

MERCANTILE BANK CORP  
Form 10-K  
March 04, 2019

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-K**

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

**For the fiscal year ended December 31, 2018**

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 000-26719

**MERCANTILE BANK CORPORATION**

(Exact name of registrant as specified in its charter)

**Michigan**

(State or other jurisdiction of incorporation or organization)

**38-3360865**

(I.R.S. Employer Identification No.)

**310 Leonard Street NW, Grand Rapids, Michigan**

(Address of principal executive offices)

**49504**

(Zip Code)

**(616) 406-3000**

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Name of each exchange on which registered  
Title of each class  
Common Stock    The Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes \_\_\_ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes \_\_\_ No X

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 X No \_\_\_

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes X No \_\_\_

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or emerging growth company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer \_\_\_                      Accelerated filer X                      Emerging growth company  
\_\_\_\_\_  
Non-accelerated filer \_\_\_                      Smaller reporting company \_\_\_

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. \_\_\_

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes \_\_\_ No X

The aggregate value of the common equity held by non-affiliates (persons other than directors and executive officers) of the registrant, computed by reference to the closing price of the common stock as of the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$590 million.

As of March 1, 2019, there were issued and outstanding 16,415,665 shares of the registrant's common stock.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's proxy statement for the Annual Meeting of Shareholders to be held May 23, 2019 are incorporated by reference into Part III of this report.

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**PART I**

**Item 1. Business.**

**The Company**

Mercantile Bank Corporation is a registered bank holding company under the Bank Holding Company Act of 1956, as amended (the “Bank Holding Company Act”). Unless the text clearly suggests otherwise, references to “us,” “we,” “our,” or “the company” include Mercantile Bank Corporation and its wholly-owned subsidiaries. As a bank holding company, we are subject to regulation by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”). We were organized on July 15, 1997, under the laws of the State of Michigan, primarily for the purpose of holding all of the stock of Mercantile Bank of Michigan (“our bank”), and of such other subsidiaries as we may acquire or establish. Our bank commenced business on December 15, 1997. During the third quarter of 2013, we filed an election to become a financial holding company, which election became effective April 14, 2014.

Mercantile Insurance Center, Inc. (“our insurance company”), a subsidiary of our bank, commenced operations during 2002 to offer insurance products. Mercantile Bank Real Estate Co., L.L.C., (“our real estate company”), a subsidiary of our bank, was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids which serves as our bank’s main office and Mercantile Bank Corporation’s headquarters.

Our expenses have generally been paid using cash dividends from our bank. Our principal source of future operating funds is expected to be dividends from our bank.

**Our Bank**

Our bank is a state banking company that operates under the laws of the State of Michigan, pursuant to a charter issued by the Michigan Department of Insurance and Financial Services. Our bank’s deposits are insured to the maximum extent permitted by law by the Federal Deposit Insurance Corporation (“FDIC”). Our bank, through its 46 office locations, provides commercial banking services primarily to small- to medium-sized businesses and retail banking services. Our bank’s main office is located in Grand Rapids, and our operations are centered around the West and Central portions of Michigan, with branch office locations in Alma, Belding, Cadillac, Canadian Lakes, Clare, Comstock Park, DeWitt, Fairview, Grand Rapids, Hastings, Holland, Howard City, Ionia, Ithaca, Kalamazoo, Kentwood, Lakeview, Lansing, Lowell, Merrill, Mt. Pleasant, Paw Paw, Portage, Remus, Rose City, Shepherd, St. Charles, St. Helen, St. Johns, Vestaburg, West Branch, and Wyoming. We expanded into Southeast Michigan in 2017,

opening a banking office in Troy during the first quarter.

Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns 40 automated teller machines ("ATM") and three video banking machines at a vast majority of our office locations that participate in the ACCEL/EXCHANGE and PLUS regional network systems, as well as other ATM networks throughout the country. Our bank also enables customers to conduct certain loan and deposit transactions by personal computer and through mobile applications. Courier service is provided to certain commercial customers, and safe deposit facilities are available at a vast majority of our office locations. Our bank does not have trust powers.

### **Our Insurance Company**

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent. To date, we have not provided the insurance products noted above and currently have no plans to do so.

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### **Our Real Estate Company**

Our real estate company was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids that serves as our bank's main office and Mercantile Bank Corporation's headquarters. This facility was placed into service during the second quarter of 2005. Our real estate company is 99% owned by our bank and 1% owned by our insurance company.

### **Our Trusts**

We have five business trusts that are wholly-owned subsidiaries of Mercantile, four of which were assumed by Mercantile in conjunction with the merger with Firstbank Corporation ("Firstbank"). Each of the trusts was formed to issue preferred securities that were sold in private sales, as well as selling common securities to Mercantile. The proceeds from the preferred and common securities sales were used by the trusts to purchase floating rate notes issued by Mercantile. The rates of interest, interest payment dates, call features and maturity dates of each floating rate note are identical to its respective preferred securities. The net proceeds from the issuance of the floating rate notes were used for a variety of purposes, including contributions to our bank as capital to provide support for asset growth and the funding of stock repurchase programs and certain acquisitions. The only significant assets of our trusts are the floating rate notes, and the only significant liabilities of our trusts are the preferred securities. The floating rate notes are categorized on our Consolidated Balance Sheets as subordinated debentures, and the interest expense is recorded on our Consolidated Statements of Income under interest expense on other borrowings.

### **Firstbank Corporation Merger**

We completed our merger with Firstbank, a Michigan corporation with approximately \$1.5 billion in total assets and 46 branch locations, into Mercantile Bank Corporation as of June 1, 2014 ("Merger Date"). The merger substantially expanded our geographic footprint and increased the size of our balance sheet.

In conjunction with the completion of the merger, Mercantile assumed the obligations of Firstbank Capital Trust I, Firstbank Capital Trust II, Firstbank Capital Trust III and Firstbank Capital Trust IV, all of which are business trust subsidiaries formed to issue trust preferred securities. At the Merger Date, Firstbank had two Michigan-chartered bank subsidiaries that were consolidated into Mercantile Bank of Michigan effective June 30, 2014.

### **Effect of Government Monetary Policies**

Our earnings are affected by domestic economic conditions and the monetary and fiscal policies of the United States Government, its agencies, and the Federal Reserve Board. The Federal Reserve Board's monetary policies have had, and will likely continue to have, an important impact on the operating results of commercial banks through its power to implement national monetary policy in order to, among other things, curb inflation, maintain or encourage employment, and mitigate economic recessions. The policies of the Federal Reserve Board have a major effect upon the levels of bank loans, investments and deposits through its open market operations in United States Government securities, and through its regulation of, among other things, the discount rate on borrowings of member banks and the reserve requirements against member bank deposits. Our bank maintains reserves directly with the Federal Reserve Bank of Chicago to the extent required by law. It is not possible to predict the nature and impact of future changes in monetary and fiscal policies.

### **Regulation and Supervision**

Banks and bank holding companies, among other financial institutions, are regulated under federal and state law. These include, among others, minimum capital requirements, state usury laws, state laws relating to fiduciaries, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"), the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Expedited Funds Availability Act, the Community Reinvestment Act, the Real Estate Settlement Procedures Act, the USA PATRIOT Act, the FACT Act, the Gramm-Leach-Bliley Act, the Sarbanes Oxley Act, the Bank Secrecy Act, electronic funds transfer laws, redlining laws, predatory lending laws, antitrust laws, environmental laws, money laundering laws and privacy laws. Our growth and earnings performance may be impacted by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. Those regulatory authorities include, but are not limited to, the Federal Reserve Board, the FDIC, the Michigan Department of Insurance and Financial Services, the Internal Revenue Service and state taxing authorities. The effect of such statutes, regulations and policies, and any changes thereto, can be significant and cannot necessarily be predicted.

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As a registered bank holding company under the Bank Holding Company Act, we are required to file an annual report with the Federal Reserve Board and such additional information as the Federal Reserve Board may require. We are also subject to examination by the Federal Reserve Board.

The Bank Holding Company Act limits the activities of bank holding companies to banking and the management of banking organizations, and to certain non-banking activities. The permitted non-banking activities include those limited activities that the Federal Reserve Board found, by order or regulation as of the day prior to enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking as to be a proper incident to banking. These permitted non-banking activities include, among other things: operating a mortgage company, finance company, or factoring company; performing certain data processing operations; providing certain investment and financial advice; acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, nonoperating basis; and providing discount securities brokerage services for customers. Neither we nor any of our subsidiaries engage in any of the non-banking activities listed above.

On April 14, 2014, our election to become a financial holding company, as permitted by the Bank Holding Company Act, as amended by Title I of the Gramm-Leach-Bliley Act, was accepted by the Federal Reserve Board. In order to continue as a financial holding company, we and our bank must satisfy statutory requirements regarding capitalization, management and compliance with the Community Reinvestment Act. As a financial holding company, we are permitted to engage in a broader range of activities under the Bank Holding Company Act than are permitted to bank holding companies. Those expanded activities include any activity which the Federal Reserve Board (in certain instances in consultation with the Department of the Treasury) determines, by order or by regulation, to be financial in nature or incidental to such financial activity, or to be complementary to a financial activity, and not to pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Such expanded activities include, among others: insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, or issuing annuities, and acting as principal, agent or broker for such purposes; providing financial, investment or economic advisory services, including advising a mutual fund; and underwriting, dealing in, or making a market in securities. While our insurance company is permitted to engage in the insurance agency activities described above by virtue of our financial holding company status, neither we nor any of our subsidiaries currently engages in the expanded activities.

Our bank is subject to restrictions imposed by federal and state law and regulations. Among other things, these restrictions apply to any extension of credit to us or to our other subsidiaries, to securities borrowing or lending, derivatives, and repurchase transactions with us or our other subsidiaries, to investments in stock or other securities that we issue, to the taking of such stock or securities as collateral for loans to any borrower, and to acquisitions of assets or services from, and sales of certain types of assets to, us or our other subsidiaries. Michigan banking laws place restrictions on various aspects of banking, including branching, payment of dividends, loan interest rates and capital and surplus requirements. Federal law restricts our ability to borrow from our bank by limiting the aggregate amount we may borrow and by requiring that all loans to us be secured in designated amounts by specified forms of collateral.



With respect to the acquisition of banking organizations, we are generally required to obtain the prior approval of the Federal Reserve Board before we can acquire all or substantially all of the assets of any bank, or acquire ownership or control of any voting shares of any bank or bank holding company, if, after the acquisition, we would own or control more than 5% of the voting shares of the bank or bank holding company. Acquisitions of banking organizations across state lines are subject to restrictions imposed by federal and state laws and regulations.

The scope of regulations and supervision of various aspects of our business have expanded as a result of the adoption in July, 2010 of the Dodd-Frank Act, and may continue to expand as the result of implementing regulations being adopted by federal regulators. However, on May 24, 2018, EGRRCPA amended certain provisions of the Dodd-Frank Act to tailor them to the specific circumstances of various categories of financial institutions and transactions. For additional information on this legislation and its potential impact, refer to the Risk Factor entitled “The effect of financial services legislation and regulations remains uncertain” in Item 1A- Risk Factors in this Annual Report.

## **Employees**

As of December 31, 2018, we employed 585 full-time and 108 part-time persons. Management believes that relations with employees are good.

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**Lending Policy**

As a routine part of our business, we make loans to businesses and individuals located within our market areas. Our lending policy states that the function of the lending operation is twofold: to provide a means for the investment of funds at a profitable rate of return with an acceptable degree of risk, and to meet the credit needs of the creditworthy businesses and individuals who are our customers. We recognize that in the normal business of lending, some losses on loans will be inevitable and should be considered a part of the normal cost of doing business.

Our lending policy anticipates that priorities in extending loans will be modified from time to time as interest rates, market conditions and competitive factors change. The policy sets forth guidelines on a nondiscriminatory basis for lending in accordance with applicable laws and regulations. The policy describes various criteria for granting loans, including the ability to pay; the character of the customer; evidence of financial responsibility; purpose of the loan; knowledge of collateral and its value; terms of repayment; source of repayment; payment history; and economic conditions.

The lending policy further limits the amount of funds that may be loaned against specified types of real estate collateral. For certain loans secured by real estate, the policy requires an appraisal of the property offered as collateral by a state certified independent appraiser. The policy also provides general guidelines for loan to value for other types of collateral, such as accounts receivable and machinery and equipment. In addition, the policy provides general guidelines as to environmental analysis, loans to employees, executive officers and directors, problem loan identification, maintenance of an allowance for loan losses, loan review and grading, mortgage and consumer lending, and other matters relating to our lending practices.

The Board of Directors has delegated significant lending authority to officers of our bank. The Board of Directors believes this empowerment, supported by our strong credit culture and the significant experience of our commercial lending staff, enables us to be responsive to our customers. The loan policy specifies lending authority for our lending officers with amounts based on the experience level and ability of each lender. Our loan officers and loan managers are able to approve loans up to \$1.0 million and \$2.5 million, respectively. We have established higher approval limits for our bank's Senior Lender, President and Chief Executive Officer ranging from \$4.0 million up to \$10.0 million. These lending authorities, however, are typically used only in rare circumstances where timing is of the essence. Generally, loan requests exceeding \$2.5 million require approval by the Officers Loan Committee, and loan requests exceeding \$7.5 million, up to the legal lending limit of approximately \$80.1 million, require approval by our bank's Board of Directors. We generally apply an in-house lending limit that is significantly less than our bank's legal lending limit.

Provisions of recent legislation, including the Dodd-Frank Act and EGRRCPA, when fully implemented by regulations to be adopted by federal agencies, may have a significant impact on our lending policy, especially in the areas of single-family residential real estate and other consumer lending. For additional information on this legislation

and its potential impact, refer to the Risk Factor entitled “The effect of financial services legislation and regulations remains uncertain” in Item 1A- Risk Factors in this Annual Report.

## **Lending Activity**

*Commercial Loans.* Our commercial lending group originates commercial loans primarily in our market areas. Our commercial lenders have extensive commercial lending experience, with most having at least ten years’ experience. Loans are originated for general business purposes, including working capital, accounts receivable financing, machinery and equipment acquisition, and commercial real estate financing, including new construction and land development.

Working capital loans are often structured as a line of credit and are reviewed periodically in connection with the borrower’s year-end financial reporting. These loans are generally secured by substantially all of the assets of the borrower and have a floating interest rate tied to the Wall Street Journal Prime Rate or 30-Day Libor Rate. Loans for machinery and equipment purposes typically have a maturity of three to five years and are fully amortizing, while commercial real estate loans are usually written with a five-year maturity and amortize over a 10- to 20-year period. Commercial loans typically have an interest rate that is fixed to maturity or is tied to the Wall Street Journal Prime Rate or 30-Day Libor Rate.

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We evaluate many aspects of a commercial loan transaction in order to minimize credit and interest rate risk. Underwriting includes an assessment of the management, products, markets, cash flow, capital, income and collateral of the borrowing entity. This analysis includes a review of the borrower's historical and projected financial results. Appraisals are generally required to be performed by certified independent appraisers where real estate is the primary collateral, and in some cases, where equipment is the primary collateral. In certain situations, for creditworthy customers, we may accept title reports instead of requiring lenders' policies of title insurance.

Commercial real estate lending involves more risk than residential lending because loan balances are typically greater and repayment is dependent upon the borrower's business operations. We attempt to minimize the risks associated with these transactions by generally limiting our commercial real estate lending to owner-operated properties and to owners of non-owner occupied properties who have an established profitable history and satisfactory tenant structure. In many cases, risk is further reduced by requiring personal guarantees, limiting the amount of credit to any one borrower to an amount considerably less than our legal lending limit and avoiding certain types of commercial real estate financings.

We have no material foreign loans, and only limited exposure to companies engaged in energy producing and agricultural-related activities.

*Single-Family Residential Real Estate Loans.* We originate single-family residential real estate loans in our market areas, generally according to secondary market underwriting standards. Loans not conforming to those standards are made in certain circumstances. Single-family residential real estate loans provide borrowers with a fixed or adjustable interest rate with terms up to 30 years, with the fixed interest rate loans generally sold to various investors.

Our bank has a home equity line of credit program. Home equity lines of credit are generally secured by either a first or second mortgage on the borrower's primary residence. The program provides revolving credit at a rate tied to the Wall Street Journal Prime Rate.

*Consumer Loans.* We originate various types of consumer loans, including new and used automobile and boat loans, credit cards and overdraft protection lines of credit for our checking account customers. Consumer loans generally have shorter terms and higher interest rates and usually involve more credit risk than single-family residential real estate loans because of the type and nature of the collateral.

We believe our consumer loans are underwritten carefully, with a strong emphasis on the amount of the down payment, credit quality, employment stability and monthly income of the borrower. These loans are generally repaid on a monthly repayment schedule with the source of repayment tied to the borrower's periodic income. In addition, consumer lending collections are dependent on the borrower's continuing financial stability, and are thus likely to be adversely affected by job loss, illness and personal bankruptcy. In many cases, repossessed collateral for a defaulted

consumer loan will not provide an adequate source of repayment of the outstanding loan balance because of depreciation of the underlying collateral. We believe that the generally higher yields earned on consumer loans compensate for the increased credit risk associated with such loans, and that consumer loans are important to our efforts to serve the credit needs of the communities and customers that we serve.

### **Loan Portfolio Quality**

We utilize a comprehensive grading system for our commercial loans, whereby 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 at various intervals.

Our independent loan review program is primarily responsible for the administration of the grading system and ensuring adherence to established lending policies and procedures. The loan review program is an integral part of maintaining our strong asset quality culture. The loan review function works closely with senior management, although it functionally reports to the Board of Directors. Using a risk-based approach to selecting credits for review, our loan review program has covered approximately 65% to 75% of total commercial loans outstanding during the past three years. In addition, a random sampling of retail loans is reviewed each quarter. Our watch list credits are reviewed monthly by our Board of Directors and our Watch List Committee, the latter of which is comprised of senior level officers from the administration, lending and loan review functions.

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Loans are placed in a nonaccrual status when, in our opinion, uncertainty exists as to the ultimate collection of all principal and interest. As of December 31, 2018, loans placed in nonaccrual status totaled \$4.1 million, or 0.2% of total loans, compared to \$7.1 million, or 0.3% of total loans, at December 31, 2017. No loans were past due 90 days or more and still accruing interest at year-end 2018 or 2017.

Additional detail and information relative to the loan portfolio is incorporated by reference to Management's Discussion and Analysis of Financial Condition and Results of Operations ("Management's Discussion and Analysis") and Note 4 of the Notes to Consolidated Financial Statements in this Annual Report.

### **Allowance for Loan Losses**

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at an adequate level. Through the loan review and credit departments, we establish specific 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, the result of which is combined with specific reserves to calculate an overall allowance amount. For non-impaired commercial loans, reserve allocation factors are based on the loan ratings as determined by our standardized grade paradigms and by loan purpose. Our commercial loan portfolio is segregated 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; lending concentrations; and other external factors, including 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.

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2018 we placed most weight on the period starting December 31, 2010 through December 31, 2018. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve

allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

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 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, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our loan portfolio.

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and the 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.

Additional detail regarding the allowance is incorporated by reference to Management's Discussion and Analysis and Note 4 of the Notes to Consolidated Financial Statements included in this Annual Report.

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### **Investments**

*Bank Holding Company Investments.* The principal investments of our bank holding company are the investments in the common stock of our bank and the common securities of our trusts. Other funds of our bank holding company may be invested from time to time in various debt instruments.

Subject to the limitations of the Bank Holding Company Act and the “Volcker Rule”, we are also permitted to make portfolio investments in equity securities and to make equity investments in subsidiaries engaged in a variety of non-banking activities, which include real estate-related activities such as community development, real estate appraisals, arranging equity financing for commercial real estate, and owning and operating real estate used substantially by our bank or acquired for its future use. Our bank holding company has no plans at this time to make directly any of these equity investments at the bank holding company level. Our Board of Directors may, however, alter the investment policy at any time without shareholder approval.

*Our Bank’s Investments.* Our bank may invest its funds in a wide variety of debt instruments and may participate in the federal funds market with other depository institutions. Subject to certain exceptions, our bank is prohibited from investing in equity securities. Among the equity investments permitted for our bank under various conditions and subject in some instances to amount limitations, are shares of a subsidiary insurance agency, mortgage company, real estate company, or Michigan business and industrial development company, such as our insurance company and our real estate company. Under another such exception, in certain circumstances and with prior notice to or approval of the FDIC, our bank could invest up to 10% of its total assets in the equity securities of a subsidiary corporation engaged in the acquisition and development of real property for sale, or the improvement of real property by construction or rehabilitation of residential or commercial units for sale or lease. Our bank has no present plans to make such an investment. Real estate acquired by our bank in satisfaction of or foreclosure upon loans may be held by our bank for specified periods. Our bank is also permitted to invest in such real estate as is necessary for the convenient transaction of its business. Our bank’s Board of Directors may alter the bank’s investment policy without shareholder approval at any time.

Additional detail and information relative to the securities portfolio is incorporated by reference to Management’s Discussion and Analysis and Note 3 of the Notes to Consolidated Financial Statements included in this Annual Report.

### **Competition**

We face substantial competition in all phases of our operations from a variety of different competitors. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks,



savings banks, thrifts, credit unions and other financial institutions as well as from other entities that provide financial services. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our primary competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do, and offer larger branch networks and other services which we do not. Most of these same entities have greater capital resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. Under specified circumstances (that have been modified by the Dodd-Frank Act and EGRRCPA), securities firms and insurance companies that elect to become financial holding companies under the Bank Holding Company Act may acquire banks and other financial institutions. Federal banking law affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. We also face new competition as a result of our expansion into the Southeast Michigan marketplace.

### **Selected Statistical Information**

Management's Discussion and Analysis beginning on Page F-4 in this Annual Report includes selected statistical information.

### **Return on Equity and Assets**

Return on Equity and Asset information is included in Management's Discussion and Analysis beginning on Page F-4 in this Annual Report.

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**Available Information**

We maintain an internet website at [www.mercbank.com](http://www.mercbank.com). We make available on or through our website, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practical after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. We do not intend the address of our website to be an active link or to otherwise incorporate the contents of our website into this Annual Report.

**Item 1A. Risk Factors.**

The following risk factors could affect our business, financial condition or results of operations. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report because they could cause the actual results and conditions to differ materially from those projected in forward-looking statements. Before you buy our common stock, you should know that investing in our common stock involves risks, including the risks described below. The risks that are highlighted here are not the only ones we face. If the adverse matters referred to in any of the risks actually occur, our business, financial condition or operations could be adversely affected. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment.

**Adverse changes in economic conditions or interest rates may negatively affect our earnings, capital and liquidity.**

The results of operations for financial institutions, including our bank, may be materially and adversely affected by changes in prevailing local and national economic conditions, including declines in real estate market values and the related declines in value of our real estate collateral, rapid increases or decreases in interest rates and changes in the monetary and fiscal policies of the federal government. Our profitability is heavily influenced by the spread between the interest rates we earn on loans and investments and the interest rates we pay on deposits and other interest-bearing liabilities. Substantially all of our loans are to businesses and individuals in Western, Central, and Southeastern Michigan, and any decline in the economy of these areas could adversely affect us. Like most banking institutions, our net interest spread and margin will be affected by general economic conditions and other factors that influence market interest rates and our ability to respond to changes in these rates. At any given time, our assets and liabilities may be such that they will be affected differently by a given change in interest rates.

**Significant declines in the value of commercial real estate could adversely impact us.**

Approximately 65% of our total commercial loans, or about 56% of our total loans, relate to commercial real estate. Stressed economic conditions may reduce the value of commercial real estate and strain the financial condition of our commercial real estate borrowers, especially in the land development and non-owner occupied commercial real estate segments of our loan portfolio. Those difficulties could adversely affect us and could produce losses and other adverse effects on our business.

**Market volatility may adversely affect us.**

The capital and credit markets may experience volatility and disruption. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without apparent regard to those issuers' underlying financial strength. Future levels of market disruption and volatility may have an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

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**Our future success is dependent on our ability to compete effectively in the highly competitive banking industry.**

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks, thrifts, credit unions and other financial institutions as well as other entities that provide financial services, including securities firms and mutual funds. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do and offer larger branch networks and other services which we do not, including trust and international banking services. Most of these entities have greater capital and other resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. This competition may limit our growth or earnings. Under specified circumstances (that have been modified by the Dodd-Frank Act and EGRRCPA), securities firms and insurance companies that elect to become financial holding companies under the Bank Holding Company Act may acquire banks and other financial institutions. Federal banking law affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.

**Our risk management systems may fall short of their intended objectives.**

We seek to monitor and control our risk exposure through a risk and control framework encompassing a variety of separate but complementary financial, credit, operational, compliance and legal reporting systems, internal controls, management review processes and other mechanisms. Our risk management process seeks to balance our ability to profit from investing or lending positions with our exposure to potential losses. While we employ a broad and diversified set of risk monitoring and risk mitigation techniques, those techniques and the judgments that accompany their application cannot anticipate every economic and financial outcome or the specifics and timing of such outcomes. Thus, we may, in the course of our activities, incur losses.

**We may not be able to successfully adapt to evolving industry standards and market pressures.**

Our success depends, in part, on the ability to adapt products and services to evolving industry standards. There is increasing pressure to provide products and services at lower prices. This can reduce net interest income and noninterest income from fee-based products and services. In addition, the widespread adoption of new technologies could require us to make substantial capital expenditures to modify or adapt existing products and services or develop new products and services. We may not be successful in introducing new products and services in response to industry

trends or developments in technology, or those new products may not achieve market acceptance. As a result, we could lose business, be forced to price products and services on less advantageous terms to retain or attract clients, or be subject to cost increases. As a result, our business, financial condition, or results of operations may be adversely affected.

**Our inability to execute or integrate potential future acquisitions successfully could impede us from realizing all of the benefits of the acquisitions, which could weaken our operations.**

In addition to pursuing organic growth, we may also pursue strategic acquisition opportunities that we believe will fit our core philosophy and culture, enhance our profitability and provide appropriate risk-adjusted returns. These acquisition opportunities could be material to our business and involve a number of risks, including the following:

- intense competition from other banking organizations and other acquirers for potential merger candidates drives market pricing;
- time and expense associated with identifying and evaluating potential acquisitions and negotiating potential transactions may divert human and capital resources without producing the desired returns;
- estimates and judgments used to evaluate credit, operations, management and market risks with respect to the target institution or assets are inherently complex and may be inaccurate;
- potential exposure to unknown or contingent liabilities of targets; and
- regulatory timeframes for review of applications may limit the number and frequency of transactions we may be able to consummate;

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If we are unable to successfully integrate potential future acquisitions, we could be impeded from realizing all of the benefits of those acquisitions and could weaken our business operations. The integration process may disrupt our business and, if implemented ineffectively, may preclude realization of the full benefits expected by us and could harm our results of operations. In addition, the overall integration of the combining companies may result in unanticipated problems, expenses, liabilities and competitive responses, and may cause our stock price to decline. The difficulties of integrating an acquisition include, among others:

- unanticipated issues in integration of information, communications and other systems;
- unanticipated incompatibility of logistics, marketing and administrative methods;
- maintaining employee morale and retaining key employees;
- integrating the business cultures of both companies;
- preserving important strategic client relationships;
- coordinating geographically diverse organizations; and
- consolidating corporate and administrative infrastructures and eliminating duplicative operations.

Finally, even if the operations of an acquisition are integrated successfully, we may not realize the full benefits of the acquisition, including the synergies, cost savings or growth opportunities we expect. These benefits may not be achieved within the anticipated time frame as well.

Our inability to overcome these risks could have an adverse effect on our ability to implement our business strategy, which, in turn, could have an adverse effect on our business, financial condition and results of operations.

**The soundness of other financial institutions could adversely affect us.**

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Even routine funding transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient

to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

**The timing and effect of Federal Reserve Board policy normalization remains uncertain.**

In September 2014, the Federal Reserve Board announced principles it would follow to implement monetary policy normalization, that is, to raise the Federal funds rate and other short-term interest rates to more historically normal levels and to reduce the Federal Reserve's securities holdings, so as to promote its statutory mandate of maximum employment and price stability. The Federal Open Market Committee ("FOMC") took the initial step in that process by raising the Federal funds rate by 25 basis points in December 2015, the first such action since December 2008. Subsequently, the FOMC refined the normalization principles and announced greater detail about its planned approach. In September 2017, the FOMC announced the start of a gradual reduction in the Federal Reserve's securities holdings, commencing in October 2017. In each of March, June, September and December 2018, the FOMC raised the Federal funds rate by 25 basis points, and announced its intention to continue to raise the Federal funds rate gradually over the next few years. In January 2019, the FOMC announced its intention to continue to implement monetary policy primarily through adjustment of its administered rates to control the target range for the Federal funds rate. The FOMC stated that it is prepared to adjust the details of the reduction of its balance sheet in light of economic and financial developments, and would be prepared to use its full range of tools, including changing the size and composition of its balance sheet, if future economic conditions warranted a more accommodative monetary policy than could be achieved solely by reducing the Federal funds rate. There can be no assurance that these reductions in the Federal Reserve's securities holdings, and increases in the Federal funds rate, will continue to occur, that they will be gradual if they do occur, or as to the actual impact of those policies on the financial markets, the broader economy, or on our business, financial condition, results of operations, access to credit or the trading price of our common stock.

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**The effect of financial services legislation and regulations remains uncertain.**

In response to the financial crisis, on July 21, 2010, President Obama signed the Dodd-Frank Act, the most comprehensive reform of the regulation of the financial services industry since the Great Depression of the 1930's. Among many other things, the Dodd-Frank Act provides for increased supervision of financial institutions by regulatory agencies, more stringent capital requirements for financial institutions, major changes to deposit insurance assessments by the FDIC, prohibitions on proprietary trading and sponsorship or investment in hedge funds and private equity funds by insured depository institutions, holding companies, and their affiliates, heightened regulation of hedging and derivatives activities, a greater focus on consumer protection issues, in part through the formation of a new Consumer Financial Protection Bureau ("CFPB") having powers formerly split among different regulatory agencies, extensive changes to the regulation of residential mortgage lending, imposition of limits on interchange transaction and network fees for electronic debit transactions and repeal of the prohibition on payment of interest on demand deposits. Many of the Dodd-Frank Act's provisions have delayed effective dates, while other provisions require implementing regulations of various federal agencies, some of which have not yet been adopted in final form.

On February 3, 2017, however, President Trump signed Executive Order 13772, specifying new core principles for regulating the U.S. financial system. Among other things, the President directed the Secretary of the Treasury, in consultation with federal regulatory agencies, to review existing laws and regulations and report on the extent to which they were consistent with the core principles. The Treasury Department has published several reports in response to the Executive Order. In addition, beginning in February 2017, Congress passed, and the President signed, more than a dozen resolutions under the Congressional Review Act, repealing various federal regulations, including regulations adopted by the CFPB.

On May 24, 2018, EGRRCPA was enacted, amending numerous provisions of the Dodd-Frank Act. While some of the changes affect only much larger institutions, a number of provisions relax or eliminate restrictions applicable to us and our bank. Among these latter changes are: simplified capital adequacy requirements; exemption from the proprietary trading and other restrictions of the Volcker Rule; less frequent periodic supervisory examinations; reductions in certain periodic reporting requirements; exclusion of specified amounts of reciprocal deposits, received by our bank from other insured depository institutions, from the "brokered deposit" limitations of the Federal Deposit Insurance Act; revised capital treatment for certain high volatility commercial real estate loans; and relaxation of certain requirements applicable to residential mortgage loans made to our customers. Some of the EGRRCPA changes became effective immediately upon enactment, while others will become effective upon adoption of implementing regulations by the federal banking agencies. In addition, the federal banking agencies, based upon periodic reviews under earlier legislation, have modified some existing regulations, such as the May 2018 action doubling, from \$250,000 to \$500,000, the threshold value of a commercial real estate loan that triggers an appraisal requirement. Other proposals to modify existing regulations in light of the new core principles are under consideration by various federal regulatory agencies, including the CFPB. There can be no assurance that any proposed changes in existing regulations will be adopted to implement the new core principles.



Thus, the effect of financial services legislation and regulations remains uncertain. The implementation, amendment, or repeal of federal financial services laws or regulations may limit our business opportunities, impose additional costs on us, impact our revenues or the value of our assets, or otherwise adversely affect our business.

**Our credit losses could increase and our allowance may not be adequate to cover actual loan losses.**

The risk of nonpayment of loans is inherent in all lending activities, and nonpayment, when it occurs, may have a materially adverse effect on our earnings and overall financial condition as well as the value of our common stock. Our focus on commercial lending may result in a larger concentration of loans to small businesses. As a result, we may assume different or greater lending risks than other banks. We make various assumptions and judgments about the collectability of our loan portfolio and provide an allowance for losses based on several factors. If our assumptions are wrong, our allowance may not be sufficient to cover our losses, which would have an adverse effect on our operating results. The actual amounts of future provisions for loan losses cannot be determined at this time and may exceed the amounts of past provisions. Additions to our allowance decrease our net income.

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**We rely heavily on our management and other key personnel, and the loss of any of them may adversely affect our operations.**

We are and will continue to be dependent upon the services of our management team, including our executive officers and our other senior managers. The unanticipated loss of our executive officers, or any of our other senior managers, could have an adverse effect on our growth and performance.

In addition, we continue to depend on our key commercial loan officers. Several of our commercial loan officers are responsible, or share responsibility, for generating and managing a significant portion of our commercial loan portfolio. Our success can be attributed in large part to the relationships these officers as well as members of our management team have developed and are able to maintain with our customers as we continue to implement our community banking philosophy. The loss of any of these commercial loan officers could adversely affect our loan portfolio and performance, and our ability to generate new loans. Many of our key employees have signed agreements with us agreeing not to compete with us in one or more of our markets for specified time periods if they leave employment with us. However, we may not be able to effectively enforce such agreements.

Some of the other financial institutions in our markets also require their key employees to sign agreements that preclude or limit their ability to leave their employment and compete with them or solicit their customers. These agreements make it more difficult for us to hire loan officers with experience in our markets who can immediately solicit their former or new customers on our behalf.

**Future sales of our common stock or other securities may dilute the value of our common stock.**

In many situations, our Board of Directors has the authority, without any vote of our shareholders, to issue shares of our authorized but unissued preferred or common stock, including shares authorized and unissued under our equity incentive plans. In the future, we may issue additional securities, through public or private offerings, in order to raise additional capital. Any such issuance would dilute the percentage of ownership interest of existing shareholders and may dilute the per share book value of the common stock. In addition, option holders under our stock-based incentive plans may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

**We are subject to significant government regulation, and any regulatory changes may adversely affect us.**

The banking industry is heavily regulated under both federal and state law. These regulations are primarily intended to protect customers, the federal deposit insurance fund, and the stability of the U.S. financial system, not our creditors or shareholders. Existing state and federal banking laws subject us to substantial limitations with respect to the making of loans, the purchase of securities, the payment of dividends and many other aspects of our business. Some of these laws may benefit us, others may increase our costs of doing business, or otherwise adversely affect us and create competitive advantages for others. Regulations affecting banks and financial services companies undergo continuous change, which may be accelerated by the recent change in the federal administration, and we cannot predict the ultimate effect of these changes, which could have a material adverse effect on our profitability or financial condition. Federal economic and monetary policy may also affect our ability to attract deposits, make loans and achieve satisfactory interest spreads.

**Minimum capital requirements have increased.**

The provisions of the Dodd-Frank Act relating to capital to be maintained by financial institutions approach convergence with the standards (generally known as Basel III) adopted in December, 2010 by the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision. Among other things, those standards contain a narrower definition of elements qualifying for inclusion as Tier 1 capital and higher minimum risk-based capital levels than those specified in previous U.S. law and regulations. In July, 2013, the U.S. federal bank regulatory agencies adopted regulations to implement the provisions of the Dodd-Frank Act and Basel III for U.S. financial institutions. The new regulations became applicable to us and our bank effective January 1, 2015.

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The new regulations implemented (i) revised definitions of regulatory capital elements, (ii) a new common equity Tier 1 (“CET 1”) minimum capital ratio requirement, (iii) an increase in the existing minimum Tier 1 capital ratio requirement, (iv) new limits on capital distributions and certain discretionary bonus payments if an institution does not hold a specified amount of CET 1 (called a capital conservation buffer) in addition to the amount required to meet its minimum risk-based capital requirements, (v) new risk-weightings for certain categories of assets, and (vi) other requirements applicable to banking organizations which have total consolidated assets of \$250 billion or more, total consolidated on-balance sheet foreign exposure of \$10 billion or more, elect to use the advanced measurement approach for calculating risk-weighted assets, or are subsidiaries of banking organizations that use the advanced measurement approach (“Advanced Approaches Entities”).

Among other things, the new regulations generally require banking organizations to recognize in regulatory capital most components of accumulated other comprehensive income (“AOCI”), including accumulated unrealized gains and losses on available for sale securities. This requirement, which was not imposed under previous risk-based capital regulations, may be avoided by banking organizations, such as us and our bank, that are not Advanced Approaches Entities, by making a one-time, irrevocable election on the first quarterly regulatory report following the date on which the regulations become effective as to them. We made the one-time, irrevocable election regarding the treatment of AOCI on March 31, 2015.

In addition, the new regulations (unlike the original proposal), permit companies such as us, which had total assets of less than \$15 billion on December 31, 2009, and had issued trust preferred securities on or prior to May 19, 2010, to continue to include such securities in Tier 1 capital.

On January 1, 2015, for banking organizations such as us and our bank that are not Advanced Approaches Entities, the new regulations mandated a minimum ratio of CET 1 to standardized total risk-weighted assets (“RWA”) of 4.5%, an increased ratio of Tier 1 capital to RWA of 6.0% (compared to the prior requirement of 4.0%), a total capital ratio (that is, the sum of Tier 1 and Tier 2 capital to RWA) of 8.0%, and a minimum leverage ratio (that is, Tier 1 capital to adjusted average total consolidated assets) of 4.0%. The calculation of these amounts is affected by the new definitions of certain capital elements. The capital conservation buffer comprised solely of CET 1 was phased-in commencing January 1, 2016, beginning at 0.625% of RWA and rising to 2.5% of RWA on January 1, 2019. Failure by a banking organization to maintain the aggregate required minimum capital ratios and capital conservation buffer will impair its ability to make certain distributions (including dividends and stock repurchases) and discretionary bonus payments to executive officers.

These increased minimum capital requirements may adversely affect our ability (and that of our bank) to pay cash dividends, reduce our profitability, or otherwise adversely affect our business, financial condition or results of operations. In the event of a need for additional capital to meet these requirements, there can be no assurance of our ability to raise funding in the equity and capital markets. Factors that we cannot control, such as the disruption of financial markets or negative views of the financial services industry generally, could impair our ability to raise qualifying equity capital. In addition, our ability to raise qualifying equity capital could be impaired if investors develop a negative perception of our financial prospects. If we were unable to raise qualifying equity capital, it might

be necessary for us to sell assets in order to maintain required capital ratios. We may be unable to sell some of our assets, or we may have to sell assets at a discount from market value, either of which could adversely affect our results of operations, cash flow and financial condition.

On May 24, 2018, EGRRCPA was enacted, amending numerous provisions of the Dodd-Frank Act. Among other things, the new law directs the federal banking agencies to develop a Community Bank Leverage Ratio (“CBLR”). The CBLR, to be set between 8% and 10% of tangible equity capital to average total consolidated assets, would apply to Qualified Community Banks. The law defines Qualified Community Banks as those depository institutions and depository institution holding companies having total consolidated assets of less than \$10 billion that meet other specified risk criteria, to be determined by regulations of the federal banking agencies based on factors prescribed in the statute. A Qualified Community Bank satisfying the CBLR, by reason of the EGRRCPA provision, would be deemed to be in compliance with all applicable leverage and risk-based capital requirements and, in the case of a depository institution, be deemed “well-capitalized” for purposes of the Federal Deposit Insurance Act.

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In February 2019, the federal banking agencies published in the Federal Register a notice of proposed rulemaking to implement this EGRRCPA capital adequacy provision. The proposal would establish a CBLR of 9% tangible equity to average total consolidated assets. Under the proposal, a bank or bank holding company having less than \$10 billion in average total consolidated assets would need to meet several requirements in order to be a Qualified Community Bank. The proposed requirements include that the bank or bank holding company: have no affiliation with a banking organization subject to the advanced approaches capital rule; have mortgage servicing rights of 25% or less of CBLR tangible equity; have deferred tax assets arising from temporary timing differences, net of valuation allowances, of 25% or less of CBLR tangible equity; have off-balance-sheet exposures (excluding derivative exposures and unconditionally cancellable commitments) of 25% or less of total consolidated assets; have total trading assets and trading liabilities of 5% or less of total consolidated assets; and have a CBLR greater than 9%. As required by EGRRCPA, the proposal also includes detailed provisions addressing the treatment of a formerly Qualified Community Bank that failed to satisfy one or more of the proposed requirements, or whose CBLR fell below 9%. There can be no assurance whether, or when, this proposed rulemaking will lead to the adoption of regulations, or as to the content of any regulations eventually adopted.

**We may need to raise additional capital in the future, and such capital may not be available when needed or at all.**

We may need or want to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs, particularly if our asset quality or earnings were to deteriorate significantly. Our ability to raise additional capital will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance. Economic conditions and any loss of confidence in financial institutions generally may increase our cost of funding and limit access to certain customary sources of capital.

There can be no assurance that capital will be available on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of equity or debt purchasers, or counterparties participating in the capital markets, may adversely affect our capital costs and our ability to raise capital and, potentially, our liquidity. Also, if we need to raise capital in the future, we may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on our business, financial condition and results of operations.

**Changes in the method of determining Libor, or the replacement of Libor with an alternative reference rate, may adversely affect interest income or expense.**

Many of the commercial loans we make bear interest at a floating rate based on Libor, the London inter-bank offered rate. We pay interest on certain subordinated notes related to our trust preferred securities at rates based on Libor.

On July 27, 2017, the United Kingdom Financial Conduct Authority, which oversees Libor, formally announced that it could not assure the continued existence of Libor in its current form beyond the end of 2021, and that an orderly transition process to one or more alternative benchmarks should begin. In June 2017, the Alternative Reference Rates Committee, a steering committee comprised of large U.S. financial institutions organized by the Federal Reserve, announced that it had selected a modified version of the unpublished Broad Treasuries Financing Rate as the preferred alternative reference rate for U.S. dollar obligations. That rate, now referred to as the Secured Overnight Funding Rate (“SOFR”), is determined based upon actual transactions in certain portions of the bi-lateral and tri-party overnight repurchase agreement markets for certain U.S. Treasury obligations. The Federal Reserve Bank of New York began publication of the SOFR in April 2018.

In February 2018, an international consortium of market participant trade associations published the IBOR Global Benchmark Survey 2018 Transition Roadmap (“Roadmap”). The Roadmap summarizes the background to the use of inter-bank offered rate benchmarks, discusses perceived reasons for reform, and identifies problems that may be encountered in making a transition to new interest rate benchmarks. Those potential problems include market adoption, liquidity, legal, valuation and risk management, infrastructure, tax, accounting, governance and control, and regulatory issues.

In May 2018, the Chicago Mercantile Exchange began trading SOFR futures contracts. The existence of a futures market may permit the development of a SOFR term curve. In July 2018, the Federal National Mortgage Association issued bonds using SOFR (an overnight rate) as a pricing mechanism. This was possible because of an unusual bond structure, in which interest was payable quarterly, but the interest reset period was daily.

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In January 2019, ICE Benchmark Administration, the current provider of Libor, proposed for comment to market participants a U.S. Dollar ICE Bank Yield Index. This index would be based on two types of U.S. dollar-denominated transaction data: primary market wholesale, unsecured funding transactions for large, internationally active banks; and secondary market transactions in wholesale, unsecured bonds issued by large, internationally active banks. These data would be used to construct a yield curve from which one-month, three-month and six-month settings could be obtained. If the proposal were accepted by market participants, it might furnish commercial bank-based term rates more directly comparable to the existing structure of Libor than the government-based overnight SOFR.

It is unclear whether, or in what form, Libor will continue to exist after 2021. Any transition to an alternative benchmark will require careful consideration and implementation so as not to disrupt the stability of financial markets. If Libor ceases to exist, we may need to take a variety of actions, including negotiating certain of our agreements based on an alternative benchmark that may be established, if any. There is no guarantee that a transition from Libor to an alternative benchmark will not result in financial market disruptions, significant changes in benchmark rates, or adverse changes in the value of certain of our loans, and our income and expense.

**We continually encounter technological change, and we may have fewer resources than our competitors to continue to invest in technological improvements.**

The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements than we do. There can be no assurance that we will be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

**Our Articles of Incorporation and By-laws and the laws of the State of Michigan contain provisions that may discourage or prevent a takeover of our company and reduce any takeover premium.**

Our Articles of Incorporation and By-laws, and the corporate laws of the State of Michigan, include provisions which are designed to provide our Board of Directors with time to consider whether a hostile takeover offer is in our and our shareholders' best interest. These provisions, however, could discourage potential acquisition proposals and could delay or prevent a change in control. The provisions also could diminish the opportunities for a holder of our common stock to participate in tender offers, including tender offers at a price above the then-current market price for our common stock. These provisions could also prevent transactions in which our shareholders might otherwise receive a premium for their shares over then-current market prices, and may limit the ability of our shareholders to approve transactions that they may deem to be in their best interest.



The Michigan Business Corporation Act contains provisions intended to protect shareholders and prohibit or discourage various types of hostile takeover activities. In addition to these provisions and the provisions of our Articles of Incorporation and By-laws, federal law requires the Federal Reserve Board's approval prior to acquiring "control" of a bank holding company. All of these provisions may delay or prevent a change in control without action by our shareholders and could adversely affect the price of our common stock.

**The full impact of recent changes in U.S. tax laws remains uncertain.**

The enactment of the Tax Cuts and Jobs Act (the "Act") on December 22, 2017 made significant changes to the Internal Revenue Code, many of which are highly complex and may require interpretations and implementing regulations. As a result of the Act's reduction of the corporate income tax rate from 35% to 21%, we recorded a one-time, non-cash charge to federal income tax expense of \$1.3 million during the fourth quarter of 2017 to reduce the value of our net deferred tax assets. See Note 11 of our Consolidated Financial Statements.

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Furthermore, the expected impact of certain aspects of the statute remains unclear and subject to change. The Act includes a number of provisions that will have an impact on the banking industry, borrowers and the market for residential real estate. These changes include: a lower limit on the deductibility of mortgage interest on single-family residential mortgage loans; the elimination of interest deductions for home equity loans; a limitation on the deductibility of business interest expense; and a limitation on the deductibility of property taxes and state and local income taxes. The Act may have an adverse effect on the market for and the valuation of residential properties, as well as on the demand for such loans in the future, and could make it harder for borrowers to make their loan payments. The value of the properties securing such loans in our loan portfolio may be adversely impacted as a result of the changing economics of home ownership. Such an impact could require an increase in our provision for loan losses, which would reduce our profitability and could materially adversely affect our business, financial condition and results of operations.

**There is a limited trading market for our common stock.**

The price of our common stock has been, and will likely continue to be, subject to fluctuations based on, among other things, economic and market conditions for bank holding companies and the stock market in general, as well as changes in investor perceptions of our company. The issuance of new shares of our common stock also may affect the market for our common stock.

Our common stock is traded on the Nasdaq Global Select Market under the symbol “MBWM.” The development and maintenance of an active public trading market depends upon the existence of willing buyers and sellers, the presence of which is beyond our control. While we are a publicly-traded company, the volume of trading activity in our stock is still relatively limited. Even if a more active market develops, there can be no assurance that such a market will continue, or that our shareholders will be able to sell their shares at or above the price at which they acquired shares.

**Our business is subject to operational risks.**

We, like most financial institutions, are exposed to many types of operational risks, including the risk of fraud by employees or outsiders, unauthorized transactions by employees or operational errors. Operational errors may include clerical or record keeping errors or those resulting from faulty or disabled computer or telecommunications systems. Given our volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully corrected. Our necessary dependence upon automated systems to record and process our transaction volume may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect.

We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control, including, for example, computer viruses or electrical or telecommunications outages, which may give rise to losses in service to customers and to loss or liability to us. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations to us, or will be subject to the same risk of fraud or operational errors by their respective employees as are we, and to the risk that our or our vendors' business continuity and data security systems prove not to be adequate. We also face the risk that the design of our controls and procedures proves inadequate or is circumvented, causing delays in detection or errors in information. Although we maintain a system of controls designed to keep operational risks at appropriate levels, there can be no assurance that we will not suffer losses from operational risks in the future that may be material in amount.

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**We face the risk of cyber-attack to our computer systems.**

In the ordinary course of business, we collect and store sensitive data, including proprietary business information and personally identifiable information of our customers and employees in systems and on networks. The secure processing, maintenance and use of this information is critical to our operations. To date, we have not experienced a significant compromise, significant data loss or any material financial losses related to cybersecurity attacks, but our systems and those of our customers and third-party service providers are under constant threat, and it is possible that we could experience a significant event in the future. Cybersecurity threats include unauthorized access, loss or destruction of data (including confidential client information), account takeovers, unavailability of service, computer viruses or other malicious code, cyber-attacks and other events. These threats may derive from human error, fraud or malice on the part of employees or third parties, or may result from accidental technological failure. If one or more of these events occurs, it could result in the disclosure of confidential client information, damage to our reputation with our clients and the market, additional costs to us (such as repairing systems or adding new personnel or protection technologies), regulatory penalties and financial losses, to both us and our clients and customers. Such events could also cause interruptions or malfunctions in our operations (such as the lack of availability of our online banking system), as well as the operations of our clients, customers or other third parties. Risks and exposures related to cybersecurity attacks are expected to remain high for the foreseeable future due to the rapidly evolving nature and sophistication of these threats, as well as due to the expanding use of Internet banking, mobile banking and other technology-based products and services by us and our customers. Although we maintain safeguards to protect against these risks, there can be no assurance that we will not suffer losses in the future that may be material in amount.

In March 2015, federal regulators issued two related statements regarding cybersecurity. One statement indicates that financial institutions should design multiple layers of security controls to establish lines of defense and to ensure that their risk management processes also address the risk posed by compromised customer credentials, including security measures to reliably authenticate customers accessing internet-based services of the financial institution. The other statement indicates that a financial institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption and maintenance of the institution's operations after a cyber-attack involving destructive malware. A financial institution is also expected to develop appropriate processes to enable recovery of data and business operations and address rebuilding network capabilities and restoring data if the institution or its critical service providers fall victim to this type of cyber-attack. Although guidance of this nature does not have the full force and effect of law, it sets out supervisory priorities and expectations regarding safe and sound operation. Failure to observe such guidance may result in supervisory identification of unsafe or unsound practices or other deficiencies in risk management or other areas that do not constitute violations of law or regulation.

**Damage to our reputation could materially harm our business.**

Our relationship with many of our clients is predicated upon our reputation as a fiduciary and a service provider that adheres to the highest standards of ethics, service quality and regulatory compliance. Adverse publicity, regulatory actions, litigation, operational failures, the failure to meet client expectations and other issues with respect to one or more of our businesses could materially and adversely affect our reputation, our ability to attract and retain clients or

our sources of funding for the same or other businesses. Preserving and enhancing our reputation also depends on maintaining systems and procedures that address known risks and regulatory requirements, as well as our ability to identify and mitigate additional risks that arise due to changes in our businesses and the marketplaces in which we operate, the regulatory environment and client expectations. If any of these developments has a material effect on our reputation, our business will suffer.

**Item 1B. Unresolved Staff Comments**

We have received no written comments regarding our periodic or current reports from the staff of the Securities and Exchange Commission that were issued 180 days or more before the end of our 2018 fiscal year and that remain unresolved.

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**Item 2. Properties.**

Our headquarters is located in our bank's main office facility in Grand Rapids, Michigan. Our bank operates 46 banking offices primarily concentrated throughout Western and Central Michigan, most of which are full-service facilities. We also opened a banking office in Troy, Michigan during the first quarter of 2017. We have larger banking facilities in Alma, Holland, Ionia, Kalamazoo, Lansing, Mt. Pleasant and West Branch. The remaining banking offices generally range in size from 1,200 to 3,200 square feet, based on the location and number of employees located at the facility. All of our banking offices are owned by our bank except for three that are rented under various operating lease agreements. In several instances, the banking offices contain more usable space than what is needed for current banking operations. This excess space, totaling approximately 23,500 square feet, is generally leased to unrelated businesses. In addition, certain functions operate out of our standalone facility located in Alma.

We consider our properties and equipment to be well maintained, in good operating condition and capable of accommodating current growth forecasts. However, we may choose to add branch locations to expand our presence in current markets and/or in new markets or, alternatively, to consolidate, close or relocate branches if we believe it would be beneficial to our overall performance.

**Item 3. Legal Proceedings.**

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

**Item 4. Mine Safety Disclosures.**

Not applicable.

**PART II**

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock is traded on the Nasdaq Global Select Market under the symbol "MBWM." At March 1, 2019, there were approximately 1,600 record holders of our common stock. In addition, we estimate that there were

approximately 7,000 beneficial owners of our common stock who own their shares through brokers or banks.

The following table shows the high and low sales prices for our common stock as reported by the Nasdaq Global Select Market for the periods indicated and the quarterly and special cash dividends paid by us during those periods.

|                | <b>High</b> | <b>Low</b> | <b>Dividend</b> |
|----------------|-------------|------------|-----------------|
| <b>2018</b>    |             |            |                 |
| First Quarter  | \$37.50     | \$32.60    | \$ 0.22         |
| Second Quarter | 37.98       | 33.00      | 0.22            |
| Third Quarter  | 38.47       | 32.98      | 0.24            |
| Fourth Quarter | 35.16       | 26.40      | 1.00            |
| <b>2017</b>    |             |            |                 |
| First Quarter  | \$37.97     | \$30.65    | \$ 0.18         |
| Second Quarter | 36.05       | 30.42      | 0.18            |
| Third Quarter  | 35.86       | 28.92      | 0.19            |
| Fourth Quarter | 38.08       | 33.75      | 0.19            |

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Holders of our common stock are entitled to receive dividends that the Board of Directors may declare from time to time. We may only pay dividends out of funds that are legally available for that purpose. We are a financial holding company and substantially all of our assets are held by our bank and its subsidiaries. Our ability to pay dividends to our shareholders depends primarily on our bank's ability to pay dividends to us. 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 dividends is also subject to its profitability, financial condition, capital expenditures and other cash flow requirements. In addition, under the terms of our subordinated debentures, we would be precluded from paying dividends on our common stock if an event of default has occurred and is continuing under the subordinated debentures, or if we exercised our right to defer payments of interest on the subordinated debentures, until the deferral ended.

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 our financial statements. Our bank's ability to pay cash and stock dividends or repurchase equity securities is subject to limitations under various laws and regulations and to prudent and sound banking practices.

On January 11, 2018, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.22 per share that was paid on March 21, 2018 to shareholders of record as of March 9, 2018. On April 12, 2018, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.22 per share that was paid on June 20, 2018 to shareholders of record as of June 8, 2018. On July 12, 2018, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.24 per share that was paid on September 19, 2018 to shareholders of record as of September 7, 2018. On October 11, 2018, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.25 per share that was paid on December 19, 2018 to shareholders of record as of December 7, 2018. In addition, on October 11, 2018, our Board of Directors declared a special cash dividend on our common stock in the amount of \$0.75 per share that was paid on December 19, 2018 to shareholders of record as of December 7, 2018.

On January 12, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.18 per share that was paid on March 22, 2017 to shareholders of record as of March 10, 2017. On April 13, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.18 per share that was paid on June 21, 2017 to shareholders of record as of June 9, 2017. On July 13, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.19 per share that was paid on September 20, 2017 to shareholders of record as of September 8, 2017. On October 12, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.19 per share that was paid on December 20, 2017 to shareholders of record as of December 8, 2017.

On January 17, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.26 per share that will be paid on March 20, 2019 to shareholders of record as of March 8, 2019.



Issuer Purchases of Equity Securities

On January 30, 2015, we announced that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase plan. The shares may be repurchased from time to time in open market transactions at prevailing market prices or by other means in accordance with federal securities laws. The actual timing, number and value of shares repurchased under the program will be determined by management in its discretion and will depend on a number of factors, including the market price of Mercantile's stock, general market and economic conditions, Mercantile's capital position, financial performance and alternative uses of capital, and applicable legal requirements. The program may be discontinued at any time.

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During 2018, we purchased a total of 199,905 shares at a total price of \$5.9 million, at an average price per share of \$29.73. No shares were purchased under the authorized plan during 2017. Since inception through year-end 2018, we purchased a total of 1,156,324 shares at a total price of \$25.4 million, at an average price per share of \$22.00. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan or a new plan, which would also likely be funded from cash dividends paid to us from our bank. Repurchases made during the fourth quarter of 2018 are detailed in the table below.

| Period          | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares or Approximate Dollar Value that May Yet Be Purchased Under the Plans or Programs |
|-----------------|--------------------------------------|----------------------------------|--------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------|
| October 1 – 31  | 12,952                               | \$ 30.86                         | 0                                                                                    | \$ 15,106,000                                                                                                  |
| November 1 – 30 | 54,326                               | 32.13                            | 0                                                                                    | 13,360,000                                                                                                     |
| December 1 – 31 | 132,627                              | 28.63                            | 0                                                                                    | 9,563,000                                                                                                      |
| Total           | 199,905                              | \$ 29.73                         | 0                                                                                    | \$ 9,563,000                                                                                                   |

## Shareholder Return Performance Graph

Set forth below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on our common stock (based on the last reported sales price of the respective year) with the cumulative total return of the Nasdaq Composite Index and the SNL Bank Nasdaq Index from December 31, 2013 through December 31, 2018. The following is based on an investment of \$100 on December 31, 2013 in our common stock, the Nasdaq Composite Index and the SNL Bank Nasdaq Index, with dividends reinvested where applicable.

| <i>Index</i>                | <i>Period Ending</i> |          |          |          |          |          |
|-----------------------------|----------------------|----------|----------|----------|----------|----------|
|                             | 12/31/13             | 12/31/14 | 12/31/15 | 12/31/16 | 12/31/17 | 12/31/18 |
| Mercantile Bank Corporation | 100.00               | 109.26   | 131.15   | 209.51   | 201.12   | 169.51   |
| NASDAQ Composite            | 100.00               | 114.75   | 122.74   | 133.62   | 173.22   | 168.30   |
| SNL Bank NASDAQ             | 100.00               | 103.57   | 111.80   | 155.02   | 163.20   | 137.56   |



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**Item 6. Selected Financial Data.**

The Selected Financial Data in this Annual Report is incorporated here by reference.

**Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.**

Management’s Discussion and Analysis included in this Annual Report is incorporated here by reference.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk.**

The information under the heading “Market Risk Analysis” included in this Annual Report is incorporated here by reference.

**Item 8. Financial Statements and Supplementary Data.**

The Consolidated Financial Statements, the Notes to Consolidated Financial Statements and the Reports of Independent Registered Public Accounting Firm included in this Annual Report are incorporated here by reference.

**Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.**

None

**Item 9A. Controls and Procedures.**

As of December 31, 2018, 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 December 31, 2018.

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

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). There are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2018. This evaluation was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Based on our evaluation under the COSO framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2018. Refer to page F-32 for management’s report.

Our independent registered public accounting firm has issued an audit report on our internal control over financial reporting which is included in this Annual Report.

**Item 9B. Other Information.**

None

**PART III**

**Item 10. Directors, Executive Officers and Corporate Governance.**

The information presented under the captions “Election of Directors,” “Executive Officers,” “Section 16(a) Beneficial Ownership Reporting Compliance” and “Corporate Governance – Code of Ethics” in the definitive Proxy Statement of Mercantile for our May 23, 2019 Annual Meeting of Shareholders (the “Proxy Statement”), a copy of which will be filed with the Securities and Exchange Commission before April 30, 2019, is incorporated here by reference.

We have a separately-designated standing audit committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934. The members of the Audit Committee consist of David M. Cassard, Edward J.

Clark, Michelle L. Eldridge, Jeff A. Gardner and Edward B. Grant. The Board of Directors has determined that Messrs. Cassard and Grant, members of the Audit Committee, are qualified as audit committee financial experts, as that term is defined in the rules of the Securities and Exchange Commission. All five members of the committee are independent, as independence for audit committee members is defined in the Nasdaq listing standards and the rules of the Securities and Exchange Commission.

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**Item 11. Executive Compensation.**

The information presented under the captions “Executive Compensation,” “Corporate Governance – Compensation Committee Interlocks and Insider Participation” and “Compensation Committee Report” in the Proxy Statement is incorporated here by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information presented under the caption “Stock Ownership of Certain Beneficial Owners and Management” in the Proxy Statement is incorporated here by reference.

Equity Compensation Plan Information

The following table summarizes information, as of December 31, 2018, relating to compensation plans under which equity securities are authorized for issuance.

| <u>Plan Category</u> | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in |
|----------------------|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|
|----------------------|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------|

|                                                            | (a)    | (b)      | column (a)<br>(c) |     |
|------------------------------------------------------------|--------|----------|-------------------|-----|
| Equity compensation plans approved by security holders (1) | 18,900 | \$ 23.92 | 197,000           | (2) |
| Equity compensation plans not approved by security holders | 0      | 0        | 0                 |     |
| Total                                                      | 18,900 | \$ 23.92 | 197,000           |     |

(1) Primarily includes Mercantile’s Stock Incentive Plan of 2016. Also, in conjunction with the merger with Firstbank, we issued Mercantile stock options in replacement of all outstanding stock option grants that had been issued to Firstbank employees under the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 and the Firstbank Corporation Stock Compensation Plan.

(2) These securities are available under the Stock Incentive Plan of 2016. Incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information presented under the captions “Transactions with Related Persons” and “Corporate Governance – Director Independence” in the Proxy Statement is incorporated here by reference.

**Item 14. Principal Accountant Fees and Services.**

The information presented under the caption “Principal Accountant Fees and Services” in the Proxy Statement is incorporated here by reference.



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**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a) (1) Financial Statements. The following financial statements and reports of the independent registered public accounting firm of Mercantile Bank Corporation and its subsidiaries are filed as part of this report:

Reports of Independent Registered Public Accounting Firm dated March 4, 2019 – BDO USA, LLP

Consolidated Balance Sheets --- December 31, 2018 and 2017

Consolidated Statements of Income for each of the three years in the period ended December 31, 2018

Consolidated Statements of Comprehensive Income for each of the three years in the period ended December 31, 2018

Consolidated Statements of Changes in Shareholders' Equity for each of the three years in the period ended December 31, 2018

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2018

Notes to Consolidated Financial Statements

The Consolidated Financial Statements, the Notes to the Consolidated Financial Statements, and the Reports of Independent Registered Public Accounting Firm listed above are incorporated by reference in Item 8 of this report.

(2) Financial Statement Schedules

Not applicable

(b) Exhibits:

The Exhibit Index immediately preceding the Signatures Page hereto is incorporated by reference under this item.

(c) Financial Statements Not Included In Annual Report

Not applicable

**Item 16. Form 10-K Summary**

None.

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**MERCANTILE BANK CORPORATION**

**FINANCIAL INFORMATION**

December 31, 2018 and 2017

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MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION

December 31, 2018 and 2017

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| <b>Consolidated Results of Operations:</b> | 2018                                         | 2017       | 2016       | 2015       | 2014(*)   |
|--------------------------------------------|----------------------------------------------|------------|------------|------------|-----------|
|                                            | (Dollars in thousands except per share data) |            |            |            |           |
| Interest income                            | \$ 141,981                                   | \$ 125,543 | \$ 118,457 | \$ 112,328 | \$ 89,118 |
| Interest expense                           | 21,899                                       | 15,795     | 12,590     | 11,154     | 11,340    |
| Net interest income                        | 120,082                                      | 109,748    | 105,867    | 101,174    | 77,778    |
| Provision for loan losses                  | 1,100                                        | 2,950      | 2,900      | (1,000 )   | (3,000 )  |
| Noninterest income                         | 19,010                                       | 19,001     | 21,038     | 16,038     | 10,028    |
| Noninterest expense                        | 86,170                                       | 79,716     | 77,118     | 79,381     | 65,610    |
| Income before income tax expense           | 51,822                                       | 46,083     | 46,887     | 38,831     | 25,196    |
| Income tax expense                         | 9,798                                        | 14,809     | 14,974     | 11,811     | 7,865     |
| Net income                                 | \$42,024                                     | \$31,274   | \$31,913   | \$27,020   | \$17,331  |

**Consolidated Balance Sheet Data:**

|                                                |             |             |             |             |             |
|------------------------------------------------|-------------|-------------|-------------|-------------|-------------|
| Total assets                                   | \$3,363,907 | \$3,286,704 | \$3,082,571 | \$2,903,556 | \$2,893,379 |
| Cash and cash equivalents                      | 75,354      | 200,101     | 183,596     | 89,891      | 172,738     |
| Securities                                     | 353,388     | 346,780     | 336,086     | 354,559     | 446,611     |
| Loans                                          | 2,753,085   | 2,558,552   | 2,378,620   | 2,277,727   | 2,089,277   |
| Allowance for loan losses                      | 22,380      | 19,501      | 17,961      | 15,681      | 20,041      |
| Bank owned life insurance                      | 69,647      | 68,689      | 67,198      | 58,971      | 57,861      |
| Deposits                                       | 2,463,708   | 2,522,365   | 2,374,985   | 2,275,382   | 2,276,915   |
| Securities sold under agreements to repurchase | 103,519     | 118,748     | 131,710     | 154,771     | 167,569     |
| Federal Home Loan Bank advances                | 350,000     | 220,000     | 175,000     | 68,000      | 54,022      |
| Subordinated debentures                        | 46,199      | 45,517      | 44,835      | 55,154      | 54,472      |
| Shareholders' equity                           | 375,249     | 365,870     | 340,811     | 333,804     | 328,138     |

**Consolidated Financial Ratios:**

|                                                     |       |   |       |   |       |   |       |   |       |   |
|-----------------------------------------------------|-------|---|-------|---|-------|---|-------|---|-------|---|
| Return on average assets                            | 1.28  | % | 1.00  | % | 1.07  | % | 0.94  | % | 0.76  | % |
| Return on average shareholders' equity              | 11.33 | % | 8.82  | % | 9.35  | % | 8.19  | % | 6.91  | % |
| Average shareholders' equity to average assets      | 11.33 | % | 11.28 | % | 11.42 | % | 11.45 | % | 11.05 | % |
| Nonperforming loans to total loans                  | 0.15  | % | 0.28  | % | 0.25  | % | 0.24  | % | 1.41  | % |
| Allowance for loan losses to total originated loans | 0.88  | % | 0.88  | % | 0.95  | % | 0.94  | % | 1.55  | % |
| Tier 1 leverage capital                             | 11.41 | % | 11.27 | % | 11.17 | % | 11.56 | % | 11.15 | % |
| Common equity risk-based capital                    | 10.41 | % | 10.74 | % | 10.88 | % | 10.89 | % | NA    |   |
| Tier 1 risk-based capital                           | 11.80 | % | 12.21 | % | 12.47 | % | 12.83 | % | 13.57 | % |
| Total risk-based capital                            | 12.50 | % | 12.88 | % | 13.13 | % | 13.45 | % | 14.43 | % |

**Per Common Share Data:**

|                                                |        |         |         |         |          |  |  |  |  |
|------------------------------------------------|--------|---------|---------|---------|----------|--|--|--|--|
| Net income:                                    |        |         |         |         |          |  |  |  |  |
| Basic                                          | \$2.53 | \$1.90  | \$1.96  | \$1.63  | \$1.28   |  |  |  |  |
| Diluted                                        | 2.53   | 1.90    | 1.96    | 1.62    | 1.28     |  |  |  |  |
| Tangible book value per share at end of period | 19.37  | 18.61   | 17.14   | 16.61   | 15.49    |  |  |  |  |
| Dividends declared                             | 1.68   | 0.74    | 1.16    | 0.58    | 2.48     |  |  |  |  |
| Dividend payout ratio                          | 65.44  | % 38.52 | % 58.70 | % 35.22 | % 141.16 |  |  |  |  |

(\*) – Merger with Firstbank effective June 1, 2014.

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**MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**FORWARD-LOOKING STATEMENTS**

The following discussion and other portions of this Annual Report contain forward-looking statements that are based on management’s beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and about 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; impact of technological advances; governmental and regulatory policy changes; 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 other risk factors described in Item 1A of this Annual Report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management’s Discussion and Analysis of Financial Condition and Results of Operations (“Management’s Discussion and Analysis”) is based on Mercantile Bank Corporation’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, and actual results could differ from those estimates. We have reviewed the analyses with the Audit Committee of our Board of Directors.

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 the allowance and operating results.

We complete a migration analysis quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2018 we placed most weight on the period starting December 31, 2010 through December 31, 2018. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.



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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 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, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our loan portfolio.

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 principal and interest 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 interest 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 are able to 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 assets and liabilities 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 assets and liabilities 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 asset or liability 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 taxing 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.

Accounting guidance requires us to assess whether a valuation allowance should be established against our deferred tax assets 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 that may impact future operating results. Significant weight is given to evidence that can be objectively verified.

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Securities and Other Financial Instruments: Securities available for sale consist of bonds and notes which might be sold prior to maturity due to changes in interest rates, prepayment risks, yield and availability of alternative investments, liquidity needs and other factors. Securities classified as available for sale are reported at their fair value. Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other than temporary losses, we consider: (1) the length of time and extent that fair value has been less than carrying value; (2) the financial condition and near term prospects of the issuer; and (3) our ability and intent to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value. Fair values for securities available for sale are generally obtained from outside sources and applied to individual securities within the portfolio. The difference between the amortized cost and the current fair value of securities is recorded as a valuation adjustment and reported in other comprehensive income.

Mortgage Servicing Rights: Mortgage servicing rights are recognized as assets based on the allocated fair value of retained servicing rights on mortgage loans sold. Servicing rights are carried at the lower of amortized cost or fair value and are expensed in proportion to, and over the period of, estimated net servicing income. We utilize a discounted cash flow model to determine the value of our servicing rights. The valuation model utilizes mortgage loan prepayment speeds, the remaining life of the mortgage loan pool, delinquency rates, our cost to service the mortgage loans and other factors to determine the cash flow that we will receive from servicing each grouping of mortgage loans. These cash flows are then discounted based on current interest rate assumptions to arrive at the fair value of the right to service those mortgage loans. Impairment is evaluated quarterly based on the fair value of the mortgage servicing rights, using groupings of the underlying mortgage loans classified by interest rates. Any impairment of a grouping is reported as a valuation allowance.

Goodwill: Generally accepted accounting principles require us to determine the fair value of all of the assets and liabilities of an acquired entity, and record their fair value on the date of acquisition. We employ a variety of means in determination of the fair value, including the use of discounted cash flow analysis, market comparisons and projected revenue streams. For certain items that we believe we have the appropriate expertise to determine the fair value, we may choose to use our own calculation of the value. In other cases, where the value is not easily determined, we consult with outside parties to determine the fair value of the asset or liability. Once valuations have been adjusted, the net difference between the price paid for the acquired company and the fair value of its balance sheet is recorded as goodwill.

Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2017 and 2018, we elected to perform a qualitative assessment for our annual impairment test and concluded it is more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required. Our qualitative assessment considered factors such as macroeconomic conditions, market conditions specifically related to the banking industry and our overall financial condition and results of operations.

## INTRODUCTION

This Management's Discussion and Analysis should be read in conjunction with the consolidated financial statements contained in this Annual Report. This discussion provides information about the consolidated financial condition and results of operations of Mercantile Bank Corporation and its consolidated subsidiary, Mercantile Bank of Michigan ("our bank"), and of Mercantile Bank Real Estate Co., L.L.C. ("our real estate company") and Mercantile Insurance Center, Inc. ("our insurance company"), subsidiaries of our bank. Unless the text clearly suggests otherwise, references to "us," "we," "our," or "the company" include Mercantile Bank Corporation and its wholly-owned subsidiaries referred to above.

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**FINANCIAL OVERVIEW**

We recorded net income of \$42.0 million, or \$2.53 per diluted share, for 2018. For 2017, we recorded net income of \$31.3 million, or \$1.90 per diluted share. Net income for 2018 benefited from a reduction in the corporate federal income tax rate, which was lowered from 35% to 21% effective January 1, 2018 due to the enactment of the Tax Cuts and Jobs Act. Our effective tax rate was approximately 19% in 2018, compared to about 32% during 2017.

The overall quality of our loan portfolio remains strong, with nonperforming loans equaling only 0.15% of total loans as of December 31, 2018. Gross loan charge-offs during 2018 totaled \$1.5 million, while recoveries of prior period loan charge-offs totaled \$3.3 million, providing for net loan recoveries of \$1.8 million, or 0.07% of average total loans. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries. Accruing loans past due 30 to 89 days remain very low.

New commercial term loan originations totaled approximately \$508 million in 2018, similar to the \$529 million, \$549 million and \$532 million we booked during 2017, 2016 and 2015, respectively. We also experienced net increases in commercial lines of credit during the past four years, in large part reflecting lines that are part of new commercial lending relationships established during recent quarterly periods. Net loan growth equaled \$195 million during 2018, compared to \$180 million, \$101 million and \$188 million during 2017, 2016 and 2015, respectively, with all years reflecting the impact of scheduled monthly payments as well as expected and unexpected commercial loan payoffs. During 2018, total commercial loans grew \$157 million, or 7.1%, primarily reflecting growth in the commercial and industrial, commercial real estate owner occupied and commercial real estate non-owner occupied segments. The new loan pipeline remains strong, and at year-end 2018, we had \$170 million in unfunded loan commitments on commercial construction and development projects that are in the construction phase. We believe our loan portfolio is well diversified, with commercial and industrial loans comprising 30%, commercial real estate non-owner occupied loans comprising 30%, commercial real estate owner occupied loans comprising 20% and residential mortgage and consumer loans aggregating 14% of total loans as of December 31, 2018. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans combined equaled 58% at both year-end 2018 and 2017.

Our funding structure is also well diversified. As of December 31, 2018, noninterest-bearing checking accounts comprised 30% of total funds, interest-bearing checking and securities sold under agreements to repurchase (“sweep accounts”) combined for 15%, savings and money market deposit accounts aggregated to 26% and local time deposits accounted for 13%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank of Indianapolis (“FHLBI”) advances, represented 16% of total funds.

**FINANCIAL CONDITION**

Our total assets increased \$77.2 million during 2018, and totaled \$3.36 billion as of December 31, 2018. Total loans increased \$195 million and securities available for sale were up \$1.6 million, while interest-earning deposits declined \$134 million. Total deposits decreased \$58.7 million and sweep accounts were down \$15.2 million, while FHLBI advances were up \$130 million. In large part, net loan growth was funded with excess funds that were maintained with the Federal Reserve Bank of Chicago and new advances from the FHLBI.

### *Earning Assets*

Average earning assets equaled 93.0% of average total assets during 2018, similar to the 92.8% during 2017. The loan portfolio continued to comprise a majority and increasing level of earning assets, followed by securities and interest-earning deposits. Average total loans equaled 86.4% of average earning assets during 2018, compared to 85.2% in 2017, while securities and other interest-earning assets combined comprised 13.6% of average earning assets during 2018, compared to 14.8% in 2017. We anticipate the level of earning assets to total assets to remain relatively stable at approximately 93%.

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Our loan portfolio has historically been primarily comprised of commercial loans. Commercial loans increased \$157 million during 2018, and at December 31, 2018 totaled \$2.36 billion, or 85.7% of the loan portfolio. As of December 31, 2017, the commercial loan portfolio comprised 86.1% of total loans. Commercial and industrial loans were up \$69.0 million, owner occupied commercial real estate (“CRE”) loans increased \$22.3 million, non-owner occupied CRE loans increased \$24.6 million, multi-family and residential rental loans grew \$25.7 million and vacant land, land development and residential construction loans were up \$15.0 million. As a percent of total commercial loans, commercial and industrial loans and owner occupied CRE loans combined equaled 58.1% as of December 31, 2018 and December 31, 2017.

We are pleased with the \$2.12 billion in new commercial term loan fundings over the past four years, and our current commercial loan pipeline reports indicate continued strong commercial loan funding opportunities in future periods. Also, as of December 31, 2018, availability on existing construction and development loans totaled \$170 million, with most of those commitments expected to be drawn during 2019. Further, we have made additional lending commitments totaling \$102 million, a majority of which we expect to be accepted and funded over the next 12 to 18 months. Our commercial loan officers also report significant additional opportunities they are currently discussing with existing borrowers and potential new customers.

We continue to experience commercial loan principal paydowns and payoffs. While a portion of the principal paydowns and payoffs received have been welcomed, such as on stressed lending relationships, we have also experienced instances where well-performing relationships have been refinanced at other financial institutions or non-bank companies, and other situations where the borrower has sold the underlying asset. In many of those cases where the loans have been refinanced elsewhere, we believed the terms and conditions of the new lending arrangements were too aggressive, generally reflecting the very competitive banking environment in our markets. We remain committed to prudent underwriting standards that provide for an appropriate yield and risk relationship, as well as concentration limits we have established within our commercial loan portfolio. Usage of existing commercial lines of credit has remained relatively steady.

Residential mortgage loans increased \$53.0 million during 2018, totaling \$308 million or 11.2% of total loans, at December 31, 2018. We originated \$214 million in residential mortgage loans during 2018, compared to \$223 million in 2017. Notwithstanding a shortage of inventory of homes listed for sale throughout our markets, the volume of mortgage loans originated for the purchase of homes in 2018 increased by almost 6% when compared to 2017. However, due to increased mortgage interest rates, the volume of mortgage loans for refinance activities declined by over 19% in 2018 when compared to 2017. We sold \$96.4 million of the residential mortgage loans originated in 2018, or about 45%, generally comprised of longer-term fixed rate mortgage loans. The remaining \$118 million was added to our balance sheet, in large part comprised of adjustable rate residential mortgage loans. We are pleased with the success of our strategic initiative to grow our residential mortgage banking operation over the past several years, and generally expect origination volume to increase in future periods. We expect to sell 45% to 50% of the new residential mortgage loan originations in 2019, with a vast majority of the loans added to our balance sheet to be comprised of adjustable rate mortgage loans. Other consumer-related loans declined \$15.0 million during 2018, and at December 31, 2018 totaled \$85.4 million, or 3.1% of the loan portfolio. Other consumer-related loans equaled 3.9% of total loans as of December 31, 2017. We expect this loan portfolio segment to decline in future periods as scheduled principal payments exceed origination volumes.

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The following table summarizes our loan portfolio:

|                                           | 12/31/18               | 12/31/17               | 12/31/16               | 12/31/15               | 12/31/14               |
|-------------------------------------------|------------------------|------------------------|------------------------|------------------------|------------------------|
| <b>Commercial:</b>                        |                        |                        |                        |                        |                        |
| Commercial & Industrial                   | \$822,723,000          | \$753,764,000          | \$713,903,000          | \$696,303,000          | \$550,629,000          |
| Land Development & Construction           | 44,885,000             | 29,873,000             | 34,828,000             | 45,120,000             | 51,977,000             |
| Owner Occupied Commercial Real Estate     | 548,619,000            | 526,328,000            | 450,464,000            | 445,919,000            | 430,406,000            |
| Non-Owner Occupied Commercial Real Estate | 816,282,000            | 791,685,000            | 748,269,000            | 644,351,000            | 559,594,000            |
| Multi-Family & Residential Rental         | 127,597,000            | 101,918,000            | 117,883,000            | 115,003,000            | 122,772,000            |
| <b>Total Commercial</b>                   | <b>2,360,106,000</b>   | <b>2,203,568,000</b>   | <b>2,065,347,000</b>   | <b>1,946,696,000</b>   | <b>1,715,378,000</b>   |
| <b>Retail:</b>                            |                        |                        |                        |                        |                        |
| 1-4 Family Mortgages                      | 307,540,000            | 254,559,000            | 195,226,000            | 190,385,000            | 214,695,000            |
| Home Equity & Other Consumer Loans        | 85,439,000             | 100,425,000            | 118,047,000            | 140,646,000            | 159,204,000            |
| <b>Total Retail</b>                       | <b>392,979,000</b>     | <b>354,984,000</b>     | <b>313,273,000</b>     | <b>331,031,000</b>     | <b>373,899,000</b>     |
| <b>Total Loans</b>                        | <b>\$2,753,085,000</b> | <b>\$2,558,552,000</b> | <b>\$2,378,620,000</b> | <b>\$2,277,727,000</b> | <b>\$2,089,277,000</b> |

The following table presents total loans outstanding as of December 31, 2018, according to scheduled repayments of principal on fixed rate loans and repricing frequency on variable rate loans. 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.

|                                       | Less Than One Year     | One Through Five Years | More Than Five Years | Total                  |
|---------------------------------------|------------------------|------------------------|----------------------|------------------------|
| Construction and land development     | \$156,796,000          | \$19,268,000           | \$31,099,000         | \$207,163,000          |
| Real estate - residential properties  | 73,486,000             | 140,496,000            | 164,743,000          | 378,725,000            |
| Real estate - multi-family properties | 26,021,000             | 43,831,000             | 2,101,000            | 71,953,000             |
| Real estate - commercial properties   | 492,703,000            | 544,068,000            | 215,984,000          | 1,252,755,000          |
| Commercial and industrial             | 624,610,000            | 161,928,000            | 27,450,000           | 813,988,000            |
| Consumer                              | 4,092,000              | 20,899,000             | 3,510,000            | 28,501,000             |
| <b>Total loans</b>                    | <b>\$1,377,708,000</b> | <b>\$930,490,000</b>   | <b>\$444,887,000</b> | <b>\$2,753,085,000</b> |
| Fixed rate loans                      | \$68,791,000           | \$852,098,000          | \$330,134,000        | \$1,251,023,000        |
| Floating rate loans                   | 1,308,917,000          | 78,392,000             | 114,753,000          | 1,502,062,000          |
| <b>Total loans</b>                    | <b>\$1,377,708,000</b> | <b>\$930,490,000</b>   | <b>\$444,887,000</b> | <b>\$2,753,085,000</b> |

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 effective 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 loan 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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Nonperforming assets, comprised of nonaccrual loans, loans past due 90 days or more and accruing interest and foreclosed properties, totaled \$5.0 million (0.2% of total assets) as of December 31, 2018, compared to \$9.4 million (0.3% of total assets) as of December 31, 2017. The volume of nonperforming assets has generally been on a steady trend over the past several years. One commercial loan relationship, which was placed on nonaccrual during late 2014, accounted for approximately 70% of total nonperforming assets at year-end 2014. This relationship was resolved during mid-2015. Given the low level of nonperforming loans and accruing loans 30 to 89 days delinquent, combined with a steady level of watch list credits and what we believe are strong credit administration practices, we are pleased with the overall quality of the loan portfolio.

The following tables provide a breakdown of nonperforming assets by property type:

## NONPERFORMING LOANS

|                          | 12/31/18    | 12/31/17    | 12/31/16    | 12/31/15    | 12/31/14     |
|--------------------------|-------------|-------------|-------------|-------------|--------------|
| Residential Real Estate: |             |             |             |             |              |
| Land Development         | \$0         | \$0         | \$16,000    | \$23,000    | \$84,000     |
| Construction             | 0           | 0           | 0           | 0           | 0            |
| Owner Occupied / Rental  | 3,157,000   | 3,381,000   | 2,739,000   | 2,917,000   | 4,229,000    |
|                          | 3,157,000   | 3,381,000   | 2,755,000   | 2,940,000   | 4,313,000    |
| Commercial Real Estate:  |             |             |             |             |              |
| Land Development         | 0           | 35,000      | 95,000      | 155,000     | 209,000      |
| Construction             | 0           | 0           | 0           | 0           | 0            |
| Owner Occupied           | 950,000     | 2,241,000   | 285,000     | 2,131,000   | 18,091,000   |
| Non-Owner Occupied       | 0           | 0           | 488,000     | 108,000     | 378,000      |
|                          | 950,000     | 2,276,000   | 868,000     | 2,394,000   | 18,678,000   |
| Non-Real Estate:         |             |             |             |             |              |
| Commercial Assets        | 17,000      | 1,444,000   | 2,293,000   | 69,000      | 6,401,000    |
| Consumer Assets          | 17,000      | 42,000      | 23,000      | 41,000      | 42,000       |
|                          | 34,000      | 1,486,000   | 2,316,000   | 110,000     | 6,443,000    |
| Total                    | \$4,141,000 | \$7,143,000 | \$5,939,000 | \$5,444,000 | \$29,434,000 |

## OTHER REAL ESTATE OWNED &amp; REPOSSESSED ASSETS

|                          | 12/31/18 | 12/31/17 | 12/31/16 | 12/31/15 | 12/31/14  |
|--------------------------|----------|----------|----------|----------|-----------|
| Residential Real Estate: |          |          |          |          |           |
| Land Development         | \$0      | \$0      | \$0      | \$0      | \$329,000 |
| Construction             | 0        | 0        | 0        | 0        | 0         |
| Owner Occupied / Rental  | 398,000  | 193,000  | 144,000  | 598,000  | 722,000   |
|                          | 398,000  | 193,000  | 144,000  | 598,000  | 1,051,000 |

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Commercial Real Estate:

|                    |         |           |         |         |         |
|--------------------|---------|-----------|---------|---------|---------|
| Land Development   | 0       | 0         | 0       | 0       | 0       |
| Construction       | 0       | 0         | 0       | 0       | 0       |
| Owner Occupied     | 413,000 | 2,031,000 | 325,000 | 612,000 | 247,000 |
| Non-Owner Occupied | 0       | 36,000    | 0       | 83,000  | 697,000 |
|                    | 413,000 | 2,067,000 | 325,000 | 695,000 | 944,000 |

Non-Real Estate:

|                   |   |   |   |   |   |
|-------------------|---|---|---|---|---|
| Commercial Assets | 0 | 0 | 0 | 0 | 0 |
| Consumer Assets   | 0 | 0 | 0 | 0 | 0 |
|                   | 0 | 0 | 0 | 0 | 0 |

|       |           |             |           |             |             |
|-------|-----------|-------------|-----------|-------------|-------------|
| Total | \$811,000 | \$2,260,000 | \$469,000 | \$1,293,000 | \$1,995,000 |
|-------|-----------|-------------|-----------|-------------|-------------|



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The following tables provide a reconciliation of nonperforming assets:

## NONPERFORMING LOANS RECONCILIATION

|                                                        | 2018        | 2017        | 2016        | 2015         | 2014         |
|--------------------------------------------------------|-------------|-------------|-------------|--------------|--------------|
| Beginning balance                                      | \$7,143,000 | \$5,939,000 | \$5,444,000 | \$29,434,000 | \$6,718,000  |
| Additions, net of transfers to other real estate owned | 2,909,000   | 7,604,000   | 5,655,000   | 4,543,000    | 25,871,000   |
| Returns to performing status                           | (175,000 )  | (232,000 )  | (13,000 )   | (48,000 )    | (779,000 )   |
| Principal payments                                     | (5,028,000) | (4,234,000) | (4,166,000) | (23,641,000) | (2,063,000 ) |
| Loan charge-offs                                       | (708,000 )  | (1,934,000) | (981,000 )  | (4,844,000 ) | (313,000 )   |
| Total                                                  | \$4,141,000 | \$7,143,000 | \$5,939,000 | \$5,444,000  | \$29,434,000 |

## OTHER REAL ESTATE OWNED &amp; REPOSSESSED ASSETS RECONCILIATION

|                       | 2018        | 2017        | 2016        | 2015        | 2014        |
|-----------------------|-------------|-------------|-------------|-------------|-------------|
| Beginning balance     | \$2,260,000 | \$469,000   | \$1,293,000 | \$1,995,000 | \$2,851,000 |
| Additions             | 1,114,000   | 4,401,000   | 725,000     | 2,186,000   | 2,593,000   |
| Sale proceeds         | (2,380,000) | (677,000 )  | (1,428,000) | (2,377,000) | (3,183,000) |
| Valuation write-downs | (183,000 )  | (1,933,000) | (121,000 )  | (511,000 )  | (266,000 )  |
| Total                 | \$811,000   | \$2,260,000 | \$469,000   | \$1,293,000 | \$1,995,000 |

Gross loan charge-offs equaled \$1.5 million during 2018, while recoveries of prior period charge-offs totaled \$3.3 million. Resulting net loan recoveries equaled \$1.8 million, or 0.07% of average total loans. Gross loan charge-offs equaled \$3.2 million during 2017, while recoveries of prior period charge-offs totaled \$1.8 million. Resulting net loan charge-offs equaled \$1.4 million, or only 0.06% of average total loans. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of recoveries.

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The following table summarizes changes in the allowance for originated loan losses for the past five years:

|                                                                       | 2018            | 2017            | 2016            | 2015            | 2014            |
|-----------------------------------------------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Originated loans outstanding at year-end                              | \$2,452,446,000 | \$2,169,957,000 | \$1,884,548,000 | \$1,616,587,000 | \$1,246,116,000 |
| Daily average balance of originated loans outstanding during the year | \$2,295,251,000 | \$2,054,809,000 | \$1,784,978,000 | \$1,428,150,000 | \$1,141,682,000 |
| Balance of allowance for originated loans at beginning of year        | \$19,133,000    | \$17,868,000    | \$15,233,000    | \$19,299,000    | \$22,821,000    |
| Originated loans charged-off:                                         |                 |                 |                 |                 |                 |
| Commercial, financial and agricultural                                | (367,000 )      | (2,272,000 )    | (980,000 )      | (4,910,000 )    | (840,000 )      |
| Construction and land development                                     | (61,000 )       | (20,000 )       | 0               | (4,000 )        | (36,000 )       |
| Residential real estate                                               | (551,000 )      | (687,000 )      | (809,000 )      | (1,053,000 )    | (484,000 )      |
| Instalment loans to individuals                                       | (210,000 )      | (204,000 )      | (344,000 )      | (228,000 )      | (70,000 )       |
| Total charge-offs                                                     | (1,189,000 )    | (3,183,000 )    | (2,133,000 )    | (6,195,000 )    | (1,430,000 )    |
| Recoveries of previously charged-off originated loans:                |                 |                 |                 |                 |                 |
| Commercial, financial and agricultural                                | 1,757,000       | 1,445,000       | 754,000         | 2,535,000       | 1,117,000       |
| Construction and land development                                     | 832,000         | 129,000         | 334,000         | 122,000         | 180,000         |
| Residential real estate                                               | 531,000         | 131,000         | 522,000         | 122,000         | 404,000         |
| Instalment loans to individuals                                       | 90,000          | 102,000         | 60,000          | 51,000          | 0               |
| Total recoveries                                                      | 3,210,000       | 1,807,000       | 1,670,000       | 2,830,000       | 1,701,000       |
| Net loan (charge-offs) recoveries                                     | 2,021,000       | (1,376,000 )    | (463,000 )      | (3,365,000 )    | 271,000         |
| Provision for loan losses for originated                              | 400,000         | 2,641,000       | 3,098,000       | (701,000 )      | (3,793,000 )    |

loans

|                                                                |              |              |              |              |              |
|----------------------------------------------------------------|--------------|--------------|--------------|--------------|--------------|
| Balance of allowance<br>for originated loans at<br>end of year | \$21,554,000 | \$19,133,000 | \$17,868,000 | \$15,233,000 | \$19,299,000 |
|----------------------------------------------------------------|--------------|--------------|--------------|--------------|--------------|

|                                                                                                     |      |   |        |   |        |   |        |   |      |   |
|-----------------------------------------------------------------------------------------------------|------|---|--------|---|--------|---|--------|---|------|---|
| Ratio of net loan<br>(charge-offs)<br>recoveries to average<br>loans outstanding<br>during the year | 0.09 | % | (0.07% | ) | (0.03% | ) | (0.24% | ) | 0.02 | % |
|-----------------------------------------------------------------------------------------------------|------|---|--------|---|--------|---|--------|---|------|---|

|                                                                         |      |   |      |   |      |   |      |   |      |   |
|-------------------------------------------------------------------------|------|---|------|---|------|---|------|---|------|---|
| Ratio of allowance to<br>originated loans<br>outstanding at<br>year-end | 0.88 | % | 0.88 | % | 0.95 | % | 0.94 | % | 1.55 | % |
|-------------------------------------------------------------------------|------|---|------|---|------|---|------|---|------|---|

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The following table illustrates the breakdown of the allowance for originated loans balance by loan type (dollars in thousands) and of the total originated loan portfolio (in percentages):

|                                        | 12/31/2018 |                | 12/31/2017 |                | 12/31/2016 |                | 12/31/2015 |                | 12/31/2014 |                |
|----------------------------------------|------------|----------------|------------|----------------|------------|----------------|------------|----------------|------------|----------------|
|                                        | Amount     | Loan Portfolio | Amount     | Loan Portfolio | Amount     | Loan Portfolio | Amount     | Loan Portfolio | Amount     | Loan Portfolio |
| Commercial, financial and agricultural | \$19,228   | 86.7 %         | \$15,616   | 77.8 %         | \$15,035   | 85.8 %         | \$12,017   | 80.7 %         | \$16,112   | 82.8 %         |
| Construction and land development      | 270        | 2.0            | 1,260      | 7.6            | 991        | 6.0            | 1,655      | 10.9           | 1,012      | 8.8            |
| Residential real estate                | 1,778      | 10.0           | 1,758      | 13.3           | 1,374      | 6.4            | 1,235      | 6.4            | 1,974      | 7.2            |
| Instalment loans to individuals        | 234        | 1.3            | 406        | 1.3            | 508        | 1.8            | 186        | 2.0            | 125        | 1.2            |
| Unallocated                            | 44         | 0.0            | 93         | 0.0            | (40 )      | 0.0            | 140        | 0.0            | 76         | 0.0            |
| Total                                  | \$21,554   | 100.0 %        | \$19,133   | 100.0 %        | \$17,868   | 100.0 %        | \$15,233   | 100.0 %        | \$19,299   | 100.0 %        |

The following table depicts the ratio of our allowance to nonperforming loans:

|                                           | 12/31/18 | 12/31/17 | 12/31/16 | 12/31/15 | 12/31/14 |
|-------------------------------------------|----------|----------|----------|----------|----------|
| Ratio of allowance to nonperforming loans | 540.4 %  | 273.0 %  | 302.4 %  | 288.0 %  | 68.1 %   |

The relatively low level of the ratio of our allowance to nonperforming loans during 2014 primarily reflects one distressed commercial loan relationship that was placed into nonaccrual status in late 2014 but resolved during mid-2015.

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at an adequate level. Through the loan review and credit departments, we establish specific 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, the result of which is combined with specific reserves to calculate an overall allowance amount. For non-impaired commercial loans, reserve allocation factors are based on the loan ratings as determined by our standardized grade paradigms and by loan purpose. Our commercial loan portfolio is segregated 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; lending concentrations; and other external factors, including 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 loans. Our migration takes into account various time periods; however, at year-end 2018 we placed most weight on the period starting December 31, 2010 through December 31, 2018. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

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 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, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our loan portfolio.

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and the 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.

The allowance for originated loans equaled \$21.6 million as of December 31, 2018, or 0.9% of total originated loans outstanding. The allowance for originated loans equaled 0.9% of total loans at year-end 2017. The allowance for acquired loans equaled \$0.8 million as of December 31, 2018, compared to \$0.4 million at year-end 2017. As of December 31, 2018, the allowance for originated loans was comprised of \$20.9 million in general reserves relating to non-impaired loans, \$0.1 million in specific reserve allocations relating to nonaccrual loans, and \$0.6 million in specific allocations on other loans, primarily accruing loans designated as troubled debt restructurings.

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

Troubled debt restructurings totaled \$19.5 million at December 31, 2018, consisting of \$0.2 million that are on nonaccrual status and \$19.3 million that are on accrual status. The latter, while considered and accounted for as impaired loans in accordance with accounting guidelines, is not included in our nonperforming loan totals. Impaired loans with an aggregate carrying value of \$0.3 million as of December 31, 2018 had been subject to previous partial charge-offs aggregating \$0.5 million. Those partial charge-offs were recorded as follows: less than \$0.1 million in 2018, 2017, 2016 and 2013, \$0.1 million in 2015 and \$0.4 million in 2011. As of December 31, 2018, specific

reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled less than \$0.1 million.

The following table provides a breakdown of our loans categorized as troubled debt restructurings:

|               | 12/31/18      | 12/31/17     | 12/31/16      | 12/31/15      | 12/31/14      |
|---------------|---------------|--------------|---------------|---------------|---------------|
| Performing    | \$ 19,223,000 | \$ 6,128,000 | \$ 12,480,000 | \$ 19,336,000 | \$ 24,001,000 |
| Nonperforming | 229,000       | 2,434,000    | 1,132,000     | 2,358,000     | 26,433,000    |
| Total         | \$ 19,452,000 | \$ 8,562,000 | \$ 13,612,000 | \$ 21,694,000 | \$ 50,434,000 |

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Securities available for sale increased \$1.6 million during 2018, totaling \$337 million as of December 31, 2018. The securities portfolio equaled 10.9% of average earning assets during 2018, compared to 11.3% during 2017. During 2018, purchases of U.S. Government agency bonds totaled \$29.3 million, U.S. Government agency issued or guaranteed mortgage-backed securities aggregated \$15.0 million and municipal bonds totaled \$4.4 million. Proceeds from matured and called U.S. Government agency and municipal bonds during 2018 totaled \$9.3 million and \$21.7 million, respectively, with another \$9.4 million from principal paydowns on mortgage-backed securities. No bonds were sold during 2018. At December 31, 2018, the securities portfolio was primarily comprised of U.S. Government agency bonds (56%), municipal bonds (31%) and U.S. Government agency issued or guaranteed mortgage-backed securities (13%). All of our securities are currently designated as available for sale, and therefore are stated at fair value. The fair value of securities designated as available for sale at December 31, 2018 totaled \$337 million, including a net unrealized loss of \$10.4 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.

The following table reflects the composition of the securities portfolio:

|                                         | 12/31/18<br>Carrying<br>Value | Percent | 12/31/17<br>Carrying<br>Value | Percent | 12/31/16<br>Carrying<br>Value | Percent |
|-----------------------------------------|-------------------------------|---------|-------------------------------|---------|-------------------------------|---------|
| U.S. Government agency debt obligations | \$ 187,077,000                | 55.5 %  | \$ 169,700,000                | 50.5 %  | \$ 152,040,000                | 46.3 %  |
| Mortgage-backed securities              | 43,658,000                    | 12.9    | 38,792,000                    | 11.6    | 47,392,000                    | 14.5    |
| Municipal general obligations           | 102,497,000                   | 30.4    | 121,293,000                   | 36.1    | 119,047,000                   | 36.3    |
| Municipal revenue bonds                 | 3,634,000                     | 1.1     | 3,978,000                     | 1.2     | 7,631,000                     | 2.3     |
| Other investments                       | 500,000                       | 0.1     | 1,981,000                     | 0.6     | 1,950,000                     | 0.6     |
| Totals                                  | \$337,366,000                 | 100.0 % | \$335,744,000                 | 100.0 % | \$328,060,000                 | 100.0 % |

FHLBI stock totaled \$16.0 million as of December 31, 2018, compared to \$11.0 million as of December 31, 2017. The \$5.0 million increase reflects stock purchases to support the increased level of FHLBI advances during 2018. Our investment in FHLBI stock is necessary to engage in their advance and other financing programs. We continue to receive regular quarterly cash dividends, and we expect a cash dividend will continue in future quarterly periods.

Market values on our U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies and 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 certain non-rated securities issued by relatively small municipalities generally located within our markets is estimated at carrying 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. Reference is made to Note 18 of the Notes to Consolidated Financial Statements for additional information.

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The following table shows by class of maturities as of December 31, 2018, the amounts and weighted average yields (on a fully taxable-equivalent basis) of investment securities:

|                                                   | Carrying<br>Value | Average<br>Yield |   |
|---------------------------------------------------|-------------------|------------------|---|
| Obligations of U.S. Government agencies:          |                   |                  |   |
| One year or less                                  | \$8,464,000       | 1.65             | % |
| Over one through five years                       | 16,913,000        | 1.81             |   |
| Over five through ten years                       | 64,464,000        | 2.44             |   |
| Over ten years                                    | 97,236,000        | 3.09             |   |
|                                                   | 187,077,000       | 2.69             |   |
| Obligations of states and political subdivisions: |                   |                  |   |
| One year or less                                  | 18,760,000        | 2.00             |   |
| Over one through five years                       | 32,672,000        | 2.60             |   |
| Over five through ten years                       | 40,481,000        | 2.93             |   |
| Over ten years                                    | 14,218,000        | 3.39             |   |
|                                                   | 106,131,000       | 2.72             |   |
| Mortgage-backed securities                        | 43,658,000        | 2.76             |   |
| Other investments                                 | 500,000           | 5.37             |   |
| Totals                                            | \$337,366,000     | 2.71             | % |

Other interest-earning assets, primarily consisting of excess funds deposited with the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate sensitivity. The average balance of these funds equaled 2.3% of average earning assets during 2018, compared to 3.1% during 2017. We anticipate the level of these earning assets to average approximately 2% of average earning assets in future periods.

***Non-Earning Assets***

Cash and due from bank balances averaged 1.5% of total assets during 2018, with no significant changes expected in future periods. Net premises and fixed assets equaled \$48.3 million as of December 31, 2018, or 1.4% of total assets. Net purchases during 2018 totaled \$6.3 million, while depreciation expense aggregated to \$3.6 million. Foreclosed and repossessed assets totaled \$0.8 million at December 31, 2018, compared to \$2.3 million at December 31, 2017; the \$1.5 million decline during 2018 primarily reflects the sale of a bank-owned parcel of real estate that was no longer being considered for use as a bank facility that had been transferred from fixed assets to other real estate owned during 2017. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on certain impaired lending relationships, we believe the strong quality of our loan portfolio will limit any overall increase in, and average balance of, this nonperforming asset category.

***Source of Funds***

Total deposits decreased \$58.7 million during 2018, totaling \$2.46 billion as of December 31, 2018. Out-of-area deposits increased \$10.6 million during 2018, and equaled 4.6% of total deposits at year-end 2018, compared to 4.1% as of December 31, 2017. FHLBI advances increased \$130 million during 2018, totaling \$350 million as of December 31, 2018.

Noninterest-bearing checking accounts increased \$23.4 million during 2018, generally due to deposit account openings as part of recently established commercial lending relationships and transfers from sweep accounts to new noninterest-bearing checking accounts. Interest-bearing checking accounts decreased \$48.7 million and savings deposits declined \$10.5 million, in part due to individuals using deposited funds for investments and various expenditures. Money market deposit accounts increased \$7.2 million during 2018, while local time deposits under \$100,000 increased \$7.8 million. Local time deposits \$100,000 and over declined \$48.5 million, primarily reflecting the managed reduction of public unit time deposits given the strong competitive environment and resulting relatively high deposit rates.

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Sweep accounts decreased \$15.2 million during 2018, totaling \$104 million as of December 31, 2018. The decline primarily reflects certain customers transferring funds from the sweep product to noninterest-bearing checking accounts. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings.

FHLBI advances increased \$130 million during 2018, totaling \$350 million as of December 31, 2018. FHLBI advances are primarily used to assist in funding loan demand, as well as playing an integral role in our interest rate risk management program. FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit at year-end 2018 totaled \$739 million, with availability of \$383 million.

Shareholders' equity increased \$9.4 million during 2018, totaling \$375 million as of December 31, 2018. Positively impacting shareholders' equity was net income of \$42.0 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling \$27.5 million. Activity relating to the issuance and sale of common stock through various stock-based compensation programs and our dividend reinvestment plan positively impacted shareholders' equity by a total of \$4.2 million. Share repurchases reduced shareholders' equity by \$5.9 million during 2018. Negatively impacting shareholders' equity during 2018 was a \$3.4 million after-tax decline in the market value of available for sale securities.

## **RESULTS OF OPERATIONS**

### **FOR THE YEARS ENDED DECEMBER 31, 2018 and 2017**

#### ***Summary***

We recorded net income of \$42.0 million, or \$2.53 per basic and diluted share, for 2018, compared to net income of \$31.3 million, or \$1.90 per basic and diluted share, for 2017. Our earnings performance in 2018 benefited from increased net interest income, lower provision expense, and decreased federal income tax expense, which more than offset increased noninterest expense. The improved net interest income resulted from an increased net interest margin and a higher level of average earning assets. The decreased provision expense mainly reflects the positive impact of net loan recoveries being recorded during the current year. The lower level of federal income tax expense depicts a reduction in our federal corporate income tax rate, which was lowered from 35.0% to 21.0% on January 1, 2018, as a result of the enactment of the Tax Cuts and Jobs Act. The increased noninterest expense was primarily attributable to higher salary costs, mainly reflecting annual employee merit pay increases, higher stock-based compensation, and a one-time pay increase for all hourly employees. Growth in several of our primary noninterest income revenue streams, including credit and debit card interchange fees, treasury management income, and payroll processing revenue, also contributed to the improved earnings performance.



The following table shows some of the key performance and equity ratios for the years ended December 31, 2018 and 2017:

|                                                | 2018    | 2017    |
|------------------------------------------------|---------|---------|
| Return on average assets                       | 1.28 %  | 1.00 %  |
| Return on average shareholders' equity         | 11.33 % | 8.82 %  |
| Average shareholders' equity to average assets | 11.33 % | 11.28 % |

### *Net Interest Income*

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled \$142 million and \$21.9 million during 2018, respectively, providing for net interest income of \$120 million. During 2017, interest income and interest expense equaled \$126 million and \$15.8 million, respectively, providing for net interest income of \$111 million.

In comparing 2018 with 2017, interest income increased 12.6%, interest expense was up 38.6%, and net interest income increased 8.9%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The \$9.8 million increase in net interest income in 2018 compared to 2017 resulted from a higher net interest margin and an increased level of average earning assets. During 2018, the net interest margin equaled 3.96%, up from 3.79% during 2017 due to an increased yield on average earning assets, which more than offset a higher cost of funds. The improved yield on average earning assets mainly resulted from an increased yield on commercial loans, primarily reflecting higher interest rates on variable-rate loans stemming from the Federal Open Market Committee ("FOMC") raising the targeted federal funds rate by 25 basis points on four occasions during 2018 and three occasions during 2017. The higher cost of funds primarily resulted from increased costs of certain non-time deposits, time deposits, and borrowed funds. During 2018, earning assets averaged \$3.04 billion, or \$127 million higher than average earning assets during 2017. Average loans increased \$145 million, average interest-earning deposits decreased \$21.4 million, and average securities increased \$3.1 million.

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The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders' equity during 2018, 2017 and 2016. The subsequent table also depicts the dollar amount of change in interest income and interest expense of interest-earning assets and interest-bearing liabilities, respectively, segregated between change due to volume and change due to rate. For tax-exempt investment securities, interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 21.0% in 2018 and 35.0% in both 2017 and 2016. Securities interest income was increased by \$0.3 million in 2018 and \$0.8 million in both 2017 and 2016 for this non-GAAP, but industry standard, adjustment. This adjustment equated to a one basis point increase in our net interest margin during 2018 and a three basis point increase in our net interest margin during both 2017 and 2016.

| (Dollars in thousands)           | Years ended December 31, |          |         |             |          |         |             |          |         |
|----------------------------------|--------------------------|----------|---------|-------------|----------|---------|-------------|----------|---------|
|                                  | 2018                     |          |         | 2017        |          |         | 2016        |          |         |
|                                  | Average                  | Interest | Average | Average     | Interest | Average | Average     | Interest | Average |
|                                  | Balance                  |          | Rate    | Balance     |          | Rate    | Balance     |          | Rate    |
| Taxable securities               | \$233,372                | \$6,736  | 2.89 %  | \$224,786   | \$5,326  | 2.37 %  | \$224,297   | \$6,842  | 3.05 %  |
| Tax-exempt securities            | 110,514                  | 2,509    | 2.27    | 115,984     | 3,103    | 2.68    | 115,875     | 2,932    | 2.53    |
| Total securities                 | 343,886                  | 9,245    | 2.69    | 340,770     | 8,429    | 2.47    | 340,172     | 9,774    | 2.87    |
| Loans                            | 2,628,906                | 131,763  | 5.01    | 2,483,440   | 116,816  | 4.70    | 2,345,308   | 109,049  | 4.65    |
| Interest-earning deposits        | 69,559                   | 1,243    | 1.79    | 90,925      | 1,096    | 1.21    | 77,852      | 401      | 0.51    |
| Federal funds sold               | 0                        | 0        | 0.00    | 0           | 0        | 0.00    | 11          | <1       | 0.25    |
| Total earning assets             | 3,042,351                | 142,251  | 4.68    | 2,915,135   | 126,341  | 4.33    | 2,763,343   | 119,224  | 4.31    |
| Allowance for loan losses        | (21,173 )                |          |         | (18,949 )   |          |         | (16,895 )   |          |         |
| Cash and due from banks          | 48,207                   |          |         | 48,061      |          |         | 45,890      |          |         |
| Other non-earning assets         | 203,252                  |          |         | 198,426     |          |         | 195,446     |          |         |
| Total assets                     | \$3,272,637              |          |         | \$3,142,673 |          |         | \$2,987,784 |          |         |
| Interest-bearing demand deposits | \$359,371                | \$552    | 0.15 %  | \$377,933   | \$507    | 0.13 %  | \$360,180   | \$336    | 0.09 %  |
| Savings deposits                 | 320,387                  | 381      | 0.12    | 341,175     | 351      | 0.10    | 340,076     | 296      | 0.09    |
|                                  | 474,651                  | 5,322    | 1.12    | 354,145     | 2,122    | 0.60    | 290,528     | 360      | 0.12    |

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|                                    |             |           |        |             |           |        |             |           |        |
|------------------------------------|-------------|-----------|--------|-------------|-----------|--------|-------------|-----------|--------|
| Money market accounts              |             |           |        |             |           |        |             |           |        |
| Time deposits                      | 478,741     | 7,614     | 1.59   | 516,525     | 6,382     | 1.24   | 577,062     | 6,557     | 1.14   |
| Total interest-bearing deposits    | 1,633,150   | 13,869    | 0.85   | 1,589,778   | 9,362     | 0.59   | 1,567,846   | 7,549     | 0.48   |
| Short-term borrowings              | 102,076     | 273       | 0.27   | 116,615     | 190       | 0.16   | 149,079     | 211       | 0.14   |
| Federal Home Loan Bank advances    | 239,068     | 4,647     | 1.94   | 217,849     | 3,657     | 1.68   | 149,344     | 2,263     | 1.51   |
| Other borrowings                   | 49,048      | 3,110     | 6.34   | 48,453      | 2,586     | 5.34   | 48,711      | 2,567     | 5.27   |
| Total interest-bearing liabilities | 2,023,342   | 21,899    | 1.08   | 1,972,695   | 15,795    | 0.80   | 1,914,980   | 12,590    | 0.66   |
| Demand deposits                    | 863,384     |           |        | 802,024     |           |        | 715,550     |           |        |
| Other liabilities                  | 15,115      |           |        | 13,506      |           |        | 15,914      |           |        |
| Total liabilities                  | 2,901,841   |           |        | 2,788,225   |           |        | 2,646,444   |           |        |
| Average equity                     | 370,796     |           |        | 354,448     |           |        | 341,340     |           |        |
| Total liabilities and equity       | \$3,272,637 |           |        | \$3,142,673 |           |        | \$2,987,784 |           |        |
| Net interest income                |             | \$120,352 |        |             | \$110,546 |        |             | \$106,634 |        |
| Rate spread                        |             |           | 3.60 % |             |           | 3.53 % |             |           | 3.65 % |
| Net interest margin                |             |           | 3.96 % |             |           | 3.79 % |             |           | 3.86 % |

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|                                                  | Years ended December 31,<br>2018 over 2017 |             |             | 2017 over 2016 |             |               |
|--------------------------------------------------|--------------------------------------------|-------------|-------------|----------------|-------------|---------------|
|                                                  | Total                                      | Volume      | Rate        | Total          | Volume      | Rate          |
| Increase (decrease) in interest income           |                                            |             |             |                |             |               |
| Taxable securities                               | \$1,410,000                                | \$210,000   | \$1,200,000 | \$(1,516,000)  | \$15,000    | \$(1,531,000) |
| Tax exempt securities                            | (594,000 )                                 | (141,000 )  | (453,000 )  | 171,000        | 3,000       | 168,000       |
| Loans                                            | 14,947,000                                 | 7,054,000   | 7,893,000   | 7,767,000      | 6,485,000   | 1,282,000     |
| Interest-earning deposit balances                | 147,000                                    | (298,000 )  | 445,000     | 695,000        | 77,000      | 618,000       |
| Federal funds sold                               | 0                                          | 0           | 0           | 0              | 0           | 0             |
| Net change in tax-equivalent interest income     | 15,910,000                                 | 6,825,000   | 9,085,000   | 7,117,000      | 6,580,000   | 537,000       |
| Increase (decrease) in interest expense          |                                            |             |             |                |             |               |
| Interest-bearing demand deposits                 | 45,000                                     | (26,000 )   | 71,000      | 171,000        | 17,000      | 154,000       |
| Savings deposits                                 | 30,000                                     | (22,000 )   | 52,000      | 55,000         | 1,000       | 54,000        |
| Money market accounts                            | 3,200,000                                  | 899,000     | 2,301,000   | 1,762,000      | 95,000      | 1,667,000     |
| Time deposits                                    | 1,232,000                                  | (494,000 )  | 1,726,000   | (175,000 )     | (721,000 )  | 546,000       |
| Short-term borrowings                            | 83,000                                     | (26,000 )   | 109,000     | (21,000 )      | (50,000 )   | 29,000        |
| Federal Home Loan Bank advances                  | 990,000                                    | 378,000     | 612,000     | 1,394,000      | 1,129,000   | 265,000       |
| Other borrowings                                 | 524,000                                    | 32,000      | 492,000     | 19,000         | (14,000 )   | 33,000        |
| Net change in interest expense                   | 6,104,000                                  | 741,000     | 5,363,000   | 3,205,000      | 457,000     | 2,748,000     |
| Net change in tax-equivalent net interest income | \$9,806,000                                | \$6,084,000 | \$3,722,000 | \$3,912,000    | \$6,123,000 | \$(2,211,000) |

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities and other interest-earning assets. Interest income increased \$15.9 million during 2018 from that earned in 2017, totaling \$142 million in 2018 compared to \$126 million in the previous year. The increase in interest income is attributable to a higher yield on average earning assets and an increased level of average earning assets. During 2018 and 2017, earning assets had an average yield (tax equivalent-adjusted basis) of 4.68% and 4.33%, respectively. The improved yield on average earning assets mainly resulted from an increased yield on commercial loans, primarily reflecting higher interest rates on variable-rate loans stemming from the previously-mentioned FOMC rate hikes. A change in earning asset mix and higher yields on securities and interest-earning deposit balances also contributed to the increased yield on average earning assets. The change in earning asset mix mainly reflects loan growth and a reduction in interest-earning deposit balances. On average, higher-yielding loans represented 86.4% of earning assets during 2018, up from 85.2% during 2017, while lower-yielding interest-earning deposit balances represented 2.3% of earning assets during 2018, down from 3.1% during 2017. The increased yields on securities and interest-earning deposit balances primarily reflect the rising interest rate environment.

Interest income generated from the loan portfolio increased \$14.9 million in 2018 compared to the level earned in 2017; an increase in loan yield from 4.70% in 2017 to 5.01% in 2018 resulted in a \$7.9 million increase in interest income, while growth in the loan portfolio during 2018 resulted in a \$7.0 million increase in interest income. The higher yield on loans mainly resulted from an increased yield on commercial loans, which more than offset a

decreased yield on residential mortgage loans. The yield on commercial loans equaled 5.11% during 2018, up from 4.70% during 2017 primarily due to the FOMC rate hikes in 2017 and 2018. The decline in the yield on residential mortgage loans from 4.70% during 2017 to 4.32% during 2018 primarily reflected the booking of adjustable-rate mortgages with initial rates that were generally lower than the existing portfolio's average rate. Interest income related to purchased loan accounting entries totaled \$4.0 million in 2018, compared to \$4.6 million in 2017.

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Interest income generated from the securities portfolio increased \$0.8 million in 2018 compared to the level earned in 2017; an increase in the yield on securities from 2.47% during 2017 to 2.69% during 2018 resulted in a \$0.7 million increase in interest income, while an increase in the average balance of the securities portfolio resulted in an increase in interest income of \$0.1 million. Proceeds from called and matured securities were reinvested into similar securities and additional securities were purchased to keep the securities portfolio at a desired level; the purchased securities' coupon rates were generally higher than the existing portfolio's average rate, reflecting the rising interest rate environment. Interest income on interest-earning deposit balances increased \$0.1 million due to an increased yield.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from borrowed funds. Interest expense increased \$6.1 million during 2018 from that expensed in 2017, totaling \$21.9 million in 2018 compared to \$15.8 million in the previous year. The increase in interest expense resulted from a higher cost of funds and an increase in interest-bearing liabilities. During 2018 and 2017, interest-bearing liabilities had a weighted average rate of 1.08% and 0.80%, respectively; an increase in interest expense of \$5.4 million was recorded during 2018 due to the higher cost of funds. The higher weighted average cost of interest-bearing liabilities mainly resulted from increased costs of certain interest-bearing non-time deposits, time deposits, and borrowed funds. The cost of interest-bearing non-time deposit accounts increased from 0.28% during 2017 to 0.54% during 2018, primarily reflecting increased rates on certain account categories in response to the increasing interest rate environment; the increased cost also reflects a large depositor transferring funds from time deposits into a money market account product at rates higher than the average rate on the money market product at the time of transfer and the offering of a high balance money market account product with a higher rate, both of which occurred during the second quarter of 2017. The cost of time deposits increased from 1.24% during 2017 to 1.59% during 2018 due to higher rates being paid on each category of time deposits, reflecting the rising interest rate environment. The cost of borrowed funds increased from 1.68% during 2017 to 2.06% during 2018, mainly reflecting higher costs of FHLBI advances and subordinated debentures and a change in borrowing mix. The cost of FHLBI advances increased from 1.68% during 2017 to 1.94% during 2018; longer-term advances totaling \$240 million were obtained during the last ten months of 2017 and first nine months of 2018 to meet loan funding and interest rate risk management needs. The cost of subordinated debentures was 6.54% during 2018, up from 5.53% during 2017 due to increased Libor rates stemming from the rising interest rate environment. Average higher-costing FHLBI advances represented 61.3% of average borrowed funds during 2018, up from 56.9% during 2017, while average lower-costing sweep accounts represented 25.9% and 30.4% of average borrowed funds during 2018 and 2017, respectively. Average interest-bearing liabilities were \$2.02 billion during 2018, up \$50.6 million, or 2.6%, from the \$1.97 billion average during 2017.

An increase in interest-bearing non-time deposits during 2018, totaling \$81.2 million, equated to an increase in interest expense of \$0.9 million, while a higher average rate paid on these deposit accounts resulted in a \$2.4 million increase in interest expense. A \$1.7 million increase in interest expense resulted from a higher average rate paid on time deposits. Average time deposits decreased \$37.8 million during 2018, reflecting a decline in public unit certificates of deposit \$100,000 and over and the aforementioned transfer of funds into a money market account product; the decreased balance equated to a decline in interest expense of \$0.5 million.

Average short-term borrowings, comprised almost entirely of sweep accounts, declined \$14.5 million during 2018, resulting in a decrease in interest expense of less than \$0.1 million, while a higher average rate paid on these accounts resulted in a \$0.1 million increase in interest expense. Average FHLBI advances increased \$21.2 million, resulting in

a \$0.4 million increase in interest expense, while a higher average rate paid on the advances resulted in a \$0.6 million increase in interest expense. A \$0.6 million increase in average other borrowings resulted in a nominal increase in interest expense, while a higher average rate paid on the borrowings resulted in a \$0.5 million increase in interest expense.

Net interest income and the net interest margin during 2018 and 2017 were also affected by purchase accounting accretion and amortization entries associated with the fair value measurements recorded effective June 1, 2014. Increases in interest income on loans totaling \$4.0 million and \$4.6 million were recorded during 2018 and 2017, respectively. An increase in interest expense on subordinated debentures totaling \$0.7 million was recorded during both 2018 and 2017. Purchased loan accretion amounts vary from period to period as a result of periodic cash flow re-estimations, loan payoffs, and payment performance.

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***Provision for Loan Losses***

A loan loss provision expense of \$1.1 million was recorded in 2018, compared to a provision expense of \$3.0 million recorded in 2017. The provision expense recorded during 2018 and 2017 primarily reflects ongoing loan growth and periodic adjustments to loan loss reserve environmental factors.

Net loan recoveries of \$1.8 million were recorded during 2018, while net loan charge-offs of \$1.4 million were recorded during 2017. The allowance for originated loans, as a percentage of total originated loans, was 0.9% as of both December 31, 2018 and December 31, 2017. Our allowance for acquired loans totaled \$0.8 million and \$0.4 million as of December 31, 2018 and December 31, 2017, respectively.

***Noninterest Income***

Noninterest income totaled \$19.0 million in both 2018 and 2017. Noninterest income during 2018 included a one-time \$0.9 million accounting adjustment related to mortgage banking activities in prior years, while noninterest income in 2017 included a \$1.4 million bank owned life insurance death benefit claim; excluding these transactions, noninterest income increased \$0.5 million, or 2.9%, during 2018 compared to 2017. Growth in credit and debit card fees, payroll processing revenue, and treasury management income during 2018 more than offset a decline in mortgage banking activity income. Although we believe our market share increased during 2018, mortgage banking activity income declined during the year compared to 2017 primarily due to the impacts of a limited supply of homes for sale in our markets and lower refinance activity due to rising residential mortgage loan interest rates.

***Noninterest Expense***

Noninterest expense during 2018 was \$86.2 million, an increase of \$6.5 million, or 8.1%, from the \$79.7 million expensed during 2017. The higher level of expense primarily resulted from increased salary costs, mainly reflecting annual employee merit pay increases and higher stock-based compensation expense. In addition, a one-time pay increase for all hourly employees that totaled \$1.6 million on an annualized basis became effective on April 1, 2018. Occupancy and furniture and equipment costs increased \$0.8 million on a combined basis in 2018, mainly resulting from higher depreciation and rent expenses. The increased rent expense primarily stemmed from the opening of our southeast Michigan office in early 2017.

***Federal Income Tax Expense***

During 2018, we recorded income before federal income tax of \$51.8 million and a federal income tax expense of \$9.8 million, compared to income before federal income tax of \$46.1 million and a federal income tax expense of \$14.8 million during 2017. The lower level of federal income tax expense primarily reflects a reduced corporate income tax rate stemming from the enactment of the Tax Cuts and Jobs Act; the rate was lowered from 35.0% to 21.0% effective January 1, 2018. Our effective tax rate was 18.9% during 2018, compared to 32.1% during 2017.



## RESULTS OF OPERATIONS

### FOR THE YEARS ENDED DECEMBER 31, 2017 and 2016

#### *Summary*

We recorded net income of \$31.3 million, or \$1.90 per basic and diluted share, for 2017, compared to net income of \$31.9 million, or \$1.96 per basic and diluted share, for 2016. Excluding the impacts of certain one-time transactions, net income was \$31.2 million, or \$1.89 per basic and diluted share, in 2017, and \$28.7 million, or \$1.76 per basic and diluted share, in 2016. A bank owned life insurance death benefit claim in the first quarter of 2017 increased net income during 2017 by \$1.4 million, or \$0.09 per basic and diluted share, while the revaluation of the net deferred tax asset in response to the Tax Cuts and Jobs Act becoming law in December 2017 decreased net income during 2017 by \$1.3 million, or \$0.08 per basic and diluted share. The repurchase of \$11.0 million in trust preferred securities at a 27% discount during the first quarter of 2016 increased net income during 2016 by \$1.8 million, or \$0.11 per basic and diluted share. We also recorded accelerated discount accretion on called U.S. Government agency bonds during 2016 that increased net income by \$1.4 million, or \$0.09 per basic and diluted share.

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Our earnings performance in 2017 benefited from increased net interest income, which more than offset increased noninterest expense. The increased net interest income resulted from a higher level of average earning assets. The increased noninterest expense was primarily attributable to expected increases in various operating expenses stemming from recent expansion initiatives and increased salary expense, mainly reflecting annual employee merit pay increases, the hiring of additional staff, a larger bonus accrual, and greater stock-based compensation expense. Growth in our primary noninterest income revenue streams, including treasury management income, credit and debit card interchange fees, mortgage banking activity income, payroll processing revenue, and customer service fees, also contributed to the improved earnings performance.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2017 and 2016:

|                                                | 2017    | 2016    |
|------------------------------------------------|---------|---------|
| Return on average assets                       | 1.00 %  | 1.07 %  |
| Return on average shareholders' equity         | 8.82 %  | 9.35 %  |
| Average shareholders' equity to average assets | 11.28 % | 11.42 % |

***Net Interest Income***

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled \$126 million and \$15.8 million during 2017, respectively, providing for net interest income of \$111 million. During 2016, interest income and interest expense equaled \$119 million and \$12.6 million, respectively, providing for net interest income of \$107 million.

In comparing 2017 with 2016, interest income increased 6.0%, interest expense was up 25.5%, and net interest income increased 3.7%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The \$3.9 million increase in net interest income in 2017 compared to 2016 resulted from a higher level of average earning assets, which more than offset a lower net interest margin. During 2017, earning assets averaged \$2.92 billion, or \$152 million higher than average earning assets during 2016. Average loans increased \$138 million, average other interest-earning assets increased \$13.1 million, and average securities increased \$0.6 million. During 2017, the net interest margin equaled 3.79%, down from 3.86% during 2016 due to a higher cost of funds, which more than offset an increased yield on average earning assets. The higher cost of funds primarily resulted from increased costs of certain non-time deposits, time deposits, and borrowed funds. The improved yield on average earning assets mainly resulted from an increased yield on loans, primarily reflecting higher interest rates on variable-rate commercial loans

stemming from recent FOMC rate hikes, which more than offset a decreased yield on securities, mainly reflecting a decreased level of accelerated purchase discount accretion on called U.S. Government agency bonds.

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities and other interest-earning assets. Interest income increased \$7.1 million during 2017 from that earned in 2016, totaling \$126 million in 2017 compared to \$119 million in the previous year. The increase in interest income is primarily attributable to a higher level of average earning assets; a slightly higher yield on average earning assets also contributed to the increased interest income. During 2017 and 2016, earning assets had an average yield (tax equivalent-adjusted basis) of 4.33% and 4.31%, respectively. The improved yield on average earning assets mainly resulted from an increased yield on loans, primarily reflecting higher interest rates on variable-rate commercial loans stemming from the previously-mentioned FOMC rate hikes, which more than offset a decreased yield on securities, mainly reflecting a decreased level of accelerated purchase discount accretion on called U.S. Government agency bonds. A change in earning asset mix also contributed to the increased yield on average earning assets; average loans represented 85.2% of average earning assets during 2017, up from 84.9% during 2016.

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Interest income generated from the loan portfolio increased \$7.8 million in 2017 compared to the level earned in 2016; growth in the loan portfolio during 2017 resulted in a \$6.5 million increase in interest income, while an increase in loan yield from 4.65% in 2016 to 4.70% in 2017 resulted in a \$1.3 million increase in interest income. The higher yield on loans mainly resulted from an increased yield on commercial loans, which more than offset a decreased yield on residential mortgage loans. The yield on commercial loans equaled 4.70% during 2017, up from 4.60% during 2016 as the positive impacts of the FOMC rate hikes in December 2016 and March, June, and December 2017 more than offset the negative impacts of loans being originated and renewed at lower rates in light of the ongoing relatively low interest rate environment and competitive pressures. The decline in the yield on residential mortgage loans from 5.10% during 2016 to 4.70% during 2017 primarily reflected the booking of adjustable-rate mortgages with initial rates that were generally lower than the existing portfolio's average rate. Interest income related to purchased loan accounting entries totaled \$4.6 million in 2017, compared to \$4.9 million in 2016.

Interest income generated from the securities portfolio decreased \$1.3 million in 2017 compared to the level earned in 2016; a decline in the yield on securities from 2.87% during 2016 to 2.47% during 2017 resulted in a \$1.4 million decrease in interest income, while an increase in the average balance of the securities portfolio resulted in an increase in interest income of less than \$0.1 million. The decreased yield on securities mainly reflects a lower level of accelerated discount accretion on called U.S. Government agency bonds being recorded as interest income. The accelerated discount accretion totaled \$2.2 million during 2016, positively impacting the net interest margin by eight basis points; a nominal level of accelerated discount accretion was recorded as interest income during 2017. Interest income on other interest-earning assets increased \$0.7 million primarily due to an increased yield.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from borrowed funds. Interest expense increased \$3.2 million during 2017 from that expensed in 2016, totaling \$15.8 million in 2017 compared to \$12.6 million in the previous year. The increase in interest expense resulted from a higher cost of funds and an increase in interest-bearing liabilities. During 2017 and 2016, interest-bearing liabilities had a weighted average rate of 0.80% and 0.66%, respectively; an increase in interest expense of \$2.7 million was recorded during 2017 due to the higher cost of funds. The higher weighted average cost of interest-bearing liabilities mainly resulted from increased costs of certain interest-bearing non-time deposits, time deposits, and borrowed funds. The cost of interest-bearing non-time deposit accounts increased from 0.10% during 2016 to 0.28% during 2017, primarily reflecting one large depositor transferring funds from time deposits into a money market account product at rates higher than the average rate on the money market product at the time of transfer and the offering of a high balance money market account product with a higher rate. The cost of time deposits increased from 1.14% during 2016 to 1.24% during 2017, primarily reflecting higher costs of public unit certificates of deposit \$100,000 and over and brokered certificates of deposit \$100,000 and over. The cost of borrowed funds increased from 1.45% during 2016 to 1.68% during 2017 primarily due to a change in borrowing mix and an increased cost of FHLBI advances. Average lower-costing sweep accounts represented 30.4% of average borrowed funds during 2017, down from 42.9% during 2016, while average higher-costing FHLBI advances represented 56.9% and 43.0% of average borrowed funds during the respective periods. Longer-term FHLBI advances totaling \$90 million were obtained during 2017 to meet loan funding and interest rate risk management needs. Average interest-bearing liabilities were \$1.97 billion during 2017, up \$57.7 million, or 3.0%, from the \$1.91 billion average during 2016.

An increase in interest-bearing non-time deposits during 2017, totaling \$82.5 million, equated to an increase in interest expense of \$0.1 million, while a higher average rate paid on these deposit accounts resulted in a \$1.9 million increase in interest expense. Average time deposits decreased \$60.5 million during 2017, in large part reflecting the aforementioned transfer of funds into a money market account product; the decreased balance equated to a decline in interest expense of \$0.7 million. A \$0.5 million increase in interest expense resulted from a higher average rate paid on time deposits.

Average short-term borrowings, comprised entirely of sweep accounts, declined \$32.5 million during 2017, resulting in a \$0.1 million decrease in interest expense, while a higher average rate paid on these accounts resulted in a nominal increase in interest expense. Average FHLBI advances increased \$68.5 million, resulting in a \$1.1 million increase in interest expense, while a higher average rate paid on the advances resulted in a \$0.3 million increase in interest expense. A \$0.3 million decrease in average other borrowings, coupled with a slight increase in the average rate paid on these borrowings, resulted in a nominal increase in interest expense.

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Net interest income and the net interest margin during 2017 and 2016 were also affected by purchase accounting accretion and amortization entries associated with the fair value measurements recorded effective June 1, 2014. Increases in interest income on loans totaling \$4.6 million and \$4.9 million were recorded during 2017 and 2016, respectively. An increase in interest expense on subordinated debentures totaling \$0.7 million was recorded during both 2017 and 2016. Purchased loan accretion amounts vary from period to period as a result of periodic cash flow re-estimations, loan payoffs, and payment performance.

### ***Provision for Loan Losses***

A loan loss provision expense of \$3.0 million was recorded in 2017, compared to a provision expense of \$2.9 million recorded in 2016. The provision expense recorded during 2017 primarily reflects ongoing loan growth and an assessment change in our economic conditions environmental factor, while the provision expense incurred during 2016 mainly reflects loan growth and an assessment change in our concentrations environmental factor.

Net loan charge-offs of \$1.4 million were recorded during 2017, compared to \$0.6 million during the prior year. The allowance for originated loans, as a percentage of total originated loans, was 0.9% and 1.0% as of December 31, 2017 and December 31, 2016, respectively. Our allowance for acquired loans totaled \$0.4 million and \$0.1 million as of December 31, 2017 and December 31, 2016, respectively.

### ***Noninterest Income***

Noninterest income totaled \$19.0 million in 2017, a decrease of \$2.0 million, or 9.7%, from the \$21.0 million earned in 2016. Our primary noninterest income revenue streams, including treasury management income, credit and debit card interchange fees, mortgage banking activity income, payroll processing revenue, and customer service fees, increased \$1.2 million, or 8.5%, on a combined basis in 2017 compared to the prior year. The increase in mortgage banking activity income primarily reflects the positive impact of strategic initiatives that were implemented in the latter half of 2016 and throughout 2017, including the hiring of additional loan originators, introduction of new and enhanced products, loan programs and increased marketing efforts. Noninterest income during both 2017 and 2016 benefited from certain one-time transactions, including a \$1.4 million bank owned life insurance death benefit claim in 2017 and a \$2.9 million pre-tax gain associated with a trust preferred securities repurchase transaction and \$0.4 million in reimbursements related to certain medical insurance premiums charged in prior years in 2016.

### ***Noninterest Expense***

Noninterest expense during 2017 totaled \$79.7 million, an increase of \$2.6 million, or 3.4%, from the \$77.1 million expensed in 2016. The higher level of expense primarily resulted from increased salary expense and expected increases in various operating expenses stemming from recent expansion initiatives. Salary expense was \$37.2 million during 2017, an increase of \$2.7 million, or 7.8%, from the \$34.5 million expensed during 2016. The increased salary expense primarily reflects annual employee merit pay increases, the hiring of additional staff, a larger bonus accrual, and greater stock-based compensation expense. A significant portion of the increased salary expense resulting from

staff additions reflects the opening of the southeast Michigan office. Employee benefit costs during 2017 were \$8.2 million, a decrease of \$0.8 million, or 9.0%, from the \$9.0 million expensed in 2016, primarily reflecting lower health insurance costs. Occupancy and furniture and equipment costs increased \$0.2 million on a combined basis in 2017, mainly resulting from higher depreciation expense. Data processing costs totaled \$8.2 million in 2017, up \$0.3 million, or 3.6%, from the \$7.9 million expensed in 2016, primarily reflecting higher costs related to credit and debit card services. FDIC insurance premiums during 2017 were \$1.0 million, a decrease of \$0.3 million, or 22.3%, from the \$1.3 million expensed during 2016; the decrease mainly resulted from changes to the deposit insurance assessment calculation that became effective in the third quarter of 2016.

***Federal Income Tax Expense***

During 2017, we recorded income before federal income tax of \$46.1 million and a federal income tax expense of \$14.8 million, compared to income before federal income tax of \$46.9 million and a federal income tax expense of \$15.0 million during 2016. Our effective tax rate was 32.1% during 2017, compared to 31.9% during 2016. The decrease in federal income tax expense during 2017 compared to 2016 period resulted from the lower level of income before federal income tax. The higher effective tax rate in 2017 compared to the prior year reflects the impact of the revaluation of our net deferred tax asset in response to the Tax Cuts and Jobs Act, which resulted in increased federal income tax expense of \$1.3 million in the current year. The aforementioned nontaxable bank owned life insurance death benefit claim positively impacted the effective tax rate in 2017.

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**CAPITAL RESOURCES**

Shareholders' equity increased \$9.4 million during 2018, totaling \$375 million as of December 31, 2018. Positively impacting shareholders' equity was net income of \$42.0 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling \$27.5 million. Activity relating to the issuance and sale of common stock through various stock-based compensation programs and our dividend reinvestment plan positively impacted shareholders' equity by a total of \$4.2 million. Share repurchases reduced shareholders' equity by \$5.9 million during 2018. Negatively impacting shareholders' equity during 2018 was a \$3.4 million after-tax decline in the market value of available for sale securities.

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. As of December 31, 2018, our bank's total risk-based capital ratio was 12.3%, compared to 12.6% at December 31, 2017. Our bank's total regulatory capital increased \$17.2 million during 2018, primarily reflecting the net impact of net income totaling \$47.7 million and cash dividends paid to Mercantile Bank Corporation aggregating \$33.7 million. Our bank's total risk-based capital ratio was also impacted by a \$222 million increase in total risk-weighted assets, primarily resulting from net commercial loan growth. As of December 31, 2018, our bank's total regulatory capital equaled \$389 million, or \$72.1 million in excess of the amount necessary to attain the 10.0% minimum total risk-based capital ratio, which is among the requirements to be categorized as "well capitalized."

Mercantile also maintains a stock repurchase program, which is discussed in Part II, Item 5 "Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

**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, federal funds sold and interest-earning deposit balances. Asset and liability management is the process of managing the balance sheet to achieve a mix of earning assets and liabilities that maximizes profitability, while providing adequate liquidity.

To assist in providing needed funds, we regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of deposits from customers outside of our market areas and advances from the FHLBI, totaled



\$463 million, or 15.9% of combined deposits and borrowed funds as of December 31, 2018, compared to \$323 million, or 11.3% of combined deposits and borrowed funds, as of December 31, 2017.

Sweep accounts decreased \$15.2 million during 2018, totaling \$104 million as of December 31, 2018. The decline primarily reflects certain customers transferring funds from the sweep product to noninterest-bearing checking accounts. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings.

Information regarding our repurchase agreements as of December 31, 2018 and during 2018 is as follows:

|                                                                          |               |   |
|--------------------------------------------------------------------------|---------------|---|
| Outstanding balance at December 31, 2018                                 | \$103,519,000 |   |
| Weighted average interest rate at December 31, 2018                      | 0.26          | % |
| Maximum daily balance twelve months ended December 31, 2018              | \$123,046,000 |   |
| Average daily balance for twelve months ended December 31, 2018          | \$101,005,000 |   |
| Weighted average interest rate for twelve months ended December 31, 2018 | 0.24          | % |

FHLBI advances increased \$130 million during 2018, totaling \$350 million as of December 31, 2018. FHLBI advances are primarily used to assist in funding loan demand, as well as playing an integral role in our interest rate risk management program. FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit at year-end 2018 totaled \$739 million, with availability of \$383 million.

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We also have the ability to borrow up to \$50.0 million on a daily basis through a correspondent bank using an established unsecured federal funds purchased line of credit. The average balance of federal funds purchased equaled \$1.1 million during 2018. In contrast, our interest-earning deposit account at the Federal Reserve Bank of Chicago averaged \$65.7 million during 2018. We have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using certain municipal bonds as collateral, we could have borrowed up to \$18.7 million at December 31, 2018. We did not utilize this line of credit during the past eight years, and do not plan to access this line of credit in future periods.

The following table reflects, as of December 31, 2018, 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 | \$1,980,220,000     | \$0                   | \$0                    | \$0                | \$1,980,220,000 |
| Certificates of deposit            | 204,253,000         | 226,155,000           | 53,080,000             | 0                  | 483,488,000     |
| Short-term borrowings              | 114,019,000         | 0                     | 0                      | 0                  | 114,019,000     |
| Federal Home Loan Bank advances    | 40,000,000          | 110,000,000           | 150,000,000            | 50,000,000         | 350,000,000     |
| Subordinated debentures            | 0                   | 0                     | 0                      | 46,199,000         | 46,199,000      |
| Other borrowed money               | 0                   | 0                     | 0                      | 3,002,000          | 3,002,000       |
| Property leases                    | 389,000             | 675,000               | 538,000                | 1,444,000          | 3,046,000       |

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. At December 31, 2018, we had a total of \$1.01 billion in unfunded loan commitments and \$25.3 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$910 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$102 million were for loan commitments generally expected to close and become funded within the next 12 to 18 months. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

The following table depicts our loan commitments at the end of the past three years:

|                                                                     | 12/31/18      | 12/31/17      | 12/31/16      |
|---------------------------------------------------------------------|---------------|---------------|---------------|
| Commercial unused lines of credit                                   | \$784,895,000 | \$682,202,000 | \$553,345,000 |
| Unused lines of credit secured by 1-4 family residential properties | 57,378,000    | 61,606,000    | 56,275,000    |
| Credit card unused lines of credit                                  | 47,432,000    | 39,807,000    | 22,689,000    |
| Other consumer unused lines of credit                               | 20,231,000    | 17,629,000    | 8,489,000     |
| Commitments to make loans                                           | 101,517,000   | 184,923,000   | 154,338,000   |

|                           |                 |                 |               |
|---------------------------|-----------------|-----------------|---------------|
| Standby letters of credit | 25,322,000      | 26,030,000      | 26,202,000    |
| Total                     | \$1,036,775,000 | \$1,012,197,000 | \$821,338,000 |

We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, economic or market conditions, reductions 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.

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**MARKET RISK ANALYSIS**

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 interest-earning assets over the interest paid on 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.

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 the net interest margin during periods of changing market interest rates.

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The following table depicts our GAP position as of December 31, 2018:

|                                                         | 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)                                    | \$ 1,256,623,000          | \$ 43,507,000                | \$ 769,095,000          | \$ 276,634,000         | \$ 2,345,859,000        |
| Residential real estate<br>loans                        | 59,196,000                | 14,290,000                   | 140,496,000             | 164,743,000            | 378,725,000             |
| Consumer loans                                          | 2,695,000                 | 1,397,000                    | 20,899,000              | 3,510,000              | 28,501,000              |
| Securities (2)                                          | 21,910,000                | 22,245,000                   | 72,421,000              | 236,812,000            | 353,388,000             |
| Interest-earning<br>deposits                            | 7,232,000                 | 250,000                      | 3,000,000               | 0                      | 10,482,000              |
| Allowance for loan<br>losses                            | 0                         | 0                            | 0                       | 0                      | (22,380,000 )           |
| Other assets                                            | 0                         | 0                            | 0                       | 0                      | 269,332,000             |
| <b>Total assets</b>                                     | <b>1,347,656,000</b>      | <b>81,689,000</b>            | <b>1,005,911,000</b>    | <b>681,699,000</b>     | <b>\$ 3,363,907,000</b> |
| <b>Liabilities:</b>                                     |                           |                              |                         |                        |                         |
| Interest-bearing<br>checking                            | 339,089,000               | 0                            | 0                       | 0                      | 339,089,000             |
| Savings deposits                                        | 317,014,000               | 0                            | 0                       | 0                      | 317,014,000             |
| Money market accounts                                   | 434,333,000               | 0                            | 0                       | 0                      | 434,333,000             |
| Time deposits under<br>\$100,000                        | 16,193,000                | 54,616,000                   | 89,283,000              | 0                      | 160,092,000             |
| Time deposits \$100,000<br>& over                       | 34,367,000                | 99,076,000                   | 189,953,000             | 0                      | 323,396,000             |
| Short-term borrowings                                   | 114,019,000               | 0                            | 0                       | 0                      | 114,019,000             |
| Federal Home Loan<br>Bank advances                      | 10,000,000                | 30,000,000                   | 260,000,000             | 50,000,000             | 350,000,000             |
| Other borrowed money                                    | 49,201,000                | 0                            | 0                       | 0                      | 49,201,000              |
| Noninterest-bearing<br>checking                         | 0                         | 0                            | 0                       | 0                      | 889,784,000             |
| Other liabilities                                       | 0                         | 0                            | 0                       | 0                      | 11,730,000              |
| <b>Total liabilities</b>                                | <b>1,314,216,000</b>      | <b>183,692,000</b>           | <b>539,236,000</b>      | <b>50,000,000</b>      | <b>2,988,658,000</b>    |
| Shareholders' equity                                    | 0                         | 0                            | 0                       | 0                      | 375,249,000             |
| <b>Total liabilities &amp;<br/>shareholders' equity</b> | <b>1,314,216,000</b>      | <b>183,692,000</b>           | <b>539,236,000</b>      | <b>50,000,000</b>      | <b>\$ 3,363,907,000</b> |
| Net asset (liability)<br>GAP                            | \$ 33,440,000             | \$ (102,003,000)             | \$ 466,675,000          | \$ 631,699,000         |                         |
| Cumulative GAP                                          | \$ 33,440,000             | \$ (68,563,000 )             | \$ 398,112,000          | \$ 1,029,811,000       |                         |
| Percent of cumulative<br>GAP to total assets            | 1.0                       | % (2.0                       | %) 11.8                 | % 30.6                 | %                       |

- (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 expected maturities based upon prepayment trends as of December 31, 2018.

The second interest rate risk measurement used 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.

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We conducted multiple simulations as of December 31, 2018, in which it was assumed that changes in market interest rates occurred ranging from up 400 basis points to down 300 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 December 31, 2018.

| Interest Rate Scenario               | Dollar<br>Change<br>In Net<br>Interest<br>Income | Percent<br>Change<br>In Net<br>Interest<br>Income |
|--------------------------------------|--------------------------------------------------|---------------------------------------------------|
| Interest rates down 300 basis points | \$(12,300,000)                                   | (10.0%)                                           |
| Interest rates down 200 basis points | (9,880,000 )                                     | (8.0 )                                            |
| Interest rates down 100 basis points | (5,410,000 )                                     | (4.4 )                                            |
| Interest rates up 100 basis points   | 4,250,000                                        | 3.5                                               |
| Interest rates up 200 basis points   | 8,500,000                                        | 6.9                                               |
| Interest rates up 300 basis points   | 12,710,000                                       | 10.3                                              |
| Interest rates up 400 basis points   | 16,850,000                                       | 13.7                                              |

The resulting estimates have been significantly impacted by the current interest rate and economic environment, 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 out-of-area deposits, which comprise a sizable portion of our balance sheet.

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.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Mercantile Bank Corporation

Grand Rapids, Michigan

**Opinion on the Consolidated Financial Statements**

We have audited the accompanying consolidated balance sheets of Mercantile Bank Corporation (the “Company”) and subsidiaries as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in shareholders’ equity, and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company and subsidiaries at December 31, 2018 and 2017, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and our report dated March 4, 2019 expressed an unqualified opinion thereon.

**Basis for Opinion**

These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of



material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP

BDO USA, LLP

We have served as the Company's auditor since 2006.

Grand Rapids, Michigan

March 4, 2019

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Mercantile Bank Corporation

Grand Rapids, Michigan

**Opinion on Internal Control over Financial Reporting**

We have audited Mercantile Bank Corporation's (the "Company's") internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets of the Company and subsidiaries as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2018, and the related notes, and our report dated March 4, 2019 expressed an unqualified opinion thereon.

**Basis for Opinion**

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report by Mercantile Bank Corporation's Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit of internal control over financial reporting in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective

internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

### **Definition and Limitations of Internal Control over Financial Reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ BDO USA, LLP

BDO USA, LLP

Grand Rapids, Michigan

March 4, 2019

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March 4, 2019

REPORT BY MERCANTILE BANK CORPORATION'S MANAGEMENT  
ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles. There are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Company's system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles as of December 31, 2018. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2018, Mercantile Bank Corporation maintained an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles based on those criteria.

The Company's independent auditors have issued an audit report on the effectiveness of the Company's internal control over financial reporting as found on page F-31.

Mercantile Bank Corporation

/s/ Robert B. Kaminski, Jr.

Robert B. Kaminski, Jr.

President and Chief Executive Officer

/s/ Charles E. Christmas

Charles E. Christmas

Executive Vice President, Chief Financial Officer and Treasurer

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MERCANTILE BANK CORPORATION  
CONSOLIDATED BALANCE SHEETS  
December 31, 2018 and 2017

|                                                                                                                                                                     | 2018            | 2017            |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------|-----------------|
| <b>ASSETS</b>                                                                                                                                                       |                 |                 |
| Cash and due from banks                                                                                                                                             | \$64,872,000    | \$55,127,000    |
| Interest-earning deposits                                                                                                                                           | 10,482,000      | 144,974,000     |
| Total cash and cash equivalents                                                                                                                                     | 75,354,000      | 200,101,000     |
| Securities available for sale                                                                                                                                       | 337,366,000     | 335,744,000     |
| Federal Home Loan Bank stock                                                                                                                                        | 16,022,000      | 11,036,000      |
| Loans                                                                                                                                                               | 2,753,085,000   | 2,558,552,000   |
| Allowance for loan losses                                                                                                                                           | (22,380,000 )   | (19,501,000 )   |
| Loans, net                                                                                                                                                          | 2,730,705,000   | 2,539,051,000   |
| Premises and equipment, net                                                                                                                                         | 48,321,000      | 46,034,000      |
| Bank owned life insurance                                                                                                                                           | 69,647,000      | 68,689,000      |
| Goodwill                                                                                                                                                            | 49,473,000      | 49,473,000      |
| Core deposit intangible, net                                                                                                                                        | 5,561,000       | 7,600,000       |
| Other assets                                                                                                                                                        | 31,458,000      | 28,976,000      |
| Total assets                                                                                                                                                        | \$3,363,907,000 | \$3,286,704,000 |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                                                                                                                         |                 |                 |
| Deposits                                                                                                                                                            |                 |                 |
| Noninterest-bearing                                                                                                                                                 | \$889,784,000   | \$866,380,000   |
| Interest-bearing                                                                                                                                                    | 1,573,924,000   | 1,655,985,000   |
| Total deposits                                                                                                                                                      | 2,463,708,000   | 2,522,365,000   |
| Securities sold under agreements to repurchase                                                                                                                      | 103,519,000     | 118,748,000     |
| Federal Home Loan Bank advances                                                                                                                                     | 350,000,000     | 220,000,000     |
| Subordinated debentures                                                                                                                                             | 46,199,000      | 45,517,000      |
| Accrued interest and other liabilities                                                                                                                              | 25,232,000      | 14,204,000      |
| Total liabilities                                                                                                                                                   | 2,988,658,000   | 2,920,834,000   |
| Shareholders' equity                                                                                                                                                |                 |                 |
| Preferred stock, no par value; 1,000,000 shares authorized; 0 shares outstanding at December 31, 2018 and December 31, 2017                                         | 0               | 0               |
| Common stock, no par value; 40,000,000 shares authorized; 16,534,256 shares outstanding at December 31, 2018 and 16,592,125 shares outstanding at December 31, 2017 | 308,005,000     | 309,772,000     |
| Retained earnings                                                                                                                                                   | 75,483,000      | 61,001,000      |

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|                                            |                 |                 |
|--------------------------------------------|-----------------|-----------------|
| Accumulated other comprehensive loss       | (8,239,000 )    | (4,903,000 )    |
| Total shareholders' equity                 | 375,249,000     | 365,870,000     |
| Total liabilities and shareholders' equity | \$3,363,907,000 | \$3,286,704,000 |

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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
Years ended December 31, 2018, 2017 and 2016

|                                                            | 2018               | 2017               | 2016               |
|------------------------------------------------------------|--------------------|--------------------|--------------------|
| Interest income                                            |                    |                    |                    |
| Loans, including fees                                      | \$ 131,763,000     | \$ 116,816,000     | \$ 109,049,000     |
| Securities, taxable                                        | 6,736,000          | 5,326,000          | 6,842,000          |
| Securities, tax-exempt                                     | 2,239,000          | 2,305,000          | 2,165,000          |
| Other interest-earning assets                              | 1,243,000          | 1,096,000          | 401,000            |
| Total interest income                                      | 141,981,000        | 125,543,000        | 118,457,000        |
| Interest expense                                           |                    |                    |                    |
| Deposits                                                   | 13,869,000         | 9,362,000          | 7,549,000          |
| Short-term borrowings                                      | 273,000            | 190,000            | 211,000            |
| Federal Home Loan Bank advances                            | 4,647,000          | 3,657,000          | 2,263,000          |
| Subordinated debentures and other borrowings               | 3,110,000          | 2,586,000          | 2,567,000          |
| Total interest expense                                     | 21,899,000         | 15,795,000         | 12,590,000         |
| <b>Net interest income</b>                                 | <b>120,082,000</b> | <b>109,748,000</b> | <b>105,867,000</b> |
| Provision for loan losses                                  | 1,100,000          | 2,950,000          | 2,900,000          |
| <b>Net interest income after provision for loan losses</b> | <b>118,982,000</b> | <b>106,798,000</b> | <b>102,967,000</b> |
| Noninterest income                                         |                    |                    |                    |
| Service charges on deposit and sweep accounts              | 4,358,000          | 4,233,000          | 4,253,000          |
| Credit and debit card fees                                 | 5,354,000          | 4,760,000          | 4,278,000          |
| Mortgage banking activities                                | 4,109,000          | 4,421,000          | 3,866,000          |
| Payroll processing                                         | 1,462,000          | 1,305,000          | 1,016,000          |
| Earnings on bank owned life insurance                      | 1,287,000          | 2,731,000          | 1,264,000          |
| Letter of credit fees                                      | 245,000            | 348,000            | 493,000            |
| Gain on trust preferred securities repurchase              | 0                  | 0                  | 2,970,000          |
| Other income                                               | 2,195,000          | 1,203,000          | 2,898,000          |
| Total noninterest income                                   | 19,010,000         | 19,001,000         | 21,038,000         |
| Noninterest expense                                        |                    |                    |                    |
| Salaries and benefits                                      | 50,910,000         | 45,397,000         | 43,524,000         |
| Occupancy                                                  | 6,711,000          | 6,186,000          | 6,063,000          |
| Furniture and equipment rent, depreciation and maintenance | 2,470,000          | 2,168,000          | 2,119,000          |
| Data processing                                            | 8,557,000          | 8,222,000          | 7,939,000          |
| Advertising                                                | 1,648,000          | 1,608,000          | 1,586,000          |
| FDIC insurance costs                                       | 930,000            | 960,000            | 1,236,000          |



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|                                                 |              |              |              |
|-------------------------------------------------|--------------|--------------|--------------|
| Problem asset costs                             | 90,000       | 355,000      | 338,000      |
| Efficiency program-related costs                | 0            | 0            | 172,000      |
| Other expense                                   | 14,854,000   | 14,820,000   | 14,141,000   |
| Total noninterest expenses                      | 86,170,000   | 79,716,000   | 77,118,000   |
| <b>Income before federal income tax expense</b> | 51,822,000   | 46,083,000   | 46,887,000   |
| Federal income tax expense                      | 9,798,000    | 14,809,000   | 14,974,000   |
| <b>Net income</b>                               | \$42,024,000 | \$31,274,000 | \$31,913,000 |
| Earnings per common share:                      |              |              |              |
| Basic                                           | \$2.53       | \$1.90       | \$1.96       |
| Diluted                                         | \$2.53       | \$1.90       | \$1.96       |

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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 Years ended December 31, 2018, 2017 and 2016

|                                                                                  | 2018                | 2017                | 2016                |
|----------------------------------------------------------------------------------|---------------------|---------------------|---------------------|
| Net income                                                                       | \$42,024,000        | \$31,274,000        | \$31,913,000        |
| Other comprehensive income (loss):                                               |                     |                     |                     |
| Unrealized holding gains (losses) on securities available for sale               | (4,225,000 )        | 2,297,000           | (10,697,000)        |
| Fair value of interest rate swap                                                 | 2,000               | 82,000              | 169,000             |
| Total other comprehensive income (loss)                                          | (4,223,000 )        | 2,379,000           | (10,528,000)        |
| Tax effect of unrealized holding gains (losses) on securities available for sale | 846,000             | (804,000 )          | 3,743,000           |
| Tax effect of fair value of interest rate swap                                   | (1,000 )            | (28,000 )           | (59,000 )           |
| Total tax effect of other comprehensive income (loss)                            | 845,000             | (832,000 )          | 3,684,000           |
| Other comprehensive income (loss), net of tax effect                             | (3,378,000 )        | 1,547,000           | (6,844,000 )        |
| <b>Comprehensive income</b>                                                      | <b>\$38,646,000</b> | <b>\$32,821,000</b> | <b>\$25,069,000</b> |

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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
Years ended December 31, 2018, 2017 and 2016

|                                                                                          | Preferred<br>Stock | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss) | Total<br>Shareholders'<br>Equity |
|------------------------------------------------------------------------------------------|--------------------|-----------------|----------------------|--------------------------------------------------------|----------------------------------|
| (\$ in thousands except per share amounts)                                               |                    |                 |                      |                                                        |                                  |
| <b>Balances, January 1, 2016</b>                                                         | \$ 0               | \$304,819       | \$27,722             | \$ 1,263                                               | \$ 333,804                       |
| Employee stock purchase plan (1,362 shares)                                              |                    | 36              |                      |                                                        | 36                               |
| Dividend reinvestment plan (58,325 shares)                                               |                    | 1,601           |                      |                                                        | 1,601                            |
| Stock option exercises (72,711 shares)                                                   |                    | 978             |                      |                                                        | 978                              |
| Stock grants to directors for retainer fees (13,000 shares)                              |                    | 327             |                      |                                                        | 327                              |
| Stock-based compensation expense                                                         |                    | 1,459           |                      |                                                        | 1,459                            |
| Share repurchase program (167,878 shares)                                                |                    | (3,732 )        |                      |                                                        | (3,732 )                         |
| Cash dividends (\$1.16 per common share)                                                 |                    |                 | (18,731)             |                                                        | (18,731 )                        |
| Net income for 2016                                                                      |                    |                 | 31,913               |                                                        | 31,913                           |
| Change in net unrealized gain/(loss) on securities available for sale, net of tax effect |                    |                 |                      | (6,954 )                                               | (6,954 )                         |
| Change in fair value of interest rate swap, net of tax effect                            |                    |                 |                      | 110                                                    | 110                              |
| <b>Balances, December 31, 2016</b>                                                       | \$ 0               | \$305,488       | \$40,904             | \$ (5,581 )                                            | \$ 340,811                       |

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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)  
Years ended December 31, 2018, 2017 and 2016

| (\$ in thousands except per share amounts)                                                                            | Preferred<br>Stock | Common<br>Stock | Retained<br>Earnings | Accumulated                             |                                  |
|-----------------------------------------------------------------------------------------------------------------------|--------------------|-----------------|----------------------|-----------------------------------------|----------------------------------|
|                                                                                                                       |                    |                 |                      | Other<br>Comprehensive<br>Income/(Loss) | Total<br>Shareholders'<br>Equity |
| <b>Balances, January 1, 2017</b>                                                                                      | \$ 0               | \$305,488       | \$40,904             | \$ (5,581)                              | ) \$ 340,811                     |
| Employee stock purchase plan (1,351 shares)                                                                           |                    | 46              |                      |                                         | 46                               |
| Dividend reinvestment plan (48,012 shares)                                                                            |                    | 1,576           |                      |                                         | 1,576                            |
| Stock option exercises, net of shares tendered (28,082 shares)                                                        |                    | 318             |                      |                                         | 318                              |
| Stock grants to directors for retainer fees (11,712 shares)                                                           |                    | 363             |                      |                                         | 363                              |
| Stock-based compensation expense                                                                                      |                    | 1,981           |                      |                                         | 1,981                            |
| Cash dividends (\$0.74 per common share)                                                                              |                    |                 | (12,046)             |                                         | (12,046 )                        |
| Net income for 2017                                                                                                   |                    |                 | 31,274               |                                         | 31,274                           |
| Change in net unrealized gain/(loss) on securities available for sale, net of tax effect                              |                    |                 |                      | 1,493                                   | 1,493                            |
| Reclassification of stranded tax effect related to available for sale securities resulting from Tax Cuts and Jobs Act |                    |                 | 869                  | (869 )                                  | 0                                |
| Change in fair value of interest rate swap, net of tax effect                                                         |                    |                 |                      | 54                                      | 54                               |
| <b>Balances, December 31, 2017</b>                                                                                    | \$ 0               | \$309,772       | \$61,001             | \$ (4,903)                              | ) \$ 365,870                     |

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See accompanying notes to consolidated financial statements.



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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)  
Years ended December 31, 2018, 2017 and 2016

| (\$ in thousands except per share amounts)                                               | Preferred<br>Stock | Common<br>Stock | Retained<br>Earnings | Accumulated                             |                                  |
|------------------------------------------------------------------------------------------|--------------------|-----------------|----------------------|-----------------------------------------|----------------------------------|
|                                                                                          |                    |                 |                      | Other<br>Comprehensive<br>Income/(Loss) | Total<br>Shareholders'<br>Equity |
| <b>Balances, January 1, 2018</b>                                                         | \$ 0               | \$ 309,772      | \$ 61,001            | \$ (4,903                               | ) \$ 365,870                     |
| Reclassification of equity securities related to ASU 2016-01 adoption                    |                    |                 | (42                  | ) 42                                    | 0                                |
| Employee stock purchase plan (1,579 shares)                                              |                    | 52              |                      |                                         | 52                               |
| Dividend reinvestment plan (37,450 shares)                                               |                    | 1,165           |                      |                                         | 1,165                            |
| Stock option exercises (11,481 shares)                                                   |                    | 108             |                      |                                         | 108                              |
| Stock grants to directors for retainer fees (12,404 shares)                              |                    | 441             |                      |                                         | 441                              |
| Stock-based compensation expense                                                         |                    | 2,410           |                      |                                         | 2,410                            |
| Share repurchase program (199,905 shares)                                                |                    | (5,943          | )                    |                                         | (5,943                           |
| Cash dividends (\$1.68 per common share)                                                 |                    |                 | (27,500)             |                                         | (27,500                          |
| Net income for 2018                                                                      |                    |                 | 42,024               |                                         | 42,024                           |
| Change in net unrealized gain/(loss) on securities available for sale, net of tax effect |                    |                 |                      | (3,379                                  | ) (3,379                         |
| Change in fair value of interest rate swap, net of tax effect                            |                    |                 |                      | 1                                       | 1                                |
| <b>Balances, December 31, 2018</b>                                                       | \$ 0               | \$ 308,005      | \$ 75,483            | \$ (8,239                               | ) \$ 375,249                     |

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See accompanying notes to consolidated financial statements.



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MERCANTILE  
BANK  
CORPORATION  
CONSOLIDATED  
STATEMENTS  
OF CASH  
FLOWS  
Years ended  
December 31,  
2018, 2017 and  
2016

|                                                                                 | 2018          | 2017          | 2016          |
|---------------------------------------------------------------------------------|---------------|---------------|---------------|
| <b>Cash flows from operating activities</b>                                     |               |               |               |
| Net income                                                                      | \$42,024,000  | \$31,274,000  | \$31,913,000  |
| Adjustments to reconcile net income to net cash from operating activities:      |               |               |               |
| Depreciation and amortization                                                   | 9,766,000     | 10,358,000    | 9,576,000     |
| Accretion of acquired loans                                                     | (1,373,000 )  | (2,338,000 )  | (4,925,000 )  |
| Provision for loan losses                                                       | 1,100,000     | 2,950,000     | 2,900,000     |
| Deferred income tax expense (benefit)                                           | (372,000 )    | 831,000       | (812,000 )    |
| Stock-based compensation expense                                                | 2,410,000     | 1,981,000     | 1,459,000     |
| Stock grants to directors for retainer fee                                      | 441,000       | 363,000       | 327,000       |
| Proceeds from sales of mortgage loans held for sale                             | 101,146,000   | 111,311,000   | 114,757,000   |
| Origination of mortgage loans held for sale                                     | (96,179,000 ) | (108,857,000) | (110,778,000) |
| Net gain on sales of mortgage loans held for sale                               | (3,536,000 )  | (3,972,000 )  | (3,699,000 )  |
| Gain on trust preferred securities repurchase                                   | 0             | 0             | (2,970,000 )  |
| Net gain from sales and valuation write-downs of foreclosed assets              | (169,000 )    | (319,000 )    | (520,000 )    |
| Net (gain) loss from sales and valuation write-downs of former bank premises    | (78,000 )     | 133,000       | 35,000        |
| Net loss from sales and disposals of premises and equipment                     | 134,000       | 71,000        | 174,000       |
| Net (gain) loss from sales of available for sale securities                     | 0             | (37,000 )     | 1,000         |
| Earnings on bank owned life insurance                                           | (1,287,000 )  | (2,731,000 )  | (1,264,000 )  |
| Net change in:                                                                  |               |               |               |
| Accrued interest receivable                                                     | (1,126,000 )  | (1,056,000 )  | 122,000       |
| Other assets                                                                    | (2,193,000 )  | (354,000 )    | (648,000 )    |
| Accrued interest and other liabilities                                          | 11,029,000    | (943,000 )    | (1,046,000 )  |
| Net cash from operating activities                                              | 61,737,000    | 38,665,000    | 34,602,000    |
| <b>Cash flows from investing activities</b>                                     |               |               |               |
| Purchases of securities available for sale                                      | (48,664,000 ) | (67,027,000 ) | (164,336,000) |
| Proceeds from maturities, calls and repayments of securities available for sale | 40,308,000    | 52,504,000    | 172,173,000   |
| Proceeds from sales of securities available for sale                            | 0             | 7,619,000     | 264,000       |
| Purchases of Federal Home Loan Bank stock                                       | (4,986,000 )  | (3,010,000 )  | (459,000 )    |



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|                                                                               |               |               |               |
|-------------------------------------------------------------------------------|---------------|---------------|---------------|
| Loan originations and payments, net                                           | (193,556,000) | (178,373,000) | (97,282,000 ) |
| Purchases of bank owned life insurance                                        | 0             | (1,500,000 )  | (7,000,000 )  |
| Proceeds from bank owned life insurance cash value release and death benefits | 0             | 2,720,000     | 0             |
| Purchases of premises and equipment, net                                      | (6,318,000 )  | (5,423,000 )  | (2,025,000 )  |
| Proceeds from sales of former bank premises                                   | 1,964,000     | 25,000        | 45,000        |
| Proceeds from sales of foreclosed assets                                      | 772,000       | 993,000       | 2,059,000     |
| Net cash for investing activities                                             | (210,480,000) | (191,472,000) | (96,561,000 ) |

**Cash flows from financing activities**

|                                                                 |               |               |               |
|-----------------------------------------------------------------|---------------|---------------|---------------|
| Net decrease in time deposits                                   | (30,091,000 ) | (55,839,000 ) | (20,854,000 ) |
| Net (decrease) increase in all other deposits                   | (28,566,000 ) | 203,219,000   | 120,457,000   |
| Net decrease in securities sold under agreements to repurchase  | (15,229,000 ) | (12,962,000 ) | (23,061,000 ) |
| Proceeds from Federal Home Loan Bank advances                   | 160,000,000   | 90,000,000    | 110,000,000   |
| Maturities of Federal Home Loan Bank advances                   | (30,000,000 ) | (45,000,000 ) | (3,000,000 )  |
| Proceeds from stock option exercises, net of cashless exercises | 108,000       | 318,000       | 978,000       |
| Employee stock purchase plan                                    | 52,000        | 46,000        | 36,000        |
| Dividend reinvestment plan                                      | 1,165,000     | 1,576,000     | 1,601,000     |
| Repurchase of common stock                                      | (5,943,000 )  | 0             | (3,732,000 )  |
| Repurchase of trust preferred securities                        | 0             | 0             | (8,030,000 )  |
| Payment of cash dividends to common shareholders                | (27,500,000 ) | (12,046,000 ) | (18,731,000 ) |
| Net cash from financing activities                              | 23,996,000    | 169,312,000   | 155,664,000   |

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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
 CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)  
 Years ended December 31, 2018, 2017 and 2016

|                                                         | 2018                | 2017                 | 2016                 |
|---------------------------------------------------------|---------------------|----------------------|----------------------|
| Net change in cash and cash equivalents                 | (124,747,000)       | 16,505,000           | 93,705,000           |
| Cash and cash equivalents at beginning of period        | 200,101,000         | 183,596,000          | 89,891,000           |
| <b>Cash and cash equivalents at end of period</b>       | <b>\$75,354,000</b> | <b>\$200,101,000</b> | <b>\$183,596,000</b> |
| Supplemental disclosures of cash flows information      |                     |                      |                      |
| Cash paid during the year for:                          |                     |                      |                      |
| Interest                                                | \$21,569,000        | \$15,468,000         | \$12,477,000         |
| Federal income taxes                                    | 10,075,000          | 14,225,000           | 15,125,000           |
| Noncash financing and investing activities:             |                     |                      |                      |
| Transfers from loans to foreclosed assets               | 744,000             | 887,000              | 414,000              |
| Transfers from bank premises to other real estate owned | 296,000             | 1,736,000            | 381,000              |

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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Principles of Consolidation: The consolidated financial statements include the accounts of Mercantile Bank Corporation (“Mercantile”) and its subsidiary, Mercantile Bank of Michigan (“our bank”), and of Mercantile Bank Real Estate Co., L.L.C. (“our real estate company”) and Mercantile Insurance Center, Inc. (“our insurance company”), subsidiaries of our bank, after elimination of significant intercompany transactions and accounts.

Mercantile has five separate business trusts: Mercantile Bank Capital Trust I, Firstbank Capital Trust I, Firstbank Capital Trust II, Firstbank Capital Trust III and Firstbank Capital Trust IV (“our trusts”). Our trusts were formed to issue trust preferred securities. We issued subordinated debentures to our trusts in return for the proceeds raised from the issuance of the trust preferred securities. Our trusts are not consolidated, but instead we report the subordinated debentures issued to the trusts as liabilities.

Nature of Operations: Mercantile was incorporated on July 15, 1997 to establish and own the bank based in Grand Rapids, Michigan. Our bank began operations on December 15, 1997. We completed the merger of Firstbank Corporation (“Firstbank”), a Michigan corporation with approximately \$1.5 billion in total assets and 46 branch locations, into Mercantile as of June 1, 2014.

Our bank is a community-based financial institution. Our bank’s primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial loans, residential mortgage loans, and instalment loans. Substantially all loans are secured by specific items of collateral including business assets, real estate or consumer assets. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by commercial or residential real estate. We have no material foreign loans or significant overdraft balances. Our bank’s loan accounts and retail deposits are primarily with customers located in the communities in which we have bank office locations. As an alternative source of funds, our bank has also issued certificates of deposit to depositors outside of its primary market areas. Substantially all revenues are derived from banking products and services and investment securities. While we monitor the revenue streams of the various products and services offered, we manage our business on the basis of one operating segment, banking.

Our real estate company was organized on July 21, 2003, principally to develop, construct, and own a facility in downtown Grand Rapids that serves as our bank's main office and Mercantile's headquarters. This facility was placed into service during the second quarter of 2005.

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent. To date, we have not provided the insurance products noted above and currently have no plans to do so.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided, and actual results could differ. The allowance for loan losses and the fair values of financial instruments are particularly subject to change.

Cash and Cash Equivalents and Cash Flow Reporting: Cash and cash equivalents include cash on hand, demand deposits with other financial institutions, short-term investments (including securities with daily put provisions) and federal funds sold. Cash flows are reported net for customer loan and deposit transactions, interest-earning time deposits with other financial institutions and short-term borrowings with maturities of 90 days or less.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Securities: Debt securities classified as held to maturity are carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities are classified as available for sale when they might be sold prior to maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. Federal Home Loan Bank stock is carried at cost.

Interest income includes amortization of purchase premiums and accretion of discounts. Premiums and discounts on securities are amortized or accreted on the level-yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Declines in the fair value of debt securities below their amortized cost that are other than temporary impairment (“OTTI”) are reflected in earnings or other comprehensive income, as appropriate. For those debt securities whose fair value is less than their amortized cost, we 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 whether we expect to recover the entire amortized cost of the security based on our assessment of the issuer’s financial condition. In analyzing an issuer’s financial condition, we consider whether the securities are issued by the federal government or its agencies, and whether downgrades by bond rating agencies have occurred. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement, and 2) OTTI related to other factors, such as liquidity conditions in the market or changes in market interest rates, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost.

Loans: Loans that we have the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Net unamortized deferred loan fees amounted to \$0.9 million and \$1.0 million, respectively, at December 31, 2018 and 2017.

Interest income on commercial loans and mortgage loans is discontinued at the time the loan is 90 days delinquent unless the loan is well-secured and in process of collection. Consumer and credit card loans are typically charged off no later than when they are 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal and interest is considered doubtful.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related mortgage loan sold, which is reduced by the cost allocated to the servicing right. We generally lock in the sale price to the purchaser of the mortgage loan at the same time we make an interest rate commitment to the borrower.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Year-end mortgage loans held for sale, included in total loans in the balance sheet, were as follows:

|                                                      | 2018        | 2017        |
|------------------------------------------------------|-------------|-------------|
| Mortgage loans held for sale                         | \$1,122,000 | \$2,553,000 |
| Less: Allowance to adjust to lower of cost or market | 0           | 0           |
| Mortgage loans held for sale, net                    | \$1,122,000 | \$2,553,000 |

**Mortgage Loan Derivatives:** We enter into forward contracts and interest rate lock commitments in the ordinary course of business, which are accounted for as derivatives. The derivatives are not designated as hedges and are carried at fair value. The net gain or loss on derivatives is included in mortgage banking activities in the income statement. The balance of derivatives was immaterial at December 31, 2018 and 2017.

**Mortgage Banking Activities:** Mortgage loan servicing rights are recognized as assets based on the allocated value of retained servicing rights on mortgage loans sold. Mortgage loan servicing rights are carried at the lower of amortized cost or fair value and are expensed in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on the fair value of the rights using groupings of the underlying mortgage loans as to interest rates. Any impairment of a grouping is reported as a valuation allowance.

Servicing fee income is recorded for fees earned for servicing mortgage loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. Amortization of mortgage loan servicing rights is netted against mortgage loan servicing income and recorded in mortgage banking activities in the statements of income.

**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.

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 below 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 for loan losses in the same manner as other defaulted loans.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF 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 loan portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. We estimate credit losses based on individual loans determined to be impaired and on all other loans grouped on similar risk characteristics. Our historical loss component is generally the most significant of the allowance components and is based on historical loss experience by credit risk grade for commercial loans and payment status for mortgage and consumer loans. Loans are pooled based on similar risk characteristics supported by observable data. The historical loss experience component of the allowance represents the results of migration analysis of historical net charge-offs for portfolios of loans, including groups of commercial loans within each credit risk grade. For measuring loss exposure in a pool of loans, the historical net charge-off or migration experience is utilized to estimate expected future losses to be realized from the pool of loans. These historical loss percentages are adjusted (both upwards and downwards) for certain qualitative environmental factors, including economic trends, credit quality trends, valuation trends, concentration risk, quality of loan review, changes in personnel, competition, increasing interest rates, external factors, and other considerations. 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 considered 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 and collateral value. 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 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.

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from our bank and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) our bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets. Our transfers of financial assets are generally limited to commercial loan participations sold and residential mortgage loans sold in the secondary market.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 33 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur and major improvements are capitalized. Premises and equipment are reviewed for impairment when events indicate their carrying amount may not be recoverable based on future undiscounted cash flows. If impaired, the assets are recorded at the lower of carrying value or fair value.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Foreclosed Assets: Assets acquired through or in lieu of foreclosure are initially recorded at their estimated fair value net of estimated selling costs, establishing a new cost basis. If fair value subsequently declines, a valuation allowance is recorded through noninterest expense, as are collection and operating costs after acquisition. Foreclosed assets, included in other assets in the balance sheet, totaled \$0.8 million and \$2.3 million as of December 31, 2018 and 2017, respectively.

Bank Owned Life Insurance: Our bank has purchased life insurance policies on certain key officers. Bank owned life insurance is recorded at its cash surrender value, or the amount that can be realized.

Goodwill and Core Deposit Intangible: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2017 and 2018, we elected to perform a qualitative assessment for our annual impairment test and concluded it is more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required.

The core deposit intangible that arose from the merger with Firstbank was initially measured at fair value and is being amortized into noninterest expense over a ten-year period using the sum-of-the-years-digits methodology.

Repurchase Agreements: Our bank sells certain securities under agreements to repurchase. The agreements are treated as collateralized financing transactions, with the obligations to repurchase the securities sold reflected as liabilities and

the securities underlying the agreements remaining in assets in the Consolidated Balance Sheets.

Financial Instruments and Loan Commitments: Financial instruments include off-balance-sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. Instruments, such as standby letters of credit, that are considered financial guarantees are recorded at fair value.

Stock-Based Compensation: Compensation cost for equity-based awards is measured on the grant date based on the fair value of the award at that date, and is recognized over the requisite service period, net of estimated forfeitures. Fair value of stock option awards is estimated using a closed option valuation (Black-Scholes) model. Fair value of restricted stock awards is based upon the quoted market price of the common stock on the date of grant.

Revenue from Contracts with Customers: We record revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, we must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) we satisfy a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

Our primary sources of revenue are derived from interest and dividends earned on loans, securities and other financial instruments that are not within the scope of Topic 606. We have evaluated the nature of our contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

We generally satisfy our performance obligations on contracts with customers as services are rendered, and the transaction prices are typically fixed and charged either on a periodic basis (generally monthly) or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Advertising Costs: Advertising costs are expensed as incurred.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable, the change in deferred income tax assets and liabilities, and any adjustments related to unrecognized tax benefits. Deferred income tax assets and liabilities are recognized for the tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates applicable to future years. A valuation allowance, if needed, reduces deferred income tax assets to the amount expected to be realized.

Fair Values of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on- and off-balance sheet financial instruments do not include the value of anticipated future business or the values of assets and liabilities not considered financial instruments.

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 using the treasury stock method. Our unvested stock awards, which contain non-forfeitable rights to dividends whether paid or unpaid (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 stock awards are excluded from the calculations of both basic and diluted earnings per share.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale and interest rate swaps which are also recognized as a separate component of equity.

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 generally consisted of interest rate swap agreements that qualified 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 assets and liabilities 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 the derivative instrument and the hedged item, as well as the risk-management objective and the strategy for undertaking the hedge transaction. 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 instrument that is used is 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.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

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.

Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. We do not believe there are any such matters outstanding that would have a material effect on the financial statements.

Reclassifications: Certain items in the prior years' financial statements have been reclassified to conform to the current year presentation.

Accounting Standards Updates: In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. We adopted this ASU effective January 1, 2018 using the modified retrospective approach. The adoption did not have a material impact on our consolidated financial statements and related disclosures as the primary sources of revenues are derived from interest and dividends earned on loans, securities and other financial instruments that are not within the scope of the new standard. Our revenue recognition pattern for revenue streams within the scope of the new standard, including but not limited to, service charges on deposit accounts, credit and debit card interchange fees and payroll service income, did not change significantly from prior practice. The modified retrospective method requires application of ASU 2014-09 to uncompleted contracts at the date

of adoption; however, periods prior to the date of adoption have not been retrospectively revised as the impact of the new standard on uncompleted contracts as of the date of adoption was not material, and therefore a cumulative effective adjustment to opening retained earnings was not deemed necessary.

In January 2016, the FASB issued ASU 2016-1, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU requires an entity to (i) measure equity investments at fair value through net income, with certain exceptions; (ii) present in OCI the changes in instrument-specific credit risk for financial liabilities measured using the fair value option; (iii) present financial assets and financial liabilities by measurement category and form of financial asset; (iv) calculate the fair value of financial instruments for disclosure purposes based on an exit price; and (v) assess a valuation allowance on deferred tax assets related to unrealized losses on available for sale debt securities in combination with other deferred tax assets. This ASU provides an election to subsequently measure certain nonmarketable equity investments at cost less any impairment and adjusted for certain observable price changes. This ASU also requires a qualitative impairment assessment of such equity investments and amends certain fair value disclosure requirements. Our adoption of this ASU effective January 1, 2018 did not have a material effect on our financial position or results of operations. The adoption of this guidance resulted in a reclassification of equity securities from available for sale securities to other assets and an insignificant cumulative-effect adjustment that decreased retained earnings, with offsetting related adjustments to deferred taxes and AOCI. In addition, the fair value of loans has been estimated using an exit price notion as disclosed in Note 17.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU (as subsequently amended by ASU 2018-01, ASU 2018-10, ASU 2018-11 and ASU 2018-20) establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The ASU is effective for annual and interim periods beginning after December 15, 2018. The adoption of this new standard as of January 1, 2019 will result in the recording of a ROU asset and associated lease liability of approximately \$1.3 million.

In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. This ASU (as subsequently amended by ASU 2018-19) significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard will replace the current “incurred loss” approach with an “expected loss” model. The new model, referred to as the current expected credit loss (“CECL”) model, will apply to: (i) financial assets subject to credit losses and measured at amortized cost, and (ii) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans, and expands the disclosure requirements regarding an entity’s assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. This ASU is effective for interim and annual reporting periods beginning after December 15, 2019, and early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard’s provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements. We have selected a software vendor for applying this new standard, and are currently working on the framework and assumptions. We expect to have our initial CECL model operational as of March 31, 2019, and plan to run the new model alongside our current incurred loss methodology for the remainder of 2019.

In August 2016, the FASB issued ASU No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. This ASU made eight targeted changes to how cash receipts and cash payments are presented and classified in the

statement of cash flows and was effective for fiscal years beginning after December 15, 2017. The new standard required adoption on a retrospective basis unless it was impractical to apply, in which case it was required to apply the amendments prospectively as of the earliest date practicable. Adoption of this new standard did not have a material effect on our financial position or results of operations.

In March 2017, the FASB issued ASU No. 2017-08, *Premium Amortization on Purchased Callable Debt Securities*. This ASU requires the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. Previously, entities were allowed to amortize to contractual maturity or to call date. This ASU is effective for annual reporting periods beginning after December 15, 2018, and early adoption is permitted. The provisions of this ASU will not have an impact on our financial position or results of operations as we have always amortized premiums to the earliest call date.

In August 2017, the FASB issued ASU 2017-12, *Targeted Improvements to Accounting for Hedging Activities*. The ASU changes the recognition and presentation requirements of hedge accounting, including eliminating the requirement to separately measure and report hedge ineffectiveness and presenting all items that affect earnings in the same income statement line as the hedged item. The ASU also eases certain documentation and assessment requirements and modifies the accounting components excluded from the assessment of hedge effectiveness. This ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on our consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** (Continued)

In February 2018, the FASB issued ASU 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*. This ASU requires reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The amount of the reclassification is the difference between the historical 35% corporate income tax rate and the newly enacted 21% corporate income tax rate. Because the amendments only relate to the reclassification of the income tax effects of the Tax Cuts and Jobs Act, the underlying guidance that requires that the effect of a change in tax laws of rates be included in income from continuing operations is not affected. This ASU is effective for fiscal years beginning after December 15, 2018. We early adopted this ASU, which resulted in the reclassification of \$0.9 million from accumulated other comprehensive income to retained earnings at December 31, 2017.

**NOTE 2 – BUSINESS COMBINATION**

We completed the merger of Firstbank Corporation (“Firstbank”), a Michigan corporation with approximately \$1.5 billion in total assets and 46 branch locations, into Mercantile Bank Corporation as of June 1, 2014 (“Merger Date”). Each share of Firstbank’s common stock was converted into the right to receive one share of Mercantile common stock, resulting in Mercantile issuing 8,087,272 shares of its common stock. The merger provided an expanded geographic footprint for the Company and increased the size of the balance sheet.

The Firstbank transaction was accounted for using the acquisition method of accounting and accordingly, assets acquired, liabilities assumed and consideration exchanged were recorded at estimated fair value on the Merger Date. Goodwill of \$49.5 million was calculated as the purchase premium after adjusting for the fair value of net assets acquired and represents the value expected from the synergies created from combining the two banking organizations as well as the economies of scale expected from combining the operations of the two companies. None of the goodwill is deductible for income tax purposes as the merger is accounted for as a tax-free exchange.

In most instances, determining the fair value of the acquired assets and assumed liabilities required us to estimate cash flows expected to result from those assets and liabilities and to discount those cash flows at appropriate rates of interest. The most significant of those determinations relates to the valuation of acquired loans. For such loans, the excess of cash flows expected at acquisition over the estimated fair value is recognized as interest income over the remaining lives of the loans. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition reflects the impact of estimated credit losses and other factors, such as prepayments. In accordance with the applicable accounting guidance for business combinations, there was no carry-over of Firstbank's previously established allowance for loan losses.

The acquired loans were divided into loans with evidence of credit quality deterioration, which are accounted for under ASC 310-30 ("acquired impaired"), and loans that do not meet this criteria, which are accounted for under ASC 310-20 ("acquired non-impaired"). In addition, the loans are further categorized into different loan pools based primarily on the type and purpose of the loan.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 3 – SECURITIES**

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

|                                         | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value  |
|-----------------------------------------|-------------------|------------------------------|-------------------------------|----------------|
| <u>2018</u>                             |                   |                              |                               |                |
| U.S. Government agency debt obligations | \$ 196,109,000    | \$ 310,000                   | \$(9,342,000)                 | \$ 187,077,000 |
| Mortgage-backed securities              | 44,263,000        | 187,000                      | (792,000)                     | 43,658,000     |
| Municipal general obligation bonds      | 103,235,000       | 427,000                      | (1,165,000)                   | 102,497,000    |
| Municipal revenue bonds                 | 3,688,000         | 4,000                        | (58,000)                      | 3,634,000      |
| Other investments                       | 500,000           | 0                            | 0                             | 500,000        |
|                                         | \$ 347,795,000    | \$ 928,000                   | \$(11,357,000)                | \$ 337,366,000 |
| <u>2017</u>                             |                   |                              |                               |                |
| U.S. Government agency debt obligations | \$ 175,953,000    | \$ 99,000                    | \$(6,352,000)                 | \$ 169,700,000 |
| Mortgage-backed securities              | 38,967,000        | 335,000                      | (510,000)                     | 38,792,000     |
| Municipal general obligation bonds      | 121,040,000       | 891,000                      | (638,000)                     | 121,293,000    |
| Municipal revenue bonds                 | 3,978,000         | 30,000                       | (30,000)                      | 3,978,000      |
| Other investments                       | 2,010,000         | 0                            | (29,000)                      | 1,981,000      |
|                                         | \$ 341,948,000    | \$ 1,355,000                 | \$(7,559,000)                 | \$ 335,744,000 |

Securities with unrealized losses at year-end 2018 and 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

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| <u>Description of Securities</u>        | Less than 12 Months |             | 12 Months or More |             | Total         |              |
|-----------------------------------------|---------------------|-------------|-------------------|-------------|---------------|--------------|
|                                         | Fair                | Unrealized  | Fair              | Unrealized  | Fair          | Unrealized   |
|                                         | Value               | Loss        | Value             | Loss        | Value         | Loss         |
| <u>2018</u>                             |                     |             |                   |             |               |              |
| U.S. Government agency debt obligations | \$31,220,000        | \$1,136,000 | \$136,445,000     | \$8,206,000 | \$167,665,000 | \$9,342,000  |
| Mortgage-backed securities              | 11,460,000          | 136,000     | 23,762,000        | 656,000     | 35,222,000    | 792,000      |
| Municipal general obligation bonds      | 28,923,000          | 299,000     | 43,961,000        | 866,000     | 72,884,000    | 1,165,000    |
| Municipal revenue bonds                 | 1,188,000           | 11,000      | 1,372,000         | 47,000      | 2,560,000     | 58,000       |
| Other investments                       | 0                   | 0           | 0                 | 0           | 0             | 0            |
|                                         | \$72,791,000        | \$1,582,000 | \$205,540,000     | \$9,775,000 | \$278,331,000 | \$11,357,000 |
| <u>2017</u>                             |                     |             |                   |             |               |              |
| U.S. Government agency debt obligations | \$35,677,000        | \$434,000   | \$115,374,000     | \$5,918,000 | \$151,051,000 | \$6,352,000  |
| Mortgage-backed securities              | 10,179,000          | 156,000     | 21,084,000        | 354,000     | 31,263,000    | 510,000      |
| Municipal general obligation bonds      | 12,807,000          | 114,000     | 54,703,000        | 524,000     | 67,510,000    | 638,000      |
| Municipal revenue bonds                 | 0                   | 0           | 1,187,000         | 30,000      | 1,187,000     | 30,000       |
| Other investments                       | 1,510,000           | 29,000      | 0                 | 0           | 1,510,000     | 29,000       |
|                                         | \$60,173,000        | \$733,000   | \$192,348,000     | \$6,826,000 | \$252,521,000 | \$7,559,000  |

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 3 – 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 December 31, 2018, 360 debt securities with fair values totaling \$278 million had unrealized losses aggregating \$11.4 million. 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 unrealized losses are deemed to be other-than-temporary.

The amortized cost and fair values of debt securities at December 31, 2018, by maturity, are shown in the following table. The contractual maturity is utilized 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 penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

| Weighted<br>Average<br>Yield | Amortized<br>Cost | Fair<br>Value |
|------------------------------|-------------------|---------------|
|------------------------------|-------------------|---------------|

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|                            |       |               |               |
|----------------------------|-------|---------------|---------------|
| Due in one year or less    | 1.89% | \$27,286,000  | \$27,223,000  |
| Due from one to five years | 2.32  | 50,143,000    | 49,585,000    |
| Due from five to ten years | 2.62  | 108,765,000   | 104,945,000   |
| Due after ten years        | 3.13  | 116,838,000   | 111,455,000   |
| Mortgage-backed securities | 2.76  | 44,263,000    | 43,658,000    |
| Other investments          | 5.37  | 500,000       | 500,000       |
|                            | 2.71% | \$347,795,000 | \$337,366,000 |

No mortgage-backed securities were sold in 2018 or 2016. Mortgage-backed securities totaling \$5.0 million were sold in 2017, resulting in a nominal net gain. No municipal general obligation bonds were sold in 2018. Municipal general obligation bonds totaling \$2.6 million and \$0.3 million were sold during 2017 and 2016, respectively, resulting in a nominal net gain/loss.

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of \$98.2 million and \$112 million at December 31, 2018 and December 31, 2017, respectively, with estimated market values of \$97.4 million and \$112 million at the respective dates. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$8.7 million and \$12.9 million at December 31, 2018 and December 31, 2017, with estimated market values of \$8.7 million and \$13.0 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, 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 was \$104 million and \$119 million at December 31, 2018 and 2017, respectively. Investments in FHLBI stock are restricted and may only be resold to, or redeemed by, the issuer.

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MERCANTILE BANK CORPORATION

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**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES**

Loans originated for investment are stated at their principal amount outstanding adjusted for partial charge-offs, the allowance, and net deferred loan fees and costs. Interest income on loans is accrued over the term of the loans primarily using the simple interest method based on the principal balance outstanding. Interest is not accrued on loans where collectability is uncertain. Accrued interest is included in other assets in the Consolidated Balance Sheets. Loan origination fees and certain direct costs incurred to extend credit are deferred and amortized over the term of the loan or loan commitment period as an adjustment to the related loan yield.

Acquired loans were recorded at estimated fair value at acquisition. The acquired loans were segregated between those considered to be performing (“acquired non-impaired loans”) and those with evidence of credit deterioration (“acquired impaired loans”). Acquired loans are considered impaired if there is evidence of credit deterioration and if it is probable, at acquisition, all contractually required payments will not be collected. Acquired loans restructured after acquisition are not considered or reported as troubled debt restructurings if the loans evidenced credit deterioration as of the Merger Date and are accounted for in pools.

The fair value estimates for acquired loans are based on expected prepayments and the amount and timing of discounted expected principal, interest and other cash flows. Credit discounts representing the principal losses expected over the life of the loan are also a component of the initial fair value. In determining the Merger Date fair value of acquired impaired loans, and in subsequent accounting, we have generally aggregated acquired commercial and consumer loans into pools of loans with common risk characteristics.

The difference between the fair value of an acquired non-impaired loan and contractual amounts due at acquisition is accreted into interest income over the estimated life of the loan. Contractually required payments represent the total undiscounted amount of all uncollected principal and interest payments. Acquired non-impaired loans are placed on nonaccrual status and reported as nonperforming or past due using the same criteria applied to the originated loan portfolio.

The excess of an acquired impaired loan's contractually required payments over the amount of its undiscounted cash flows expected to be collected is referred to as the non-accretable difference. The non-accretable difference, which is neither accreted into income nor recorded on the Consolidated Balance Sheets, reflects estimated future credit losses and uncollectable contractual interest expected to be incurred over the life of the acquired impaired loan. The excess cash flows expected to be collected over the carrying amount of the acquired loan is referred to as the accretable yield. This amount is accreted into interest income over the remaining life of the acquired loans or pools using the level yield method. The accretable yield is affected by changes in interest rate indices for variable rate loans, changes in prepayment speed assumptions and changes in expected principal and interest payments over the estimated lives of the acquired impaired loans.

We evaluate quarterly the remaining contractually required payments receivable and estimate cash flows expected to be collected over the lives of the impaired loans. Contractually required payments receivable may increase or decrease for a variety of reasons, for example, when the contractual terms of the loan agreement are modified, when interest rates on variable rate loans change, or when principal and/or interest payments are received. Cash flows expected to be collected on acquired impaired loans are estimated by incorporating several key assumptions similar to the initial estimate of fair value. These key assumptions include probability of default, loss given default, and the amount of actual prepayments after acquisition. Prepayments affect the estimated lives of loans and could change the amount of interest income, and possibly principal, expected to be collected. In re-forecasting future estimated cash flows, credit loss expectations are adjusted as necessary. The adjustments are based, in part, on actual loss severities recognized for each loan type, as well as changes in the probability of default. For periods in which estimated cash flows are not re-forecasted, the prior reporting period's estimated cash flows are adjusted to reflect the actual cash received and credit events that transpired during the current reporting period.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Increases in expected cash flows of acquired impaired loans subsequent to acquisition are recognized prospectively through adjustments of the yield on the loans or pools over their remaining lives, while decreases in expected cash flows are recognized as impairment through a provision for loan losses and an increase in the allowance.

Year-end loans disaggregated by class of loan within the loan portfolio segments were as follows:

|                                                             | December 31, 2018 |        | December 31, 2017 |        | Percent                |   |
|-------------------------------------------------------------|-------------------|--------|-------------------|--------|------------------------|---|
|                                                             | Balance           | %      | Balance           | %      | Increase<br>(Decrease) |   |
| <b><u>Originated Loans</u></b>                              |                   |        |                   |        |                        |   |
| Commercial:                                                 |                   |        |                   |        |                        |   |
| Commercial and industrial                                   | \$768,698,000     | 31.3 % | \$680,805,000     | 31.3 % | 12.9                   | % |
| Vacant land, land development, and residential construction | 39,950,000        | 1.6    | 23,682,000        | 1.1    | 68.7                   |   |
| Real estate – owner occupied                                | 500,188,000       | 20.4   | 456,065,000       | 21.0   | 9.7                    |   |
| Real estate – non-owner occupied                            | 745,127,000       | 30.4   | 708,824,000       | 32.7   | 5.1                    |   |
| Real estate – multi-family and residential rental           | 98,035,000        | 4.0    | 64,852,000        | 3.0    | 51.2                   |   |
| Total commercial                                            | 2,151,998,000     | 87.7   | 1,934,228,000     | 89.1   | 11.3                   |   |
| Retail:                                                     |                   |        |                   |        |                        |   |
| Home equity and other                                       | 65,023,000        | 2.7    | 69,675,000        | 3.2    | (6.7                   | ) |
| 1-4 family mortgages                                        | 235,425,000       | 9.6    | 166,054,000       | 7.7    | 41.8                   |   |
| Total retail                                                | 300,448,000       | 12.3   | 235,729,000       | 10.9   | 27.5                   |   |
| Total originated loans                                      | \$2,452,446,000   | 100.0% | \$2,169,957,000   | 100.0% | 13.0                   | % |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

|                                                             | December 31, 2018 |        | December 31, 2017 |        | Percent                |
|-------------------------------------------------------------|-------------------|--------|-------------------|--------|------------------------|
|                                                             | Balance           | %      | Balance           | %      | Increase<br>(Decrease) |
| <b><u>Acquired Loans</u></b>                                |                   |        |                   |        |                        |
| Commercial:                                                 |                   |        |                   |        |                        |
| Commercial and industrial                                   | \$54,025,000      | 18.0 % | \$72,959,000      | 18.8 % | (26.0% )               |
| Vacant land, land development, and residential construction | 4,935,000         | 1.6    | 6,191,000         | 1.6    | (20.3 )                |
| Real estate – owner occupied                                | 48,431,000        | 16.1   | 70,263,000        | 18.1   | (31.1 )                |
| Real estate – non-owner occupied                            | 71,155,000        | 23.7   | 82,861,000        | 21.3   | (14.1 )                |
| Real estate – multi-family and residential rental           | 29,562,000        | 9.8    | 37,066,000        | 9.5    | (20.2 )                |
| Total commercial                                            | 208,108,000       | 69.2   | 269,340,000       | 69.3   | (22.7 )                |
| Retail:                                                     |                   |        |                   |        |                        |
| Home equity and other                                       | 20,416,000        | 6.8    | 30,750,000        | 7.9    | (33.6 )                |
| 1-4 family mortgages                                        | 72,115,000        | 24.0   | 88,505,000        | 22.8   | (18.5 )                |
| Total retail                                                | 92,531,000        | 30.8   | 119,255,000       | 30.7   | (22.4 )                |
| Total acquired loans                                        | \$300,639,000     | 100.0% | \$388,595,000     | 100.0% | (22.6% )               |

|                                                             | December 31, 2018 |        | December 31, 2017 |        | Percent                |
|-------------------------------------------------------------|-------------------|--------|-------------------|--------|------------------------|
|                                                             | Balance           | %      | Balance           | %      | Increase<br>(Decrease) |
| <b><u>Total Loans</u></b>                                   |                   |        |                   |        |                        |
| Commercial:                                                 |                   |        |                   |        |                        |
| Commercial and industrial                                   | \$822,723,000     | 29.9 % | \$753,764,000     | 29.4 % | 9.1 %                  |
| Vacant land, land development, and residential construction | 44,885,000        | 1.6    | 29,873,000        | 1.2    | 50.3                   |
| Real estate – owner occupied                                | 548,619,000       | 19.9   | 526,328,000       | 20.6   | 4.2                    |

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|                                                   |                 |        |                 |        |         |
|---------------------------------------------------|-----------------|--------|-----------------|--------|---------|
| Real estate – non-owner occupied                  | 816,282,000     | 29.7   | 791,685,000     | 30.9   | 3.1     |
| Real estate – multi-family and residential rental | 127,597,000     | 4.6    | 101,918,000     | 4.0    | 25.2    |
| Total commercial                                  | 2,360,106,000   | 85.7   | 2,203,568,000   | 86.1   | 7.1     |
| Retail:                                           |                 |        |                 |        |         |
| Home equity and other                             | 85,439,000      | 3.1    | 100,425,000     | 3.9    | (14.9 ) |
| 1-4 family mortgages                              | 307,540,000     | 11.2   | 254,559,000     | 10.0   | 20.8    |
| Total retail                                      | 392,979,000     | 14.3   | 354,984,000     | 13.9   | 10.7    |
| Total loans                                       | \$2,753,085,000 | 100.0% | \$2,558,552,000 | 100.0% | 7.6 %   |

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

The total contractually required payments and carrying value of acquired impaired loans were \$8.0 million and \$4.6 million, respectively, as of December 31, 2018. The total contractually required payments and carrying value of acquired impaired loans were \$11.9 million and \$5.2 million, respectively, as of December 31, 2017. Changes in the accretable yield for acquired impaired loans for the years ended December 31, 2018 and December 31, 2017 were as follows:

|                                                       |              |
|-------------------------------------------------------|--------------|
|                                                       | 2018         |
| Balance at December 31, 2017                          | \$ 1,404,000 |
| Additions                                             | 0            |
| Accretion income                                      | (490,000 )   |
| Net reclassification from nonaccretable to accretable | 437,000      |
| Reductions (1)                                        | (77,000 )    |
| Balance at December 31, 2018                          | \$ 1,274,000 |
|                                                       | 2017         |
| Balance at December 31, 2016                          | \$ 1,726,000 |
| Additions                                             | 223,000      |
| Accretion income                                      | (562,000 )   |
| Net reclassification from nonaccretable to accretable | 367,000      |
| Reductions (1)                                        | (350,000 )   |
| Balance at December 31, 2017                          | \$ 1,404,000 |

(1) Reductions primarily reflect the result of exit events, including loan payoffs and charge-offs.

Concentrations within the loan portfolio were as follows at year-end:

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|                                                                      | 2018          |                                       | 2017            |                                       |
|----------------------------------------------------------------------|---------------|---------------------------------------|-----------------|---------------------------------------|
|                                                                      | Balance       | Percentage<br>of<br>Loan<br>Portfolio | Balance         | Percentage<br>of<br>Loan<br>Portfolio |
| Commercial real estate loans to lessors of non-residential buildings | \$568,134,000 | 20.6                                  | % \$547,841,000 | 21.4 %                                |

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Year-end nonperforming originated loans were as follows:

|                                                        | 2018      | 2017        |
|--------------------------------------------------------|-----------|-------------|
| Loans past due 90 days or more still accruing interest | \$0       | \$0         |
| Nonaccrual loans                                       | 803,000   | 3,672,000   |
| Total nonperforming loans                              | \$803,000 | \$3,672,000 |

Year-end nonperforming acquired loans were as follows:

|                                                        | 2018        | 2017        |
|--------------------------------------------------------|-------------|-------------|
| Loans past due 90 days or more still accruing interest | \$0         | \$0         |
| Nonaccrual loans                                       | 3,337,000   | 3,471,000   |
| Total nonperforming loans                              | \$3,337,000 | \$3,471,000 |

The recorded principal balance of all nonperforming loans was as follows:

|                                                             | December<br>31,<br>2018 | December<br>31,<br>2017 |
|-------------------------------------------------------------|-------------------------|-------------------------|
| Commercial:                                                 |                         |                         |
| Commercial and industrial                                   | \$16,000                | \$1,444,000             |
| Vacant land, land development, and residential construction | 0                       | 35,000                  |
| Real estate – owner occupied                                | 950,000                 | 2,241,000               |

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|                                                   |             |             |
|---------------------------------------------------|-------------|-------------|
| Real estate – non-owner occupied                  | 0           | 0           |
| Real estate – multi-family and residential rental | 141,000     | 178,000     |
| Total commercial                                  | 1,107,000   | 3,898,000   |
| Retail:                                           |             |             |
| Home equity and other                             | 454,000     | 577,000     |
| 1-4 family mortgages                              | 2,579,000   | 2,668,000   |
| Total retail                                      | 3,033,000   | 3,245,000   |
| Total nonperforming loans                         | \$4,140,000 | \$7,143,000 |

Acquired impaired loans are not reported as nonperforming loans based on acquired impaired loan accounting. Acquired non-impaired loans are placed on nonaccrual status and reported as nonperforming or past due using the same criteria applied to the originated loan portfolio.

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

An age analysis of past due loans is as follows as of December 31, 2018:

|                                                                | 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<br>><br>89<br>Days<br>and<br>Accruing |
|----------------------------------------------------------------|-----------------------------|-----------------------------|----------------------------------------|-------------------|------------------|------------------|-----------------------------------------------------------|
| <b><u>Originated Loans</u></b>                                 |                             |                             |                                        |                   |                  |                  |                                                           |
| Commercial:                                                    |                             |                             |                                        |                   |                  |                  |                                                           |
| Commercial and industrial                                      | \$ 186,000                  | \$ 0                        | \$ 0                                   | \$ 186,000        | \$ 768,512,000   | \$ 768,698,000   | \$ 0                                                      |
| Vacant land, land development,<br>and residential construction | 0                           | 0                           | 0                                      | 0                 | 39,950,000       | 39,950,000       | 0                                                         |
| Real estate – owner occupied                                   | 0                           | 0                           | 0                                      | 0                 | 500,188,000      | 500,188,000      | 0                                                         |
| Real estate – non-owner<br>occupied                            | 0                           | 0                           | 0                                      | 0                 | 745,127,000      | 745,127,000      | 0                                                         |
| Real estate – multi-family and<br>residential rental           | 0                           | 0                           | 0                                      | 0                 | 98,035,000       | 98,035,000       | 0                                                         |
| Total commercial                                               | 186,000                     | 0                           | 0                                      | 186,000           | 2,151,812,000    | 2,151,998,000    | 0                                                         |
| Retail:                                                        |                             |                             |                                        |                   |                  |                  |                                                           |
| Home equity and other                                          | 44,000                      | 0                           | 0                                      | 44,000            | 64,979,000       | 65,023,000       | 0                                                         |
| 1- 4 family mortgages                                          | 291,000                     | 0                           | 137,000                                | 428,000           | 234,997,000      | 235,425,000      | 0                                                         |
| Total retail                                                   | 335,000                     | 0                           | 137,000                                | 472,000           | 299,976,000      | 300,448,000      | 0                                                         |
| Total past due loans                                           | \$ 521,000                  | \$ 0                        | \$ 137,000                             | \$ 658,000        | \$ 2,451,788,000 | \$ 2,452,446,000 | \$ 0                                                      |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

|                                                             | 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<br>><br>89<br>Days<br>and<br>Accruing |
|-------------------------------------------------------------|-----------------------------|-----------------------------|----------------------------------------|-------------------|---------------|----------------|-----------------------------------------------------------|
| <b><u>Acquired Loans</u></b>                                |                             |                             |                                        |                   |               |                |                                                           |
| Commercial:                                                 |                             |                             |                                        |                   |               |                |                                                           |
| Commercial and industrial                                   | \$8,000                     | \$0                         | \$0                                    | \$8,000           | \$54,017,000  | \$54,025,000   | \$ 0                                                      |
| Vacant land, land development, and residential construction | 19,000                      | 0                           | 0                                      | 19,000            | 4,916,000     | 4,935,000      | 0                                                         |
| Real estate – owner occupied                                | 108,000                     | 950,000                     | 0                                      | 1,058,000         | 47,373,000    | 48,431,000     | 0                                                         |
| Real estate – non-owner occupied                            | 62,000                      | 0                           | 0                                      | 62,000            | 71,093,000    | 71,155,000     | 0                                                         |
| Real estate – multi-family and residential rental           | 0                           | 0                           | 0                                      | 0                 | 29,562,000    | 29,562,000     | 0                                                         |
| Total commercial                                            | 197,000                     | 950,000                     | 0                                      | 1,147,000         | 206,961,000   | 208,108,000    | 0                                                         |
| Retail:                                                     |                             |                             |                                        |                   |               |                |                                                           |
| Home equity and other                                       | 167,000                     | 31,000                      | 0                                      | 198,000           | 20,218,000    | 20,416,000     | 0                                                         |
| 1- 4 family mortgages                                       | 821,000                     | 347,000                     | 612,000                                | 1,780,000         | 70,335,000    | 72,115,000     | 0                                                         |
| Total retail                                                | 988,000                     | 378,000                     | 612,000                                | 1,978,000         | 90,553,000    | 92,531,000     | 0                                                         |
| Total past due loans                                        | \$1,185,000                 | \$1,328,000                 | \$612,000                              | \$3,125,000       | \$297,514,000 | \$300,639,000  | \$ 0                                                      |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

An age analysis of past due loans is as follows as of December 31, 2017:

|                                                             | 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<br>><br>89<br>Days<br>and<br>Accruing |
|-------------------------------------------------------------|-----------------------------|-----------------------------|----------------------------------------|-------------------|---------------|----------------|-----------------------------------------------------------|
| <b><u>Originated Loans</u></b>                              |                             |                             |                                        |                   |               |                |                                                           |
| Commercial:                                                 |                             |                             |                                        |                   |               |                |                                                           |
| Commercial and industrial                                   | \$0                         | \$0                         | \$178,000                              | \$178,000         | \$680,627,000 | \$680,805,000  | \$ 0                                                      |
| Vacant land, land development, and residential construction | 0                           | 0                           | 35,000                                 | 35,000            | 23,647,000    | 23,682,000     | 0                                                         |
| Real estate – owner occupied                                | 0                           | 0                           | 1,244,000                              | 1,244,000         | 454,821,000   | 456,065,000    | 0                                                         |
| Real estate – non-owner occupied                            | 0                           | 0                           | 0                                      | 0                 | 708,824,000   | 708,824,000    | 0                                                         |
| Real estate – multi-family and residential rental           | 0                           | 0                           | 0                                      | 0                 | 64,852,000    | 64,852,000     | 0                                                         |
| Total commercial                                            | 0                           | 0                           | 1,457,000                              | 1,457,000         | 1,932,771,000 | 1,934,228,000  | 0                                                         |
| Retail:                                                     |                             |                             |                                        |                   |               |                |                                                           |
| Home equity and other                                       | 647,000                     | 11,000                      | 86,000                                 | 744,000           | 68,931,000    | 69,675,000     | 0                                                         |
| 1- 4 family mortgages                                       | 0                           | 0                           | 250,000                                | 250,000           | 165,804,000   | 166,054,000    | 0                                                         |

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|                      |           |          |             |             |                 |                 |      |
|----------------------|-----------|----------|-------------|-------------|-----------------|-----------------|------|
| Total retail         | 647,000   | 11,000   | 336,000     | 994,000     | 234,735,000     | 235,729,000     | 0    |
| Total past due loans | \$647,000 | \$11,000 | \$1,793,000 | \$2,451,000 | \$2,167,506,000 | \$2,169,957,000 | \$ 0 |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

|                                                             | 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<br>><br>89<br>Days<br>and<br>Accruing |
|-------------------------------------------------------------|-----------------------------|-----------------------------|----------------------------------------|-------------------|---------------|----------------|-----------------------------------------------------------|
| <b><u>Acquired Loans</u></b>                                |                             |                             |                                        |                   |               |                |                                                           |
| Commercial:                                                 |                             |                             |                                        |                   |               |                |                                                           |
| Commercial and industrial                                   | \$40,000                    | \$0                         | \$114,000                              | \$154,000         | \$72,805,000  | \$72,959,000   | \$ 0                                                      |
| Vacant land, land development, and residential construction | 14,000                      | 0                           | 0                                      | 14,000            | 6,177,000     | 6,191,000      | 0                                                         |
| Real estate – owner occupied                                | 634,000                     | 0                           | 271,000                                | 905,000           | 69,358,000    | 70,263,000     | 0                                                         |
| Real estate – non-owner occupied                            | 0                           | 0                           | 0                                      | 0                 | 82,861,000    | 82,861,000     | 0                                                         |
| Real estate – multi-family and residential rental           | 0                           | 0                           | 108,000                                | 108,000           | 36,958,000    | 37,066,000     | 0                                                         |
| Total commercial                                            | 688,000                     | 0                           | 493,000                                | 1,181,000         | 268,159,000   | 269,340,000    | 0                                                         |
| Retail:                                                     |                             |                             |                                        |                   |               |                |                                                           |
| Home equity and other                                       | 408,000                     | 52,000                      | 154,000                                | 614,000           | 30,136,000    | 30,750,000     | 0                                                         |
| 1- 4 family mortgages                                       | 690,000                     | 333,000                     | 661,000                                | 1,684,000         | 86,821,000    | 88,505,000     | 0                                                         |
| Total retail                                                | 1,098,000                   | 385,000                     | 815,000                                | 2,298,000         | 116,957,000   | 119,255,000    | 0                                                         |
| Total past due loans                                        | \$1,786,000                 | \$385,000                   | \$1,308,000                            | \$3,479,000       | \$385,116,000 | \$388,595,000  | \$ 0                                                      |

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Impaired originated loans with no related allowance recorded were as follows as of December 31, 2018:

|                                                            | Unpaid       | Recorded     | Related   | Year-To-<br>Date<br>Average<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|--------------|--------------|-----------|-----------------------------------------------------------------|
|                                                            | Contractual  | Principal    | Allowance |                                                                 |
|                                                            | Principal    | Balance      |           |                                                                 |
|                                                            | Balance      |              |           |                                                                 |
| With no related allowance recorded:                        |              |              |           |                                                                 |
| Commercial:                                                |              |              |           |                                                                 |
| Commercial and industrial                                  | \$8,604,000  | \$8,604,000  |           | \$2,096,000                                                     |
| Vacant land, land development and residential construction | 94,000       | 94,000       |           | 65,000                                                          |
| Real estate – owner occupied                               | 632,000      | 632,000      |           | 1,145,000                                                       |
| Real estate – non-owner occupied                           | 0            | 0            |           | 0                                                               |
| Real estate – multi-family and residential rental          | 0            | 0            |           | 187,000                                                         |
| Total commercial                                           | 9,330,000    | 9,330,000    |           | 3,493,000                                                       |
| Retail:                                                    |              |              |           |                                                                 |
| Home equity and other                                      | 607,000      | 586,000      |           | 691,000                                                         |
| 1-4 family mortgages                                       | 1,053,000    | 390,000      |           | 414,000                                                         |
| Total retail                                               | 1,660,000    | 976,000      |           | 1,105,000                                                       |
| Total with no related allowance recorded                   | \$10,990,000 | \$10,306,000 |           | \$4,598,000                                                     |

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## MERCANTILE BANK CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Impaired originated loans with an allowance recorded and total impaired originated loans were as follows as of December 31, 2018:

|                                                            | Unpaid       | Recorded     | Related   | Year-To-<br>Date<br>Average<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|--------------|--------------|-----------|-----------------------------------------------------------------|
|                                                            | Contractual  | Principal    | Allowance | Principal<br>Balance                                            |
| With an allowance recorded:                                |              |              |           |                                                                 |
| Commercial:                                                |              |              |           |                                                                 |
| Commercial and industrial                                  | \$5,011,000  | \$5,011,000  | \$83,000  | \$3,455,000                                                     |
| Vacant land, land development and residential construction | 0            | 0            | 0         | 0                                                               |
| Real estate – owner occupied                               | 2,658,000    | 2,658,000    | 363,000   | 2,072,000                                                       |
| Real estate – non-owner occupied                           | 0            | 0            | 0         | 0                                                               |
| Real estate – multi-family and residential rental          | 140,000      | 135,000      | 5,000     | 112,000                                                         |
| Total commercial                                           | 7,809,000    | 7,804,000    | 451,000   | 5,639,000                                                       |
| Retail:                                                    |              |              |           |                                                                 |
| Home equity and other                                      | 442,000      | 431,000      | 194,000   | 600,000                                                         |
| 1-4 family mortgages                                       | 409,000      | 341,000      | 44,000    | 299,000                                                         |
| Total retail                                               | 851,000      | 772,000      | 238,000   | 899,000                                                         |
| Total with an allowance recorded                           | \$8,660,000  | \$8,576,000  | \$689,000 | \$6,538,000                                                     |
| Total impaired loans:                                      |              |              |           |                                                                 |
| Commercial                                                 | \$17,139,000 | \$17,134,000 | \$451,000 | \$9,132,000                                                     |
| Retail                                                     | 2,511,000    | 1,748,000    | 238,000   | 2,004,000                                                       |

|                                 |              |              |           |              |
|---------------------------------|--------------|--------------|-----------|--------------|
| Total impaired originated loans | \$19,650,000 | \$18,882,000 | \$689,000 | \$11,136,000 |
|---------------------------------|--------------|--------------|-----------|--------------|

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Impaired acquired loans with no related allowance recorded were as follows as of December 31, 2018:

|                                                            | Unpaid       | Recorded     | Related   | Year-To-<br>Date<br>Average<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|--------------|--------------|-----------|-----------------------------------------------------------------|
|                                                            | Contractual  | Principal    | Allowance |                                                                 |
|                                                            | Principal    | Balance      |           |                                                                 |
|                                                            | Balance      |              |           |                                                                 |
| With no related allowance recorded:                        |              |              |           |                                                                 |
| Commercial:                                                |              |              |           |                                                                 |
| Commercial and industrial                                  | \$ 398,000   | \$ 398,000   |           | \$ 690,000                                                      |
| Vacant land, land development and residential construction | 0            | 0            |           | 0                                                               |
| Real estate – owner occupied                               | 1,193,000    | 1,193,000    |           | 749,000                                                         |
| Real estate – non-owner occupied                           | 0            | 0            |           | 182,000                                                         |
| Real estate – multi-family and residential rental          | 45,000       | 26,000       |           | 73,000                                                          |
| Total commercial                                           | 1,636,000    | 1,617,000    |           | 1,694,000                                                       |
| Retail:                                                    |              |              |           |                                                                 |
| Home equity and other                                      | 388,000      | 361,000      |           | 615,000                                                         |
| 1-4 family mortgages                                       | 2,494,000    | 1,849,000    |           | 2,031,000                                                       |
| Total retail                                               | 2,882,000    | 2,210,000    |           | 2,646,000                                                       |
| Total with no related allowance recorded                   | \$ 4,518,000 | \$ 3,827,000 |           | \$ 4,340,000                                                    |

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Impaired acquired loans with an allowance recorded and total impaired acquired loans were as follows as of December 31, 2018:

|                                                            | Unpaid       | Recorded     | Related    | Year-To-<br>Date<br>Average<br>Recorded<br>Principal<br>Balance |
|------------------------------------------------------------|--------------|--------------|------------|-----------------------------------------------------------------|
|                                                            | Contractual  | Principal    | Allowance  |                                                                 |
|                                                            | Principal    | Balance      |            |                                                                 |
|                                                            | Balance      |              |            |                                                                 |
| With an allowance recorded:                                |              |              |            |                                                                 |
| Commercial:                                                |              |              |            |                                                                 |
| Commercial and industrial                                  | \$ 175,000   | \$ 166,000   | \$ 43,000  | \$ 33,000                                                       |
| Vacant land, land development and residential construction | 0            | 0            | 0          | 0                                                               |
| Real estate – owner occupied                               | 147,000      | 147,000      | 0          | 349,000                                                         |
| Real estate – non-owner occupied                           | 210,000      | 210,000      | 0          | 42,000                                                          |
| Real estate – multi-family and residential rental          | 3,000        | 3,000        | 0          | 1,000                                                           |
| Total commercial                                           | 535,000      | 526,000      | 43,000     | 425,000                                                         |
| Retail:                                                    |              |              |            |                                                                 |
| Home equity and other                                      | 462,000      | 440,000      | 178,000    | 95,000                                                          |
| 1-4 family mortgages                                       | 418,000      | 371,000      | 89,000     | 74,000                                                          |
| Total retail                                               | 880,000      | 811,000      | 267,000    | 169,000                                                         |
| Total with an allowance recorded                           | \$ 1,415,000 | \$ 1,337,000 | \$ 310,000 | \$ 594,000                                                      |
| Total impaired loans:                                      |              |              |            |                                                                 |
| Commercial                                                 | \$ 2,171,000 | \$ 2,143,000 | \$ 43,000  | \$ 2,119,000                                                    |
| Retail                                                     | 3,762,000    | 3,021,000    | 267,000    | 2,815,000                                                       |

|                               |             |             |           |             |
|-------------------------------|-------------|-------------|-----------|-------------|
| Total impaired acquired loans | \$5,933,000 | \$5,164,000 | \$310,000 | \$4,934,000 |
|-------------------------------|-------------|-------------|-----------|-------------|

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2018

**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Impaired originated loans with no related allowance recorded were as follows as of December 31, 2017:

| Unpaid      | Recorded  | Related   | Year-To-<br>Date<br>Average<br>Recorded<br>Principal<br>Balance |
|-------------|-----------|-----------|-----------------------------------------------------------------|
| Contractual | Principal | Allowance |                                                                 |
| Principal   | Balance   |           |                                                                 |
| Balance     |           |           |                                                                 |

With no related allowance recorded: