

MERCANTILE BANK CORP  
Form 10-K  
February 28, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-K**

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

**For the fiscal year ended December 31, 2013**

**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:**

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
<b>Common Stock</b>	<b>The Nasdaq Stock Market LLC</b>
<b>Securities registered pursuant to Section 12(g) of the Act: None</b>	

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark 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.

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

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 \$151.5 million.

As of February 1, 2014, there were issued and outstanding 8,739,108 shares of the registrant's common stock.

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

Portions of the proxy statement for the 2014 annual meeting of shareholders (Portions of Part III) and the risk factors contained in our Section 424(b)(3) prospectus filed with the SEC on November 6, 2013, at pages 31-37.

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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 October 17, 2013.

Mercantile Bank Mortgage Company initiated business in October 2000 as a subsidiary of our bank, and was reorganized as Mercantile Bank Mortgage Company, LLC ( our mortgage company ), on January 1, 2004. Effective January 1, 2013, we dissolved our mortgage company and transferred all of the assets to our bank to streamline the administration of our mortgage business. A cash amount commensurate with its 1% ownership interest was distributed to the insurance company. For additional details regarding the dissolution of the mortgage company, see Our Mortgage Company below. 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. Mercantile Bank Capital Trust I ( our trust ), a business trust subsidiary, was formed in September 2004 to issue trust preferred securities.

To date we have raised capital from our initial public offering of common stock in October 1997, a public offering of common stock in July 1998, three private placements of common stock during 2001, a public offering of common stock in August 2001 and a public offering of common stock in September 2003. In addition, we raised capital through a public offering of \$16.0 million of trust preferred securities in 1999, which was refinanced as part of a \$32.0 million private placement of trust preferred securities in 2004. In May 2009, we raised \$21.0 million from the sale of preferred stock and a warrant for common stock to the United States Treasury Department under the Capital Purchase Program. We exited the Capital Purchase Program during 2012 by repurchasing the preferred stock for \$21.0 million and the warrant for approximately \$7.5 million. Our expenses have generally been paid using the proceeds of the capital sales and dividends from our bank. Our principal source of future operating funds is expected to be dividends from our bank.

**Merger Agreement**

On August 14, 2013, Mercantile Bank Corporation ( Mercantile ) and Firstbank Corporation ( Firstbank ), a Michigan corporation, entered into an Agreement and Plan of Merger (the merger agreement ). Under the terms of the merger agreement, Firstbank will be merged with and into Mercantile, with Mercantile as the surviving corporation. Both Mercantile and Firstbank shareholders approved the merger effective December 12, 2013.



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Upon completion of the merger, Firstbank shareholders will receive one share of Mercantile common stock for each share of Firstbank common stock that they own. Each right of any kind to receive Firstbank common stock or benefits measured by the value of a number of shares of Firstbank common stock granted under the Firstbank stock plans will be converted into an award with respect to a number of shares of Mercantile common stock equal to the aggregate number of shares of Firstbank common stock subject to such award. Firstbank restricted stock and unvested stock options will become fully vested as of the effective time of the merger. The exchange ratio is fixed and will not be adjusted to reflect stock price changes prior to the effective time of the merger. Based on the closing price of Mercantile common stock on the Nasdaq Stock Market on August 14, 2013, the last trading day before public announcement of the merger agreement, the exchange ratio represented approximately \$18.77 in value for each share of Firstbank common stock. Mercantile shareholders will continue to own their existing Mercantile shares.

Based on the estimated number of shares of Mercantile and Firstbank common stock that will be outstanding immediately prior to the effective time of the merger, we estimate that, upon the closing, former Mercantile shareholders will own approximately 52% of the combined company following the merger and former Firstbank shareholders will own approximately 48% of the combined company following the merger.

As part of the merger, Mercantile's Board of Directors expects to declare and pay a special cash dividend of \$2.00 per share to Mercantile shareholders prior to the effective time of the merger, subject to the satisfaction of the closing conditions set forth in the merger agreement.

Approval of the Board of Governors of the Federal Reserve System (FRB) is required to complete the merger. An application was filed with the FRB on September 17, 2013. Approval has not yet been obtained. Mercantile and Firstbank have each agreed to take actions in order to obtain regulatory clearance required to consummate the merger.

The obligations of Mercantile and Firstbank to complete the merger are subject to the satisfaction of the remaining conditions, which include, among others: (i) obtaining the consents, authorizations, approvals, or exemptions required under the Bank Holding Company Act, the FDI Act, and the Michigan Banking Code; (ii) the absence of any injunction, decree, order, statute, rule or regulation by a court of other governmental entity that makes unlawful or prohibits the consummation of the merger; and (iii) the authorization for the listing on Nasdaq of the shares of Mercantile common stock to be issued in connection with the merger and upon conversion of the Firstbank restricted stock and the shares of Mercantile common stock reserved for issuance pursuant to Mercantile stock options, subject to official notice of issuance.

Mercantile and Firstbank have each made customary representations, warranties and covenants in the merger agreement, including, among others, covenants to conduct their business in the ordinary course between the execution of the merger agreement and the completion of the merger, and covenants not to engage in certain kinds of transactions during that period.

The merger agreement generally precludes Mercantile and Firstbank from soliciting or engaging in discussions or negotiations with a third party with respect to an acquisition proposal. However, if Mercantile or Firstbank receives an unsolicited acquisition proposal from a third party and Mercantile's or Firstbank's Board of Directors, as applicable, among other things, determines in good faith (after consultation with its legal and financial advisors) that such unsolicited proposal is a superior proposal, then Mercantile or Firstbank, as applicable, may furnish non-public information to and enter into discussions with, and only with, that third party regarding such acquisition proposal.

Mercantile and Firstbank may mutually agree to terminate the merger agreement at any time, notwithstanding approval of the merger agreement by shareholders. Either company may also terminate the merger agreement if the merger is not consummated by June 30, 2014, subject to certain exceptions. In addition, either company may

terminate the agreement to enter into a definitive agreement with respect to a superior proposal, subject to certain conditions and the payment of a termination fee.

Generally, all fees and expenses incurred in connection with the merger agreement and the transactions contemplated by the merger agreement will be paid by the party incurring those expenses. Subject to specific exceptions, Mercantile or Firstbank may be required to pay a termination fee of \$7.9 million and/or expense reimbursement up to \$2.0 million.

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The merger will be accounted for using the acquisition method of accounting, with Mercantile treated as the acquirer for accounting purposes.

The merger agreement was filed as exhibit 2.1 to our Form 8-K filed August 15, 2013 to provide security holders with information regarding its terms. On February 20, 2014, Mercantile and Firstbank entered into a first amendment to the merger agreement, a copy of which was attached as exhibit 10.1 to our Form 8-K filed on February 21, 2014. The amendment extends the date on which the merger agreement becomes terminable from March 31, 2014 to June 30, 2014. Mercantile and Firstbank currently expect the effective time of the merger to occur before the extended termination date. However, the merger is subject to various regulatory clearances and the satisfaction or waiver of other conditions as described in the merger agreement, some of which may be outside the control of Mercantile and Firstbank, and the merger could be completed at a later time through further extension(s) of the merger agreement or not at all.

The merger agreement and first amendment are not intended to provide any other factual information about Mercantile, Firstbank or their respective subsidiaries and affiliates. The merger agreement contains representations and warranties by each of the parties to the merger agreement. These representations and warranties were made solely for the benefit of the other party to the merger agreement and (i) are not intended to be treated as categorical statements of fact, but rather as a way of allocating risk to one of the parties if those statements prove to be inaccurate, (ii) may have been qualified in the merger agreement by confidential disclosure schedules that were delivered to the other party in connection with the signing of the merger agreement, which disclosure schedules may contain information that modifies, qualifies and creates exceptions to the representations, warranties and covenants set forth in the merger agreement, (iii) may be subject to standards of materiality applicable to the parties that differ from what might be viewed as material to investors, (iv) were made only as of the date of the merger agreement or such other date or dates as may be specified in the merger agreement or the amendment. Moreover, information concerning the subject matter of the representations, warranties and covenants may change after the date of the merger agreement, which subsequent information may or may not be fully reflected in public disclosures by Mercantile or Firstbank. Accordingly, the representations, warranties and covenants or any descriptions should not be relied upon as characterizations of the actual state of facts or condition of Mercantile or Firstbank.

Mercantile's Board of Directors and Mercantile shareholders approved an amendment to the Mercantile articles of incorporation which increases the number of authorized shares of common stock from 20 million to 40 million. Although this proposal was approved by Mercantile shareholders, if the merger is not completed the amendment will not become effective.

## **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 Office of Financial and Insurance Regulation. Our bank's deposits are insured to the maximum extent permitted by law by the Federal Deposit Insurance Corporation ( FDIC ). Our bank, through its seven offices, provides commercial banking services primarily to small- to medium-sized businesses and retail banking services in and around the Grand Rapids, Holland and Lansing areas. These offices consist of a main office located at 310 Leonard Street NW, Grand Rapids, Michigan, a combination branch and retail loan center located at 4613 Alpine Avenue NW, Comstock Park, Michigan, a combination branch and operations center located at 5610 Byron Center Avenue SW, Wyoming, Michigan, and branches located at 4860 Broadmoor Avenue SE, Kentwood, Michigan, 3156 Knapp Street NE, Grand Rapids, Michigan, 880 East 16<sup>th</sup> Street, Holland, Michigan, and 3737 Coolidge Road, East Lansing, Michigan.



Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns eight automated teller machines ( ATM ), located at each of our seven office locations and one at an off-site location, 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 each of our office locations. Our bank does not have trust powers.

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### **Our Mortgage Company**

Our mortgage company's predecessor, Mercantile Bank Mortgage Company, commenced operations on October 24, 2000, when our bank contributed most of its residential mortgage loan portfolio and participation interests in certain commercial mortgage loans to Mercantile Bank Mortgage Company. On the same date, our bank also transferred its residential mortgage origination function to Mercantile Bank Mortgage Company. On January 1, 2004, Mercantile Bank Mortgage Company was reorganized as Mercantile Bank Mortgage Company, LLC, a limited liability company, which was 99% owned by our bank and 1% owned by our insurance company. The reorganization had no impact on the company's financial position or results of operations. Mortgage loans originated and held by our mortgage company were serviced by our bank pursuant to a servicing agreement. Effective January 1, 2013, we dissolved the mortgage company to streamline the administration of our mortgage business. A cash amount commensurate with its 1% ownership interest was distributed to the insurance company. The remaining assets of the mortgage company were assigned to our bank. The business that was formerly conducted by our mortgage company is now performed by our bank in its ordinary course of operation.

### **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.

### **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 Trust**

In 2004, we formed our trust, a Delaware business trust. Our trust's business and affairs are conducted by its property trustee, a Delaware trust company, and three individual administrative trustees who are employees and officers of the company. Our trust was established for the purpose of issuing and selling its Series A and Series B trust preferred securities and common securities, and used the proceeds from the sales of those securities to acquire Series A and Series B Floating Rate Notes issued by the company. Substantially all of the net proceeds received by the company from the Series A transaction were used to redeem the trust preferred securities that had been issued by MBWM Capital Trust I in September 1999. We established MBWM Capital Trust I in 1999 to issue the trust preferred securities that were redeemed. Substantially all of the net proceeds received by the company from the Series B transaction were contributed to our bank as capital. The Series A and Series B Floating Rate Notes are categorized on our consolidated financial statements as subordinated debentures. Additional information regarding our trust is incorporated by reference to Note 17 Subordinated Debentures and Note 18 Regulatory Matters of the Notes to Consolidated Financial Statements included in this Annual Report.



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### **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 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**

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 that are not qualified as financial holding companies to banking and the management of banking organizations, and to certain non-banking activities. These non-banking activities include those 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 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. With the exception of the activities formerly conducted by our mortgage company discussed above, neither we nor any of our subsidiaries engage in any of the non-banking activities listed above.

Our bank is subject to restrictions imposed by federal law and regulation. 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. 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 existing regulation and supervision of various aspects of our business has expanded, and continues to expand, as a result of the adoption in July, 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), and of implementing regulations that are being adopted by federal regulators. 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.

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### **Employees**

As of December 31, 2013, we employed 227 full-time and 41 part-time persons. Management believes that relations with employees are good.

### **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 Chairman of the Board 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 \$4.0 million, up to the legal lending limit of approximately \$38.4 million, require approval by the Board of Directors. In most circumstances, we 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, 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 Factors entitled "The effect of financial services legislation and regulations remains uncertain and Our single-family real estate lending business faces significant change" 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.

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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 Mercantile Bank Prime Rate, 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, Mercantile Bank Prime Rate or 30-day Libor Rate.

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, usually according to secondary market underwriting standards. Loans not conforming to those standards are made in limited circumstances. Single-family residential real estate loans provide borrowers with a fixed or adjustable interest rate with terms up to 30 years and are generally sold to certain 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 consumer loans for a variety of personal financial needs, including new and used automobiles, boats, credit cards and overdraft protection 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.

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We utilize a comprehensive grading system for our commercial loans as well as for our residential mortgage and consumer loans. All commercial loans are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, operating performance, financial condition, collateral, industry condition and management. All commercial loans are graded at inception and reviewed at various intervals. Residential mortgage and consumer loans are graded on a random sampling basis after the loan has been made using a separate standardized grade paradigm that analyzes several critical factors such as debt-to-income and credit and employment histories.

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. All commercial loan relationships equal to or exceeding \$1.6 million are formally reviewed every twelve months, with a random sampling performed on credits under \$1.6 million. Our watch list credits are reviewed monthly by our Board of Directors and our Watch List Committee, the latter of which is comprised of personnel from the administration, lending and loan review functions.

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, 2013, loans placed in nonaccrual status totaled \$6.7 million, or 0.6% of total loans, compared to \$19.0 million, or 1.8% of total loans, at December 31, 2012. We had no loans past due 90 days or more and still accruing interest at year-end 2013 or 2012.

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 3 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 dollar amount. For non-impaired commercial loans, which continue to comprise a vast majority of our total loans, reserve allocation factors are based upon loan ratings as determined by our standardized grade paradigms and by loan purpose. We have divided our commercial loan portfolio into five classes: 1) commercial and industrial loans; 2) vacant land, land development and residential construction loans; 3) owner occupied real estate loans; 4) non-owner occupied real estate loans; and 5) multi-family and residential rental property loans. The reserve allocation factors are primarily based on the historical trends of net loan charge-offs through a migration analysis whereby net loan losses are tracked via assigned grades over various time periods, with adjustments made for environmental factors reflecting the current status of, or recent changes in, items such as: lending policies and procedures; economic conditions; nature and volume of the loan portfolio; experience, ability and depth of management and lending staff; volume and severity of past due, nonaccrual and adversely classified loans; effectiveness of the loan review program; value of underlying collateral; 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 commercial loans. Our migration takes into account various time periods, and while historically we have generally placed most weight on the eight-quarter time frame, consideration was given to the other time periods as part of our assessment. Given the stabilization of and decrease in loan losses experienced in recent quarters in comparison to loan losses recorded during the economic downturn of 2007 through 2011, we decided to transition from the eight-quarter time frame to a longer twelve-quarter time frame during 2012. Given current economic conditions and the general economic outlook over the near future, we believe the twelve-quarter period now represents a more appropriate range of economic conditions and provides for a more relevant basis in determining reserve allocation factors.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our commercial loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data. Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings. Although we have been consistent in our approach to commercial loan ratings, the stressed economic conditions of the past several years have resulted in an even higher sense of aggressiveness with regards to the downgrading of lending relationships. For example, we made revisions to our grading paradigms in early 2009 that mathematically resulted in commercial loan relationships being more quickly downgraded when signs of stress are noted, such as slower sales activity for construction and land development commercial real estate relationships and reduced operating performance/cash flow coverage for commercial and industrial relationships. These changes, coupled with the stressed economic environment, resulted in significant downgrades and the need for substantial provisions to the allowance during the three-year period ended December 31, 2010. To more effectively manage our commercial loan portfolio, we also created a specific group tasked with managing our most distressed lending relationships.

Coinciding with our transition from an eight-quarter loan loss migration analysis to a twelve-quarter loan loss migration analysis during 2012, we also transitioned from a 50-basis point environmental factor matrix to a 35-basis point environmental factor matrix. We believe this reduction was appropriate since extending the look-back period of the loan loss migration analysis expands the level of environmental experience inherently included in the quantitative-based reserve allocation factors. This transition, along with typical periodic adjustments to the environmental factors, resulted in a net decrease of \$1.5 million to the required loan loss reserve level as of December 31, 2012.

The most significant external environmental factor is the assessment of the current economic environment and the resulting implications on our commercial loan portfolio. Currently, we believe conditions remain stressed for certain non-owner occupied commercial real estate ( CRE ); however, recent data and performance reflect a level of stability, and in some cases improvement, in the other classes of our commercial loan portfolio.

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

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Reflecting the stressed economic conditions and resulting negative impact on our loan portfolio, we substantially increased the allowance as a percent of the loan portfolio beginning in 2009. The allowance equaled \$22.8 million, or 2.2% of total loans outstanding, as of December 31, 2013, compared to 2.8%, 3.4%, 3.6%, 3.1%, 1.5% and 1.4% at year-end 2012, 2011, 2010, 2009, 2008 and 2007, respectively. A significant portion of the decline in the level of the allowance to total loans outstanding during 2013 and 2012 reflects the charge-off of specific reserves that were created in prior periods and the elimination and reduction of specific reserves due to successful collection efforts, while the remainder of the decline is primarily associated with commercial loan upgrades and reductions in many reserve allocation factors on non-impaired commercial loans resulting from the impact of lower net loan charge-offs in recent periods on our migration calculations.

As of December 31, 2013, the allowance was comprised of \$10.4 million in general reserves relating to non-impaired loans, \$2.0 million in specific reserve allocations relating to nonaccrual loans, and \$10.4 million in specific allocations on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$34.9 million at December 31, 2013, consisting of \$4.6 million that are on nonaccrual status and \$30.3 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 \$3.1 million as of December 31, 2013 had been subject to previous partial charge-offs aggregating \$3.1 million. Those partial charge-offs were recorded as follows: \$1.1 million in 2013, \$1.2 million in 2012, \$0.6 million in 2011 and \$0.2 million in 2010. As of December 31, 2013, specific reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled \$0.1 million.

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.

Additional detail regarding the allowance 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.

**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 Mercantile trust. 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, our mortgage company, or 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.

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Additional detail and information relative to the securities portfolio is incorporated by reference to Management's Discussion and Analysis and Note 2 of the Notes to Consolidated Financial Statements included in this Annual Report.

## **Competition**

Our primary markets for loans and core deposits are the Grand Rapids, Holland and Lansing metropolitan areas. 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), 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.

## **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.

## **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.

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**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 or south central 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.**

Many of our 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.

**We face certain risks related to our planned merger with Firstbank as outlined in the merger prospectus.**

We face certain risks related to our planned merger with Firstbank, including risks related to our ability to consummate the merger in a timely fashion and our ability to successfully integrate the companies following the merger. These risks are outlined in our Section 424(b)(3) prospectus filed with the SEC on November 6, 2013, at pages 31-37, and are incorporated here by reference.

**Anticipation of the special dividend may cause upward pressure on or support of the price of Mercantile common stock as investors purchase or hold shares to collect the expected special dividend. The price of Mercantile common stock may decline on or after the ex-dividend date or payment date of the dividend.**

As part of the merger, Mercantile's Board of Directors expects to declare and pay a special cash dividend of \$2.00 per share to Mercantile shareholders prior to the effective time of the merger, subject to the satisfaction of the closing conditions set forth in the merger agreement. Anticipation of the special dividend may cause upward pressure on or support of the price of Mercantile common stock as investors purchase or hold shares to collect the expected special dividend. The price of Mercantile common stock may decline on or after the ex-dividend date or payment date of the dividend because the shareholders' equity of Mercantile will decrease by the amount of the distribution.



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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. Most 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 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), 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.

**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.

**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.



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**Table of Contents****The effect of the U.S. Government's response to the financial crisis remains uncertain.**

In response to the turmoil in the financial services sector and the severe recession in the broader economy, the U.S. Government took legislative and other action intended to restore financial stability and economic growth. In October, 2008, then President Bush signed the Emergency Economic Stabilization Act of 2008 (the EESA). Among other things, the EESA established the Troubled Asset Relief Program (TARP). Under TARP, among other things, the United States Treasury Department (the Treasury Department) made senior preferred stock investments in qualifying financial institutions. In February, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (the ARRA). The ARRA contained, among other things, a further package of economic stimulus measures and amendments to EESA's restrictions on compensation of executives of financial institutions and others participating in the TARP. The FDIC and the Treasury Department also implemented further measures to address the crisis in the financial services sector. Further legislation providing tax relief and other economic stimulus was adopted by Congress in 2010 and 2011. Many of the programs initiated under the EESA and ARRA, and emergency regulatory actions of the FDIC and the Treasury Department, have expired or been terminated by subsequent legislative and regulatory actions. In addition to legislation, the Federal Reserve Board eased short-term interest rates and implemented a series of emergency programs to furnish liquidity to the financial markets and credit to various participants in those markets, as well as programs of quantitative easing through direct open market purchases of certain Treasury and other securities. In December, 2013, the Federal Reserve Board began a phased reduction in the amount of such securities purchases, contingent upon the general performance of the U.S. economy and unemployment and inflation metrics. There can be no assurance as to the actual impact of these laws, and their respective implementing regulations, the programs of the government agencies, or any further legislation or regulations, 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.

**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, repeal of the prohibition on payment of interest on demand deposits, the effective winding up of additional expenditures of funds under the TARP, and the imposition of a sunset date of December 31, 2012 on expenditures under the ARRA. 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. There can be no assurance that the Dodd-Frank Act and its implementing regulations will not limit our ability to pursue 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 Michael H. Price, Chairman of the Board, President and Chief Executive Officer, and our other senior managers. The loss of Mr. Price, or any of our other senior managers, could have an adverse effect on our growth and performance. We have entered into employment contracts with Mr. Price and two other executive officers. The contracts provide for a three-year employment period that is extended for an additional year each year unless a notice is given indicating that the contract will not be extended.

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.

### **Decline in the availability of out-of-area deposits could cause liquidity or interest rate margin concerns, or limit our growth.**

We utilize out-of-area or wholesale deposits to support our assets. These deposits are generally a lower cost source of funds when compared to the interest rates that we would have to offer in our local markets to generate a commensurate level of funds. In addition, the overhead costs associated with wholesale deposits are considerably less than the overhead costs we would incur to obtain and administer a similar level of local deposits. A decline in the availability of these wholesale deposits would require us to fund our growth with more costly funding sources, which could reduce our net interest margin, limit our growth, reduce our asset size, or increase our overhead costs. Wholesale deposits include deposits obtained through brokers. If a bank is not well capitalized, regulatory approval is required to accept brokered deposits.

### **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 Stock Incentive Plan of 2006. 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.





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**Table of Contents****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, 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.

**Our single-family real estate lending business faces significant change.**

The Dodd-Frank Act significantly changed the regulation of single-family residential mortgage lending in the United States. Among other things, the law transferred rule-making and enforcement powers from a number of federal agencies to the CFPB, imposed new risk retention and recordkeeping requirements on lenders (such as our bank) which sell single-family residential mortgage loans in the secondary market, required revision of disclosure documents mandated by various federal laws, limited loan originator compensation and expanded recordkeeping and reporting requirements under other federal statutes. Regulations implementing the Dodd-Frank Act adopted in 2013 by the CFPB (i) require lenders to make a reasonable good faith determination of a prospective residential mortgage borrower's ability to repay based on specific underwriting criteria and define the characteristics of qualified mortgages that presumptively satisfy the ability to pay requirement, (ii) impose new requirements on mortgage servicing that address many issues, including periodic billing statements, error resolution, force-placed insurance, payment crediting and payoff, early intervention with delinquent borrowers, and enhanced loss mitigation procedures, (iii) specify new limitations on loan originator compensation, (iv) further restrict certain high-cost mortgage loans, (v) expand mandated loan escrow accounts for certain loans, (vi) revise existing appraisal requirements under the Equal Credit Opportunity Act and require provision of a free copy of all appraisals to applicants for first lien loans, and (vii) combine in a single, new form required loan disclosures under the Truth-in-Lending Act ( TILA ) and the Real Estate Settlement Procedures Act ( RESPA ). Apart from use of the TILA/RESPA combined disclosure form (which becomes effective August 1, 2015), the effective dates of these changes are in 2014. These and other changes required by the Dodd-Frank Act will require substantial modifications to the entire mortgage lending and servicing industry. Their impact may involve changes to our operations and increased compliance costs in making single-family residential mortgage loans.

**Minimum capital requirements are scheduled to increase.**

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 current 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 will become applicable to us and our bank on January 1, 2015.

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The new regulations implement (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 is not imposed under existing 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 it, now scheduled for the first quarter of 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 mandate 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 current 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 will be affected by the new definitions of certain capital elements.

The capital conservation buffer comprised solely of CET 1 will be 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.

**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.

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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.

### **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 interests.

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.

### **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 offering price.

Our ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices.

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### **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.

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

Our computer systems, software and networks have been and will continue to be vulnerable to 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. 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.

### **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 2013 fiscal year and that remain unresolved.

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**Item 2. Properties.**

During 2005, our bank placed into service a new four-story facility located approximately two miles north from the center of downtown Grand Rapids. This facility serves as our headquarters and our bank's main office, and houses the administration function, our bank's commercial lending and review function, our bank's loan operations function, our bank's deposit operations function, a full service branch, and portions of our bank's retail lending and business development function. The facility consists of approximately 55,000 square feet of usable space and contains multiple drive-through lanes with ample parking. The land and building are owned by our real estate company. The address of this facility is 310 Leonard Street NW, Grand Rapids, Michigan.

Our bank designed and constructed a full service branch and retail loan facility, which opened in July of 1999, in Alpine Township, a northwest suburb of Grand Rapids. The facility is one story and has approximately 8,000 square feet of usable space. The land and building are owned by our bank. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 4613 Alpine Avenue NW, Comstock Park, Michigan.

During 2001, our bank designed and constructed two facilities on a four-acre parcel of land located in the City of Wyoming, a southwest suburb of Grand Rapids. The land had been purchased by our bank in 2000. The larger of the two buildings is a full service branch, which opened in September of 2001. The facility is two-stories and has approximately 25,000 square feet of usable space. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 5610 Byron Center Avenue SW, Wyoming, Michigan. The other building is a single-story facility with approximately 11,000 square feet of usable space. Our bank's accounting, audit, loss prevention and wire transfer functions are housed in this building, which underwent a renovation in 2005 that almost doubled its size. The address of this facility is 5650 Byron Center Avenue SW, Wyoming, Michigan.

During 2002, our bank designed and constructed a full service branch, which opened in December of 2002, in the City of Kentwood, a southeast suburb of Grand Rapids. The land had been purchased by our bank in 2001. The facility is one story and has approximately 10,000 square feet of usable space. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 4860 Broadmoor Avenue SE, Kentwood, Michigan.

During 2003, our bank designed and constructed a full service branch in the northeast quadrant of the City of Grand Rapids. The land had been purchased by our bank in 2002. The facility is one story and has approximately 3,500 square feet of usable space. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 3156 Knapp Street NE, Grand Rapids, Michigan.

During 2003, our bank designed and started construction of a new two-story facility located in Holland, Michigan. This facility, which was completed during the fourth quarter of 2004, serves as a full service banking center for the Holland area, including commercial lending, retail lending and a full service branch. The facility, which is owned by our bank, consists of approximately 30,000 square feet of usable space and contains multiple drive-through lanes with ample parking. The address of this facility is 880 East 16<sup>th</sup> Street, Holland, Michigan.

During 2006, our bank purchased approximately three acres of vacant land and designed and initiated construction of a new three-story facility in East Lansing, Michigan. This facility was completed during the second quarter of 2007, and serves as a full service banking center for the greater Lansing area, including commercial lending, retail lending, and a full service branch. The facility consists of approximately 27,000 square feet of usable space and contains multiple drive-through lanes with ample parking. The address of this facility is 3737 Coolidge Road, East Lansing, Michigan.





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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 February 1, 2014, there were 298 record holders of our common stock. In addition, we estimate that there were approximately 4,000 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 cash dividends paid by us during those periods.

	<b>High</b>	<b>Low</b>	<b>Dividend</b>
<b>2013</b>			
First Quarter	\$ 17.29	\$ 16.03	\$ 0.10
Second Quarter	18.00	16.50	0.11
Third Quarter	22.41	17.87	0.12
Fourth Quarter	22.52	19.95	0.12
<b>2012</b>			
First Quarter	\$ 9.77	\$ 14.25	\$ 0.00
Second Quarter	18.46	13.71	0.00
Third Quarter	18.69	15.77	0.00
Fourth Quarter	17.98	13.41	0.09

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 holding company and substantially all of our assets are held by our 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. Also, in connection with our participation in the Treasury Department's Capital Purchase Program, we agreed that we would not, without the Treasury Department's consent, increase our cash dividend rate on our common stock, or with certain exceptions, repurchase any shares of our common stock. These restrictions relating to the Capital Purchase Program

expired when we repurchased the preferred stock and warrant during 2012.

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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 is subject to limitations under various laws and regulations and to prudent and sound banking practices. On October 11, 2012, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.09 per share, that was paid on December 10, 2012 to shareholders of record as of November 9, 2012. This represented our first common stock cash dividend since the first quarter of 2010, as in April 2010 we suspended payments of cash dividends on our common stock. On January 10, 2013, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.10 per share that was paid on March 8, 2013 to shareholders of record as of February 8, 2013. On April 11, 2013, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.11 per share that was paid on June 10, 2013 to shareholders of record as of May 10, 2013. On July 11, 2013, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.12 per share that was paid on September 10, 2013 to shareholders of record as of August 9, 2013. On October 10, 2013, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.12 per share that was paid on December 10, 2013 to shareholders of record as of November 8, 2013. On January 16, 2014, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.12 per share that will be paid on March 10, 2014 to shareholders of record as of February 10, 2014.

As part of our planned merger with Firstbank, Mercantile's Board of Directors expects to declare and pay a special cash dividend of \$2.00 per share to Mercantile shareholders prior to the effective time of the merger, subject to the satisfaction of the closing conditions set forth in the merger agreement. Anticipation of the special dividend may cause upward pressure on or support of the price of Mercantile common stock as investors purchase or hold shares to collect the expected special dividend. The price of Mercantile common stock may decline on or after the ex-dividend date or payment date of the dividend.

**Issuer Purchases of Equity Securities**

<b>Period</b>	<b>(a) Total Number of Shares Purchased</b>	<b>(b) Average Price Paid Per Share</b>	<b>(c) Total Number of Shares that May Yet Be Purchased as Part of Publicly Announced Plans or Programs</b>	<b>(d) Maximum Number Be Purchased Under the Plans or Programs</b>
October 1 - 31	N/A	N/A	0	0
November 1 - 30	16,531	\$ 21.73	0	0
December 1 - 31	N/A	N/A	0	0
<b>Total</b>	<b>16,531</b>	<b>\$ 21.73</b>	<b>0</b>	<b>0</b>

The shares shown in column (a) above as having been purchased were acquired from several of our employees when they used shares of common stock that they already owned to pay part of the exercise price when exercising stock options under our employee stock-based compensation plans.

**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, 2008 through December 31, 2013. The following is based on an investment of \$100 on December 31, 2008 in our common stock, the Nasdaq Composite Index and the SNL Bank Nasdaq Index, with dividends reinvested where applicable.

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<i>Index</i>	<i>Period Ending</i>					
	<b>12/31/08</b>	<b>12/31/09</b>	<b>12/31/10</b>	<b>12/31/11</b>	<b>12/31/12</b>	<b>12/31/13</b>
Mercantile Bank Corporation	100.00	72.88	194.60	231.39	393.98	527.88
NASDAQ Composite	100.00	145.36	171.74	170.38	200.63	281.22
SNL Bank NASDAQ	100.00	81.12	95.71	84.92	101.22	145.48

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

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

None

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

As of December 31, 2013, 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, 2013.

There have been no significant changes in our internal control over financial reporting during the quarter ended December 31, 2013, 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, 2013. This evaluation was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (1992)* 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, 2013. Refer to page F-39 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 April 24, 2014 Annual Meeting of Shareholders (the Proxy Statement ), a copy of which will be filed with the Securities and Exchange Commission before the meeting date, 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, John F. Donnelly, Calvin D. Murdock, and Timothy O. Schad. The Board of Directors has determined that Messrs. Cassard, Murdock and Schad, 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. Messrs. Cassard, Donnelly, Murdock, and Schad are independent, as independence for audit committee members is defined in the Nasdaq listing standards and the rules of the Securities and Exchange Commission.



**Table of Contents****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, 2013, relating to compensation plans under which equity securities are authorized for issuance.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders (1)	60,876	\$ 33.11	384,000(2)
Equity compensation plans not approved by security holders	0	0	0
<b>Total</b>	<b>60,876</b>	<b>\$ 33.11</b>	<b>384,000</b>

(1) These plans are Mercantile's 2000 Employee Stock Option Plan, 2004 Employee Stock Option Plan, Independent Director Stock Option Plan and the Stock Incentive Plan of 2006.

(2) These securities are available under the Stock Incentive Plan of 2006. 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 February 28, 2014 BDO USA, LLP

Consolidated Balance Sheets December 31, 2013 and 2012

Consolidated Statements of Income for each of the three years in the period ended December 31, 2013

Consolidated Statements of Comprehensive Income for each of the three years in the period ended December 31, 2013

Consolidated Statements of Changes in Shareholders Equity for each of the three years in the period ended December 31, 2013

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2013

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:

EXHIBIT NO.	EXHIBIT DESCRIPTION
2.1	Agreement and Plan of Merger dated August 14, 2013, incorporated by reference to exhibit 2.1 to our Current Report on Form 8-K filed August 15, 2013
2.2	First Amendment to Merger Agreement dated February 20, 2014, incorporated by reference to exhibit 10.1 to our Current Report on Form 8-K filed February 21, 2014
3.1	Our Articles of Incorporation are incorporated by reference to exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2009
3.2	Our Amended and Restated By-laws dated as of January 16, 2003 are incorporated by reference to exhibit 3.2 of our Registration Statement on Form S-3 (Commission File No. 333-103376) that became effective on February 21, 2003

10.1

Our 2000 Employee Stock Option Plan is incorporated by reference to exhibit 10.14 of our Form 10-K for the year ended December 31, 2000 \*

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EXHIBIT NO.	EXHIBIT DESCRIPTION
10.2	Our 2004 Employee Stock Option Plan is incorporated by reference to exhibit 10.1 of our Form 10-Q for the quarter ended September 30, 2004 *
10.3	Our Independent Director Stock Option Plan is incorporated by reference to exhibit 10.26 of our Form 10-K for the year ended December 31, 2002 *
10.4	Form of Stock Option Agreement for options under the Independent Director Stock Option Plan is incorporated by reference to exhibit 10.1 of our Form 8-K filed October 22, 2004 *
10.5	Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan for Members of the Board of Directors dated June 29, 2006 is incorporated by reference to exhibit 10.9 of our Form 10-K for the year ended December 31, 2007 *
10.6	First Amendment dated October 25, 2007 to the Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan for Members of the Board of Directors dated June 29, 2006 is incorporated by reference to exhibit 10.10 of our Form 10-K for the year ended December 31, 2007 *
10.7	Second Amendment dated October 23, 2008 to the Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan for Members of the Board of Directors dated June 29, 2006 is incorporated by reference to exhibit 10.9 of our Form 10-K for the year ended December 31, 2008 *
10.8	Amended and Restated Employment Agreement dated as of October 18, 2001, among the company, our bank and Michael H. Price, is incorporated by reference to exhibit 10.22 of our Form 10-K for the year ended December 31, 2001 *
10.9	Employment Agreement dated as of October 18, 2001, among the company, our bank and Robert B. Kaminski, Jr., is incorporated by reference to exhibit 10.23 of our Form 10-K for the year ended December 31, 2001 *
10.10	Employment Agreement dated as of October 18, 2001, among the company, our bank and Charles E. Christmas, is incorporated by reference to exhibit 10.23 of our Form 10-K for the year ended December 31, 2001 *
10.11	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Michael H. Price, is incorporated by reference to exhibit 10.22 of our Form 10-K for the year ended December 31, 2002 *
10.12	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Robert B. Kaminski, Jr., is incorporated by reference to exhibit 10.23 of our Form 10-K for the year ended December 31, 2002 *
10.13	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Charles E. Christmas, is incorporated by reference to exhibit 10.24 of our Form 10-K for the year ended December 31, 2002 *
10.14	Amendment to Employment Agreement dated as of October 28, 2004, among the company, our bank and Robert B. Kaminski, Jr., is incorporated by reference to exhibit 10.21 of our Form 10-K for the year ended December 31, 2004 *

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EXHIBIT NO.	EXHIBIT DESCRIPTION
10.15	Junior Subordinated Indenture between us and Wilmington Trust Company dated September 16, 2004 providing for the issuance of the Series A and Series B Floating Rate Junior Subordinated Notes due 2034 is incorporated by reference to exhibit 10.1 of our Form 8-K filed December 15, 2004
10.16	Amended and Restated Trust Agreement dated September 16, 2004 for Mercantile Bank Capital Trust I is incorporated by reference to exhibit 10.2 of our Form 8-K filed December 15, 2004
10.17	Placement Agreement between us, Mercantile Bank Capital Trust I, and SunTrust Capital Markets, Inc. dated September 16, 2004 is incorporated by reference to exhibit 10.3 of our Form 8-K filed December 15, 2004
10.18	Guarantee Agreement dated September 16, 2004 between Mercantile as Guarantor and Wilmington Trust Company as Guarantee Trustee is incorporated by reference to exhibit 10.4 of our Form 8-K filed December 15, 2004
10.19	Form of Agreement Amending Stock Option Agreement, dated November 17, 2005 issued under our 2004 Employee Stock Option Plan, is incorporated by reference to exhibit 10.1 of our Form 8-K filed December 14, 2005 *
10.20	Second Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Michael H. Price is incorporated by reference to exhibit 10.29 of our Form 10-K for the year ended December 31, 2005 *
10.21	Third Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Robert B. Kaminski, Jr. is incorporated by reference to exhibit 10.30 of our Form 10-K for the year ended December 31, 2005 *
10.22	Second Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Charles E. Christmas is incorporated by reference to exhibit 10.31 of our Form 10-K for the year ended December 31, 2005 *
10.23	Form of Mercantile Bank of Michigan Amended and Restated Executive Deferred Compensation Agreement dated November 18, 2006, that has been entered into between our bank and each of Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank is incorporated by reference to exhibit 10.34 of our Form 10-K for the year ended December 31, 2007 *
10.24	Form of First Amendment to the Mercantile Bank of Michigan Executive Deferred Compensation Agreement dated November 18, 2006, that has been entered into between our bank and each of Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank, dated October 25, 2007 is incorporated by reference to exhibit 10.35 of our Form 10-K for the year ended December 31, 2007 *
10.25	Form of Second Amendment to the Mercantile Bank of Michigan Executive Deferred Compensation Agreement dated November 18, 2006, that has been entered into between our bank and each of Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank, dated October 23, 2008 is incorporated by reference to exhibit 10.34 of our Form 10-K for the year ended December 31, 2008 *

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EXHIBIT NO.	EXHIBIT DESCRIPTION
10.26	Form of Mercantile Bank of Michigan Split Dollar Agreement that has been entered into between our bank and each of Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank is incorporated by reference to exhibit 10.33 of our Form 10-K for the year ended December 31, 2005 *
10.27	Director Fee Summary *
10.28	Stock Incentive Plan of 2006 is incorporated by reference to Appendix A of our proxy statement for our April 27, 2006 annual meeting of shareholders that was filed with the Securities and Exchange Commission *
10.29	Amendment and Restatement of Stock Incentive Plan of 2006 dated November 18, 2008 is incorporated by reference to exhibit 10.39 of our Form 10-K for the year ended December 31, 2008 *
10.30	Form of Notice of Grant of Incentive Stock Option and Stock Option Agreement for incentive stock options granted in 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.1 of our Form 8-K filed November 22, 2006 *
10.31	Form of Notice of Grant of Incentive Stock Option and Stock Option Agreement for incentive stock options granted after 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.41 of our Form 10-K for the year ended December 31, 2007 *
10.32	Form of Restricted Stock Award Agreement Notification of Award and Terms and Conditions of Award for restricted stock granted in 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.2 of our Form 8-K filed November 22, 2006 *
10.33	Form of Restricted Stock Award Agreement Notification of Award and Terms and Conditions of Award for restricted stock granted after 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.43 of our Form 10-K for the year ended December 31, 2007 *
10.34	Mercantile Bank Corporation Employee Stock Purchase Plan of 2002 is incorporated by reference to exhibit 10.47 of our Form 10-K for the year ended December 31, 2008
10.35	First Amendment to Mercantile Bank Corporation Employee Stock Purchase Plan of 2002 is incorporated by reference to exhibit 4(c) of our Registration Statement on Form S-8 (Commission File No. 333-158280) that became effective on March 30, 2009
10.36	Second Amendment to Mercantile Bank Corporation Employee Stock Purchase Plan of 2002 is incorporated by reference to exhibit 4(d) of our Registration Statement on Form S-8 (Commission File No. 333-158280) that became effective on March 30, 2009
10.37	Amendment to Employment Agreements, dated May 15, 2009, by and among Mercantile Bank Corporation, Mercantile Bank of Michigan, Michael H. Price, Robert B. Kaminski, Jr. and Charles E. Christmas is incorporated by reference to exhibit 10.3 of our Form 8-K filed May 15, 2009 *

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EXHIBIT NO.	EXHIBIT DESCRIPTION
10.38	Letter Agreement dated April 4, 2012 between the United States Department of the Treasury and Mercantile Bank Corporation relating to Mercantile's repurchase of 10,500 shares of its Preferred Stock is incorporated by reference to exhibit 10.1 of our Form 10-Q filed August 8, 2012
10.39	Letter Agreement dated June 6, 2012 between the United States Department of the Treasury and Mercantile Bank Corporation relating to Mercantile's repurchase of 10,500 shares of its Preferred Stock is incorporated by reference to exhibit 10.2 of our Form 10-Q filed August 8, 2012
10.40	Letter dated June 27, 2012 from the United States Department of the Treasury to Mercantile Bank Corporation relating to Mercantile's repurchase of its Warrant for 616,438 shares of common stock is incorporated by reference to exhibit 10.3 of our Form 10-Q filed August 8, 2012
10.41	Letter Agreement dated July 3, 2012 between the United States Department of the Treasury and Mercantile Bank Corporation relating to Mercantile's repurchase of its Warrant for 616,438 shares of common stock is incorporated by reference to exhibit 10.4 of our Form 10-Q filed August 8, 2012
10.42	2012 Mercantile Senior Executive Officer Bonus Plan for Michael H. Price is incorporated by reference to exhibit 10.1 of our Form 8-K filed July 5, 2012 *
10.43	2012 Mercantile Senior Executive Officer Bonus Plan for Robert B. Kaminski, Jr. and Charles E. Christmas is incorporated by reference to exhibit 10.2 of our Form 8-K filed July 5, 2012 *
10.44	2013 Mercantile Executive Officer Bonus Plan, incorporated by reference to exhibit 10.1 of our Form 8-K filed May 5, 2013 *
10.45	Form of Voting Agreement dated August 14, 2013, incorporated by reference to exhibit 10.1 of our Form 8-K filed August 15, 2013
10.46	Employment Agreement with Thomas Sullivan dated August 14, 2013, incorporated by reference to exhibit 10.2 of our Form 8-K filed August 15, 2013
10.47	Employment Agreement with Samuel Stone dated August 14, 2013, incorporated by reference to exhibit 10.3 of our Form 8-K filed August 15, 2013
10.48	Master Agreement between Fiserv Solutions, Inc. and our bank dated November 18, 2013
21	Subsidiaries of the company
23	Consent of BDO USA, LLP
31	Rule 13a-14(a) Certifications
32.1	Section 1350 Chief Executive Officer Certification
32.2	Section 1350 Chief Financial Officer Certification



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EXHIBIT NO.	EXHIBIT DESCRIPTION
99.1	Certification of our principal executive officer and principal financial officer relating to our participation in the Capital Purchase Program of the Troubled Asset Relief Program, covering January 1, 2012 to June 6, 2012, and incorporated by reference to exhibit 99.1 of our Form 10-K filed March 14, 2013
101	The following information from Mercantile's Annual Report on Form 10-K for the year ended December 31, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Changes in Shareholders' Equity, (v) the Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements

\* Management contract or compensatory plan.

(c) Financial Statements Not Included In Annual Report

Not applicable

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**MERCANTILE BANK CORPORATION**

**FINANCIAL INFORMATION**

December 31, 2013 and 2012

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MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION

December 31, 2013 and 2012

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**Table of Contents****SELECTED FINANCIAL DATA**

	2013	2012	2011	2010	2009
	(Dollars in thousands except per share data)				
<b>Consolidated Results of Operations:</b>					
Interest income	\$ 58,242	\$ 59,917	\$ 71,069	\$ 88,143	\$ 104,909
Interest expense	10,786	13,216	19,832	31,794	53,576
Net interest income	47,456	46,701	51,237	56,349	51,333
Provision for loan losses	(7,200)	(3,100)	6,900	31,800	59,000
Noninterest income	6,872	7,994	7,282	9,244	7,558
Noninterest expense	36,403	39,624	41,495	47,156	46,488
Income (loss) before income tax expense (benefit)	25,125	18,171	10,124	(13,363)	(46,597)
Income tax expense (benefit)	8,092	5,636	(27,361)	(47)	5,490
Net income (loss)	17,033	12,535	37,485	(13,316)	(52,087)
Preferred stock dividends and accretion	0	1,030	1,343	1,295	802
Net income (loss) attributable to common shares	\$ 17,033	\$ 11,505	\$ 36,142	\$ (14,611)	\$ (52,889)
<b>Consolidated Balance Sheet Data:</b>					
Total assets	\$ 1,426,966	\$ 1,422,926	\$ 1,433,229	\$ 1,632,421	\$ 1,906,208
Cash and cash equivalents	146,965	136,003	76,372	64,198	21,735
Securities	143,139	150,275	184,953	235,175	257,384
Loans	1,053,243	1,041,189	1,072,422	1,262,630	1,539,818
Allowance for loan losses	22,821	28,677	36,532	45,368	47,878
Bank owned life insurance	51,377	50,048	48,520	46,743	45,024
Deposits	1,118,911	1,135,204	1,112,075	1,273,832	1,401,627
Securities sold under agreements to repurchase	69,305	64,765	72,569	116,979	99,755
Federal Home Loan Bank advances	45,000	35,000	45,000	65,000	205,000
Subordinated debentures	32,990	32,990	32,990	32,990	32,990
Shareholders equity	153,325	146,590	164,999	125,936	140,104
<b>Consolidated Financial Ratios:</b>					
Return on average assets	1.22%	0.82%	2.36%	(0.80%)	(2.51%)
Return on average shareholders equity	11.36%	7.51%	27.28%	(10.62%)	(29.91%)
Average shareholders equity to average assets	10.77%	10.90%	8.66%	7.56%	8.40%

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Nonperforming loans to total loans	0.64%	1.82%	4.20%	5.50%	5.52%
Allowance for loan losses to total loans	2.17%	2.75%	3.41%	3.59%	3.11%
Tier 1 leverage capital	12.53%	11.31%	12.09%	9.09%	8.64%
Tier 1 leverage risk-based capital	14.65%	13.37%	14.19%	11.17%	9.92%
Total risk-based capital	15.91%	14.63%	15.46%	12.45%	11.18%
<b>Per Common Share Data:</b>					
Net income (loss):					
Basic	\$ 1.96	\$ 1.33	\$ 4.20	\$ (1.72)	\$ (6.23)
Diluted	1.95	1.30	4.07	(1.72)	(6.23)
Book value at end of period	17.54	16.84	16.73	12.20	13.86
Dividends declared	0.45	0.09	0.00	0.01	0.07
Dividend payout ratio	22.83%	6.73%	NA	NA	NA

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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. Management has 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 operating earnings.



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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. During 2011, we returned to pre-tax profitability for four consecutive quarters. Additionally, we experienced lower provision expense, continued declines in nonperforming assets and problem asset administration costs, a higher net interest margin, a further strengthening of our regulatory capital ratios and additional reductions in wholesale funding. This positive evidence allowed us to conclude that, as of December 31, 2011, it was more likely than not that we returned to sustainable profitability in amounts sufficient to allow for realization of our deferred tax assets in future years. Consequently, we reversed the valuation allowance that we had previously determined necessary to carry against our entire net deferred tax asset as of December 31, 2010 and 2009.



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**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 Mortgage Company, LLC (our mortgage company), 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.

On December 12, 2013, our shareholders and the shareholders of Firstbank Corporation overwhelmingly voted to approve an Agreement and Plan of Merger providing for the merger of Mercantile and Firstbank. Under the terms of the merger agreement, Firstbank will be merged with and into Mercantile, with Mercantile as the surviving corporation. The merger will be consummated once we have obtained the required regulatory approvals and the other closing conditions have been satisfied. For additional information, see Item 1 Business Merger Agreement in this Annual Report.

**FINANCIAL OVERVIEW**

Our operating performance and financial condition continued to improve during 2013. In prior years, especially in 2008 through 2010, our earnings performance was negatively impacted by substantial provisions to the allowance and problem asset administration costs. During that period, ongoing state, regional and national economic struggles negatively impacted some of our borrowers' cash flows and underlying collateral values, leading to increased nonperforming assets, higher loan charge-offs and increased overall credit risk within our loan portfolio. We have worked with our borrowers to develop constructive dialogue to strengthen our relationships and enhance our ability to resolve complex issues. As a result of these efforts and improved economic conditions, we have experienced significant improvement in our asset quality since the early stages of 2011, resulting in substantially lower provisions to the allowance and problem asset administration costs. Although improving, conditions remain stressed in some sectors, most notably in certain non-owner occupied commercial real estate markets. While we have increased our sales efforts to grow the commercial loan portfolio, we remain vigilant as to the administration and quality of our loan portfolio.

We recorded a net profit during 2013, 2012 and 2011, after recording net losses during the prior three years. Significantly improved asset quality has resulted in lower provision expense and problem asset administration costs. In addition, our improved earnings performance reflects many positive steps we have taken over the past six years to not only partially mitigate the impact of asset quality-related costs in the short term, but to establish an improved foundation for our longer-term performance as well. First, our net interest margin has improved as we have lowered local deposit rates and have replaced maturing high-rate deposits and borrowed funds with lower-costing funds, which has more than offset a decline in asset yields primarily due to a lower interest rate environment. Our commercial loan pricing initiatives have significantly mitigated the negative impact of a higher level of nonaccrual loans. In addition, we have increased our local deposit balances, primarily reflecting the successful implementation of various initiatives, campaigns and product enhancements. The local deposit growth, combined with the reduction of loans outstanding, have provided for a substantial reduction of, and reliance on, wholesale funds and a reduction in our cost of funds. Lastly, our regulatory capital position remains strong.

Our asset quality metrics remain on an improving trend, and we are optimistic that the positive trend will continue. In aggregate dollar amounts, nonperforming asset levels have declined over 91% since the peak level at March 31, 2010, and at year-end 2013 were at the lowest level since year-end 2006. Progress in the stabilization of economic and real

estate market conditions has resulted in numerous loan rating upgrades and significantly less loan rating downgrades, which when combined with increasing recoveries of prior loan charge-offs, have provided for a substantially lower provision expense.

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**Table of Contents****FINANCIAL CONDITION**

Our total assets were virtually unchanged during 2013, increasing \$4.0 million, and totaling \$1.43 billion as of December 31, 2013. During 2013, total loans and federal funds sold increased \$12.1 million and \$18.5 million, respectively, while securities declined \$7.1 million. Total deposits declined \$16.3 million, while Federal Home Loan Bank ( FHLB ) advances and securities sold under agreements to repurchase ( repurchase agreements ) increased \$10.0 million and \$4.5 million, respectively.

***Earning Assets***

Average earning assets equaled 92.3% of average total assets during 2013, compared to 91.7% during 2012. The increase during 2013 was in large part due to a decrease in nonearning assets resulting from a refund of prepaid FDIC insurance assessments in June of 2013, a lower average balance of foreclosed assets and a reduction in our average net deferred tax asset primarily from use of the imbedded tax loss carryforward. The loan portfolio continued to comprise a majority of earning assets, followed by securities, federal funds sold and interest-bearing deposits; however, during 2013, as in the three years prior, securities, federal funds sold and interest-bearing deposits comprised a larger percentage of earning assets compared to historical levels, primarily reflecting our decision to operate with a larger volume of on-balance sheet liquidity given market conditions. Average total loans equaled 81.7% of average earning assets in 2013, compared to 81.4%, 79.6% and 81.8% in 2012, 2011 and 2010, respectively. Meanwhile, average securities, federal funds sold and interest-bearing deposits equaled a combined 18.3% of average earning assets in 2013, compared to 18.6%, 20.4%, and 18.2% in 2012, 2011 and 2010, respectively. Historically, our average total loans comprised about 89% of average earning assets.

Our loan portfolio is primarily comprised of commercial loans. Commercial loans increased \$18.2 million during 2013, and at December 31, 2013, totaled \$986.7 million, or 93.7% of the total loan portfolio. The \$18.2 million increase includes approximately \$230 million in new commercial loans funded during the year. Non-owner occupied commercial real estate ( CRE ) loans increased \$39.2 million, owner occupied CRE loans were up \$2.6 million and commercial and industrial loans grew \$1.1 million, while multi-family and residential rental loans declined \$13.3 million and vacant land, land development and residential construction loans were down \$11.4 million.

We are very pleased with the approximately \$406 million in new commercial loan fundings during the past two years, and our current pipeline reports indicate continued strong commercial loan funding opportunities in future periods. Starting in early 2012, with a pruned commercial loan portfolio, an improved earnings performance and financial condition, and stabilized economic conditions, we significantly enhanced our commercial loan sales efforts. However, we experienced significant commercial loan paydowns and payoffs. A majority of these principal paydowns and payoffs were welcomed, such as on stressed loan relationships; however, we also experienced instances where performing relationships had been refinanced at other financial institutions and other situations where the borrower had sold the underlying asset, paying off the loan. In many of those cases where the loans were 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. In addition, we continued to receive accelerated principal paydowns from certain borrowers who had elevated deposit balances generally resulting from profitable operations and an apparent unwillingness to expand their businesses and/or replace equipment primarily due to economic- and tax-related uncertainties. Usage of existing commercial lines of credit remained relatively steady.

Although we had significant commercial loan pay-offs during the past two years, the net decline in the commercial loan portfolio total balance is much smaller than what we experienced during the previous three years. During the period of 2009 through 2011, we had made a concerted effort to reduce exposure to certain non-owner occupied

commercial real estate lending, and the sluggishness in business activity in our markets resulted in fewer opportunities to make quality loans. We employed a systematic approach to reducing our exposure to certain non-owner occupied CRE lending given the nature of CRE lending and depressed economic conditions. We believed that such a reduction was in our best interest when taking into account the increased inherent credit risk and nominal deposit balances associated with targeted borrowing relationships.

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During 2012, commercial loans collateralized by non-owner occupied CRE declined \$9.3 million, compared to a reduction of \$178.9 million during the previous three years. Our commercial and industrial ( C&I ) loan portfolio increased \$18.8 million during 2012, in large part reflecting new borrowing relationships established during the year. Commercial line of credit usage from existing borrowing relationships was relatively steady during 2012, but we would expect to see higher commercial line of credit usage, along with increased equipment financing requests, when economic conditions further improve. Also during 2012, commercial loans collateralized by owner-occupied real estate declined \$5.1 million and commercial loans related to residential land development and construction decreased by \$15.4 million.

The commercial loan portfolio represents loans to businesses generally located within our market areas. Approximately 71% of the commercial loan portfolio is primarily secured by real estate properties, with the remaining generally secured by other business assets such as accounts receivable, inventory, and equipment. The continued concentration of the loan portfolio in commercial loans is consistent with our strategy of focusing a substantial amount of our efforts on commercial banking. Corporate and business lending is an area of expertise for our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least ten years experience. Of each of the loan categories that we originate, commercial loans are most efficiently originated and managed, thus limiting overhead costs by necessitating the attention of fewer employees. Our commercial lending business generates the largest portion of local deposits and is our primary source of demand deposits.

Residential mortgage loans and consumer loans declined in aggregate \$6.1 million during 2013, and at December 31, 2013, totaled \$66.5 million, or 6.3% of the total loan portfolio. Although the residential mortgage loan and consumer loan portfolios may increase in future periods, we expect the commercial sector of the lending efforts and resultant assets to remain the dominant loan portfolio category.

The following table summarizes our loan portfolio:

	12/31/13	12/31/12	12/31/11	12/31/10	12/31/09
<b>Commercial:</b>					
Commercial & Industrial	\$ 286,373,000	\$ 285,322,000	\$ 266,548,000	\$ 288,515,000	\$ 408,234,000
Land Development & Construction	36,741,000	48,099,000	63,467,000	83,786,000	109,293,000
Owner Occupied Commercial RE	261,877,000	259,277,000	264,426,000	277,377,000	332,793,000
Non-Owner Occupied Commercial RE	364,066,000	324,886,000	334,165,000	449,104,000	503,736,000
Multi-Family & Residential Rental	37,639,000	50,922,000	68,299,000	77,188,000	88,657,000
<b>Total Commercial</b>	<b>986,696,000</b>	<b>968,506,000</b>	<b>996,905,000</b>	<b>1,175,970,000</b>	<b>1,442,713,000</b>
<b>Retail:</b>					
1-4 Family Mortgages	31,467,000	33,766,000	33,181,000	35,474,000	39,568,000
Home Equity & Other Consumer Loans	35,080,000	38,917,000	42,336,000	51,186,000	57,537,000

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	66,547,000	72,683,000	75,517,000	86,660,000	97,105,000
Total	\$ 1,053,243,000	\$ 1,041,189,000	\$ 1,072,422,000	\$ 1,262,630,000	\$ 1,539,818,000

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The following table presents total loans outstanding as of December 31, 2013, 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, comprising a majority of our floating rate commercial loans, 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	\$ 39,202,000	\$ 50,517,000	\$ 4,481,000	\$ 94,200,000
Real estate residential properties	32,280,000	26,257,000	13,515,000	72,052,000
Real estate multi-family properties	6,697,000	19,253,000	205,000	26,155,000
Real estate commercial properties	109,379,000	439,124,000	31,554,000	580,057,000
Commercial and industrial	168,899,000	105,818,000	3,374,000	278,091,000
Consumer	1,684,000	761,000	243,000	2,688,000
<b>Total loans</b>	<b>\$ 358,141,000</b>	<b>\$ 641,730,000</b>	<b>\$ 53,372,000</b>	<b>\$ 1,053,243,000</b>
Fixed rate loans	\$ 226,696,000	\$ 635,256,000	\$ 53,345,000	\$ 915,297,000
Floating rate loans	131,445,000	6,474,000	27,000	137,946,000
<b>Total loans</b>	<b>\$ 358,141,000</b>	<b>\$ 641,730,000</b>	<b>\$ 53,372,000</b>	<b>\$ 1,053,243,000</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.

Our asset quality continued to improve significantly during 2013, and has now been on an improving trend for over three years. Nonperforming assets, comprised of nonaccrual loans and foreclosed properties, totaled \$9.6 million as of December 31, 2013, compared to \$25.9 million at December 31, 2012. The volume of nonperforming assets has generally been on a declining trend since the peak of \$117.6 million on March 31, 2010, and is currently at its lowest level since year-end 2006. The level of nonperforming assets began to increase during 2007, with ongoing and significant increases during 2008 and 2009. The increases primarily reflected the impact of poor economic conditions and the resulting negative impact on many of our commercial borrowers' operating results and financial condition, but were also indicative of our aggressive posture and conservative loan administration practices in regards to measuring borrower financial strength and assigning loan grades on the entire commercial loan portfolio, and developing workout strategies for financially-troubled borrowers. Since 2009, the level of additions to the nonperforming asset category has declined significantly, while the level of interest in, and sales of, foreclosed properties and assets

securing nonperforming loans has increased substantially. We believe that our loan administration strategies, combined with a stabilization of economic conditions, have provided for significant improvement in our asset quality and have given us optimism that the momentum will continue into future periods.

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The substantial and rapid country-wide collapse of the residential real estate market that started in 2007 had a significant negative impact on the residential real estate development lending portion of our business. The resulting decline in real estate prices and slowdown in sales stretched the cash flow of our local developers and eroded the value of our underlying collateral, which caused elevated levels of nonperforming assets and net loan charge-offs. From the period of 2007 through most of 2011, we witnessed stressed economic conditions in Michigan and throughout the country. The resulting decline in business revenue negatively impacted the cash flows of many of our borrowers, some to the point where loan payments became past due. In addition, real estate prices had fallen significantly, thereby exposing us to larger-than-typical losses in those instances where the sale of collateral was the primary source of repayment. Also during this time, we saw deterioration in guarantors' financial capacities to fund deficient cash flows and reduce or eliminate collateral deficiencies.

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

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

As of December 31, 2013, nonperforming assets totaled \$9.6 million, or 0.7% of total assets, compared to \$25.9 million (1.8% of total assets), \$60.4 million (4.2% of total assets), \$86.1 million (5.3% of total assets) and \$111.7 million (5.9% of total assets) as of December 31, 2012, 2011, 2010 and 2009, respectively. The reductions primarily reflect principal payments and charge-offs on nonaccruals loans, as well as sales proceeds and valuation write-downs on foreclosed properties. The \$16.3 million reduction during 2013 and the \$102.1 million reduction during the four-year period ended December 31, 2013 equate to declines of 63.1% and 91.4%, respectively.

As of December 31, 2013, nonperforming loans secured by and foreclosed properties associated with non-owner occupied CRE properties totaled \$2.1 million, reflecting reductions of \$11.1 million and \$36.3 million during 2013 and the four-year period ended December 31, 2013, respectively. Nonperforming loans secured by and foreclosed properties consisting of owner occupied CRE properties totaled \$1.0 million as of December 31, 2013, reflecting reductions of \$2.5 million and \$18.9 million during 2013 and the four-year period ended December 31, 2013, respectively. Nonperforming loans secured by and foreclosed properties associated with residential real estate totaled \$4.9 million as of December 31, 2013, reflecting reductions of \$2.7 million and \$34.4 million during 2013 and the four-year period ended December 31, 2013, respectively.

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

**NONPERFORMING LOANS**

	12/31/13	12/31/12	12/31/11	12/31/10	12/31/09
<b>Residential Real Estate:</b>					
Land Development	\$ 40,000	\$ 1,188,000	\$ 1,179,000	\$ 11,775,000	\$ 13,852,000
Construction	0	319,000	686,000	1,037,000	10,229,000
Owner Occupied / Rental	4,219,000	4,321,000	6,018,000	9,149,000	6,399,000
	4,259,000	5,828,000	7,883,000	21,961,000	30,480,000
<b>Commercial Real Estate:</b>					
Land Development	389,000	737,000	1,661,000	2,044,000	2,509,000
Construction	0	0	409,000	0	1,268,000
Owner Occupied	885,000	2,577,000	8,133,000	11,629,000	14,463,000
Non-Owner Occupied	169,000	9,093,000	23,914,000	25,428,000	26,747,000
	1,443,000	12,407,000	34,117,000	39,101,000	44,987,000
<b>Non-Real Estate:</b>					
Commercial Assets	1,016,000	734,000	3,060,000	8,221,000	9,583,000
Consumer Assets	0	1,000	14,000	161,000	0
	1,016,000	735,000	3,074,000	8,382,000	9,583,000
<b>Total</b>	<b>\$ 6,718,000</b>	<b>\$ 18,970,000</b>	<b>\$ 45,074,000</b>	<b>\$ 69,444,000</b>	<b>\$ 85,050,000</b>

**OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS**

	12/31/13	12/31/12	12/31/11	12/31/10	12/31/09
<b>Residential Real Estate:</b>					
Land Development	\$ 427,000	\$ 1,174,000	\$ 4,300,000	\$ 2,772,000	\$ 5,870,000
Construction	22,000	157,000	711,000	1,296,000	1,874,000
Owner Occupied / Rental	207,000	491,000	1,120,000	305,000	1,094,000
	656,000	1,822,000	6,131,000	4,373,000	8,838,000
<b>Commercial Real Estate:</b>					
Land Development	92,000	52,000	450,000	410,000	462,000
Construction	0	0	0	0	0
Owner Occupied	164,000	957,000	2,509,000	3,111,000	5,455,000
Non-Owner Occupied	1,939,000	4,139,000	6,192,000	8,781,000	11,670,000
	2,195,000	5,148,000	9,151,000	12,302,000	17,587,000

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Non-Real Estate:

Commercial Assets	0	0	0	0	175,000
Consumer Assets	0	0	0	0	8,000
	0	0	0	0	183,000
Total	\$ 2,851,000	\$ 6,970,000	\$ 15,282,000	\$ 16,675,000	\$ 26,608,000

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The following tables provide a reconciliation of nonperforming assets:

**NONPERFORMING LOANS RECONCILIATION**

	2013	2012	2011	2010	2009
Beginning balance	\$ 18,970,000	\$ 45,074,000	\$ 69,444,000	\$ 85,050,000	\$ 49,303,000
Additions, net of transfers to ORE	1,726,000	4,998,000	12,750,000	51,503,000	83,499,000
Returns to performing status	0	(774,000)	(766,000)	(11,124,000)	(1,203,000)
Principal payments	(10,934,000)	(25,095,000)	(24,795,000)	(24,213,000)	(19,115,000)
Loan charge-offs	(3,044,000)	(5,233,000)	(11,559,000)	(31,772,000)	(27,434,000)
Total	\$ 6,718,000	\$ 18,970,000	\$ 45,074,000	\$ 69,444,000	\$ 85,050,000

**OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION**

	2013	2012	2011	2010	2009
Beginning balance	\$ 6,970,000	\$ 15,282,000	\$ 16,675,000	\$ 26,608,000	\$ 8,118,000
Additions	2,181,000	11,808,000	11,504,000	9,159,000	29,137,000
Sale proceeds	(5,585,000)	(16,916,000)	(10,340,000)	(13,969,000)	(6,918,000)
Valuation write-downs	(715,000)	(3,204,000)	(2,557,000)	(5,123,000)	(3,729,000)
Total	\$ 2,851,000	\$ 6,970,000	\$ 15,282,000	\$ 16,675,000	\$ 26,608,000

The level of net loan charge-offs continued to improve during 2013, especially in comparison to the levels charged-off during 2010 and 2009. The improvement primarily reflects a decline in nonperforming loans, an overall improvement in the quality of the loan portfolio and significant recoveries of prior period charge-offs. During 2013, we recorded a net recovery of prior period charge-offs totaling \$1.3 million, or a negative 0.1% of average total loans. By comparison, net loan charge-offs totaled \$4.8 million (0.5% of average total loans), \$15.7 million (1.4% of average total loans), \$34.3 million (2.4% of average total loans) and \$38.2 million (2.2% of average total loans) during 2012, 2011, 2010 and 2009, respectively. Loan charge-offs totaled \$5.3 million during 2013, compared to \$12.7 million, \$19.9 million, \$37.1 million and \$39.6 million during 2012, 2011, 2010 and 2009, respectively. Recoveries of previously charged-off loans totaled \$6.6 million during 2013, compared to \$7.9 million, \$4.2 million, \$2.8 million and \$1.4 million in 2012, 2011, 2010 and 2009, respectively.

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The following table provides a breakdown of net loan charge-offs (recoveries) by collateral type during the past five years:

	2013	2012	2011	2010	2009
<b>Residential Real Estate:</b>					
Land Development	\$ 106,000	\$ (114,000)	\$ 2,644,000	\$ 4,246,000	\$ 4,355,000
Construction	0	10,000	(110,000)	1,502,000	5,050,000
Owner Occupied / Rental	(71,000)	469,000	4,016,000	2,065,000	3,647,000
	35,000	365,000	6,550,000	7,813,000	13,052,000
<b>Commercial Real Estate:</b>					
Land Development	(180,000)	167,000	(163,000)	1,870,000	119,000
Construction	0	0	0	660,000	0
Owner Occupied	21,000	1,230,000	2,241,000	4,952,000	3,062,000
Non-Owner Occupied	131,000	4,021,000	5,104,000	13,943,000	9,407,000
	(28,000)	5,418,000	7,182,000	21,425,000	12,588,000
<b>Non-Real Estate:</b>					
Commercial Assets	(1,352,000)	(1,016,000)	1,861,000	5,018,000	12,413,000
Consumer Assets	1,000	(12,000)	143,000	54,000	177,000
	(1,351,000)	(1,028,000)	2,004,000	5,072,000	12,590,000
<b>Total</b>	<b>\$ (1,344,000)</b>	<b>\$ 4,755,000</b>	<b>\$ 15,736,000</b>	<b>\$ 34,310,000</b>	<b>\$ 38,230,000</b>

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

	2013	2012	2011	2010	2009
Loans outstanding at year-end	\$ 1,053,243,000	\$ 1,041,189,000	\$ 1,072,422,000	\$ 1,262,630,000	\$ 1,539,818,000
Daily average balance of loans outstanding during the year	\$ 1,050,961,000	\$ 1,049,315,000	\$ 1,148,671,000	\$ 1,412,555,000	\$ 1,704,335,000
Balance of allowance at beginning of year	\$ 28,677,000	\$ 36,532,000	\$ 45,368,000	\$ 47,878,000	\$ 27,108,000
Loans charged-off:					
Commercial, financial and agricultural	(3,596,000)	(11,311,000)	(12,373,000)	(25,539,000)	(25,978,000)
Construction and land development	(822,000)	(348,000)	(2,919,000)	(9,273,000)	(9,606,000)
Residential real estate	(862,000)	(938,000)	(4,422,000)	(2,242,000)	(3,797,000)
Instalment loans to individuals	(10,000)	(46,000)	(183,000)	(74,000)	(240,000)
Total charge-offs	(5,290,000)	(12,643,000)	(19,897,000)	(37,128,000)	(39,621,000)
Recoveries of previously charged-off loans:					
Commercial, financial and agricultural	4,795,000	7,076,000	3,186,000	1,637,000	1,145,000
Construction and land development	897,000	285,000	441,000	995,000	81,000
Residential real estate	933,000	469,000	513,000	178,000	150,000
	9,000	58,000	21,000	8,000	15,000

Instalment  
loans to  
individuals

Total recoveries	6,634,000	7,888,000	4,161,000	2,818,000	1,391,000
Net loan charge-offs	1,344,000	(4,755,000)	(15,736,000)	(34,310,000)	(38,230,000)
Provision for loan losses	(7,200,000)	(3,100,000)	6,900,000	31,800,000	59,000,000
Balance of allowance at year-end	\$ 22,821,000	\$ 28,677,000	\$ 36,532,000	\$ 45,368,000	\$ 47,878,000
Ratio of net loan charge-offs during the year to average loans outstanding during the year	0.13%	(0.45%)	(1.37%)	(2.43%)	(2.24%)
Ratio of allowance to loans outstanding at year-end	2.17%	2.75%	3.41%	3.59%	3.11%

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

	12/31/2013		12/31/2012		12/31/2011		12/31/2010		12/31/2009	
	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio
Commercial, financial and agricultural	\$ 17,786	84.0%	\$ 22,646	85.3%	\$ 28,913	83.3%	\$ 32,645	81.5%	\$ 37,639	80.1%
Construction and land development	1,858	8.9	2,246	6.2	3,484	7.5	7,019	9.3	6,566	11.4
Residential real estate	3,027	6.8	3,646	8.1	3,895	8.8	5,495	8.8	3,517	8.1
Instalment loans to individuals	68	0.3	139	0.4	158	0.4	172	0.4	156	0.4
Unallocated	82	0.0	0	0.0	82	0.0	37	0.0	0	0.0
<b>Total</b>	<b>\$ 22,821</b>	<b>100.0%</b>	<b>\$ 28,677</b>	<b>100.0%</b>	<b>\$ 36,532</b>	<b>100.0%</b>	<b>\$ 45,368</b>	<b>100.0%</b>	<b>\$ 47,878</b>	<b>100.0%</b>

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 dollar amount. For non-impaired commercial loans, which continue to comprise a vast majority of our total loans, reserve allocation factors are based upon loan ratings as determined by our standardized grade paradigms and by loan purpose. We have divided our commercial loan portfolio into five classes: 1) commercial and industrial loans; 2) vacant land, land development and residential construction loans; 3) owner occupied real estate loans; 4) non-owner occupied real estate loans; and 5) multi-family and residential rental property loans. The reserve allocation factors are primarily based on the historical trends of net loan charge-offs through a migration analysis whereby net loan losses are tracked via assigned grades over various time periods, with adjustments made for environmental factors reflecting the current status of, or recent changes in, items such as: lending policies and procedures; economic conditions; nature and volume of the loan portfolio; experience, ability and depth of management and lending staff; volume and severity of past due, nonaccrual and adversely classified loans; effectiveness of the loan review program; value of underlying collateral; 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 commercial loans. Our migration takes into account various time periods, and while we have historically generally placed most weight on the eight-quarter time frame, consideration was given to the other time periods as part of our assessment. Given the stabilizing loan losses experienced in recent years in comparison to loan losses recorded in the more stressed economic conditions in earlier time periods, we decided to transition from the eight-quarter time frame to a longer twelve-quarter time frame during 2012. We believe the twelve-quarter period represents a more appropriate range of economic conditions, and that it provides for a more relevant basis in determining reserve allocation factors given current economic conditions and the general 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 commercial loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data.

Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings.

Although we have been consistent in our approach to commercial loan ratings, the stressed economic conditions of the past several years have resulted in an even higher sense of aggressiveness with regards to the downgrading of lending relationships. For example, we made revisions to our grading paradigms in early 2009 that mathematically resulted in commercial loan relationships being more quickly downgraded when signs of stress are noted, such as slower sales activity for construction and land development commercial real estate relationships and reduced operating performance/cash flow coverage for commercial and industrial relationships. These changes, coupled with the stressed economic environment, resulted in significant downgrades and the need for substantial provisions to the allowance during the three-year period ended December 31, 2010. To more effectively manage our commercial loan portfolio, we also created a specific group tasked with managing our most distressed lending relationships.

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

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

Reflecting the stressed economic conditions and resulting negative impact on our loan portfolio, we substantially increased the allowance as a percent of the loan portfolio beginning in 2009. However, with the improved quality of our loan portfolio, we have reduced the allowance in recent periods. The allowance equaled \$22.8 million, or 2.2% of total loans, as of December 31, 2013. By comparison, the allowance equaled 2.8%, 3.4%, 3.6%, 3.1%, 1.5% and 1.4% of total loans at year-end 2012, 2011, 2010, 2009, 2008 and 2007, respectively. A significant portion of the decline in the level of the allowance during 2013 and 2012 reflects the charge-off of specific reserves that were created in prior periods and the elimination and reduction of specific reserves due to successful collection efforts, while the remainder of the decline is primarily associated with commercial loan upgrades and reductions in many reserve allocation factors on non-impaired commercial loans resulting from the impact of lower net loan charge-offs in recent periods on our migration calculations. The allowance equaled 339.7% of nonperforming loans as of December 31, 2013, compared to 151.2%, 81.0%, 65.3%, 56.3%, 55.0% and 86.6% at year-end 2012, 2011, 2010, 2009, 2008 and 2007, respectively. This particular allowance measurement has increased significantly during the past two years, reflecting total nonperforming loans declining at a faster rate than the balance of the allowance and certain higher-balance commercial loan relationships being categorized as troubled debt restructurings resulting in higher specific reserve allocations.

As of December 31, 2013, the allowance was comprised of \$10.4 million in general reserves relating to non-impaired loans, \$2.0 million in specific reserve allocations relating to nonaccrual loans, and \$10.4 million in specific allocations on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$34.9 million at December 31, 2013, consisting of \$4.6 million that are on nonaccrual status and \$30.3 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 \$3.1 million as of December 31, 2013 had been subject to previous partial charge-offs aggregating \$3.1 million. Those partial charge-offs were recorded as follows: \$1.1 million in 2013, \$1.2 million in 2012, \$0.6 million in 2011 and \$0.2 million in 2010. As of December 31, 2013, specific reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled \$0.1 million.

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

	12/31/13	12/31/12	12/31/11	12/31/10	12/31/09
Performing	\$ 30,247,000	\$ 38,148,000	\$ 26,155,000	\$ 12,263,000	\$ 2,988,000
Nonperforming	4,645,000	12,612,000	14,508,000	19,050,000	33,017,000
<b>Total</b>	<b>\$ 34,892,000</b>	<b>\$ 50,760,000</b>	<b>\$ 40,663,000</b>	<b>\$ 31,313,000</b>	<b>\$ 36,005,000</b>

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.

Securities decreased \$7.1 million during 2013, totaling \$143.1 million as of December 31, 2013. The securities portfolio equaled 11.2% of average earning assets during 2013. Proceeds from called U.S. Government agency bonds during 2013 totaled \$20.0 million, with another \$7.8 million from principal paydowns on mortgage-backed securities and \$6.1 million from called and matured tax-exempt municipal securities. In addition, we received \$10.3 million from the sale of, and \$0.9 million from principal payments on, Michigan Strategic Fund bonds. Purchases during 2013, consisting almost exclusively of U.S. Government agency bonds, totaled \$49.8 million. All of our securities, exclusive of FHLB stock, 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, 2013 totaled \$131.2 million, including a net unrealized loss of \$8.3 million. As of December 31, 2012, the securities portfolio had a net unrealized gain of \$3.7 million. The \$12.0 million decline in market value during 2013 primarily results from higher medium and longer-term market interest rates, which increased in a range of approximately 75 to 100 basis points during the year. We maintain the securities portfolio at levels to provide for required pledging purposes and secondary liquidity for daily operations. In addition, the portfolio serves a primary interest rate risk management function.

The following table reflects the composition of the securities portfolio, excluding FHLB stock:

	12/31/13		12/31/12		12/31/11	
	Carrying Value	Percent	Carrying Value	Percent	Carrying Value	Percent
U.S. Government agency debt obligations	\$ 98,477,000	75.1%	\$ 79,098,000	57.2%	\$ 88,596,000	51.2%
Mortgage-backed Securities	13,558,000	10.3	21,996,000	15.9	34,610,000	20.0
Michigan Strategic Fund bonds	0	0.0	11,255,000	8.1	16,700,000	9.7
Municipal general Obligations	16,872,000	12.9	22,743,000	16.5	27,309,000	15.8
Municipal revenue bonds	916,000	0.7	1,817,000	1.3	4,423,000	2.5
Mutual funds	1,355,000	1.0	1,405,000	1.0	1,354,000	0.8
<b>Totals</b>	<b>\$ 131,178,000</b>	<b>100.0%</b>	<b>\$ 138,314,000</b>	<b>100.0%</b>	<b>\$ 172,992,000</b>	<b>100.0%</b>

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FHLB stock totaled \$12.0 million as of December 31, 2013, unchanged from December 31, 2012. Our investment in FHLB stock is necessary to participate in their advance and other financing programs. We received cash dividends at an average rate of approximately 3.50%, 3.25%, 2.50% and 2.00% during 2013, 2012, 2011 and 2010, respectively, and we expect a cash dividend will continue to be paid in future periods.

Market values on our U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies and tax-exempt general obligation and revenue municipal bonds are determined on a monthly basis with the assistance of a third party vendor. Evaluated pricing models that vary by type of security and incorporate available market data are utilized. Standard inputs include issuer and type of security, benchmark yields, reported trades, broker/dealer quotes and issuer spreads. The market value of other securities is estimated at carrying value as those financial instruments are generally bought and sold at par value. We believe our valuation methodology provides for a reasonable estimation of market value, and that it is consistent with the requirements of accounting guidelines. Reference is made to Note 15 of the Notes to Consolidated Financial Statements for additional information.

The following table shows by class of maturities as of December 31, 2013, the amounts and weighted average yields (on a fully taxable-equivalent basis) of investment securities:

	Carrying Value	Average Yield
<b>Obligations of U.S. Government agencies:</b>		
One year or less	\$ 2,046,000	5.12%
Over one through five years	0	0.00
Over five through ten years	23,925,000	2.37
Over ten years	72,506,000	3.44
	98,477,000	3.22
<b>Obligations of states and political subdivisions:</b>		
One year or less	448,000	6.23
Over one through five years	1,047,000	6.31
Over five through ten years	7,083,000	5.94
Over ten years	9,210,000	5.93
	17,788,000	5.97
Mortgage-backed securities	13,558,000	5.17
Mutual funds	1,355,000	2.32
<b>Totals</b>	<b>\$ 131,178,000</b>	<b>3.73%</b>

Federal funds sold, consisting of excess funds sold overnight to a correspondent bank, along with investments in interest-bearing deposits at correspondent and other banks, are used to manage daily liquidity needs and interest rate sensitivity. The average balance of these funds equaled 7.1%, 6.7%, 6.1%, 4.5% and 3.0% of average earning assets during 2013, 2012, 2011, 2010, and 2009, respectively, considerably higher than the historical average of less than 1.0%. Given the stressed market and economic conditions, we made the decision in early 2009 to operate with a higher than traditional balance of federal funds sold and interest-bearing deposits. Reflecting our improved operating performance and financial condition, we expect to modestly reduce the level of federal funds sold and interest-bearing

deposits in 2014, likely to an average of 3.0% to 4.0% of average earning assets; however, until market and economic conditions return to more normalized levels, the average balance of federal funds sold and interest-bearing balances will likely remain above our historical average of less than 1.0%.

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**Table of Contents*****Non-Earning Assets***

Cash and due from bank balances totaled \$17.1 million at December 31, 2013, compared to \$20.3 million on December 31, 2012. Cash and due from bank balances averaged \$17.4 million during 2013, compared to \$16.2 million during 2012. Net premises and equipment decreased from \$25.9 million at December 31, 2012, to \$24.9 million on December 31, 2013, primarily reflecting depreciation expense. Purchases of premises and equipment during 2013 totaled \$0.3 million.

On December 30, 2009, all FDIC-insured financial institutions were required to prepay estimated FDIC deposit insurance assessments for the fourth quarter of 2009 and the years 2010, 2011 and 2012. The prepaid amounts were used to offset regular quarterly deposit insurance assessments. The amount we paid equaled \$16.3 million, which was expensed over the future quarterly assessment periods. The balance at December 31, 2012 equaled \$8.3 million. Per regulations, any unused portion of the amount prepaid remaining after payment of amounts due on June 30, 2013 would be returned to us by the FDIC; we received \$8.1 million on June 28, 2013.

Foreclosed and repossessed assets totaled \$2.9 million at December 31, 2013, compared to \$7.0 million on December 31, 2012, \$15.3 million on December 31, 2011, \$16.7 million on December 31, 2010 and \$26.6 million on December 31, 2009. The \$4.1 million decline during 2013 consisted of \$7.9 million in sales proceeds (includes \$1.6 million in net gains on sales and valuation write-downs), which was partially offset by \$2.2 million in transfers from the loan portfolio. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on impaired lending relationships, we believe the improved quality of our loan portfolio combined with the increased sales activity we have experienced during the past couple of years will continue and limit the overall increase in, and average balance of, this nonperforming asset category.

***Source of Funds***

Our major sources of funds are from deposits, repurchase agreements and FHLB advances. Total deposits decreased from \$1.14 billion at December 31, 2012 to \$1.12 billion on December 31, 2013, a decrease of \$16.3 million. In comparing total deposit balances as of December 31, 2013 to those at December 31, 2008, total deposits have declined by \$480.7 million. Local deposits increased \$435.4 million during the five-year period ended December 31, 2013, while out-of-area deposits decreased \$916.1 million during the same time period. As of December 31, 2013, local deposits comprised 81.0% of total deposits, compared to 76.2% and 29.4% at December 31, 2012 and December 31, 2008, respectively.

Repurchase agreements increased from \$64.8 million at December 31, 2012 to \$69.3 million on December 31, 2013, an increase of \$4.5 million. As part of our sweep account program, collected funds from certain business noninterest-bearing checking accounts are invested in 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. FHLB advances increased from \$35.0 million at December 31, 2012 to \$45.0 million on December 31, 2013, an increase of \$10.0 million. FHLB advances declined \$225.0 million during the five-year period ended December 31, 2013.

At December 31, 2013, local deposits and repurchase agreements equaled 79.1% of total funding liabilities, compared to 75.3% and 28.5% on December 31, 2012 and December 31, 2008, respectively. The significant reduction in wholesale funding reliance over the past five years is primarily a result of the increase in local deposits and the decline in total loans. The increase in local deposits reflects various programs and initiatives we have implemented over the past several years, including: implementation of several deposit-gathering initiatives in our commercial lending function; introduction of new deposit-related products and services; certificate of deposit campaign, and the

continuation of providing our customers with the latest in technological advances that give improved information, convenience and timeliness.

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Noninterest-bearing checking deposit accounts further increased during 2013, having also increased during 2012 and 2011 after remaining relatively stable over the prior several years. Noninterest-bearing checking accounts averaged \$197.6 million during 2013, compared to an average balance of \$164.1 million and \$137.0 million during 2012 and 2011, respectively, and \$110.0 million to \$120.0 million over the prior several years. The increase in noninterest-bearing deposit balances during the past two years primarily reflects deposit account openings as part of new commercial lending relationships. Increases in noninterest-bearing checking accounts during 2012 and 2011 also reflect transfers from our repurchase agreement product, generally reflecting rate and pricing changes in the latter product.

Local interest-bearing checking accounts increased \$9.3 million during 2013, and are up \$147.1 million since December 31, 2008. Money market deposit accounts decreased \$11.1 million during 2013, but have increased \$108.5 million since year-end 2008. The net increase in both interest-bearing checking accounts and money market deposit accounts over the past five years primarily reflects the success of our enhanced products and marketing programs, as well as relatively aggressive deposit rates, which resulted in many new individual, business and municipality deposits and increased balances from existing deposit account holders and transfers from maturing certificates of deposit. The decline in money market deposit accounts during 2013 is due in large part to significant income tax payments by certain individuals and businesses during April, 2013. Savings deposits decreased \$3.8 million during 2013, after having increased \$24.0 million during 2012, decreased \$27.7 million during 2011, increased \$21.6 million during 2010 and declined \$11.3 million during 2009. The relatively large balance fluctuations in our savings deposits are typical, generally reflecting periodic deposits and withdrawals from several local municipal customers, as well as from certain municipal customers transferring funds between savings accounts and certificates of deposit. In addition, some customers have transferred their savings balances to other deposit products, particularly interest-bearing checking and money market deposit accounts.

Certificates of deposit purchased by customers located within our market areas increased \$11.7 million during 2013, and have increased \$63.3 million since December 31, 2008. A majority of the increase since year-end 2008 reflects our enhanced marketing efforts and transfers from savings accounts from certain municipal customers. Deposits obtained from customers located outside of our market areas declined \$56.7 million during 2013, and are down \$916.1 million during the five-year period ended December 31, 2013. Out-of-area deposits primarily consist of certificates of deposit obtained from depositors located outside our market areas and placed by deposit brokers for a fee, but also include certificates of deposit obtained from the deposit owners directly. The owners of the out-of-area deposits include individuals, businesses and governmental units located throughout the United States. In addition, in early 2011 we established an interest-bearing checking account relationship with an out-of-area depositor engaged in managing retirement accounts. This custodial relationship, which totaled \$22.0 million as of December 31, 2012, was closed during the third quarter of 2013. Reflecting our strategy to reduce our federal funds sold position, we provided notice to the custodian that we wished to terminate the deposit relationship. The significant decline in out-of-area deposits since year-end 2008 primarily reflects the influx of cash resulting from the reduction in total loans and from increased local deposits.

FHLB advances increased \$10.0 million during 2013, but are down \$225.0 million during the five-year period ended December 31, 2013. The decline during the past five years primarily reflects the influx of cash resulting from the reduction in total loans and from increased local deposits. FHLB advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit at December 31, 2013 totaled \$171.9 million, with availability of \$116.1 million.

Shareholders' equity increased \$6.7 million during 2013. Net income attributable to common shares of \$17.0 million was partially offset by a total of \$3.9 million in cash dividends on our common stock and a net decline in the net

unrealized gain on securities available for sale and fair value of an interest rate swap of \$7.2 million.

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**Table of Contents****RESULTS OF OPERATIONS****FOR THE YEARS ENDED DECEMBER 31, 2013 and 2012***Summary*

We recorded net income attributable to common shares of \$17.0 million, or \$1.96 per basic share and \$1.95 per diluted share, for 2013, compared to net income attributable to common shares of \$11.5 million, or \$1.33 per basic share and \$1.30 per diluted share, for 2012. The results for 2013 include costs associated with our pending merger with Firstbank Corporation. On an after-tax basis, we expensed \$1.2 million during 2013, nearly all of which was expensed during the third and fourth quarters. We expect to expense further merger-related costs during 2014, although the exact amounts and timing are not currently known.

The improved earnings performance in 2013 compared to 2012 resulted from a larger negative loan loss provision, decreased overhead costs, lower preferred stock dividends and discount accretion, and increased net interest income. The continued improvement in the quality of our loan portfolio and recoveries of prior period loan charge-offs have produced a positive impact on our loan loss reserve calculations and allowed us to make negative provisions to the loan loss reserve during 2013 and 2012. The decline in preferred stock dividends and discount accretion in 2013 compared to 2012 resulted from us repurchasing the non-voting preferred stock issued in May of 2009 to the U.S. Department of the Treasury during the second quarter of 2012.

The decline in overhead costs in 2013 mainly resulted from decreased problem asset administration and resolution costs. Gains on sales of other real estate, which are netted against problem asset costs, contributed to the reduction in costs associated with the administration and resolution of problem assets in 2013 compared to the prior year; excluding the impact of these gains, problem asset costs still decreased significantly in 2013 compared to 2012. Costs associated with the administration and resolution of problem assets remain elevated; however, these costs trended downward during 2011, 2012, and 2013 as the level of problem assets declined. Although decreasing, the level of problem assets remains elevated compared to pre-2006 levels as a result of the state, regional and national economic struggles experienced over the past few years and related impact on certain of our borrowers.

A higher net interest margin, which more than offset a slight decline in average earning assets, resulted in an increased level of net interest income in 2013 compared to 2012. The yield on average earning assets, although declining in comparison to 2012 primarily due to decreased yields on average loans and securities, was relatively stable throughout 2013 as the collection of unaccrued interest on several larger nonaccrual commercial loan relationships that were paid off during the year and the collection of prepayment fees associated with several larger performing commercial loan relationships substantially offset a high level of lower-yielding federal funds sold. The cost of funds declined in 2013 compared to 2012 mainly due to decreases in the costs of various certificate of deposit account categories, certain non-certificate of deposit account categories, FHLB advances, and repurchase agreements and a change in interest-bearing liability mix, most notably a decrease in various higher-costing average certificates of deposit account categories and increases in certain lower-costing non-certificate of deposit account categories and repurchase agreements as a percentage of average interest-bearing liabilities.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2013 and 2012:

	2013	2012
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Return on average assets	1.22%	0.82%
Return on average shareholders' equity	11.36%	7.51%
Average shareholders' equity to average assets	10.77%	10.90%

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**Table of Contents*****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 \$58.7 million and \$10.8 million during 2013, respectively, providing for net interest income of \$47.9 million. During 2012, interest income and interest expense equaled \$60.5 million and \$13.2 million, respectively, providing for net interest income of \$47.3 million.

In comparing 2013 with 2012, interest income decreased 3.0%, interest expense was down 18.4%, and net interest income increased 1.3%. 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, 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 \$0.6 million increase in net interest income in 2013 compared to 2012 resulted from an improved net interest margin, which more than offset a slight decline in average earning assets. During 2013, the net interest margin equaled 3.73%, up from 3.67% during 2012. Although our yield on earning assets declined in 2013 compared to 2012 primarily due to a decreased yield on average loans, our cost of funds declined at a greater rate, resulting in the improved net interest margin. The decline in loan yield primarily resulted from a decreased yield on commercial loans, while the cost of funds decreased primarily due to decreases in the costs of various certificate of deposit account categories, certain non-certificate of deposit account categories, FHLB advances, and repurchase agreements and a change in funding mix, most notably a decrease in higher-costing average certificates of deposit and increases in certain lower-costing non-certificate of deposit accounts, noninterest-bearing deposit accounts, and repurchase agreements as a percentage of average total funding sources.

The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders' equity during 2013, 2012 and 2011. The subsequent table also depicts the dollar amount of change in interest income and interest expense of interest-earning assets and interest-bearing liabilities, 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 35%. As a result, securities interest income was increased by \$0.5 million in 2013, \$0.6 million in 2012, and \$0.7 million in 2011.

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(Dollars in thousands)

	2013			Years ended December 31, 2012			2011		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Taxable securities	\$ 117,887	\$ 4,134	3.51%	\$ 112,122	\$ 4,383	3.91%	\$ 157,081	\$ 6,685	4.26%
Tax-exempt securities	25,706	1,434	5.58	40,818	2,018	4.94	49,428	2,508	5.07
<b>Total securities</b>	<b>143,593</b>	<b>5,568</b>	<b>3.88</b>	<b>152,940</b>	<b>6,401</b>	<b>4.19</b>	<b>206,509</b>	<b>9,193</b>	<b>4.45</b>
Loans	1,050,961	52,924	5.04	1,049,315	53,898	5.14	1,148,671	62,356	5.43
Interest-bearing deposits	7,703	21	0.28	10,522	29	0.28	9,709	24	0.24
Federal funds sold	83,468	212	0.25	75,678	192	0.25	78,596	199	0.25
<b>Total earning assets</b>	<b>1,285,725</b>	<b>58,725</b>	<b>4.57</b>	<b>1,288,455</b>	<b>60,520</b>	<b>4.70</b>	<b>1,443,485</b>	<b>71,772</b>	<b>4.97</b>
Allowance for loan losses	(26,505)			(31,171)			(41,517)		
Cash and due from banks	17,420			16,217			15,080		
Other non-earning assets	115,758			132,105			112,983		
<b>Total assets</b>	<b>\$ 1,392,398</b>			<b>\$ 1,405,606</b>			<b>\$ 1,530,031</b>		
Interest-bearing demand deposits	\$ 204,945	\$ 1,276	0.62%	\$ 205,848	\$ 1,572	0.76%	\$ 184,140	\$ 2,536	1.38%
Savings deposits	55,214	142	0.26	42,452	118	0.28	45,860	210	0.46
Money market accounts	134,875	366	0.27	148,596	571	0.38	154,450	1,179	0.76
Time deposits	504,672	7,128	1.41	549,535	8,876	1.62	697,664	12,459	1.79
<b>Total interest-bearing deposits</b>	<b>899,706</b>	<b>8,912</b>	<b>0.99</b>	<b>946,431</b>	<b>11,137</b>	<b>1.18</b>	<b>1,082,114</b>	<b>16,384</b>	<b>1.51</b>
Short-term borrowings	65,939	80	0.12	61,930	157	0.25	80,137	405	0.51
Federal Home Loan Bank advances	39,082	533	1.36	39,809	993	2.49	54,753	2,033	3.71
Other borrowings	34,505	1,261	3.65	34,406	929	2.70	37,776	1,010	2.67

Total interest-bearing liabilities	1,039,232	10,786	1.04	1,082,576	13,216	1.22	1,254,780	19,832	1.58
Demand deposits	197,621			164,081			136,980		
Other liabilities	5,555			5,675			5,808		
Total liabilities	1,242,408			1,252,332			1,397,568		
Average equity	149,990			153,274			132,463		
Total liabilities and equity	\$ 1,392,398			\$ 1,405,606			\$ 1,530,031		
Net interest income		\$ 47,939			\$ 47,304			\$ 51,940	
Rate spread			3.53%			3.48%			3.39%
Net interest margin			3.73%			3.67%			3.60%

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	Years ended December 31,					
	2013 over 2012			2012 over 2011		
	Total	Volume	Rate	Total	Volume	Rate
<b>Increase (decrease) in interest income</b>						
Taxable securities	\$ (249,000)	\$ 218,000	\$ (467,000)	\$ (2,302,000)	\$ (1,792,000)	\$ (510,000)
Tax exempt securities	(584,000)	(818,000)	234,000	(490,000)	(427,000)	(63,000)
Loans	(974,000)	136,000	(1,110,000)	(8,458,000)	(5,215,000)	(3,243,000)
<b>Interest-bearing deposit balances</b>						
Federal funds sold	(8,000)	(8,000)	0	5,000	2,000	3,000
	20,000	20,000	0	(7,000)	(7,000)	0
<b>Net change in tax-equivalent interest income</b>						
	(1,795,000)	(452,000)	(1,343,000)	(11,252,000)	(7,439,000)	(3,813,000)
<b>Increase (decrease) in interest expense</b>						
<b>Interest-bearing demand deposits</b>						
Savings deposits	(296,000)	(7,000)	(289,000)	(964,000)	271,000	(1,235,000)
Money market accounts	24,000	33,000	(9,000)	(92,000)	(15,000)	(77,000)
Time deposits	(205,000)	(49,000)	(156,000)	(608,000)	(43,000)	(565,000)
Short-term borrowings	(1,748,000)	(689,000)	(1,059,000)	(3,583,000)	(2,471,000)	(1,112,000)
Federal Home Loan Bank advances	(77,000)	10,000	(87,000)	(248,000)	(77,000)	(171,000)
Other borrowings	(460,000)	(18,000)	(442,000)	(1,040,000)	(472,000)	(568,000)
	332,000	3,000	329,000	(81,000)	(91,000)	10,000
<b>Net change in interest expense</b>						
	(2,430,000)	(717,000)	(1,713,000)	(6,616,000)	(2,898,000)	(3,718,000)
<b>Net change in tax-equivalent net interest income</b>						
	\$ 635,000	\$ 265,000	\$ 370,000	\$ (4,636,000)	\$ (4,541,000)	\$ (95,000)

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities, federal funds sold, and interest-bearing deposit balances. Interest income decreased \$1.8 million during 2013 from that earned in 2012, totaling \$58.7 million in 2013 compared to \$60.5 million in the previous year. The reduction in interest income is attributable to a decreased yield on average earning assets and, to a much lesser extent, a lower level of average earning assets. During 2013 and 2012, earning assets had an average yield (tax equivalent-adjusted basis) of 4.57% and 4.70%, respectively. The decline in earning asset yield in 2013 mainly resulted from a decreased yield on average loans, and to a lesser extent, a decreased yield on average securities. During 2013, earning assets averaged \$1.29 billion, or \$2.7 million lower than average earning assets during 2012. Average securities were down \$9.3 million, average federal funds sold increased \$7.8 million, average interest-bearing deposit balances decreased \$2.8 million, and average loans increased \$1.6 million.

Interest income generated from the loan portfolio decreased \$1.0 million in 2013 compared to the level earned in 2012; a decline in loan yield from 5.14% in 2012 to 5.04% in 2013 resulted in a \$1.1 million decrease in interest income, while growth in the loan portfolio during 2013 resulted in a \$0.1 million increase in interest income. The



lower yield on average loans mainly resulted from a decreased yield on average commercial loans, which equaled 5.06% in 2013 compared to 5.16% in 2012. The commercial loan yield was negatively impacted by the lowering of rates on certain commercial loans throughout 2012 and 2013 as a result of borrowers warranting decreased loan rates due to improved financial performance, the renewal of certain maturing term loans at lower rates, and competitive pricing pressures. In addition, the commercial loan yield was negatively impacted by an ongoing interest rate risk management strategy implemented in early 2011 whereby certain commercial loan relationships are being converted from the Mercantile Bank Prime Rate to the Wall Street Journal Prime Rate; this strategy, which helps mitigate interest rate risk exposure in an increasing rate environment, has a short-term negative impact on net interest income as the conversions generally involve interest rate reductions. A declining level of nonaccrual loans and the collection of unaccrued interest on nonaccrual commercial loan relationships that were paid off and commercial loan prepayment fees helped mitigate the negative impact of these factors on the commercial loan yield. Unaccrued interest totaling \$1.9 million was collected on the paid off nonaccrual commercial loan relationships and recorded as interest income during 2013.

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Interest income generated from the securities portfolio decreased \$0.8 million in 2013 compared to the level earned in 2012 due to portfolio contraction and a lower yield on average securities, which equaled 3.88% in 2013 compared to 4.19% in 2012. The reduced average portfolio balance resulted in a \$0.6 million decrease in interest income, while the lower yield on average securities equated to a decrease in interest income of \$0.2 million. Average securities equaled \$143.6 million during 2013, down from \$152.9 million during 2012 primarily due to decreases in the average balances of mortgage-backed securities, municipal securities, and Michigan Strategic Fund bonds, which more than offset an increase in the average balance of U.S. Government agency bonds. The lower yield on average securities resulted from a decreased yield on U.S. Government agency bonds, reflecting a decline in market rates, and a shift in the securities portfolio mix from higher-yielding mortgage-backed and municipal securities to lower-yielding agency bonds. The yield on U.S. Government agency bonds was 3.28% during 2013 compared to 3.70% during 2012. Purchases of U.S. Government agency bonds with lower yields during 2012 and 2013 using proceeds received from called bonds of the same type and called and matured municipal securities and principal paydowns on mortgage-backed securities negatively impacted the yield on average securities. Proceeds received from called U.S. Government agency bonds totaled \$78.4 million and \$20.0 million in 2012 and 2013, respectively, while proceeds from called and matured municipal bonds totaled \$7.1 million and \$6.1 million in 2012 and 2013, respectively. Principal payments received on mortgage-backed securities totaled \$11.7 million in 2012 and \$7.8 million in 2013. The bond purchases were necessary to meet pledging requirements and internal funds management policy guidelines. Unaccreted discount of \$30,000 related to called U.S. Government agency bonds was recognized as income during 2013; excluding this discount, the yield on U.S. Government agency bonds would have been 3.25% in 2013. Unaccreted discount of \$116,000 related to called U.S. Government agency bonds was recognized as income during 2012; excluding this discount, the yield on U.S. Government agency bonds would have been 3.54% in 2012. Average U.S. Government agency bonds, municipal securities, and mortgage-backed securities represented 61.0%, 14.3%, and 11.8%, respectively, of average total securities during 2013 compared to 46.0%, 18.5%, and 18.6%, respectively, during 2012. A decline in the market value of the available for sale securities portfolio during 2013 partially offset the negative impacts of the decreased yield on U.S. Government agency bonds and the shift in securities portfolio mix on portfolio yield. The average net unrealized loss on available for sale securities equaled \$1.5 million during 2013, while the average net unrealized gain on available for sale securities equaled \$5.1 million during 2012.

Interest income earned on federal funds sold increased slightly in 2013 compared to 2012 due to a higher average balance, while interest income earned on interest-bearing deposit balances decreased slightly due to a lower average balance.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from subordinated debentures, FHLB advances, repurchase agreements, and other borrowings. Interest expense decreased \$2.4 million during 2013 from that expensed in 2012, totaling \$10.8 million in 2012 compared to \$13.2 million in the previous year. The decline in interest expense is attributable to a decreased cost of funds and a lower level of average interest-bearing liabilities.

During 2013 and 2012, interest-bearing liabilities had a weighted average rate of 1.04% and 1.22%, respectively; a decline in interest expense of \$1.7 million was recorded during 2013 due to the decreased cost of funds. The lower weighted average cost of interest-bearing liabilities was primarily due to decreases in the costs of various certificate of deposit account categories, certain non-certificate of deposit account categories, FHLB advances, and repurchase agreements and a change in interest-bearing liability mix, most notably a decrease in various higher-costing average certificates of deposit account categories and increases in certain lower-costing non-certificate of deposit account categories and repurchase agreements as a percentage of average interest-bearing liabilities. Market interest rates began falling in the latter part of 2007 and have remained low since. The lowering of interest rates on non-certificate of deposit accounts and repurchase agreements periodically during 2012 positively impacted the weighted average cost of interest-bearing liabilities in 2013; interest rates on certain non-certificate of deposit accounts were also

reduced in December of 2013. In addition, maturing fixed-rate certificates of deposit and FHLB advances were renewed at lower rates, replaced by lower-costing funds, or allowed to runoff during 2012 and 2013.

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During 2013, interest-bearing liabilities averaged \$1.04 billion, or \$43.3 million lower than average interest-bearing liabilities of \$1.08 billion during the prior year. This reduction resulted in decreased interest expense of \$0.7 million. Average interest-bearing deposits were down \$46.7 million, while average short-term borrowings increased \$4.0 million, average FHLB advances decreased \$0.7 million, and average other borrowings increased \$0.1 million.

Average certificates of deposit declined \$44.9 million during 2013, which equated to a decrease in interest expense of \$0.7 million. An additional \$1.0 million reduction in interest expense resulted from a decrease in the average rate paid as higher-rate certificates of deposit matured and were renewed at lower rates, replaced with lower-costing funds, or allowed to runoff throughout 2013. A reduction in other average interest-bearing deposit accounts, totaling \$1.9 million, equated to a nominal decrease in interest expense, while a decrease in the average rate paid on these deposit accounts resulted in a \$0.5 million decline in interest expense.

Average short-term borrowings, comprised entirely of repurchase agreements, increased \$4.0 million during 2013, resulting in a slight increase in interest expense, while a decrease in the average rate paid during 2013 resulted in a reduction in interest expense of \$0.1 million. Average FHLB advances decreased \$0.7 million, resulting in a nominal decrease in interest expense, while a lower average rate paid on the advances resulted in a \$0.4 million decrease in interest expense. A \$0.1 million increase in average other borrowings, which is comprised of subordinated debentures and deferred director and officer compensation programs, equated to a nominal increase in interest expense, while a higher average rate paid on subordinated debentures resulted in a \$0.3 million increase in interest expense.

***Provision for Loan Losses***

A negative loan loss provision expense of \$7.2 million was recorded in 2013, compared to a negative provision expense of \$3.1 million recorded in 2012. The negative provision expense reflects recoveries of previously charged-off loans and a reduced level of loan-rating downgrades and ongoing loan-rating upgrades as the quality of the loan portfolio continued to improve. Continued progress in the stabilization of economic and real estate market conditions and resulting collateral valuations also positively impacted provision expense. Recoveries of previously charged-off loans totaled \$6.6 million during 2013, while loan charge-offs not specifically reserved for in prior periods amounted to \$1.4 million, resulting in a net positive impact of \$5.2 million on provision expense. Net loan recoveries of \$1.3 million were recorded during 2013, compared to net loan charge-offs of \$4.8 million during the prior year. Of the \$5.2 million in gross loans charged-off during 2013, \$3.9 million, or 73.4%, represents the elimination of specific reserves that were established through provision expense in earlier periods. Nonperforming loans totaled \$6.7 million, or 0.6% of total loans, as of December 31, 2013, compared to \$19.0 million, or 1.8% of total loans, as of December 31, 2012. The allowance, as a percentage of total loans outstanding, was 2.2% as of December 31, 2013, compared to 2.8% as of December 31, 2012.

***Noninterest Income***

Noninterest income totaled \$6.9 million in 2013, a decrease of \$1.1 million, or 14.0%, from the \$8.0 million earned in 2012. The decrease in noninterest income was mainly due to lower residential mortgage banking fee income, rental income from foreclosed properties, and earnings on bank owned life insurance. Residential mortgage rates were relatively stable during 2012 and the first few months of 2013, resulting in a lower level of refinance activity during 2013 as many qualifying borrowers had already refinanced at these rates during 2012. Residential mortgage rates began increasing during the latter part of the second quarter of 2013, continued increasing during the early part of the third quarter, and stabilized during the rest of the year. Increased fee income from the sales of purchase mortgages during 2013 helped mitigate the decreased fee income resulting from the lower level of refinance activity. A reduction in the number of foreclosed properties, reflecting ongoing sales of these properties, resulted in the decreased rental income, while the decline in earnings on bank owned life insurance primarily resulted from reduced investment yields,

as paydowns on mortgage-backed securities were reinvested into similar securities with lower rates.

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### ***Noninterest Expense***

Noninterest expense during 2013 totaled \$36.4 million, a decrease of \$3.2 million, or 8.1%, from the \$39.6 million expensed in 2012. Merger-related costs were \$1.2 million during 2013. The decrease in noninterest expense primarily resulted from lower problem asset administration and resolution costs and FDIC insurance premiums.

Problem asset administration and resolution costs totaled \$0.6 million during 2013, a decrease of \$5.3 million, or 89.8%, from the \$5.9 million in costs incurred during 2012. Gains on sales of other real estate owned, which are netted against problem asset costs, totaled \$2.3 million in 2013 compared to \$1.3 million in 2012.

FDIC insurance costs were \$0.8 million during 2013, a decrease of \$0.4 million, or 33.9%, from the \$1.2 million in costs incurred during 2012. The lower premiums mainly resulted from a decreased assessment rate, reflecting further improvement in our financial condition and operating performance.

### ***Federal Income Tax Expense***

During 2013, we recorded income before federal income tax of \$25.1 million and a federal income tax expense of \$8.1 million, compared to income before federal income tax of \$18.2 million and a federal income tax expense of \$5.6 million during 2012. The increase in federal income tax expense resulted from the higher level of income before federal income tax and an increase in our effective tax rate from 31.0% in 2012 to 32.2% in 2013.

### ***Preferred Stock Dividends and Accretion***

Preferred stock dividends and discount accretion totaled \$1.0 million during 2012. No preferred stock dividends and discount accretion were recorded during 2013 as we repurchased the \$21.0 million in non-voting preferred stock issued in May of 2009 to the U.S. Department of the Treasury under the Treasury's Capital Purchase Program, as part of the Troubled Asset Relief Program, during the second quarter of 2012.

## **RESULTS OF OPERATIONS**

### **FOR THE YEARS ENDED DECEMBER 31, 2012 and 2011**

#### ***Summary***

We recorded net income attributable to common shares of \$11.5 million, or \$1.33 per basic share and \$1.30 per diluted share, for 2012, compared to net income attributable to common shares of \$36.1 million, or \$4.20 per basic share and \$4.07 per diluted share, for 2011. The establishment of a valuation allowance against our net deferred tax asset in the fourth quarter of 2009 and the reversal of the valuation allowance in the fourth quarter of 2011 distort 2012 and 2011 after-tax operating result comparisons. On a pre-tax basis, our income was \$18.2 million for 2012 compared to \$10.1 million for 2011.

The improved pre-tax earnings performance in 2012 compared to 2011 primarily resulted from lower provisions to the allowance for loan losses. The decreased provision expense reflected lower volumes of loan rating downgrades and nonperforming loans, a higher volume of loan rating upgrades, significant recoveries of prior-period loan charge-offs, the elimination or significant reduction of certain specific reserve allocations due to successful collection efforts, and continued progress in the stabilization of economic and real estate market conditions and resulting collateral valuations. In addition, the reserve allocation factors for non-impaired commercial loans reflected in the quarterly reserve migrations were reduced in 2012 in light of the lower level of net loan charge-offs. A higher net interest

margin, which partially mitigated the negative impact of a lower level of average earning assets, reduced costs associated with the administration and resolution of problem assets, lower FDIC insurance premiums, and increased noninterest income also contributed to the improved earnings performance in 2012 compared to 2011.

Our earnings performance continued to be hindered by elevated costs associated with the administration and resolution of problem assets; however, these costs trended downward during 2011 and 2012 as the level of nonperforming assets declined. Although decreasing, the level of nonperforming assets remained elevated when compared to pre-2007 reporting periods as a result of the state, regional and national economic struggles experienced over the past several years and related impact on certain of our borrowers.

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The following table shows some of the key performance and equity ratios for the years ended December 31, 2012 and 2011:

	2012	2011
Return on average assets	0.82%	2.36%
Return on average shareholders equity	7.51%	27.28%
Average shareholders equity to average assets	10.90%	8.66%

**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 \$60.5 million and \$13.2 million, respectively, during 2012, providing for net interest income of \$47.3 million. During 2011, interest income and interest expense equaled \$71.8 million and \$19.8 million, respectively, providing for net interest income of \$52.0 million. In comparing 2012 with 2011, interest income decreased 15.7%, interest expense was down 33.4%, and net interest income decreased 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, 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 \$4.7 million decrease in net interest income in 2012 compared to 2011 resulted from a decreased level of average earning assets, which more than offset an improved net interest margin. During 2012, the net interest margin equaled 3.67%, up from 3.60% during 2011. Although our yield on earning assets declined in 2012 compared to 2011 primarily due to a decreased yield on average loans, our cost of funds declined at a far greater rate, resulting in the improved net interest margin. The decline in loan yield primarily resulted from a decreased yield on commercial loans, while the cost of funds decreased as a result of the lowering of interest rates on non-certificate of deposit accounts and repurchase agreements on various occasions during the latter half of 2011 and during 2012. The cost of funds also decreased as a result of higher-costing matured certificates of deposit and FHLB advances being renewed at lower rates, replaced by lower-costing funds, or allowed to runoff.

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities, federal funds sold, and interest-bearing deposit balances. Interest income decreased \$11.3 million during 2012 from that earned in 2011, totaling \$60.5 million in 2012 compared to \$71.8 million in the previous year. The reduction in interest income was attributable to a decreased level of average earning assets and, to a lesser extent, a declining yield on average earning assets. During 2012, earning assets averaged \$1.29 billion, or \$155.0 million lower than average earning assets of \$1.44 billion during 2011. Average loans were down \$99.3 million, average securities decreased \$53.6 million, average federal funds sold decreased \$2.9 million, and average interest-bearing deposit balances increased \$0.8 million.

Interest income generated from the loan portfolio decreased \$8.5 million in 2012 compared to the level earned in 2011; the reduction in the loan portfolio during 2012 resulted in a \$5.2 million decrease in interest income, while a decline in loan yield from 5.43% in 2011 to 5.14% in 2012 resulted in a \$3.3 million decrease in interest income. The lower yield on average loans mainly resulted from a decreased yield on average commercial loans, which equaled 5.16% in 2012 compared to 5.46% in 2011. The commercial loan yield was negatively impacted by the lowering of rates on certain commercial loans throughout 2011 and 2012 as a result of borrowers warranting decreased loan rates due to improved financial performance, the renewal of certain maturing term loans at lower rates, and competitive



pricing pressures. In addition, the commercial loan yield was negatively impacted by an ongoing interest rate risk management strategy implemented in early 2011 whereby certain commercial loan relationships are being converted from the Mercantile Bank Prime Rate to the Wall Street Journal Prime Rate; this strategy has a short-term negative impact on net interest income as the conversions generally involve interest rate reductions. The commercial loan yields in 2012 and 2011 were negatively impacted by net declines of \$254,000 and \$259,000, respectively, in the present values of the purchased and sold interest rate caps; excluding the impact of these net declines, the yield on average commercial loans was 5.18% in 2012 and 5.48% in 2011, and the yield on average total loans was 5.16% in 2012 and 5.45% in 2011.

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Interest income generated from the securities portfolio decreased \$2.8 million in 2012 compared to the level earned in 2011 due to portfolio contraction and a lower yield on average securities, which equaled 4.19% in 2012 compared to 4.45% in 2011. The reduced average portfolio balance resulted in a \$2.2 million decrease in interest income, while the lower yield on average securities equated to a decrease in interest income of \$0.6 million. Average securities equaled \$152.9 million during 2012, down from \$206.5 million during 2011 primarily due to decreases in the average balances of U.S. Government agency bonds and mortgage-backed securities. The lower yield on average securities in 2012 compared to 2011 mainly resulted from a decreased yield on U.S. Government agency bonds, reflecting a decline in market rates. The yield on U.S. Government agency bonds was 3.70% in 2012 compared to 4.27% in 2011. Purchases of U.S. Government agency bonds with lower yields during the fourth quarter of 2011 and during 2012 using proceeds received from called bonds of the same type negatively impacted the yield on average securities. The bond purchases were necessary to meet collateral requirements and internal funds management policy guidelines. Unaccreted discount of \$116,000 related to called U.S. Government agency bonds was recognized as income during 2012; excluding this discount, the yield on U.S. Government agency bonds would have been 3.54% in 2012. Unaccreted discount of \$138,000 related to called U.S. Government agency bonds was recognized as income during 2011; excluding this discount, the yield on U.S. Government agency bonds would have been 4.13% in 2011. The negative impact of the declined U.S. Government agency bond yield on the yield on average total securities was partially offset by a shift in the securities portfolio mix from lower-yielding agency bonds to higher-yielding municipal securities. Average U.S. Government agency bonds represented 46.0% of average total securities in 2012 compared to 49.3% in 2011, while average municipal securities represented 18.5% of average total securities in 2012 compared to 15.6% in 2011. Principal payments received on mortgage-backed securities totaled \$11.7 million in 2012.

Interest income earned on federal funds sold declined slightly in 2012 compared to 2011 due to a decreased average balance, while interest income earned on interest-bearing deposit balances increased slightly due to an increased average balance and average rate.

During 2012 and 2011, earning assets had an average yield (tax equivalent-adjusted basis) of 4.70% and 4.97%, respectively. The decline in earning asset yield in 2012 compared to 2011 resulted from a decreased yield on average loans, and to a much lesser extent, a decreased yield on average securities.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from FHLB advances, repurchase agreements, subordinated debentures, and other borrowings. Interest expense decreased \$6.6 million during 2012 from that expensed in 2011, totaling \$13.2 million in 2012 compared to \$19.8 million in the previous year. The decline in interest expense is attributable to a decreased level of average interest-bearing liabilities and a decreased cost of funds.

During 2012, interest-bearing liabilities averaged \$1.08 billion, or \$172.2 million lower than average interest-bearing liabilities of \$1.25 billion during the prior year. This reduction resulted in decreased interest expense of \$2.9 million. Average interest-bearing deposits were down \$135.7 million, while average short-term borrowings decreased \$18.2 million, average FHLB advances decreased \$14.9 million, and average other borrowings decreased \$3.4 million.

During 2012 and 2011, interest-bearing liabilities had a weighted average rate of 1.22% and 1.58%, respectively; a decline in interest expense of \$3.7 million was recorded during 2012 due to the decreased cost of funds. The lower weighted average cost of interest-bearing liabilities in 2012 compared to 2011 is primarily due to the decline in market interest rates that began late in the third quarter of 2007 and continued through December of 2008 and, to a much lesser extent, a change in average interest-bearing liability mix, most notably decreases in higher-costing average certificates of deposit and average FHLB advances and increases in lower-costing average non-certificate of deposit accounts as a percentage of average interest-bearing liabilities. Market interest rates remained low during 2009, 2010, 2011, and 2012. Maturing fixed-rate certificates of deposit and borrowings were renewed at lower rates, replaced by

lower-costing funds, or allowed to runoff during the 24-month period ended December 31, 2012. In addition, the lowering of interest rates on non-certificate of deposit accounts and repurchase agreements during this time frame positively impacted the weighted average cost of interest-bearing liabilities in 2012 compared to 2011.

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Average certificates of deposit declined \$148.1 million during 2012, which equated to a decrease in interest expense of \$2.5 million. An additional \$1.1 million reduction in interest expense resulted from a decrease in the average rate paid as higher-rate certificates of deposit matured and were renewed at lower rates, replaced with lower-costing funds, or allowed to runoff throughout 2012. Growth in other average interest-bearing deposit accounts, totaling \$12.4 million, equated to an increase in interest expense of \$0.2 million, while a decrease in the average rate paid on these deposit accounts resulted in a \$1.9 million decline in interest expense.

Average short-term borrowings, comprised primarily of repurchase agreements, declined \$18.2 million during 2012, resulting in decreased interest expense of \$0.1 million, while a decrease in the average rate paid during 2012 resulted in a reduction in interest expense of \$0.2 million. Average FHLB advances decreased \$14.9 million, equating to a \$0.5 million reduction in interest expense, while a lower average rate paid on the advances resulted in a \$0.6 million decrease in interest expense. A reduction in average other borrowings, which is comprised of subordinated debentures, structured repurchase agreements, and deferred director and officer compensation programs, equated to a decrease in interest expense of \$0.1 million during 2012, while a higher average rate paid on these borrowings slightly increased interest expense.

***Provision for Loan Losses***

A negative provision expense of \$3.1 million was recorded in 2012, compared to a provision expense of \$6.9 million recorded in 2011. The reduced provision expense reflects lower volumes of loan rating downgrades and nonperforming loans, a higher volume of loan rating upgrades, significant recoveries of prior-period loan charge-offs, the elimination or significant reduction of certain specific reserve allocations due to successful collection efforts, and continued progress in the stabilization of economic and real estate market conditions and resulting collateral valuations. In addition, the reserve allocation factors for non-impaired commercial loans reflected in the quarterly reserve migrations were reduced in 2012 in light of the lower level of net loan charge-offs. Nonperforming loans totaled \$19.0 million, or 1.82% of total loans, as of December 31, 2012, compared to \$45.1 million, or 4.20% of total loans, as of December 31, 2011. Net loan charge-offs totaled \$4.8 million, or 0.45% of average total loans, during 2012 compared to \$15.7 million, or 1.37% of average total loans, during 2011. Of the \$12.6 million in gross loans charged-off during 2012, \$4.4 million, or 34.6%, represents the elimination of specific reserves that were established through provision expense in earlier periods. The allowance, as a percentage of total loans outstanding, was 2.75% as of December 31, 2012, compared to 3.41% as of December 31, 2011.

***Noninterest Income***

Noninterest income totaled \$8.0 million in 2012, an increase of \$0.7 million, or 9.8%, from the \$7.3 million earned in 2011. The increase in noninterest income in 2012 compared to 2011 was mainly due to higher residential mortgage banking fee income, reflecting increased activity due to lower mortgage interest rates, and rental income from foreclosed properties, which more than offset decreased earnings on bank owned life insurance and service charges on accounts. The decline in earnings on bank owned life insurance primarily resulted from reduced investment yields, as paydowns on mortgage-backed securities were reinvested into similar securities with lower rates, while the decline in service charges on accounts mainly resulted from decreased fees associated with a particular checking account category as a result of a reduction in the number of active accounts.

***Noninterest Expense***

Noninterest expense during 2012 totaled \$39.6 million, a decrease of \$1.9 million, or 4.5%, from the \$41.5 million expensed in 2011. The decline in noninterest expense in 2012 compared to 2011 primarily resulted from decreased nonperforming asset administration and resolution costs and FDIC insurance premiums, which more than offset

increased salary and benefit costs. Salary and benefit costs totaled \$19.4 million during 2012, an increase of \$1.5 million, or 8.2%, from the \$17.9 million expensed during 2011, primarily reflecting expenses associated with the reinstatement or increasing of certain employee benefit programs that had been suspended or lowered in prior years.

Nonperforming asset administration and resolution costs, including legal expenses, property tax payments, appraisal fees, and write-downs on foreclosed properties, totaled \$5.9 million during 2012, a decrease of \$2.4 million, or 29.3%, from the \$8.3 million in costs incurred during 2011.

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FDIC insurance premiums were \$1.2 million during 2012, down \$1.6 million from the \$2.8 million in premiums expensed during 2011. The lower premiums during 2012 compared to 2011 resulted from a decreased assessment rate and base. The decreased assessment rate reflected our improved financial condition and operating performance and the implementation of the FDIC's revised risk-based assessment system on April 1, 2011.

Occupancy and furniture and equipment costs declined by \$0.3 million in 2012 compared to 2011, primarily resulting from an aggregate reduction in depreciation expense and decreased property taxes.

***Federal Income Tax Expense***

During 2012, we recorded income before federal income tax of \$18.2 million and a federal income tax expense of \$5.6 million, compared to income before federal income tax of \$10.1 million and a federal income tax benefit of \$27.4 million during 2011. A federal income tax expense was recorded in 2012 as a result of the valuation allowance against our net deferred tax asset being reversed at year-end 2011. Tax expense on 2011 income was entirely offset by a corresponding reduction to the valuation allowance against deferred tax assets, and the \$27.4 million benefit was the result of reversing the remaining valuation allowance.

Accounting guidance requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. We reviewed our deferred tax assets and determined that the valuation allowance necessary at year-end 2010, due to operating losses in 2010 and earlier years, was no longer necessary at year-end 2011 due to an expected return to sustainable profitability. Consequently, we reversed the valuation allowance that we had previously determined necessary to carry against our entire net deferred tax asset as of December 31, 2010 and 2009.

**CAPITAL RESOURCES**

Shareholders' equity increased \$6.7 million during 2013. Net income attributable to common shares of \$17.0 million was partially offset by a total of \$3.9 million in cash dividends on our common stock and a net decline in the net unrealized gain on securities available for sale and fair value of an interest rate swap of \$7.2 million.

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. The increase in shareholders' equity during 2013 provided for improved regulatory capital ratios, and our bank remains well capitalized. As of December 31, 2013, our bank's total risk-based capital ratio was 15.7%, compared to 14.7% at December 31, 2012. Our bank's total regulatory capital, consisting of shareholders' equity plus a portion of the allowance but less a portion of our net deferred tax asset, increased \$16.7 million during 2013, primarily reflecting net income of \$19.9 million which more than offset \$5.5 million in cash dividends paid. Our bank's total risk-based capital ratio was also impacted by a \$33.8 million increase in total risk-weighted assets, primarily resulting from growth in commercial loans. As of December 31, 2013, our bank's total regulatory capital equaled \$190.5 million, or approximately \$69.0 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.

**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-bearing

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.

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To assist in providing needed funds, we regularly obtain monies from wholesale funding sources. Wholesale funds, primarily comprised of deposits from customers outside of our market areas and FHLB advances, totaled \$258.1 million, or 20.9% of combined deposits and borrowed funds as of December 31, 2013, compared to \$304.8 million, or 24.7% of combined deposits and borrowed funds, as of December 31, 2012, and \$1.41 billion, or 71.5% of combined deposits and borrowed funds, as of December 31, 2008. The significant decline in wholesale funds since year-end 2008 primarily reflects the influx of cash resulting from the reduction in total loans and increased local deposits.

Although local deposits have generally increased as new business, municipal governmental unit and individual deposit relationships are established and as existing customers increase the balances in their accounts, and we witnessed significant local deposit growth during the past five years, some reliance on wholesale funds will likely remain, although at a much lower level than historical levels. As part of our interest rate risk management strategy, a vast majority of our wholesale funds have a fixed rate and mature within five years, reflecting the fact that a majority of our loans have a floating interest rate or a fixed interest rate and balloon in five years from origination date. We have developed a comprehensive contingency funding plan which we believe mitigates any increased liquidity risk from our wholesale funding program.

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

As part of our sweep program, collected funds from certain business noninterest-bearing checking accounts are invested into over-night interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. Repurchase agreements increased \$4.5 million during 2013, totaling \$69.3 million as of December 31, 2013.

Information regarding our repurchase agreements as of December 31, 2013 and during 2013 is as follows:

Outstanding balance at December 31, 2013	\$ 69,305,000
Weighted average interest rate at December 31, 2013	0.12%
Maximum daily balance twelve months ended December 31, 2013	\$ 78,960,000
Average daily balance for twelve months ended December 31, 2013	\$ 65,939,000
Weighted average interest rate for twelve months ended December 31, 2013	0.12%

As a member of the FHLB, we have access to the FHLB advance borrowing programs. Advances totaled \$45.0 million as of December 31, 2013, compared to \$35.0 million, \$45.0 million, \$65.0 million, \$205.0 million, and \$270.0 million as of December 31, 2012, 2011, 2010, 2009 and 2008, respectively. Based on available collateral as of December 31, 2013, we could borrow an additional \$116.1 million.

We also have the ability to borrow up to \$38.0 million on a daily basis through correspondent banks using established unsecured federal funds purchased lines of credit. We did not access these lines of credit during 2013; in fact, we have not accessed the lines of credit since January of 2010. In contrast, federal funds sold averaged \$83.5 million, \$75.7



million and \$78.6 million during 2013, 2012 and 2011, respectively. In addition, interest-bearing deposit balances averaged \$7.7 million, \$10.5 million and \$9.7 million during the respective time periods. Given the volatile market and stressed economic conditions, we have been operating with a higher than normal balance of federal funds sold and interest-bearing deposit balances over the past several years. Reflecting our improved operating performance and financial condition, we expect to modestly reduce the level of federal funds sold and interest-bearing deposits in 2014, likely to average 3.0% to 4.0% of average earning assets; however, until market and economic conditions return to more normalized levels, the average balance of federal funds sold and interest-bearing deposits will likely remain above our historical average of less than 1.0%. As a result, we expect the use of our federal funds purchased lines of credit, in at least the near future, will be rare, if at all.

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We have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using a substantial majority of our tax-exempt municipal securities as collateral, we could have borrowed up to \$14.4 million for terms of 1 to 28 days at December 31, 2013. We did not utilize this line of credit during the past five years, and do not plan to access this line of credit in future periods.

The following table reflects, as of December 31, 2013, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Deposits without a stated Maturity	\$ 607,943,000	\$ 0	\$ 0	\$ 0	\$ 607,943,000
Certificates of deposit	213,454,000	153,409,000	144,105,000	0	510,968,000
Short-term borrowings	69,305,000	0	0	0	69,305,000
Federal Home Loan Bank Advances	0	0	45,000,000	0	45,000,000
Subordinated debentures	0	0	0	32,990,000	32,990,000
Other borrowed money	0	0	0	1,620,000	1,620,000

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, 2013, we had a total of \$354.8 million in unfunded loan commitments and \$19.7 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$296.0 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$58.8 million were for loan commitments scheduled to close and become funded within the next twelve months. The level of commitments to make loans over the past several years had declined significantly when compared to historical levels, primarily reflecting stressed economic conditions; however, the \$58.8 million level at December 31, 2013 is higher when compared to the levels over the past several years. The increase primarily reflects the impact of our improved operating performance and financial condition, expanded sales efforts and improved economic conditions. 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:

	12/31/13	12/31/12	12/31/11
Commercial unused lines of credit	\$ 257,937,000	\$ 222,237,000	\$ 171,683,000
Unused lines of credit secured by 1-4 family residential properties	23,429,000	24,250,000	24,663,000
Credit card unused lines of credit	9,013,000	8,512,000	7,565,000
Other consumer unused lines of credit	5,695,000	4,613,000	3,367,000
Commitments to make loans	58,799,000	64,565,000	30,929,000
Standby letters of credit	19,670,000	10,591,000	15,923,000
<b>Total</b>	<b>\$ 374,543,000</b>	<b>\$ 334,768,000</b>	<b>\$ 254,130,000</b>

We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, economic or market conditions, reduction in earnings performance, declining capital levels or situations beyond our control could cause liquidity challenges. While we believe it is unlikely that a funding crisis of any significant degree is likely to materialize, we have developed a comprehensive contingency funding plan that provides a framework for meeting liquidity disruptions.

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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, 2013:

	Within Three Months	Three to Twelve Months	One to Five Years	After Five Years	Total
<b>Assets:</b>					
Commercial loans (1)	\$ 169,662,000	\$ 154,515,000	\$ 614,712,000	\$ 39,614,000	\$ 978,503,000
Residential real estate loans	24,530,000	7,750,000	26,257,000	13,515,000	72,052,000
Consumer loans	1,531,000	153,000	761,000	243,000	2,688,000
Securities (2)	14,321,000	1,598,000	13,845,000	113,375,000	143,139,000
Federal funds sold	123,427,000	0	0	0	123,427,000
Interest-bearing deposits	5,639,000	0	750,000	0	6,389,000
Allowance for loan losses	0	0	0	0	(22,821,000)
Other assets	0	0	0	0	123,589,000
<b>Total assets</b>	<b>339,110,000</b>	<b>164,016,000</b>	<b>656,325,000</b>	<b>166,747,000</b>	<b>\$ 1,426,966,000</b>
<b>Liabilities:</b>					
Interest-bearing checking	197,388,000	0	0	0	197,388,000
Savings deposits	52,606,000	0	0	0	52,606,000
Money market accounts	133,369,000	0	0	0	133,369,000
Time deposits under \$100,000	7,068,000	13,760,000	26,501,000	0	47,329,000
Time deposits \$100,000 & over	57,469,000	135,157,000	271,013,000	0	463,639,000
Short-term borrowings	69,305,000	0	0	0	69,305,000
Federal Home Loan Bank advances	0	0	45,000,000	0	45,000,000
Other borrowed money	34,610,000	0	0	0	34,610,000
Noninterest-bearing checking	0	0	0	0	224,580,000
Other liabilities	0	0	0	0	5,815,000
<b>Total liabilities</b>	<b>551,815,000</b>	<b>148,917,000</b>	<b>342,514,000</b>	<b>0</b>	<b>1,273,641,000</b>
Shareholders' equity	0	0	0	0	153,325,000
<b>Total liabilities &amp; shareholders' equity</b>	<b>551,815,000</b>	<b>148,917,000</b>	<b>342,514,000</b>	<b>0</b>	<b>\$ 1,426,966,000</b>
	\$ (212,705,000)	\$ 15,099,000	\$ 313,811,000	\$ 166,747,000	

Net asset (liability)  
GAP

Cumulative GAP	\$ (212,705,000)	\$ (197,606,000)	\$ 116,205,000	\$ 282,952,000
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Percent of cumulative  
GAP to total assets

(14.9%)	(13.8%)	8.1%	19.8%
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- (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, 2013.

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.

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Key assumptions in the model include prepayment speeds on various loan and investment assets; cash flows and maturities of interest-sensitive assets and liabilities; and changes in market conditions impacting loan and deposit volume and pricing. These assumptions are inherently uncertain, subject to fluctuation and revision in a dynamic environment; therefore, the model cannot precisely estimate net interest income or exactly predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude, and frequency of interest rate changes and changes in market conditions and our strategies, among other factors.

We conducted multiple simulations as of December 31, 2013, in which it was assumed that changes in market interest rates occurred ranging from up 400 basis points to down 400 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on net interest income over the next twelve months in comparison to estimated net interest income based on our balance sheet structure, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of December 31, 2013. The resulting estimates are well within our policy parameters established to manage and monitor interest rate risk.