

FARMERS & MERCHANTS BANCORP INC

Form 10-Q

May 05, 2009

Table of Contents

**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended March 31, 2009**

OR

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____**

**Commission File Number 0-14492
FARMERS & MERCHANTS BANCORP, INC.
(Exact name of registrant as specified in its charter)**

OHIO

34-1469491

(State or other jurisdiction of
incorporation or organization)

(I.R.S Employer
Identification No.)

307-11 North Defiance Street, Archbold, Ohio

43502

(Address of principal executive offices)

(Zip Code)

(419) 446-2501

Registrant's telephone number, including area code

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Indicate by check mark whether the registrant 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 (§ 232.405 of this chapter) 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 shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares of each of the issuers classes of common stock, as of the latest practicable date:

Common Stock, No Par Value

4,749,148

Class

Outstanding as of March 31, 2009

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10Q
FARMERS & MERCHANTS BANCORP, INC.
INDEX

| Form 10-Q Items | Page |
|--|-------|
| PART I. FINANCIAL INFORMATION | |
| <u>Item 1. Financial Statements (Unaudited)</u> | |
| <u>Condensed Consolidated Balance Sheets- March 31, 2009 and December 31, 2008</u> | 1 |
| <u>Condensed Consolidated Statements of Net Income- Three Months Ended March 31, 2009 and March 31, 2008</u> | 2 |
| <u>Condensed Consolidated Statements of Cash Flows- Three Months Ended March 31, 2009 and March 31, 2008</u> | 3 |
| <u>Notes to Condensed Financial Statements</u> | 4 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 4-10 |
| <u>Item 3. Qualitative and Quantitative Disclosures About Market Risk</u> | 10-11 |
| <u>Item 4. Controls and Procedures</u> | 11 |
| <u>PART II. OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 11 |
| <u>Item 1A. Risk Factors</u> | 11 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 11-12 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 12 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 12 |
| <u>Item 5. Other Information</u> | 12 |
| <u>Item 6. Exhibits</u> | 12 |
| <u>Signatures</u> | 12 |
| Exhibit 31. Certifications Under Section 302 | 13-14 |
| Exhibit 32. Certifications Under Section 906 | 15-16 |

EX-31.1

EX-31.2

EX-32.1

EX-32.2

Table of Contents

ITEM 1 FINANCIAL STATEMENTS

FARMERS & MERCHANTS BANCORP, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)
 (in thousands of dollars)

| | March 31, 2009 | Dec 31, 2008 |
|---|-----------------------|-----------------------|
| ASSETS: | | |
| Cash and due from banks | \$ 33,844 | \$ 19,148 |
| Interest bearing deposits with banks | 0 | 0 |
| Federal funds sold | 20,586 | 1,739 |
| Investment Securities: | | |
| U.S. Treasury | 0 | 0 |
| U.S. Government | 136,802 | 134,501 |
| State & political obligations | 44,089 | 43,160 |
| All others | 4,498 | 4,498 |
| Loans and leases (Net of reserve for loan losses of \$5,931 and \$5,497 respectively) | 549,618 | 562,336 |
| Bank premises and equipment-net | 16,559 | 16,806 |
| Accrued interest and other assets | 20,592 | 19,467 |
| Goodwill | 4,074 | 4,074 |
| TOTAL ASSETS | \$ 830,662 | \$ 805,729 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest bearing | \$ 57,918 | \$ 62,582 |
| Interest bearing | 586,528 | 553,150 |
| Federal funds purchased and securities sold under agreement to repurchase | 43,036 | 48,214 |
| Other borrowed money | 45,559 | 45,635 |
| Accrued interest and other liabilities | 6,355 | 5,601 |
| Total Liabilities | 739,396 | 715,182 |
| SHAREHOLDERS EQUITY: | | |
| Common stock, no par value authorized 6,500,000 shares; issued 5,200,000 shares | 12,677 | 12,677 |
| Treasury Stock - 427,277 shares 2009, 418,294 shares 2008 | (8,899) | (8,727) |
| Unearned Stock Awards 23,575 for 2009 and 17,240 for 2008 | (503) | (503) |
| Undivided profits | 85,739 | 84,864 |
| Accumulated other comprehensive income (expense) | 2,252 | 2,236 |
| Total Shareholders Equity | 91,266 | 90,547 |
| LIABILITIES AND SHAREHOLDERS EQUITY | \$ 830,662 | \$ 805,729 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2008 Balance Sheet has been derived from the audited financial statements of that date.

Table of Contents

FARMERS & MERCHANTS BANCORP, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME
 (Unaudited)
 (in thousands of dollars, except per share data)

| | Three Months Ended | |
|---|--------------------|-------------------|
| | March 31, 2009 | March 31, 2008 |
| INTEREST INCOME: | | |
| Loans and leases | \$ 8,434 | \$ 8,894 |
| Investment Securities: | | |
| U.S. Treasury securities | | |
| Securities of U.S. Government agencies | 1,479 | 1,648 |
| Obligations of states and political subdivisions | 403 | 407 |
| Other | 50 | 54 |
| Federal funds | 10 | 208 |
| Deposits in banks | | |
| Total Interest Income | 10,376 | 11,211 |
| INTEREST EXPENSE: | | |
| Deposits | 2,877 | 4,493 |
| Borrowed funds | 597 | 801 |
| Total Interest Expense | 3,474 | 5,294 |
| NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES | 6,902 | 5,917 |
| PROVISION FOR LOAN LOSSES | 659 | 269 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 6,243 | 5,648 |
| OTHER INCOME: | | |
| Service charges | 721 | 820 |
| Other | 1,004 | 787 |
| Net securities gains (losses) | 118 | 15 |
| | 1,843 | 1,622 |
| OTHER EXPENSES: | | |
| Salaries and wages | 2,185 | 2,029 |
| Pension and other employee benefits | 867 | 854 |
| Occupancy expense (net) | 270 | 253 |
| Other operating expenses | 2,401 | 1,985 |
| | 5,723 | 5,121 |
| INCOME BEFORE FEDERAL INCOME TAX | 2,363 | 2,149 |
| FEDERAL INCOME TAXES | 633 | 581 |
| NET INCOME | 1,730 | 1,568 |

OTHER COMPREHENSIVE INCOME (NET OF TAX):

| | | |
|---|----|-------|
| Unrealized gains (losses) on securities | 16 | 1,899 |
|---|----|-------|

| | | |
|--------------------------------|----------|----------|
| COMPREHENSIVE INCOME (EXPENSE) | \$ 1,746 | \$ 3,467 |
|--------------------------------|----------|----------|

| | | |
|----------------------|---------|---------|
| NET INCOME PER SHARE | \$ 0.36 | \$ 0.32 |
|----------------------|---------|---------|

| | | |
|--|-----------|-----------|
| Based upon average weighted shares outstanding of: | 4,756,389 | 4,917,707 |
|--|-----------|-----------|

| | | |
|--------------------|---------|---------|
| DIVIDENDS DECLARED | \$ 0.18 | \$ 0.16 |
|--------------------|---------|---------|

No disclosure of diluted earnings per share is required as shares are antidiluted as of quarter end.

See Notes to Condensed Consolidated Unaudited Financial Statements.

Table of Contents

FARMERS & MERCHANTS BANCORP, INC.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Unaudited)
 (in thousands of dollars)

| | Three Months Ended | |
|--|--------------------|-------------------|
| | March 31, 2009 | March 31, 2008 |
| <i>CASH FLOWS FROM OPERATING ACTIVITIES:</i> | | |
| Net income | \$ 1,730 | \$ 1,568 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Depreciation and amortization | 364 | 293 |
| Premium amortization | 177 | 81 |
| Discount amortization | (19) | (31) |
| Amortization of servicing rights | 308 | 159 |
| Amortization of core deposit intangible | 39 | 39 |
| Provision for loan losses | 659 | 269 |
| (Gain) Loss on sale of fixed assets | (1) | (19) |
| (Gain) Loss on sale of investment securities | (118) | (15) |
| Changes in Operating Assets and Liabilities: | | |
| Accrued interest receivable and other assets | (1,595) | (1,353) |
| Accrued interest payable and other liabilities | 853 | (751) |
| Net Cash Provided by Operating Activities | 2,397 | 240 |
| <i>CASH FLOWS FROM INVESTING ACTIVITIES</i> | | |
| Capital expenditures | (116) | (443) |
| Proceeds from maturities of investment securities: | 26,599 | 26,978 |
| Proceeds from sale of investment securities: | 4,284 | 25 |
| Purchase of investment securities | (34,110) | (24,643) |
| Net (increase) decrease in loans and leases | 12,058 | (7,699) |
| Net Cash Provided (Used) by Investing Activities | 8,715 | (5,782) |
| <i>CASH FLOWS FROM FINANCING ACTIVITIES</i> | | |
| Net increase (decrease) in deposits | 28,714 | (12,076) |
| Net change in short-term borrowings | (5,178) | (1,630) |
| Payments on long-term borrowings | (76) | (93) |
| Purchase of Treasury stock | (172) | (874) |
| Payments of dividends | (857) | (795) |
| Net Cash Provided (Used) by Financing Activities | 22,431 | (15,468) |
| Net change in cash and cash equivalents | 33,543 | (21,010) |
| Cash and cash equivalents Beginning of year | 20,887 | 48,887 |
| CASH AND CASH EQUIVALENTS END OF THE PERIOD | \$ 54,430 | \$ 27,877 |

RECONCILIATION OF CASH AND CASH EQUIVALENTS:

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| | | | |
|------------------------------|-----------|----|--------|
| Cash and cash due from banks | \$ 33,844 | \$ | 18,308 |
| Federal funds sold | 20,586 | | 9,569 |
| | \$ 54,430 | \$ | 27,877 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

3

Table of Contents

FARMERS & MERCHANTS BANCORP, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2009 are not necessarily indicative of the results that are expected for the year ended December 31, 2009. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2008.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

INTRODUCTION

Farmers & Merchants Bancorp, Inc. was incorporated on February 25, 1985, under the laws of the State of Ohio. Farmers & Merchants Bancorp, Inc., and its subsidiary The Farmers & Merchants State Bank are engaged in commercial banking. On December 31, 2007 the Bank closed on a agreement to acquire Knisely Bank, Indiana, adding two more full service locations. The executive offices of Farmers & Merchants Bancorp, Inc are located at 307 North Defiance Street, Archbold, Ohio 43502.

As the new year began, the banking industry along with the rest of the business world continued to feel the impact of the slow and difficult economy. As lending rates continued downward the Bank found itself very active in making home mortgage real estate and home equity loans. Customers were taking advantage of the low interest rate and were refinancing their existing mortgages. The gain on the sale of real estate loans in the secondary market was two and a half times the 2008's level for the first quarter.

The Bank also chose to sell off a portion of the security portfolio, mainly securities that were outside the state of Ohio. The Bank replaced these securities with Ohio based securities to help support pledging to the Ohio Public accounts that are deposited with the Bank. The sales produced a favorable gain on securities for the Bank in the first quarter 2009.

One major impact to the financial position for the Bank will be the increased FDIC assessment on deposits that will be charged in 2009. This increase effectively constitutes a penalty to the Bank as well as to other community banks across the nation for the questionable judgment of others in the finance and business communities. Liquidity remains high and overall the quarter had better earnings than first quarter 2008 and fourth quarter 2008.

Table of Contents

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

(Continued)

The Bank has chosen to not take part in the TARP money that was offered by the Federal government. The Bank remains a healthy, stable institution with money to lend to credit worthy customers. It has been and will continue to be impacted by the difficult economy and the issues facing the banking industry.

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the industries in which it operates. At times the application of these principles requires Management to make assumptions estimates and judgments that affect the amounts reported in the financial statements. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL), the valuation of its Mortgage Servicing Rights, the valuation of goodwill and the valuation of its post retirement benefit liability as the accounting areas that requires the most subjective or complex judgments, and as such have the highest possibility of being subject to revision as new information becomes available.

The ALLL represents management's estimate of credit losses inherent in the Bank's loan portfolio at the report date. The estimate is a composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion.

FAIR VALUE MEASUREMENTS

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis at March 31, 2009, and the valuation techniques used by the Company to determine those fair values. In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability.

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS**

(Continued)

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset or liability.

Disclosures concerning assets and liabilities measured at fair value are as follows:

Assets and Liabilities Measured at Fair Value on a Recurring Basis at March 31, 2009

(\$ in Thousands)

| | Quoted Prices in Active Markets for Identical | Significant Observable Inputs | Significant Observable Inputs | Balance at March 31, 2009 |
|-------------------------------|--|-------------------------------------|-------------------------------------|---------------------------------|
| | Assets (Level 1) | (Level 2) | (Level 3) | |
| Assets | | | | |
| Securities Available for Sale | \$ 136,802 | \$ 44,089 | \$ 0 | \$ 180,891 |
| Liabilities | \$ 0 | \$ 0 | \$ 0 | \$ 0 |

The Company did not have any assets or liabilities measured at fair value that were categorized as Level 3 during the period. All of the Company's available for sale securities, including any bonds issued by local municipalities, have CUSIP numbers making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At March 31, 2009, such assets consist primarily of impaired loans. The Company has established the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections. During the quarter ended March 31, 2009, the impairment charges recorded to the income statement for impaired loans were not significant.

Impaired loans accounted for under FAS 114 categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

Other assets, including bank owned life insurance, are also subject to periodic impairment assessments under other accounting principles generally accepted in the United States of America. These assets are not considered financial instruments. Effective February 12, 2008, the FASB issued a staff position, FSP FAS 157-2, which delayed the applicability of FAS 157 to non-financial instruments. Accordingly, these assets have been omitted from the above disclosures.

LIQUIDITY, CAPITAL RESOURCES AND MATERIAL CHANGES IN FINANCIAL CONDITION

In comparing the balance sheet of March 31, 2009 to that of December 31, 2008, the largest change is the \$33.5 million increase in the cash position. Federal Reserve Bank funds increased by \$14.8 million over the prior year end balances. Federal Funds Sold at December 31 2008, was just \$1.02 million and in March 2009, \$20.0 million was sold. The increase in liquidity was derived from deposits which increased in the quarter ended March 2009 by \$28.6 million over December 2008 year end balances. The new Reward checking product is a major reason for the improvement in deposits in the first quarter of 2009. The investment portfolio increased almost \$2.2 million in agencies and \$1.0 million in state obligations for a change of \$3.2 million over 2008 year end.

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS**

(Continued)

On the asset side, loans declined by \$12.7 million since year end, primarily in the agricultural and consumer real estate loans. Consumer loan balances were down due to the large number being converted to fixed rate loans and being sold as customers took advantage of the lower interest rates. The slower growth was not due to a lack of funds or tightening of credit by the Bank. As businesses put off expansions, the demand for commercial loans drastically decreased. Past due loans over 30 days ended March 31, 2009 at 2.09% as compared to the December 31, 2008 past due percentage of 2.87%. While still above 2.0 %, the percentage is lower than all of 2008. Driving the percentage is the commercial and agricultural portfolios. Many of those same loans have increased the non-accrual balances of the Bank. A loan is placed in non-accrual automatically once it has reached 90 days past due or management questions its collectability. The balance in non-accruals has increased to \$15.5 million as of March, 31 2009 as compared to December 31, 2008 non-accrual balance of \$13.6 million. The increases were based on just a few relationships experiencing cash flow difficulty. Residential mortgage delinquency was two and one half percent and consumer loan delinquency is less than one quarter of a percent. A discussion of the additional impact to profitability caused by the non accruals will follow in the results of operations.

Liquidity and capital remain strong with capital increasing during the first quarter even though the Company continued its repurchasing of treasury stock and increased its dividend payout as compared to first quarter 2008. The Company repurchased 171,889 shares during 2008 and continued with an additional 8,983 repurchased during the first quarter of 2009. In terms of dollars spent, 2008 purchases cost just over \$3.58 million and 2009 purchases cost over \$172 thousand. The Company has authorization to purchase up to 225 thousand shares during 2009.

The Company continues to be well-capitalized as the capital ratios below show:

| | |
|-----------------------------------|--------|
| Primary Ratio | 11.02% |
| Tier I Leverage Ratio | 10.33% |
| Risk Based Capital Tier 1 | 13.29% |
| Total Risk Based Capital | 14.26% |
| Stockholders' Equity/Total Assets | 10.99% |

As the economic conditions in this country continued to deteriorate over the past year, many banks and companies have chosen to decrease their quarterly dividends and some have chosen to not declare any dividend. This is not the case for this Company as the Board of Directors have confidence in the Company's financial position, choosing to declare a first quarter dividend of 18 cents per share. This is an increase over the 16 cents paid out in the first quarter 2008, maintaining a long term focus for the Company's stockholders.

Table of Contents

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

(Continued)

MATERIAL CHANGES IN RESULTS OF OPERATIONS

Interest income and yield on the loan portfolio were down significantly in the first quarter 2009 compared to first quarter 2008. Reversal of interest income due to the loans whose status went to nonaccrual totaled \$138 thousand for 2009 and \$430 thousand for 2008 same period. Non-accrual loans currently total over \$15.5 million as of March 31, 2009. Classifying a loan as non-accrual does not exclude collection of the interest but rather a timing of when the revenue can be recognized. Non-accrual loan interest is recognized when collected on a cash basis. As mentioned earlier and as the past due percentages support, these loans are mainly in the commercial and agricultural portfolios. The high non-accrual balance remains a barrier to higher profitability. The Bank has also experienced customers refinancing their loans to take advantage of the lower interest rates and the number of loans being sold in the secondary market has increased 2.5 times that of the same time period a year ago.

The Federal Fund rate cuts during 2007 and 2008 also impacted the yield of the portfolio. Lines of credit, adjustable rate mortgages subject to repricing, home equities and new loans all priced considerably lower in first quarter 2009 versus 2008. This was another large factor in the lower interest income even though the cash balances have almost doubled over last year totals. With the yield on the Federal Funds Sold being impacted by the cuts, interest earned on Federal Funds Sold was \$198 thousand lower in 2009 when compared to the same first quarter 2008.

The first quarter end 2009 investment portfolio balance reflected a decrease of \$5.0 million when compared to prior year first quarter. The lower balance was caused by increases in prepayment speeds on mortgage backed securities and option calls being exercised. The same factors applied to the interest income from the investment portfolio which was \$177 thousand lower in the first quarter 2009 than the first quarter 2008. This was due to the timing of the maturities and the rates on the replacement of the portfolio securities. In February 2009 the bank chose to sell off some of the securities located outside the state of Ohio. This generated a gain on securities of \$118 thousand in the quarter. The securities were then replaced with securities located in Ohio. The investment portfolio provides liquidity but also is used heavily for pledging to the Bank's Ohio public funds.

With rates dropping over the last sixteen months, it would be expected for interest expense to have decreased. The positive statement here is that year-to-date, the drop has been almost \$1.8 million when the deposit balances are significantly higher by \$21.8 million than a year ago. The cost of funds on the deposits dropped 114 basis points as compared to same quarter end last year. This was accomplished as a large percentage of the certificate of deposit portfolio reached maturity after the first quarter in 2008 and either left the bank or repriced at a lower rate. Other borrowings also experienced maturities and new purchases. The new purchases were at significantly lower interest costs. Overall net interest income was higher for the 2009 period end comparison by \$985 thousand. Net interest margin for quarter ended March 2009 was at 3.66% while the same quarter 2008 was at 3.29%. This improvement is caused by the current interest expense being lower due to the fact that a large part of our CD portfolio repriced at lower rates or rate shoppers left the Bank. The margin was also impacted by the reversal of non-accrual interest being much larger in the first quarter 2008 than same period 2009.

The reserve for loan losses at both March 31, 2009 and March 31, 2008 was \$5.9 million. The total reserve for loan losses was \$5.5 million at December 31, 2008. An increase to the provision for loan losses during the first quarter of 2009 relates primarily to the reclassification of one large commercial loan and the overall increase in loan balances by \$19 million over the prior year. Factors influencing the calculation of the ALLL include the local economy, the overall credit quality of the loan portfolio and the analysis of specific troubled accounts. The increase in the non-accrual loans, and the overall decrease in past dues were all given consideration in the provision to the loan loss balance. Net charge-offs for the corresponding periods show 2009 at \$205 thousand with last year's net charge-offs at \$380 thousand. Again, management's concern is not with respect to residential loans, but rather with respect to a few large commercial and agricultural loans. The Bank continues to work on the collection process which has been slowed due to an increase in bankruptcy and foreclosure filings flowing through the court systems.

Table of Contents

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)

The new Reward checking product is increasing non interest income through increased debit card activity the first quarter of 2009. Debit card usage from the reward checking customers is double that of our free checking account customers. The convenience to the customer and increased revenue to the Bank will continue to be a positive for all involved as debit card fees were \$81 thousand higher than same period last year. Overall customer service fees were \$73 thousand higher than the prior year quarter. The Bank generated an additional \$96 thousand on the sale of mortgage loans as compared to same period last year. Mortgage servicing rights were also \$59 thousand higher due to the increased refinancing of home mortgages. These increases were off set by decreases in NSF charges and service charges of \$109 thousand over same period 2008. Overall, non interest income for the three months ended March 31, 2009 was \$221 thousand higher than the same period 2008.

Non interest expense was \$602 thousand higher for first three months 2009 as compared to same period 2008. Computer services for the first quarter 2009 was \$299 thousand and 2008 was \$323 thousand. This difference was contributed to the conversion and start up of the acquired Knisley bank locations in 2008. The Bank's data processing expense is based mainly on the number of accounts under management. Each application such as loan, checking, certificate of deposit, are priced individually along with the household account database. Costs derived from the number of accounts were higher in 2009 from the growth over 2008. However additional expense was also carried the first part of 2008 until the software conversion of the acquisition was completed in January. Maintenance on the acquired institution's systems continued through April 2008.

With the current economic issues in the Banking industry, our Bank has seen the impact that this crisis has brought with the significant increase in FDIC assessments in the first quarter of 2009. Current quarter expense related to the assessment is \$258 thousand while last year same period was only \$14 thousand. In addition, legal service expenses for loan collection have increased as a result of increases in borrower defaults. We have seen an increase in collection costs as additional expertise is utilized on the large commercial and agricultural accounts.

Salaries and expenses show an increase in the quarterly period. This was partly due to having one additional office this year and funding the incentive plan for 2009, which was not done in the first quarter 2008. Also noteworthy is the increase in the pension and other benefits. These increases are being driven by higher medical costs as the bank is partially self-insured. The Bank's share of claim expense is higher by over \$85 thousand year over year. Medical costs continue to be a concern due to the rising cost of premiums and claims.

Overall, net income was up \$162 thousand in comparing 2009 to 2008 three months performance. The Company earnings per share year to date March 2009 was \$0.36 while the March 2008 was at \$0.32. Without the large FDIC assessment and additional loan loss provision, the 2009 performance would have better reflected the efforts of the Bank's management team. The Bank is strong, well capitalized and has money to lend. The challenge lies in maintaining the net interest margin and decreasing the balance of non-accrual loans. The Company expects to continue focusing on these issues throughout 2009. Improvement in asset quality will continue to be a focus for the remainder of 2009.

Table of Contents**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)**

Expected loan growth will require additional provision for loan loss to fund the reserve. The newest locations are anticipated to continue growing and provide new opportunities for long term profitability of the Company. In these uncertain times with the many unprecedented events occurring, each day presents new challenges and more importantly new opportunities.

FORWARD LOOKING STATEMENTS

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as intend, believe, expect, anticipate, should, planned, estimated, and potential. Such forward-looking statements are based on current expectations, but may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of the Company's interest rate risk arises from the instruments, positions and transactions entered into for purposes, other than trading, such as lending, investing and securing sources of funds. Interest rate risk occurs when interest bearing assets and liabilities reprice at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework for the Company. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. The Company employs a sensitivity analysis in the form of a net interest rate shock as shown in the table following.

| Interest Rate Shock on Net Interest Margin | | | Interest Rate Shock on Net Interest Income | | |
|--|-----------------------|----------------|--|--------------------------|-----------------------|
| Net Interest Margin (Ratio) | % Change to Flat Rate | Rate Direction | Rate Changes by | Cumulative Total (\$000) | % Change to Flat Rate |
| 3.15% | -7.607% | Rising | 3.000% | 6,184 | -6.922% |
| 3.23% | -5.049% | Rising | 2.000% | 6,338 | -4.594% |
| 3.32% | -2.513% | Rising | 1.000% | 6,492 | -2.287% |
| 3.41% | 0.000% | Flat | 0.000% | 6,644 | 0.000% |
| 3.46% | 1.634% | Falling | -1.000% | 6,737 | 1.407% |
| 3.48% | 2.290% | Falling | -2.000% | 6,762 | 1.775% |
| 3.47% | 1.996% | Falling | -3.000% | 6,729 | 1.283% |

Table of Contents**QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK (Continued)**

The net interest margin represents the forecasted twelve month margin. It also shows what effect rate changes will have on both the margin and the net interest income. In the flat rate environment the chart reflects a continued decline in the interest margin ratio as it has changed by 14 basis points since last quarter. This does show that the Bank has less exposure to interest rate sensitivity but that also means that there is less opportunity for profits that can be generated by accepting more risk. On the liability side of the balance sheet, we do not have any products tied directly to the prime interest rate. This means we have the opportunity to limit the impact of the rate change. On the asset side of the balance sheet we do have some that are tied to the prime. To help improve the net interest margin on these products, we are changing the interest spread where possible and adding floors as the loans reprice. The majority of these are variable loans with a one year renewal term. These rate shocks are based on the current loan structure, not with the anticipated modifications.

The shock report has consistently shown an improvement in a falling rate environment; however the floor has been reached in many portfolios. The net interest margin could also be improved by a decrease in the nonaccrual loan balances and/or collection of the interest. Again, this shock report shows a much lower exposure to rate changes in either direction than in the same reports during 2008.

ITEM 4 CONTROLS AND PROCEDURES

As of March 31, 2009, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2009. There have been no significant changes in the Company's internal controls that occurred during the quarter ended March 31, 2009.

PART II**ITEM 1 LEGAL PROCEEDINGS**

None

ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2008.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs | (d) Maximum Number of Shares that may yet be purchased under the Plans or Programs |
|-----------------------|--------------------------------------|----------------------------------|---|--|
| 1/1/2009 to 1/31/2009 | | | | 225,000 |
| 2/1/2009 to 2/28/2009 | | | | |
| 3/1/2009 to 3/31/2009 | 8,983 | \$ 19.15 | 8,983 | 216,017 |
| Total | 8,983 | \$ 19.15 | 8,983(1) | 216,017 |

Table of Contents

UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS (Continued)

(1) The Company purchased these shares in the market pursuant to a stock repurchase program publicly announced on January 16, 2009. On that date, the Board of Directors authorized the repurchase of 225,000 common shares between January 1, 2009 and December 31, 2009.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None

ITEM 5 OTHER INFORMATION

ITEM 6 EXHIBITS

- 3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on August 1, 2006)
- 3.2 Code of Regulations of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)
- 31.1 Rule 13-a-14(a) Certification CEO
- 31.2 Rule 13-a-14(a) Certification CFO
- 32.1 Section 1350 Certification CEO
- 32.2 Section 1350 Certification CFO

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.

Farmers & Merchants Bancorp, Inc.,

Date: April 30, 2009

By: /s/ Paul S. Siebenmorgen
Paul S. Siebenmorgen
President and CEO

Date: April 30, 2009

By: /s/ Barbara J. Britenriker
Barbara J. Britenriker
Exec. Vice-President and CFO