MERCANTILE BANK CORP
Form 10-Q
August 08, 2008

Table of Contents

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

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

For the quarterly period ended June 30, 2008

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

For the transition period from to

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

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

310 Leonard Street, NW, Grand Rapids, MI 49504

(Address of principal executive offices) (Zip Code)

(616) 406-3000

(Registrant s telephone number, including area code)

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

Yes þ No o

Indicate by check mark whether the registrant 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 o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

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

Yes o No þ

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

MERCANTILE BANK CORPORATION
INDEX

Page No.

PART I. Financial Information

Item 1. Financial Statements

Consolidated Balance Sheets — June 30, 2008 (Unaudited) and December 31, 2007 — 3

Consolidated Statements of Income — Three and Six Months Ended June 30, 2008 (Unaudited) and June 30, 2007 (Unaudited) — 4

Consolidated Statements of Changes in Shareholders' Equity — Six Months Ended June 30, 2008 (Unaudited) and June 30, 2007 (Unaudited) — 5

Consolidated Statements of Cash Flows — Three and Six Months Ended June 30, 2008 (Unaudited) and June 30, 2007 (Unaudited) — 7

Notes to Consolidated Financial Statements (Unaudited) — 9

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations — 22

Item 3. Quantitative and Qualitative Disclosures About Market Risk — 35

Item 4. Controls and Procedures — 37

PART II. Other Information

Item 1. Legal Proceedings — 38

Item 1A. Risk Factors — 38

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds — 38

Item 3. Defaults upon Senior Securities — 38

Item 4. Submission of Matters to a Vote of Security Holders — 38

Item 5. Other Information — 39

Item 6. Exhibits — 39

Signatures — 40

Our Articles of Incorporation
Rule 13a-14(a) Certifications
Section 1350 Chief Executive Officer Cerification
Section 1350 Chief Financial Officer Certification

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

MERCANTILE BANK CORPORATION
CONSOLIDATED BALANCE SHEETS

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

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

See accompanying notes to consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF INCOME

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

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

See accompanying notes to consolidated financial statements.

Table of Contents

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

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

See accompanying notes to consolidated financial statements.

Table of Contents

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

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

See accompanying notes to consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

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

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

See accompanying notes to consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

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

See accompanying notes to consolidated financial statements.

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three and six months ended June 30, 2008 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan (our bank), our bank s three subsidiaries, Mercantile Bank Mortgage Company, LLC (our mortgage company), Mercantile Bank Real Estate Co., LLC (our real estate company), and Mercantile Insurance Center, Inc. (our insurance center). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the periods ended June 30, 2008 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2007.

We formed a business trust, Mercantile Bank Capital Trust I (the trust), in 2004 to issue trust preferred securities. We issued subordinated debentures to the trust in return for the proceeds raised from the issuance of the trust preferred securities. In accordance with FASB Interpretation No. 46, the trust is not consolidated, but instead we report the subordinated debentures issued to the trust as a liability.

Earnings Per Share: Basic earnings per share is based on weighted average common shares outstanding during the period exclusive of unvested restricted shares outstanding. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under stock options and restricted shares and are determined using the treasury stock method. Stock-based awards for 322,165 shares of common stock for the three and six month periods ended June 30, 2008 and 112,514 shares of common stock for the three and six month periods ended June 30, 2007 were antidilutive and were not included in determining diluted earnings per share.

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan and Lease Losses: The allowance for loan and lease losses (allowance) is a valuation allowance for probable incurred credit losses, increased by the provision for loan and lease losses and recoveries, and decreased by charge-offs. Management estimates the allowance balance required based on past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, and economic conditions. Allocations of the allowance may be made for specific loans and leases, but the entire allowance is available for any loan or lease that, in management s judgment, should be charged-off. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is likely.

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

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

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

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

2. LOANS AND LEASES

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

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

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

3. ALLOWANCE FOR LOAN AND LEASE LOSSES

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

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

4. PREMISES AND EQUIPMENT NET

Premises and equipment are comprised of the following:

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

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

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

5. DEPOSITS

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

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

6. SHORT-TERM BORROWINGS

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

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

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

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

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

7. FEDERAL HOME LOAN BANK ADVANCES

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

Each advance is payable at its maturity date and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of June 30, 2008 totaled $322.3 million, with availability approximating $27.1 million.

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

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

8. COMMITMENTS AND OFF-BALANCE-SHEET RISK

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

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

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 June 30, 2008 and December 31, 2007 follows:

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

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of June 30, 2008, the total notional amount of the underlying interest rate swap agreements was $38.8 million, with a net fair value from our commercial loan customers perspective of negative $0.3 million. We made no payments during the first six months of 2008 in regards to the risk participation agreements, and have accrued no liability for such potential payments. These risk participation agreements are considered financial guarantees in accordance with FASB Interpretation No. 45 and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years.

9. HEDGING ACTIVITIES

Our interest rate risk policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using net interest income simulation.
Our policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within the policy parameters.

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

9. HEDGING ACTIVITIES (Continued)

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

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

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

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

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

10. FAIR VALUES

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

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

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

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

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. FAIR VALUES (Continued)

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

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 1 securities include U.S. Government Agency bonds and mortgage-backed securities issued or guaranteed by U.S. Government Agencies that are traded by dealers or brokers in active over-the-counter markets. We have no Level 2 or 3 securities.

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

Mortgage loans held for sale. Mortgage loans held for sale are carried at the lower of cost or fair value and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of June 30, 2008, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the $1.3 million of such loans at cost so they are not included in the nonrecurring table below.

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

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

Table of Contents

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. FAIR VALUES (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2008 are as follows:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities available for sale	$ 129,013,000	$ 129,013,000	$ 0	$ 0
Derivatives	(763,000)	0	(763,000)	0
Total	$ 128,250,000	$ 129,013,000	$ (763,000)	$ 0

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

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2008 and related gains (losses) for the three and six months ended June 30, 2008 are as follows:

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

[1] Represents carrying value and related write-downs for which

adjustments are
based on the
estimated value
of the property.

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

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

MERCANTILE BANK CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

11. REGULATORY MATTERS

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

The prompt corrective action regulations provide five classifications, including we