     |
| 1-4 family mortgages                                       | 342,000                                       | 319,000                          |                      | 363,000                                                      | 228,000                                                     |
| Total retail                                               | 1,209,000                                     | 1,174,000                        |                      | 1,219,000                                                    | 731,000                                                     |
| Total with no related allowance recorded                   | \$ 29,875,000                                 | \$ 18,439,000                    |                      | \$ 19,786,000                                                | \$ 26,340,000                                               |

(Continued)

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

|                                                            | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Principal<br>Balance | Related<br>Allowance | Third Quarter<br>Average<br>Recorded<br>Principal<br>Balance | Year-To-Date<br>Average<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|-----------------------------------------------|----------------------------------|----------------------|--------------------------------------------------------------|-------------------------------------------------------------|
| With an allowance recorded:                                |                                               |                                  |                      |                                                              |                                                             |
| Commercial:                                                |                                               |                                  |                      |                                                              |                                                             |
| Commercial and industrial                                  | \$ 6,128,000                                  | \$ 5,922,000                     | \$ 1,808,000         | \$ 4,886,000                                                 | \$ 6,422,000                                                |
| Vacant land, land development and residential construction | 4,269,000                                     | 3,259,000                        | 1,076,000            | 2,064,000                                                    | 3,814,000                                                   |
| Real estate owner occupied                                 | 6,930,000                                     | 5,385,000                        | 1,523,000            | 4,205,000                                                    | 5,821,000                                                   |
| Real estate non-owner occupied                             | 19,661,000                                    | 13,424,000                       | 3,726,000            | 11,291,000                                                   | 10,650,000                                                  |
| Real estate multi-family and residential rental            | 2,772,000                                     | 2,301,000                        | 410,000              | 2,428,000                                                    | 2,887,000                                                   |
| Total commercial                                           | 39,760,000                                    | 30,291,000                       | 8,543,000            | 24,874,000                                                   | 29,594,000                                                  |
| Retail:                                                    |                                               |                                  |                      |                                                              |                                                             |
| Home equity and other                                      | 737,000                                       | 717,000                          | 312,000              | 753,000                                                      | 1,314,000                                                   |
| 1-4 family mortgages                                       | 968,000                                       | 956,000                          | 269,000              | 778,000                                                      | 932,000                                                     |
| Total retail                                               | 1,705,000                                     | 1,673,000                        | 581,000              | 1,531,000                                                    | 2,246,000                                                   |
| Total with an allowance recorded                           | \$ 41,465,000                                 | \$ 31,964,000                    | \$ 9,124,000         | \$ 26,405,000                                                | \$ 31,840,000                                               |
| Total impaired loans:                                      |                                               |                                  |                      |                                                              |                                                             |
| Commercial                                                 | \$ 68,426,000                                 | \$ 47,556,000                    | \$ 8,543,000         | \$ 43,441,000                                                | \$ 55,203,000                                               |
| Retail                                                     | 2,914,000                                     | 2,847,000                        | 581,000              | 2,750,000                                                    | 2,977,000                                                   |
| Total impaired loans                                       | \$ 71,340,000                                 | \$ 50,403,000                    | \$ 9,124,000         | \$ 46,191,000                                                | \$ 58,180,000                                               |

The adoption of the new troubled debt restructuring guidance effective September 30, 2011 resulted in an increase of \$10.8 million in both the Unpaid Contractual Principal Balance and Recorded Principal Balance figures above, with an associated increase of \$4.2 million in the Related Allowance.

Interest income of \$0.2 million and \$0.7 million was recognized on impaired loans during the third quarter of 2011 and the first nine months of 2011, respectively.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Impaired loans were as follows as of December 31, 2010:

|                                                            | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Principal<br>Balance | Related<br>Allowance |
|------------------------------------------------------------|-----------------------------------------------|----------------------------------|----------------------|
| With no related allowance recorded:                        |                                               |                                  |                      |
| Commercial:                                                |                                               |                                  |                      |
| Commercial and industrial                                  | \$ 3,133,000                                  | \$ 2,135,000                     |                      |
| Vacant land, land development and residential construction | 13,255,000                                    | 10,071,000                       |                      |
| Real estate owner occupied                                 | 9,327,000                                     | 4,920,000                        |                      |
| Real estate non-owner occupied                             | 23,380,000                                    | 15,775,000                       |                      |
| Real estate multi-family and residential rental            | 1,657,000                                     | 1,052,000                        |                      |
| Total commercial                                           | 50,752,000                                    | 33,953,000                       |                      |
| Retail:                                                    |                                               |                                  |                      |
| Home equity and other                                      | 277,000                                       | 151,000                          |                      |
| 1-4 family mortgages                                       | 151,000                                       | 137,000                          |                      |
| Total retail                                               | 428,000                                       | 288,000                          |                      |
| Total with no related allowance recorded                   | \$ 51,180,000                                 | \$ 34,241,000                    |                      |
| With an allowance recorded:                                |                                               |                                  |                      |
| Commercial:                                                |                                               |                                  |                      |
| Commercial and industrial                                  | \$ 7,405,000                                  | \$ 6,922,000                     | \$ 3,554,000         |
| Vacant land, land development and residential construction | 5,702,000                                     | 4,370,000                        | 954,000              |
| Real estate owner occupied                                 | 7,047,000                                     | 6,257,000                        | 1,996,000            |
| Real estate non-owner occupied                             | 13,773,000                                    | 7,875,000                        | 1,091,000            |
| Real estate multi-family and residential rental            | 5,544,000                                     | 3,472,000                        | 909,000              |
| Total commercial                                           | 39,471,000                                    | 28,896,000                       | 8,504,000            |
| Retail:                                                    |                                               |                                  |                      |
| Home equity and other                                      | 1,799,000                                     | 1,910,000                        | 1,007,000            |
| 1-4 family mortgages                                       | 1,141,000                                     | 909,000                          | 191,000              |
| Total retail                                               | 2,940,000                                     | 2,819,000                        | 1,198,000            |

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|                                  |               |               |              |
|----------------------------------|---------------|---------------|--------------|
| Total with an allowance recorded | \$ 42,411,000 | \$ 31,715,000 | \$ 9,702,000 |
| Total impaired loans:            |               |               |              |
| Commercial                       | 90,223,000    | 62,849,000    | 8,504,000    |
| Retail                           | 3,368,000     | 3,107,000     | 1,198,000    |
| Total impaired loans             | \$ 93,591,000 | \$ 65,956,000 | \$ 9,702,000 |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

Loans by credit quality indicators were as follows as of September 30, 2011:

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

|                                       | Commercial<br>and<br>Industrial | Commercial<br>Vacant Land,<br>Land Development,<br>and Residential<br>Construction | Commercial<br>Real Estate -<br>Owner<br>Occupied | Commercial<br>Real Estate -<br>Non-Owner<br>Occupied | Commercial<br>Real Estate -<br>Multi-Family<br>and<br>Residential<br>Rental |
|---------------------------------------|---------------------------------|------------------------------------------------------------------------------------|--------------------------------------------------|------------------------------------------------------|-----------------------------------------------------------------------------|
| Internal credit risk grade groupings: |                                 |                                                                                    |                                                  |                                                      |                                                                             |
| Grades 1 - 4                          | \$ 157,192,000                  | \$ 8,594,000                                                                       | \$ 143,620,000                                   | \$ 125,525,000                                       | \$ 29,660,000                                                               |
| Grades 5 - 7                          | 97,597,000                      | 47,858,000                                                                         | 107,680,000                                      | 168,897,000                                          | 26,695,000                                                                  |
| Grades 8 - 9                          | 8,183,000                       | 7,587,000                                                                          | 15,449,000                                       | 54,507,000                                           | 13,929,000                                                                  |
| Total commercial                      | \$ 262,972,000                  | \$ 64,039,000                                                                      | \$ 266,749,000                                   | \$ 348,929,000                                       | \$ 70,284,000                                                               |

Retail credit exposure credit risk profiled by collateral type:

|              | Retail<br>Home Equity<br>and Other | Retail<br>1-4 Family<br>Mortgages |
|--------------|------------------------------------|-----------------------------------|
| Total retail | \$ 44,751,000                      | \$ 36,313,000                     |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Loans by credit quality indicators were as follows as of December 31, 2010:

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

|                                       | Commercial<br>and<br>Industrial | Commercial<br>Vacant Land,<br>Land Development,<br>and Residential<br>Construction | Commercial<br>Real Estate -<br>Owner<br>Occupied | Commercial<br>Real Estate -<br>Non-Owner<br>Occupied | Commercial<br>Real Estate -<br>Multi-Family<br>and<br>Residential<br>Rental |
|---------------------------------------|---------------------------------|------------------------------------------------------------------------------------|--------------------------------------------------|------------------------------------------------------|-----------------------------------------------------------------------------|
| Internal credit risk grade groupings: |                                 |                                                                                    |                                                  |                                                      |                                                                             |
| Grades 1 4                            | \$ 161,623,000                  | \$ 8,098,000                                                                       | \$ 137,340,000                                   | \$ 160,746,000                                       | \$ 29,902,000                                                               |
| Grades 5 7                            | 113,904,000                     | 58,326,000                                                                         | 123,572,000                                      | 249,246,000                                          | 31,852,000                                                                  |
| Grades 8 9                            | 12,988,000                      | 17,362,000                                                                         | 16,465,000                                       | 39,112,000                                           | 15,434,000                                                                  |
| Total commercial                      | \$ 288,515,000                  | \$ 83,786,000                                                                      | \$ 277,377,000                                   | \$ 449,104,000                                       | \$ 77,188,000                                                               |

Retail credit exposure credit risk profiled by collateral type:

|              | Retail<br>Home Equity<br>and Other | Retail<br>1-4 Family<br>Mortgages |
|--------------|------------------------------------|-----------------------------------|
| Total retail | \$ 51,186,000                      | \$ 35,474,000                     |

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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

All commercial loans are graded using the following number system:

- Grade 1. Excellent credit rating that contain very little, if any, risk of loss.
- Grade 2. Strong sources of repayment and have low repayment risk.
- Grade 3. Good sources of repayment and have limited repayment risk.
- Grade 4. Adequate sources of repayment and acceptable repayment risk; however, characteristics are present that render the credit more vulnerable to a negative event.
- Grade 5. Marginally acceptable sources of repayment and exhibit defined weaknesses and negative characteristics.
- Grade 6. Well defined weaknesses which may include negative current cash flow, high leverage, or operating losses. Generally, if the credit does not stabilize or if further deterioration is observed in the near term, the loan will likely be downgraded and placed on the Watch List (i.e., list of lending relationships that receive increased scrutiny and review by the Board of Directors and senior management).
- Grade 7. Defined weaknesses or negative trends that merit close monitoring through Watch List status.
- Grade 8. Inadequately protected by current sound net worth, paying capacity of the obligor, or pledged collateral, resulting in a distinct possibility of loss requiring close monitoring through Watch List status.
- Grade 9. Vital weaknesses exist where collection of principal is highly questionable.
- Grade 10. Considered uncollectable and of such little value that their continuance as an asset is not warranted.

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

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Activity in the allowance for loan losses and the recorded investments in loans as of and during the three and nine months ended September 30, 2011 are as follows:

|                                                       | Commercial<br>Loans | Retail<br>Loans | Unallocated | Total            |
|-------------------------------------------------------|---------------------|-----------------|-------------|------------------|
| <b>Allowance for loan losses:</b>                     |                     |                 |             |                  |
| Balance at June 30, 2011                              | \$ 35,986,000       | \$ 2,641,000    | \$ 93,000   | \$ 38,720,000    |
| Provision for loan losses                             | 586,000             | 533,000         | (19,000)    | 1,100,000        |
| Charge-offs                                           | (1,260,000)         | (82,000)        | 0           | (1,342,000)      |
| Recoveries                                            | 838,000             | 35,000          | 0           | 873,000          |
| Ending balance                                        | \$ 36,150,000       | \$ 3,127,000    | \$ 74,000   | \$ 39,351,000    |
| <b>Allowance for loan losses:</b>                     |                     |                 |             |                  |
| Balance at December 31, 2010                          | \$ 42,358,000       | \$ 2,972,000    | \$ 38,000   | \$ 45,368,000    |
| Provision for loan losses                             | 3,074,000           | 1,890,000       | 36,000      | 5,000,000        |
| Charge-offs                                           | (12,168,000)        | (1,938,000)     | 0           | (14,106,000)     |
| Recoveries                                            | 2,886,000           | 203,000         | 0           | 3,089,000        |
| Ending balance                                        | \$ 36,150,000       | \$ 3,127,000    | \$ 74,000   | \$ 39,351,000    |
| Ending balance: individually evaluated for impairment | \$ 8,543,000        | \$ 581,000      | \$ 0        | \$ 9,124,000     |
| Ending balance: collectively evaluated for impairment | \$ 27,607,000       | \$ 2,546,000    | \$ 74,000   | \$ 30,227,000    |
| <b>Total loans:</b>                                   |                     |                 |             |                  |
| Ending balance                                        | \$ 1,012,973,000    | \$ 81,064,000   |             | \$ 1,094,037,000 |
| Ending balance: individually evaluated for impairment | \$ 47,556,000       | \$ 2,847,000    |             | \$ 50,403,000    |
| Ending balance: collectively evaluated for impairment | \$ 965,417,000      | \$ 78,217,000   |             | \$ 1,043,634,000 |



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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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

Activity in the allowance for loan losses during the nine months ended September 30, 2010 is as follows:

|                           |               |
|---------------------------|---------------|
| Beginning balance         | \$ 47,878,000 |
| Provision for loan losses | 25,000,000    |
| Charge-offs               | (31,236,000)  |
| Recoveries                | 2,234,000     |
| Ending balance            | \$ 43,876,000 |

During the three and nine months ended September 30, 2011, there were no purchases or sales of loans or reclassifications of loans held for sale.

Loans modified as troubled debt restructurings during the three months ended September 30, 2011 were as follows:

|                                                            | Number of<br>Contracts | Pre-<br>Modification<br>Recorded<br>Principal<br>Balance | Post-<br>Modification<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|------------------------|----------------------------------------------------------|-----------------------------------------------------------|
| <b>Commercial:</b>                                         |                        |                                                          |                                                           |
| Commercial and industrial                                  | 2                      | \$ 110,000                                               | \$ 110,000                                                |
| Vacant land, land development and residential construction | 6                      | 2,219,000                                                | 2,219,000                                                 |
| Real estate owner occupied                                 | 0                      | 0                                                        | 0                                                         |
| Real estate non-owner occupied                             | 2                      | 701,000                                                  | 701,000                                                   |
| Real estate multi-family and residential rental            | 6                      | 709,000                                                  | 549,000                                                   |
| <b>Total commercial</b>                                    | <b>16</b>              | <b>3,739,000</b>                                         | <b>3,579,000</b>                                          |
| <b>Retail:</b>                                             |                        |                                                          |                                                           |
| Home equity and other                                      | 0                      | 0                                                        | 0                                                         |
| 1-4 family mortgages                                       | 0                      | 0                                                        | 0                                                         |
| <b>Total retail</b>                                        | <b>0</b>               | <b>0</b>                                                 | <b>0</b>                                                  |
| <b>Total</b>                                               | <b>16</b>              | <b>\$ 3,739,000</b>                                      | <b>\$ 3,579,000</b>                                       |

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There were no loans modified as troubled debt restructurings within the previous twelve months that became over 30 days past due during the three months ended September 30, 2011.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

Loans modified as troubled debt restructurings during the nine months ended September 30, 2011 were as follows:

|                                                            | Number of<br>Contracts | Pre-<br>Modification<br>Recorded<br>Principal<br>Balance | Post-<br>Modification<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|------------------------|----------------------------------------------------------|-----------------------------------------------------------|
| <b>Commercial:</b>                                         |                        |                                                          |                                                           |
| Commercial and industrial                                  | 14                     | \$ 2,339,000                                             | \$ 2,330,000                                              |
| Vacant land, land development and residential construction | 8                      | 3,422,000                                                | 3,421,000                                                 |
| Real estate owner occupied                                 | 7                      | 3,973,000                                                | 3,466,000                                                 |
| Real estate non-owner occupied                             | 9                      | 7,006,000                                                | 7,004,000                                                 |
| Real estate multi-family and residential rental            | 10                     | 1,450,000                                                | 1,290,000                                                 |
| <b>Total commercial</b>                                    | <b>48</b>              | <b>18,190,000</b>                                        | <b>17,511,000</b>                                         |
| <b>Retail:</b>                                             |                        |                                                          |                                                           |
| Home equity and other                                      | 0                      | 0                                                        | 0                                                         |
| 1-4 family mortgages                                       | 0                      | 0                                                        | 0                                                         |
| <b>Total retail</b>                                        | <b>0</b>               | <b>0</b>                                                 | <b>0</b>                                                  |
| <b>Total</b>                                               | <b>48</b>              | <b>\$ 18,190,000</b>                                     | <b>\$ 17,511,000</b>                                      |

The following loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the nine months ended September 30, 2011 (amounts as of period end):

|                                                            | Number of<br>Contracts | Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|------------------------|----------------------------------|
| <b>Commercial:</b>                                         |                        |                                  |
| Commercial and industrial                                  | 2                      | \$ 280,000                       |
| Vacant land, land development and residential construction | 0                      | 0                                |
| Real estate owner occupied                                 | 0                      | 0                                |
| Real estate non-owner occupied                             | 1                      | 793,000                          |
| Real estate multi-family and residential rental            | 2                      | 135,000                          |

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|                       |   |              |
|-----------------------|---|--------------|
| Total commercial      | 5 | 1,208,000    |
| Retail:               |   |              |
| Home equity and other | 0 | 0            |
| 1-4 family mortgages  | 0 | 0            |
| Total retail          | 0 | 0            |
| Total                 | 5 | \$ 1,208,000 |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

As a result of adopting the amendments in ASU 2011-02 effective September 30, 2011, we reassessed all loan renewals and modifications that occurred on or after January 1, 2011 to determine whether they should now be considered troubled debt restructurings. In general, our policy dictates that a renewal or modification of an 8- or 9-rated loan meets the criteria of a troubled debt restructuring, although we review and consider all renewed and modified loans as part of our troubled debt restructuring assessment procedures. Loan relationships rated 8 contain significant financial weaknesses, resulting in a distinct possibility of loss, while relationships rated 9 reflect vital financial weaknesses, resulting in a highly questionable ability on our part to collect principal; we believe borrowers warranting such ratings would have difficulty obtaining financing from other market participants. Thus, due to the lack of comparable market rates for loans with similar risk characteristics, we believe 8- or 9-rated loans that were renewed or modified during the first nine months of 2011 were done so at below market rates. Loans that are identified as troubled debt restructurings are considered impaired and are individually evaluated for impairment when assessing these credits in our allowance for loan losses calculation. Certain of the loans, totaling \$10.8 million as of September 30, 2011, that were identified as troubled debt restructurings under the new guidance had been previously measured under a general allowance methodology (i.e., pooling) for calculation of our allowance for loan losses. The allowance for loan losses associated with these specific loans totaled \$4.2 million as of September 30, 2011, or approximately \$1.0 million higher than would have been recorded using a general allowance methodology.

**4. PREMISES AND EQUIPMENT, NET**

Premises and equipment are comprised of the following:

|                                | September 30,<br>2011 | December 31,<br>2010 |
|--------------------------------|-----------------------|----------------------|
| Land and improvements          | \$ 8,531,000          | \$ 8,531,000         |
| Buildings                      | 24,528,000            | 24,528,000           |
| Furniture and equipment        | 12,644,000            | 12,478,000           |
|                                | 45,703,000            | 45,537,000           |
| Less: accumulated depreciation | 18,838,000            | 17,664,000           |
| Premises and equipment, net    | \$ 26,865,000         | \$ 27,873,000        |

Depreciation expense totaled \$0.4 million during the third quarter of 2011 and 2010. Depreciation expense totaled \$1.2 million during the first nine months of 2011, compared to \$1.5 million during the first nine months of 2010.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**5. DEPOSITS**

Our total deposits at September 30, 2011 totaled \$1.19 billion compared to \$1.27 billion at December 31, 2010, a decrease of \$88.5 million, or 6.9%. The components of our outstanding balances at September 30, 2011 and December 31, 2010, and percentage change in deposits from the end of 2010 to the end of the third quarter of 2011, are as follows:

|                                       | September 30, 2011 |        | December 31, 2010 |        | Percent Increase<br>(Decrease) |
|---------------------------------------|--------------------|--------|-------------------|--------|--------------------------------|
|                                       | Balance            | %      | Balance           | %      |                                |
| Noninterest-bearing demand            | \$ 144,022,000     | 12.1%  | \$ 112,944,000    | 8.9%   | 27.5%                          |
| Interest-bearing checking             | 165,707,000        | 14.0   | 158,177,000       | 12.4   | 4.8                            |
| Money market                          | 152,603,000        | 12.9   | 150,631,000       | 11.8   | 1.3                            |
| Savings                               | 37,336,000         | 3.1    | 60,201,000        | 4.7    | (38.0)                         |
| Time, under \$100,000                 | 65,966,000         | 5.6    | 75,857,000        | 6.0    | (13.0)                         |
| Time, \$100,000 and over              | 212,486,000        | 17.9   | 206,954,000       | 16.2   | 2.7                            |
|                                       | 778,120,000        | 65.6   | 764,764,000       | 60.0   | 1.7                            |
| Out-of-area interest-bearing checking | 26,987,000         | 2.3    | 0                 | NA     | NA                             |
| Out-of-area time, under \$100,000     | 23,413,000         | 2.0    | 37,253,000        | 2.9    | (37.2)                         |
| Out-of-area time, \$100,000 and over  | 356,813,000        | 30.1   | 471,815,000       | 37.1   | (24.4)                         |
|                                       | 407,213,000        | 34.4   | 509,068,000       | 40.0   | (20.0)                         |
| Total deposits                        | \$ 1,185,333,000   | 100.0% | \$ 1,273,832,000  | 100.0% | (6.9)%                         |

**6. SHORT-TERM BORROWINGS**

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

|                                         | Nine Months Ended<br>September 30,<br>2011 | Twelve Months Ended<br>December 31, 2010 |
|-----------------------------------------|--------------------------------------------|------------------------------------------|
| Outstanding balance at end of period    | \$ 69,340,000                              | \$ 116,979,000                           |
| Average interest rate at end of period  | 0.29%                                      | 0.69%                                    |
| Average daily balance during the period | \$ 82,719,000                              | \$ 107,781,000                           |
| Average interest rate during the period | 0.57%                                      | 1.31%                                    |
| Maximum daily balance during the period | \$ 116,979,000                             | \$ 133,280,000                           |

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



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agreements are recorded as assets of our bank and are held in safekeeping by a correspondent bank. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements are secured by securities with an aggregate market value equal to the aggregate outstanding balance.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**7. FEDERAL HOME LOAN BANK ADVANCES**

Our outstanding balances at September 30, 2011 totaled \$45.0 million and mature at varying dates from March 2012 through January 2014, with fixed rates of interest from 3.04% to 4.42% and averaging 3.57%. At December 31, 2010, outstanding balances totaled \$65.0 million with maturities ranging from June 2011 through January 2014, with fixed rates of interest from 3.04% to 4.42% and averaging 3.73%.

Each advance is payable at its maturity date, and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of September 30, 2011 totaled about \$117.0 million, with availability approximating \$70.0 million.

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

|      |            |
|------|------------|
| 2011 | \$ 0       |
| 2012 | 30,000,000 |
| 2013 | 10,000,000 |
| 2014 | 5,000,000  |
| 2015 | 0          |

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

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

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on our credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and is generally recorded as a liability. During the third quarter of 2011, we expensed \$0.4 million through provision for loan losses in association with a particular standby letter of credit. Due to the nature of the transaction and the insignificant amount, the \$0.4 million was included as a specific reserve within the allowance for loan losses as of September 30, 2011. There was no reserve or liability balance as of December 31, 2010.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at September 30, 2011 and December 31, 2010 follows:

|                                                                     | September 30,<br>2011 | December 31,<br>2010  |
|---------------------------------------------------------------------|-----------------------|-----------------------|
| Commercial unused lines of credit                                   | \$ 163,822,000        | \$ 158,945,000        |
| Unused lines of credit secured by 1-4 family residential properties | 25,537,000            | 26,870,000            |
| Credit card unused lines of credit                                  | 7,708,000             | 7,768,000             |
| Other consumer unused lines of credit                               | 4,099,000             | 4,052,000             |
| Commitments to extend credit                                        | 23,671,000            | 9,840,000             |
| Standby letters of credit                                           | 17,501,000            | 19,343,000            |
|                                                                     | <b>\$ 242,338,000</b> | <b>\$ 226,818,000</b> |

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of September 30, 2011, the total notional amount of the underlying interest rate swap agreements was \$42.5 million, with a net fair value from our commercial loan customers' perspective of negative \$6.3 million. These risk participation agreements are considered financial guarantees in accordance with applicable accounting guidance and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

**9. 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**9. HEDGING ACTIVITIES** (Continued)

A majority of our assets are comprised of commercial loans on which the interest rates are variable; however, the interest rates on a significant portion of these loans will likely lag an increase in market interest rates under a rising interest rate environment. As of September 30, 2011, the Mercantile Bank Prime Rate, the index on which a substantial portion of our commercial floating rate loans are based, was 4.50% compared to the Wall Street Journal Prime Rate of 3.25%. Historically, the two indices have been equal; however, we elected not to reduce the Mercantile Bank Prime Rate in late October and mid-December of 2008 when the Wall Street Journal Prime Rate declined by 50 and 75 basis points, respectively. It is our general intent to keep the Mercantile Bank Prime Rate unchanged until the Wall Street Journal Prime Rate equals the Mercantile Bank Prime Rate, at which time the two indices will likely remain equal in future periods. In addition, a majority of our floating rate loans, whether tied to the Mercantile Bank Prime Rate, Wall Street Journal Prime Rate or Libor rates, have interest rate floors that are currently higher than the indexed rate provides for. To help mitigate the negative impact to our net interest income in an increasing interest rate environment resulting from our cost of funds likely increasing at a higher rate than the yield on our assets, we may periodically enter into derivative financial instruments.

In June 2011, we simultaneously purchased and sold an interest rate cap with a correspondent bank, a structure commonly referred to as a cap corridor. The cap corridor, which does not qualify for hedge accounting, consisted of us purchasing a \$100 million interest rate cap with a strike rate in close proximity to the then-current 30-day Libor rate and selling a \$100 million interest rate cap with a strike rate that is 125 basis points higher than the purchased interest rate cap strike rate. On the settlement date, the present value of the purchased interest rate cap of \$729,500 was recorded as an asset, while the present value of the sold interest rate cap of \$213,500 was recorded as a liability. At each month end, the recorded balances of the purchased and sold interest rate caps are adjusted to reflect the current present values, with the offsetting entry being recorded to interest income on commercial loans. We recorded a net decrease of \$283,000 and \$231,000 during the third quarter and first nine months of 2011, respectively, to interest income on commercial loans to reflect the net change in present values. Payments made or received under the purchased and sold interest rate cap contracts, if any, are also recorded to interest income on commercial loans. No such payments were made or received during the third quarter or the first nine months of 2011.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**10. FAIR VALUES OF FINANCIAL INSTRUMENTS**

Carrying amounts and estimated fair values of financial instruments were as follows as of September 30, 2011 and December 31, 2010:

|                                                | September 30, 2011 |                | December 31, 2010  |                |
|------------------------------------------------|--------------------|----------------|--------------------|----------------|
|                                                | Carrying<br>Values | Fair<br>Values | Carrying<br>Values | Fair<br>Values |
| <b>Financial assets</b>                        |                    |                |                    |                |
| Cash and cash equivalents                      | \$ 125,703,000     | \$ 125,703,000 | \$ 64,198,000      | \$ 64,198,000  |
| Securities available for sale                  | 173,134,000        | 173,134,000    | 220,830,000        | 220,830,000    |
| Federal Home Loan Bank stock                   | 11,961,000         | 11,961,000     | 14,345,000         | 14,345,000     |
| Loans, net                                     | 1,054,686,000      | 1,061,270,000  | 1,217,262,000      | 1,223,911,000  |
| Bank owned life insurance                      | 48,083,000         | 48,083,000     | 46,743,000         | 46,743,000     |
| Accrued interest receivable                    | 4,887,000          | 4,887,000      | 5,942,000          | 5,942,000      |
| Purchased interest rate cap                    | 347,000            | 347,000        | 0                  | 0              |
| <b>Financial liabilities</b>                   |                    |                |                    |                |
| Deposits                                       | 1,185,333,000      | 1,193,486,000  | 1,273,832,000      | 1,284,767,000  |
| Securities sold under agreements to repurchase | 69,340,000         | 69,340,000     | 116,979,000        | 116,979,000    |
| Federal Home Loan Bank advances                | 45,000,000         | 46,355,000     | 65,000,000         | 67,668,000     |
| Subordinated debentures                        | 32,990,000         | 33,061,000     | 32,990,000         | 33,006,000     |
| Accrued interest payable                       | 5,007,000          | 5,007,000      | 4,749,000          | 4,749,000      |
| Sold interest rate cap                         | 62,000             | 62,000         | 0                  | 0              |

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES**

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

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

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

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES** (Continued)

*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 is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. We had no securities held to maturity outstanding as of September 30, 2011 or December 31, 2010.

*Mortgage loans held for sale.* Mortgage loans held for sale are carried at the lower of aggregate cost or fair value and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of September 30, 2011 and December 31, 2010, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the \$5.0 million and \$2.7 million, respectively, of such loans at cost so they are not included in the nonrecurring table below.

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

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

*Derivatives.* For interest rate cap contracts, we measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves, and accordingly, interest rate cap contracts are classified as Level 2.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

The balances of assets and liabilities measured at fair value on a recurring basis as of September 30, 2011 are as follows:

|                                         | Total          | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-----------------------------------------|----------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| Available for sale securities           |                |                                                                                  |                                                           |                                                    |
| U.S. Government agency debt obligations | \$ 84,512,000  | \$ 0                                                                             | \$ 84,512,000                                             | \$ 0                                               |
| Mortgage-backed securities              | 38,467,000     | 0                                                                                | 38,467,000                                                | 0                                                  |
| Michigan Strategic Fund bonds           | 16,955,000     | 0                                                                                | 16,955,000                                                | 0                                                  |
| Municipal general obligation bonds      | 27,458,000     | 0                                                                                | 27,458,000                                                | 0                                                  |
| Municipal revenue bonds                 | 4,399,000      | 0                                                                                | 4,399,000                                                 | 0                                                  |
| Mutual funds                            | 1,343,000      | 0                                                                                | 1,343,000                                                 | 0                                                  |
| Derivatives                             |                |                                                                                  |                                                           |                                                    |
| Interest rate cap contracts             | 285,000        | 0                                                                                | 285,000                                                   | 0                                                  |
| Total                                   | \$ 173,419,000 | \$ 0                                                                             | \$ 173,419,000                                            | \$ 0                                               |

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first nine months of 2011.

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 are as follows:

|                                         | Total          | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|-----------------------------------------|----------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| U.S. Government agency debt obligations | \$ 121,562,000 | \$ 0                                                                             | \$ 121,562,000                                            | \$ 0                                               |
| Mortgage-backed securities              | 46,941,000     | 0                                                                                | 46,941,000                                                | 0                                                  |
| Michigan Strategic Fund bonds           | 18,175,000     | 0                                                                                | 18,175,000                                                | 0                                                  |

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|                                    |                |      |                |      |
|------------------------------------|----------------|------|----------------|------|
| Municipal general obligation bonds | 28,042,000     | 0    | 28,042,000     | 0    |
| Municipal revenue bonds            | 4,843,000      | 0    | 4,843,000      | 0    |
| Mutual funds                       | 1,267,000      | 0    | 1,267,000      | 0    |
| Total                              | \$ 220,830,000 | \$ 0 | \$ 220,830,000 | \$ 0 |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**11. FAIR VALUES** (Continued)

We had no interest rate cap contracts outstanding at December 31, 2010. There were no transfers in or out of Level 1, Level 2 or Level 3 during 2010.

*Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis*

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2011 are as follows:

|                                  | Total                | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|----------------------------------|----------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| Impaired loans <sup>(1)</sup>    | \$ 29,284,000        | \$ 0                                                                             | \$ 0                                                      | \$ 29,284,000                                      |
| Foreclosed assets <sup>(1)</sup> | 17,287,000           | 0                                                                                | 0                                                         | 17,287,000                                         |
| <b>Total</b>                     | <b>\$ 46,571,000</b> | <b>\$ 0</b>                                                                      | <b>\$ 0</b>                                               | <b>\$ 46,571,000</b>                               |

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2010 are as follows:

|                                  | Total                | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|----------------------------------|----------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| Impaired loans <sup>(1)</sup>    | \$ 39,056,000        | \$ 0                                                                             | \$ 0                                                      | \$ 39,056,000                                      |
| Foreclosed assets <sup>(1)</sup> | 16,675,000           | 0                                                                                | 0                                                         | 16,675,000                                         |
| <b>Total</b>                     | <b>\$ 55,731,000</b> | <b>\$ 0</b>                                                                      | <b>\$ 0</b>                                               | <b>\$ 55,731,000</b>                               |

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

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**12. REGULATORY MATTERS**

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

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At September 30, 2011 and December 31, 2010, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since September 30, 2011 that we believe have changed our bank's categorization.

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

|                                          | Actual     |       | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Regulations |       |
|------------------------------------------|------------|-------|------------------------------------------------------|-------|------------------------------------------------------------------------------------------------|-------|
|                                          | Amount     | Ratio | Amount                                               | Ratio | Amount                                                                                         | Ratio |
| <b><u>September 30, 2011</u></b>         |            |       |                                                      |       |                                                                                                |       |
| Total capital (to risk weighted assets)  |            |       |                                                      |       |                                                                                                |       |
| Consolidated                             | \$ 179,348 | 14.5% | \$ 98,850                                            | 8.0%  | \$ NA                                                                                          | NA    |
| Bank                                     | 178,991    | 14.5  | 98,767                                               | 8.0   | 123,458                                                                                        | 10.0% |
| Tier 1 capital (to risk weighted assets) |            |       |                                                      |       |                                                                                                |       |
| Consolidated                             | 163,608    | 13.2  | 49,425                                               | 4.0   | NA                                                                                             | NA    |
| Bank                                     | 163,263    | 13.2  | 49,384                                               | 4.0   | 74,075                                                                                         | 6.0   |
| Tier 1 capital (to average assets)       |            |       |                                                      |       |                                                                                                |       |
| Consolidated                             | 163,608    | 10.9  | 60,186                                               | 4.0   | NA                                                                                             | NA    |
| Bank                                     | 163,263    | 10.9  | 60,146                                               | 4.0   | 75,182                                                                                         | 5.0   |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**12. REGULATORY MATTERS** (Continued)

|                                          | Actual     |       | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Regulations |       |
|------------------------------------------|------------|-------|------------------------------------------------------|-------|------------------------------------------------------------------------------------------------|-------|
|                                          | Amount     | Ratio | Amount                                               | Ratio | Amount                                                                                         | Ratio |
| <b>December 31, 2010</b>                 |            |       |                                                      |       |                                                                                                |       |
| Total capital (to risk weighted assets)  |            |       |                                                      |       |                                                                                                |       |
| Consolidated                             | \$ 175,029 | 12.5% | \$ 112,480                                           | 8.0%  | \$ NA                                                                                          | NA    |
| Bank                                     | 175,122    | 12.5  | 112,398                                              | 8.0   | 140,497                                                                                        | 10.0% |
| Tier 1 capital (to risk weighted assets) |            |       |                                                      |       |                                                                                                |       |
| Consolidated                             | 157,111    | 11.2  | 56,240                                               | 4.0   | NA                                                                                             | NA    |
| Bank                                     | 157,217    | 11.2  | 56,199                                               | 4.0   | 84,299                                                                                         | 6.0   |
| Tier 1 capital (to average assets)       |            |       |                                                      |       |                                                                                                |       |
| Consolidated                             | 157,111    | 9.1   | 69,135                                               | 4.0   | NA                                                                                             | NA    |
| Bank                                     | 157,217    | 9.1   | 69,112                                               | 4.0   | 86,389                                                                                         | 5.0   |

Our consolidated capital levels as of September 30, 2011 and December 31, 2010 include \$32.0 million of trust preferred securities issued by the trust in September 2004 and December 2004 subject to certain limitations. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in our Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than \$15.0 billion. As of September 30, 2011 and December 31, 2010, all \$32.0 million of the trust preferred securities were included in our consolidated Tier 1 capital.

On July 9, 2010, we announced via a Form 8-K filed with the SEC that we were deferring regularly scheduled quarterly interest payments on our subordinated debentures beginning with the quarterly interest payment scheduled to be paid on July 18, 2010. The deferral of interest payments on the subordinated debentures resulted in the deferral of distributions on our trust preferred securities. We also announced that we were deferring regularly scheduled quarterly dividend payments on our preferred stock beginning with the quarterly dividend payment scheduled to be paid on August 15, 2010. On October 18, 2011, we paid and brought current all accrued and unpaid interest on our subordinated debentures, and on October 19, 2011, we paid and brought current all accrued and unpaid dividends on our preferred stock.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**12. REGULATORY MATTERS** (Continued)

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. In April 2010, we suspended future payments of cash dividends on our common stock until economic conditions and our financial performance improve. In addition, during the period of July 9, 2010 through October 19, 2011, we were precluded from paying dividends on our common stock and preferred stock because, under the terms of our subordinated debentures, we could not pay dividends during periods when we had deferred the payment of interest on our subordinated debentures; and, as indicated above in this Note 12, we had been deferring such interest payments. Also, pursuant to our Articles of Incorporation, we were precluded from paying dividends on our common stock while any dividends accrued on our preferred stock had not been declared and paid. Because, as indicated above in this Note 12, we had suspended the payment of dividends on our preferred stock, we were precluded from paying dividends on our common stock. These restrictions are no longer in place as of October 19, 2011.

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MERCANTILE BANK CORPORATION

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

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

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2010 or in this report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

**Introduction**

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, Mercantile Bank of Michigan ( our bank ), our bank's three subsidiaries, Mercantile Bank Mortgage Company, LLC ( our mortgage company ), Mercantile Bank Real Estate Co., LLC ( our real estate company ) and Mercantile Insurance Center, Inc. ( our insurance company ), at September 30, 2011 and December 31, 2010 and the results of operations for the three and nine months ended September 30, 2011 and September 30, 2010. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to us, we, our or the company include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

**Critical Accounting Policies**

Accounting principles generally accepted in the United States of America are complex and require us to apply significant judgment to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a discussion of our significant accounting policies, see Note 1 of the Notes to our Consolidated Financial Statements included on pages F-46 through F-51 in our Form 10-K for the fiscal year ended December 31, 2010 (Commission file number 000-26719). Our allowance for loan losses policy and accounting for income taxes are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements, and actual results may differ from those estimates. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

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### MERCANTILE BANK CORPORATION

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

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

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

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### MERCANTILE BANK CORPORATION

Accounting guidance requires that we assess whether a valuation allowance should be established against our net deferred tax asset based on the consideration of all available evidence using a more likely than not standard. In making such judgments, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors which may impact future operating results. Significant weight is given to evidence that can be objectively verified. Despite improvements in key areas such as an expanded net interest margin, increased regulatory capital levels, a continued shift to local funding sources and reduced controllable overhead costs, the loan provision expense and problem asset administrative costs remain sizable. The continuing impact from the distressed operating environment has restricted our ability to rely on projections of future taxable income to support the recovery of our deferred tax asset. Consequently, we have determined it necessary to establish and maintain a valuation allowance against our entire net deferred tax asset as of September 30, 2011 and December 31, 2010. We will continue to monitor our net deferred tax asset quarterly for changes affecting its realizability.

## **Financial Overview**

Over the past several years, our earnings performance has been negatively impacted by substantial provisions to the allowance for loan losses as well as administrative costs associated with problem assets. Ongoing state, regional and national economic struggles have negatively impacted some of our borrowers' cash flows and underlying collateral values, leading to an elevated level of nonperforming assets, higher loan charge-offs and increased overall credit risk within our loan portfolio. We have worked with our borrowers to develop constructive dialogue to strengthen our relationships and enhance our ability to resolve complex issues; however, with the environment for the banking industry likely to remain stressed until economic conditions improve, credit quality will continue to be our major concern. We will remain vigilant in the identification and administration of problem assets, but provisions to the allowance and problem asset administration costs will likely remain above historical levels for some period of time, dampening future earnings performance.

We recorded a net profit during the third quarter of 2011, our third consecutive quarterly net profit after two years of quarterly losses. A significantly lower provision expense primarily provided for the positive earnings performance; however, our improved earnings performance also reflects the many positive steps we have taken over the past several years to not only partially mitigate the impact of asset quality-related costs in the near term, but to benefit us on a longer-term basis as well. First, our net interest margin has improved as we have lowered local non-CD deposit rates and have replaced maturing higher-rate deposits and borrowed funds with lower-cost funds, while at the same time our commercial loan pricing initiatives offset the negative impact of a relatively high level of nonaccrual loans. Next, our regulatory risk-based capital ratios are increasing, reflecting the impact of the net income recorded during the first nine months of 2011, the sale of preferred stock under the Department of Treasury's Capital Purchase Program and the reduction of loans outstanding, which have more than offset the impact of our net losses recorded during 2010 and 2009. In addition, we are increasing our local deposit balances, reflecting the successful implementation of various initiatives, campaigns and product enhancements. The local deposit growth, combined with the reduction of loans outstanding, are providing for a substantial reduction of, and reliance on, wholesale funds. Lastly, we are seeing the positive effect of our branch consolidation and other overhead cost reduction initiatives, as we continue to make strides to reduce noninterest expense.

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### MERCANTILE BANK CORPORATION

Our asset quality metrics are on an improving trend, and we are cautiously optimistic that the positive trend will continue. In aggregate dollar amounts, nonperforming asset levels have been declining over the past six quarters, and as of September 30, 2011 were at the lowest level since September 30, 2008. Progress in the stabilization of economic and real estate market conditions has provided for numerous loan rating upgrades and significantly lower volumes of loan rating downgrades, providing for a substantially lower provision expense during the first nine months of 2011. We believe a continuation of improved market conditions will provide for lower future period provision expense and problem asset administration costs when compared to levels over the past several years.

### **Financial Condition**

During the first nine months of 2011, our total assets decreased \$154.4 million, and totaled \$1.48 billion as of September 30, 2011. The decline in total assets was comprised primarily of a \$168.6 million reduction in total loans and a \$50.1 million decrease in securities, more than offsetting a \$61.5 million increase in cash and cash equivalents. Total deposits declined \$88.5 million, securities sold under agreements to repurchase ( repurchase agreements ) decreased \$47.6 million and Federal Home Loan Bank advances were down \$20.0 million.

Commercial loans declined \$163.0 million during the first nine months of 2011, and at September 30, 2011 totaled \$1.01 billion, or 92.6% of the loan portfolio. The decline in outstanding balances primarily reflects the impact of a concerted effort on our part to reduce exposure to certain non-owner occupied commercial real estate ( CRE ) lending and the sluggishness in business activity in our markets. During the first nine months of 2011, commercial loans collateralized by non-owner occupied CRE declined \$100.2 million. Our systematic approach to reducing our exposure to certain non-owner occupied CRE lending will be prolonged, given the nature of CRE lending and depressed economic conditions; however, we believe that such a reduction is in our best interest when taking into account the increased inherent credit risk and nominal deposit balances generally associated with the targeted borrowing relationships. Our commercial and industrial ( C&I ) loan portfolio declined \$25.5 million during the first nine months of 2011, in large part reflecting ongoing sluggish business activity. We would expect to see an increase in commercial line of credit usage when economic conditions improve. Also during the first nine months of 2011, commercial loans collateralized by owner-occupied CRE and commercial loans related to vacant land, land development and residential construction decreased \$10.6 million and \$19.7 million, respectively.

The commercial loan portfolio represents loans to businesses generally located within our market areas. Approximately 74% of the commercial loan portfolio is primarily secured by real estate properties, with the remaining generally secured by other business assets such as accounts receivable, inventory and equipment. The continued concentration of the loan portfolio in commercial loans is consistent with our strategy of focusing a substantial amount of our efforts on commercial banking. Corporate and business lending is an area of expertise for our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least ten years experience. Of each of the loan categories that we originate, commercial loans are most efficiently originated and managed, thus limiting overhead costs by necessitating the attention of fewer employees. Our commercial lending business generates the largest portion of local deposits and is our primary source of demand deposits.



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## MERCANTILE BANK CORPORATION

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:

|                                   | 9/30/11               | 6/30/11               | 3/31/11               | 12/31/10              | 9/30/10               |
|-----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| <b>Residential-Related:</b>       |                       |                       |                       |                       |                       |
| Vacant Land                       | \$ 13,264,000         | \$ 13,484,000         | \$ 16,321,000         | \$ 17,201,000         | \$ 18,013,000         |
| Land Development                  | 17,441,000            | 18,134,000            | 27,171,000            | 28,147,000            | 29,735,000            |
| Construction                      | 4,647,000             | 4,706,000             | 4,906,000             | 5,621,000             | 5,854,000             |
|                                   | 35,352,000            | 36,324,000            | 48,398,000            | 50,969,000            | 53,602,000            |
| <b>Comm 1 Non-Owner Occupied:</b> |                       |                       |                       |                       |                       |
| Vacant Land                       | 11,082,000            | 12,639,000            | 13,669,000            | 14,293,000            | 15,416,000            |
| Land Development                  | 14,541,000            | 16,348,000            | 16,492,000            | 17,807,000            | 18,221,000            |
| Construction                      | 11,061,000            | 10,709,000            | 10,046,000            | 31,827,000            | 39,620,000            |
| Commercial Buildings              | 397,279,000           | 429,708,000           | 484,629,000           | 489,371,000           | 509,777,000           |
|                                   | 433,963,000           | 469,404,000           | 524,836,000           | 553,298,000           | 583,034,000           |
| <b>Comm 1 Owner Occupied:</b>     |                       |                       |                       |                       |                       |
| Construction                      | 2,986,000             | 1,517,000             | 1,404,000             | 672,000               | 0                     |
| Commercial Buildings              | 269,776,000           | 264,848,000           | 273,739,000           | 282,388,000           | 298,846,000           |
|                                   | 272,762,000           | 266,365,000           | 275,143,000           | 283,060,000           | 298,846,000           |
| <b>Total</b>                      | <b>\$ 742,077,000</b> | <b>\$ 772,093,000</b> | <b>\$ 848,377,000</b> | <b>\$ 887,327,000</b> | <b>\$ 935,482,000</b> |

Residential mortgage loans and consumer loans declined in aggregate \$5.6 million during the first nine months of 2011, and at September 30, 2011, totaled \$81.1 million, or 7.4% of the total loan portfolio. Although the residential mortgage loan and consumer loan portfolios may increase in future periods, we expect the commercial sector of the lending efforts and resultant assets to remain the dominant loan portfolio category.

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

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### MERCANTILE BANK CORPORATION

The levels of net loan charge-offs and nonperforming assets have been elevated since early 2007. The substantial and rapid collapse of the residential real estate market that started in 2007 had a significant negative impact on the residential real estate development lending portion of our business. The resulting decline in real estate prices and slowdown in sales have 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 charge-offs. In addition, we have witnessed stressed economic conditions in Michigan and throughout the country over the past several years. The resulting decline in business revenue has negatively impacted the cash flows of many of our borrowers, some to the point where loan payments have become past due or will likely become delinquent in future periods. In addition, real estate prices have fallen significantly, thereby exposing us to larger-than-typical losses in those instances where the sale of collateral is the primary source of repayment. Also during this time, we have seen deterioration in guarantors financial capacities to fund deficient cash flows and reduce or eliminate collateral deficiencies. It is likely that the net loan charge-offs and nonperforming assets will remain elevated in comparison to our historical levels until economic conditions improve.

Throughout 2008, we experienced a rapid deterioration in a number of commercial loan relationships which previously had been performing satisfactorily. 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 source of collateral for many of these borrowing relationships and updated evaluations and appraisals in many cases reflected significant declines from the original estimated values.

Throughout 2009, 2010 and during the first nine months of 2011, we saw a continuation of the stresses caused by the poor economic conditions, especially in the CRE markets. High vacancy rates or slow absorption have resulted in inadequate cash flow generated from some real estate projects we have financed, and have required guarantors to provide personal funds to make full contractual loan payments and pay other operating costs. In some cases, the guarantors cash and other liquid reserves have become seriously diminished. In other cases, sale of the collateral, either by the borrower or us, is our primary source of repayment.

We are, however, encouraged by the apparent credit quality stabilization within our loan portfolio during the past several quarters. After a period of significant and ongoing increases from 2007 through September 30, 2009, the level of nonperforming assets was relatively unchanged from September 30, 2009 through June 30, 2010, and then declined during the last six months of 2010 and first nine months of 2011. Of particular note are the reduced level of additions to the nonperforming asset category and increased level of interest in, and sales of, foreclosed properties and assets securing nonperforming loans.

As of September 30, 2011, nonperforming assets totaled \$56.8 million, or 3.9% of total assets, compared to \$86.1 million (5.3% of total assets) and \$92.4 million (5.1% of total assets) as of December 31, 2010 and September 30, 2010, respectively. The \$29.3 million reduction during the first nine months of 2011 and the \$35.6 million decline during the twelve-month period ended September 30, 2011, are primarily associated with loans on, and properties consisting of, non-owner occupied CRE and residential-related development. As of September 30, 2011, nonperforming loans secured by, and foreclosed properties consisting of, non-owner occupied CRE properties totaled \$22.4 million, reflecting reductions of \$11.8 million and \$19.3 million from December 31, 2010 and September 30, 2010, respectively. Nonperforming loans and foreclosed properties associated with the development of residential-related real estate totaled \$9.6 million as of September 30, 2011, reflecting reductions of \$7.3 million and \$10.1 million from December 31, 2010 and September 30, 2010, respectively.

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## MERCANTILE BANK CORPORATION

The following table provides a breakdown of nonperforming assets by property type:

|                                 | 9/30/11              | 6/30/11              | 3/31/11              | 12/31/10             | 9/30/10              |
|---------------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| <b>Residential Real Estate:</b> |                      |                      |                      |                      |                      |
| Land Development                | \$ 8,139,000         | \$ 8,531,000         | \$ 14,252,000        | \$ 14,547,000        | \$ 16,746,000        |
| Construction                    | 1,418,000            | 2,089,000            | 2,268,000            | 2,333,000            | 2,924,000            |
| Owner Occupied / Rental         | 7,737,000            | 8,996,000            | 8,893,000            | 9,454,000            | 7,251,000            |
|                                 | 17,294,000           | 19,616,000           | 25,413,000           | 26,334,000           | 26,921,000           |
| <b>Commercial Real Estate:</b>  |                      |                      |                      |                      |                      |
| Land Development                | 1,885,000            | 2,223,000            | 2,422,000            | 2,454,000            | 2,277,000            |
| Construction                    | 0                    | 0                    | 0                    | 0                    | 0                    |
| Owner Occupied                  | 11,287,000           | 10,749,000           | 13,389,000           | 14,740,000           | 15,083,000           |
| Non-Owner Occupied              | 22,435,000           | 25,526,000           | 30,086,000           | 34,209,000           | 41,725,000           |
|                                 | 35,607,000           | 38,498,000           | 45,897,000           | 51,403,000           | 59,085,000           |
| <b>Non-Real Estate:</b>         |                      |                      |                      |                      |                      |
| Commercial Assets               | 3,897,000            | 3,777,000            | 4,728,000            | 8,221,000            | 6,386,000            |
| Consumer Assets                 | 29,000               | 4,000                | 51,000               | 161,000              | 5,000                |
|                                 | 3,926,000            | 3,781,000            | 4,779,000            | 8,382,000            | 6,391,000            |
| <b>Total</b>                    | <b>\$ 56,827,000</b> | <b>\$ 61,895,000</b> | <b>\$ 76,089,000</b> | <b>\$ 86,119,000</b> | <b>\$ 92,397,000</b> |

The following table provides a reconciliation of nonperforming assets:

|                              | 3rd Qtr<br>2011      | 2nd Qtr<br>2011      | 1st Qtr<br>2011      | 4th Qtr<br>2010      | 3rd Qtr<br>2010      |
|------------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| Beginning balance            | \$ 61,895,000        | \$ 76,089,000        | \$ 86,119,000        | \$ 92,397,000        | \$ 110,533,000       |
| Additions                    | 3,740,000            | 6,478,000            | 3,848,000            | 13,602,000           | 10,905,000           |
| Returns to performing status | 0                    | 0                    | (766,000)            | (1,019,000)          | (7,938,000)          |
| Principal payments           | (5,058,000)          | (12,067,000)         | (5,555,000)          | (7,217,000)          | (5,422,000)          |
| Sale proceeds                | (2,670,000)          | (2,547,000)          | (2,085,000)          | (5,282,000)          | (1,209,000)          |
| Loan charge-offs             | (476,000)            | (5,393,000)          | (4,800,000)          | (4,650,000)          | (12,829,000)         |
| Valuation write-downs        | (604,000)            | (665,000)            | (672,000)            | (1,712,000)          | (1,643,000)          |
| <b>Total</b>                 | <b>\$ 56,827,000</b> | <b>\$ 61,895,000</b> | <b>\$ 76,089,000</b> | <b>\$ 86,119,000</b> | <b>\$ 92,397,000</b> |

Net loan charge-offs during the first nine months of 2011 totaled \$11.0 million, or an annualized 1.25% of average total loans. For comparative purposes, net loan charge-offs equaled 2.43% and 2.24% of average loans during 2010 and 2009, respectively. Approximately 40% of the gross loan charge-offs during the first nine months of 2011 represent the charge-off of specific reserves that were created through provision expense in prior years. Although we recorded a sharply reduced level of net loan charge-offs during the third quarter of 2011 when compared to the

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quarterly levels over the past several years, primarily reflecting a significantly lower level of additions to nonperforming loans and an increased level of recoveries of prior period charge-offs, net loan charge-offs in at least the next few quarters are likely to remain elevated compared to historical averages due to the higher volume of nonperforming loans and stressed economic conditions.

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The following table provides a breakdown of net loan charge-offs (recoveries) by collateral type:

|                          | 3rd Qtr<br>2011 | 2nd Qtr<br>2011 | 1st Qtr<br>2011 | 4th Qtr<br>2010 | 3rd Qtr<br>2010 |
|--------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Residential Real Estate: |                 |                 |                 |                 |                 |
| Land Development         | \$ 135,000      | \$ 2,496,000    | \$ (2,000)      | \$ 312,000      | \$ 2,115,000    |
| Construction             | (11,000)        | (9,000)         | 0               | 173,000         | 93,000          |
| Owner Occupied / Rental  | (187,000)       | 1,819,000       | 1,208,000       | 120,000         | 1,212,000       |
|                          | (63,000)        | 4,306,000       | 1,206,000       | 605,000         | 3,420,000       |
| Commercial Real Estate:  |                 |                 |                 |                 |                 |
| Land Development         | 47,000          | (62,000)        | (73,000)        | 219,000         | 360,000         |
| Construction             | 0               | 0               | 0               | 0               | 0               |
| Owner Occupied           | (18,000)        | 755,000         | 1,436,000       | 976,000         | 2,159,000       |
| Non-Owner Occupied       | 639,000         | 445,000         | (40,000)        | 2,642,000       | 6,805,000       |
|                          | 668,000         | 1,138,000       | 1,323,000       | 3,837,000       | 9,324,000       |
| Non-Real Estate:         |                 |                 |                 |                 |                 |
| Commercial Assets        | (162,000)       | (336,000)       | 2,794,000       | 819,000         | 1,517,000       |
| Consumer Assets          | 26,000          | (9,000)         | 126,000         | 47,000          | 1,000           |
|                          | (136,000)       | (345,000)       | 2,920,000       | 866,000         | 1,518,000       |
| Total                    | \$ 469,000      | \$ 5,099,000    | \$ 5,449,000    | \$ 5,308,000    | \$ 14,262,000   |

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 review and credit departments, we attempt to establish portions of the allowance based on specifically identifiable problem loans. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Allowance Analysis, loan loss migration analysis, composition of the loan portfolio, third party analysis of the loan administration processes and portfolio, and general economic conditions.

The Allowance Analysis applies reserve allocation factors to non-impaired outstanding loan balances, which is combined with specific reserves to calculate an overall allowance dollar amount. For non-impaired commercial loans, which continue to comprise a vast majority of our total loans, reserve allocation factors are based on the loan ratings as determined by our standardized grade paradigms and by loan purpose. We have divided our commercial loan portfolio into five classes: 1) commercial and industrial loans; 2) vacant land, land development and residential construction loans; 3) owner occupied real estate loans; 4) non-owner occupied real estate loans; and 5) multi-family and residential rental property loans. The reserve allocation factors are primarily based on the historical trends of net loan charge-offs through a migration analysis whereby net loan losses are tracked via assigned grades over various time periods, with adjustments made for environmental factors reflecting the current status of, or recent changes in, items such as: lending policies and procedures; economic conditions; nature and volume of the loan portfolio; experience, ability and depth of management and lending staff; volume and severity of past due, nonaccrual and adversely classified loans; effectiveness of the loan review program; value of underlying collateral; loan concentrations; and other external factors such as competition and regulatory environment. Adjustments for specific lending relationships, particularly impaired loans, are made on a case-by-case basis. Non-impaired retail loan reserve allocations are determined in a similar fashion as those for non-impaired commercial loans, except that retail loans are segmented by type of credit and not a grading system. We regularly review the Allowance Analysis and make adjustments periodically based upon identifiable trends and experience.

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A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired commercial loans. Our migration takes into account various time periods, and while we generally place most weight on the eight-quarter time frame as that period is close to the average duration of our loan portfolio, consideration is given to other time periods as part of our assessment. Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our commercial loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data.

Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings. Although we have been consistent in our approach to commercial loan ratings, ongoing stressed economic conditions have resulted in an even higher sense of aggressiveness with regards to the downgrading of lending relationships. In addition, we made revisions to our grading paradigms in early 2009 that mathematically resulted in commercial loan relationships being more quickly downgraded when signs of stress are noted, such as slower sales activity for construction and land development CRE relationships and reduced operating performance/cash flow coverage for C&I relationships. These changes, coupled with the stressed economic environment, have resulted in significant downgrades and the need for substantial provisions to the allowance over the past several years. To more effectively manage our commercial loan portfolio, we created two specific groups tasked with managing our higher exposure lending relationships. One team manages the most distressed credits, while the other team manages larger weakened credit relationships.

The most significant external environmental factor is the assessment of the current economic environment and the resulting implications on our commercial loan portfolio. Currently, we believe conditions remain stressed for non-owner occupied CRE; however, recent data and performance reflect a level of stability in the C&I segment of our loan portfolio.

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

Reflecting the stressed economic conditions and resulting negative impact on our loan portfolio, we have substantially increased the allowance as a percent of the loan portfolio over the past several years. The allowance equaled \$39.4 million, or 3.60% of total loans outstanding, as of September 30, 2011, compared to 3.59%, 3.11%, 1.46% and 1.43% at year-end 2010, 2009, 2008 and 2007, respectively. As of September 30, 2011, the allowance was comprised of \$30.3 million in general reserves relating to non-impaired loans and \$9.1 million in specific reserve allocations relating to impaired loans. Impaired loans with an aggregate carrying value of \$23.2 million as of September 30, 2011 had been subject to previous partial charge-offs aggregating \$21.3 million. Those partial charge-offs were recorded as follows: \$7.2 million in the first nine months of 2011, \$11.9 million in 2010, \$1.3 million in 2009 and \$0.9 million in 2008. As of September 30, 2011, specific reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled \$1.4 million.

Although we believe the allowance is adequate to absorb loan losses as they arise, there can be no assurance that we will not sustain loan losses in any given period that could be substantial in relation to, or greater than, the size of the allowance.



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Securities decreased by \$50.1 million during the first nine months of 2011, totaling \$185.1 million as of September 30, 2011. Proceeds from called U.S. Government agency bonds during the first nine months of 2011 totaled \$42.3 million, with another \$2.5 million received from called tax-exempt municipal bonds, \$9.2 million from principal paydowns on mortgage-backed securities and \$1.2 million from matured Michigan Strategic Fund bonds. We also received \$2.4 million from the redemption of FHLB stock. Purchases during the first nine months of 2011, consisting almost exclusively of U.S. Government agency bonds, totaled \$3.1 million. At September 30, 2011, the portfolio was comprised of U.S. Government agency bonds (46%), U.S. Government agency issued or guaranteed mortgage-backed securities (21%), tax-exempt municipal general obligation and revenue bonds (17%), Michigan Strategic Fund bonds (9%), FHLB stock (6%) and mutual funds (1%). All of our securities, exclusive of FHLB stock, are currently designated as available for sale, and are therefore stated at fair value. The fair value of securities designated as available for sale at September 30, 2011 totaled \$173.1 million, including a net unrealized gain of \$6.3 million. We maintain the securities portfolio at levels to provide adequate pledging and secondary liquidity for our daily operations. In addition, the securities portfolio serves a primary interest rate risk management function.

FHLB stock totaled \$12.0 million as of September 30, 2011, down \$2.4 million from December 31, 2010 due to an unsolicited redemption during the second quarter of 2011. Our investment in FHLB stock is necessary to engage in their advance and other financing programs. We received a quarterly cash dividend at a rate of 2.50% per annum during the first nine months of 2011 and at an average rate of 2.00% per annum during 2010, and we expect a cash dividend will continue to be paid in future quarters.

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

Federal funds sold, consisting of excess funds sold overnight to a correspondent bank, along with investments in interest-bearing deposits at correspondent banks, are used to manage daily liquidity needs and interest rate sensitivity. During the first nine months of 2011, the average balance of these funds equaled \$82.6 million, or 5.6% of average earning assets. This level is elevated from the 4.5% and 3.0% maintained during 2010 and 2009, respectively. However, the level maintained during the past several years is considerably higher than our historical average of less than 1.0%. Given the stressed market and economic conditions, we made the decision in early 2009 to operate with a higher than traditional balance of federal funds sold and interest-bearing deposits. We expect to maintain the higher balance of federal funds sold and other interest-bearing deposits, likely 3.0% to 5.0% of average earning assets, until market and economic conditions return to more normalized levels.

Premises and equipment at September 30, 2011 equaled \$26.9 million, a decrease of \$1.0 million during the first nine months of 2011. Purchases of premises and equipment during the first nine months of 2011 totaled only \$0.2 million, while depreciation expense totaled \$1.2 million. On December 30, 2009, all FDIC-insured financial institutions were required to prepay estimated FDIC deposit insurance assessments for the fourth quarter of 2009 and the years 2010, 2011 and 2012. The amount we paid equaled \$16.3 million, which is being expensed over the future quarterly assessment periods. As of September 30, 2011, the balance of this prepaid asset was \$9.9 million. Under current regulation, any unused portion of the amount prepaid remaining after payment of amounts due on June 30, 2013 will be returned to us by the FDIC.

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Foreclosed and repossessed assets totaled \$17.3 million at September 30, 2011, compared to \$16.7 million and \$26.6 million on December 31, 2010, and December 31, 2009, respectively. The \$0.6 million increase during the first nine months of 2011 consisted of \$9.8 million in transfers from the loan portfolio, which were partially offset by \$7.9 million in sales proceeds and \$1.3 million in valuation write-downs. We expect foreclosed and repossessed assets to remain at elevated levels as we move through the stressed economic environment and in certain situations elect to foreclose or repossess collateral. The State of Michigan has a relatively protracted foreclosure process that generally takes six to twelve months before deed is obtained. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on impaired lending relationships, we are hopeful that the increased sales activity we witnessed during 2010 and the first nine months of 2011 will continue and limit the overall increase in and average balance of this nonperforming asset category.

Deposits decreased \$88.5 million during the first nine months of 2011, totaling \$1.19 billion at September 30, 2011. Local deposits increased \$13.4 million, while out-of-area deposits decreased \$101.9 million. As a percent of total deposits, local deposits equaled 65.6% on September 30, 2011, compared to 60.0%, 48.3% and 29.4% on December 31, 2010, December 31, 2009 and December 31, 2008, respectively. In comparing balances as of September 30, 2011 to those at December 31, 2008, total deposits have declined by \$414.2 million, consisting of a \$307.8 million increase in local deposits and a \$722.0 million decrease in out-of-area deposits. The decline in out-of-area deposits primarily results from the decline in total loans and the increase in local deposits. The increase in local deposits reflects various programs and initiatives we have implemented over the past several years, including: certificate of deposit campaign; implementation of several deposit-gathering initiatives in our commercial lending function; introduction of new deposit-related products and services; and the continuation of providing our customers with the latest in technological advances that give improved information, convenience and timeliness.

Noninterest-bearing checking deposit accounts increased during the first nine months of 2011 after having been relatively stable over the past several years. Noninterest-bearing checking accounts averaged \$134.0 million during the first nine months of 2011, compared to an average balance of \$110 million to \$120 million over the past several years. In fact, during the third quarter of 2011, the average balance was closer to the quarter-end balance of about \$144 million. A majority of the increase represents transfers from our repurchase agreement product, reflecting a change in rates offered on the repurchase agreement product whereby for certain lower-balance customers, maintaining their relationship with us in a noninterest-bearing checking account was less expensive for them than keeping their funds in the repurchase agreement product when taking into account the rate paid and fees assessed. We proactively worked with these customers, resulting in approximately \$20 million being transferred during the first nine months of 2011.

Local interest-bearing checking accounts, in large part reflecting the continued success of our executive banking product, increased \$7.5 million during the first nine months of 2011, and are up \$79.4 million since year-end 2009. Money market deposit accounts increased \$2.0 million during the first nine months of 2011, and are up \$120.6 million since year-end 2009. The increases in both interest-bearing checking accounts and money market deposit accounts reflect our enhanced marketing program and relatively aggressive rates which resulted in many new individual, business and municipality deposits and increased balances from existing depositors, as well as transfers from maturing certificates of deposit. Savings deposits decreased \$22.9 million during the first nine months of 2011, and are down \$1.3 million since year-end 2009. A vast majority of the changes in savings accounts reflect periodic deposits and withdrawals from several local municipal customers that tend to correspond with the receipt and use of property tax collections, as well as from certain municipal customers transferring funds between savings accounts and certificates of deposit.

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Certificates of deposit purchased by customers located within our market areas declined \$4.4 million during the first nine months of 2011, after decreasing \$115.8 million during 2010. A majority of the decline during both time periods reflects funds from maturing certificates of deposit being transferred to interest-bearing checking and money market deposit accounts, and we expect that trend to continue in future periods.

Deposits obtained from customers located outside of our market areas decreased \$101.9 million during the first nine months of 2011, and have declined \$317.7 million since year-end 2009. As of September 30, 2011, out-of-area deposits totaled \$407.2 million. Out-of-area deposits primarily consist of certificates of deposit obtained from depositors located outside our market areas and placed by deposit brokers for a fee, but also include certificates of deposit obtained from the deposit owners directly. The owners of out-of-area deposits include individuals, businesses and municipalities located throughout the United States. In addition, in early 2011 we established an interest-bearing checking account relationship with an out-of-area depositor engaged in the management of retirement accounts. This custodial relationship totaled \$27.0 million as of September 30, 2011, and is expected to remain relatively stable in future periods. We expect this to be a long-term relationship. The significant decline in out-of-area deposits since year-end 2009 primarily reflects the influx of cash resulting from the reduction in total loans and from the increase in local deposits.

Repurchase agreements decreased \$47.6 million during the first nine months of 2011, totaling \$69.3 million as of September 30, 2011. About 40% of the decline represents transfers to noninterest-bearing checking accounts, while the remainder primarily reflects seasonal declines in balances as business customers use funds for tax and bonus payments, especially during the early part of the calendar year. Year-end balances are typically high points in this account. As part of our sweep account program, collected funds from certain business noninterest-bearing checking accounts are invested into over-night interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance.

FHLB advances decreased \$20.0 million during the first nine months of 2011, and are down \$160.0 million since year-end 2009. As of September 30, 2011, FHLB advances totaled \$45.0 million. The decline in FHLB advances since year-end 2009 primarily reflects the influx of cash resulting from the reduction in total loans and from the increase in local deposits. The FHLB advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of September 30, 2011 totaled about \$117 million, with availability approximating \$70 million.

## **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 fund loans, meet deposit withdrawals, maintain reserve requirements and operate our company. Liquidity is primarily achieved through local and out-of-area deposits and 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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To assist in providing needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, comprised primarily of deposits from customers outside of our market areas and advances from the FHLB, totaled \$452.2 million, or 34.8% of combined deposits and borrowed funds, as of September 30, 2011, compared to \$584.1 million, or 39.8% of combined deposits and borrowed funds as of December 31, 2010, \$944.9 million, or 54.8% of combined deposits and borrowed funds as of December 31, 2009, and \$1.41 billion, or 71.5% of combined deposits and borrowed funds as of December 31, 2008. The significant decline since year-end 2008 primarily reflects the influx of cash resulting from the reduction in total loans and from increased local deposits.

Although local deposits have generally increased as new business, municipality and individual deposit relationships are established and as existing customers increase the balances in their accounts, and we witnessed significant local deposit growth during the past several years, the relatively high reliance on wholesale funds will likely remain. As part of our interest rate risk management strategy, a majority of our wholesale funds have a fixed interest rate and mature within one year, reflecting the fact that a majority of our loans have a floating rate. While this maturity strategy increases inherent liquidity risk, we believe the increased liquidity risk is sufficiently mitigated by the benefits derived from an interest rate risk management standpoint. In addition, we have developed a comprehensive contingency funding plan which we believe further mitigates the increased liquidity risk.

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

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. Repurchase agreements decreased \$47.6 million during the first nine months of 2011, totaling \$69.3 million as of September 30, 2011. Approximately 40% of the decline represents transfers to noninterest-bearing checking accounts, reflecting a reduction in rates offered on the repurchase agreement product whereby for certain lower-balance customers, maintaining their relationship with us in a noninterest-bearing checking account was less expensive for them than keeping their funds in the repurchase agreement product when taking into account the rate paid and fees assessed. We proactively worked with these customers, resulting in approximately \$20 million being transferred during the first nine months of 2011. The remainder of the decline primarily reflects seasonal reductions in balances as business customers use funds for tax and bonus payments, especially during the early part of the calendar year. Year-end balances are typically high points in this account. Information regarding our repurchase agreements as of September 30, 2011 and during the first nine months of 2011 is as follows:

|                                                                         |                |
|-------------------------------------------------------------------------|----------------|
| Outstanding balance at September 30, 2011                               | \$ 69,340,000  |
| Weighted average interest rate at September 30, 2011                    | 0.29%          |
| Maximum daily balance nine months ended September 30, 2011              | \$ 116,979,000 |
| Average daily balance for nine months ended September 30, 2011          | \$ 82,719,000  |
| Weighted average interest rate for nine months ended September 30, 2011 | 0.57%          |

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As a member of the FHLB, we have access to the FHLB advance borrowing programs. FHLB advances were down \$20.0 million during the first nine months of 2011, and are down \$160.0 million since December 31, 2009 and \$225.0 million since December 31, 2008. As of September 30, 2011, FHLB advances totaled \$45.0 million. The decline in FHLB advances since year-end 2008 primarily reflects the influx of cash resulting from the reduction in total loans and from the increase in local deposits. Based on available collateral at September 30, 2011, we could borrow an additional \$70.0 million.

We also have the ability to borrow up to \$38.0 million on a daily basis through correspondent banks using established unsecured federal funds purchased lines of credit. At no time during the first nine months of 2011 did we access the federal funds purchased lines of credit; in fact, we have not accessed the lines of credit since January of 2010. In contrast, federal funds sold averaged \$72.9 million during the first nine months of 2011 and \$69.3 million during all of 2010, with another \$9.7 million invested in interest-bearing deposits at correspondent banks during the first nine months of 2011 and \$9.3 million during all of 2010. Given the volatile market and stressed economic conditions, we have been operating with a higher than normal balance of federal funds sold and other short-term investments. It is expected that we will maintain the higher balance of liquid funds, likely to average 3.0% to 5.0% of average earning assets, until market and economic conditions return to more normalized levels. As a result, we expect the use of our federal funds purchased lines of credit, in at least the near future, will be rare, if at all.

We have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using a substantial majority of our tax-exempt municipal securities as collateral, we could have borrowed up to \$27.1 million for terms of 1 to 28 days at September 30, 2011. We did not utilize this line of credit during the first nine months of 2011 or at any time during 2010 or 2009, and do not plan to access this line of credit in future periods.

The following table reflects, as of September 30, 2011, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

|                                    | One Year<br>or Less | One to<br>Three Years | Three to<br>Five Years | Over<br>Five Years | Total          |
|------------------------------------|---------------------|-----------------------|------------------------|--------------------|----------------|
| Deposits without a stated maturity | \$ 526,655,000      | \$ 0                  | \$ 0                   | \$ 0               | \$ 526,655,000 |
| Certificates of deposit            | 437,014,000         | 153,188,000           | 68,476,000             | 0                  | 658,678,000    |
| Short-term borrowings              | 69,340,000          | 0                     | 0                      | 0                  | 69,340,000     |
| Federal Home Loan Bank advances    | 30,000,000          | 15,000,000            | 0                      | 0                  | 45,000,000     |
| Subordinated debentures            | 0                   | 0                     | 0                      | 32,990,000         | 32,990,000     |
| Other borrowed money               | 0                   | 0                     | 0                      | 1,714,000          | 1,714,000      |

In addition to normal loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. As of September 30, 2011, we had a total of \$224.8 million in unfunded loan commitments and \$17.5 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$201.1 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$23.7 million were for loan commitments expected to close and become funded within the next twelve months. The level of commitments to make loans has declined significantly when compared to historical levels, primarily reflecting stressed economic conditions; however, the \$23.7 million level at September 30, 2011 is relatively high when compared to the levels over the past couple of years. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.



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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, a reduction in earnings performance, declining capital levels or situations beyond our control could cause 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 liquidity disruptions.

**Capital Resources**

Shareholders' equity is a noninterest-bearing source of funds that can provide support for asset growth. Shareholders' equity was \$136.7 million at September 30, 2011, compared to \$125.9 million at December 31, 2010. The \$10.8 million increase during the first nine months of 2011 is primarily due to net income attributable to common shares of \$6.2 million and a \$4.3 million increase in the market value of our available for sale securities portfolio.

The increase in shareholders' equity during the first nine months of 2011 provided for improved regulatory capital ratios, and our bank remains well capitalized. As of September 30, 2011, our bank's total risk-based capital ratio was 14.5%, compared to 12.5% at December 31, 2010. Our bank's total regulatory capital, consisting of shareholders' equity plus a portion of the allowance, increased by \$3.9 million during the first nine months of 2011, reflecting net income of \$8.6 million, \$2.5 million in cash dividends paid, and a reduction of \$2.2 million in eligible allowance primarily due to a decline in total risk-weighted assets. In addition to the increased total regulatory capital, our bank's total risk-based capital ratio increased due to a decline of \$170.4 million in total risk-weighted assets, primarily resulting from a reduction in commercial loans. As of September 30, 2011, our bank's total regulatory capital equaled \$179.0 million, or approximately \$55 million in excess of the 10.0% minimum which is among the requirements to be categorized as well capitalized. Our and our bank's capital ratios as of September 30, 2011 and December 31, 2010 are disclosed in Note 12 of the Notes to Consolidated Financial Statements.

On July 9, 2010, we announced via a Form 8-K filed with the SEC that we were deferring regularly scheduled quarterly interest payments on our subordinated debentures beginning with the quarterly interest payment to have been paid on July 18, 2010. The deferral of interest payments on the subordinated debentures results in the deferral of distributions on our trust preferred securities. We also announced that we were deferring regularly scheduled quarterly dividend payments on our preferred stock beginning with the quarterly dividend payment scheduled to have been paid on August 15, 2010. On October 18, 2011, we announced via a Form 8-K filed with the SEC that as of that date we were bringing all accrued and unpaid interest current on our subordinated debentures, and that on October 19, 2011 we were bringing all accrued and unpaid dividends current on our preferred stock.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. Our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations, to prudent and sound banking practices, and to contractual provisions relating to our subordinated debentures and participation in the Capital Purchase Program.

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## **Results of Operations**

We recorded net income attributable to common shares of \$2.7 million for the third quarter of 2011 (\$0.31 per basic share and \$0.30 per diluted share), compared with a net loss attributable to common shares of \$5.7 million (\$0.67 per basic and diluted share) recorded during the third quarter of 2010. We recorded net income attributable to common shares of \$6.2 million (\$0.72 per basic share and \$0.69 per diluted share) for the first nine months of 2011, compared with a net loss attributable to common shares of \$9.3 million (\$1.10 per basic and diluted share) recorded during the first nine months of 2010.

The improved earnings performance in the third quarter of 2011 and the first nine months of 2011 compared to the respective prior-year periods primarily results from lower provisions to the allowance for loan losses. The decreased provision expense reflects lower volumes of loan rating downgrades and nonperforming loans and a higher volume of loan rating upgrades, as well as progress in the stabilization of economic and real estate market conditions and resulting collateral valuations. An increased net interest margin, which partially mitigated the negative impact of a lower level of average earning assets, and a reduction in overhead expenses also contributed to the improved earnings performance in the third quarter of 2011 and first nine months of 2011 compared to the respective 2010 periods.

Our earnings performance continues to be hindered by elevated provisions to the allowance for loan losses and costs associated with the administration and resolution of problem assets, reflecting continuing difficulties in the loan portfolio, most notably in the CRE segment. Ongoing state, regional and national economic struggles have significantly hampered certain of our borrowers' cash flows and negatively impacted real estate values, resulting in elevated levels of nonperforming assets and net loan charge-offs when compared to pre-2007 reporting periods.

Interest income during the third quarter of 2011 was \$17.0 million, a decrease of \$4.7 million, or 21.6%, from the \$21.7 million earned during the third quarter of 2010. Interest income during the first nine months of 2011 was \$54.7 million, a decrease of \$12.9 million, or 19.2%, from the \$67.6 million earned during the first nine months of 2010. The reduction in interest income is primarily attributable to a significant decrease in earning assets and, to a lesser extent, a declining yield on earning assets. During the third quarter of 2011, earning assets averaged \$1.41 billion, a decline of \$265.6 million, or 15.8%, from the \$1.68 billion in average earning assets during the third quarter of 2010. Average loans were down \$267.1 million, average federal funds sold increased \$29.9 million, average securities decreased \$28.5 million, and average interest-bearing deposit balances increased nominally. During the first nine months of 2011, earning assets averaged \$1.47 billion, or \$285.6 million lower than average earning assets of \$1.76 billion during the same time period in 2010. Average loans were down \$278.9 million, average securities decreased \$22.2 million, average federal funds sold increased \$14.9 million, and average interest-bearing deposit balances increased \$0.6 million.

During the third quarter of 2011 and 2010, earning assets had a weighted average yield (tax equivalent-adjusted basis) of 4.83% and 5.18%, respectively. The decline in earning asset yield in the third quarter of 2011 compared to the prior-year third quarter resulted from a decreased yield on average loans, a change in average earning asset mix, most notably a decline in higher-yielding average loans and an increase in lower-yielding average federal funds sold as a percentage of average earning assets, and a decreased yield on average securities. The yield on average loans was 5.34% in the third quarter of 2011 compared to 5.55% in the respective 2010 period. The lower yield on average loans in the third quarter of 2011 compared to the prior-year third quarter mainly resulted from a decreased yield on average commercial loans, which equaled 5.37% in the current year third quarter compared to 5.58% in the respective prior-year period. The commercial loan yield in the third quarter of 2011 was negatively impacted by a \$283,000 net decline in the present values of the purchased and sold interest rate caps; excluding the impact of this net decline, the yield on average commercial loans was 5.47% and the yield on average total loans was 5.44% in the third quarter of 2011.



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In addition, the commercial loan yield was negatively impacted by the lowering of rates on certain commercial loans throughout 2011 as a result of competitive pricing pressures and borrowers warranting decreased loan rates due to improved financial performance. Average loans equaled 78.5% of average earning assets during the third quarter of 2011, while average securities, federal funds sold, and interest-bearing deposit balances equaled 14.1%, 6.7%, and 0.7%, respectively. During the third quarter of 2010, average loans, securities, federal funds sold, and interest-bearing deposit balances represented 82.0%, 13.6%, 3.8%, and 0.6%, respectively, of average earning assets. The yield on average securities was 4.42% in the third quarter of 2011 compared to 4.54% in the respective 2010 period. The lower yield on average securities in the third quarter of 2011 compared to the prior-year third quarter mainly resulted from a decreased yield on U.S. Government agency bonds, reflecting a decline in market rates. Purchases of U.S. Government agency bonds using proceeds received from called bonds of the same type, along with additional purchases of agency bonds necessary to support increased collateral requirements, during the decreased market rate environment experienced in the latter six months of 2010, negatively impacted the yield on average securities.

During the first nine months of 2011 and 2010, earning assets had an average weighted yield (tax equivalent-adjusted basis) of 5.01% and 5.19%, respectively. The decline in earning asset yield in the 2011 period compared to the prior-year period resulted from a change in earning asset mix, most notably a decrease in higher-yielding average loans and an increase in lower-yielding average federal funds sold as a percentage of average earning assets, a decreased yield on average loans, and a decreased yield on average securities. Average loans equaled 79.8% of average earning assets during the first nine months of 2011, while average securities, federal funds sold, and interest-bearing deposit balances equaled 14.6%, 5.0%, and 0.6%, respectively. During the first nine months of 2010, average loans, securities, federal funds sold, and interest-bearing deposit balances represented 82.7%, 13.5%, 3.3%, and 0.5%, respectively, of average earning assets. The yield on average loans equaled 5.45% during the first nine months of 2011 compared to 5.50% during the comparable 2010 period. The declined yield on average loans in the first nine months of 2011 compared to the same 2010 time period primarily resulted from a decreased yield on average commercial loans, which equaled 5.48% and 5.52% in 2011 and 2010 periods, respectively. The commercial loan yield during the first nine months of 2011 was negatively impacted by a \$231,000 net decline in the present values of the purchased and sold interest rate caps; excluding the impact of this net decline, the yield on average commercial loans was 5.51% and the yield on average total loans was 5.48% in the first nine months of 2011. The commercial loan yield was also negatively impacted by the lowering of rates on certain commercial loans throughout 2011 as a result of competitive pricing pressures and borrowers warranting decreased loan rates due to improved financial performance. The yield on average securities was 4.45% in the first nine months of 2011 compared to 4.70% in the same prior-year period. The lower yield on average securities in the 2011 period compared to the respective 2010 period primarily resulted from a decreased yield on U.S. Government agency bonds, reflecting a decrease in market rates, and a shift in the securities portfolio mix from higher-yielding municipal securities to lower-yielding U.S. Government agency bonds. After analyzing our current and forecasted federal income tax position, we decided to sell certain tax-exempt municipal bonds with an aggregate book value of \$20.0 million in late March 2010. A vast majority of the sales proceeds were used to purchase U.S. Government agency bonds during April and early May of 2010. The increase in U.S. Government agency bonds as a percentage of average total securities also resulted from purchases necessitated by increased collateral requirements in the latter part of 2010.

Interest expense during the third quarter of 2011 was \$4.7 million, a decrease of \$3.1 million, or 39.1%, from the \$7.8 million expensed during the third quarter of 2010. Interest expense during the first nine months of 2011 was \$15.8 million, a decrease of \$9.2 million, or 36.9%, from the \$25.0 million expensed during the first nine months of 2010. The reduction in interest expense in the 2011 periods compared to the respective 2010 periods is attributable to a decrease in the volume of average interest-bearing liabilities and a decline in the weighted average cost of interest-bearing liabilities.

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During the third quarter of 2011, interest-bearing liabilities averaged \$1.22 billion, or \$291.0 million lower than average interest-bearing liabilities of \$1.51 billion during the prior-year third quarter. Average interest-bearing deposits were down \$126.7 million, while average FHLB advances decreased \$115.0 million, average short-term borrowings decreased \$39.1 million, and average other borrowings decreased \$10.2 million. During the first nine months of 2011, interest-bearing liabilities averaged \$1.29 billion, or \$302.5 million lower than average interest-bearing liabilities of \$1.59 billion during the same time period in 2010. Average interest-bearing deposits decreased \$154.0 million, while average FHLB advances decreased \$118.3 million, average short-term borrowings decreased \$20.9 million, and average other borrowings decreased \$9.3 million.

During the third quarter of 2011 and 2010, interest-bearing liabilities had a weighted average rate of 1.54% and 2.05%, respectively. During the first nine months of 2011 and 2010, interest-bearing liabilities had a weighted average rate of 1.64% and 2.10%, respectively. The lower weighted average cost of interest-bearing liabilities in the 2011 periods compared to the respective 2010 periods is primarily due to the decline in market interest rates that began late in the third quarter of 2007 and continued through December of 2008 and a change in average interest-bearing liability mix, most notably decreases in higher-costing average certificates of deposit and average FHLB advances and increases in certain lower-costing average non-certificate of deposit accounts as a percentage of average interest-bearing liabilities. Market interest rates remained low during 2009, 2010, and the first nine months of 2011. Maturing fixed-rate certificates of deposit and borrowings were renewed at lower rates, replaced by lower-costing funds, or allowed to runoff during the 21-month period ending September 30, 2011. In addition, the lowering of interest rates on non-certificate of deposit accounts and repurchase agreements during this timeframe positively impacted the weighted average cost of interest-bearing liabilities in the 2011 periods compared to the 2010 periods.

Net interest income during the third quarter of 2011 was \$12.3 million, a decrease of \$1.6 million, or 11.8%, from the \$13.9 million earned during the third quarter of 2010. Net interest income during the first nine months of 2011 was \$38.9 million, a decrease of \$3.8 million, or 8.8%, from the \$42.7 million earned during the first nine months of 2010. The decrease in net interest income in the 2011 periods compared to the respective 2010 periods was due to a decrease in earning assets, which more than offset an increase in the net interest margin. Average total loans during the third quarter of 2011 declined \$267.1 million, or 19.4%, compared to the prior-year third quarter, while average total loans during the first nine months of 2011 decreased \$278.9 million, or 19.2%, compared to the same 2010 period. The net interest margin during the third quarter of 2011 was 3.50%, compared to 3.33% during the third quarter of 2010. During the first nine months of 2011, the net interest margin was 3.58%, compared to 3.29% during the same time period in 2010. Excluding the impact of the net decline in the present values of the purchased and sold interest rate caps, the net interest margin equaled 3.58% in the third quarter of 2011 and 3.60% in the first nine months of 2011. The improved net interest margin in the third quarter of 2011 and the first nine months of 2011 compared to the respective prior-year periods reflects a reduction in our cost of funds, which more than offset the decreased yield on earning assets. Although our yield on earning assets declined in the 2011 periods compared to the respective prior-year periods, our cost of funds declined at a significantly greater rate, resulting in the improved net interest margin. The cost of funds primarily decreased as a result of higher-costing matured certificates of deposit and FHLB advances being renewed at lower rates, replaced by lower-costing funds, or allowed to runoff. In addition, the lowering of interest rates on certain non-certificate of deposit accounts and repurchase agreements during the 21 months ended September 30, 2011, positively impacted the cost of funds.

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 third quarter of 2011 and 2010. 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.

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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 \$180,000 and \$191,000 in the third quarter of 2011 and 2010, respectively, for this adjustment.

|                                            | Quarters ended September 30, |                  |                 |                    |                  |                 |
|--------------------------------------------|------------------------------|------------------|-----------------|--------------------|------------------|-----------------|
|                                            | Average<br>Balance           | 2011<br>Interest | Average<br>Rate | Average<br>Balance | 2010<br>Interest | Average<br>Rate |
|                                            | (dollars in thousands)       |                  |                 |                    |                  |                 |
| ASSETS                                     |                              |                  |                 |                    |                  |                 |
| Loans                                      | \$ 1,111,184                 | \$ 14,951        | 5.34%           | \$ 1,378,248       | \$ 19,284        | 5.55%           |
| Investment securities                      | 199,715                      | 2,207            | 4.42            | 228,201            | 2,589            | 4.54            |
| Federal funds sold                         | 94,049                       | 60               | 0.25            | 64,171             | 41               | 0.25            |
| Interest-bearing deposit balances          | 9,775                        | 6                | 0.24            | 9,742              | 11               | 0.43            |
| Total interest - earning assets            | 1,414,723                    | 17,224           | 4.83            | 1,680,362          | 21,925           | 5.18            |
| Allowance for loan losses                  | (39,149)                     |                  |                 | (47,543)           |                  |                 |
| Other assets                               | 129,066                      |                  |                 | 141,852            |                  |                 |
| Total assets                               | \$ 1,504,640                 |                  |                 | \$ 1,774,671       |                  |                 |
| LIABILITIES AND SHAREHOLDERS' EQUITY       |                              |                  |                 |                    |                  |                 |
| Interest-bearing deposits                  | \$ 1,070,887                 | \$ 4,040         | 1.50%           | \$ 1,197,568       | \$ 5,636         | 1.87%           |
| Short-term borrowings                      | 71,493                       | 73               | 0.41            | 110,584            | 394              | 1.41            |
| Federal Home Loan Bank advances            | 45,000                       | 410              | 3.57            | 160,000            | 1,441            | 3.52            |
| Other borrowings                           | 34,704                       | 226              | 2.55            | 44,874             | 328              | 2.90            |
| Total interest-bearing liabilities         | 1,222,084                    | 4,749            | 1.54            | 1,513,026          | 7,799            | 2.05            |
| Noninterest-bearing deposits               | 140,976                      |                  |                 | 116,334            |                  |                 |
| Other liabilities                          | 6,722                        |                  |                 | 5,682              |                  |                 |
| Shareholders' equity                       | 134,858                      |                  |                 | 139,629            |                  |                 |
| Total liabilities and shareholders' equity | \$ 1,504,640                 |                  |                 | \$ 1,774,671       |                  |                 |
| Net interest income                        |                              | \$ 12,475        |                 |                    | \$ 14,126        |                 |
| Net interest rate spread                   |                              |                  | 3.29%           |                    |                  | 3.13%           |
| Net interest spread on average assets      |                              |                  | 3.29%           |                    |                  | 3.16%           |
| Net interest margin on earning assets      |                              |                  | 3.50%           |                    |                  | 3.33%           |

Provisions for loan losses during the third quarter of 2011 were \$1.1 million, compared to \$10.4 million during the third quarter of 2010. Provisions for loan losses during the first nine months of 2011 were \$5.0 million, compared to \$25.0 million during the same time period in 2010.

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The reduced provision expense reflects lower volumes of loan rating downgrades and nonperforming loans and a higher volume of loan rating upgrades, as well as progress in the stabilization of economic and real estate market conditions and resulting collateral valuations. Net loan charge-offs of \$0.5 million were recorded during the third quarter of 2011, compared to \$14.3 million during the prior-year third quarter. During the first nine months of 2011, net loan charge-offs totaled \$11.0 million, compared to \$29.0 million during the same time period in 2010. Of the \$14.1 million in gross loans charged-off during the first nine months of 2011, \$5.6 million, or about 40%, represents the elimination of specific reserves that were established through provision expense in earlier periods. The allowance, as a percentage of total loans outstanding, was 3.60% as of September 30, 2011, compared to 3.59% as of December 31, 2010 and 3.30% as of September 30, 2010.

Noninterest income during the third quarter of 2011 was \$1.8 million, a decrease of \$0.5 million, or 21.2%, from the \$2.3 million earned during the third quarter of 2010. Noninterest income during the first nine months of 2011 was \$5.2 million, a decrease of \$1.7 million, or 24.2% from the \$6.9 million earned during the same time period in 2010. Noninterest income during the first nine months of 2010 includes gains totaling \$0.8 million from the sales of tax-exempt municipal bonds and guaranteed portions of certain Small Business Administration-guaranteed loans. Excluding these gains, noninterest income during the first nine months of 2011 decreased \$0.9 million, or 14.3%, compared to the first nine months of 2010. The decline in noninterest income in the 2011 periods compared to the respective 2010 periods was mainly due to lower rental income from fewer foreclosed properties and decreased mortgage banking income, commercial letter of credit fees, and service charges on accounts.

Noninterest expense during the third quarter of 2011 was \$10.0 million, a decrease of \$1.9 million, or 16.2%, from the \$11.9 million expensed during the third quarter of 2010. Noninterest expense during the first nine months of 2011 was \$32.0 million, down \$3.0 million, or 8.5%, from the \$35.0 million expensed during the same time period in 2010. Nonperforming asset administration and resolution costs totaled \$1.6 million during the third quarter of 2011, a decrease of \$1.3 million, or 45.1%, from the \$2.9 million in costs incurred during the third quarter of 2010; these costs totaled \$6.7 million during the first nine months of 2011, a decrease of \$1.2 million, or 15.5%, from the \$7.9 million in costs incurred during the first nine months of 2010. As a result of the significant level of nonperforming assets, these costs remain elevated; however, the costs are expected to decrease further in future periods if the level of nonperforming assets continues to decline.

FDIC insurance premiums were \$0.6 million during the third quarter of 2011, compared to \$1.1 million during the third quarter of 2010; the lower premiums resulted from a decreased assessment rate. The implementation of the FDIC's revised risk-based assessment system on April 1, 2011, resulted in the decreased assessment rate. FDIC insurance premiums were \$2.3 million during the first nine months of 2011, down from \$3.5 million during the first nine months of 2010. A lower assessment base and rate during the first quarter of 2011 compared to the first quarter of 2010 and the decreased assessment rate resulting from the FDIC's revised risk-base assessment system during the second and third quarters of 2011 compared to the respective prior-year periods resulted in the lower FDIC insurance premiums. Given the large number of insured institution failures in recent years, the increase in per-depositor insurance coverage, the temporary unlimited insurance of noninterest-bearing deposit accounts, and other changes in federal deposit insurance made by the Dodd-Frank Act, it is difficult to predict the level of our future deposit insurance assessments.

Controllable operating expenses, including salaries and benefits, occupancy, and furniture and equipment costs, declined \$0.1 million, or 1.0%, in the third quarter of 2011 compared to the prior-year third quarter; these costs decreased \$0.8 million, or 4.7%, during the first nine months of 2011 compared to the same time period in 2010.

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Salary and benefit costs, which declined slightly in the third quarter of 2011 compared to the prior-year third quarter and decreased \$0.5 million during the first nine months of 2011 compared to the respective prior-year period, were positively impacted by a reduction in full-time equivalent employees from 250 at third quarter-end 2010 to 237 at third quarter-end 2011. Occupancy and furniture and equipment costs declined by \$0.1 million in the third quarter of 2011 compared to the prior-year third quarter and \$0.3 million in the first nine months of 2011 compared to the respective 2010 period, primarily resulting from an aggregate reduction in depreciation expense.

During the third quarter of 2011, we recorded income before federal income tax of \$3.0 million and no federal income tax expense or benefit. During the third quarter of 2010, we recorded a loss before federal income tax of \$6.1 million and a federal income tax benefit of \$0.7 million. During the first nine months of 2011, we recorded income before federal income tax of \$7.2 million and no federal income tax or benefit, compared to a loss before federal income tax of \$10.4 million and a federal income tax benefit of \$2.0 million during the first nine months of 2010. Although we recorded taxable income during the third quarter and first nine months of 2011, the existence of a net operating loss carryforward resulted in no tax expense being recognized. Our ability to recognize federal income tax benefits during periods in which net losses are recorded is significantly limited due to the establishment of a valuation allowance against the entire balance of our net deferred tax asset in the fourth quarter of 2009. Generally, the calculation for the federal income tax provision (benefit) does not consider the tax effects of changes in other comprehensive income ( OCI ), which is a component of shareholders' equity on the balance sheet. However, an exception is provided in certain circumstances, such as when there is a pre-tax loss from continuing operations. In such cases, pre-tax income from other categories (such as changes in OCI) is included in the calculation of the federal income tax provision (benefit) for the current year. This resulted in the recognition of the \$0.7 million federal income tax benefit in the third quarter of 2010 and the \$2.0 million federal income tax benefit during the first nine months of 2010.

**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.

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

The following table depicts our GAP position as of September 30, 2011:

|                                                     | Within<br>Three<br>Months | Three to<br>Twelve<br>Months | One to<br>Five<br>Years | After<br>Five<br>Years | Total                   |
|-----------------------------------------------------|---------------------------|------------------------------|-------------------------|------------------------|-------------------------|
| <b>Assets:</b>                                      |                           |                              |                         |                        |                         |
| Commercial loans (1)                                | \$ 240,343,000            | \$ 224,652,000               | \$ 500,289,000          | \$ 24,340,000          | \$ 989,624,000          |
| Residential real estate loans                       | 35,947,000                | 8,997,000                    | 43,493,000              | 11,701,000             | 100,138,000             |
| Consumer loans                                      | 1,615,000                 | 574,000                      | 1,970,000               | 116,000                | 4,275,000               |
| Securities (2)                                      | 30,259,000                | 212,000                      | 41,966,000              | 112,658,000            | 185,095,000             |
| Federal funds sold                                  | 97,183,000                | 0                            | 0                       | 0                      | 97,183,000              |
| Interest-bearing deposits                           | 9,630,000                 | 0                            | 0                       | 0                      | 9,630,000               |
| Allowance for loan losses                           | 0                         | 0                            | 0                       | 0                      | (39,351,000)            |
| Other assets                                        | 0                         | 0                            | 0                       | 0                      | 131,391,000             |
| <b>Total assets</b>                                 | <b>414,977,000</b>        | <b>234,435,000</b>           | <b>587,718,000</b>      | <b>148,815,000</b>     | <b>\$ 1,477,985,000</b> |
| <b>Liabilities:</b>                                 |                           |                              |                         |                        |                         |
| Interest-bearing checking                           | 192,694,000               | 0                            | 0                       | 0                      | 192,694,000             |
| Savings deposits                                    | 37,336,000                | 0                            | 0                       | 0                      | 37,336,000              |
| Money market accounts                               | 152,603,000               | 0                            | 0                       | 0                      | 152,603,000             |
| Time deposits under \$100,000                       | 14,934,000                | 40,942,000                   | 33,503,000              | 0                      | 89,379,000              |
| Time deposits \$100,000 & over                      | 99,288,000                | 281,850,000                  | 188,161,000             | 0                      | 569,299,000             |
| Short-term borrowings                               | 69,340,000                | 0                            | 0                       | 0                      | 69,340,000              |
| Federal Home Loan Bank advances                     | 0                         | 30,000,000                   | 15,000,000              | 0                      | 45,000,000              |
| Other borrowed money                                | 34,704,000                | 0                            | 0                       | 0                      | 34,704,000              |
| Noninterest-bearing checking                        | 0                         | 0                            | 0                       | 0                      | 144,022,000             |
| Other liabilities                                   | 0                         | 0                            | 0                       | 0                      | 6,875,000               |
| <b>Total liabilities</b>                            | <b>600,899,000</b>        | <b>352,792,000</b>           | <b>236,664,000</b>      | <b>0</b>               | <b>1,341,252,000</b>    |
| Shareholders' equity                                | 0                         | 0                            | 0                       | 0                      | 136,733,000             |
| <b>Total liabilities &amp; shareholders' equity</b> | <b>600,899,000</b>        | <b>352,792,000</b>           | <b>236,664,000</b>      | <b>0</b>               | <b>\$ 1,477,985,000</b> |
| <b>Net asset (liability) GAP</b>                    | <b>\$ (185,922,000)</b>   | <b>\$ (118,357,000)</b>      | <b>\$ 351,054,000</b>   | <b>\$ 148,815,000</b>  |                         |
| <b>Cumulative GAP</b>                               | <b>\$ (185,922,000)</b>   | <b>\$ (304,279,000)</b>      | <b>\$ 46,775,000</b>    | <b>\$ 195,590,000</b>  |                         |
| <b>Percent of cumulative GAP to total assets</b>    | <b>(12.6%)</b>            | <b>(20.6%)</b>               | <b>3.2%</b>             | <b>13.2%</b>           |                         |



- (1) Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.
- (2) Mortgage-backed securities are categorized by average life calculations based upon prepayment trends as of September 30, 2011.

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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, it 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 timing, magnitude, and frequency of interest rate changes and changes in market conditions and our strategies, among other factors.

We conducted multiple simulations as of September 30, 2011, in which it was assumed that changes in market interest rates occurred ranging from up 400 basis points to down 400 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on net interest income over the next twelve months in comparison to estimated net interest income based on our balance sheet structure, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of September 30, 2011. The resulting estimates are well within our policy parameters established to manage and monitor interest rate risk.

| Interest Rate Scenario               | Dollar Change                | Percent Change               |
|--------------------------------------|------------------------------|------------------------------|
|                                      | In Net<br>Interest<br>Income | In Net<br>Interest<br>Income |
| Interest rates down 400 basis points | \$ (1,300,000)               | (2.7%)                       |
| Interest rates down 300 basis points | (800,000)                    | (1.7)                        |
| Interest rates down 200 basis points | (300,000)                    | (0.6)                        |
| Interest rates down 100 basis points | 300,000                      | 0.6                          |
| No change in interest rates          | 1,000,000                    | 2.1                          |
| Interest rates up 100 basis points   | 500,000                      | 1.0                          |
| Interest rates up 200 basis points   | 100,000                      | 0.1                          |
| Interest rates up 300 basis points   | 500,000                      | 1.1                          |
| Interest rates up 400 basis points   | 1,400,000                    | 2.8                          |

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The resulting estimates have been significantly impacted by the current interest rate and economic environments, as adjustments have been made to critical model inputs with regards to traditional interest rate relationships. This is especially important as it relates to floating rate commercial loans and brokered certificates of deposit, which comprise a substantial portion of our balance sheet. As of September 30, 2011, the Mercantile Bank Prime Rate was 4.50% as compared to the Wall Street Journal Prime Rate of 3.25%. Historically, the two indices have been equal; however, we elected not to reduce the Mercantile Bank Prime Rate in late October and mid-December of 2008 when the Wall Street Journal Prime Rate declined by 50 and 75 basis points, respectively. In conducting our simulations since year-end 2008, we have made the assumption that the Mercantile Bank Prime Rate will remain unchanged until the Wall Street Journal Prime Rate equals the Mercantile Bank Prime Rate, at which time the two indices will remain equal in the increasing interest rate scenarios. Also, brokered certificate of deposit rates have substantially decreased since December of 2008, with part of the decline attributable to a significant imbalance whereby the supply of available funds far outweighs the demand from banks looking to raise funds. As a result, we have substantially limited further reductions in brokered certificate of deposit rates in the declining interest rate scenarios. The resulting estimates also take into account the cap corridor that is addressed in Note 9, which provides for net increased net interest income of \$0.5 million, \$0.9 million, \$1.0 million and \$1.1 million in the increasing rate environments of 100 basis points, 200 basis points, 300 basis points and 400 basis points, respectively.

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.

**Item 4. Controls and Procedures**

As of September 30, 2011, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of September 30, 2011. There have been no significant changes in our controls over financial reporting during the quarter ended September 30, 2011 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

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

**Item 1A. Risk Factors.**

There have been no material changes in our risk factors from those previously disclosed in our annual report on Form 10-K for the year ended December 31, 2010.

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

We made no unregistered sale of equity securities, nor did we purchase our equity securities, during the quarter ended September 30, 2011.

In April 2010, our Board of Directors suspended future payments of cash dividends on our common stock. Holders of our common stock are entitled to receive cash dividends to the extent that they are declared from time to time by our Board of Directors. Holders of our preferred stock are entitled to receive cash dividends in the amount provided for in our Articles of Incorporation, to the extent that they are declared by our Board of Directors. We may only pay cash dividends out of funds that are legally available for that purpose. We are a holding company and substantially all of our assets are held by our subsidiaries. Our ability to pay cash dividends to our shareholders depends primarily on our bank's ability to pay cash dividends to us. Cash dividend payments and extensions of credit to us from our bank are subject to legal and regulatory limitations, generally based on capital levels and current and retained earnings, imposed by law and regulatory agencies with authority over our bank. The ability of our bank to pay cash dividends is also subject to its profitability, financial condition, capital expenditures and other cash flow requirements.

Also, in connection with our participation in the Capital Purchase Program, we agreed that we would not, without the Treasury Department's consent, pay a cash dividend on our common stock, other than a regular quarterly dividend of not more than \$0.04 per share. This limit on paying dividends without the Treasury Department's consent remains in effect until the earlier of (i) May 15, 2012, or (ii) when all of the preferred stock that we sold to the Treasury Department has been redeemed by us or transferred by the Treasury Department to third parties.

In addition, before October 18 and 19, 2011 there were restrictions on our payment of dividends on our preferred stock and common stock resulting from deferral of interest on our subordinated debentures and suspension of payments of dividends on our preferred stock. These restrictions terminated when we brought the deferred interest on our subordinated debentures current and declared and paid all accrued and unpaid dividends on our preferred stock in October of 2011. Details on these restrictions and their termination in October are set forth below.

Under the terms of the subordinated debentures that we issued to the trust, we are precluded from paying cash dividends on our common stock or preferred stock if an event of default has occurred and is continuing under the subordinated debentures, or if we have exercised our right to defer payments of interest on the subordinated debentures, until the deferral ends. On July 9, 2010, we gave notice that we were deferring the regularly scheduled quarterly interest payments on our subordinated debentures beginning with the quarterly interest payment that was scheduled to be paid on July 18, 2010. On October 18, 2011, we paid and brought current the deferred interest on the subordinated debentures and ended the deferral of interest. From July 18, 2010 until October 18, 2011, when the deferral ended, the terms of the subordinated debentures precluded us from paying any dividends on our common stock or preferred stock.

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Our outstanding preferred stock was issued on May 15, 2009 pursuant to the United State Treasury Department's Capital Purchase Program. The provisions of our Articles of Incorporation relating to our preferred stock preclude us from paying any cash dividends on our common stock while any dividends accrued on our preferred stock have not been declared and paid. We suspended the payment of dividends on our preferred stock, beginning with the dividend that would have been paid on August 15, 2010. On October 19, 2011, our Board of Directors declared a dividend on our preferred stock that paid and brought current all of the accrued and unpaid dividends on our preferred stock. The provisions of our Articles of Incorporation relating to our preferred stock precluded us from paying dividends on our common stock from August 15, 2010 to October 19, 2011, when all accrued and unpaid dividends on our preferred stock were paid and brought current.

**Item 3. Defaults Upon Senior Securities.**

As indicated in Item 2 above, we suspended the payment of dividends on our preferred stock beginning with the dividend that would have been paid on August 15, 2010, and ending when all accrued and unpaid dividends on our preferred stock were paid and brought current on October 19, 2011. Our outstanding preferred stock is designated as Fixed Rate Cumulative Perpetual Preferred Stock, Series A. As of the date of filing of this report, there is no aggregate arrearage in the payment of cumulative quarterly dividends on our preferred stock.

**Item 4. Reserved**

Not applicable.

**Item 5. Other Information.**

Not applicable.

**Item 6. Exhibits**

| EXHIBIT NO. | EXHIBIT DESCRIPTION                                                                                                                                                                                                                                                                                                                                                                                                                                          |
|-------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1         | Our Articles of Incorporation are incorporated by reference to Exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2009                                                                                                                                                                                                                                                                                                                              |
| 3.2         | Our Amended and Restated Bylaws dated as of January 16, 2003 are incorporated by reference to Exhibit 3.2 of our Registration Statement on Form S-3 (Commission File No. 333-103376) that became effective on February 21, 2003                                                                                                                                                                                                                              |
| 31          | Rule 13a-14(a) Certifications                                                                                                                                                                                                                                                                                                                                                                                                                                |
| 32.1        | Section 1350 Chief Executive Officer Certification                                                                                                                                                                                                                                                                                                                                                                                                           |
| 32.2        | Section 1350 Chief Financial Officer Certification                                                                                                                                                                                                                                                                                                                                                                                                           |
| 101         | The following financial information from Mercantile's Quarterly Report on Form 10-Q for the quarter ended September 30, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Operations, (iii) the Consolidated Statements of Changes in Shareholders Equity, (iv) the Consolidated Statements of Cash Flows, and (v) the Notes to Consolidated Financial Statements * |

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\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 8, 2011.

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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**EXHIBIT INDEX**

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