



# GROWING COMMUNITY

2014 Annual Report



Mercantile<sup>®</sup>  
Bank Corporation



53 BRANCHES

# LIMITLESS OPPORTUNITIES

This combination of two equal-sized companies was a large undertaking, and our success was a direct reflection of the talent and dedication of our staff.

## A truly transformational year.

The year 2014 was a phenomenal year for our Company. Our goal of creating “Michigan’s Community Bank®” was greatly advanced during that time. Highlighted by the June 1 closing of our merger with Firstbank, the year was noteworthy on many fronts. **Mercantile Bank of Michigan® now boasts an enhanced statewide branching system of 53 locations to better serve our customers.**

These branches are staffed with some of the best bankers in the state, ready to offer premier service and an expanded array of products and services. Our larger retail footprint, combined with our strong e-banking platform, affords our customers maximum flexibility for their banking needs. The integration of the merger went exceedingly well, with minimal customer disruption. This combination of two equal-sized companies was a large undertaking, and our success was a direct reflection of the talent and dedication of our staff. The merger transition and operational teams are to be commended for their excellent work.

# 2014

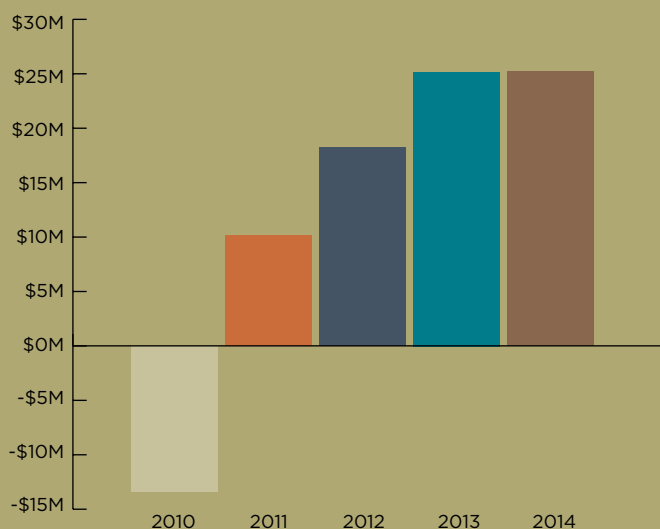
The financial benefits of the merger began to accrue immediately upon consummation. Despite an interest rate environment that has challenged our industry with interest rate margin compression, we were able to increase our net interest margin from 3.42% during the first quarter of 2014 to an average of 3.87% during the third and fourth quarters of 2014. We remain on track to realize the \$5.5 million in annual cost savings articulated with the merger announcement. These savings will become even more meaningful in 2015 as one-time merger expenses dissipate and the full benefit of our consolidation accrues.

The merger also enhanced our strategic efforts to improve liquidity and to diversify both our loan and deposit portfolios. Local deposits represented 92% of total deposits as of year-end 2014, while wholesale funds accounted for less than 10% of total funding sources. The charts included with this report show the expanded diversity of both our loan and deposit portfolios.

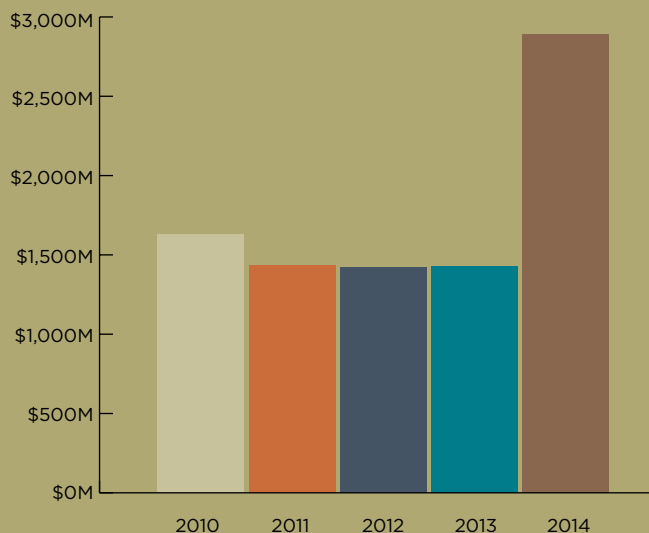
# FINANCIAL PERFORMANCE

## PERFORMANCE

Income (loss)  
Before Income Tax Expense (benefit)



Total Assets

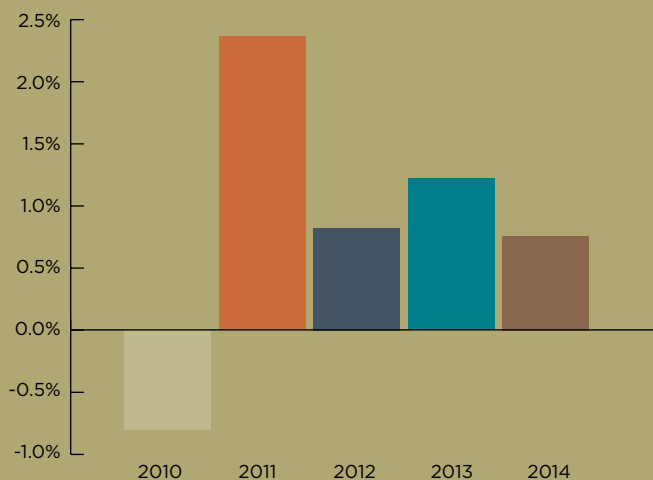


While our main focus was clearly on the successful completion of the merger, our dedication to strong financial performance was also evident for the year. Net income increased to \$17.3 million for 2014, despite \$5.4 million in one-time merger related expenses. Asset quality continued to be outstanding, with our ratio of non-performing loans to total assets at 1.09% as of December 31, 2014.

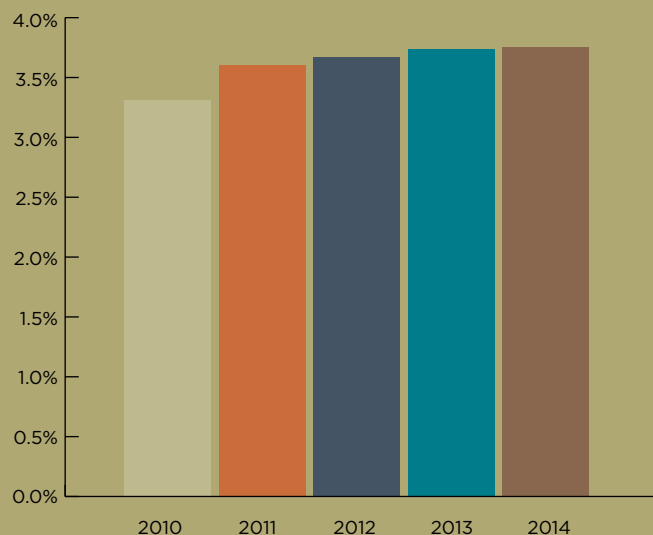
The healthy state of our loan portfolio, combined with our low loan loss experience and high loan loss recoveries for the year, allowed us to record a negative provision for loan loss of \$3.0 million, following a negative provision of \$7.2 million in 2013. We are encouraged by the outlook for asset quality as measured by our very low delinquency rate of 0.08% for our 30- to 89-day past due loans at year-end 2014.

## RETURN

Return on Average Assets

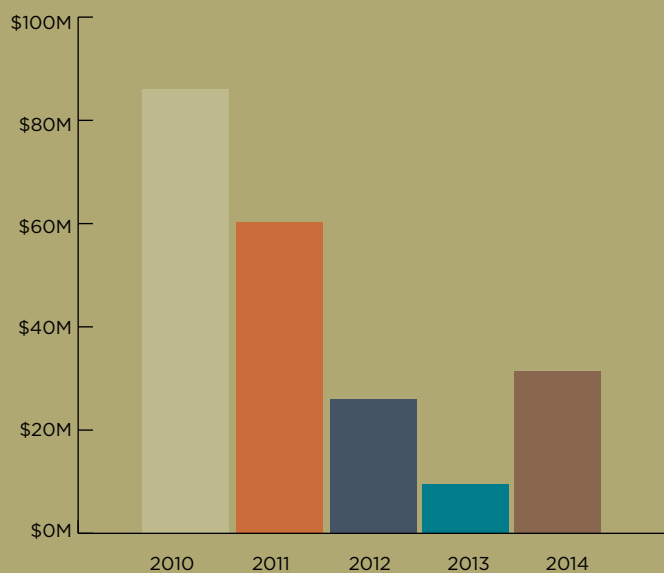


Net Interest Margin

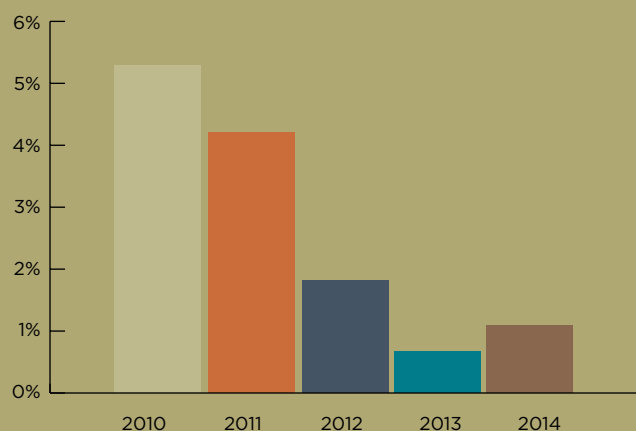


## STRENGTH

Non-Performing Assets



Non-Performing Assets (% of total assets)



The year was rewarding for our shareholders as well. Cash dividends paid to our shareholders totaled \$2.48 per share, including the special \$2.00 per share dividend declared and paid prior to the merger as part of the Firstbank merger agreement. Despite the increased dividends and the completion of the merger, Mercantile Bank of Michigan remained “well-capitalized” with a total risk-based capital ratio of 14.37% as of December 31, 2014, with approximately \$100 million in excess of the 10% minimum regulatory threshold required to be considered a “well-capitalized” institution.

As a result of our strong capital position, the Board of Directors recently initiated a new program to repurchase up to \$20.0 million of the Company’s common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with federal securities laws. We believe the repurchase program will be an additional benefit to our shareholders and will enhance shareholder value.



OUR PASSION

## COMMUNITY BANKING

In 2014, 29,688 volunteer hours were reported. That is 57 volunteer hours per employee. In addition, Mercantile employees hold 168 board positions in our various communities.

29,

The strength of Mercantile resides in our talented, experienced and dedicated team of employees. **They performed at an outstanding level all year.** The merger integration was a challenging process, with numerous changes to procedures and operating systems. Additionally, our workforce more than doubled, requiring exceptional teamwork to ensure our customers continued to receive the fantastic service they have come to expect, even during the system conversion process.



Our community involvement and philanthropic support of the markets we serve were stronger than ever in 2014. Mercantile employees contributed over 29,000 hours of volunteer service to help make our communities better places to live and work. Our employees were busy providing leadership, guidance and manpower for many organizations throughout Western and Central Michigan. Our Giving Together program, launched in 2013 via our Facebook page to support local non-profit organizations, awarded \$5,000 each to:

- **Alma Community Art Center** (Alma)
- **Arbor Circle** (Grand Rapids)
- **Conductive Learning Center** (Grand Rapids)
- **The Geek Group** (Grand Rapids)



Each of our locations conducts monthly Jean Days, when employees may wear jeans for a donation to selected organizations. During the year, a total of \$28,500 was generated through the program and donated to numerous non-profits within our markets. In addition to the amount raised by our employees, Mercantile Bank contributed over \$460,000 in community support during 2014.

688

**For the tenth consecutive year, we were named by the Michigan's Business and Professional Association (MBPA) one of West Michigan's 101 Best and Brightest Companies to Work For.™**

THE ROAD AHEAD

# CONFIDENT JOURNEY

Measured by total deposits,  
Mercantile Bank of Michigan  
is the fourth largest Michigan-  
headquartered bank.

4  
20





Measured by total deposits, Mercantile is the fourth largest Michigan-headquartered bank. Our size and scale allow us to provide cutting-edge products and services.

**Our strong community banking culture values excellent relationships.** We believe we are well positioned to participate in the growing economic vitality of our communities and plan to play a large role in strengthening all of our markets.

# 15

We appreciate all of the incredible work put forth by our associates this year. Additionally, the support and confidence of our customers as well as the communities we serve have been most gratifying. As a shareholder, we want you to know that we deeply value your ongoing trust in our Company and assure you that we are motivated to extend our success into 2015 and beyond!

**Michael H. Price**  
President & Chief Executive Officer

**Thomas R. Sullivan**  
Chairman, Board of Directors



## BOARD OF DIRECTORS

### STANDING, LEFT TO RIGHT

**David M. Cassard**

Retired Real Estate Executive

**Edward B. Grant, CPA, PhD**

General Manager of Public Broadcasting  
Central Michigan University

**Jeff A. Gardner, CPM**

Owner, Gardner Group

**Calvin D. Murdock**

Retired Electronics Executive

### SEATED, LEFT TO RIGHT

**Michael H. Price**

President & Chief Executive Officer

**Thomas R. Sullivan**

Chairman, Board of Directors

**Mr. Calvin Murdock, who is a founding organizer and Director of our Company, will retire effective at our 2015 Annual Meeting. We wish to thank Calvin for his 17 years of leadership and guidance. He is a friend to many of us and made numerous contributions to our success.**

## EXECUTIVE OFFICERS



### LEFT TO RIGHT

**Samuel G. Stone**

Executive Vice President  
Corporate Finance & Strategic Planning

**Charles E. Christmas**

Senior Vice President  
Chief Financial Officer & Treasurer

**Michael H. Price**

President & Chief Executive Officer

**Robert B. Kaminski, Jr.**

Executive Vice President  
Chief Operating Officer & Secretary

**Thomas R. Sullivan**

Chairman, Board of Directors

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2014

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:

Title of each class

Common Stock

Name of each exchange on which registered

The Nasdaq Stock Market LLC

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

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

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 \$377 million.

As of March 6, 2015, there were issued and outstanding 16,888,530 shares of the registrant's common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's proxy statement for the Annual Meeting of Shareholders to be held May 28, 2015 are incorporated by reference into Part III of this report.

## PART I

### Item 1. Business.

#### The Company

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

Mercantile Insurance Center, Inc. (“our insurance company”), a subsidiary of our bank, commenced operations during 2002 to offer insurance products. Mercantile Bank Real Estate Co., L.L.C., (“our real estate company”), a subsidiary of our bank, was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids which serves as our bank’s main office and Mercantile Bank Corporation’s headquarters. Mercantile Bank Capital Trust I (“our trust”), a business trust subsidiary, was formed in September 2004 to issue trust preferred securities.

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

#### Firstbank Corporation Merger

We completed our merger with Firstbank Corporation (“Firstbank”), a Michigan corporation with approximately \$1.5 billion in total assets and 46 branch locations, into Mercantile Bank Corporation as of June 1, 2014 (“Merger Date”). The merger was accounted for using the acquisition method of accounting, with Mercantile treated as the acquirer for accounting purposes. The results of operations due to the Firstbank transaction have been included in Mercantile’s financial results since the Merger Date. All of Firstbank’s common stock was converted into the right to receive one share of Mercantile common stock for each share of Firstbank common stock. The conversion of Firstbank’s common stock into Mercantile’s common stock resulted in Mercantile issuing 8,087,272 shares of common stock. As of the Merger Date, former Firstbank shareholders owned approximately 48% of the combined company. The merger substantially expanded our geographic footprint and increased the size of our balance sheet.

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

Our Board of Directors declared a special cash dividend on our common stock on May 9, 2014, in the amount of \$2.00 per share that was paid on May 29, 2014 to shareholders of record as of May 22, 2014. The special cash dividend, in contemplation of the plan of merger with Firstbank, was paid to Mercantile shareholders prior to the effective date of the merger with Firstbank and before the issuance of Mercantile shares in exchange for Firstbank shares.

## **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 53 office locations, provides commercial banking services primarily to small- to medium-sized businesses and retail banking services in and around the West and Central portions of Michigan. Our bank's main office is located in Grand Rapids, with branch office locations in Alma, Ashley, Belding, Cadillac, Canadian Lakes, Clare, Comstock Park, DeWitt, Fairview, Grand Rapids, Hale, Hastings, Higgins Lake, Holland, Howard City, Ionia, Ithaca, Kalamazoo, Kentwood, Lakeview, Lansing, Lowell, Merrill, Mt. Pleasant, Paw Paw, Portage, Remus, Rose City, Shepherd, St. Charles, St. Helen, St. Johns, St. Louis, Vestaburg, West Branch, and Wyoming.

Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns 53 automated teller machines ("ATM") located at certain of our office locations and at one 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 a vast majority of our office locations. Our bank does not have trust powers.

## **Our Insurance Company**

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent.

## **Our Real Estate Company**

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

## **Our Trusts**

We have five business trusts that are wholly-owned subsidiaries of Mercantile, four of which were assumed by Mercantile in conjunction with the merger with Firstbank. Each of the trusts was formed to issue Preferred Securities that were sold in private sales, as well as selling Common Securities to Mercantile. The proceeds from the Preferred and Common Securities sales were used by the trusts to purchase Floating Rate Notes issued by Mercantile. The rates of interest, interest payment dates, call features and maturity dates of each Floating Rate Note are identical to its respective Preferred Securities. The net proceeds from the issuance of the Floating Rate Notes were used for a variety of purposes, including contributions to our bank as capital to provide support for asset growth and the funding of stock repurchase programs and certain acquisitions.

The only significant assets of our trusts are the Floating Rate Notes, and the only significant liabilities of our trusts are the Preferred Securities. The Floating Rate Notes are categorized on our Consolidated Balance Sheets as subordinated debentures, and the interest expense is recorded on our Consolidated Statements of Income under interest expense on other borrowings.

## **Effect of Government Monetary Policies**

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

## **Regulation and Supervision**

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

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

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

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.

## **Employees**

As of December 31, 2014, we employed 550 full-time and 181 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 \$7.5 million, up to the legal lending limit of approximately \$80.2 million, require approval by the Board of Directors. 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.

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, generally according to secondary market underwriting standards. Loans not conforming to those standards are made in certain circumstances. Single-family residential real estate loans provide borrowers with a fixed or adjustable interest rate with terms up to 30 years 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.

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We believe our consumer loans are underwritten carefully, with a strong emphasis on the amount of the down payment, credit quality, employment stability and monthly income of the borrower. These loans are generally repaid on a monthly repayment schedule with the source of repayment tied to the borrower's periodic income. In addition, consumer lending collections are dependent on the borrower's continuing financial stability, and are thus likely to be adversely affected by job loss, illness and personal bankruptcy. In many cases, repossessed collateral for a defaulted consumer loan will not provide an adequate source of repayment of the outstanding loan balance because of depreciation of the underlying collateral.

We believe that the generally higher yields earned on consumer loans compensate for the increased credit risk associated with such loans, and that consumer loans are important to our efforts to serve the credit needs of the communities and customers that we serve.

### **Loan Portfolio Quality**

We utilize a comprehensive grading system for our commercial loans, whereby all commercial loans are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, operating performance, financial condition, collateral, industry condition and management. All commercial loans are graded at inception and reviewed at various intervals.

Our independent loan review program is primarily responsible for the administration of the grading system and ensuring adherence to established lending policies and procedures. The loan review program is an integral part of maintaining our strong asset quality culture. The loan review function works closely with senior management, although it functionally reports to the Board of Directors. Using a risk-based approach to selecting credits for review, our loan review program covers approximately 40% of total loans outstanding each year. Our watch list credits are reviewed monthly by our Board of Directors and our Watch List Committee, the latter of which is comprised of senior level officers from the administration, lending and loan review functions.

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, 2014, loans placed in nonaccrual status totaled \$29.4 million, or 1.4% of total loans, compared to \$6.7 million, or 0.6% of total loans, at December 31, 2013. Loans past due 90 days or more and still accruing interest at year-end 2014 totaled less than \$0.1 million, and we had no such loans as of year-end 2013.

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

### **Allowance for Loan Losses**

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at an adequate level. Through the loan review and credit departments, we establish specific portions of the allowance based on specifically identifiable problem loans. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Allowance Analysis, loan loss migration analysis, composition of the loan portfolio, third party analysis of the loan administration processes and portfolio, and general economic conditions.

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

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired commercial loans. Our migration takes into account various time periods, with most weight placed on the twelve-quarter time frame. We believe the twelve-quarter period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our 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, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on 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.

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

## **Investments**

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

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

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

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

## **Competition**

We face substantial competition in all phases of our operations from a variety of different competitors. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks, savings banks, thrifts, credit unions and other financial institutions as well as from other entities that provide financial services. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our primary competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do, and offer larger branch networks and other services which we do not. Most of these same entities have greater capital resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. Under specified circumstances (that have been modified by the Dodd-Frank Act), 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.

#### **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 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.

**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.

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

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

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

Our success depends, in part, on the ability to adapt products and services to evolving industry standards. There is increasing pressure to provide products and services at lower prices. This can reduce net interest income and noninterest income from fee-based products and services. In addition, the widespread adoption of new technologies could require us to make substantial capital expenditures to modify or adapt existing products and services or develop new products and services. We may not be successful in introducing new products and services in response to industry trends or developments in technology, or those new products may not achieve market acceptance. As a result, we could lose business, be forced to price products and services on less advantageous terms to retain or attract clients, or be subject to cost increases. As a result, our business, financial condition, or results of operations may be adversely affected.

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

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

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

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

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

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial industry. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Even routine funding transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

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

In response to the turmoil in the financial services sector and the severe recession in the broader economy that began in 2008, 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, and ceased such purchases by the end of October, 2014. In September, 2014, the Federal Reserve Board announced principles it would follow to implement monetary policy normalization, that is, to raise the Federal funds rate and other short-term interest rates to more normal levels and to reduce the Federal Reserve's securities holdings, so as to promote its statutory mandate of maximum employment and price stability. There can be no assurance as to the actual impact of those policies on the financial markets, the broader economy, or on our business, financial condition, results of operations, access to credit or the trading price of our common stock.

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

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

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

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

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

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

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

In many situations, our Board of Directors has the authority, without any vote of our shareholders, to issue shares of our authorized but unissued preferred or common stock, including shares authorized and unissued under our 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.

**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) that 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 previous U.S. law and regulations. In July, 2013, the U.S. federal bank regulatory agencies adopted regulations to implement the provisions of the Dodd-Frank Act and Basel III for U.S. financial institutions. The new regulations became applicable to us and our bank effective January 1, 2015.

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 was not imposed under previous risk-based capital regulations, may be avoided by banking organizations, such as us and our bank, that are not Advanced Approaches Entities, by making a one-time, irrevocable election on the first quarterly regulatory report following the date on which the regulations become effective as to them. We intend to make the one-time, irrevocable election regarding the treatment of AOCI by March 31, 2015.

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

On January 1, 2015, for banking organizations such as us and our bank that are not Advanced Approaches Entities, the new regulations 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.

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 interest.

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

**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 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 2014 fiscal year and that remain unresolved.

**Item 2. Properties.**

Our headquarters is located in our bank's main office facility in Grand Rapids, Michigan. Our bank operates 53 banking offices throughout Western and Central Michigan, most of which are full-service facilities. We have larger banking facilities in Alma, Holland, Ionia, Kalamazoo, Lansing, Mt. Pleasant and West Branch. The remaining banking offices generally range in size from 1,200 to 3,200 square feet, based on the location and number of employees located at the facility. All but six of the banking offices are owned by our bank, with the remaining facilities rented under various operating lease agreements. In several instances, the banking offices contain more usable space than what is needed for current banking operations. This excess space, totaling approximately 23,500 square feet, is generally leased to unrelated businesses. In addition, certain functions operate out of our standalone facility located in Alma.

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

**Item 3. Legal Proceedings.**

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

**Item 4. Mine Safety Disclosures.**

Not applicable.

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

Our common stock is traded on the Nasdaq Global Select Market under the symbol "MBWM." At March 6, 2015, there were 1,663 record holders of our common stock. In addition, we estimate that there were approximately 7,000 beneficial owners of our common stock who own their shares through brokers or banks. The following table shows the high and low sales prices for our common stock as reported by the Nasdaq Global Select Market for the periods indicated and the quarterly and special cash dividends paid by us during those periods.

	<u>High</u>	<u>Low</u>	<u>Dividend</u>
<b>2014</b>			
First Quarter.....	\$ 22.15	\$ 18.82	\$ 0.12
Second Quarter .....	24.34	18.26	2.12
Third Quarter .....	23.58	18.40	0.12
Fourth Quarter .....	22.27	18.69	0.12
<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

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

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

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 was paid on March 10, 2014 to shareholders of record as of February 10, 2014. On May 9, 2014, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.12 per share that was paid on June 25, 2014 to shareholders of record as of June 13, 2014. On July 17, 2014, 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 24, 2014 to shareholders of record as of September 12, 2014. On October 16, 2014, 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 24, 2014 to shareholders of record as of December 12, 2014. In addition, on May 9, 2014, our Board of Directors declared a special cash dividend on our common stock in the amount of \$2.00 per share that was paid on May 29, 2014 to shareholders of record as of May 22, 2014. The special cash dividend, in contemplation of the plan of merger with Firstbank, was paid to Mercantile shareholders prior to the effective date of the merger with Firstbank and before the issuance of Mercantile shares in exchange for Firstbank shares.

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.

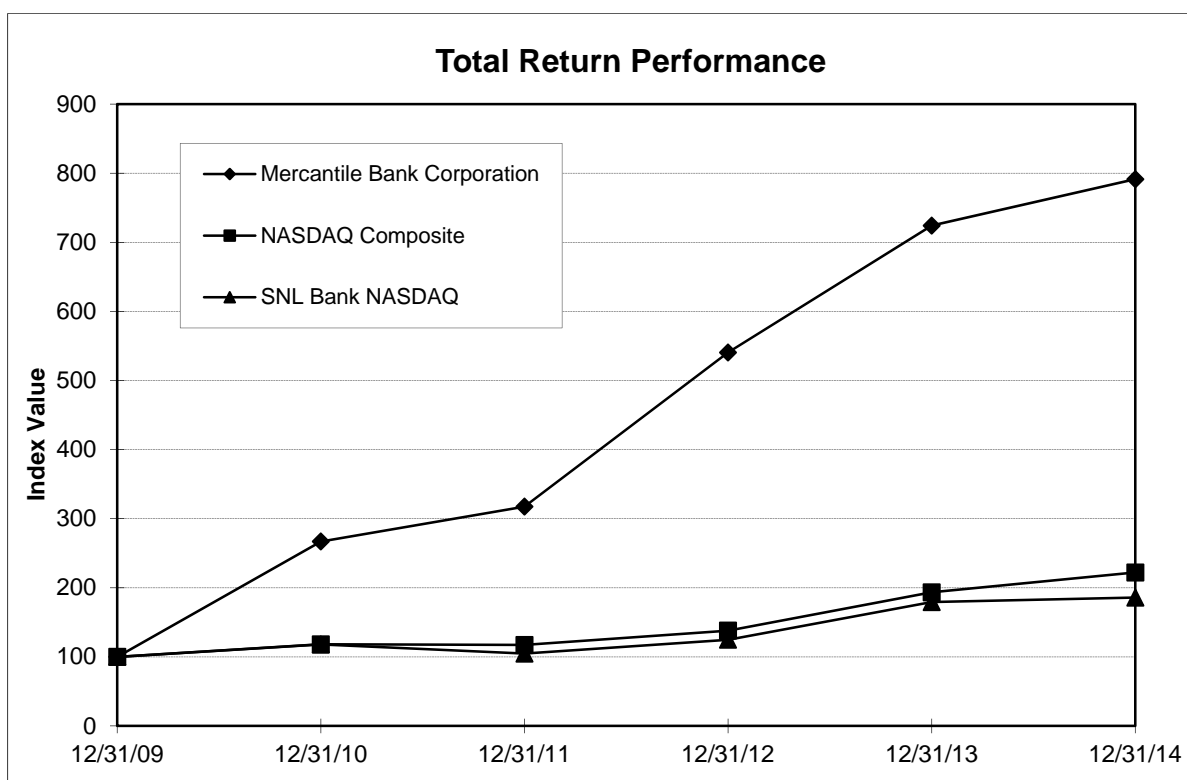
On January 15, 2015, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.14 per share that will be paid on March 25, 2015 to shareholders of record as of March 13, 2015.

#### Issuer Purchases of Equity Securities

There were no issuer purchases of equity securities during the fourth quarter of 2014. However, on January 30, 2015, we announced that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. We expect to fund a majority of such repurchases from cash dividends paid to us from our bank.

#### 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, 2009 through December 31, 2014. The following is based on an investment of \$100 on December 31, 2009 in our common stock, the Nasdaq Composite Index and the SNL Bank Nasdaq Index, with dividends reinvested where applicable.



Index	Period Ending					
	12/31/09	12/31/10	12/31/11	12/31/12	12/31/13	12/31/14
Mercantile Bank Corporation	100.00	267.01	317.48	540.57	724.28	791.34
NASDAQ Composite	100.00	118.15	117.22	138.02	193.47	222.16
SNL Bank NASDAQ	100.00	117.98	104.68	124.77	179.33	185.73

#### Item 6. Selected Financial Data.

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

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

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

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

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

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

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

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

None

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

As of December 31, 2014, 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, 2014.

There have been no significant changes in our internal control over financial reporting during the quarter ended December 31, 2014, 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, 2014. This evaluation was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Based on our evaluation under the COSO framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2014. Refer to page F-36 for management’s report.

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

**Item 9B. Other Information.**

None

### PART III

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

The information presented under the captions “Election of Directors,” “Executive Officers,” “Section 16(a) Beneficial Ownership Reporting Compliance” and “Corporate Governance – Code of Ethics” in the definitive Proxy Statement of Mercantile for our May 28, 2015 Annual Meeting of Shareholders (the “Proxy Statement”), a copy of which will be filed with the Securities and Exchange Commission before April 30, 2015, 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, Jeff A. Gardner, Edward B. Grant, and Calvin D. Murdock. The Board of Directors has determined that Messrs. Cassard, Grant, and Murdock, 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, Gardner, Grant, and Murdock are independent, as independence for audit committee members is defined in the Nasdaq listing standards and the rules of the Securities and Exchange Commission.

#### **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, 2014, relating to compensation plans under which equity securities are authorized for issuance.

<u>Plan Category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u> (a)	<u>Weighted-average exercise price of outstanding options, warrants and rights</u> (b)	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u> (c)
Equity compensation plans approved by security holders (1)	253,317	\$ 17.15	277,000 (2)
Equity compensation plans not approved by security holders	0	0	0
Total	253,317	\$ 17.15	277,000



(1) These plans are Mercantile's 2004 Employee Stock Option Plan and the Stock Incentive Plan of 2006. Also, in conjunction with the merger with Firstbank, we issued Mercantile stock options in replacement of all outstanding stock option grants that had been issued to Firstbank employees under the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 and the Firstbank Corporation Stock Compensation Plan.

(2) These securities are available under the Stock Incentive Plan of 2006. Incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards. No further issuances will be made under the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 or the Firstbank Corporation Stock Compensation Plan.

**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.

**PART IV**

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

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

Reports of Independent Registered Public Accounting Firm dated March 10, 2015 – BDO USA, LLP

Consolidated Balance Sheets --- December 31, 2014 and 2013

Consolidated Statements of Income for each of the three years in the period ended December 31, 2014

Consolidated Statements of Comprehensive Income for each of the three years in the period ended December 31, 2014

Consolidated Statements of Changes in Shareholders' Equity for each of the three years in the period ended December 31, 2014

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2014

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:

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
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 February 26, 2014 are incorporated by reference to exhibit 3.1 to our Current Report on Form 8-K filed February 26, 2015
4.1	Instruments defining the Rights of Security Holders – reference is made to Exhibits 3.1 and 3.2. In accordance with Regulation S-K Item 601(b)(4), Mercantile Bank Corporation is not filing copies of instruments defining the rights of holders of long-term debt because none of those instruments authorizes debt in excess of 10% of the total assets of Mercantile Bank Corporation and its subsidiaries on a consolidated basis. Mercantile Bank Corporation hereby agrees to furnish a copy of any such instrument to the Securities and Exchange Commission upon request.
10.1	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 *
10.2	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 *
10.3	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 *
10.4	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 *
10.5	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 *
10.6	Mercantile Bank Corporation Employee Stock Purchase Plan of 2014 is incorporated by reference to exhibit 4(b) of our Registration Statement on Form S-8 that became effective on June 27, 2014
10.7	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 *

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<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
10.8	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 *
10.9	2014 Mercantile Executive Officer Bonus Plan for the First Six Months of 2014, as amended by First Amendment, incorporated by reference to exhibit 10.1 of our Form 8-K filed May 22, 2014 *
10.10	Mercantile Executive Officer Bonus Plan for July – December 2014, incorporated by reference to exhibit 10.1 of our Form 8-K filed August 21, 2014 *
10.11	Credit Agreement and Form of Term Note between Mercantile Bank Corporation and U.S. Bank National Association dated as of May 21, 2014, incorporated by reference to exhibit 10.1 of our Form 8-K filed May 28, 2014
10.12	Employment Agreement dated as of November 13, 2014, effective as of December 31, 2014, among the company, our bank and Michael H. Price *
10.13	Employment Agreement dated as of November 13, 2014, effective as of December 31, 2014, among the company, our bank and Robert B. Kaminski, Jr *
10.14	Employment Agreement dated as of November 13, 2014, effective as of December 31, 2014, among the company, our bank and Charles E. Christmas *
10.15	Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan dated as of November 13, 2014, effective on January 1, 2015 *
10.16	Director Fee Summary *
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
101	The following information from Mercantile's Annual Report on Form 10-K for the year ended December 31, 2014, 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

**MERCANTILE BANK CORPORATION**

**FINANCIAL INFORMATION**

December 31, 2014 and 2013

MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION  
December 31, 2014 and 2013

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## SELECTED FINANCIAL DATA

	<u>2014 (*)</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
	(Dollars in thousands except per share data)				
<b>Consolidated Results of Operations:</b>					
Interest income	\$ 89,118	\$ 58,242	\$ 59,917	\$ 71,069	\$ 88,143
Interest expense	<u>11,340</u>	<u>10,786</u>	<u>13,216</u>	<u>19,832</u>	<u>31,794</u>
Net interest income	77,778	47,456	46,701	51,237	56,349
Provision for loan losses	(3,000)	(7,200)	(3,100)	6,900	31,800
Noninterest income	10,028	6,872	7,994	7,282	9,244
Noninterest expense	<u>65,610</u>	<u>36,403</u>	<u>39,624</u>	<u>41,495</u>	<u>47,156</u>
Income (loss) before income tax expense (benefit)	25,196	25,125	18,171	10,124	(13,363)
Income tax expense (benefit)	<u>7,865</u>	<u>8,092</u>	<u>5,636</u>	<u>(27,361)</u>	<u>(47)</u>
Net income (loss)	17,331	17,033	12,535	37,485	(13,316)
Preferred stock dividends and accretion	<u>0</u>	<u>0</u>	<u>1,030</u>	<u>1,343</u>	<u>1,295</u>
Net income (loss) attributable to common shares	<u>\$ 17,331</u>	<u>\$ 17,033</u>	<u>\$ 11,505</u>	<u>\$ 36,142</u>	<u>\$ (14,611)</u>
<b>Consolidated Balance Sheet Data:</b>					
Total assets	\$2,893,379	\$1,426,966	\$1,422,926	\$1,433,229	\$1,632,421
Cash and cash equivalents	172,738	146,965	136,003	76,372	64,198
Securities	446,611	143,139	150,275	184,953	235,175
Loans	2,089,277	1,053,243	1,041,189	1,072,422	1,262,630
Allowance for loan losses	20,041	22,821	28,677	36,532	45,368
Bank owned life insurance	57,861	51,377	50,048	48,520	46,743
Deposits	2,276,915	1,118,911	1,135,204	1,112,075	1,273,832
Securities sold under agreements to repurchase	167,569	69,305	64,765	72,569	116,979
Federal Home Loan Bank advances	54,022	45,000	35,000	45,000	65,000
Subordinated debentures	54,472	32,990	32,990	32,990	32,990
Shareholders' equity	328,138	153,325	146,590	164,999	125,936
<b>Consolidated Financial Ratios:</b>					
Return on average assets	0.76%	1.22%	0.82%	2.36%	(0.80%)
Return on average shareholders' equity	6.91%	11.36%	7.51%	27.28%	(10.62%)
Average shareholders' equity to average assets	11.05%	10.77%	10.90%	8.66%	7.56%
Nonperforming loans to total loans	1.41%	0.64%	1.82%	4.20%	5.50%
Allowance for loan losses to total originated loans	1.55%	2.17%	2.75%	3.41%	3.59%
Tier 1 leverage capital	11.15%	12.53%	11.31%	12.09%	9.09%
Tier 1 leverage risk-based capital	13.57%	14.65%	13.37%	14.19%	11.17%
Total risk-based capital	14.43%	15.91%	14.63%	15.46%	12.45%
<b>Per Common Share Data:</b>					
Net income (loss):					
Basic	\$ 1.28	\$ 1.96	\$ 1.33	\$ 4.20	\$ (1.72)
Diluted	1.28	1.95	1.30	4.07	(1.72)
Tangible book value per share at end of period	15.49	17.54	16.84	16.73	12.20
Dividends declared	2.48	0.45	0.09	0.00	0.01
Dividend payout ratio	141.16%	22.83%	6.73%	NA	NA

(\*) – Includes the merger with Firstbank effective June 1, 2014. See Note 2 to the Consolidated Financial Statements for additional information.

## **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; future impacts of the Firstbank merger; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; impact of technological advances; governmental and regulatory policy changes; outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and other risk factors described in Item 1A of this Annual Report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

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

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

We complete a migration analysis each quarter to assist us in determining appropriate reserve allocation factors for non-impaired commercial loans. Our migration takes into account various time periods, with most weight placed on the twelve-quarter time frame. We believe the twelve-quarter period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our 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, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our commercial loan portfolio.

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

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

Accounting guidance requires us to assess whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In making such judgments, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors that may impact future operating results. Significant weight is given to evidence that can be objectively verified.



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

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

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

Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. The quantitative test is a two-step process consisting of comparing the carrying value of the reporting unit to an estimate of its fair value. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2014, we elected to perform a qualitative assessment for our annual impairment test and concluded our fair value was greater than its carrying amount; therefore, no further testing was required.

## **INTRODUCTION**

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

On December 12, 2013, our shareholders and the shareholders of Firstbank Corporation (“Firstbank”) overwhelmingly voted to approve an Agreement and Plan of Merger providing for the merger of Mercantile and Firstbank. The merger was consummated effective June 1, 2014. For additional information, see “Item 1 - Business – Firstbank Corporation Merger” and Note 2- Business Combination in this Annual Report.

## **FINANCIAL OVERVIEW**

We reported net income of \$17.3 million, or \$1.28 per diluted share, for 2014, compared to \$17.0 million, or \$1.95 per diluted share, for 2013. Our 2014 earnings results were significantly impacted by the Firstbank merger. In addition to our results reflecting seven months of operations as a combined organization, we recorded relatively large merger-related costs during the year. Merger-related costs totaled \$5.4 million during 2014, equating to \$3.8 million, or \$0.28 per diluted share, on an after-tax basis. Merger-related costs totaled \$1.2 million during 2013, equating to \$1.1 million, or \$0.13 per diluted share, on an after-tax basis. We do not expect to record any further significant costs related to the Firstbank merger in future periods. Our projected annual cost savings as disclosed at the time the merger was announced were \$5.5 million, or approximately \$1.4 million quarterly. Our fourth quarter 2014 results included realizing a vast majority of this target. We expect to realize the full amount of this target in the first quarter of 2015 and subsequent quarters.

The overall quality of our loan portfolio remains strong, which when combined with recoveries of prior loan charge-offs and the eliminations of and reductions in specific reserves, have produced a positive impact on our allowance calculations and allowed us to make no or negative provisions in eight consecutive quarters and in eleven of the last twelve quarters. In addition, we have recorded a net loan recovery during seven out of the last twelve quarters. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries. The level of problem asset administration costs has declined substantially over the past several years, reflecting our improved asset quality.

New term loan originations totaled approximately \$258 million during 2014. We also experienced net increases in commercial lines of credit, in large part reflecting lines that are part of new commercial lending relationships established during recent quarterly periods. The new loan pipeline remains strong, and at year-end 2014 we had over \$150 million in unfunded loan commitments on commercial construction and development loans that are in the construction phase. We believe our loan portfolio is well diversified post-merger, with commercial real estate non-owner occupied loans comprising 27%, commercial and industrial loans equaling 26%, commercial real estate owner occupied loans comprising 21% and residential mortgage and consumer loans aggregating 18% of total loans as of December 31, 2014. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans combined equaled 57% at year-end 2014.

The merger with Firstbank also had a significant impact on our funding structure, resulting in a well diversified funding mix and an approximate 20 basis point reduction in our cost of funds as a percent of average earning assets. As of December 31, 2014, noninterest-bearing checking accounts comprised 22% of total funds, interest-bearing checking and sweep accounts combined for 23%, savings deposits and money market deposit accounts aggregated to 23% and local time deposits accounted for 23%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank (“FHLB”) advances, represented 9% of total funds.

## **FINANCIAL CONDITION**

Primarily reflecting the merger with Firstbank, our total assets increased \$1.47 billion during 2014, and totaled \$2.89 billion as of December 31, 2014. Total loans increased \$1.04 billion, securities available for sale were up \$302 million and cash and cash equivalents increased \$25.8 million. Total deposits increased \$1.16 billion and securities sold under agreements to repurchase (“sweep accounts”) were up \$98.3 million during 2014.

### ***Earning Assets***

Average earning assets equaled 92.0% of average total assets during 2014, compared to 92.3% during 2013. The loan portfolio continued to comprise a majority of earning assets, followed by securities, federal funds sold and interest-bearing deposits. Average total loans equaled 79.1% of average earning assets in 2014, while average securities, federal funds sold and interest-bearing deposits equaled a combined 20.9%. We expect the percentage of average assets comprised of average earning assets to remain relatively unchanged in future periods in comparison to 2014 levels; however, we also expect the loan component of earning assets to increase over the next couple of years as a sizable portion of our anticipated net loan growth is funded from monies from our excess interest-bearing deposit balances and from maturities and calls of U.S. Agency and municipal bonds and paydowns on mortgage-backed securities.

Our loan portfolio has historically been primarily comprised of commercial loans, although less so now following the merger with Firstbank. Commercial loans increased \$729 million during 2014, and at December 31, 2014 totaled \$1.72 billion, or 82.1% of the loan portfolio. As of December 31, 2013, the commercial loan portfolio comprised 93.7% of total loans. Commercial and industrial loans were up \$264 million, non-owner occupied commercial real estate (“CRE”) loans increased \$196 million, owner occupied CRE loans increased \$169 million, multi-family and residential rental loans increased \$85.1 million and vacant land, land development and residential construction loans were up \$15.2 million. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans combined equaled 57.2% as of December 31, 2014.

We have significantly enhanced our commercial loan calling efforts over the past few years. We are very pleased with the approximately \$664 million in new commercial term loan fundings over the past three years, and our current commercial loan pipeline reports indicate continued strong commercial loan funding opportunities in future periods. Also, as of December 31, 2014, availability on existing construction and development loans totaled over \$150 million, with most of those commitments expected to be drawn during 2015. Further, we have made additional lending commitments totaling about \$110 million, a majority of which we expect to be accepted and funded over the next 12 to 18 months. Our commercial loan officers also report substantial additional opportunities they are currently discussing with existing borrowers and potential new customers.

We continue to experience commercial loan principal paydowns and payoffs. While a portion of the principal paydowns and payoffs received thus far have been welcomed, such as on stressed lending relationships, we have also experienced significant instances where well-performing relationships have been refinanced at other financial institutions and other situations where the borrower has sold the underlying asset, paying off the loan. In many of those cases where the loans have been refinanced elsewhere, we believed the terms and conditions of the new lending arrangements were too aggressive, generally reflecting the very competitive banking environment in our markets. We remain committed to prudent underwriting standards that provide for an appropriate yield and risk relationship. In addition, we continue to receive accelerated principal paydowns from certain borrowers who have elevated deposit balances generally resulting from profitable operations and an apparent unwillingness to expand their business and /or replace equipment due to economic- and tax-related uncertainties. Usage of existing commercial lines of credit has remained relatively steady.

Reflecting the merger with Firstbank, one-to-four family mortgage loans increased \$183 million and other consumer-related loans were up \$124 million during 2014, and at December 31, 2014 totaled a combined \$374 million, or 17.9% of the loan portfolio. One-to-four family mortgage loans and other consumer-related loans equated to 6.3% of total loans as of December 31, 2013.

The following table summarizes our loan portfolio:

	<u>12/31/14</u>	<u>12/31/13</u>	<u>12/31/12</u>	<u>12/31/11</u>	<u>12/31/10</u>
Commercial:					
Commercial & Industrial	\$ 550,629,000	\$ 286,373,000	\$ 285,322,000	\$ 266,548,000	\$ 288,515,000
Land Development & Construction	51,977,000	36,741,000	48,099,000	63,467,000	83,786,000
Owner Occupied Commercial RE	430,406,000	261,877,000	259,277,000	264,426,000	277,377,000
Non-Owner Occupied Commercial RE	559,594,000	364,066,000	324,886,000	334,165,000	449,104,000
Multi-Family & Residential Rental	<u>122,772,000</u>	<u>37,639,000</u>	<u>50,922,000</u>	<u>68,299,000</u>	<u>77,188,000</u>
Total Commercial	<u>1,715,378,000</u>	<u>986,696,000</u>	<u>968,506,000</u>	<u>996,905,000</u>	<u>1,175,970,000</u>
Retail:					
1-4 Family Mortgages	214,695,000	31,467,000	33,766,000	33,181,000	35,474,000
Home Equity & Other Consumer Loans	<u>159,204,000</u>	<u>35,080,000</u>	<u>38,917,000</u>	<u>42,336,000</u>	<u>51,186,000</u>
Total Retail	<u>373,899,000</u>	<u>66,547,000</u>	<u>72,683,000</u>	<u>75,517,000</u>	<u>86,660,000</u>
Total	\$ <u>2,089,277,000</u>	\$ <u>1,053,243,000</u>	\$ <u>1,041,189,000</u>	\$ <u>1,072,422,000</u>	\$ <u>1,262,630,000</u>

The following table presents total loans outstanding as of December 31, 2014, 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.

	<u>Less Than One Year</u>	<u>One Through Five Years</u>	<u>More Than Five Years</u>	<u>Total</u>
Construction and land development	\$ 49,317,000	\$ 75,778,000	\$ 22,818,000	\$ 147,913,000
Real estate - residential properties	57,591,000	140,054,000	155,795,000	353,440,000
Real estate - multi-family properties	2,740,000	30,494,000	30,491,000	63,725,000
Real estate - commercial properties	192,177,000	668,671,000	89,950,000	950,798,000
Commercial and industrial	293,264,000	191,675,000	28,246,000	513,185,000
Consumer	<u>4,372,000</u>	<u>43,663,000</u>	<u>12,181,000</u>	<u>60,216,000</u>
Total loans	\$ <u>599,461,000</u>	\$ <u>1,150,335,000</u>	\$ <u>339,481,000</u>	\$ <u>2,089,277,000</u>
Fixed rate loans	\$ 329,023,000	\$ 1,133,206,000	\$ 332,789,000	\$ 1,795,018,000
Floating rate loans	<u>270,438,000</u>	<u>17,129,000</u>	<u>6,692,000</u>	<u>294,259,000</u>
Total loans	\$ <u>599,461,000</u>	\$ <u>1,150,335,000</u>	\$ <u>339,481,000</u>	\$ <u>2,089,277,000</u>

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.

Nonperforming assets, comprised of nonaccrual loans, loans past due 90 days or more and accruing interest and foreclosed properties, totaled \$31.4 million (1.1% of total assets) as of December 31, 2014, compared to \$9.6 million (0.7% of total assets) at December 31, 2013. The volume of nonperforming assets has generally been on a declining trend since the peak of \$118 million on March 31, 2010. Reductions in nonperforming assets over the past couple of years primarily reflect principal payments on nonaccrual loans and sales proceeds on foreclosed properties. After placing less than \$2.0 million of loans into nonaccrual status during 2013, that level increased to \$25.9 million during 2014; however, over 85% of that figure is related to one commercial loan relationship that was placed into nonaccrual status in late 2014. We are working closely with the owners to address the identified financial and operating weaknesses. Notwithstanding this one relatively large loan relationship, we are pleased with the overall quality of the loan portfolio.

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

#### NONPERFORMING LOANS

	<u>12/31/14</u>	<u>12/31/13</u>	<u>12/31/12</u>	<u>12/31/11</u>	<u>12/31/10</u>
Residential Real Estate:					
Land Development	\$ 84,000	\$ 40,000	\$ 1,188,000	\$ 1,179,000	\$ 11,775,000
Construction	0	0	319,000	686,000	1,037,000
Owner Occupied / Rental	<u>4,229,000</u>	<u>4,219,000</u>	<u>4,321,000</u>	<u>6,018,000</u>	<u>9,149,000</u>
	4,313,000	4,259,000	5,828,000	7,883,000	21,961,000
Commercial Real Estate:					
Land Development	209,000	389,000	737,000	1,661,000	2,044,000
Construction	0	0	0	409,000	0
Owner Occupied	18,089,000	885,000	2,577,000	8,133,000	11,629,000
Non-Owner Occupied	<u>378,000</u>	<u>169,000</u>	<u>9,093,000</u>	<u>23,914,000</u>	<u>25,428,000</u>
	18,676,000	1,443,000	12,407,000	34,117,000	39,101,000
Non-Real Estate:					
Commercial Assets	6,401,000	1,016,000	734,000	3,060,000	8,221,000
Consumer Assets	<u>42,000</u>	<u>0</u>	<u>1,000</u>	<u>14,000</u>	<u>161,000</u>
	6,443,000	1,016,000	735,000	3,074,000	8,382,000
 Total	 <u>\$ 29,432,000</u>	 <u>\$ 6,718,000</u>	 <u>\$ 18,970,000</u>	 <u>\$ 45,074,000</u>	 <u>\$ 69,444,000</u>

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

	<u>12/31/14</u>	<u>12/31/13</u>	<u>12/31/12</u>	<u>12/31/11</u>	<u>12/31/10</u>
Residential Real Estate:					
Land Development	\$ 329,000	\$ 427,000	\$ 1,174,000	\$ 4,300,000	\$ 2,772,000
Construction	0	22,000	157,000	711,000	1,296,000
Owner Occupied / Rental	<u>722,000</u>	<u>207,000</u>	<u>491,000</u>	<u>1,120,000</u>	<u>305,000</u>
	1,051,000	656,000	1,822,000	6,131,000	4,373,000
Commercial Real Estate:					
Land Development	0	92,000	52,000	450,000	410,000
Construction	0	0	0	0	0
Owner Occupied	247,000	164,000	957,000	2,509,000	3,111,000
Non-Owner Occupied	<u>697,000</u>	<u>1,939,000</u>	<u>4,139,000</u>	<u>6,192,000</u>	<u>8,781,000</u>
	944,000	2,195,000	5,148,000	9,151,000	12,302,000
Non-Real Estate:					
Commercial Assets	0	0	0	0	0
Consumer Assets	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
	0	0	0	0	0
Total	\$ <u>1,995,000</u>	\$ <u>2,851,000</u>	\$ <u>6,970,000</u>	\$ <u>15,282,000</u>	\$ <u>16,675,000</u>

The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Beginning balance	\$ 6,718,000	\$ 18,970,000	\$ 45,074,000	\$ 69,444,000	\$ 85,050,000
Additions, net of transfers to ORE	25,870,000	1,726,000	4,998,000	12,750,000	51,503,000
Returns to performing status	(779,000)	0	(774,000)	(766,000)	(11,124,000)
Principal payments	(2,064,000)	(10,934,000)	(25,095,000)	(24,795,000)	(24,213,000)
Loan charge-offs	<u>(313,000)</u>	<u>(3,044,000)</u>	<u>(5,233,000)</u>	<u>(11,559,000)</u>	<u>(31,772,000)</u>
Total	\$ <u>29,432,000</u>	\$ <u>6,718,000</u>	\$ <u>18,970,000</u>	\$ <u>45,074,000</u>	\$ <u>69,444,000</u>

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION

	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Beginning balance	\$ 2,851,000	\$ 6,970,000	\$ 15,282,000	\$ 16,675,000	\$ 26,608,000
Additions	2,593,000	2,181,000	11,808,000	11,504,000	9,159,000
Sale proceeds	(3,183,000)	(5,585,000)	(16,916,000)	(10,340,000)	(13,969,000)
Valuation write-downs	<u>(266,000)</u>	<u>(715,000)</u>	<u>(3,204,000)</u>	<u>(2,557,000)</u>	<u>(5,123,000)</u>
Total	\$ <u>1,995,000</u>	\$ <u>2,851,000</u>	\$ <u>6,970,000</u>	\$ <u>15,282,000</u>	\$ <u>16,675,000</u>

The level of net loan charge-offs continued to improve during 2014, primarily reflecting a decline in nonperforming loans, an improvement in the overall quality of the loan portfolio and significant recoveries of prior period charge-offs. During 2014, we recorded loan charge-offs totaling \$1.5 million and recoveries of prior period loan charge-offs aggregating \$1.7 million, thereby providing for a net loan recovery of \$0.2 million.

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

	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Originated loans outstanding at year-end	\$ <u>1,246,116,000</u>	\$ <u>1,053,243,000</u>	\$ <u>1,041,189,000</u>	\$ <u>1,072,422,000</u>	\$ <u>1,262,630,000</u>
Daily average balance of originated loans outstanding during the year	\$ <u>1,141,682,000</u>	\$ <u>1,050,961,000</u>	\$ <u>1,049,315,000</u>	\$ <u>1,148,671,000</u>	\$ <u>1,412,555,000</u>
Balance of allowance for originated loans at beginning of year	\$ 22,821,000	\$ 28,677,000	\$ 36,532,000	\$ 45,368,000	\$ 47,878,000
Originated loans charged-off:					
Commercial, financial and agricultural	(840,000)	(3,596,000)	(11,311,000)	(12,373,000)	(25,539,000)
Construction and land development	(36,000)	(822,000)	(348,000)	(2,919,000)	(9,273,000)
Residential real estate	(484,000)	(862,000)	(938,000)	(4,422,000)	(2,242,000)
Instalment loans to individuals	<u>(70,000)</u>	<u>(10,000)</u>	<u>(46,000)</u>	<u>(183,000)</u>	<u>(74,000)</u>
Total charge-offs	<u>(1,430,000)</u>	<u>(5,290,000)</u>	<u>(12,643,000)</u>	<u>(19,897,000)</u>	<u>(37,128,000)</u>
Recoveries of previously charged-off originated loans:					
Commercial, financial and agricultural	1,117,000	4,795,000	7,076,000	3,186,000	1,637,000
Construction and land development	180,000	897,000	285,000	441,000	995,000
Residential real estate	404,000	933,000	469,000	513,000	178,000
Instalment loans to individuals	<u>0</u>	<u>9,000</u>	<u>58,000</u>	<u>21,000</u>	<u>8,000</u>
Total recoveries	<u>1,701,000</u>	<u>6,634,000</u>	<u>7,888,000</u>	<u>4,161,000</u>	<u>2,818,000</u>
Net loan (charge-offs) recoveries	271,000	1,344,000	(4,755,000)	(15,736,000)	(34,310,000)
Provision for loan losses for originated loans	<u>(3,793,000)</u>	<u>(7,200,000)</u>	<u>(3,100,000)</u>	<u>6,900,000</u>	<u>31,800,000</u>
Balance of allowance for originated loans at end of year	\$ <u>19,299,000</u>	\$ <u>22,821,000</u>	\$ <u>28,677,000</u>	\$ <u>36,532,000</u>	\$ <u>45,368,000</u>
Ratio of net loan (charge-offs) recoveries to average loans outstanding during the year	<u>0.02%</u>	<u>0.13%</u>	<u>(0.45%)</u>	<u>(1.37%)</u>	<u>(2.43%)</u>
Ratio of allowance to originated loans outstanding at year-end	<u>1.55%</u>	<u>2.17%</u>	<u>2.75%</u>	<u>3.41%</u>	<u>3.59%</u>

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

	<u>12/31/2014</u>		<u>12/31/2013</u>		<u>12/31/2012</u>		<u>12/31/2011</u>		<u>12/31/2010</u>	
	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio
Commercial, financial and agricultural	\$ 16,112	82.8%	\$ 17,786	84.0%	\$ 22,646	85.3%	\$ 28,913	83.3%	\$ 32,645	81.5%
Construction and land development	1,012	8.8	1,858	8.9	2,246	6.2	3,484	7.5	7,019	9.3
Residential real estate	1,974	7.2	3,027	6.8	3,646	8.1	3,895	8.8	5,495	8.8
Instalment loans to individuals	125	1.2	68	0.3	139	0.4	158	0.4	172	0.4
Unallocated	<u>76</u>	<u>0.0</u>	<u>0</u>	<u>0.0</u>	<u>0</u>	<u>0.0</u>	<u>82</u>	<u>0.0</u>	<u>37</u>	<u>0.0</u>
Total	<u>\$ 19,299</u>	<u>100.0%</u>	<u>\$ 22,821</u>	<u>100.0%</u>	<u>\$ 28,677</u>	<u>100.0%</u>	<u>\$ 36,532</u>	<u>100.0%</u>	<u>\$ 45,368</u>	<u>100.0%</u>

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

	<u>12/31/14</u>	<u>12/31/13</u>	<u>12/31/12</u>	<u>12/31/11</u>	<u>12/31/10</u>
Ratio of allowance to nonperforming loans	68.09%	339.70%	151.17%	81.05%	65.33%

The ratio of our allowance to nonperforming loans had been on an increasing trend during the period of 2010 through 2013, generally reflecting total nonperforming loans declining at a faster rate than the balance of the allowance, as well as certain higher-balance commercial loan relationships being categorized as troubled debt restructurings resulting in higher specific reserve allocations. The decline during 2014 primarily reflects the aforementioned one commercial loan relationship that was placed into nonaccrual status during the fourth quarter of 2014.

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

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired commercial loans. Our migration takes into account various time periods, with most weight placed on the twelve-quarter time frame. We believe the twelve-quarter period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our 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, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on 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.

The allowance for originated loans equaled \$19.3 million as of December 31, 2014, or 1.5% of total originated loans outstanding, compared to 2.2% as of December 31, 2013. We also had an allowance for acquired loans as of December 31, 2014, totaling \$0.7 million. A large portion of the recent decline in the level of the allowance for originated loans reflects 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 most 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 total allowance equaled 68.1% of nonperforming loans as of December 31, 2014, compared to 339.7% as of December 31, 2013. Although this particular measurement had been increasing during the past several years primarily due to total nonperforming loans declining at a faster rate than the balance of the allowance and certain accruing higher-balance commercial loan relationships having been categorized as troubled debt restructurings resulting in higher specific reserve allocations, the aforementioned relatively larger credit relationship that was put into nonaccrual status in late 2014 had a substantial impact on this measurement. This particular credit relationship is collateralized by real estate and equipment.

As of December 31, 2014, the allowance for originated loans was comprised of \$9.1 million in general reserves relating to non-impaired loans, \$4.4 million in specific reserve allocations relating to nonaccrual loans, and \$5.8 million in specific allocations on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$50.4 million at December 31, 2014, consisting of \$26.4 million that are on nonaccrual status and \$24.0 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 \$1.3 million as of December 31, 2014 had been subject to previous partial charge-offs aggregating \$2.3 million. Those partial charge-offs were recorded as follows: \$0.2 million in 2014, \$0.3 million in 2013, \$1.0 million in 2012, \$0.6 million in 2011 and \$0.2 million in 2010. As of December 31, 2014, specific reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled less than \$0.1 million.

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

	<u>12/31/14</u>	<u>12/31/13</u>	<u>12/31/12</u>	<u>12/31/11</u>	<u>12/31/10</u>
Performing	\$ 24,001,000	\$ 30,247,000	\$ 38,148,000	\$ 26,155,000	\$ 12,263,000
Nonperforming	<u>26,433,000</u>	<u>4,645,000</u>	<u>12,612,000</u>	<u>14,508,000</u>	<u>19,050,000</u>
Total	<u>\$ 50,434,000</u>	<u>\$ 34,892,000</u>	<u>\$ 50,760,000</u>	<u>\$ 40,663,000</u>	<u>\$ 31,313,000</u>

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.

In large part reflecting the merger with Firstbank, securities increased \$302 million during 2014, totaling \$433 million as of December 31, 2014. The securities portfolio equaled 15.5% of average earning assets during 2014. Purchases during 2014, generally consisting of U.S. Government agency and municipal bonds, totaled \$19.9 million. Proceeds from matured and called U.S. Government agency and municipal bonds during 2014 totaled \$40.0 million and \$18.0 million, respectively, with another \$17.7 million from principal paydowns on mortgage-backed securities. At December 31, 2014, the securities portfolio was primarily comprised of U.S. Government agency bonds (45%), municipal bonds (33%) and U.S. Government agency issued or guaranteed mortgage-backed securities (22%). All of our securities are currently designated as available for sale, and therefore are stated at fair value. The fair value of securities designated as available for sale at December 31, 2014 totaled \$433 million, including a net unrealized gain of \$0.3 million. We maintain the securities portfolio at levels to provide adequate pledging and secondary liquidity for our daily operations. In addition, the securities portfolio serves a primary interest rate risk management function.

The following table reflects the composition of the securities portfolio:

	<u>12/31/14</u>		<u>12/31/13</u>		<u>12/31/12</u>	
	Carrying Value	Percent	Carrying Value	Percent	Carrying Value	Percent
U.S. Government agency debt obligations	\$ 193,468,000	44.7%	\$ 98,477,000	75.1%	\$ 79,098,000	57.2%
Mortgage-backed securities	93,561,000	21.6	13,558,000	10.3	21,996,000	15.9
Municipal general obligations	133,082,000	30.8	16,872,000	12.9	22,743,000	16.5
Municipal revenue bonds	10,873,000	2.5	916,000	0.7	1,817,000	1.3
Other investments	<u>1,928,000</u>	<u>0.4</u>	<u>1,355,000</u>	<u>1.0</u>	<u>12,660,000</u>	<u>9.1</u>
Totals	\$ <u>432,912,000</u>	<u>100.0%</u>	\$ <u>131,178,000</u>	<u>100.0%</u>	\$ <u>138,314,000</u>	<u>100.0%</u>

FHLB of Indianapolis (“FHLBI”) stock totaled \$13.7 million as of December 31, 2014, an increase of \$1.7 million during 2014. During 2014, our FHLBI stock investment increased \$7.2 million as a result of the merger with Firstbank, but then declined in late 2014 by \$5.5 million reflecting the impact of an involuntary excess stock repurchase program by the FHLBI. We continue to receive regular quarterly cash dividends, and we expect a cash dividend will continue in future quarterly periods.

Market values on our U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies and municipal bonds are determined on a monthly basis with the assistance of a third party vendor. Evaluated pricing models that vary by type of security and incorporate available market data are utilized. Standard inputs include issuer and type of security, benchmark yields, reported trades, broker/dealer quotes and issuer spreads. The market value of certain non-rated securities issued by relatively small municipalities generally located within our markets is estimated at carrying value. We believe our valuation methodology provides for a reasonable estimation of market value, and that it is consistent with the requirements of accounting guidelines. Reference is made to Note 18 of the Notes to Consolidated Financial Statements for additional information.

The following table shows by class of maturities as of December 31, 2014, the amounts and weighted average yields (on a fully taxable-equivalent basis) of investment securities:

	<u>Carrying Value</u>	<u>Average Yield</u>
Obligations of U.S. Government agencies:		
One year or less	\$ 10,960,000	0.31%
Over one through five years	73,105,000	1.08
Over five through ten years	26,365,000	2.31
Over ten years	<u>83,038,000</u>	<u>3.45</u>
	193,468,000	2.25
Obligations of states and political subdivisions:		
One year or less	16,702,000	1.00
Over one through five years	74,869,000	1.62
Over five through ten years	43,826,000	3.43
Over ten years	<u>8,558,000</u>	<u>5.49</u>
	143,955,000	2.31
Mortgage-backed securities	93,561,000	1.79
Other investments	<u>1,928,000</u>	<u>2.57</u>
Totals	\$ <u>432,912,000</u>	<u>2.17%</u>

Federal funds sold, consisting of excess funds sold overnight to correspondent banks, 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 4.5% of average earning assets during 2014, compared to 7.1% during 2013. We anticipate the level of these earning assets to average approximately 2% of average earning assets in future periods, with the year-end 2014 excess over that amount expected to fund net loan growth during the first part of 2015.

#### ***Non-Earning Assets***

In large part reflecting the merger with Firstbank, cash and due from bank balances increased \$26.6 million during 2014, while premises and fixed assets increased \$23.9 million. As of December 31, 2014, cash and due from bank balances totaled \$43.8 million, and premises and fixed assets totaled \$48.8 million. Foreclosed and repossessed assets totaled \$2.0 million at December 31, 2014, compared to \$2.9 million at December 31, 2013. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on some impaired lending relationships, we believe the strong 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***

Primarily reflecting the merger with Firstbank, total deposits increased \$1.16 billion during 2014, totaling \$2.28 billion as of December 31, 2014. Out-of-area deposits decreased \$37.5 million during 2014, and equaled 7.7% of total deposits at year-end 2014, compared to 19.0% as of December 31, 2013.

Noninterest-bearing checking accounts increased \$334 million during 2014. While the growth was primarily due to the merger with Firstbank, noninterest-bearing checking accounts also increased due to deposit account openings as part of new commercial lending relationships. Also primarily reflecting the impact of the Firstbank merger, interest-bearing checking accounts increased \$216 million, savings deposits grew \$278 million, money market deposit accounts increased \$102 million and local time deposits grew \$265 million during 2014.

Sweep accounts increased \$98.3 million during 2014, totaling \$168 million at December 31, 2014. The increase is primarily due to the merger with Firstbank. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings.

Primarily reflecting the merger with Firstbank, FHLB advances increased \$9.0 million during 2014, totaling \$54.0 million as of December 31, 2014. The FHLB advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit at year-end 2014 totaled \$410 million, with availability of \$356 million.

Shareholders' equity increased \$175 million during 2014, primarily reflecting the merger with Firstbank. We issued almost 8.1 million shares of common stock, with a value of \$173 million, in connection with the Firstbank merger. Net income totaled \$17.3 million during 2014. Negatively impacting shareholders' equity during 2014 were cash dividends on our common stock totaling \$24.5 million. In accordance with the plan of merger with Firstbank, we declared and paid a special \$2.00 per share cash dividend to Mercantile shareholders prior to the effective date of the merger and before the issuance of Mercantile shares in exchange for Firstbank shares. In addition, we declared and paid a \$0.12 per share cash dividend during each of the four quarters during 2014. Positively impacting shareholders' equity during 2014 was an increase in the net unrealized gain on securities available for sale of \$5.6 million.

## **RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2014 and 2013**

### ***Summary***

We recorded net income of \$17.3 million, or \$1.28 per basic and diluted share, for 2014, compared to net income of \$17.0 million, or \$1.96 per basic share and \$1.95 per diluted share, for 2013. The results for 2014 and 2013 were impacted by the merger with Firstbank, which was consummated on June 1, 2014; operating results for 2014 include seven months of operations as a combined organization. After-tax merger-related costs totaled \$3.8 million, or \$0.28 per basic and diluted share, during 2014 and \$1.1 million, or \$0.13 per basic and diluted share, during 2013. We do not expect to record any further significant costs related to the Firstbank merger in future periods. Our projected annual cost savings as disclosed at the time the merger was announced were \$5.5 million, or approximately \$1.4 million quarterly. Our fourth quarter 2014 results included realizing a vast majority of this target. We expect to realize the full amount of this target in the first quarter of 2015 and subsequent quarters.

The improved earnings performance in 2014 compared to 2013 primarily resulted from increased net interest income, which more than offset increased overhead costs. The increased net interest income primarily resulted from the higher level of average earning assets associated with the completion of the merger. Various nonmerger-related costs necessary to operate the combined company, along with a higher level of merger-related costs, resulted in the increase in overhead costs. The continued improvement in the quality of our loan portfolio and associated recoveries of previously charged-off loans, reversals of specific reserves, reduced level of loan-rating downgrades and ongoing loan-rating upgrades produced a positive impact on our loan loss reserve calculations and allowed us to make negative provisions to the loan loss reserve during 2014 and 2013. Increased noninterest income also contributed to the improved earnings performance in 2014; substantially all categories of noninterest income benefitted from the consummation of the merger.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2014 and 2013:

	<u>2014</u>	<u>2013</u>
Return on average assets	0.76%	1.22%
Return on average shareholders' equity	6.91%	11.36%
Average shareholders' equity to average assets	11.05%	10.77%

### ***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 \$89.6 million and \$11.3 million during 2014, respectively, providing for net interest income of \$78.3 million. During 2013, interest income and interest expense equaled \$58.7 million and \$10.8 million, respectively, providing for net interest income of \$47.9 million.

In comparing 2014 with 2013, interest income increased 52.6%, interest expense was up 5.1%, and net interest income increased 63.3%. 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, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The \$30.4 million increase in net interest income in 2014 compared to 2013 primarily resulted from a higher level of average earning assets. Average earning assets include Firstbank's assets from the date of acquisition. During 2014, the net interest margin equaled 3.75%, up from 3.73% during 2013. Although our yield on earning assets declined in 2014 compared to 2013 primarily due to decreased yields on average securities and loans, our cost of funds declined at a greater rate, resulting in the improved net interest margin. The declines in the yields on securities and loans reflect the ongoing low interest rate environment, while the cost of funds was positively impacted by the absorption of Firstbank's lower-costing interest-bearing liability base and the lowering of interest rates on certain non-certificate of deposit accounts in the latter part of the fourth quarter of 2013.

The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders' equity during 2014, 2013 and 2012. 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 both 2014 and 2013 and \$0.6 million in 2012.

(Dollars in thousands)	Years ended December 31,								
	2 0 1 4			2 0 1 3			2 0 1 2		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Taxable securities	\$ 262,696	\$ 6,417	2.44%	\$ 117,887	\$ 4,134	3.51%	\$ 112,122	\$ 4,383	3.91%
Tax-exempt securities	78,075	2,157	2.76	25,706	1,434	5.58	40,818	2,018	4.94
Total securities	340,771	8,574	2.52	143,593	5,568	3.88	152,940	6,401	4.19
Loans	1,653,605	80,824	4.89	1,050,961	52,924	5.04	1,049,315	53,898	5.14
Interest-bearing deposits	46,161	110	0.24	7,703	21	0.28	10,522	29	0.28
Federal funds sold	48,690	124	0.25	83,468	212	0.25	75,678	192	0.25
Total earning assets	2,089,227	89,632	4.29	1,285,725	58,725	4.57	1,288,455	60,520	4.70
Allowance for loan losses	(21,214)			(26,505)			(31,171)		
Cash and due from banks	35,248			17,420			16,217		
Other non-earning assets	166,652			115,758			132,105		
Total assets	<u>\$ 2,269,913</u>			<u>\$ 1,392,398</u>			<u>\$ 1,405,606</u>		
Interest-bearing demand deposits	\$ 323,335	\$ 1,141	0.35%	\$ 204,945	\$ 1,276	0.62%	\$ 205,848	\$ 1,572	0.76%
Savings deposits	223,658	405	0.18	55,214	142	0.26	42,452	118	0.28
Money market accounts	196,723	364	0.19	134,875	366	0.27	148,596	571	0.38
Time deposits	648,102	6,468	1.00	504,672	7,128	1.41	549,535	8,876	1.62
Total interest-bearing deposits	1,391,818	8,378	0.60	899,706	8,912	0.99	946,431	11,137	1.18
Short-term borrowings	105,474	122	0.12	65,939	80	0.12	61,930	157	0.25
Federal Home Loan Bank advances	51,456	636	1.24	39,082	533	1.36	39,809	993	2.49
Other borrowings	51,642	2,204	4.27	34,505	1,261	3.65	34,406	929	2.70
Total interest-bearing liabilities	1,600,390	11,340	0.71	1,039,232	10,786	1.04	1,082,576	13,216	1.22
Demand deposits	407,870			197,621			164,081		
Other liabilities	10,774			5,555			5,675		
Total liabilities	2,019,034			1,242,408			1,252,332		
Average equity	250,879			149,990			153,274		
Total liabilities and equity	<u>\$ 2,269,913</u>			<u>\$ 1,392,398</u>			<u>\$ 1,405,606</u>		
Net interest income		<u>\$ 78,292</u>			<u>\$ 47,939</u>			<u>\$ 47,304</u>	
Rate spread			<u>3.58%</u>			<u>3.53%</u>			<u>3.48%</u>
Net interest margin			<u>3.75%</u>			<u>3.73%</u>			<u>3.67%</u>

	Years ended December 31,					
	-----2014 over 2013-----			-----2013 over 2012-----		
	<u>Total</u>	<u>Volume</u>	<u>Rate</u>	<u>Total</u>	<u>Volume</u>	<u>Rate</u>
Increase (decrease) in interest income						
Taxable securities	\$ 2,283,000	\$ 3,842,000	\$ (1,559,000)	\$ (249,000)	\$ 218,000	\$ (467,000)
Tax exempt securities	723,000	1,740,000	(1,017,000)	(584,000)	(818,000)	234,000
Loans	27,900,000	29,447,000	(1,547,000)	(974,000)	136,000	(1,110,000)
Interest-bearing deposit balances	89,000	92,000	(3,000)	(8,000)	(8,000)	0
Federal funds sold	<u>(88,000)</u>	<u>(88,000)</u>	<u>0</u>	<u>20,000</u>	<u>20,000</u>	<u>0</u>
Net change in tax-equivalent interest income	30,907,000	35,033,000	(4,126,000)	(1,795,000)	(452,000)	(1,343,000)
Increase (decrease) in interest expense						
Interest-bearing demand deposits	(135,000)	555,000	(690,000)	(296,000)	(7,000)	(289,000)
Savings deposits	263,000	316,000	(53,000)	24,000	33,000	(9,000)
Money market accounts	(2,000)	136,000	(138,000)	(205,000)	(49,000)	(156,000)
Time deposits	(660,000)	1,733,000	(2,393,000)	(1,748,000)	(689,000)	(1,059,000)
Short-term borrowings	42,000	46,000	(4,000)	(77,000)	10,000	(87,000)
Federal Home Loan Bank advances	103,000	157,000	(54,000)	(460,000)	(18,000)	(442,000)
Other borrowings	<u>943,000</u>	<u>705,000</u>	<u>238,000</u>	<u>332,000</u>	<u>3,000</u>	<u>329,000</u>
Net change in interest expense	<u>554,000</u>	<u>3,648,000</u>	<u>(3,094,000)</u>	<u>(2,430,000)</u>	<u>(717,000)</u>	<u>(1,713,000)</u>
Net change in tax-equivalent net interest income	<u>\$30,353,000</u>	<u>\$31,385,000</u>	<u>\$ (1,032,000)</u>	<u>\$ 635,000</u>	<u>\$ 265,000</u>	<u>\$ 370,000</u>

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities, federal funds sold, and interest-bearing deposits. Interest income increased \$30.9 million during 2014 from that earned in 2013, totaling \$89.6 million in 2014 compared to \$58.7 million in the previous year. The increase in interest income is attributable to a higher level of average earning assets, which more than offset a decreased yield on average earning assets. During 2014 and 2013, earning assets had an average yield (tax equivalent-adjusted basis) of 4.29% and 4.57%, respectively. The decline in earning asset yield in 2014 mainly resulted from a decreased yield on average securities, and to a lesser extent, a decreased yield on average loans. During 2014, earning assets averaged \$2.09 billion, or \$803.5 million higher than average earning assets during 2013. Average loans increased \$602.6 million, average securities increased \$197.2 million, average interest-bearing deposits increased \$38.5 million, and average federal funds sold decreased \$34.8 million.

Interest income generated from the loan portfolio increased \$27.9 million in 2014 compared to the level earned in 2013; growth in the loan portfolio during 2014 resulted in a \$29.4 million increase in interest income, while a decline in loan yield from 5.04% in 2013 to 4.89% in 2014 resulted in a \$1.5 million decrease in interest income. The lower yield on average loans mainly resulted from a decreased yield on average commercial loans, which equaled 4.83% in 2014 compared to 5.06% in 2013. The commercial loan yield was negatively impacted by the lowering of rates on certain commercial loans throughout 2013 and 2014 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. Accretion of acquired loans totaled \$3.2 million during 2014.



Interest income generated from the securities portfolio increased \$3.0 million in 2014 compared to the level earned in 2013 due to portfolio growth associated with the merger with Firstbank, which more than offset a lower yield on average securities. The higher average portfolio balance resulted in a \$5.6 million increase in interest income, while the lower yield on average securities equated to a decrease in interest income of \$2.6 million. Average securities equaled \$340.8 million during 2014, up from \$143.6 million during 2013. The yield on securities equaled 2.52% in 2014 compared to 3.88% in 2013; the lower yield on average securities primarily resulted from decreased yields on municipal securities, mortgage-backed securities, and U.S. Government agency bonds, reflecting the ongoing low interest rate environment.

Interest income earned on federal funds sold decreased \$0.1 million in 2014 compared to 2013 due to a lower average balance, while interest income earned on interest-bearing deposits increased \$0.1 million due to a higher average balance, which more than offset a slight decline in yield.

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 increased \$0.5 million during 2014 from that expensed in 2013, totaling \$11.3 million in 2014 compared to \$10.8 million in the previous year. The increase in interest expense is attributable to a higher level of average interest-bearing liabilities, primarily reflecting the completion of the merger, which more than offset a decreased cost of funds.

During 2014 and 2013, interest-bearing liabilities had a weighted average rate of 0.71% and 1.04%, respectively; a decline in interest expense of \$3.1 million was recorded during 2014 due to the decreased cost of funds. The absorption of Firstbank's lower-costing interest-bearing liability base and the lowering of interest rates on certain non-certificate of deposit accounts in the latter part of the fourth quarter of 2013 positively impacted the cost of funds during 2014. In addition, maturing fixed-rate certificates of deposit were renewed at lower rates, replaced by lower-costing funds, or allowed to runoff during 2013 and 2014.

During 2014, interest-bearing liabilities averaged \$1.60 billion, or \$561.2 million higher than average interest-bearing liabilities of \$1.04 billion during the prior year. Growth in these liabilities resulted in increased interest expense of \$3.6 million. Interest-bearing liabilities include Firstbank's liabilities from the date of acquisition. Average interest-bearing deposits were up \$492.1 million, while average short-term borrowings increased \$39.6 million, average other borrowings increased \$17.1 million, and average FHLB advances increased \$12.4 million.

Average certificates of deposit increased \$143.4 million during 2014, which equated to an increase in interest expense of \$1.7 million. A \$2.4 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 and 2014. An increase in other average interest-bearing deposit accounts, totaling \$348.7 million, equated to a \$1.0 million increase in interest expense, while a decrease in the average rate paid on these deposit accounts resulted in a \$0.9 million decline in interest expense.

Average short-term borrowings, comprised entirely of repurchase agreements, increased \$39.6 million during 2014, resulting in a slight increase in interest expense. Average FHLB advances increased \$12.4 million, resulting in a \$0.2 million increase in interest expense, while a lower average rate paid on the advances resulted in a \$0.1 million decrease in interest expense. A \$17.1 million increase in average other borrowings, which is comprised of subordinated debentures and deferred director and officer compensation programs, equated to a \$0.7 million increase in interest expense, while a higher average rate paid on these borrowings resulted in a \$0.2 million increase in interest expense.

Net interest income and the net interest margin were affected by purchase accounting accretion and amortization entries associated with the fair value measurements recorded effective June 1, 2014. An increase in interest income on loans totaling \$3.2 million, as well as a decrease in interest expense on deposits and FHLB advances aggregating \$1.4 million, were recorded during the seven months subsequent to consummation of the Firstbank merger. An increase in interest expense on subordinated debentures totaling \$0.4 million was also recorded during the same time period. Mercantile expects to continue to record adjustments in interest income on loans and interest expense on subordinated debentures in future periods; however, the adjustments to interest expense on deposits and FHLB advances will no longer occur after July of 2015 in accordance with our fair value measurements at the time of the merger. The resulting increase in interest expense will negatively affect our net interest margin by approximately nine basis points in future periods starting after July 31, 2015. An ongoing reallocation of our earning asset mix will help offset this negative impact, as excess lower-yielding overnight funds and cash flows from lower-yielding investments are invested into higher-yielding loans.

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

A negative loan loss provision expense of \$3.0 million was recorded in 2014, compared to a negative provision expense of \$7.2 million recorded in 2013. The negative provision expense reflects recoveries of previously charged-off loans, reversals of specific reserves, 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.

Net loan recoveries of \$0.2 million were recorded during 2014, compared to net loan recoveries of \$1.3 million recorded during the prior year. The allowance for originated loans, as a percentage of total originated loans, was 1.6% as of December 31, 2014, compared to 2.2% as of December 31, 2013. Our allowance for acquired loans totaled \$0.7 million as of December 31, 2014.

#### ***Noninterest Income***

Noninterest income totaled \$10.0 million in 2014, an increase of \$3.1 million, or 45.9%, from the \$6.9 million earned in 2013. The increase in noninterest income was mainly due to higher debit and credit card fee income, service charges on deposit accounts, and mortgage referral and sale fees. These categories of noninterest income benefited from the consummation of the merger with Firstbank. An industry-wide slowdown in mortgage banking activity negatively affected our mortgage banking income during 2014; however, reflecting lower interest rates, mortgage banking income in the fourth quarter of 2014 increased approximately 21 percent in comparison to the linked quarter, and was approximately 10 percent below what Firstbank and Mercantile combined had achieved in the fourth quarter of 2013. During the third quarter of 2014, mortgage banking income was less than half of what the two companies combined recorded during the third quarter of 2013.

#### ***Noninterest Expense***

Noninterest expense during 2014 totaled \$65.6 million, an increase of \$29.2 million, or 80.2%, from the \$36.4 million expensed in 2013. The increase in noninterest expense primarily resulted from higher salary and benefit expenses; these expenses totaled \$33.7 million during 2014, an increase of \$13.4 million, or 66.0%, from the \$20.3 million expensed during 2013. The increase in salary and benefit expenses was mainly due to the increase in employees associated with the completion of the merger with Firstbank, along with the hiring of additional staff members over the past year and merit pay increases. As of December 31, 2014, full-time equivalent employees numbered 653, up from 241 as of December 31, 2013. In addition, we recorded core deposit intangible expense totaling \$1.9 million during the last seven months of 2014.

Increases in merger-related expenses and other categories of nonmerger-related costs necessary to operate the combined company also contributed to the higher level of overhead costs. Pre-tax merger-related costs totaled \$5.4 million in 2014 compared to \$1.2 million in 2013.

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

During 2014, we recorded income before federal income tax of \$25.2 million and a federal income tax expense of \$7.9 million, compared to income before federal income tax of \$25.1 million and a federal income tax expense of \$8.1 million during 2013. The decline in federal income tax expense resulted from a decrease in our effective tax rate from 32.2% in 2013 to 31.2% in 2014, generally reflecting a higher level of tax-exempt interest income in 2014.

### ***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 2014 or 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, 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.

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 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 remained 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 remained 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:

	<u>2013</u>	<u>2012</u>
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%

### ***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.

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.

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.

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 refinancing 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 refinancing 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.

### ***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.

## **CAPITAL RESOURCES**

Shareholders' equity increased \$175 million during 2014, primarily reflecting the merger with Firstbank. We issued almost 8.1 million shares of common stock, with a value of \$173 million, in connection with the Firstbank merger. Net income totaled \$17.3 million during 2014. Negatively impacting shareholders' equity during 2014 were cash dividends on our common stock totaling \$24.5 million. In accordance with the plan of merger with Firstbank, we declared and paid a special \$2.00 per share cash dividend to Mercantile shareholders prior to the effective date of the merger and before the issuance of Mercantile shares in exchange for Firstbank shares. In addition, we declared and paid a \$0.12 per share cash dividend during each of the four quarters during 2014. Positively impacting shareholders' equity during 2014 was an increase in the net unrealized gain on securities available for sale of \$5.6 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. As of December 31, 2014, our bank's total risk-based capital ratio was 14.4%, compared to 15.7% at December 31, 2013. Our bank's total regulatory capital increased \$142 million during 2014, primarily reflecting the net impact of the Firstbank merger whereby the Firstbank and Keystone Community Bank charters were consolidated into the existing Mercantile Bank of Michigan charter, and net income of \$21.2 million. Negatively impacting total regulatory capital were cash dividends paid to Mercantile Bank Corporation during 2014 totaling \$12.1 million. Our bank's total risk-based capital ratio was also impacted by a \$1.10 billion increase in total risk-weighted assets, primarily resulting from the merger with Firstbank. As of December 31, 2014, our bank's total regulatory capital equaled \$333 million, or approximately \$101 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."

On January 30, 2015, we announced that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. We expect to fund a majority of such repurchases from cash dividends paid to us from our bank.

## 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.

To assist in providing needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of deposits from customers outside of our market areas and advances from the FHLB, totaled \$230 million, or 9.2% of combined deposits and borrowed funds as of December 31, 2014, compared to \$258 million, or 20.9% of combined deposits and borrowed funds, as of December 31, 2013.

Sweep accounts increased \$98.3 million during 2014, totaling \$168 million at December 31, 2014. The increase is primarily due to the merger with Firstbank. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings. Information regarding our repurchase agreements as of December 31, 2014 and during 2014 is as follows:

Outstanding balance at December 31, 2014	\$ 167,569,000
Weighted average interest rate at December 31, 2014	0.11%
Maximum daily balance twelve months ended December 31, 2014	\$ 178,042,000
Average daily balance for twelve months ended December 31, 2014	\$ 105,474,000
Weighted average interest rate for twelve months ended December 31, 2014	0.12%

Primarily reflecting the merger with Firstbank, FHLB advances increased \$9.0 million during 2014, totaling \$54.0 million as of December 31, 2014. The FHLB advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit at year-end 2014 totaled \$410 million, with availability of \$356 million.



We also have the ability to borrow up to \$63.0 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 2014; in fact, we have not accessed the lines of credit since January of 2010. In contrast, federal funds sold averaged \$48.7 million and interest-bearing deposit balances averaged \$46.2 million during 2014. We have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using certain municipal bonds as collateral, we could have borrowed up to \$12.1 million at December 31, 2014. We did not utilize this line of credit during the past six years, and do not plan to access this line of credit in future periods.

The following table reflects, as of December 31, 2014, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

	<u>One Year or Less</u>	<u>One to Three Years</u>	<u>Three to Five Years</u>	<u>Over Five Years</u>	<u>Total</u>
Deposits without a stated maturity	\$ 1,538,166,000	\$ 0	\$ 0	\$ 0	\$ 1,538,166,000
Certificates of deposit	368,163,000	272,265,000	98,321,000	0	738,749,000
Short-term borrowings	167,569,000	0	0	0	167,569,000
Federal Home Loan Bank advances	6,022,000	48,000,000	0	0	54,022,000
Subordinated debentures	0	0	0	54,472,000	54,472,000
Other borrowed money	0	0	0	3,727,000	3,727,000
Property leases	368,000	753,000	493,000	143,000	1,757,000

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, 2014, we had a total of \$746 million in unfunded loan commitments and \$35.5 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$636 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$110 million were for loan commitments generally expected to close and become funded within the next twelve months. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

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

	<u>12/31/14</u>	<u>12/31/13</u>	<u>12/31/12</u>
Commercial unused lines of credit	\$ 554,856,000	\$ 257,937,000	\$ 222,237,000
Unused lines of credit secured by 1-4 family residential properties	60,983,000	23,429,000	24,250,000
Credit card unused lines of credit	11,649,000	9,013,000	8,512,000
Other consumer unused lines of credit	8,673,000	5,695,000	4,613,000
Commitments to make loans	110,126,000	58,799,000	64,565,000
Standby letters of credit	<u>35,461,000</u>	<u>19,670,000</u>	<u>10,591,000</u>
Total	\$ <u>781,748,000</u>	\$ <u>374,543,000</u>	\$ <u>334,768,000</u>

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.

## 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.

The following table depicts our GAP position as of December 31, 2014:

	Within Three Months	Three to Twelve Months	One to Five Years	After Five Years	Total
<b>Assets:</b>					
Commercial loans (1)	\$ 311,964,000	\$ 225,534,000	\$ 966,618,000	\$ 171,505,000	\$ 1,675,621,000
Residential real estate loans	37,501,000	20,090,000	140,054,000	155,795,000	353,440,000
Consumer loans	2,438,000	1,934,000	43,663,000	12,181,000	60,216,000
Securities (2)	18,381,000	26,545,000	233,561,000	168,124,000	446,611,000
Federal funds sold	11,207,000	0	0	0	11,207,000
Interest-bearing deposits	116,530,000	497,000	750,000	0	117,777,000
Allowance for loan losses	0	0	0	0	(20,041,000)
Other assets	0	0	0	0	248,548,000
<b>Total assets</b>	<b>498,021,000</b>	<b>274,600,000</b>	<b>1,384,646,000</b>	<b>507,605,000</b>	<b>\$ 2,893,379,000</b>
<b>Liabilities:</b>					
Interest-bearing checking	413,382,000	0	0	0	413,382,000
Savings deposits	330,459,000	0	0	0	330,459,000
Money market accounts	235,587,000	0	0	0	235,587,000
Time deposits under \$100,000	26,951,000	74,526,000	81,971,000	0	183,448,000
Time deposits \$100,000 & over	75,356,000	191,330,000	288,615,000	0	555,301,000
Short-term borrowings	167,569,000	0	0	0	167,569,000
Federal Home Loan Bank advances	6,022,000	0	48,000,000	0	54,022,000
Other borrowed money	3,727,000	0	0	54,472,000	58,199,000
Noninterest-bearing checking	0	0	0	0	558,738,000
Other liabilities	0	0	0	0	8,536,000
<b>Total liabilities</b>	<b>1,259,053,000</b>	<b>265,856,000</b>	<b>418,586,000</b>	<b>54,472,000</b>	<b>2,565,241,000</b>
Shareholders' equity	0	0	0	0	328,138,000
<b>Total liabilities &amp; shareholders' equity</b>	<b>1,259,053,000</b>	<b>265,856,000</b>	<b>418,586,000</b>	<b>54,472,000</b>	<b>\$ 2,893,379,000</b>
<b>Net asset (liability) GAP</b>	<b>\$ (761,032,000)</b>	<b>\$ 8,744,000</b>	<b>\$ 966,060,000</b>	<b>\$ 453,133,000</b>	
<b>Cumulative GAP</b>	<b>\$ (761,032,000)</b>	<b>\$ (752,288,000)</b>	<b>\$ 213,772,000</b>	<b>\$ 666,905,000</b>	
<b>Percent of cumulative GAP to total assets</b>	<b>(26.3%)</b>	<b>(26.0%)</b>	<b>7.4%</b>	<b>23.0%</b>	

- (1) Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.
- (2) Mortgage-backed securities are categorized by expected maturities based upon prepayment trends as of December 31, 2014.

The second interest rate risk measurement used is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, it serves as our primary interest rate risk measurement technique. The simulation model assesses the direction and magnitude of variations in net interest income resulting from potential changes in market interest rates.

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

We conducted multiple simulations as of December 31, 2014, 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, 2014. The resulting estimates are well within our policy parameters established to manage and monitor interest rate risk.

<u>Interest Rate Scenario</u>	<u>Dollar Change In Net Interest Income</u>	<u>Percent Change In Net Interest Income</u>
Interest rates down 400 basis points	\$ (6,730,000)	(7.3%)
Interest rates down 300 basis points	(5,870,000)	(6.4)
Interest rates down 200 basis points	(4,890,000)	(5.3)
Interest rates down 100 basis points	(3,140,000)	(3.4)
No change in interest rates	70,000	0.1
Interest rates up 100 basis points	1,230,000	1.3
Interest rates up 200 basis points	2,180,000	2.4
Interest rates up 300 basis points	3,130,000	3.4
Interest rates up 400 basis points	3,670,000	4.0

The resulting estimates have been significantly impacted by the current interest rate and economic environment, as adjustments have been made to critical model inputs with regards to traditional interest rate relationships. This is especially important as it relates to floating rate commercial loans and out-of-area deposits, which comprise a sizable portion of our balance sheet.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; level of nonperforming assets; economic and competitive conditions; potential changes in lending, investing, and deposit gathering strategies; client preferences; and other factors.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Mercantile Bank Corporation  
Grand Rapids, Michigan

We have audited the accompanying Consolidated Balance Sheets of Mercantile Bank Corporation as of December 31, 2014 and 2013, and the related Consolidated Statements of Income, Comprehensive Income, Changes in Shareholders' Equity and Cash Flows for each of the three years in the period ended December 31, 2014. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercantile Bank Corporation as of December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2014, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Mercantile Bank Corporation's internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and our report dated March 10, 2015 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP  
BDO USA, LLP

Grand Rapids, Michigan  
March 10, 2015

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Mercantile Bank Corporation  
Grand Rapids, Michigan

We have audited Mercantile Bank Corporation's internal control over financial reporting as of December 31, 2014, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Mercantile Bank Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report by Mercantile Bank Corporation's Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Mercantile Bank Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Consolidated Balance Sheets of Mercantile Bank Corporation as of December 31, 2014 and 2013, and the related Consolidated Statements of Income, Comprehensive Income, Changes in Shareholders' Equity and Cash Flows for each of the three years in the period ended December 31, 2014, and our report dated March 10, 2015 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP  
BDO USA, LLP

Grand Rapids, Michigan  
March 10, 2015

March 10, 2015

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

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

Management assessed the Company's system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles as of December 31, 2014. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2014, Mercantile Bank Corporation maintained an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles based on those criteria.

The Company's independent auditors have issued an audit report on the effectiveness of the Company's internal control over financial reporting as found on page F-35.

Mercantile Bank Corporation

/s/ Michael H. Price  
Michael H. Price  
President and Chief Executive Officer

/s/ Charles E. Christmas  
Charles E. Christmas  
Senior Vice President, Chief Financial Officer and Treasurer

MERCANTILE BANK CORPORATION  
CONSOLIDATED BALANCE SHEETS  
December 31, 2014 and 2013

	<u>2014</u>	<u>2013</u>
<b>ASSETS</b>		
Cash and due from banks	\$ 43,754,000	\$ 17,149,000
Interest-bearing deposits	117,777,000	6,389,000
Federal funds sold	<u>11,207,000</u>	<u>123,427,000</u>
Total cash and cash equivalents	172,738,000	146,965,000
Securities available for sale	432,912,000	131,178,000
Federal Home Loan Bank stock	13,699,000	11,961,000
Loans	2,089,277,000	1,053,243,000
Allowance for loan losses	<u>(20,041,000)</u>	<u>(22,821,000)</u>
Loans, net	2,069,236,000	1,030,422,000
Premises and equipment, net	48,812,000	24,898,000
Bank owned life insurance	57,861,000	51,377,000
Goodwill	49,473,000	0
Cored deposit intangible	15,624,000	0
Other assets	<u>33,024,000</u>	<u>30,165,000</u>
Total assets	<u>\$2,893,379,000</u>	<u>\$1,426,966,000</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest-bearing	\$ 558,738,000	\$ 224,580,000
Interest-bearing	<u>1,718,177,000</u>	<u>894,331,000</u>
Total deposits	2,276,915,000	1,118,911,000
Securities sold under agreements to repurchase	167,569,000	69,305,000
Federal Home Loan Bank advances	54,022,000	45,000,000
Subordinated debentures	54,472,000	32,990,000
Accrued interest and other liabilities	<u>12,263,000</u>	<u>7,435,000</u>
Total liabilities	2,565,241,000	1,273,641,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; 0 shares outstanding at December 31, 2014 and December 31, 2013	0	0
Common stock, no par value; 40,000,000 shares authorized; 16,976,839 shares outstanding at December 31, 2014 and 8,739,108 shares outstanding at December 31, 2013	317,904,000	162,999,000
Retained earnings (deficit)	10,218,000	(4,101,000)
Accumulated other comprehensive income (loss)	<u>16,000</u>	<u>(5,573,000)</u>
Total shareholders' equity	<u>328,138,000</u>	<u>153,325,000</u>
Total liabilities and shareholders' equity	<u>\$2,893,379,000</u>	<u>\$1,426,966,000</u>

See accompanying notes to consolidated financial statements.



MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
Years ended December 31, 2014, 2013 and 2012

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Interest income			
Loans, including fees	\$ 80,824,000	\$ 52,924,000	\$ 53,898,000
Securities, taxable	6,417,000	4,134,000	4,383,000
Securities, tax-exempt	1,643,000	951,000	1,415,000
Federal funds sold	124,000	212,000	192,000
Interest-bearing deposits	<u>110,000</u>	<u>21,000</u>	<u>29,000</u>
Total interest income	89,118,000	58,242,000	59,917,000
Interest expense			
Deposits	8,378,000	8,912,000	11,137,000
Short-term borrowings	122,000	80,000	157,000
Federal Home Loan Bank advances	636,000	533,000	993,000
Subordinated debentures and other borrowings	<u>2,204,000</u>	<u>1,261,000</u>	<u>929,000</u>
Total interest expense	<u>11,340,000</u>	<u>10,786,000</u>	<u>13,216,000</u>
<b>Net interest income</b>	77,778,000	47,456,000	46,701,000
Provision for loan losses	<u>(3,000,000)</u>	<u>(7,200,000)</u>	<u>(3,100,000)</u>
<b>Net interest income after provision for loan losses</b>	80,778,000	54,656,000	49,801,000
Noninterest income			
Service charges on deposit and sweep accounts	2,586,000	1,532,000	1,523,000
Credit and debit card fees	2,494,000	1,063,000	891,000
Mortgage banking activities	1,672,000	800,000	1,479,000
Earnings on bank owned life insurance	1,184,000	1,329,000	1,528,000
Payroll processing	782,000	660,000	591,000
Letter of credit fees	335,000	370,000	336,000
Rental income from other real estate owned	109,000	528,000	1,061,000
Other income	<u>866,000</u>	<u>590,000</u>	<u>585,000</u>
Total noninterest income	10,028,000	6,872,000	7,994,000
Noninterest expense			
Salaries and benefits	33,703,000	20,298,000	19,367,000
Occupancy	4,637,000	2,547,000	2,501,000
Furniture and equipment rent, depreciation and maintenance	1,738,000	984,000	1,176,000
Data processing	5,869,000	3,440,000	3,193,000
Merger-related costs	5,447,000	1,246,000	0
Advertising	1,315,000	1,113,000	1,167,000
FDIC insurance costs	1,182,000	793,000	1,200,000
Problem asset costs	585,000	595,000	5,862,000
Other expense	<u>11,134,000</u>	<u>5,387,000</u>	<u>5,158,000</u>
Total noninterest expenses	<u>65,610,000</u>	<u>36,403,000</u>	<u>39,624,000</u>
<b>Income before federal income tax expense</b>	25,196,000	25,125,000	18,171,000
Federal income tax expense	<u>7,865,000</u>	<u>8,092,000</u>	<u>5,636,000</u>
<b>Net income</b>	17,331,000	17,033,000	12,535,000
Preferred stock dividends and accretion	<u>0</u>	<u>0</u>	<u>1,030,000</u>
<b>Net income attributable to common shares</b>	<u>\$ 17,331,000</u>	<u>\$ 17,033,000</u>	<u>\$ 11,505,000</u>
Earnings per common share:			
Basic	<u>\$ 1.28</u>	<u>\$ 1.96</u>	<u>\$ 1.33</u>
Diluted	<u>\$ 1.28</u>	<u>\$ 1.95</u>	<u>\$ 1.30</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
Years ended December 31, 2014, 2013 and 2012

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	<u>2014</u>	<u>2013</u>	<u>2012</u>
Net income	\$ 17,331,000	\$ 17,033,000	\$ 12,535,000
Other comprehensive income (loss):			
Unrealized holding gains (losses) on securities available for sale	8,596,000	(11,960,000)	(2,184,000)
Fair value of interest rate swap	<u>11,000</u>	<u>849,000</u>	<u>(1,113,000)</u>
	<u>8,607,000</u>	<u>(11,111,000)</u>	<u>(3,297,000)</u>
Tax effect of unrealized holding gains (losses) on securities available for sale	(3,014,000)	4,186,000	1,229,000
Tax effect of fair value of interest rate swap	<u>(4,000)</u>	<u>(298,000)</u>	<u>390,000</u>
	<u>(3,018,000)</u>	<u>3,888,000</u>	<u>1,619,000</u>
Other comprehensive income (loss), net of tax effect	<u>5,589,000</u>	<u>(7,223,000)</u>	<u>(1,678,000)</u>
<b>Comprehensive income</b>	<b><u>\$ 22,920,000</u></b>	<b><u>\$ 9,810,000</u></b>	<b><u>\$ 10,857,000</u></b>

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See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
Years ended December 31, 2014, 2013 and 2012

(\$ in thousands)	<u>Preferred Stock</u>	<u>Common Stock</u>	<u>Common Stock Warrant</u>	<u>Retained Earnings (Deficit)</u>	<u>Accumulated Other Comprehensive Income/(Loss)</u>	<u>Total Shareholders' Equity</u>
<b>Balances, January 1, 2012</b>	\$ 20,331	\$ 172,841	\$ 1,138	\$(32,639)	\$ 3,328	\$ 164,999
Repurchase of preferred stock	(21,000)					(21,000)
Preferred stock dividends				(361)		(361)
Accretion of preferred stock	669			(669)		0
Repurchase of stock warrant		(6,327)	(1,138)			(7,465)
Employee stock purchase plan (2,400 shares)		39				39
Dividend reinvestment plan (934 shares)		14				14
Stock option exercises (50,930 shares)		551				551
Stock tendered for stock option exercises (19,120 shares)		(324)				(324)
Stock-based compensation expense		54				54
Cash dividends (\$0.09 per common share)		(774)				(774)
Net income for 2012				12,535		12,535
Change in net unrealized gain on securities available for sale, net of tax effect					(955)	(955)
Change in fair value of interest rate swap, net tax effect	_____	_____	_____	_____	(723)	(723)
<b>Balances, December 31, 2012</b>	<u>\$ 0</u>	<u>\$ 166,074</u>	<u>\$ 0</u>	<u>\$(21,134)</u>	<u>\$ 1,650</u>	<u>\$ 146,590</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)  
Years ended December 31, 2014, 2013 and 2012

(\$ in thousands)	Preferred Stock	Common Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
<b>Balances, January 1, 2013</b>	\$ 0	\$ 166,074	\$ (21,134)	\$ 1,650	\$ 146,590
Employee stock purchase plan (1,098 shares)		19			19
Dividend reinvestment plan (1,954 shares)		33			33
Stock option exercises (51,055 shares)		700			700
Stock tendered for stock option exercises (18,950 shares)		(411)			(411)
Stock-based compensation expense		473			473
Cash dividends (\$0.45 per common share)		(3,889)			(3,889)
Net income for 2013			17,033		17,033
Change in net unrealized gain on securities available for sale, net of tax effect				(7,774)	(7,774)
Change in fair value of interest rate swap, net of tax effect	_____	_____	_____	551	551
<b>Balances, December 31, 2013</b>	<u>\$ 0</u>	<u>\$ 162,999</u>	<u>\$ (4,101)</u>	<u>\$ (5,573)</u>	<u>\$ 153,325</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)  
Years ended December 31, 2014, 2013 and 2012

(\$ in thousands)	Preferred Stock	Common Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
<b>Balances, January 1, 2014</b>	\$ 0	\$ 162,999	\$ (4,101)	\$ (5,573)	\$ 153,325
Common stock issued in connection with Firstbank merger (8,087,272 shares)		173,310			173,310
Issuance of stock options to replace existing Firstbank options at merger date		1,664			1,664
Employee stock purchase plan (1,150 shares)		23			23
Dividend reinvestment plan (10,359 shares)		209			209
Stock option exercises (30,585 shares)		282			282
Stock grants to directors for retainer fees (7,375 shares)		155			155
Stock-based compensation expense		714			714
Cash dividends (\$2.48 per common share)		(21,452)	(3,012)		(24,464)
Net income for 2014			17,331		17,331
Change in net unrealized gain on securities available for sale, net of tax effect				5,582	5,582
Change in fair value of interest rate swap, net of tax effect	_____	_____	_____	7	7
<b>Balances, December 31, 2014</b>	<u>\$ 0</u>	<u>\$ 317,904</u>	<u>\$ 10,218</u>	<u>\$ 16</u>	<u>\$ 328,138</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Years ended December 31, 2014, 2013 and 2012

	<u>2014</u>	<u>2013</u>	<u>2012</u>
<b>Cash flows from operating activities</b>			
Net income	\$ 17,331,000	\$ 17,033,000	\$ 12,535,000
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	7,613,000	2,208,000	2,238,000
Accretion of acquired loans	(3,194,000)	0	0
Provision for loan losses	(3,000,000)	(7,200,000)	(3,100,000)
Deferred income tax expense	4,506,000	8,092,000	5,636,000
Stock-based compensation expense	714,000	473,000	54,000
Stock grants to directors for retainer fee	155,000	0	0
Proceeds from sales of mortgage loans held for sale	67,422,000	51,373,000	83,713,000
Origination of mortgage loans held for sale	(65,392,000)	(48,321,000)	(83,986,000)
Net gain on sales of mortgage loans held for sale	(1,625,000)	(658,000)	(1,247,000)
Net (gain) loss on sale and valuation write-downs of foreclosed assets	(894,000)	(1,585,000)	1,725,000
Earnings on bank owned life insurance	(1,184,000)	(1,329,000)	(1,528,000)
Net change in:			
Accrued interest receivable	(11,000)	225,000	529,000
Other assets	1,795,000	8,465,000	(1,805,000)
Accrued interest and other liabilities	(9,822,000)	(94,000)	2,267,000
Net cash from operating activities	<u>14,414,000</u>	<u>28,682,000</u>	<u>17,031,000</u>
<b>Cash flows from investing activities</b>			
Cash received in merger	91,806,000	0	0
Purchases of:			
Securities available for sale	(19,874,000)	(49,812,000)	(69,956,000)
Proceeds from:			
Maturities, calls and repayments of securities available for sale	75,880,000	34,809,000	102,672,000
Proceeds from sales of securities available for sale	0	10,310,000	0
Proceeds from Federal Home Loan Bank stock redemption	5,527,000	0	0
Loan originations and payments, net	(90,853,000)	(15,298,000)	16,237,000
Purchases of premises and equipment, net	(2,150,000)	(326,000)	(571,000)
Proceeds from sale of foreclosed assets	<u>4,427,000</u>	<u>7,898,000</u>	<u>18,348,000</u>
Net cash from (for) investing activities	<u>64,763,000</u>	<u>(12,419,000)</u>	<u>66,730,000</u>
<b>Cash flows from financing activities</b>			
Net decrease in time deposits	(58,927,000)	(23,038,000)	(47,257,000)
Net increase (decrease) in all other deposits	(11,307,000)	6,745,000	70,386,000
Net increase (decrease) in securities sold under agreements to repurchase	43,780,000	4,540,000	(7,804,000)
Proceeds from Federal Home Loan Bank advances	0	10,000,000	20,000,000
Maturities and prepayments of Federal Home Loan Bank advances	(3,000,000)	0	(30,000,000)
Repurchase of preferred stock	0	0	(21,000,000)
Repurchase of common stock warrant	0	0	(7,465,000)
Proceeds from stock option exercises, net of cashless exercises	282,000	289,000	227,000
Employee stock purchase plan	23,000	19,000	39,000
Dividend reinvestment plan	209,000	33,000	14,000
Payment of cash dividends on preferred stock	0	0	(496,000)
Payment of cash dividends to common shareholders	<u>(24,464,000)</u>	<u>(3,889,000)</u>	<u>(774,000)</u>
Net cash for financing activities	<u>(53,404,000)</u>	<u>(5,301,000)</u>	<u>(24,130,000)</u>
Net change in cash and cash equivalents	25,773,000	10,962,000	59,631,000
Cash and cash equivalents at beginning of period	<u>146,965,000</u>	<u>136,003,000</u>	<u>76,372,000</u>
<b>Cash and cash equivalents at end of period</b>	<u>\$ 172,738,000</u>	<u>\$ 146,965,000</u>	<u>\$ 136,003,000</u>

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)  
Years ended December 31, 2014, 2013 and 2012

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	<u>2014</u>	<u>2013</u>	<u>2012</u>
Supplemental disclosures of cash flows information			
Cash paid during the year for:			
Interest	\$ 11,439,000	\$ 11,059,000	\$ 13,741,000
Federal income taxes	2,625,000	0	0
Noncash financing and investing activities:			
Transfers from loans to foreclosed assets	1,490,000	2,194,000	11,761,000
Common stock issued in connection with the Firstbank merger	173,310,000	0	0

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See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

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

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

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

The Bank is a community-based financial institution. The Bank’s primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial loans, residential mortgage loans, and instalment loans. Substantially all loans are secured by specific items of collateral including business assets, real estate or consumer assets. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by commercial or residential real estate. The Bank’s loan accounts and retail deposits are primarily with customers located in the communities in which we have bank office locations. As an alternative source of funds, the Bank has also issued certificates of deposit to depositors outside of its primary market areas. Substantially all revenues are derived from banking products and services and investment securities. While we monitor the revenue streams of the various products and services offered, we manage our business on the basis of one operating segment, banking.

Mercantile Insurance was formed during 2002 through the acquisition of an existing shelf insurance agency. Insurance products are offered through an Agency and Institutions Agreement among Mercantile Insurance, the Bank and Hub International. The insurance products are marketed through a central facility operated by the Michigan Bankers Insurance Association, members of which include the insurance subsidiaries of various Michigan-based financial institutions and Hub International. Mercantile Insurance receives commissions based upon written premiums produced under the Agency and Institutions Agreement.

Mercantile Real Estate was organized on July 21, 2003, principally to develop, construct, and own a facility in downtown Grand Rapids that serves as our Bank’s main office and Mercantile’s headquarters. This facility was placed into service during the second quarter of 2005.

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

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

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(Continued)



MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

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

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

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

Loans: Loans that we have the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Net unamortized deferred loan fees amounted to \$1.1 million and \$0.5 million at December 31, 2014 and 2013, respectively.

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

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

Year-end mortgage loans held for sale were as follows:

	<u>2014</u>	<u>2013</u>
Mortgage loans held for sale	\$ 1,574,000	\$ 1,115,000
Less: Allowance to adjust to lower of cost or market	<u>0</u>	<u>0</u>
Mortgage loans held for sale, net	<u>\$ 1,574,000</u>	<u>\$ 1,115,000</u>

Mortgage Loan Derivatives: From time to time, we enter into mortgage loan derivatives such as forward contracts and interest rate lock commitments in the ordinary course of business. The derivatives are not designated as hedges and are carried at fair value. The net gain or loss on mortgage loan derivatives is included in mortgage banking activities in the income statement. The balance of mortgage loan derivatives was immaterial at December 31, 2014 and 2013.

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

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

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

Allowance for Loan Losses: The allowance for loan losses (“allowance”) is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when we believe the uncollectability of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required using past loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. We estimate credit losses based on individual loans determined to be impaired and on all other loans grouped on similar risk characteristics. Our historical loss component is the most significant of the allowance components and is based on historical loss experience by credit risk grade for commercial loans and payment status for mortgage and consumer loans. Loans are pooled based on similar risk characteristics supported by observable data. The historical loss experience component of the allowance represents the results of migration analysis of historical net charge-offs for portfolios of loans, including groups of commercial loans within each credit risk grade. For measuring loss exposure in a pool of loans, the historical net charge-off or migration experience is utilized to estimate expected future losses to be realized from the pool of loans. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged-off.

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

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

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 33 years. Furniture, fixtures and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Maintenance, repairs and minor alterations are charged to current operations as expenditures occur and major improvements are capitalized.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

Long-lived Assets: Premises and equipment and other long-lived assets are reviewed for impairment when events indicate their carrying amount may not be recoverable based on future undiscounted cash flows. If impaired, the assets are recorded at the lower of carrying value or fair value.

Foreclosed Assets: Assets acquired through or in lieu of foreclosure are initially recorded at their estimated fair value net of estimated selling costs, establishing a new cost basis. If fair value subsequently declines, a valuation allowance is recorded through noninterest expense, as are collection and operating costs after acquisition. Foreclosed assets totaled \$2.0 million and \$2.9 million as of December 31, 2014 and 2013, respectively.

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

Goodwill and Core Deposit Intangible: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. The quantitative test is a two-step process consisting of comparing the carrying value of the reporting unit to an estimate of its fair value. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2014, we elected to perform a qualitative assessment for our annual impairment test and concluded our fair value was greater than its carrying amount; therefore, no further testing was required.

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

Repurchase Agreements: The Bank sells certain securities under agreements to repurchase. The agreements are treated as collateralized financing transactions, with the obligations to repurchase the securities sold reflected as liabilities and the securities underlying the agreements remaining in assets in the Consolidated Balance Sheets.

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

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

Advertising Costs: Advertising costs are expensed as incurred.

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

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

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans using the treasury stock method. In addition, diluted earnings per share for 2012 include the dilutive effect of our common stock warrant granted to the U.S. Department of Treasury that we repurchased on July 3, 2012, also using the treasury stock method. Our unvested stock awards, which contain non-forfeitable rights to dividends whether paid or unpaid (i.e., participating securities), are included in the number of shares outstanding for both basic and diluted earnings per share calculations. In the event of a net loss, our unvested stock awards are excluded from the calculations of both basic and diluted earnings per share.

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

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

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

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

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

Accounting Standards Updates: In January of 2014, the FASB issued Accounting Standards Update (“ASU”) 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. This ASU clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The ASU also requires additional related interim and annual disclosures. The guidance in this ASU is effective for annual and interim periods beginning after December 15, 2014, and is not expected to have a material effect on our financial position or results of operations when adopted.

In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. This ASU establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard’s core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. The guidance in this ASU is effective for annual and interim periods beginning after December 15, 2016, with three transition methods available – full retrospective, retrospective and cumulative effect approach. Although we are in process of evaluating the impact, the adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

In June 2014, the FASB issued ASU 2014-11, *Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. This ASU requires two accounting changes. First, repurchase-to-maturity transactions will be accounted for as secured borrowing transactions on the balance sheet, rather than sales. Second, for repurchase financing arrangements, the ASU requires separate accounting for a transfer of a financial asset executed contemporaneously with (or in contemplation of) a repurchase agreement with the same counterparty, which also will generally result in secured borrowing accounting for the repurchase agreement. The ASU also introduces new disclosures to increase transparency about the types of collateral pledged for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions that are accounted for as secured borrowings. The ASU also requires a transferor to disclose information about transactions accounted for as a sale in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets through an agreement with the transferee. The accounting changes and disclosure for certain transactions accounted for as a sale are effective for the first annual and interim periods beginning after December 15, 2014. The disclosure for transactions accounted for as secured borrowings is required for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

In August 2014, the FASB issued ASU 2014-14, *Classification of Certain Government-Guaranteed Mortgage Loans Upon Foreclosure*. This ASU requires that certain government-guaranteed mortgage loans, including those guaranteed by the Federal Housing Administration, be derecognized and that a separate other receivable be recognized upon foreclosure if certain conditions are met. Upon foreclosure on the loans that meet these criteria, a separate receivable should be recorded based on the amount of the loan balance expected to be recovered from the guarantor. The guidance in this ASU is effective for annual and interim periods beginning after December 15, 2014, and is not expected to have a material effect on our financial position or results of operations when adopted.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 2 - BUSINESS COMBINATION**

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

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

The following table provides the purchase price calculation as of the Merger Date and the identifiable assets purchased and the liabilities assumed at their estimated fair values. These fair value measurements are provisional based on third-party valuations that are currently under review and are subject to refinement for up to one year after the Merger Date based on additional information that may be obtained by us that existed as of the Merger Date.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 2 - BUSINESS COMBINATION** (Continued)

**Purchase Price:**

Mercantile common shares issued for Firstbank common shares	8,087,272
Price per share, based on Mercantile closing price on May 30, 2014	\$ <u>21.43</u>
Value of common stock issued	173,310,000
Value of replacement stock options granted	<u>1,664,000</u>
Total purchase price	<u>\$ 174,974,000</u>

**Preliminary Statement of Net Assets Acquired at Fair Value:**

Assets		
Cash and cash equivalents	\$ 91,806,000	
Securities	358,599,000	
Total loans	943,662,000	
Premises and equipment	24,049,000	
Core deposit intangible	17,478,000	
Mortgage servicing rights	7,389,000	
Other assets	<u>9,897,000</u>	
Total Assets	\$ 1,452,880,000	
Liabilities		
Deposits	\$ 1,229,609,000	
Borrowings	87,615,000	
Other liabilities	<u>10,155,000</u>	
Total Liabilities	\$ 1,327,379,000	
Net Identifiable Assets Acquired		\$ <u>125,501,000</u>
Goodwill		<u>\$ 49,473,000</u>

Effective December 31, 2014, we identified certain Firstbank deferred tax assets and liabilities that should have been addressed on the Merger Date. The net impact of recording the necessary entries was a \$1.4 million reduction to Goodwill and a \$1.4 million increase to our net deferred tax asset account (included in other assets above) from what we reported in our June 30, 2014 and September 30, 2014 Form 10-Qs.

Firstbank's results of operations prior to the Merger Date are not included in our Consolidated Statements of Income or Consolidated Statements of Comprehensive Income. We recorded merger-related expenses of \$5.4 million and \$1.2 million during 2014 and 2013, respectively. Such expenses were generally for professional services, costs related to termination of existing contractual arrangements for various services, retention and severance compensation costs, marketing and promotional expenses, travel costs, and printing and supplies costs. We do not expect to record any additional significant expenses related to the Firstbank merger in future periods. We are not presenting the amounts of revenue and earnings of Firstbank since the Merger Date as it is impracticable due to the integration of Firstbank upon the consummation of the merger.

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(Continued)



MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 2 - BUSINESS COMBINATION** (Continued)

The following table provides the unaudited pro forma information for the results of operations for the twelve month periods ended December 31, 2014 and 2013, as if the acquisition had occurred on January 1, 2013. These adjustments reflect the impact of certain purchase accounting fair value measurements primarily related to Firstbank's loan and deposit portfolios. In addition, the aggregate \$12.2 million in merger-related expenses recorded by us and Firstbank during 2014 and 2013 are reflected to have been recorded during 2013. We expect to achieve further operating cost savings and other business synergies as a result of the merger which are not reflected in the pro forma amounts. These unaudited pro forma results are presented for illustrative purposes only and are not intended to represent or be indicative of the actual results of operations of the combined banking organization that would have been achieved had the merger occurred at the beginning of each period presented, nor are they intended to represent or be indicative of future results of operations.

	<u>2014</u>	<u>2013</u>
Net interest income	\$ 98,607,000	\$ 93,862,000
Noninterest expense	81,295,000	93,263,000
Net income	22,659,000	16,068,000
Net income per diluted share	1.33	0.96

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 2 - BUSINESS COMBINATION** (Continued)

The provisional fair value of loans at the Merger Date is presented in the following table:

	<u>Acquired Impaired</u>	<u>Acquired Non-Impaired</u>	<u>Acquired Total Loans</u>
Commercial Loans:			
Commercial & industrial	\$ 878,000	\$ 163,316,000	\$ 164,194,000
Commercial real estate	12,973,000	378,016,000	390,989,000
Construction & development	<u>1,289,000</u>	<u>33,726,000</u>	<u>35,015,000</u>
Total Commercial Loans	\$ 15,140,000	\$ 575,058,000	\$ 590,198,000
Consumer Loans:			
Residential mortgages	\$ 9,694,000	\$ 216,653,000	\$ 226,347,000
Instalment	167,000	61,657,000	61,824,000
Home equity lines	288,000	52,054,000	52,342,000
Construction	<u>76,000</u>	<u>12,875,000</u>	<u>12,951,000</u>
Total Consumer Loans	\$ 10,225,000	\$ 343,239,000	\$ 353,464,000
Total Loans	<u>\$ 25,365,000</u>	<u>\$ 918,297,000</u>	<u>\$ 943,662,000</u>

The following table presents data on acquired impaired loans at the Merger Date:

	<u>Acquired Impaired</u>
Contractually required payments	\$ 44,936,000
Nonaccretable difference	<u>17,057,000</u>
Expected cash flows	27,879,000
Accretable yield	<u>2,514,000</u>
Carrying balance	<u>\$ 25,365,000</u>

The nonaccretable difference includes \$10.4 million in principal cash flows not expected to be collected, \$2.8 million of pre-acquisition charge-offs and \$3.9 million of future interest not expected to be collected. The unpaid principal balance of acquired performing loans was \$926.4 million at the Merger Date, and the unaccreted discount on such loans was \$8.1 million.

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(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

**NOTE 3 – SECURITIES**

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

	Amortized <u>Cost</u>	Gross Unrealized <u>Gains</u>	Gross Unrealized <u>Losses</u>	Fair <u>Value</u>
<u>2014</u>				
U.S. Government agency debt obligations	\$ 194,894,000	\$ 1,612,000	\$ (3,038,000)	\$ 193,468,000
Mortgage-backed securities	92,656,000	1,123,000	(218,000)	93,561,000
Municipal general obligation bonds	132,347,000	1,042,000	(307,000)	133,082,000
Municipal revenue bonds	10,769,000	117,000	(13,000)	10,873,000
Other investments	<u>1,925,000</u>	<u>3,000</u>	<u>0</u>	<u>1,928,000</u>
	<u>\$ 432,591,000</u>	<u>\$ 3,897,000</u>	<u>\$ (3,576,000)</u>	<u>\$ 432,912,000</u>
<u>2013</u>				
U.S. Government agency debt obligations	\$ 108,279,000	\$ 263,000	\$(10,065,000)	\$ 98,477,000
Mortgage-backed securities	12,456,000	1,102,000	0	13,558,000
Municipal general obligation bonds	16,488,000	388,000	(4,000)	16,872,000
Municipal revenue bonds	878,000	38,000	0	916,000
Mutual funds	<u>1,386,000</u>	<u>0</u>	<u>(31,000)</u>	<u>1,355,000</u>
	<u>\$ 139,487,000</u>	<u>\$ 1,791,000</u>	<u>\$(10,100,000)</u>	<u>\$ 131,178,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

**NOTE 3 – SECURITIES (Continued)**

Securities with unrealized losses at year-end 2014 and 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

<u>Description of Securities</u>	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>	<u>Fair Value</u>	<u>Unrealized Loss</u>
<u>2014</u>						
U.S. Government agency debt obligations	\$ 81,891,000	\$ 202,000	\$ 74,120,000	\$ 2,836,000	\$ 156,011,000	\$ 3,038,000
Mortgage-backed securities	49,940,000	218,000	0	0	49,940,000	218,000
Municipal general obligation bonds	54,104,000	307,000	0	0	54,104,000	307,000
Municipal revenue bonds	4,644,000	13,000	0	0	4,644,000	13,000
Other investments	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
	<u>\$190,579,000</u>	<u>\$ 740,000</u>	<u>\$ 74,120,000</u>	<u>\$ 2,836,000</u>	<u>\$264,699,000</u>	<u>\$ 3,576,000</u>
<u>2013</u>						
U.S. Government agency debt obligations	\$ 57,117,000	\$ 5,798,000	\$ 29,679,000	\$ 4,267,000	\$ 86,796,000	\$10,065,000
Mortgage-backed securities	0	0	0	0	0	0
Municipal general obligation bonds	295,000	4,000	0	0	295,000	4,000
Municipal revenue bonds	0	0	0	0	0	0
Mutual funds	<u>1,355,000</u>	<u>31,000</u>	<u>0</u>	<u>0</u>	<u>1,355,000</u>	<u>31,000</u>
	<u>\$ 58,767,000</u>	<u>\$ 5,833,000</u>	<u>\$ 29,679,000</u>	<u>\$ 4,267,000</u>	<u>\$ 88,446,000</u>	<u>\$10,100,000</u>

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

At December 31, 2014, 341 debt securities with fair values totaling \$264.7 million have unrealized losses aggregating \$3.6 million. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no unrealized losses are deemed to be other-than-temporary.

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 3 – SECURITIES** (Continued)

The amortized cost and fair values of debt securities at December 31, 2014, by maturity, are shown in the following table. The contractual maturity is utilized for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

	Weighted Average <u>Yield</u>	Amortized <u>Cost</u>	Fair <u>Value</u>
Due in one year or less	0.72%	\$ 27,651,000	\$ 27,662,000
Due from one to five years	1.35	148,233,000	147,974,000
Due from five to ten years	2.99	70,282,000	70,191,000
Due after ten years	3.62	91,844,000	91,596,000
Mortgage-backed securities	1.79	92,656,000	93,561,000
Other investments	2.57	<u>1,925,000</u>	<u>1,928,000</u>
	2.17%	<u>\$ 432,591,000</u>	<u>\$ 432,912,000</u>

During 2013, Michigan Strategic Fund bonds totaling \$10.3 million were sold at par. No securities were sold during 2014 and 2012.

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of \$113.1 million and \$17.4 million at December 31, 2014 and December 31, 2013, respectively, with estimated market values of \$113.9 million and \$17.8 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$30.0 million and estimated market value of \$30.0 million at December 31, 2014; as of December 31, 2013, our entire municipal bond portfolio consisted of securities issued by the State of Michigan and its political subdivisions. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was \$180.5 million and \$94.4 million at December 31, 2014 and 2013, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in FHLB stock are restricted and may only be resold to, or redeemed by, the issuer.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES**

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

Acquired loans are those purchased in the Firstbank merger (see Note 2 – Business Combination for further information). These loans were recorded at estimated fair value at the Merger Date with no carryover of the related allowance. The acquired loans were segregated between those considered to be performing (“acquired non-impaired loans”) and those with evidence of credit deterioration (“acquired impaired loans”). Acquired loans are considered impaired if there is evidence of credit deterioration and if it is probable, at acquisition, all contractually required payments will not be collected. Acquired loans restructured after acquisition are not considered or reported as troubled debt restructurings if the loans evidenced credit deterioration as of the Merger Date and are accounted for in pools.

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

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

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

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

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

	December 31, 2014		December 31, 2013		Percent
	<u>Balance</u>	<u>%</u>	<u>Balance</u>	<u>%</u>	<u>Increase (Decrease)</u>
<b><u>Originated Loans</u></b>					
Commercial:					
Commercial and industrial	\$ 384,570,000	30.8%	\$ 286,373,000	27.2%	34.3%
Vacant land, land development, and residential construction	29,826,000	2.4	36,741,000	3.5	(18.8)
Real estate – owner occupied	291,758,000	23.4	261,877,000	24.9	11.4
Real estate – non-owner occupied	410,977,000	33.0	364,066,000	34.6	12.9
Real estate – multi-family and residential rental	<u>36,058,000</u>	<u>2.9</u>	<u>37,639,000</u>	<u>3.5</u>	<u>(4.2)</u>
Total commercial	1,153,189,000	92.5	986,696,000	93.7	16.9
Retail:					
Home equity and other	50,059,000	4.0	35,080,000	3.3	42.7
1-4 family mortgages	<u>42,868,000</u>	<u>3.5</u>	<u>31,467,000</u>	<u>3.0</u>	<u>36.2</u>
Total retail	<u>92,927,000</u>	<u>7.5</u>	<u>66,547,000</u>	<u>6.3</u>	<u>39.6</u>
Total originated loans	<u>\$ 1,246,116,000</u>	<u>100.0%</u>	<u>\$ 1,053,243,000</u>	<u>100.0%</u>	<u>18.3%</u>

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

	December 31, 2014		December 31, 2013		Percent Increase (Decrease)
	<u>Balance</u>	<u>%</u>	<u>Balance</u>	<u>%</u>	
<b><u>Acquired Loans</u></b>					
Commercial:					
Commercial and industrial	\$ 166,037,000	19.7%	\$ 0	NA	NM
Vacant land, land development, and residential construction	22,148,000	2.6	0	NA	NM
Real estate – owner occupied	138,630,000	16.4	0	NA	NM
Real estate – non-owner occupied	148,597,000	17.6	0	NA	NM
Real estate – multi-family and residential rental	<u>86,702,000</u>	<u>10.3</u>	<u>0</u>	<u>NA</u>	<u>NM</u>
Total commercial	562,114,000	66.6	0	NA	NM
Retail:					
Home equity and other	109,219,000	13.0	0	NA	NM
1-4 family mortgages	<u>171,828,000</u>	<u>20.4</u>	<u>0</u>	<u>NA</u>	<u>NM</u>
Total retail	<u>281,047,000</u>	<u>33.4</u>	<u>0</u>	<u>NA</u>	<u>NM</u>
Total acquired loans	<u>\$ 843,161,000</u>	<u>100.0%</u>	<u>\$ 0</u>	<u>NA</u>	<u>NM</u>

	December 31, 2014		December 31, 2013		Percent Increase (Decrease)
	<u>Balance</u>	<u>%</u>	<u>Balance</u>	<u>%</u>	
<b><u>Total Loans</u></b>					
Commercial:					
Commercial and industrial	\$ 550,607,000	26.4%	\$ 286,373,000	27.2%	92.3%
Vacant land, land development, and residential construction	51,974,000	2.5	36,741,000	3.5	41.5
Real estate – owner occupied	430,388,000	20.5	261,877,000	24.9	64.3
Real estate – non-owner occupied	559,574,000	26.8	364,066,000	34.6	53.7
Real estate – multi-family and residential rental	<u>122,760,000</u>	<u>5.9</u>	<u>37,639,000</u>	<u>3.5</u>	<u>226.2</u>
Total commercial	1,715,303,000	82.1	986,696,000	93.7	73.8
Retail:					
Home equity and other	159,278,000	7.6	35,080,000	3.3	354.0
1-4 family mortgages	<u>214,696,000</u>	<u>10.3</u>	<u>31,467,000</u>	<u>3.0</u>	<u>582.3</u>
Total retail	<u>373,974,000</u>	<u>17.9</u>	<u>66,547,000</u>	<u>6.3</u>	<u>462.0</u>
Total loans	<u>\$ 2,089,277,000</u>	<u>100.0%</u>	<u>\$ 1,053,243,000</u>	<u>100.0%</u>	<u>98.4%</u>

(Continued)



MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

The total contractually required payments and carrying value of acquired impaired loans was \$31.4 million and \$18.6 million, respectively, as of December 31, 2014. Changes in the accretible yield for acquired impaired loans for the seven-month period ended December 31, 2014 were as follows:

	<u>2014</u>
Balance at May 31, 2014	\$ 0
Additions	2,514,000
Accretion	(786,000)
Net reclassification from nonaccretible to accretible	3,537,000
Disposals	(40,000)
Other activity	<u>(227,000)</u>
Balance at December 31, 2014	\$ 4,998,000

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

	<u>2014</u>	<u>2013</u>
	<u>Balance</u>	<u>Balance</u>
	<u>Percentage of</u>	<u>Percentage of</u>
	<u>Loan Portfolio</u>	<u>Loan Portfolio</u>
Commercial real estate loans to lessors of non-residential buildings	\$ 480,170,000	\$ 299,446,000
	23.0%	28.4%

Year-end nonperforming originated loans were as follows:

	<u>2014</u>	<u>2013</u>
Loans past due 90 days or more still accruing interest	\$ 0	\$ 0
Nonaccrual loans	<u>26,048,000</u>	<u>6,718,000</u>
Total nonperforming loans	<u>\$ 26,048,000</u>	<u>\$ 6,718,000</u>

Year-end nonperforming acquired loans were as follows:

	<u>2014</u>	<u>2013</u>
Loans past due 90 days or more still accruing interest	\$ 26,000	\$ NA
Nonaccrual loans	<u>3,358,000</u>	<u>NA</u>
Total nonperforming loans	<u>\$ 3,384,000</u>	<u>\$ NA</u>

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 4 – LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

The recorded principal balance of nonperforming loans was as follows:

	December 31, <u>2014</u>	December 31, <u>2013</u>
Commercial:		
Commercial and industrial	\$ 6,478,000	\$ 1,501,000
Vacant land, land development, and residential construction	209,000	785,000
Real estate – owner occupied	18,062,000	389,000
Real estate – non-owner occupied	378,000	168,000
Real estate – multi-family and residential rental	<u>106,000</u>	<u>208,000</u>
Total commercial	25,233,000	3,051,000
Retail:		
Home equity and other	800,000	788,000
1-4 family mortgages	<u>3,399,000</u>	<u>2,879,000</u>
Total retail	<u>4,199,000</u>	<u>3,667,000</u>
Total nonperforming loans	<u>\$ 29,432,000</u>	<u>\$ 6,718,000</u>

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

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(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

An age analysis of past due loans is as follows as of December 31, 2014:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
<b><u>Originated Loans</u></b>							
Commercial:							
Commercial and industrial	\$ 0	\$ 0	\$ 0	\$ 0	\$ 384,570,000	\$ 384,570,000	\$ 0
Vacant land, land development, and residential construction	0	0	0	0	29,826,000	29,826,000	0
Real estate – owner occupied	0	0	120,000	120,000	291,638,000	291,758,000	0
Real estate – non-owner occupied	0	0	116,000	116,000	410,861,000	410,977,000	0
Real estate – multi-family and residential rental	0	0	236,000	236,000	36,058,000	36,058,000	0
Total commercial	0	0	236,000	236,000	1,152,953,000	1,153,189,000	0
Retail:							
Home equity and other 1-4 family mortgages	38,000	3,000	0	41,000	50,018,000	50,059,000	0
Total retail	38,000	3,000	366,000	407,000	92,520,000	92,927,000	0
Total past due loans	\$ 38,000	\$ 3,000	\$ 602,000	\$ 643,000	\$ 1,245,473,000	\$ 1,246,116,000	\$ 0

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
<b>Acquired Loans</b>							
Commercial:							
Commercial and industrial	\$ 29,000	\$ 32,000	\$ 76,000	\$ 137,000	\$ 165,900,000	\$ 166,037,000	\$ 0
Vacant land, land development, and residential construction	0	38,000	0	38,000	22,110,000	22,148,000	0
Real estate – owner occupied	51,000	425,000	1,625,000	2,101,000	136,529,000	138,630,000	0
Real estate – non-owner occupied	68,000	598,000	395,000	1,061,000	147,536,000	148,597,000	0
Real estate – multi-family and residential rental	37,000	0	105,000	142,000	86,560,000	86,702,000	0
Total commercial	185,000	1,093,000	2,201,000	3,479,000	558,635,000	562,114,000	0
Retail:							
Home equity and other 1-4 family mortgages	445,000	419,000	155,000	1,019,000	108,200,000	109,219,000	26,000
Total retail	1,087,000	408,000	750,000	2,245,000	169,583,000	171,828,000	0
	1,532,000	827,000	905,000	3,264,000	277,783,000	281,047,000	26,000
Total past due loans	\$ 1,717,000	\$ 1,920,000	\$ 3,106,000	\$ 6,743,000	\$ 836,418,000	\$ 843,161,000	\$ 26,000

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

An age analysis of past due loans is as follows as of December 31, 2013:

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
<b><u>Originated Loans</u></b>							
Commercial:							
Commercial and industrial	\$ 0	\$ 0	\$ 309,000	\$ 309,000	\$ 286,064,000	\$ 286,373,000	\$ 0
Vacant land, land development, and residential construction	0	0	0	0	36,741,000	36,741,000	0
Real estate – owner occupied	65,000	0	50,000	115,000	261,762,000	261,877,000	0
Real estate – non-owner occupied	0	0	0	0	364,066,000	364,066,000	0
Real estate – multi-family and residential rental	0	0	64,000	64,000	37,575,000	37,639,000	0
Total commercial	65,000	0	423,000	488,000	986,208,000	986,696,000	0
Retail:							
Home equity and other	14,000	0	0	14,000	35,066,000	35,080,000	0
1-4 family mortgages	21,000	44,000	375,000	440,000	31,027,000	31,467,000	0
Total retail	35,000	44,000	375,000	454,000	66,093,000	66,547,000	0
Total past due loans	\$ 100,000	\$ 44,000	\$ 798,000	\$ 942,000	\$ 1,052,301,000	\$ 1,053,243,000	\$ 0

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Impaired originated loans with no related allowance recorded were as follows as of December 31, 2014:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	\$ 1,170,000	\$ 1,164,000		\$ 652,000
Vacant land, land development and residential construction	540,000	209,000		227,000
Real estate – owner occupied	3,609,000	1,901,000		4,365,000
Real estate – non-owner occupied	1,210,000	1,210,000		971,000
Real estate – multi-family and residential rental	<u>375,000</u>	<u>317,000</u>		<u>64,000</u>
Total commercial	<u>6,904,000</u>	<u>4,801,000</u>		<u>6,279,000</u>
Retail:				
Home equity and other	207,000	191,000		517,000
1-4 family mortgages	<u>1,144,000</u>	<u>560,000</u>		<u>585,000</u>
Total retail	<u>1,351,000</u>	<u>751,000</u>		<u>1,102,000</u>
Total with no related allowance recorded	<u>\$ 8,255,000</u>	<u>\$ 5,552,000</u>		<u>\$ 7,381,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

Impaired originated loans with an allowance recorded and total impaired loans were as follows as of December 31, 2014:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	\$ 5,299,000	\$ 5,226,000	\$ 1,578,000	\$ 2,759,000
Vacant land, land development and residential construction	2,000,000	2,000,000	151,000	3,229,000
Real estate – owner occupied	15,745,000	15,674,000	2,200,000	4,630,000
Real estate – non-owner occupied	16,033,000	15,949,000	4,779,000	18,245,000
Real estate – multi-family and residential rental	<u>1,371,000</u>	<u>1,371,000</u>	<u>666,000</u>	<u>1,700,000</u>
Total commercial	40,448,000	40,220,000	9,374,000	30,563,000
Retail:				
Home equity and other	115,000	84,000	84,000	128,000
1-4 family mortgages	<u>2,194,000</u>	<u>2,000,000</u>	<u>694,000</u>	<u>2,115,000</u>
Total retail	2,309,000	2,084,000	778,000	2,243,000
Total with an allowance recorded	<u>\$ 42,757,000</u>	<u>\$ 42,304,000</u>	<u>\$ 10,152,000</u>	<u>\$ 32,806,000</u>
Total impaired loans:				
Commercial	\$ 47,352,000	\$ 45,021,000	\$ 9,374,000	\$ 36,842,000
Retail	<u>3,660,000</u>	<u>2,835,000</u>	<u>778,000</u>	<u>3,345,000</u>
Total impaired loans	<u>\$ 51,012,000</u>	<u>\$ 47,856,000</u>	<u>\$ 10,152,000</u>	<u>\$ 40,187,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Impaired acquired loans with no related allowance recorded were as follows as of December 31, 2014:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	\$ 1,586,000	\$ 1,579,000		\$ 563,000
Vacant land, land development and residential construction	0	0		0
Real estate – owner occupied	113,000	113,000		52,000
Real estate – non-owner occupied	326,000	326,000		260,000
Real estate – multi-family and residential rental	487,000	487,000		166,000
Total commercial	<u>2,512,000</u>	<u>2,505,000</u>		<u>1,041,000</u>
Retail:				
Home equity and other	641,000	639,000		262,000
1-4 family mortgages	866,000	866,000		458,000
Total retail	<u>1,507,000</u>	<u>1,505,000</u>		<u>720,000</u>
Total with no related allowance recorded	<u>\$ 4,019,000</u>	<u>\$ 4,010,000</u>		<u>\$ 1,761,000</u>

(Continued)



MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Impaired acquired loans with an allowance recorded and total impaired loans were as follows as of December 31, 2014:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	\$ 0	\$ 0	\$ 0	\$ 0
Vacant land, land development and residential construction	0	0	0	0
Real estate – owner occupied	1,516,000	1,502,000	605,000	501,000
Real estate – non-owner occupied	0	0	0	0
Real estate – multi-family and residential rental	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total commercial	<u>1,516,000</u>	<u>1,502,000</u>	<u>605,000</u>	<u>501,000</u>
Retail:				
Home equity and other	0	0	0	0
1-4 family mortgages	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total retail	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total with an allowance recorded	<u>\$ 1,516,000</u>	<u>\$ 1,502,000</u>	<u>\$ 605,000</u>	<u>\$ 501,000</u>
Total impaired loans:				
Commercial	\$ 4,028,000	\$ 4,007,000	\$ 605,000	\$ 1,542,000
Retail	<u>1,507,000</u>	<u>1,505,000</u>	<u>0</u>	<u>720,000</u>
Total impaired loans	<u>\$ 5,535,000</u>	<u>\$ 5,512,000</u>	<u>\$ 605,000</u>	<u>\$ 2,262,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Impaired originated loans with no related allowance recorded were as follows as of December 31, 2013:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	\$ 2,229,000	\$ 511,000		\$ 1,205,000
Vacant land, land development and residential construction	475,000	362,000		991,000
Real estate – owner occupied	1,270,000	785,000		1,084,000
Real estate – non-owner occupied	895,000	733,000		4,049,000
Real estate – multi-family and residential rental	<u>41,000</u>	<u>1,000</u>		<u>390,000</u>
Total commercial	<u>4,910,000</u>	<u>2,392,000</u>		<u>7,719,000</u>
Retail:				
Home equity and other	507,000	461,000		471,000
1-4 family mortgages	<u>1,272,000</u>	<u>647,000</u>		<u>727,000</u>
Total retail	<u>1,779,000</u>	<u>1,108,000</u>		<u>1,198,000</u>
Total with no related allowance recorded	<u>\$ 6,689,000</u>	<u>\$ 3,500,000</u>		<u>\$ 8,917,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

Impaired originated loans with an allowance recorded and total impaired loans were as follows as of December 31, 2013:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	Year-To-Date Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	\$ 1,517,000	\$ 1,440,000	\$ 792,000	\$ 1,880,000
Vacant land, land development and residential construction	4,436,000	4,139,000	844,000	3,354,000
Real estate – owner occupied	1,513,000	1,513,000	528,000	2,550,000
Real estate – non-owner occupied	21,088,000	21,072,000	7,969,000	28,388,000
Real estate – multi-family and residential rental	<u>3,219,000</u>	<u>2,684,000</u>	<u>1,127,000</u>	<u>2,915,000</u>
Total commercial	<u>31,773,000</u>	<u>30,848,000</u>	<u>11,260,000</u>	<u>39,087,000</u>
Retail:				
Home equity and other	320,000	289,000	96,000	329,000
1-4 family mortgages	<u>2,274,000</u>	<u>2,231,000</u>	<u>1,030,000</u>	<u>1,628,000</u>
Total retail	<u>2,594,000</u>	<u>2,520,000</u>	<u>1,126,000</u>	<u>1,957,000</u>
Total with an allowance recorded	<u>\$ 34,367,000</u>	<u>\$ 33,368,000</u>	<u>\$ 12,386,000</u>	<u>\$ 41,044,000</u>
Total impaired loans:				
Commercial	\$ 36,683,000	\$ 33,240,000	\$ 11,260,000	\$ 46,806,000
Retail	<u>4,373,000</u>	<u>3,628,000</u>	<u>1,126,000</u>	<u>3,155,000</u>
Total impaired loans	<u>\$ 41,056,000</u>	<u>\$ 36,868,000</u>	<u>\$ 12,386,000</u>	<u>\$ 49,961,000</u>

Impaired loans for which no allocation of the allowance for loan losses has been made generally reflect situations whereby the loans have been charged-down to estimated collateral value. Interest income recognized on accruing troubled debt restructurings totaled \$1.8 million, \$2.5 million and \$2.0 million during 2014, 2013 and 2012, respectively. Interest income recognized on nonaccrual loans totaled \$1.9 million during 2013, reflecting the collection of interest at the time of principal pay-off. No such significant collections of interest income were recorded during 2014 or 2012. Lost interest income on nonaccrual loans totaled \$0.1 million, \$0.4 million and \$0.8 million during 2014, 2013 and 2012, respectively.

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

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

Loans by credit quality indicators were as follows as of December 31, 2014:

**Originated Loans**

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

	Commercial and <u>Industrial</u>	Commercial Vacant Land, Land Development, and Residential <u>Construction</u>	Commercial Real Estate - Owner <u>Occupied</u>	Commercial Real Estate - Non-Owner <u>Occupied</u>	Commercial Real Estate - Multi-Family and Residential <u>Rental</u>
Internal credit risk grade groupings:					
Grades 1 – 4	\$ 266,631,000	\$ 11,242,000	\$ 190,656,000	\$ 285,035,000	\$ 12,394,000
Grades 5 – 7	109,639,000	16,375,000	83,123,000	113,982,000	22,282,000
Grades 8 – 9	<u>8,300,000</u>	<u>2,209,000</u>	<u>17,979,000</u>	<u>11,960,000</u>	<u>1,382,000</u>
Total commercial	<u>\$ 384,570,000</u>	<u>\$ 29,826,000</u>	<u>\$ 291,758,000</u>	<u>\$ 410,977,000</u>	<u>\$ 36,058,000</u>

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and <u>Other</u>	Retail 1-4 Family <u>Mortgages</u>
Total retail	<u>\$ 50,059,000</u>	<u>\$ 42,868,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

**Acquired Loans**

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	\$ 72,411,000	\$ 5,875,000	\$ 39,496,000	\$ 65,886,000	\$ 35,858,000
Grades 5 – 7	90,320,000	14,472,000	92,212,000	78,103,000	49,781,000
Grades 8 – 9	<u>3,306,000</u>	<u>1,801,000</u>	<u>6,922,000</u>	<u>4,608,000</u>	<u>1,063,000</u>
Total commercial	<u>\$ 166,037,000</u>	<u>\$ 22,148,000</u>	<u>\$ 138,630,000</u>	<u>\$ 148,597,000</u>	<u>\$ 86,702,000</u>

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	<u>\$ 109,219,000</u>	<u>\$ 171,828,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Loans by credit quality indicators were as follows as of December 31, 2013:

**Originated Loans**

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	\$ 208,151,000	\$ 6,973,000	\$ 156,230,000	\$ 219,325,000	\$ 15,465,000
Grades 5 – 7	76,237,000	25,535,000	103,066,000	122,717,000	19,469,000
Grades 8 – 9	1,985,000	4,233,000	2,581,000	22,024,000	2,705,000
Total commercial	<u>\$ 286,373,000</u>	<u>\$ 36,741,000</u>	<u>\$ 261,877,000</u>	<u>\$ 364,066,000</u>	<u>\$ 37,639,000</u>

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	<u>\$ 35,080,000</u>	<u>\$ 31,467,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

All commercial loans are graded using the following number system:

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

The allowance for originated loan losses and recorded investments in originated loans for the year-ended December 31, 2014 are as follows:

	<u>Commercial Loans</u>	<u>Retail Loans</u>	<u>Unallocated</u>	<u>Total</u>
Allowance for loan losses:				
Beginning balance	\$ 20,455,000	\$ 2,358,000	\$ 8,000	\$ 22,821,000
Provision for loan losses	(3,140,000)	(721,000)	68,000	(3,793,000)
Charge-offs	(876,000)	(554,000)	0	(1,430,000)
Recoveries	1,297,000	404,000	0	1,701,000
Ending balance	<u>\$ 17,736,000</u>	<u>\$ 1,487,000</u>	<u>\$ 76,000</u>	<u>\$ 19,299,000</u>
Ending balance: individually evaluated for impairment	<u>\$ 9,374,000</u>	<u>\$ 777,000</u>	<u>\$ 0</u>	<u>\$ 10,151,000</u>
Ending balance: collectively evaluated for impairment	<u>\$ 8,362,000</u>	<u>\$ 710,000</u>	<u>\$ 76,000</u>	<u>\$ 9,148,000</u>
Total loans:				
Ending balance	<u>\$1,153,189,000</u>	<u>\$ 92,927,000</u>		<u>\$1,246,116,000</u>
Ending balance: individually evaluated for impairment	<u>\$ 45,021,000</u>	<u>\$ 2,835,000</u>		<u>\$ 47,856,000</u>
Ending balance: collectively evaluated for impairment	<u>\$1,108,168,000</u>	<u>\$ 90,092,000</u>		<u>\$1,198,260,000</u>

The allowance for acquired loan losses for the year-ended December 31, 2014 is as follows:

	<u>Commercial Loans</u>	<u>Retail Loans</u>	<u>Unallocated</u>	<u>Total</u>
Allowance for loan losses:				
Beginning balance	\$ 0	\$ 0	\$ 0	\$ 0
Provision for loan losses	734,000	59,000	0	793,000
Charge-offs	(55,000)	(16,000)	0	(71,000)
Recoveries	2,000	18,000	0	20,000
Ending balance	<u>\$ 681,000</u>	<u>\$ 61,000</u>	<u>\$ 0</u>	<u>\$ 742,000</u>

In accordance with the applicable accounting guidance for business combinations, there was no carry-over of Firstbank's previously established allowance for loan losses.

(Continued)



MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

The allowance for loan losses and recorded investments in loans for the year-ended December 31, 2013 are as follows:

	<u>Commercial Loans</u>	<u>Retail Loans</u>	<u>Unallocated</u>	<u>Total</u>
Allowance for loan losses:				
Beginning balance	\$ 26,043,000	\$ 2,645,000	\$ (11,000)	\$ 28,677,000
Provision for loan losses	(6,730,000)	(489,000)	19,000	(7,200,000)
Charge-offs	(5,120,000)	(170,000)	0	(5,290,000)
Recoveries	6,262,000	372,000	0	6,634,000
Ending balance	<u>\$ 20,455,000</u>	<u>\$ 2,358,000</u>	<u>\$ 8,000</u>	<u>\$ 22,821,000</u>
Ending balance: individually evaluated for impairment	<u>\$ 11,260,000</u>	<u>\$ 1,126,000</u>	<u>\$ 0</u>	<u>\$ 12,386,000</u>
Ending balance: collectively evaluated for impairment	<u>\$ 9,195,000</u>	<u>\$ 1,232,000</u>	<u>\$ 8,000</u>	<u>\$ 10,435,000</u>
Total loans:				
Ending balance	<u>\$ 986,696,000</u>	<u>\$ 66,547,000</u>		<u>\$1,053,243,000</u>
Ending balance: individually evaluated for impairment	<u>\$ 33,240,000</u>	<u>\$ 3,628,000</u>		<u>\$ 36,868,000</u>
Ending balance: collectively evaluated for impairment	<u>\$ 953,456,000</u>	<u>\$ 62,919,000</u>		<u>\$1,016,375,000</u>

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(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

The allowance for loan losses and recorded investments in loans for the year-ended December 31, 2012 are as follows:

	<u>Commercial Loans</u>	<u>Retail Loans</u>	<u>Unallocated</u>	<u>Total</u>
Allowance for loan losses:				
Beginning balance	\$ 33,431,000	\$ 3,019,000	\$ 82,000	\$ 36,532,000
Provision for loan losses	(2,800,000)	(207,000)	(93,000)	(3,100,000)
Charge-offs	(12,075,000)	(569,000)	0	(12,644,000)
Recoveries	7,487,000	402,000	0	7,889,000
Ending balance	<u>\$ 26,043,000</u>	<u>\$ 2,645,000</u>	<u>\$ (11,000)</u>	<u>\$ 28,677,000</u>
Ending balance: individually evaluated for impairment	<u>\$ 16,860,000</u>	<u>\$ 329,000</u>	<u>\$ 0</u>	<u>\$ 17,189,000</u>
Ending balance: collectively evaluated for impairment	<u>\$ 9,183,000</u>	<u>\$ 2,316,000</u>	<u>\$ (11,000)</u>	<u>\$ 11,488,000</u>
Total loans:				
Ending balance	<u>\$ 968,506,000</u>	<u>\$ 72,683,000</u>		<u>\$1,041,189,000</u>
Ending balance: individually evaluated for impairment	<u>\$ 55,138,000</u>	<u>\$ 2,141,000</u>		<u>\$ 57,279,000</u>
Ending balance: collectively evaluated for impairment	<u>\$ 913,368,000</u>	<u>\$ 70,542,000</u>		<u>\$ 983,910,000</u>

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

Loans modified as troubled debt restructurings during 2014 were as follows:

	<u>Number of Contracts</u>	<u>Pre- Modification Recorded Principal Balance</u>	<u>Post- Modification Recorded Principal Balance</u>
<b><u>Originated Loans</u></b>			
Commercial:			
Commercial and industrial	2	\$ 5,994,000	\$ 6,094,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	2	16,787,000	16,787,000
Real estate – non-owner occupied	1	146,000	146,000
Real estate – multi-family and residential rental	<u>0</u>	<u>0</u>	<u>0</u>
Total commercial	5	22,927,000	23,027,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	<u>0</u>	<u>0</u>	<u>0</u>
Total retail	<u>0</u>	<u>0</u>	<u>0</u>
Total	<u>5</u>	<u>\$ 22,927,000</u>	<u>\$ 23,027,000</u>

**Acquired Loans**

Commercial:			
Commercial and industrial	7	\$ 1,604,000	\$ 1,604,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	2	1,619,000	1,619,000
Real estate – non-owner occupied	1	65,000	65,000
Real estate – multi-family and residential rental	<u>4</u>	<u>394,000</u>	<u>394,000</u>
Total commercial	14	3,682,000	3,682,000
Retail:			
Home equity and other	1	26,000	26,000
1-4 family mortgages	<u>1</u>	<u>179,000</u>	<u>179,000</u>
Total retail	<u>2</u>	<u>205,000</u>	<u>205,000</u>
Total	<u>16</u>	<u>\$ 3,887,000</u>	<u>\$ 3,887,000</u>

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MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Originated loans modified as troubled debt restructurings during 2013 were as follows:

	Number of <u>Contracts</u>	Pre- Modification Recorded Principal <u>Balance</u>	Post- Modification Recorded Principal <u>Balance</u>
Commercial:			
Commercial and industrial	3	\$ 741,000	\$ 741,000
Vacant land, land development and residential construction	2	3,610,000	3,610,000
Real estate – owner occupied	2	715,000	715,000
Real estate – non-owner occupied	1	45,000	45,000
Real estate – multi-family and residential rental	<u>1</u>	<u>241,000</u>	<u>241,000</u>
Total commercial	9	5,352,000	5,352,000
Retail:			
Home equity and other	0	0	0
1-4 family mortgages	<u>1</u>	<u>1,879,000</u>	<u>1,879,000</u>
Total retail	<u>1</u>	<u>1,879,000</u>	<u>1,879,000</u>
Total	<u>10</u>	<u>\$ 7,231,000</u>	<u>\$ 7,231,000</u>

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due during the twelve months ended December 31, 2014 (amounts as of period end):

	Number of <u>Contracts</u>	Recorded Principal <u>Balance</u>
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	<u>0</u>	<u>0</u>
Total commercial	0	0
Retail:		
Home equity and other	0	0
1-4 family mortgages	<u>0</u>	<u>0</u>
Total retail	<u>0</u>	<u>0</u>
Total	<u>0</u>	<u>\$ 0</u>

(Continued)

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

The following acquired loans, modified as troubled debt restructurings within the previous seven months, became over 30 days past due during the seven months ended December 31, 2014 (amounts as of period end):

	<u>Number of Contracts</u>	<u>Recorded Principal Balance</u>
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	<u>0</u>	<u>0</u>
Total commercial	0	0
Retail:		
Home equity and other	0	0
1-4 family mortgages	<u>0</u>	<u>0</u>
Total retail	<u>0</u>	<u>0</u>
Total	<u>0</u>	<u>\$ 0</u>

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due during the twelve months ended December 31, 2013 (amounts as of period end):

	<u>Number of Contracts</u>	<u>Recorded Principal Balance</u>
Commercial:		
Commercial and industrial	0	\$ 0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	65,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	<u>0</u>	<u>0</u>
Total commercial	1	65,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	<u>0</u>	<u>0</u>
Total retail	<u>0</u>	<u>0</u>
Total	<u>1</u>	<u>\$ 65,000</u>

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(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Activity for originated loans categorized as troubled debt restructurings during 2014 is as follows:

	Commercial and <u>Industrial</u>	Commercial Vacant Land, Land Development, and Residential <u>Construction</u>	Commercial Real Estate - Owner <u>Occupied</u>	Commercial Real Estate - Non-Owner <u>Occupied</u>	Commercial Real Estate - Multi-Family and Residential <u>Rental</u>
Commercial Loan Portfolio:					
Beginning Balance	\$ 1,656,000	\$ 4,501,000	\$ 1,816,000	\$ 22,311,000	\$ 2,620,000
Charge-Offs	(67,000)	0	(11,000)	0	(420,000)
Payments	(871,000)	(4,719,000)	(2,343,000)	(5,190,000)	(1,695,000)
Transfers to ORE	(21,000)	0	(48,000)	0	0
Net Additions/Deletions	<u>6,329,000</u>	<u>2,898,000</u>	<u>17,746,000</u>	<u>318,000</u>	<u>0</u>
Ending Balance	<u>\$ 7,026,000</u>	<u>\$ 2,680,000</u>	<u>\$ 17,160,000</u>	<u>\$ 17,439,000</u>	<u>\$ 505,000</u>

	Retail Home Equity and <u>Other</u>	Retail 1-4 Family <u>Mortgages</u>
Retail Loan Portfolio:		
Beginning Balance	\$ 0	\$ 1,987,000
Charge-Offs	0	0
Payments	0	(224,000)
Transfers to ORE	0	0
Net Additions/Deletions	<u>0</u>	<u>204,000</u>
Ending Balance	<u>\$ 0</u>	<u>\$ 1,967,000</u>

(Continued)

MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Activity for acquired loans categorized as troubled debt restructurings during the last seven months of 2014 is as follows:

	Commercial and <u>Industrial</u>	Commercial Vacant Land, Land Development, and Residential <u>Construction</u>	Commercial Real Estate - Owner <u>Occupied</u>	Commercial Real Estate - Non-Owner <u>Occupied</u>	Commercial Real Estate - Multi-Family and Residential <u>Rental</u>
Commercial Loan Portfolio:					
Beginning Balance	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Charge-Offs	0	0	0	0	0
Payments	(2,000)	0	0	0	(18,000)
Transfers to ORE	0	0	0	0	0
Net Additions/Deletions	<u>1,441,000</u>	<u>0</u>	<u>1,569,000</u>	<u>64,000</u>	<u>399,000</u>
Ending Balance	<u>\$ 1,439,000</u>	<u>\$ 0</u>	<u>\$ 1,569,000</u>	<u>\$ 64,000</u>	<u>\$ 381,000</u>

	Retail Home Equity and <u>Other</u>	Retail 1-4 Family <u>Mortgages</u>
Retail Loan Portfolio:		
Beginning Balance	\$ 0	\$ 0
Charge-Offs	0	0
Payments	0	0
Transfers to ORE	0	0
Net Additions/Deletions	<u>26,000</u>	<u>178,000</u>
Ending Balance	<u>\$ 26,000</u>	<u>\$ 178,000</u>

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MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Activity for loans categorized as troubled debt restructurings during 2013 is as follows:

	Commercial and <u>Industrial</u>	Commercial Vacant Land, Land Development, and Residential <u>Construction</u>	Commercial Real Estate - Owner <u>Occupied</u>	Commercial Real Estate - Non-Owner <u>Occupied</u>	Commercial Real Estate - Multi-Family and Residential <u>Rental</u>
Commercial Loan Portfolio:					
Beginning Balance	\$ 2,720,000	\$ 3,071,000	\$ 4,116,000	\$ 37,671,000	\$ 3,027,000
Charge-Offs	(35,000)	(725,000)	(70,000)	(2,537,000)	(15,000)
Payments	(2,781,000)	(1,596,000)	(2,151,000)	(13,795,000)	(735,000)
Transfers to ORE	(74,000)	0	(363,000)	(1,153,000)	0
Net Additions/Deletions	<u>1,826,000</u>	<u>3,751,000</u>	<u>284,000</u>	<u>2,126,000</u>	<u>343,000</u>
Ending Balance	<u>\$ 1,656,000</u>	<u>\$ 4,501,000</u>	<u>\$ 1,816,000</u>	<u>\$ 22,312,000</u>	<u>\$ 2,620,000</u>
Retail Loan Portfolio:					
Beginning Balance	\$ 0	\$ 155,000			
Charge-Offs	0	0			
Payments	0	(46,000)			
Transfers to ORE	0	0			
Net Additions/Deletions	<u>0</u>	<u>1,878,000</u>			
Ending Balance	<u>\$ 0</u>	<u>\$ 1,987,000</u>			

(Continued)



MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 December 31, 2014

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

Activity for loans categorized as troubled debt restructurings during 2012 is as follows:

	Commercial and <u>Industrial</u>	Commercial Vacant Land, Land Development, and Residential <u>Construction</u>	Commercial Real Estate - Owner <u>Occupied</u>	Commercial Real Estate - Non-Owner <u>Occupied</u>	Commercial Real Estate - Multi-Family and Residential <u>Rental</u>
<b>Commercial Loan Portfolio:</b>					
Beginning Balance	\$ 4,553,000	\$ 5,100,000	\$ 6,183,000	\$ 12,036,000	\$ 12,626,000
Charge-Offs	(540,000)	(63,000)	(426,000)	(720,000)	(2,180,000)
Payments	(2,584,000)	(2,013,000)	(3,443,000)	(2,482,000)	(7,422,000)
Transfers to ORE	(96,000)	0	(65,000)	(1,045,000)	(186,000)
Net Additions/Deletions	<u>1,387,000</u>	<u>47,000</u>	<u>1,867,000</u>	<u>29,882,000</u>	<u>189,000</u>
Ending Balance	<u>\$ 2,720,000</u>	<u>\$ 3,071,000</u>	<u>\$ 4,116,000</u>	<u>\$ 37,671,000</u>	<u>\$ 3,027,000</u>
<b>Retail Loan Portfolio:</b>					
Beginning Balance	\$ 0	\$ 164,000			
Charge-Offs	0	0			
Payments	0	(9,000)			
Transfers to ORE	0	0			
Net Additions/Deletions	<u>0</u>	<u>0</u>			
Ending Balance	<u>\$ 0</u>	<u>\$ 155,000</u>			

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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

The allowance related to loans categorized as troubled debt restructurings was as follows:

	<u>December 31,</u> <u>2014</u>	<u>December 31,</u> <u>2013</u>
Commercial:		
Commercial and industrial	\$ 16,000	\$ 187,000
Vacant land, land development, and residential construction	151,000	798,000
Real estate – owner occupied	182,000	528,000
Real estate – non-owner occupied	4,778,000	7,828,000
Real estate – multi-family and residential rental	<u>666,000</u>	<u>1,010,000</u>
Total commercial	5,793,000	10,351,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	<u>0</u>	<u>48,000</u>
Total retail	<u>0</u>	<u>48,000</u>
Total related allowance	<u>\$ 5,793,000</u>	<u>\$ 10,399,000</u>

In general, our policy dictates that a renewal or modification of an 8- or 9-rated commercial loan meets the criteria of a troubled debt restructuring, although we review and consider all renewed and modified loans as part of our troubled debt restructuring assessment procedures. Loan relationships rated 8 contain significant financial weaknesses, resulting in a distinct possibility of loss, while relationships rated 9 reflect vital financial weaknesses, resulting in a highly questionable ability on our part to collect principal; we believe borrowers warranting such ratings would have difficulty obtaining financing from other market participants. Thus, due to the lack of comparable market rates for loans with similar risk characteristics, we believe 8- or 9-rated loans renewed or modified were done so at below market rates. Loans that are identified as troubled debt restructurings are considered impaired and are individually evaluated for impairment when assessing these credits in our allowance for loan losses calculation.

**NOTE 5 - PREMISES AND EQUIPMENT, NET**

Year-end premises and equipment were as follows:

	<u>2014</u>	<u>2013</u>
Land and improvements	\$ 16,579,000	\$ 8,556,000
Buildings	38,761,000	24,733,000
Furniture and equipment	<u>16,622,000</u>	<u>12,718,000</u>
	71,962,000	46,007,000
Less: accumulated depreciation	<u>23,150,000</u>	<u>21,109,000</u>
Total premises and equipment	<u>\$ 48,812,000</u>	<u>\$ 24,898,000</u>

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 5 - PREMISES AND EQUIPMENT, NET** (Continued)

Future lease payments total \$1.8 million, comprised of \$0.4 million in one year, \$0.8 million in one to three years, \$0.5 million in three to five years and \$0.1 million in over five years. Depreciation expense totaled \$2.3 million in 2014, \$1.3 million in 2013, and \$1.5 million in 2012.

**NOTE 6 – MORTGAGE LOAN SERVICING**

Mortgage loans serviced for others are not reported as assets in the Consolidated Balance Sheets. The mortgage loan servicing portfolio was acquired in the merger with Firstbank. The year-end aggregate unpaid principal balances of mortgage loans serviced for others were as follows:

	<u>2014</u>
Mortgage loan portfolios serviced for:	
Federal Home Loan Mortgage Corporation	\$ 589,118,000
Federal Home Loan Bank	<u>1,702,000</u>
Total mortgage loans serviced for others	<u>\$ 590,820,000</u>

Custodial escrow balances maintained in connection with serviced loans were \$2.8 million as of December 31, 2014.

Activity for capitalized mortgage loan servicing rights, included in other assets in the Consolidated Balance Sheets, during 2014 was as follows:

	<u>2014</u>
Balance at January 1, 2014	\$ 0
Firstbank merger	7,389,000
Additions	575,000
Amortized to expense	<u>(1,252,000)</u>
Balance at December 31, 2014	<u>\$ 6,712,000</u>

We determined that no valuation allowance was necessary as of December 31, 2014. The estimated fair value of mortgage servicing rights was \$7.3 million as of December 31, 2014. The fair value of mortgage servicing rights is estimated using a valuation model that calculates the present value of estimated future net servicing cash flows, taking into consideration expected mortgage loan prepayment rates, discount rates, servicing costs and other economic factors, which are determined based on current market conditions. Fair value was determined using a discount rate of 7.05%, a weighted average constant prepayment rate of 12.6%, depending on the stratification of the specific right, and a weighted average delinquency rate of 1.01%.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2014

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**NOTE 6 – MORTGAGE LOAN SERVICING** (Continued)

The weighted average amortization period is 3.7 years as of December 31, 2014. Estimated amortization is as follows:

2015	\$ 1,560,000
2016	1,256,000
2017	1,023,000
2018	857,000
2019	722,000
Thereafter	1,294,000

**NOTE 7 – CORE DEPOSIT INTANGIBLE ASSETS, NET**

The gross carrying amount of core deposit intangible assets totaled \$17.5 million as of December 31, 2014 (none at December 31, 2013). The accumulated amortization on core deposit intangible assets was \$1.9 million, providing for a net carry balance of \$15.6 million as of December 31, 2014.

The estimated amortization expense on core deposit intangible assets in future periods is:

2015	\$ 2,992,000
2016	2,675,000
2017	2,357,000
2018	2,039,000
2019	1,721,000
Thereafter	3,839,000

MERCANTILE BANK CORPORATION  
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December 31, 2014

**NOTE 8 – DEPOSITS**

Deposits at year-end are summarized as follows:

	<u>December 31, 2014</u>		<u>December 31, 2013</u>		Percent Increase (Decrease)
	<u>Balance</u>	<u>%</u>	<u>Balance</u>	<u>%</u>	
Noninterest-bearing demand	\$ 558,738,000	24.5%	\$ 224,580,000	20.1%	148.8%
Interest-bearing checking	413,382,000	18.2	197,388,000	17.6	109.4
Money market	235,587,000	10.3	133,369,000	11.9	76.6
Savings	330,459,000	14.5	52,606,000	4.7	528.2
Time, under \$100,000	181,026,000	8.0	43,251,000	3.9	318.5
Time, \$100,000 and over	<u>382,120,000</u>	<u>16.8</u>	<u>254,600,000</u>	<u>22.8</u>	<u>50.1</u>
	2,101,312,000	92.3	905,794,000	81.0	132.0
Out-of-area time, under \$100,000	2,422,000	0.1	4,078,000	0.4	(40.6)
Out-of-area time, \$100,000 and over	<u>173,181,000</u>	<u>7.6</u>	<u>209,039,000</u>	<u>18.6</u>	<u>(17.2)</u>
	<u>175,603,000</u>	<u>7.7</u>	<u>213,117,000</u>	<u>19.0</u>	<u>(17.6)</u>
Total deposits	<u>\$ 2,276,915,000</u>	<u>100.0%</u>	<u>\$1,118,911,000</u>	<u>100.0%</u>	<u>103.5</u>

Out-of-area certificates of deposit consist of certificates obtained from depositors outside of our primary market areas almost exclusively through deposit brokers.

The following table depicts the maturity distribution for certificates of deposit at year-end:

	<u>2014</u>	<u>2013</u>
In one year or less	\$ 368,163,000	\$ 213,454,000
In one to two years	153,346,000	80,138,000
In two to three years	118,919,000	73,271,000
In three to four years	60,953,000	95,979,000
In four to five years	<u>37,368,000</u>	<u>48,126,000</u>
Total certificates of deposit	<u>\$ 738,749,000</u>	<u>\$ 510,968,000</u>

MERCANTILE BANK CORPORATION  
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 December 31, 2014

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**NOTE 8 – DEPOSITS (Continued)**

The following table depicts the maturity distribution for certificates of deposit with balances of \$100,000 or more at year-end:

	<u>2014</u>	<u>2013</u>
Up to three months	\$ 75,356,000	\$ 57,469,000
Three months to six months	65,838,000	41,237,000
Six months to twelve months	125,492,000	93,920,000
Over twelve months	<u>288,615,000</u>	<u>271,013,000</u>
Total certificates of deposit	<u>\$ 555,301,000</u>	<u>\$ 463,639,000</u>

**NOTE 9 – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE**

Information regarding securities sold under agreements to repurchase at year-end is summarized below:

	<u>2014</u>	<u>2013</u>
Outstanding balance at year-end	\$ 167,569,000	\$ 69,305,000
Weighted average interest rate at year-end	0.11%	0.12%
Average daily balance during the year	\$ 105,474,000	\$ 65,939,000
Weighted average interest rate during the year	0.12%	0.12%
Maximum daily balance during the year	\$ 178,042,000	\$ 78,960,000

Securities sold under agreements to repurchase (“repurchase agreements”) generally have original maturities of less than one year. Repurchase agreements are treated as financings, and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the repurchase agreements are recorded as assets of our Bank and are held in safekeeping by a correspondent bank. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements are secured by securities with an aggregate fair value equal to the aggregate outstanding balance.

**NOTE 10 - FEDERAL HOME LOAN BANK ADVANCES**

Federal Home Loan Bank (“FHLB”) advances totaled \$54.0 million at December 31, 2014, and mature at varying dates from January 2015 through September 2017, with fixed rates of interest from 0.62% to 1.51% and averaging 1.26%. FHLB advances totaled \$45.0 million at December 31, 2013, and were expected to mature at varying dates ranging from March 2017 through September 2017, with fixed rates of interest from 1.22% to 1.51% and averaging 1.34%.

Each advance is payable at its maturity date, and is subject to a prepayment fee if paid prior to the maturity date. The advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit as of December 31, 2014 totaled \$409.5 million, with availability of \$355.5 million.

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MERCANTILE BANK CORPORATION  
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**NOTE 10 - FEDERAL HOME LOAN BANK ADVANCES (Continued)**

Maturities over the next five years are:

2015	\$ 6,022,000
2016	3,000,000
2017	45,000,000
2018	0
2019	0

**NOTE 11 - FEDERAL INCOME TAXES**

The consolidated income tax expense is as follows:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Current expense	\$ 3,359,000	\$ 0	\$ 0
Deferred expense	<u>4,506,000</u>	<u>8,092,000</u>	<u>5,636,000</u>
Tax expense	<u>\$ 7,865,000</u>	<u>\$ 8,092,000</u>	<u>\$ 5,636,000</u>

A reconciliation of the differences between the federal income tax expense recorded and the amount computed by applying the federal statutory rate to income before income taxes is as follows:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Tax at statutory rate (35%)	\$ 8,819,000	\$ 8,794,000	\$ 6,360,000
Increase (decrease) from			
Tax-exempt interest	(621,000)	(347,000)	(486,000)
Bank owned life insurance	(415,000)	(465,000)	(535,000)
Other	<u>82,000</u>	<u>110,000</u>	<u>297,000</u>
Tax expense	<u>\$ 7,865,000</u>	<u>\$ 8,092,000</u>	<u>\$ 5,636,000</u>

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MERCANTILE BANK CORPORATION  
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**NOTE 11 - FEDERAL INCOME TAXES** (Continued)

Significant components of deferred tax assets and liabilities as of December 31, 2014 and 2013 are as follows:

	<u>2014</u>	<u>2013</u>
Deferred income tax assets		
Allowance for loan losses	\$ 7,014,000	\$ 7,987,000
Tax credit carryforwards	3,395,000	1,397,000
Nonaccrual loan interest income	471,000	605,000
Deferred compensation	1,304,000	567,000
Deferred loan fees	445,000	273,000
Fair value write-downs on foreclosed properties	212,000	241,000
Fair value of interest rate swap	89,000	92,000
Losses on capital investments	450,000	0
Stock compensation	521,000	207,000
Net operating loss carryforward	0	4,050,000
Unrealized loss on securities	0	2,908,000
Other	<u>725,000</u>	<u>136,000</u>
	14,626,000	18,463,000
Deferred income tax liabilities		
Depreciation	1,217,000	419,000
Prepaid expenses	425,000	192,000
Core deposit intangible	5,386,000	0
Mortgage loan servicing rights	2,349,000	0
Unrealized gain on securities	112,000	0
Other	<u>476,000</u>	<u>98,000</u>
	<u>9,965,000</u>	<u>709,000</u>
Net deferred tax asset before valuation allowance	4,661,000	17,754,000
Valuation allowance	<u>(450,000)</u>	<u>0</u>
Total net deferred tax asset	<u>\$ 4,211,000</u>	<u>\$ 17,754,000</u>

A valuation allowance related to deferred tax assets is required when it is considered more likely than not that all or part of the benefits related to such assets will not be realized. We do not believe the deferred tax asset related to losses on certain capital investments acquired in our merger with Firstbank is more likely than not to be realized. Therefore, we established a valuation allowance of \$0.5 million in connection with the acquisition accounting at the time of the merger.

At December 31, 2014, we had carryforwards of the following tax attributes: general business tax credits of \$0.6 million that expire in the years 2028 through 2034; and \$2.8 million of federal alternative minimum tax credits with an indefinite life.

We had no unrecognized tax benefits at any time during 2014 or 2013 and do not anticipate any significant increase in unrecognized tax benefits during 2015. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is our policy to record such accruals in our income tax accounts; no such accruals existed at any time during 2014 or 2013. Our U.S. federal income tax returns are no longer subject to examination for all years before 2011.



**NOTE 12 – STOCK-BASED COMPENSATION**

Stock-based compensation plans are used to provide directors and employees with an increased incentive to contribute to our long-term performance and growth, to align the interests of directors and employees with the interests of our shareholders through the opportunity for increased stock ownership and to attract and retain directors and employees. From 2000 through 2005, stock option grants were provided to directors and certain employees through several stock option plans, including the 2000 Employee Stock Option Plan, 2004 Employee Stock Option Plan and Independent Director Stock Option Plan. During 2006, 2007 and 2008, stock option and restricted stock grants were provided to certain employees through the Stock Incentive Plan of 2006. No stock option or restricted stock grants were made during 2009, 2010 or 2011. During 2012, restricted stock grants were provided to directors and certain employees through the Stock Incentive Plan of 2006. No stock option or restricted stock grants were made during 2013 due to the pending merger with Firstbank. During 2014, stock option and restricted stock grants were provided to certain employees through the Stock Incentive Plan of 2006. In addition, stock grants were provided to directors as retainer payments during 2014 through the Stock Incentive Plan of 2006.

Under our 2000 Employee Stock Option Plan and 2004 Employee Stock Option Plan, stock options granted to employees were granted at the market price on the date of grant, generally fully vested after one year and expired ten years from the date of grant. Stock options granted to non-executive officers during 2005 vested about three weeks after being granted. Under our Independent Director Stock Option Plan, stock options granted to non-employee directors were at 125% of the market price on the date of grant, fully vested after five years and expire ten years from the date of grant.

The Stock Incentive Plan of 2006 replaced all of our outstanding stock option plans for stock options not previously granted. 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. Incentive awards that are stock options or stock appreciation rights are granted with an exercise price not less than the closing price of our common stock on the date of grant, or for stock options granted in 2006 or 2007, the day before the date of grant, if the closing price was higher on the day before the date of grant. Price, vesting and expiration date parameters are determined by Mercantile's Compensation Committee on a grant-by-grant basis. Generally, the stock options granted to employees during 2006, 2007 and 2008 fully vested after two years and expire after seven years. The restricted stock awards granted to certain employees during 2006, 2007 and 2008 fully vested after four years, while the restricted stock awards granted to directors and certain employees during 2012 fully vested after two years. No payments were required from employees for the restricted stock awards. The restricted stock awards granted to certain employees during 2014 fully vest after three years. The stock options granted to certain employees during 2014, which were at 110% of the market price on the date of grant, fully vest after two years and expire after seven years. At year-end 2014, there were approximately 277,000 shares authorized for future incentive awards.

In conjunction with the Firstbank merger, all of our outstanding restricted stock awards, which were scheduled to vest in full in November, 2014, became fully vested on June 1, 2014, resulting in the recognition of compensation expense of \$0.2 million in the second quarter of 2014 to reflect the accelerated vesting of the restricted stock awards. The unrecognized compensation cost related to unvested stock options was less than \$0.1 million as of December 31, 2014, which will be recognized as expense over the next two years. The unrecognized compensation cost related to restricted stock grants was \$2.0 million as of December 31, 2014, which will be recognized as expense over the next three years.

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MERCANTILE BANK CORPORATION  
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**NOTE 12 – STOCK-BASED COMPENSATION (Continued)**

Also in conjunction with the Firstbank merger, we issued Mercantile stock options in replacement of all outstanding Firstbank stock option grants that had been previously issued to Firstbank employees under the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 and the Firstbank Corporation 2006 Stock Compensation Plan. In general, stock option grants for 50 shares or less fully vested after one year from date of grant, while stock option grants for more than 50 shares vested over a five-year period at 20% of the grant per annum starting one year from date of grant. The stock option grants expire ten years from date of grant. There were approximately 282,200 Mercantile stock options issued as a result of the merger, with about 258,400 of the stock option grants fully vested and exercisable on the date of merger. Unrecognized compensation cost related to the unvested stock options was less than \$0.1 million as of December 31, 2014, which will be fully expensed during 2015.

A summary of restricted stock activity from grants issued under the Mercantile Stock Incentive Plan of 2006 during the past three years is as follows:

	<u>2014</u>		<u>2013</u>		<u>2012</u>	
	<u>Shares</u>	Weighted Average <u>Fair Value</u>	<u>Shares</u>	Weighted Average <u>Fair Value</u>	<u>Shares</u>	Weighted Average <u>Fair Value</u>
Nonvested at beginning of year	63,800	\$ 14.30	66,100	\$ 14.30	38,650	\$ 6.20
Granted	101,490	20.13	0	NA	66,100	14.30
Vested	(63,300)	14.30	0	NA	(38,266)	6.20
Forfeited	<u>(500)</u>	<u>14.30</u>	<u>(2,300)</u>	<u>14.30</u>	<u>(384)</u>	<u>6.20</u>
Nonvested at end of year	<u>101,490</u>	<u>\$ 20.13</u>	<u>63,800</u>	<u>\$ 14.30</u>	<u>66,100</u>	<u>\$ 14.30</u>

A summary of stock option activity from grants issued under various Mercantile plans during the past three years is as follows:

	<u>2014</u>		<u>2013</u>		<u>2012</u>	
	<u>Shares</u>	Weighted Average Exercise <u>Price</u>	<u>Shares</u>	Weighted Average Exercise <u>Price</u>	<u>Shares</u>	Weighted Average Exercise <u>Price</u>
Outstanding at beginning of year	60,876	\$ 33.11	152,896	\$ 26.15	214,903	\$ 22.40
Granted	6,488	22.15	0	NA	0	NA
Exercised	(2,845)	17.74	(51,055)	13.72	(50,930)	10.83
Forfeited or expired	<u>(29,184)</u>	<u>34.60</u>	<u>(40,965)</u>	<u>31.30</u>	<u>(11,077)</u>	<u>23.77</u>
Outstanding at end of year	<u>35,335</u>	<u>\$ 31.09</u>	<u>60,876</u>	<u>\$ 33.11</u>	<u>152,896</u>	<u>\$ 26.15</u>
Options exercisable at year-end	<u>28,847</u>	<u>\$ 33.11</u>	<u>60,876</u>	<u>\$ 33.11</u>	<u>152,896</u>	<u>\$ 26.15</u>

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**NOTE 12 – STOCK-BASED COMPENSATION** (Continued)

The fair value of each stock option award is estimated on the date of grant using a closed option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities on our common stock. Historical data is used to estimate stock option expense and post-vesting termination behavior. The expected term of stock options granted is based on historical data and represents the period of time that stock options granted are expected to be outstanding, which takes into account that the stock options are not transferable. The risk-free interest rate for the expected term of the stock option is based on the U.S. Treasury yield curve in effect at the time of the stock option grant.

The fair value of stock options granted during 2014 was determined using the following weighted-average assumptions as of the grant date. No stock options were granted during 2013 or 2012.

	<u>2014</u>
Risk-free interest rate	1.56%
Expected option life	5 Years
Expected stock price volatility	26%
Dividend yield	2.5%

Options issued under various Mercantile plans outstanding at year-end 2014 were as follows:

Range of Exercise Prices	Outstanding			Exercisable	
	<u>Number</u>	Weighted Average Remaining Contractual <u>Life</u>	Weighted Average Exercise <u>Price</u>	<u>Number</u>	Weighted Average Exercise <u>Price</u>
\$ 6.21 - \$ 8.00	2,700	0.9 Years	\$ 6.21	2,700	\$ 6.21
\$20.01 - \$24.00	6,488	6.9 Years	22.15	0	NA
\$32.01 - \$36.00	<u>26,147</u>	0.9 Years	35.88	<u>26,147</u>	35.88
Outstanding at year end	<u>35,335</u>	2.0 Years	\$ 31.09	<u>28,847</u>	\$ 33.11

Information related to options issued under various Mercantile plans outstanding at year-end 2014, 2013 and 2012 is as follows:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Minimum exercise price	\$ 6.21	\$ 6.21	\$ 6.21
Maximum exercise price	35.88	40.28	40.28
Average remaining option term	2.0 Years	1.4 Years	1.9 Years

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**NOTE 12 – STOCK-BASED COMPENSATION** (Continued)

Information related to stock option grants and exercises issued under various Mercantile plans during 2014, 2013 and 2012 is as follows:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
Aggregate intrinsic value of stock options exercised	\$ 11,000	\$408,000	\$ 307,000
Cash received from stock option exercises	50,000	289,000	227,000
Tax benefit realized from stock option exercises	0	0	0
Weighted average per share fair value of stock options granted	\$ 2.72	NA	NA

The aggregate intrinsic value of all stock options issued under various Mercantile plans outstanding and exercisable at December 31, 2014 was less than \$0.1 million. Shares issued as a result of the exercise of stock option grants have been authorized and previously unissued shares.

A summary of stock option activity from grants issued under various Firstbank plans that became part of Mercantile's plans upon consummation of the merger on June 1, 2014 is as follows:

	<u>2014</u>	Weighted Average Exercise Price
	<u>Shares</u>	<u>Price</u>
Outstanding at beginning of year	0	NA
Granted	0	NA
Replaced as part of merger	282,178	15.48
Exercised	(27,740)	8.34
Forfeited or expired	<u>(36,456)</u>	<u>24.46</u>
Outstanding at end of year	<u>217,982</u>	<u>\$ 14.89</u>
Options exercisable at year-end	<u>210,777</u>	<u>\$ 15.22</u>

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**NOTE 12 – STOCK-BASED COMPENSATION (Continued)**

Options issued under various Firstbank plans outstanding at year-end 2014 were as follows:

Range of Exercise Prices	Outstanding			Exercisable	
	Number	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number	Weighted Average Exercise Price
\$ 4.00 - \$ 8.00	63,590	4.9 Years	\$ 6.53	56,385	\$ 6.70
\$ 8.01 - \$12.00	68,430	3.7 Years	13.20	68,430	13.20
\$20.01 - \$25.00	<u>85,962</u>	1.4 Years	22.43	<u>85,962</u>	22.43
Outstanding at year end	<u>217,982</u>	3.1 Years	\$ 14.89	<u>210,777</u>	\$ 15.22

Information related to options issued under various Firstbank plans outstanding at year-end 2014 is as follows:

	<u>2014</u>
Minimum exercise price	\$ 5.19
Maximum exercise price	24.46
Average remaining option term	3.1 Years

Information related to stock option grants and exercises issued under various Firstbank plans during 2014 is as follows:

	<u>2014</u>
Aggregate intrinsic value of stock options exercised	\$ 333,000
Cash received from stock option exercises	232,000
Tax benefit realized from stock option exercises	116,000
Weighted average per share fair value of stock options granted	NA

The aggregate intrinsic value of all stock options issued under various Firstbank plans outstanding and exercisable at December 31, 2014 was \$1.3 million. Shares issued as a result of the exercise of stock option grants have been authorized and previously unissued shares.

On June 26, 2014, we granted a total of 7,375 shares of common stock to our Corporate, Bank and Regional Advisory Boards of Directors for retainer payments for the period of June 1, 2014 through December 31, 2014. The associated \$0.2 million cost was expensed on a straightline basis over the last six months of 2014.

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**NOTE 13 – RELATED PARTIES**

Certain directors and executive officers of the Bank, including their immediate families and companies in which they are principal owners, were loan customers of the Bank. At year-end 2014 and 2013, the Bank had \$15.8 million and \$7.8 million in loan commitments to directors and executive officers, of which \$9.0 million and \$6.9 million were outstanding at year-end 2014 and 2013, respectively, as reflected in the following table. The line item entitled “Adjustments” primarily relates to the Firstbank merger in 2014 and Board member retirements during 2013.

	<u>2014</u>	<u>2013</u>
Beginning balance	\$ 6,884,000	\$ 1,418,000
New loans	781,000	6,309,000
Repayments	(381,000)	(252,000)
Adjustments	<u>1,718,000</u>	<u>(591,000)</u>
Ending balance	<u>\$ 9,002,000</u>	<u>\$ 6,884,000</u>

Related party deposits and repurchase agreements totaled \$16.6 million and \$3.9 million at year-end 2014 and 2013, respectively.

**NOTE 14 – COMMITMENTS AND OFF-BALANCE-SHEET RISK**

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

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on management’s credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. There was no liability balance for these instruments as of December 31, 2014 and 2013.

At year-end 2014 and 2013, the rates on existing off-balance sheet instruments were substantially equivalent to current market rates, considering the underlying credit standing of the counterparties.

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MERCANTILE BANK CORPORATION  
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**NOTE 14 – COMMITMENTS AND OFF-BALANCE-SHEET RISK (Continued)**

Our maximum exposure to credit losses for loan commitments and standby letters of credit outstanding at year-end was as follows:

	<u>2014</u>	<u>2013</u>
Commercial unused lines of credit	\$ 554,856,000	\$ 257,937,000
Unused lines of credit secured by 1 – 4 family residential properties	60,983,000	23,429,000
Credit card unused lines of credit	11,649,000	9,013,000
Other consumer unused lines of credit	8,673,000	5,695,000
Commitments to make loans	110,126,000	58,799,000
Standby letters of credit	<u>35,461,000</u>	<u>19,670,000</u>
 Total commitments	 <u>\$ 781,748,000</u>	 <u>\$ 374,543,000</u>

Commitments to make loans generally reflect our binding obligations to existing and prospective customers to extend credit, including line of credit facilities secured by accounts receivable and inventory, and term debt secured by either real estate or equipment. In most instances, line of credit facilities are for a one-year term and are at a floating rate tied to the Mercantile Bank Prime Rate, the Wall Street Journal Prime Rate or the 30-Day Libor rate. For term debt secured by real estate, customers are generally offered a floating rate tied to the Mercantile Bank Prime Rate or Wall Street Journal Prime Rate, and a fixed rate currently ranging from 4.00% to 7.00%. These credit facilities generally balloon within five years, with payments based on amortizations ranging from 10 to 20 years. For term debt secured by non-real estate collateral, customers are generally offered a floating rate tied to the Mercantile Bank Prime Rate or Wall Street Journal Prime Rate, and a fixed rate currently ranging from 4.00% to 7.50%. These credit facilities generally mature and fully amortize within five years.

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of December 31, 2014, the total notional amount of the underlying interest rate swap agreements was \$15.4 million, with a net fair value from our commercial loan customers' perspective of negative \$2.9 million. These risk participation agreements are considered financial guarantees in accordance with applicable accounting guidance and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the terms of the interest rate swap agreements, generally ranging from an original term of four to fifteen years, and totaled less than \$0.1 million at December 31, 2014 and December 31, 2013.

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**NOTE 14 – COMMITMENTS AND OFF-BALANCE-SHEET RISK (Continued)**

The following instruments are considered financial guarantees under current accounting guidance. These instruments are carried at fair value.

	<u>2014</u>		<u>2013</u>	
	<u>Contract</u>	<u>Carrying</u>	<u>Contract</u>	<u>Carrying</u>
	<u>Amount</u>	<u>Value</u>	<u>Amount</u>	<u>Value</u>
Standby letters of credit	\$ 35,461,000	\$ 150,000	\$ 19,670,000	\$ 148,000

We were required to have \$8.4 million and \$1.5 million of cash on hand or on deposit with the Federal Reserve Bank of Chicago to meet regulatory reserve and clearing requirements at year-end 2014 and 2013, respectively.

**NOTE 15 – BENEFIT PLANS**

We have a 401(k) benefit plan that covers substantially all of our employees. The percent of our matching contributions to the 401(k) benefit plan is determined annually by the Board of Directors. The matching contribution was 3% as of January 1, 2012, and then increased to 4% as of October 1, 2012. Effective January 1, 2014, the matching contribution was increased to 4.25%. Matching contributions, if made, are immediately vested. Our 2014, 2013 and 2012 matching 401(k) contributions charged to expense were \$0.9 million, \$0.5 million and \$0.4 million, respectively.

We have a deferred compensation plan in which all persons serving on the Board of Directors may defer all or portions of their annual retainer and meeting fees, with distributions to be paid upon termination of service as a director or specific dates selected by the director. We also have a non-qualified deferred compensation program in which selected officers may defer all or portions of salary and bonus payments. The deferred amounts, totaling \$3.7 million and \$1.6 million as of December 31, 2014 and 2013, respectively, are categorized as other liabilities in the Consolidated Balance Sheets, and are paid interest at a rate equal to the Wall Street Journal Prime Rate. Interest expense is insignificant for all periods presented.

The Mercantile Bank Corporation Employee Stock Purchase Plan of 2002 was replaced by the Mercantile Bank Corporation Employee Stock Purchase Plan of 2014 (herein after referred to as the “Stock Purchase Plans”) in June of 2014. The Stock Purchase Plans are non-compensatory plans intended to encourage full- and part-time employees of Mercantile and its subsidiaries to promote our best interests and to align employees’ interests with the interests of our shareholders by permitting employees to purchase shares of our common stock through regular payroll deductions. Shares are purchased on the last business day of each calendar quarter at a price equal to the consolidated closing bid price of our common stock reported on The Nasdaq Stock Market. A total of 250,000 shares of common stock may be issued under the existing plan; however, the number of shares may be adjusted to reflect any stock dividends and other changes in our capitalization. The number of shares issued under the Stock Purchase Plans totaled 1,150 and 1,098 in 2014 and 2013, respectively. As of December 31, 2014, there were 28,850 shares available under our current plan.



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**NOTE 16 – HEDGING ACTIVITIES**

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

In February 2012, we entered into an interest rate swap agreement with a correspondent bank to hedge the floating rate on the subordinated debentures issued to Mercantile Bank Capital Trust I, which became effective in January 2013 and matures in January 2018. The \$32.0 million of subordinated debentures have a rate equal to the 90-Day Libor Rate plus a fixed spread of 218 basis points, and are subject to repricing quarterly. The interest rate swap agreement provides for us to pay our correspondent bank a fixed rate, while our correspondent bank will pay us the 90-Day Libor Rate on a \$32.0 million notional amount. The quarterly re-set dates for the floating rate on the interest rate swap agreement are the same as the re-set dates for the floating rate on the subordinated debentures. The interest rate swap agreement qualifies for hedge accounting; therefore, fluctuations in the fair value of the interest rate swap agreement, net of tax effect, are recorded in other comprehensive income. As of December 31, 2014 and 2013, the fair value of the interest rate swap agreement was recorded as a liability in the amount of \$0.3 million.

**NOTE 17 – FAIR VALUES OF FINANCIAL INSTRUMENTS**

Carrying amount, estimated fair value and level within the fair value hierarchy of financial instruments were as follows at year-end (dollars in thousands):

	Level in Fair Value Hierarchy	<u>2014</u>		<u>2013</u>	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets					
Cash	Level 1	\$ 13,261	\$ 13,261	\$ 1,464	\$ 1,464
Cash equivalents	Level 2	159,477	159,477	145,501	145,501
Securities available for sale	(1)	432,912	432,912	131,178	131,178
Federal Home Loan Bank stock	(2)	13,699	13,699	11,961	11,961
Loans, net	Level 3	2,069,236	2,064,140	1,030,422	1,027,300
Bank owned life insurance	Level 2	57,861	57,861	51,377	51,377
Accrued interest receivable	Level 2	8,033	8,033	3,649	3,649
Financial liabilities					
Deposits	Level 2	2,276,915	2,254,749	1,118,911	1,120,576
Securities sold under agreements to repurchase	Level 2	167,569	167,569	69,305	69,305
Federal Home Loan Bank advances	Level 2	54,022	54,720	45,000	45,139
Subordinated debentures	Level 2	54,472	54,508	32,990	32,974
Accrued interest payable	Level 2	1,942	1,942	2,041	2,041
Interest rate swap	(1)	253	253	264	264

(1) See Note 18 for a description of the fair value hierarchy as well as a disclosure of levels for classes of financial assets and liabilities.

(2) It is not practical to determine the fair value of FHLB stock due to transferability restrictions.

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**NOTE 17 – FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)**

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

**NOTE 18 – FAIR VALUE MEASUREMENTS**

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

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

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

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

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**NOTE 18 – FAIR VALUE MEASUREMENTS** (Continued)

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

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

*Securities available for sale.* Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government agency debt obligations, mortgage-backed securities issued or guaranteed by U.S. Government agencies, municipal general obligation and revenue bonds, and mutual funds. Level 3 securities include bonds issued by certain relatively small municipalities located within our markets that have very limited marketability due to their size and lack of ratings from a recognized rating service. We carry these bonds at historical cost, which we believe approximates fair value, unless our periodic financial analysis or other information becomes known which necessitates a valuation allowance. There was no such valuation allowance as of December 31, 2014 or 2013. We have no Level 1 securities available for sale.

*Mortgage loans held for sale.* Mortgage loans held for sale are carried at the lower of aggregate cost or fair value and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of December 31, 2014 and 2013, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$1.6 million and \$1.1 million, respectively.

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

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

*Derivatives.* The interest rate swap agreement is measured at fair value on a recurring basis. We measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves, and accordingly, the interest rate swap agreement is classified as Level 2.

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**NOTE 18 – FAIR VALUE MEASUREMENTS** (Continued)

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

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2014 are as follows:

	<u>Total</u>	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	\$ 193,468,000	\$ 0	\$ 193,468,000	\$ 0
Mortgage-backed securities	93,561,000	0	93,561,000	0
Municipal general obligation bonds	133,082,000	0	122,801,000	10,281,000
Municipal revenue bonds	10,873,000	0	10,873,000	0
Other investments	1,928,000	0	1,928,000	0
Derivatives				
Interest rate swap agreement	<u>(253,000)</u>	<u>0</u>	<u>(253,000)</u>	<u>0</u>
Total	<u>\$ 432,659,000</u>	<u>\$ 0</u>	<u>\$ 422,378,000</u>	<u>\$ 10,281,000</u>

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2014. The Level 3 investments in the table above originated from the merger with Firstbank.

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2013 are as follows:

	<u>Total</u>	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities				
U.S. Government agency debt obligations	\$ 98,477,000	\$ 0	\$ 98,477,000	\$ 0
Mortgage-backed securities	13,558,000	0	13,558,000	0
Municipal general obligation bonds	16,872,000	0	16,872,000	0
Municipal revenue bonds	916,000	0	916,000	0
Mutual funds	1,355,000	0	1,355,000	0
Derivatives				
Interest rate swap agreement	<u>(264,000)</u>	<u>0</u>	<u>(264,000)</u>	<u>0</u>
Total	<u>\$ 130,914,000</u>	<u>\$ 0</u>	<u>\$ 130,914,000</u>	<u>\$ 0</u>

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2013.

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**NOTE 18 – FAIR VALUE MEASUREMENTS (Continued)**

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

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2014 are as follows:

	<u>Total</u>	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans <sup>(1)</sup>	\$ 17,097,000	\$ 0	\$ 0	\$ 17,097,000
Foreclosed assets <sup>(1)</sup>	<u>1,995,000</u>	<u>0</u>	<u>0</u>	<u>1,995,000</u>
Total	<u>\$ 19,092,000</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 19,092,000</u>

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2013 are as follows:

	<u>Total</u>	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans <sup>(1)</sup>	\$ 23,405,000	\$ 0	\$ 0	\$ 23,405,000
Foreclosed assets <sup>(1)</sup>	<u>2,851,000</u>	<u>0</u>	<u>0</u>	<u>2,851,000</u>
Total	<u>\$ 26,256,000</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 26,256,000</u>

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

Fair value estimates of collateral on impaired loans, as well as on foreclosed assets, are reviewed periodically. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside appraisals and internal evaluations based on identifiable trends within our markets, such as sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address current distressed market conditions.

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**NOTE 19 – EARNINGS PER SHARE**

The factors used in the earnings per share computation follow:

	<u>2014</u>	<u>2013</u>	<u>2012</u>
<b>Basic</b>			
Net income attributable to common shares	\$ <u>17,331,000</u>	\$ <u>17,033,000</u>	\$ <u>11,505,000</u>
Weighted average common shares outstanding	<u>13,510,991</u>	<u>8,710,677</u>	<u>8,625,198</u>
Basic earnings per common share	\$ <u>1.28</u>	\$ <u>1.96</u>	\$ <u>1.33</u>
<b>Diluted</b>			
Net income attributable to common shares	\$ <u>17,331,000</u>	\$ <u>17,033,000</u>	\$ <u>11,505,000</u>
Weighted average common shares outstanding for basic earnings per common share	13,510,991	8,710,677	8,625,198
Add: Dilutive effects of share-based awards	<u>30,913</u>	<u>14,031</u>	<u>224,429</u>
Average shares and dilutive potential common shares	<u>13,541,904</u>	<u>8,724,708</u>	<u>8,849,627</u>
Diluted earnings per common share	\$ <u>1.28</u>	\$ <u>1.95</u>	\$ <u>1.30</u>

Stock options for approximately 168,000, 55,000 and 132,000 shares of common stock were antidilutive and were not included in determining dilutive earnings per share in 2014, 2013, and 2012, respectively.

**NOTE 20 – SUBORDINATED DEBENTURES**

We have five business trusts that are wholly-owned subsidiaries of Mercantile, four of which were assumed by Mercantile in conjunction with the Firstbank merger. A fair value discount of \$15.0 million was recorded at the time of the merger, which is being amortized at \$0.7 million annually over the next 21.5 years. Each of the trusts was formed to issue Preferred Securities that were sold in private sales, as well as selling Common Securities to Mercantile. The proceeds from the Preferred and Common Securities sales were used by the trusts to purchase Floating Rate Notes issued by Mercantile. The rates of interest, interest payment dates, call features and maturity dates of each Floating Rate Note are identical to its respective Preferred Securities. The net proceeds from the issuance of the Floating Rate Notes were used for a variety of purposes, including contributions to the Bank as capital to provide support for asset growth and the funding of stock repurchase programs and certain acquisitions.

The only significant assets of our trusts are the Floating Rate Notes, and the only significant liabilities of our trusts are the Preferred Securities. The Floating Rate Notes are categorized on our Consolidated Balance Sheets as subordinated debentures and the interest expense is recorded on our Consolidated Statements of Income under interest expense on other borrowings.

MERCANTILE BANK CORPORATION  
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**NOTE 20 – SUBORDINATED DEBENTURES (Continued)**

The following table depicts our five business trusts as of December 31, 2014:

<u>Trust Name</u>	<u>Preferred Securities Outstanding</u>	<u>Interest Rate</u>	<u>Maturity Date</u>
Mercantile Bank Capital Trust I	\$32,000,000	3 Month Libor + 218 bps	September 16, 2034
Firstbank Capital Trust I	\$10,000,000	3 Month Libor + 199 bps	October 18, 2034
Firstbank Capital Trust II	\$10,000,000	3 Month Libor + 127 bps	April 7, 2036
Firstbank Capital Trust III	\$7,500,000	3 Month Libor + 135 bps	July 30, 2037
Firstbank Capital Trust IV	\$7,500,000	3 Month Libor + 135 bps	July 30, 2037

**NOTE 21 - REGULATORY MATTERS**

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

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At year-end 2014 and 2013, our Bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since December 31, 2014 that we believe have changed our Bank's categorization.

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**NOTE 21 - REGULATORY MATTERS** (Continued)

Our actual capital levels (dollars in thousands) and minimum required levels were:

	<u>Actual</u>		<u>Minimum Required for Capital Adequacy Purposes</u>		<u>Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<u>2014</u>						
Total capital (to risk weighted assets)						
Consolidated	\$ 334,793	14.4%	\$ 185,553	8.0%	\$ NA	NA
Bank	332,749	14.4	185,309	8.0	231,636	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	314,752	13.6	92,777	4.0	NA	NA
Bank	312,708	13.5	92,655	4.0	138,982	6.0
Tier 1 capital (to average assets)						
Consolidated	314,752	11.2	112,949	4.0	NA	NA
Bank	312,708	11.1	112,856	4.0	141,070	5.0
<u>2013</u>						
Total capital (to risk weighted assets)						
Consolidated	\$ 193,925	15.9%	\$ 97,498	8.0%	\$ NA	NA
Bank	190,493	15.7	97,329	8.0	121,662	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	178,598	14.7	48,749	4.0	NA	NA
Bank	175,192	14.4	48,665	4.0	72,997	6.0
Tier 1 capital (to average assets)						
Consolidated	178,598	12.5	57,006	4.0	NA	NA
Bank	175,192	12.3	56,860	4.0	71,075	5.0

Federal and state banking laws and regulations place certain restrictions on the amount of dividends our Bank can transfer to Mercantile and on the capital levels that must be maintained. At year-end 2014, under the most restrictive of these regulations, our Bank could distribute approximately \$87.7 million to Mercantile as dividends without prior regulatory approval.



MERCANTILE BANK CORPORATION  
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**NOTE 21 - REGULATORY MATTERS (Continued)**

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. 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 was paid on March 10, 2014 to shareholders of record as of February 10, 2014. On May 9, 2014, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.12 per share that was paid on June 25, 2014 to shareholders of record as of June 13, 2014. On July 17, 2014, 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 24, 2014 to shareholders of record as of September 12, 2014. On October 16, 2014, 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 24, 2014 to shareholders of record as of December 12, 2014. In addition, on May 9, 2014, our Board of Directors declared a special cash dividend on our common stock in the amount of \$2.00 per share that was paid on May 29, 2014 to shareholders of record as of May 22, 2014. The special cash dividend, in contemplation of the plan of merger with Firstbank, was paid to Mercantile shareholders prior to the effective date of the merger with Firstbank and before the issuance of Mercantile shares in exchange for Firstbank shares.

On January 15, 2015, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.14 per share that will be paid on March 25, 2015 to shareholders of record as of March 13, 2015. In addition, on January 30, 2015, we announced that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. We expect to fund a majority of such repurchases from cash dividends paid to us from our Bank.

Our consolidated capital levels as of December 31, 2014 and 2013 include \$52.4 million and \$32.0 million, respectively, of trust preferred securities subject to certain limitations. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than \$15.0 billion. At December 31, 2014 and 2013, all \$52.4 million and \$32.0 million, respectively, of the trust preferred securities were included as Tier 1 capital of Mercantile.

**NOTE 22 – U.S. TREASURY CAPITAL PURCHASE PROGRAM PARTICIPATION**

On May 15, 2009, we completed the sale of preferred stock and a warrant for common stock to the United States Treasury Department ("Treasury") for \$21.0 million under the Treasury's Capital Purchase Program. The program was designed to attract broad participation by healthy banking institutions to help stabilize the financial system and increase lending for the benefit of the U.S. economy. Under the terms of the sale, the Treasury received 21,000 shares of fixed rate cumulative perpetual preferred stock with a liquidation value of \$1,000 per share and a warrant to purchase 616,438 shares of our common stock, no par value, in exchange for \$21.0 million. The preferred stock qualified as Tier 1 capital and paid cumulative dividends at a rate of 5.00% for the first five years, and 9.00% thereafter. The common stock warrant had a 10-year term and was immediately exercisable upon its issuance, with an exercise price equal to \$5.11 per share. The Treasury agreed not to exercise voting power with respect to any shares of common stock issued upon exercise of the warrant, while it held the shares.

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MERCANTILE BANK CORPORATION  
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**NOTE 22 – U.S. TREASURY CAPITAL PURCHASE PROGRAM PARTICIPATION (Continued)**

During the second quarter of 2012, we consummated the repurchase of the \$21.0 million in preferred stock at par from the Treasury following approval from the Federal Reserve and consultation with the Federal Deposit Insurance Corporation. To fund the repurchase, our bank paid us cash dividends aggregating approximately the same amount. We recorded a reduction of retained earnings of approximately \$0.6 million in the second quarter of 2012 resulting from the accelerated discount on the preferred stock which was being amortized over an original period of five years from the issuance date of May 15, 2009. During the third quarter of 2012, we consummated the repurchase of the warrant for approximately \$7.5 million from the Treasury. To fund the repurchase, our bank paid us a cash dividend of approximately the same amount. As part of the repurchase, we recorded a reduction in shareholders' equity of approximately \$7.5 million during the third quarter of 2012.

**NOTE 23 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

At December 31, 2014, accumulated other comprehensive loss, net of tax effects (as applicable), consists of a net unrealized gain on available for sale securities of \$0.2 million and the fair value of an interest rate swap of negative \$0.2 million. At December 31, 2013, accumulated other comprehensive income, net of tax effects (as applicable), consists of a net unrealized loss on available for sale securities of \$5.4 million and the fair value of an interest rate swap of negative \$0.2 million. At December 31, 2012, accumulated other comprehensive income, net of tax effects (as applicable), consists of a net unrealized gain on available for sale securities of \$2.4 million and the fair value of an interest rate swap of negative \$0.7 million.

**NOTE 24 - QUARTERLY FINANCIAL DATA (Unaudited)**

	Interest <u>Income</u>	Net Interest <u>Income</u>	Net <u>Income</u>	<u>Earnings per Share</u>	
				<u>Basic</u>	<u>Diluted</u>
<u>2014</u>					
First quarter	\$ 13,588,000	\$ 11,064,000	\$ 3,580,000	\$ 0.41	\$ 0.41
Second quarter	18,483,000	15,552,000	1,510,000	0.13	0.13
Third quarter	28,900,000	25,989,000	5,948,000	0.35	0.35
Fourth quarter	28,147,000	25,173,000	6,293,000	0.37	0.37
<u>2013</u>					
First quarter	\$ 14,210,000	\$ 11,455,000	\$ 4,401,000	\$ 0.51	\$ 0.50
Second quarter	13,992,000	11,312,000	4,016,000	0.46	0.46
Third quarter	14,667,000	11,994,000	3,453,000	0.40	0.40
Fourth quarter	15,373,000	12,695,000	5,163,000	0.59	0.59

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**NOTE 25 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)  
CONDENSED FINANCIAL STATEMENTS**

CONDENSED BALANCE SHEETS

	<u>2014</u>	<u>2013</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 1,441,000	\$ 2,506,000
Investment in bank subsidiary	361,355,000	179,706,000
Other assets	<u>20,948,000</u>	<u>4,740,000</u>
Total assets	<u>\$ 383,744,000</u>	<u>\$ 186,952,000</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities	\$ 1,134,000	\$ 637,000
Subordinated debentures	54,472,000	32,990,000
Shareholders' equity	<u>328,138,000</u>	<u>153,325,000</u>
Total liabilities and shareholders' equity	<u>\$ 383,744,000</u>	<u>\$ 186,952,000</u>

CONDENSED STATEMENTS OF INCOME

	<u>2014</u>	<u>2013</u>	<u>2012</u>
<b>Income</b>			
Interest and dividends from subsidiaries	<u>\$ 12,139,000</u>	<u>\$ 5,516,000</u>	<u>\$ 32,532,000</u>
Total income	12,139,000	5,516,000	32,532,000
<b>Expenses</b>			
Interest expense	2,145,000	1,213,000	884,000
Other operating expenses	<u>3,552,000</u>	<u>2,773,000</u>	<u>1,048,000</u>
Total expenses	<u>5,697,000</u>	<u>3,986,000</u>	<u>1,932,000</u>
<b>Income before income tax benefit and equity in undistributed net income (loss) of subsidiary</b>	6,442,000	1,530,000	30,600,000
Federal income tax benefit	(1,758,000)	(1,042,000)	(665,000)
Equity in undistributed net income (loss) of subsidiary	<u>9,131,000</u>	<u>14,461,000</u>	<u>(18,730,000)</u>
<b>Net income</b>	17,331,000	17,033,000	12,535,000
Preferred stock dividends and accretion	<u>0</u>	<u>0</u>	<u>1,030,000</u>
<b>Net income attributable to common shares</b>	<u>\$ 17,331,000</u>	<u>\$ 17,033,000</u>	<u>\$ 11,505,000</u>
Comprehensive income	<u>\$ 22,920,000</u>	<u>\$ 9,810,000</u>	<u>\$ 10,857,000</u>

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**NOTE 25 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)**  
**CONDENSED FINANCIAL STATEMENTS (Continued)**

CONDENSED STATEMENTS OF CASH FLOWS

	<u>2014</u>	<u>2013</u>	<u>2012</u>
<b>Cash flows from operating activities</b>			
Net income	\$ 17,331,000	\$ 17,033,000	\$ 12,535,000
Adjustments to reconcile net income to net cash from operating activities:			
Equity in undistributed (income) loss of subsidiary	(9,131,000)	(14,461,000)	18,730,000
Stock-based compensation expense	714,000	473,000	54,000
Change in other assets	(8,163,000)	3,244,000	(3,006,000)
Change in other liabilities	<u>21,979,000</u>	<u>(708,000)</u>	<u>1,073,000</u>
Net cash from operating activities	22,730,000	5,581,000	29,386,000
<b>Cash flows from investing activities</b>			
Net capital investment into subsidiaries	<u>0</u>	<u>0</u>	<u>0</u>
Net cash for investing activities	0	0	0
<b>Cash flows from financing activities</b>			
Repurchase of preferred stock	0	0	(21,000,000)
Repurchase of common stock warrant	0	0	(7,465,000)
Stock option exercises, net of cashless exercises	282,000	289,000	227,000
Employee stock purchase plan	23,000	19,000	39,000
Dividend reinvestment plan	209,000	33,000	14,000
Stock grants to directors for retainer fees	155,000	0	0
Cash dividends on preferred stock	0	0	(496,000)
Cash dividends on common stock	<u>(24,464,000)</u>	<u>(3,889,000)</u>	<u>(774,000)</u>
Net cash for financing activities	<u>(23,795,000)</u>	<u>(3,548,000)</u>	<u>(29,455,000)</u>
Net change in cash and cash equivalents	(1,065,000)	2,033,000	(69,000)
Cash and cash equivalents at beginning of period	<u>2,506,000</u>	<u>473,000</u>	<u>542,000</u>
<b>Cash and cash equivalents at end of period</b>	<u>\$ 1,441,000</u>	<u>\$ 2,506,000</u>	<u>\$ 473,000</u>

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 10, 2015.

### MERCANTILE BANK CORPORATION

/s/ Michael H. Price  
Michael H. Price  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 10, 2015.

/s/ David M. Cassard  
David M. Cassard, Director

/s/ Jeff A. Gardner  
Jeff A. Gardner, Director

/s/ Edward B. Grant  
Edward B. Grant, Director

/s/ Calvin D. Murdock  
Calvin D. Murdock, Director

/s/ Michael H. Price  
Michael H. Price, Director, President and  
Chief Executive Officer  
(principal executive officer)

/s/ Thomas R. Sullivan  
Thomas R. Sullivan, Chairman of the Board

s/ Charles E. Christmas  
Charles E. Christmas, Senior Vice President  
Chief Financial Officer and Treasurer  
(principal financial and accounting officer)

# CORPORATE INFORMATION

## 2015 Strategic Planning Team

**Mark S. Augustyn**

Senior Vice President, Commercial Loan Manager

**Charles E. Christmas**

Senior Vice President, Chief Financial Officer

**Amy W.M. Kam**

Assistant Vice President, Executive Administrator

**Robert B. Kaminski, Jr.**

Executive Vice President & Chief Operating Officer

**David L. Miller**

Senior Vice President, Retail Banking Director

**Douglas J. Ouellette**

Senior Vice President, Central Region President

**Michael H. Price**

President & Chief Executive Officer

**Raymond E. Reitsma**

Senior Vice President, Senior Lending Officer

**Richard D. Rice**

Senior Vice President, Operations Manager

**John R. Schulte**

Senior Vice President, Chief Information Officer

**Michelle L. Shangraw**

Senior Vice President, Retail Banking Director

**Samuel G. Stone**

Executive Vice President

Corporate Finance & Strategic Planning

**Lonna L. Wiersma**

Senior Vice President, Human Resource Director

**Robert T. Worthington**

Senior Vice President

Risk Management Director & General Counsel

## mercbank.com

Mercantile Bank Corporation does not discriminate on the basis of race, color, national origin, sex, religion, age or disability in employment or the provision of services.

## Shareholder Information

**Annual Meeting**

The Corporation's Annual Meeting of Shareholders will be held on Thursday, May 28, 2015, at Kent Country Club, 1600 College Ave. NE, Grand Rapids, MI 49505 at 9:00 a.m. local time.

**Administrative Headquarters**

310 Leonard Street NW, 4th Floor  
Grand Rapids, MI 49504  
616.406.3000 or 888.345.6296

**Legal Counsel**

Dickinson Wright PLLC  
500 Woodward Avenue, Suite 4000  
Detroit, MI 48226-3425  
www.dickinsonwright.com

**Independent Certified Public Accountants**

BDO USA, LLP  
200 Ottawa Avenue NW, Suite 300  
Grand Rapids, MI 49503-2654  
www.bdo.com

**Investor Relations**

Lambert, Edwards & Associates  
47 Commerce  
Grand Rapids, MI 49503

**Common Stock Listing**

NASDAQ Global Select Market  
Symbol: MBWM

**Stock Registrar and Transfer Agent**

Computershare Investor Services  
P.O. Box 30170  
College Station, TX 77842-3170  
Shareholder Inquiries 1.800.733.5001  
www.computershare.com/investor

**SEC Form 10-K**

Copies of the Corporation's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, are available to shareholders without charge upon written request.

Please mail your request to:

**Charles E. Christmas**

Mercantile Bank Corporation  
310 Leonard Street NW, 4th Floor  
Grand Rapids, MI 49504

## Mission Statement

The mission of Mercantile Bank of Michigan is to provide financial products and services in a highly professional and personalized manner. We recognize that our most important partners are our **customers**. We will satisfy our customers by delivering top quality service that distinguishes us from our competitors.

Our **employees** are our most valuable asset. We strive to hire exceptional team members and are committed to maintaining an environment of growth and development.

We recognize the importance of being strong supporters of the diverse **communities** we serve, and pledge to make them stronger.

We believe that fulfilling our mission to our customers, employees and community will allow us to reward our **shareholders** with an excellent return on their investment in Mercantile Bank Corporation.



310 Leonard Street NW  
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888.345.6296  
[mercbank.com](http://mercbank.com)