

FARMERS & MERCHANTS BANCORP  
Form 10-Q  
November 06, 2015

---

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

FORM 10-Q

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

For the quarterly period ended September 30, 2015

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: 000-26099

FARMERS & MERCHANTS BANCORP  
(Exact name of registrant as specified in its charter)

Delaware 94-3327828  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

111 W. Pine Street, Lodi, California 95240  
(Address of principal Executive offices) (Zip Code)

Registrant's telephone number, including area code (209) 367-2300

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

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

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

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

Yes    No

Number of shares of common stock of the registrant 788,982 outstanding as of October 31, 2015.

---

---

FARMERS & MERCHANTS BANCORP

FORM 10-Q

TABLE OF CONTENTS

<u>PART I. - FINANCIAL INFORMATION</u>	<u>Page</u>
Item 1 -Financial Statements	
<u>Consolidated Balance Sheets (Unaudited) as of September 30, 2015, December 31, 2014 and September 30, 2014</u>	3
<u>Consolidated Statements of Income (Unaudited) for the Three and Nine Months Ended September 30, 2015 and 2014</u>	4
<u>Consolidated Statements of Comprehensive Income (Unaudited) for the Three and Nine Months Ended September 30, 2015 and 2014</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Nine Months Ended September 30, 2015 and 2014</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited) for the Nine Months Ended September 30, 2015 and 2014</u>	7
<u>Notes to the Consolidated Financial Statements (Unaudited)</u>	8
<u>Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	34
<u>Item 3 - Quantitative and Qualitative Disclosures About Market Risk</u>	56
<u>Item 4 - Controls and Procedures</u>	59
<u>PART II. - OTHER INFORMATION</u>	
<u>Item 1 - Legal Proceedings</u>	59
<u>Item 1A – Risk Factors</u>	59
<u>Item 2 -Unregistered Sales of Equity Securities and Use of Proceeds</u>	60
<u>Item 3 - Defaults Upon Senior Securities</u>	60
<u>Item 4 – Mine Safety Disclosures</u>	61
<u>Item 5 - Other Information</u>	61
<u>Item 6 - Exhibits</u>	61
<u>Signatures</u>	61
<u>Index to Exhibits</u>	62

31(a) Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31(b) Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

2

---

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Balance Sheets

(in thousands, except shares)

	Sept. 30, 2015 (Unaudited)	December 31, 2014	Sept. 30, 2014 (Unaudited)
<b>Assets</b>			
<b>Cash and Cash Equivalents:</b>			
Cash and Due from Banks	\$41,595	\$42,375	\$34,293
Interest Bearing Deposits with Banks	8,705	34,750	4,923
Total Cash and Cash Equivalents	50,300	77,125	39,216
<b>Investment Securities:</b>			
Available-for-Sale	344,728	366,542	336,526
Held-to-Maturity	66,257	63,863	69,441
Total Investment Securities	410,985	430,405	405,967
<b>Loans &amp; Leases</b>			
Loans & Leases	1,910,270	1,712,244	1,615,771
Less: Allowance for Credit Losses	39,090	35,401	34,267
Loans & Leases, Net	1,871,180	1,676,843	1,581,504
<b>Premises and Equipment, Net</b>			
Premises and Equipment, Net	26,856	25,821	24,927
Bank Owned Life Insurance	55,418	53,990	53,514
Interest Receivable and Other Assets	85,332	96,367	92,541
Total Assets	\$2,500,071	\$2,360,551	\$2,197,669
<b>Liabilities</b>			
<b>Deposits:</b>			
Demand	\$603,430	\$610,133	\$516,093
Interest Bearing Transaction	373,193	341,397	326,368
Savings and Money Market	672,052	644,260	614,137
Time	483,967	468,283	419,615
Total Deposits	2,132,642	2,064,073	1,876,213
<b>Federal Home Loan Bank Advances</b>			
Federal Home Loan Bank Advances	5,500	-	36,000
<b>Subordinated Debentures</b>			
Subordinated Debentures	10,310	10,310	10,310
<b>Interest Payable and Other Liabilities</b>			
Interest Payable and Other Liabilities	100,495	52,990	47,910
Total Liabilities	2,248,947	2,127,373	1,970,433
<b>Shareholders' Equity</b>			
<b>Preferred Stock: No Par Value, 1,000,000 Shares Authorized, None Issued or Outstanding</b>			
Preferred Stock: No Par Value, 1,000,000 Shares Authorized, None Issued or Outstanding	-	-	-
<b>Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 788,982, 784,082 and 777,882 Shares Issued and Outstanding at September 30, 2015, December 31, 2014 and September 30, 2014, Respectively</b>			
Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 788,982, 784,082 and 777,882 Shares Issued and Outstanding at September 30, 2015, December 31, 2014 and September 30, 2014, Respectively	8	8	8
<b>Additional Paid-In Capital</b>			
Additional Paid-In Capital	80,217	77,804	75,014

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Retained Earnings	167,996	152,833	151,268
Accumulated Other Comprehensive Income	2,903	2,533	946
Total Shareholders' Equity	251,124	233,178	227,236
Total Liabilities and Shareholders' Equity	\$2,500,071	\$2,360,551	\$2,197,669

The accompanying notes are an integral part of these unaudited consolidated financial statements

3

---

Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Income (Unaudited)

(in thousands except per share data)	Three Months		Nine Months	
	Ended September 30, 2015	2014	Ended September 30, 2015	2014
Interest Income				
Interest and Fees on Loans & Leases	\$20,915	\$18,166	\$59,648	\$51,178
Interest on Deposits with Banks	36	5	159	110
Interest on Investment Securities:				
Taxable	1,574	1,849	4,742	6,073
Exempt from Federal Tax	513	594	1,538	1,758
Total Interest Income	23,038	20,614	66,087	59,119
Interest Expense				
Deposits	777	621	2,243	1,819
Borrowed Funds	-	5	-	5
Subordinated Debentures	83	82	244	242
Total Interest Expense	860	708	2,487	2,066
Net Interest Income	22,178	19,906	63,600	57,053
Provision for Credit Losses	-	-	650	-
Net Interest Income After Provision for Credit Losses	22,178	19,906	62,950	57,053
Non-Interest Income				
Service Charges on Deposit Accounts	840	1,022	2,603	2,944
Net Gain on Sale of Investment Securities	266	4	272	38
Increase in Cash Surrender Value of Life Insurance	485	477	1,428	1,405
Debit Card and ATM Fees	808	797	2,389	2,322
Net Gain (Loss) on Deferred Compensation Investments	224	(37)	773	1,493
Other	1,087	657	3,735	1,823
Total Non-Interest Income	3,710	2,920	11,200	10,025
Non-Interest Expense				
Salaries and Employee Benefits	9,980	9,336	29,645	26,710
Net Gain (Loss) on Deferred Compensation Investments	224	(37)	773	1,493
Occupancy	757	724	2,142	1,981
Equipment	786	714	2,294	2,117
FDIC Insurance	302	264	883	778
Other	2,439	1,541	5,730	4,137
Total Non-Interest Expense	14,488	12,542	41,467	37,216
Income Before Income Taxes	11,400	10,284	32,683	29,862
Provision for Income Taxes	4,360	3,852	12,491	11,044
Net Income	\$7,040	\$6,432	\$20,192	\$18,818
Basic Earnings Per Common Share	\$8.96	\$8.27	\$25.70	\$24.19

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2015	2014	2015	2014
Net Income	\$7,040	\$6,432	\$20,192	\$18,818
Other Comprehensive Income (Loss)				
Change in Net Unrealized Gain (Loss) on Available-for-Sale Securities	2,460	(1,752)	910	5,929
Deferred Tax Benefit (Expense) Related to Unrealized Gains	(1,033)	736	(382)	(2,493)
Reclassification Adjustment for Realized Gains on Available-for-Sale Securities Included in Net Income	(266)	(4)	(272)	(38)
Deferred Tax Benefit Related to Reclassification Adjustment	111	2	114	16
Change in Net Unrealized Gain (Loss) on Available-for-Sale Securities, Net of Tax	1,272	(1,018)	370	3,414
Total Other Comprehensive (Loss) Income	1,272	(1,018)	370	3,414
Comprehensive Income	\$8,312	\$5,414	\$20,562	\$22,232

The accompanying notes are an integral part of these unaudited consolidated financial statements



Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)

	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss), net	Total Shareholders' Equity
Balance, January 1, 2014	777,882	\$ 8	\$ 75,014	\$ 137,350	\$ (2,468 )	\$ 209,904
Net Income		-	-	18,818	-	18,818
Cash Dividends Declared on Common Stock (\$6.30 per share)		-	-	(4,900 )	-	(4,900 )
Change in Net Unrealized Gain (Loss) on Securities Available-for-Sale, Net of Tax		-	-	-	3,414	3,414
Balance, September 30, 2014	777,882	\$ 8	\$ 75,014	\$ 151,268	\$ 946	\$ 227,236
Balance, January 1, 2015	784,082	\$ 8	\$ 77,804	\$ 152,833	\$ 2,533	\$ 233,178
Net Income		-	-	20,192	-	20,192
Cash Dividends Declared on Common Stock (\$6.40 per share)		-	-	(5,029 )	-	(5,029 )
Issuance of Common Stock	4,900	-	2,413	-	-	2,413
Change in Net Unrealized Gain (Loss) on Securities Available-for-Sale, Net of Tax		-	-	-	370	370
Balance, September 30, 2015	788,982	\$ 8	\$ 80,217	\$ 167,996	\$ 2,903	\$ 251,124

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

## FARMERS &amp; MERCHANTS BANCORP

## Consolidated Statements of Cash Flows (Unaudited)

(in thousands)	Nine Months Ended September 30,	
	2015	2014
Operating Activities:		
Net Income	\$20,192	\$18,818
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	650	-
Depreciation and Amortization	1,184	991
Net Amortization of Investment Security Premiums & Discounts	1,163	1,249
Net Gain on Sale of Investment Securities	(272 )	(38 )
Net Gain on Sale of Property & Equipment	(392 )	(15 )
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(1,245 )	(5,984 )
Net Increase (Decrease) in Interest Payable and Other Liabilities	60,303	(258 )
Net Cash Provided by Operating Activities	81,583	14,763
Investing Activities:		
Purchase of Investment Securities Available-for-Sale	(134,407)	(65,637 )
Proceeds from Sold, Matured or Called Securities Available-for-Sale	156,214	138,298
Purchase of Investment Securities Held-to-Maturity	(12,015 )	(15,660 )
Proceeds from Matured or Called Securities Held-to-Maturity	9,574	14,711
Net Loans & Leases Paid, Originated or Acquired	(198,093)	(227,739)
Principal Collected on Loans & Leases Previously Charged Off	3,106	197
Additions to Premises and Equipment	(2,498 )	(3,045 )
Proceeds from Sale of Property & Equipment	671	29
Net Cash Used by Investing Activities	(177,448)	(158,846)
Financing Activities:		
Net Increase in Deposits	68,569	68,522
Net Changes in Other Borrowings	5,500	36,000
Cash Dividends	(5,029 )	(4,900 )
Net Cash Provided by Financing Activities	69,040	99,622
Decrease in Cash and Cash Equivalents	(26,825 )	(44,461 )
Cash and Cash Equivalents at Beginning of Period	77,125	83,677
Cash and Cash Equivalents at End of Period	\$50,300	\$39,216
Supplementary Data		
Cash Payments Made for Income Taxes	\$5,175	\$10,900
Issuance of Common Stock to the Bank's Non-Qualified Retirement Plans	\$2,413	\$-
Interest Paid	\$2,275	\$2,103

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

Farmers & Merchants Bancorp (the “Company”) was organized March 10, 1999. Primary operations are related to traditional banking activities through its subsidiary Farmers & Merchants Bank of Central California (the “Bank”), which was established in 1916. The Bank’s wholly owned subsidiaries include Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation has been dormant since 1991. Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

The Company’s other subsidiaries include F & M Bancorp, Inc. and FMCB Statutory Trust I. F & M Bancorp, Inc. was created in March 2002 to protect the name F & M Bank. During 2002 the Company completed a fictitious name filing in California to begin using the streamlined name “F & M Bank” as part of a larger effort to enhance the Company’s image and build brand name recognition. In December 2003 the Company formed a wholly owned subsidiary, FMCB Statutory Trust I. FMCB Statutory Trust I is a non-consolidated subsidiary per Generally Accepted Accounting Principles in the United States of America (“U.S. GAAP”) and was formed for the sole purpose of issuing Trust Preferred Securities and related subordinated debentures.

The accounting and reporting policies of the Company conform to U.S. GAAP and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

Basis of Presentation

The accompanying consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information.

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. Accordingly, certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with U.S. GAAP have been omitted. The Company believes that the disclosures are adequate to make the information not misleading. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014. The results of operations for the three-month and nine-month periods ended September 30, 2015 may not necessarily be indicative of future operating results.

The accompanying consolidated financial statements include the accounts of the Company and the Company’s wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank’s wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with U. S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Certain amounts in the prior years' consolidated financial statements and related footnote disclosures have been reclassified to conform to the current-year presentation. These reclassifications had no effect on previously reported net income or total shareholders' equity. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which are necessary for a fair

presentation of financial results for the periods presented.

8

---

## Table of Contents

### Cash and Cash Equivalents

For purposes of the Consolidated Statements of Cash Flows, the Company has defined cash and cash equivalents as those amounts included in the balance sheet captions Cash and Due from Banks, Interest Bearing Deposits with Banks, Federal Funds Sold and Securities Purchased Under Agreements to Resell. For these instruments, the carrying amount is a reasonable estimate of fair value.

### Investment Securities

Investment securities are classified at the time of purchase as held-to-maturity (“HTM”) if it is management’s intent and the Company has the ability to hold the securities until maturity. These securities are carried at cost, adjusted for amortization of premium and accretion of discount using a level yield of interest over the estimated remaining period until maturity. Losses, reflecting a decline in value judged by the Company to be other than temporary, are recognized in the period in which they occur.

Securities are classified as available-for-sale (“AFS”) if it is management’s intent, at the time of purchase, to hold the securities for an indefinite period of time and/or to use the securities as part of the Company’s asset/liability management strategy. These securities are reported at fair value with aggregate unrealized gains or losses excluded from income and included as a separate component of shareholders’ equity, net of related income taxes. Fair values are based on quoted market prices or broker/dealer price quotations on a specific identification basis. Gains or losses on the sale of these securities are computed using the specific identification method.

Trading securities, if any, are acquired for short-term appreciation and are recorded in a trading portfolio and are carried at fair value, with unrealized gains and losses recorded in non-interest income.

Management evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. 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, 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 basis. For equity securities, the entire amount of impairment is recognized through earnings.

In order to determine OTTI for purchased beneficial interests that, on the purchase date, were not highly rated, the Company compares the present value of the remaining cash flows as estimated at the preceding evaluation date to the current expected remaining cash flows. OTTI is deemed to have occurred if there has been an adverse change in the remaining expected future cash flows.

### Loans & Leases

Loans & leases are reported at the principal amount outstanding net of unearned discounts and deferred loan & lease fees and costs. Interest income on loans & leases is accrued daily on the outstanding balances using the simple interest method. Loan & lease origination fees are deferred and recognized over the contractual life of the loan or lease as an adjustment to the yield. Loans & leases are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose a loan or lease is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or lease or is guaranteed by a financially capable party. When a loan or lease is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged

against current income; thereafter, interest income is recognized only as it is collected in cash. Additionally, cash would be applied to principal if all principal was not expected to be collected. Loans & leases placed on non-accrual status are returned to accrual status when the loans or leases are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan or lease.

### Table of Contents

A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Impaired loans or leases are either: (1) non-accrual loans & leases; or (2) restructured loans & leases that are still accruing interest. Loans or leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

A restructuring of a loan or lease constitutes a troubled debt restructuring ("TDR") if the Company for economic or legal reasons related to the borrower's (the term "borrower" is used herein to describe a customer who has entered into either a loan or lease transaction) financial difficulties grants a concession to the borrower that it would not otherwise consider. Restructured loans & leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment as described above.

Generally, the Company will not restructure loans or leases for borrowers unless: (1) the existing loan or lease is brought current as to principal and interest payments; and (2) the restructured loan or lease can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan or lease amounts. After restructure a determination is made whether the loan or lease will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

### Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance sheet date. The allowance is established through a provision for credit losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components: specific reserves related to impaired loans & leases; general reserves for inherent losses related to loans & leases that are not impaired; and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

The determination of the general reserve for loans & leases that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, qualitative factors that include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan & lease portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1<sup>st</sup> mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer and other; and (9) equipment leases. The allowance for credit losses attributable to each portfolio segment, which includes both individually evaluated impaired loans & leases and loans & leases that are

collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.



### Table of Contents

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

**Pass** – A pass loan or lease is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

**Special Mention** – A special mention loan or lease has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or lease or in the Company's credit position at some future date. Special mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

**Substandard** – A substandard loan or lease is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans or leases classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful** – Loans or leases classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

**Loss** – Loans or leases classified as loss are considered uncollectible. Once a loan or lease becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Company will estimate its probable loss and immediately charge-off some or all of the balance.

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

**Commercial Real Estate** – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

**Real Estate Construction** – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability

of construction projects.

Commercial – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

11

---

### Table of Contents

**Agricultural Real Estate and Agricultural** – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

**Leases** – Equipment leases are generally considered to possess a moderate inherent risk of loss. As Lessor, the Company is subject to both the credit risk of the borrower and the residual value risk of the equipment. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

**Residential 1st Mortgages and Home Equity Lines and Loans** – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the correction in residential real estate values that occurred between 2007 and 2012. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

**Consumer & Other** – A consumer installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's and Bank's regulators, including the Federal Reserve Bank (“FRB”), the California Department of Business Oversight (“DBO”) and the Federal Deposit Insurance Corporation (“FDIC”), as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

### **Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures**

The Company also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in Interest Payable and Other Liabilities on the Company's Consolidated Balance Sheet.

### **Premises and Equipment**

Premises, equipment, and leasehold improvements are stated at cost, less accumulated depreciation and amortization. Depreciation is computed principally by the straight line method over the estimated useful lives of the assets. Estimated useful lives of buildings range from 30 to 40 years, and for furniture and equipment from 3 to 7 years. Leasehold improvements are amortized over the lesser of the terms of the respective leases, or their useful lives, which are generally 5 to 10 years. Remodeling and capital improvements are capitalized while maintenance and repairs are charged directly to occupancy expense.

### **Other Real Estate**

Other real estate, which is included in other assets, is expected to be sold and is comprised of properties no longer utilized for business operations and property acquired through foreclosure in satisfaction of indebtedness. These properties are recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value

less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Initial losses on properties acquired through full or partial satisfaction of debt are treated as credit losses and charged to the allowance for credit losses at the time of acquisition. Subsequent declines in value from the recorded amounts, routine holding costs, and gains or losses upon disposition, if any, are included in non-interest expense as incurred.

## Table of Contents

### Income Taxes

The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount combined with the current taxes payable or refundable results in the income tax expense for the current year.

The Company follows the standards set forth in the “Income Taxes” topic of the Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements. This standard prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest expense and penalties associated with unrecognized tax benefits, if any, are included in the provision for income taxes in the Unaudited Consolidated Statements of Income.

### Dividends and Basic Earnings Per Common Share

The Company’s common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. There are no common stock equivalent shares. Therefore, there is no presentation of diluted earnings per common share. See Note 6.

### Segment Reporting

The “Segment Reporting” topic of the FASB ASC requires that public companies report certain information about operating segments. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. The Company is a holding company for a community bank, which offers a wide array of products and services to its customers. Pursuant to its banking strategy, emphasis is placed on building relationships with its customers, as opposed to building specific lines of business. As a result, the Company is not organized around discernible lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change. Therefore, the Company reports one segment.

### Derivative Instruments and Hedging Activities

The “Derivatives and Hedging” topic of the FASB ASC establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. All

derivatives, whether designated in hedging relationships or not, are required to be recorded on the balance sheet at fair value. Changes in the fair value of those derivatives are accounted for depending on the intended use of the derivative and the resulting designation under specified criteria. If the derivative is designated as a fair value hedge, the changes in the fair value of the derivative and of the hedged item attributable to the hedged risk are recognized in earnings. If the derivative is designated as a cash flow hedge, designed to minimize interest rate risk, the effective portions of the change in the fair value of the derivative are recorded in other comprehensive income (loss), net of related income taxes. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

Table of Contents

From time to time, the Company utilizes derivative financial instruments such as interest rate caps, floors, swaps, and collars. These instruments are purchased and/or sold to reduce the Company's exposure to changing interest rates. The Company marks to market the value of its derivative financial instruments and reflects gain or loss in earnings in the period of change or in other comprehensive income (loss). The Company was not utilizing any derivative instruments as of or for the periods ended September 30, 2015, December 31, 2014 or September 30, 2014.

## Comprehensive Income

The "Comprehensive Income" topic of the FASB ASC establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Other comprehensive income (loss) refers to revenues, expenses, gains, and losses that U.S. GAAP recognize as changes in value to an enterprise but are excluded from net income. For the Company, comprehensive income includes net income and changes in fair value of its available-for-sale investment securities.

## Loss 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. Management does not believe there now are such matters that will have a material effect on the financial statements.

## 2. Investment Securities

The amortized cost, fair values, and unrealized gains and losses of the securities available-for-sale are as follows (in thousands):

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
September 30, 2015				
Government Agency & Government-Sponsored Entities	\$ 41,448	\$65	\$-	\$ 41,513
US Treasury Notes	30,069	231	-	30,300
Mortgage Backed Securities <sup>(1)</sup>	251,483	5,024	312	256,195
Corporate Securities	16,235	-	-	16,235
Other	485	-	-	485
Total	\$ 339,720	\$5,320	\$312	\$ 344,728

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
December 31, 2014				
Government Agency & Government-Sponsored Entities	\$ 78,051	\$61	\$3	\$ 78,109
Mortgage Backed Securities <sup>(1)</sup>	283,636	4,969	657	287,948
Other	485	-	-	485
Total	\$ 362,172	\$5,030	\$660	\$ 366,542

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
September 30, 2014				
Government Agency & Government-Sponsored Entities	\$ 13,220	\$141	\$-	\$ 13,361
Mortgage Backed Securities <sup>(1)</sup>	321,187	3,936	2,443	322,680
Other	485	-	-	485
Total	\$ 334,892	\$4,077	\$2,443	\$ 336,526

<sup>(1)</sup> All Mortgage Backed Securities consist of securities collateralized by residential real estate and were issued by an agency or government sponsored entity of the U.S. government.





Table of Contents

The book values, estimated fair values and unrealized gains and losses of investments classified as held-to-maturity are as follows (in thousands):

	Book	Gross		Fair
	Value	Unrealized	Losses	Value
		Gains		
September 30, 2015				
Obligations of States and Political Subdivisions	\$64,134	\$ 658	\$ 26	\$64,766
Other	2,123	-	-	2,123
Total	\$66,257	\$ 658	\$ 26	\$66,889

	Book	Gross		Fair
	Value	Unrealized	Losses	Value
		Gains		
December 31, 2014				
Obligations of States and Political Subdivisions	\$61,716	\$ 782	\$ 10	\$62,488
Other	2,147	-	-	2,147
Total	\$63,863	\$ 782	\$ 10	\$64,635

	Book	Gross		Fair
	Value	Unrealized	Losses	Value
		Gains		
September 30, 2014				
Obligations of States and Political Subdivisions	\$67,206	\$ 725	\$ 17	\$67,914
Other	2,235	-	-	2,235
Total	\$69,441	\$ 725	\$ 17	\$70,149

Fair values are based on quoted market prices or dealer quotes. If a quoted market price or dealer quote is not available, fair value is estimated using quoted market prices for similar securities.

The amortized cost and estimated fair values of investment securities at September 30, 2015 by contractual maturity are shown in the following table (in thousands):

	Available-for-Sale		Held-to-Maturity	
	Amortized	Fair/Book	Book	Fair
	Cost	Value	Value	Value
September 30, 2015				
Within one year	\$26,719	\$26,722	\$2,124	\$2,123
After one year through five years	61,518	61,811	15,386	15,462
After five years through ten years	-	-	9,286	9,382
After ten years	-	-	39,461	39,922
	88,237	88,533	66,257	66,889
Investment securities not due at a single maturity date:				
Mortgage Backed Securities	251,483	256,195	-	-
Total	\$339,720	\$344,728	\$66,257	\$66,889

Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without prepayment penalties.

Table of Contents

The following tables show those investments with gross unrealized losses and their market value aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at the dates indicated (in thousands):

	Less Than 12		12 Months or More		Total	
	Months					
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

September 30, 2015

Securities Available-for-Sale

Mortgage Backed Securities	\$36,898	\$ 256	\$7,593	\$ 56	\$44,491	\$ 312
Total	\$36,898	\$ 256	\$7,593	\$ 56	\$44,491	\$ 312

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$1,991	\$ 26	\$-	\$ -	\$1,991	\$ 26
Total	\$1,991	\$ 26	\$-	\$ -	\$1,991	\$ 26

	Less Than 12		12 Months or More		Total	
	Months					
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

December 31, 2014

Securities Available-for-Sale

Government Agency & Government-Sponsored Entities	\$66,980	\$ 3	\$-	\$ -	\$66,980	\$ 3
Mortgage Backed Securities	14,487	151	33,574	506	48,061	657
Total	\$81,467	\$ 154	\$33,574	\$ 506	\$115,041	\$ 660

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$849	\$ 5	\$876	\$ 5	\$1,725	\$ 10
Total	\$849	\$ 5	\$876	\$ 5	\$1,725	\$ 10

	Less Than 12		12 Months or More		Total	
	Months					
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

September 30, 2014

Securities Available-for-Sale

Mortgage Backed Securities	\$62,825	\$ 240	\$64,968	\$ 2,203	127,793	\$ 2,443
Total	\$62,825	\$ 240	\$64,968	\$ 2,203	\$127,793	\$ 2,443

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$1,943	\$ 11	\$2,556	\$ 6	\$4,499	\$ 17
Total	\$1,943	\$ 11	\$2,556	\$ 6	\$4,499	\$ 17

As of September 30, 2015, the Company held 261 investment securities of which 10 were in a loss position for less than twelve months and 1 security was in a loss position for twelve months or more. Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

Securities of Government Agency and Government Sponsored Entities – There were no unrealized losses on the Company’s investment in securities of government agency and government sponsored entities at September 30, 2015 and September 30, 2014. The unrealized losses on the Company’s investment in securities of government agency and government sponsored entities at December 31, 2014 were \$3,000. The unrealized losses were caused by interest rate fluctuations. Repayment of these investments is guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company did not consider these investments to be other-than-temporarily impaired at December 31, 2014.

Table of Contents

**Mortgage Backed Securities** – At September 30, 2015, five mortgage backed security investments were in a loss position for less than 12 months and one was in a loss position for 12 months or more. The unrealized losses on the Company's investment in mortgage backed securities were \$312,000, \$657,000, and \$2.4 million at September 30, 2015, December 31, 2014, and September 30, 2014, respectively. The unrealized losses on the Company's investment in mortgage backed securities were caused by interest rate fluctuations. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2015, December 31, 2014 and September 30, 2014, respectively.

**Obligations of States and Political Subdivisions** - At September 30, 2015, five obligations of states and political subdivisions were in a loss position for less than 12 months. None were in a loss position for 12 months or more. As of September 30, 2015, over ninety-eight percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of the two percent of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

The unrealized losses on the Company's investment in obligations of states and political subdivisions were \$26,000, \$10,000, and \$17,000 at September 30, 2015, December 31, 2014 and September 30, 2014, respectively. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were primarily caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2015, December 31, 2014 and September 30, 2014, respectively.

**Corporate Securities** - There were no unrealized losses on the Company's investments in corporate securities at September 30, 2015. The Company did not hold any corporate securities December 31, 2014 or September 30, 2014. Changes in the prices of corporate securities are primarily influenced by: (1) changes in market interest rates; (2) changes in perceived credit risk in the general economy or in particular industries; (3) changes in the perceived credit risk of a particular company; and (4) day to day trading supply, demand and liquidity.

**US Treasury Notes** – There were no unrealized losses on the Company's investments in US treasury notes at September 30, 2015. The Company did not hold any US treasury notes at December 31, 2014 or September 30, 2014.

Proceeds from sales and calls of securities were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2015	2014	2015	2014
Proceeds	\$53,465	\$85,433	\$58,000	\$95,349
Gains	266	811	272	845
Losses	-	807	-	807

Table of Contents

Pledged Securities

As of September 30, 2015, securities carried at \$197.8 million were pledged to secure public deposits, Federal Home Loan Bank (“FHLB”) borrowings, and other government agency deposits as required by law. This amount was \$178.8 million at December 31, 2014, and \$360.0 million at September 30, 2014.

The decrease in pledged securities since September 30, 2014 was due to the Company’s use of a \$165 million standby Letter of Credit (“LC”) issued by the FHLB as collateral for Public Deposits. The LC was issued December 4, 2014, and matures December 2, 2016, with a maintenance fee of 10 basis points per annum.

3. Loans & Leases and Allowance for Credit Losses

The following tables show the allocation of the allowance for credit losses by portfolio segment and by impairment methodology at the dates indicated (in thousands):

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
Year-To-Date Allowance for Credit Losses:											
Beginning Balance-											
January 1, 2015	\$7,842	\$4,185	\$1,669	\$1,022	\$2,426	\$6,104	\$8,195	\$218	\$2,211	\$1,529	\$30,291
Charge-Offs	-	-	-	-	-	-	(12 )	(55 )	-	-	(68 )
Recoveries	2,939	-	-	4	85	3	24	51	-	-	3,099
Provision	(1,536 )	3,295	719	(274 )	(356 )	(969 )	38	2	860	(1,129)	600
Ending Balance-											
September 30, 2015	\$9,245	\$7,480	\$2,388	\$752	\$2,155	\$5,138	\$8,245	\$216	\$3,071	\$400	\$30,380
Third Quarter Allowance for Credit Losses:											
Beginning Balance-											
July 1, 2015	\$8,591	\$7,272	\$2,177	\$731	\$2,073	\$5,046	\$8,878	\$217	\$2,532	\$1,520	\$30,150
Charge-Offs	-	-	-	-	-	-	-	(21 )	-	-	(21 )
Recoveries	-	-	-	3	37	1	20	13	-	-	74
Provision	654	208	211	18	45	91	(653 )	7	539	(1,120)	-
Ending Balance-											
September 30, 2015	\$9,245	\$7,480	\$2,388	\$752	\$2,155	\$5,138	\$8,245	\$216	\$3,071	\$400	\$30,380
Ending Balance Individually Evaluated for Impairment											
September 30, 2015	61	-	-	70	35	120	879	31	-	-	1,176
September 30, 2014	9,184	7,480	2,388	682	2,120	5,018	7,366	185	3,071	400	31,704

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Ending Balance Collectively Evaluated for Impairment Loans & Leases: Ending Balance	\$558,743	\$432,610	\$161,762	\$196,893	\$31,833	\$249,783	\$210,491	\$6,735	\$61,420	\$-	\$1
Ending Balance Individually Evaluated for Impairment	4,120	-	4,307	2,036	1,264	630	4,797	37	-	-	1
Ending Balance Collectively Evaluated for Impairment	\$554,623	\$432,610	\$157,455	\$194,857	\$30,569	\$249,153	\$205,694	\$6,698	\$61,420	\$-	\$1

Table of Contents

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
December 31, 2014											
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2014											
	\$5,178	\$3,576	\$654	\$1,108	\$2,767	\$12,205	\$5,697	\$176	\$639	\$2,274	\$34,2
Charge-Offs	-	-	-	(73 )	(70 )	-	(1 )	(132 )	-	-	(270
Recoveries	11	-	-	-	58	8	86	65	-	-	228
Provision	2,653	609	1,015	(13 )	(329 )	(6,109 )	2,413	109	1,572	(745 )	1,17
Ending Balance- December 31, 2014											
	\$7,842	\$4,185	\$1,669	\$1,022	\$2,426	\$6,104	\$8,195	\$218	\$2,211	\$1,529	\$35,4
Ending Balance Individually Evaluated for Impairment											
	377	-	-	422	329	114	914	41	-	-	2,19
Ending Balance Collectively Evaluated for Impairment											
	7,465	4,185	1,669	600	2,097	5,990	7,281	177	2,211	1,529	33,2
Loans & Leases:											
Ending Balance											
	\$491,903	\$357,207	\$96,519	\$171,880	\$33,017	\$281,963	\$230,819	\$4,719	\$44,217	\$-	\$1,71
Ending Balance Individually Evaluated for Impairment											
	20,066	-	4,386	2,108	1,643	461	4,874	46	-	-	33,5
Ending Balance Collectively Evaluated for Impairment											
	\$471,837	\$357,207	\$92,133	\$169,772	\$31,374	\$281,502	\$225,945	\$4,673	\$44,217	\$-	\$1,67
September 30, 2014											

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Year-To-Date Allowance for Credit Losses:

Beginning

Balance-

January 1,

2014 \$5,178 \$3,576 \$654 \$1,108 \$2,767 \$12,205 \$5,697 \$176 \$639 \$2,274 \$34

Charge-Offs - - - (58 ) (70 ) - - (76 ) - - (2

Recoveries 12 - - - 54 3 83 45 - - 19

Provision 2,608 370 1,026 92 (76 ) (6,426 ) 2,135 76 1,206 (1,011) -

Ending

Balance-

September

30, 2014 \$7,798 \$3,946 \$1,680 \$1,142 \$2,675 \$5,782 \$7,915 \$221 \$1,845 \$1,263 \$34

Third Quarter Allowance for Credit

Losses:

Beginning

Balance-

July 1, 2014 \$6,991 \$3,677 \$1,290 \$1,094 \$2,737 \$8,291 \$7,377 \$193 \$1,108 \$1,532 \$34

Charge-Offs - - - (25 ) (5 ) - - (31 ) - - (6

Recoveries 12 - - - 3 1 6 16 - - 38

Provision 795 269 390 73 (60 ) (2,510 ) 532 43 737 (269 ) -

Ending

Balance-

September

30, 2014 \$7,798 \$3,946 \$1,680 \$1,142 \$2,675 \$5,782 \$7,915 \$221 \$1,845 \$1,263 \$34

Ending

Balance

Individually

Evaluated

for Impairment 190 - 239 370 328 120 912 42 - - 2,

Ending

Balance

Collectively

Evaluated

for Impairment 7,608 3,946 1,441 772 2,347 5,662 7,003 179 1,845 1,263 32

Loans &

Leases:

Ending

Balance \$473,505 \$364,161 \$104,463 \$168,310 \$33,283 \$237,521 \$192,804 \$4,816 \$36,908 \$- \$1,

Ending

Balance

Individually

Evaluated

for Impairment 20,175 - 4,419 1,847 1,658 518 4,877 42 - - 33

Ending

Balance 453,330 364,161 100,044 166,463 31,625 237,003 187,927 4,774 36,908 - 1,

Balance

Collectively

Evaluated

for



Impairment

19

---

Table of Contents

The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$9.3 million at September 30, 2015, \$26.4 million at December 31, 2014 and \$26.6 million at September 30, 2014, which are no longer disclosed or classified as TDR's.

The following tables show the loan & lease portfolio allocated by management's internal risk ratings at the dates indicated (in thousands):

September 30, 2015	Pass	Special Mention	Substandard	Total Loans & Leases
Loans & Leases:				
Commercial Real Estate	\$550,011	\$8,038	\$ 694	\$558,743
Agricultural Real Estate	432,610	-	-	432,610
Real Estate Construction	160,133	1,629	-	161,762
Residential 1st Mortgages	195,477	733	683	196,893
Home Equity Lines & Loans	31,149	78	606	31,833
Agricultural	249,116	437	230	249,783
Commercial	197,193	9,752	3,546	210,491
Consumer & Other	6,461	-	274	6,735
Leases	61,420	-	-	61,420
Total	\$1,883,570	\$20,667	\$ 6,033	\$1,910,270

December 31, 2014	Pass	Special Mention	Substandard	Total Loans
Loans & Leases:				
Commercial Real Estate	\$483,146	\$8,651	\$ 106	\$491,903
Agricultural Real Estate	357,207	-	-	357,207
Real Estate Construction	94,887	1,632	-	96,519
Residential 1st Mortgages	170,462	744	674	171,880
Home Equity Lines and Loans	32,054	85	878	33,017
Agricultural	281,232	679	52	281,963
Commercial	211,036	18,143	1,640	230,819
Consumer & Other	4,449	-	270	4,719
Leases	44,217	-	-	44,217
Total	\$1,678,690	\$29,934	\$ 3,620	\$1,712,244

September 30, 2014	Pass	Special Mention	Substandard	Total Loans & Leases
Loans & Leases:				
Commercial Real Estate	\$464,714	\$8,683	\$ 108	\$473,505
Agricultural Real Estate	364,161	-	-	364,161
Real Estate Construction	102,831	1,632	-	104,463
Residential 1st Mortgages	166,884	752	674	168,310
Home Equity Lines & Loans	32,309	88	886	33,283
Agricultural	236,760	695	66	237,521
Commercial	168,215	22,929	1,660	192,804
Consumer & Other	4,520	-	296	4,816
Leases	36,908	-	-	36,908
Total	\$1,577,302	\$34,779	\$ 3,690	\$1,615,771

See “Note 1. Significant Accounting Policies - Allowance for Credit Losses” for a description of the internal risk ratings used by the Company. There were no loans or leases outstanding rated doubtful or loss at September 30, 2015, December 31, 2014, and September 30, 2014.

20

---

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

The following tables show an aging analysis of the loan & lease portfolio by the time past due at the dates indicated (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans & Leases
September 30, 2015							
Loans & Leases:							
Commercial Real Estate	\$-	\$-	\$ -	\$ 696	\$696	\$558,047	\$558,743
Agricultural Real Estate	-	-	-	-	-	432,610	432,610
Real Estate Construction	-	-	-	-	-	161,762	161,762
Residential 1st Mortgages	74	196	-	68	338	196,555	196,893
Home Equity Lines & Loans	150	-	-	576	726	31,107	31,833
Agricultural	-	-	-	8	8	249,775	249,783
Commercial	-	-	-	1,545	1,545	208,946	210,491
Consumer & Other	6	-	-	11	17	6,718	6,735
Leases	-	-	-	-	-	61,420	61,420
Total	\$230	\$196	\$ -	\$ 2,904	\$3,330	\$1,906,940	\$1,910,270

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans & Leases
December 31, 2014							
Loans & Leases:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$-	\$491,903	\$491,903
Agricultural Real Estate	-	-	-	-	-	357,207	357,207
Real Estate Construction	-	-	-	-	-	96,519	96,519
Residential 1st Mortgages	-	-	-	77	77	171,803	171,880
Home Equity Lines and Loans	79	-	-	576	655	32,362	33,017
Agricultural	-	-	-	18	18	281,945	281,963
Commercial	-	-	-	1,586	1,586	229,233	230,819
Consumer & Other	10	-	-	13	23	4,696	4,719
Leases	-	-	-	-	-	44,217	44,217
Total	\$ 89	\$ -	\$ -	\$ 2,270	\$2,359	\$1,709,885	\$1,712,244

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans & Leases
September 30, 2014							
Loans & Leases:							
Commercial Real Estate	\$-	\$ -	\$ -	\$ -	\$-	\$473,505	\$473,505
Agricultural Real Estate	-	-	-	-	-	364,161	364,161
Real Estate Construction	-	-	-	-	-	104,463	104,463
Residential 1st Mortgages	-	-	-	283	283	168,027	168,310
Home Equity Lines & Loans	92	-	-	575	667	32,616	33,283
Agricultural	-	-	-	25	25	237,496	237,521
Commercial	-	-	-	1,600	1,600	191,204	192,804
Consumer & Other	12	-	-	14	26	4,790	4,816
Leases	-	-	-	-	-	36,908	36,908
Total	\$104	\$ -	\$ -	\$ 2,497	\$2,601	\$1,613,170	\$1,615,771



Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

The following tables show information related to impaired loans & leases for the periods indicated (in thousands):

September 30, 2015	Recorded Investment	Unpaid Principal Balance	Related Allowance	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
				Average Recorded Investment	Average Interest Recognized	Average Recorded Investment	Average Interest Recognized
With no related allowance recorded:							
Commercial Real Estate	\$ 821	\$ 821	\$ -	\$812	\$ 2	\$468	\$ 6
Residential 1st Mortgages	557	623	-	561	4	471	12
Home Equity Lines & Loans	619	659	-	620	1	531	2
Agricultural	203	216	-	107	-	42	-
Commercial	3,118	3,118	-	3,122	26	1,578	54
	\$ 5,318	\$ 5,437	\$ -	\$5,222	\$ 33	\$3,090	\$ 74
With an allowance recorded:							
Residential 1st Mortgages	\$ 352	\$ 424	\$ 17	\$354	\$ 4	\$453	12
Home Equity Lines & Loans	135	153	7	136	2	273	4
Agricultural	427	427	120	435	7	443	21
Commercial	1,679	1,803	879	1,687	2	3,233	29
Consumer & Other	37	43	31	39	-	42	2
	\$ 2,630	\$ 2,850	\$ 1,054	\$2,651	\$ 15	\$4,444	\$ 68
Total	\$ 7,948	\$ 8,287	\$ 1,054	\$7,873	\$ 48	\$7,534	\$ 142

December 31, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Interest	
				Recorded Investment	Income Recognized
With no related allowance recorded:					
Commercial Real Estate	\$ -	\$ -	\$ -	\$ 49	\$ 4
Home Equity Lines and Loans	-	-	-	169	-
Agricultural	-	-	-	15	-
Commercial	-	-	-	1,620	54
	\$ -	\$ -	\$ -	\$ 1,853	\$ 58
With an allowance recorded:					
Commercial Real Estate	\$ 92	\$ 92	\$ 2	\$ 47	\$ 4
Residential 1st Mortgages	937	1,069	187	612	9
Home Equity Lines and Loans	951	1,020	190	803	10
Agricultural	461	473	114	473	28
Commercial	4,742	4,813	910	3,182	54
Consumer & Other	46	51	41	46	2
	\$ 7,229	\$ 7,518	\$ 1,444	\$ 5,163	\$ 107
Total	\$ 7,229	\$ 7,518	\$ 1,444	\$ 7,016	\$ 165

September 30, 2014	Recorded Investment	Unpaid Principal Balance	Related Allowance	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
				Average Recorded Investment	Average Interest Recognized	Average Recorded Investment	Average Interest Recognized
With no related allowance recorded:							

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Commercial Real Estate	\$ -	\$ -	\$ -	\$49	\$ -	\$82	\$ 4
Home Equity Lines & Loans	-	-	-	-	-	226	-
Agricultural	-	-	-	14	-	26	-
Commercial	-	-	-	1,575	-	2,740	54
	\$ -	\$ -	\$ -	\$1,638	\$ -	\$3,074	\$ 58
With an allowance recorded:							
Commercial Real Estate	\$ 94	\$ 94	\$ 2	\$47	\$ 2	\$16	\$ 2
Residential 1st Mortgages	658	771	131	550	1	522	3
Home Equity Lines & Loans	955	1,008	191	934	3	710	6
Agricultural	483	493	119	478	7	477	21
Commercial	4,744	4,801	908	3,179	27	2,144	27
Consumer & Other	43	47	43	44	1	47	2
	\$ 6,977	\$ 7,214	\$ 1,394	\$5,232	\$ 41	\$3,916	\$ 61
Total	\$ 6,977	\$ 7,214	\$ 1,394	\$6,870	\$ 41	\$6,990	\$ 119

22

---

Table of Contents

Total recorded investment shown in the prior tables will not equal the total ending balance of loans & leases individually evaluated for impairment on the allocation of allowance tables. This is because the calculation of recorded investment takes into account charge-offs, net unamortized loan & lease fees & costs, unamortized premium or discount, and accrued interest. This table also excludes impaired loans that were previously modified in a troubled debt restructuring, are currently performing and are no longer disclosed or classified as TDR's.

At September 30, 2015, the Company allocated \$1.1 million of specific reserves to \$6.6 million of troubled debt restructured loans & leases, of which \$5.0 million were performing. The Company had no commitments at September 30, 2015 to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the three and nine month period ending September 30, 2015, the terms of certain loans & leases were modified as troubled debt restructurings. The modification of the terms of such loans & leases can include one or a combination of the following: a reduction of the stated interest rate; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate were from 5 to 10 years. Modifications involving an extension of the maturity date were from 5 to 10 years.

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three and nine-month periods ended September 30, 2015 (in thousands):

Troubled Debt Restructurings	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015			
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Agricultural	1	\$ 194	\$ 194	1	\$ 194	\$ 194
Commercial	-	-	-	1	131	119
Total	1	\$ 194	\$ 194	2	\$ 325	\$ 313

The TDRs described above increased the allowance for credit losses by \$0 and \$70,000 for the three and nine-month periods ending September 30, 2015, and resulted in charge-offs of \$0 and \$12,000 for the three and nine-month periods ended September 30, 2015.

During the three and nine-months ended September 30, 2015, there were no payment defaults on loans or leases modified as troubled debt restructurings within twelve months following the modification. The Company considers a loan or lease to be in payment default once it is greater than 90 days contractually past due under the modified terms.

At December 31, 2014, the Company allocated \$1.3 million of specific reserves to \$6.6 million of troubled debt restructured loans, of which \$5.0 million were performing. The Company had no commitments at December 31, 2014 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the period ending December 31, 2014, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.



Modifications involving a reduction of the stated interest rate of the loan were for periods ranging from 4 to 30 years.  
Modifications involving an extension of the maturity date were for periods ranging from 6 months to 30 years.

Table of Contents

The following table presents loans or leases by class modified as TDRs for the period ended December 31, 2014 (in thousands):

	December 31, 2014	
	Number of Loans	Investment
Troubled Debt Restructurings		
Residential 1st Mortgages	5	\$ 857
Home Equity Lines and Loans	3	98
Agricultural	1	32
Commercial	1	18
Consumer & Other	1	7
Total	11	\$ 1,012

The troubled debt restructurings described above increased the allowance for credit losses by \$28,000 and resulted in charge-offs of \$63,000 for the twelve months ended December 31, 2014.

During the period ended December 31, 2014, there were no payment defaults on loans modified as troubled debt restructurings within twelve months following the modification.

At September 30, 2014, the Company allocated \$1.3 million of specific reserves to \$6.4 million of troubled debt restructured loans & leases, of which \$4.5 million were performing. The Company had no commitments at September 30, 2014 to lend additional amounts to customers with outstanding loans or leases that are classified as troubled debt restructurings.

During the three and nine month periods ending September 30, 2014, the terms of certain loans & leases were modified as troubled debt restructurings. The modification of the terms of such loans & leases can include one or a combination of the following: a reduction of the stated interest rate; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate were for periods ranging from 5 years to 30 years. Modifications involving an extension of the maturity date were for periods ranging from 5 years to 30 years.

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three and nine-month periods ended September 30, 2014 (in thousands):

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Number of Loans	Investment	Number of Loans	Investment
Troubled Debt Restructurings				
Residential 1st Mortgages	1	\$ 248	4	\$ 565
Home Equity Lines & Loans	1	51	3	98
Agricultural	-	-	1	32
Total	2	\$ 299	8	\$ 649

The TDRs described above increased the allowance for credit losses by \$51,000 and \$50,000 and resulted in charge-offs of \$30,000 and \$46,000 for the three and nine-month periods ended September 30, 2014.

During the three and nine-months ended September 30, 2014, there were no payment defaults on loans or leases modified as troubled debt restructurings within twelve months following the modification.

Table of Contents

4. Fair Value Measurements

The Company follows the “Fair Value Measurement and Disclosures” topic of the FASB ASC, which establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. This standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, this standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity’s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Securities classified as AFS are reported at fair value on a recurring basis utilizing Level 1, 2 and 3 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond’s terms and conditions, among other things.

The Company does not record all loans & leases at fair value on a recurring basis. However, from time to time, a loan or lease is considered impaired and an allowance for credit losses is established. Once a loan or lease is identified as individually impaired, management measures impairment in accordance with the “Receivable” topic of the FASB ASC. The fair value of impaired loans or leases is estimated using one of several methods, including collateral value when the loan is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Impaired loans & leases not requiring an allowance represent loans & leases for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans & leases. Impaired loans & leases where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. The fair value of collateral dependent impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including sales comparison, cost and the income approach. Adjustments are often made in the appraisal process by the appraisers to take into account differences between the comparable sales and income and other available data. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for Level 3 nonrecurring impaired loans is primarily the sales comparison approach less selling costs of 10%.

Other Real Estate (“ORE”) is reported at fair value on a non-recurring basis. Fair values are based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including sales comparison, cost and the income approach. Adjustments are often made in the appraisal process by the appraisers to take into account differences between the comparable sales and income and other available data. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for Level 3 nonrecurring ORE is primarily the sales comparison approach less selling costs of 10%.

Table of Contents

At September 30, 2015, formal foreclosure proceedings were in process for \$575,000 of consumer mortgage loans secured by residential real estate properties.

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated.

	Fair Value	Fair Value Measurements At September 30, 2015, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Total			
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$41,513	\$-	\$41,513	\$ -
US Treasury Notes	30,300	30,300	-	-
Mortgage Backed Securities	256,195	-	256,195	-
Corporate Securities	16,235	-	16,235	-
Other	485	175	310	-
Total Assets Measured at Fair Value On a Recurring Basis	\$344,728	\$30,475	\$314,253	\$ -

	Fair Value	Fair Value Measurements At December 31, 2014, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Total			
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$78,109	\$10,005	\$68,104	\$ -
Mortgage Backed Securities	287,948	-	287,948	-
Other	485	175	310	-
Total Assets Measured at Fair Value On a Recurring Basis	\$366,542	\$10,180	\$356,362	\$ -

Fair Value	Fair Value Measurements At September 30, 2014, Using		
	Quoted Prices in	Other Observable Inputs	Significant Unobservable Inputs

(in thousands)	Total	Active Markets for Identical Assets (Level 1)	(Level 2)	(Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$13,361	\$13,361	\$ -	\$ -
Mortgage Backed Securities	322,680	39,566	283,114	-
Other	485	175	310	-
Total Assets Measured at Fair Value On a Recurring Basis	\$336,526	\$53,102	\$283,424	\$ -

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the nine months ended September 30, 2015, the year ended December 31, 2014, and the nine months ended September 30, 2014, there were no transfers in or out of level 1, 2, or 3.

Table of Contents

The following tables present information about the Company's other real estate and impaired loans or leases, classes of assets or liabilities that the Company carries at fair value on a non-recurring basis, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated. Not all impaired loans or leases are carried at fair value. Impaired loans or leases are only included in the following tables when their fair value is based upon a current appraisal of the collateral, and if that appraisal results in a partial charge-off or the establishment of a specific reserve.

	Fair Value	Fair Value Measurements At September 30, 2015, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Total	1)	(Level 2)	(Level 3)
Impaired Loans				
Residential 1st Mortgage	\$334	\$-	\$ -	\$ 334
Home Equity Lines and Loans	126	-	-	126
Agricultural	308	-	-	308
Commercial	800	-	-	800
Consumer	5	-	-	5
Total Impaired Loans	1,573	-	-	1,573
Other Real Estate				
Real Estate Construction	2,441	-	-	2,441
Total Other Real Estate	2,441	-	-	2,441
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$4,014	\$-	\$ -	\$ 4,014

	Fair Value	Fair Value Measurements At December 31, 2014, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)	Total	1)	(Level 2)	(Level 3)
Impaired Loans				
Commercial Real Estate	\$90	\$-	\$ -	\$ 90
Residential 1st Mortgage	748	-	-	748
Home Equity Lines and Loans	759	-	-	759
Agricultural	346	-	-	346
Commercial	3,832	-	-	3,832
Consumer	6	-	-	6



Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Total Impaired Loans	5,781	-	-	5,781
Other Real Estate				
Real Estate Construction	2,441	-	-	2,441
Agricultural Real Estate	858	-	-	858
Total Other Real Estate	3,299	-	-	3,299
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$9,080	\$-	\$-	\$ 9,080

27

---

Table of Contents

(in thousands)	Fair Value	Fair Value Measurements At September 30, 2014, Using Quoted Prices in Other Significant Unobservable Inputs		
		Total	Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)
Impaired Loans				
Commercial Real Estate	\$92	\$-	\$-	\$ 92
Residential 1st Mortgages	526	-	-	526
Home Equity Lines and Loans	763	-	-	763
Agricultural	363	-	-	363
Commercial	3,836	-	-	3,836
Total Impaired Loans	5,580	-	-	5,580
Other Real Estate				
Real Estate Construction	2,441	-	-	2,441
Agricultural Real Estate	858	-	-	858
Total Other Real Estate	3,299	-	-	3,299
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$8,879	\$-	\$-	\$ 8,879

The Company's property appraisals are primarily based on the sales comparison approach and the income approach methodologies, which consider recent sales of comparable properties, including their income generating characteristics, and then make adjustments to reflect the general assumptions that a market participant would make when analyzing the property for purchase. These adjustments may increase or decrease an appraised value and can vary significantly depending on the location, physical characteristics and income producing potential of each property. Additionally, the quality and volume of market information available at the time of the appraisal can vary from period to period and cause significant changes to the nature and magnitude of comparable sale adjustments.

Given these variations, comparable sale adjustments are generally not a reliable indicator for how fair value will increase or decrease from period to period. Under certain circumstances, management discounts are applied based on specific characteristics of an individual property.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at September 30, 2015:

(in thousands)	Fair Value	Valuation Technique	Unobservable Inputs	Range, Weighted Avg.
Impaired Loans				
Residential 1st Mortgage	\$334	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	2% - 5%, 4 %
Home Equity Lines and Loans	\$126	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% - 3%, 2 %
Agricultural	\$308	Income Approach	Capitalization Rate	16% - 16%, 16 %

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Commercial	\$800	Income Approach	Capitalization Rate	16% - 16%,
		Sales Comparison	Adjustment for Difference Between	16 %
Consumer	\$5	Approach	Comparable Sales	1% - 1%, 1 %
Other Real Estate				
		Sales Comparison	Adjustment for Difference Between	10% - 10%,
Real Estate Construction	\$2,441	Approach	Comparable Sales	10 %

28

---

Table of Contents

## 5. Fair Value of Financial Instruments

U.S. GAAP requires disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practical to estimate that value. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization.

The following tables summarize the book value and estimated fair value of financial instruments for the periods indicated.

	Carrying Amount	Fair Value of Financial Instruments			Total Estimated Fair Value
		Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
September 30, 2015 (in thousands)					
Assets:					
Cash and Cash Equivalents	\$ 50,300	\$ 50,300	\$ -	\$ -	\$ 50,300
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	41,513	-	41,513	-	41,513
U.S. Treasury Notes	30,300	30,300	-	-	30,300
Mortgage Backed Securities	256,195	-	256,195	-	256,195
Corporate Securities	16,235	-	16,235	-	16,235
Other	485	175	310	-	485
Total Investment Securities Available-for-Sale	344,728	30,475	314,253	-	344,728
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	64,134	-	51,966	12,800	64,766
Other	2,123	-	2,123	-	2,123
Total Investment Securities Held-to-Maturity	66,257	-	54,089	12,800	66,889
FHLB Stock	7,795	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance:					
Commercial Real Estate	549,498	-	-	552,323	552,323
Agricultural Real Estate	425,130	-	-	415,304	415,304
Real Estate Construction	159,374	-	-	159,295	159,295
Residential 1st Mortgages	196,141	-	-	199,565	199,565
Home Equity Lines and Loans	29,678	-	-	31,314	31,314
Agricultural	244,645	-	-	243,495	243,495
Commercial	202,246	-	-	200,932	200,932

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Consumer & Other	6,519	-	-	6,543	6,543
Leases	58,349			58,854	58,854
Unallocated Allowance	(400 )	-	-	(400 )	(400 )
Total Loans & Leases, Net of Deferred Fees & Allowance	1,871,180	-	-	1,867,225	1,867,225
Accrued Interest Receivable	10,548	-	10,548	-	10,548
Liabilities:					
Deposits:					
Demand	603,430	603,430	-	-	603,430
Interest Bearing Transaction	373,193	373,193	-	-	373,193
Savings and Money Market	672,052	672,052	-	-	672,052
Time	483,967	-	484,018	-	484,018
Total Deposits	2,132,642	1,648,675	484,018	-	2,132,693
FHLB Advances & Securities Sold Under					
Agreement to Repurchase	5,500	-	5,500	-	5,500
Subordinated Debentures	10,310	-	6,292	-	6,292
Accrued Interest Payable	590	-	590	-	590

29

---

Table of Contents

	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Total Estimated Fair Value
		Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
December 31, 2014 (in thousands)					
Assets:					
Cash and Cash Equivalents	\$77,125	\$77,125	\$ -	\$ -	\$77,125
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	78,109	10,005	68,104	-	78,109
Mortgage Backed Securities	287,948	-	287,948	-	287,948
Other	485	175	310	-	485
Total Investment Securities Available-for-Sale	366,542	10,180	356,362	-	366,542
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	61,716	-	49,085	13,403	62,488
Other	2,147	-	2,147	-	2,147
Total Investment Securities Held-to-Maturity	63,863	-	51,232	13,403	64,635
FHLB Stock	7,677	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance:					
Commercial Real Estate	484,061	-	-	481,037	481,037
Agricultural Real Estate	353,022	-	-	353,288	353,288
Real Estate Construction	94,850	-	-	95,022	95,022
Residential 1st Mortgages	170,858	-	-	173,916	173,916
Home Equity Lines and Loans	30,591	-	-	32,456	32,456
Agricultural	275,859	-	-	274,195	274,195
Commercial	222,624	-	-	222,175	222,175
Consumer & Other	4,501	-	-	4,535	4,535
Leases	42,006	-	-	40,298	40,298
Unallocated Allowance	(1,529 )	-	-	(1,529 )	(1,529 )
Total Loans & Leases, Net of Deferred Fees & Allowance	1,676,843	-	-	1,675,393	1,675,393
Accrued Interest Receivable	7,797	-	7,797	-	7,797
Liabilities:					
Deposits:					
Demand	610,133	610,133	-	-	610,133
Interest Bearing Transaction	341,397	341,397	-	-	341,397
Savings and Money Market	644,260	644,260	-	-	644,260
Time	468,283	-	468,161	-	468,161
Total Deposits	2,064,073	1,595,790	468,161	-	2,063,951
Subordinated Debentures	10,310	-	6,227	-	6,227

Accrued Interest Payable	378	-	378	-	378
--------------------------	-----	---	-----	---	-----

30

---

Table of Contents

	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Total Estimated Fair Value
		Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
September 30, 2014 (in thousands)					
Assets:					
Cash and Cash Equivalents	\$39,216	\$39,216	\$ -	\$ -	\$39,216
Investment Securities Available-for-Sale:					
Government Agency & Government-Sponsored Entities	13,361	13,361	-	-	13,361
Mortgage Backed Securities	322,680	39,566	283,114	-	322,680
Other	485	175	310	-	485
Total Investment Securities Available-for-Sale	336,526	53,102	283,424	-	336,526
Investment Securities Held-to-Maturity:					
Obligations of States and Political Subdivisions	67,206	-	54,375	13,539	67,914
Other	2,235	-	2,235	-	2,235
Total Investment Securities Held-to-Maturity	69,441	-	56,610	13,539	70,149
FHLB Stock	7,677	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance:					
Commercial Real Estate	465,707	-	-	462,469	462,469
Agricultural Real Estate	360,215	-	-	360,976	360,976
Real Estate Construction	102,783	-	-	103,095	103,095
Residential 1st Mortgages	167,168	-	-	169,971	169,971
Home Equity Lines and Loans	30,608	-	-	32,601	32,601
Agricultural	231,739	-	-	230,572	230,572
Commercial	184,889	-	-	184,466	184,466
Consumer & Other	4,595	-	-	4,619	4,619
Leases	35,063	-	-	33,519	33,519
Unallocated Allowance	(1,263 )	-	-	(1,263 )	(1,263 )
Total Loans & Leases, Net of Deferred Fees & Allowance	1,581,504	-	-	1,581,025	1,581,025
Accrued Interest Receivable	8,986	-	8,986	-	8,986
Liabilities:					
Deposits:					
Demand	516,093	516,093	-	-	516,093
Interest Bearing Transaction	326,368	326,368	-	-	326,368
Savings and Money Market	614,137	614,137	-	-	614,137
Time	419,615	-	419,663	-	419,663
Total Deposits	1,876,213	1,456,598	419,663	-	1,876,261
	36,000	-	36,000	-	36,000



FHLB Advances & Securities Sold Under

Agreement to Repurchase

Subordinated Debentures	10,310	-	6,227	-	6,227
-------------------------	--------	---	-------	---	-------

Accrued Interest Payable	314	-	314	-	314
--------------------------	-----	---	-----	---	-----

31

---

### Table of Contents

Fair value estimates presented herein are based on pertinent information available to management as of September 30, 2015, December 31, 2014, and September 30, 2014. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purpose of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above. The methods and assumptions used to estimate the fair value of each class of financial instrument listed in the table above are explained below.

**Cash and Cash Equivalents** - The carrying amounts reported in the balance sheet for cash and due from banks, interest bearing deposits with banks, federal funds sold, and securities purchased under agreements to resell are a reasonable estimate of fair value. All cash and cash equivalents are classified as Level 1.

**Investment Securities** - Fair values for investment securities consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Based on the available market information the classification level could be 1, 2, or 3.

**Federal Home Loan Bank Stock** - It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

**Loans & Leases, Net of Deferred Fees & Allowance** - Fair values of loans & leases are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans & leases are estimated using discounted cash flow analyses, using interest rates currently being offered for loans & leases with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans & leases are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans & leases do not necessarily represent an exit price.

**Deposit Liabilities** - The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. Fair values for fixed-maturity certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

**FHLB Advances & Securities Sold Under Agreement to Repurchase** - The fair value of federal funds purchased and other short-term borrowings is approximated by the book value resulting in a Level 2 classification. The fair value for Federal Home Loan Bank advances is determined using discounted future cash flows resulting in a Level 2 classification.

**Subordinated Debentures** - The fair values of the Company's Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

**Accrued Interest Receivable and Payable** - The carrying amount of accrued interest receivable and payable approximates their fair value resulting in a Level 2 classification.

### 6. Dividends and Basic Earnings Per Common Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded.

Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the basic earnings per common share for the three and six months ended September 30, 2015 and 2014.

32

---

Table of Contents

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
(net income in thousands)	2015	2014	2015	2014
Net Income	\$7,040	\$6,432	\$20,192	\$18,818
Weighted Average Number of Common Shares Outstanding	785,852	777,882	785,668	777,882
Basic Earnings Per Common Share Amount	\$8.96	\$8.27	\$25.70	\$24.19

## 7. Shareholders' Equity

In January, 2015, the Company issued 1,700 shares of common stock and in September, 2015, the Company issued 3,200 shares of common stock. All of these shares were contributed to the Bank's non-qualified defined contribution retirement plans. The shares issued in January had a price of \$450 per share and the shares issued in September had a price of \$515 per share. These share prices were based upon valuations completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, the regulations promulgated thereunder. The proceeds from these issuances were contributed to the Bank as equity capital.

## 8. Recent Accounting Pronouncements

In January, 2014, the FASB issued Accounting Standards Update (ASU) 2014-04 - Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. This Update clarifies when an in-substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The objective of the amendments in this Update is to reduce diversity in practice. 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 foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments in this Update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The adoption of this ASU did not have a material impact on the Company's financial position, results of operation, cash flows, or disclosure.

In May 2014, the FASB issued ASU 2014-09 - Revenue from Contracts with Customers (Topic 606), which will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific revenue recognition guidance throughout the Accounting Standards Codification. The amendments in this update affect any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets unless those contracts, including leases and insurance contracts, are within the scope of other standards. The amendments establish a core principle requiring the recognition of revenue to depict the transfer of goods or services to customers in an amount reflecting the consideration to which the entity expects to be entitled in exchange for such goods or services. The amendments also require expanded disclosures concerning the nature, amount, timing and uncertainty of revenues and cash flows arising from contracts with customers. For public entities, the amendments in this update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, and must be applied retrospectively. Early application is not permitted. Management is currently evaluating the impact of adoption.

In August 2015, the FASB issued ASU 2015-14 - Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date. The amendments in this Update defer the effective date of Update 2014-09 for all entities by one

year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in Update 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

## Table of Contents

### Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three and nine months ended September 30, 2015. This analysis should be read in conjunction with our 2014 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

#### Forward-Looking Statements

This Form 10-Q contains various forward-looking statements, usually containing the words "estimate," "project," "expect," "objective," "goal," or similar expressions and includes assumptions concerning Farmers & Merchants Bancorp's (together with its subsidiaries, the "Company" or "we") operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks and uncertainties. In connection with the "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (1) continuing economic sluggishness in the Central Valley of California; (2) significant changes in interest rates and prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; (8) ongoing drought conditions in California and the resulting impact on the Company's agricultural customers; (9) expansion into new geographic markets and new lines of business; and (10) other factors discussed in Item 1A. Risk Factors located in the Company's 2014 Annual Report on Form 10-K and in Part II. Other Information, Item 1A. Risk Factors of this Form 10-Q.

Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

#### Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. The Bank serves the needs of its customers through twenty-four full-service branches and a stand-alone ATM. The service area includes Sacramento, San Joaquin, Stanislaus, Merced, Contra Costa and Orange Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock, Hilmar, Merced, Walnut Creek, Concord and Irvine.

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System ("FRB"). As a California, state-chartered, non-fed member bank, the Bank is subject to regulation and examination by the California Department of Business Oversight ("DBO") and the Federal Deposit Insurance Corporation ("FDIC").

#### Overview

At the present time, the Company's primary service area remains the mid Central Valley of California, a region that can be significantly impacted by the seasonal needs of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations is influenced by the seasonal banking needs of its

agricultural customers (e.g., during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in fall and winter as crops are harvested and sold).

## Table of Contents

The state of California has experienced drought conditions since 2013. Although management continues to believe that current conditions will not have a material impact on credit quality during the 2015 growing season, the lack of rain continues to have an adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels begin to significantly deteriorate or riparian rights are further curtailed. See "Part II. Other Information, Item 1A. Risk Factors" for additional information.

For the three and nine months ended September 30, 2015, Farmers & Merchants Bancorp reported net income of \$7,040,000 and \$20,192,000, earnings per share of \$8.96 and \$25.70 and return on average assets of 1.14% and 1.12%, respectively. Return on average shareholders' equity was 11.50% and 11.13% for the three and nine months ended September 30, 2015.

For the three and nine months ended September 30, 2014, Farmers & Merchants Bancorp reported net income of \$6,432,000 and \$18,818,000, basic earnings per common share of \$8.27 and \$24.19 and return on average assets of 1.19% and 1.18%, respectively. Return on average shareholders' equity was 11.45% and 11.42% for the three and nine months ended September 30, 2014.

The primary reasons for the Company's improved earnings performance in the first nine months of 2015 as compared to the same period last year were: (1) a \$6.5 million increase in net interest income; and (2) a \$1.2 million increase in non-interest income. These positive impacts were partially offset by: (1) a \$650,000 increase in the provision for credit losses; (2) a \$2.9 million increase in salaries and employee benefits; and (3) a \$757,000 increase in marketing, product development and promotional expenses.

The following is a summary of the financial results for the nine-month period ended September 30, 2015 compared to September 30, 2014.

- Net income increased 7.3% to \$20.2 million from \$18.8 million.
- Earnings per share increased 6.2% to \$25.70 from \$24.19.
- Total assets increased 13.8% to \$2.5 billion.
- Total loans & leases increased 18.2% to \$1.9 billion.
- Total deposits increased 13.7% to \$2.1 billion.

## Results of Operations

### Net Interest Income / Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analyses for the three and nine-month periods ended September 30, 2015 and 2014.

The average yields on earning assets and average rates paid on interest-bearing liabilities have been computed on an annualized basis for purposes of comparability with full year data. Average balance amounts for assets and liabilities are the computed average of daily balances.

Net interest income is the amount by which the interest and fees on loans & leases and other interest earning assets exceed the interest paid on interest bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as "taxable equivalent" and is noted wherever applicable.





Table of Contents

The Volume and Rate Analysis of Net Interest Income summarizes the changes in interest income and interest expense based on changes in average asset and liability balances (volume) and changes in average rates (rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to: (1) changes in volume (change in volume multiplied by initial rate); (2) changes in rate (change in rate multiplied by initial volume); and (3) changes in rate/volume (allocated in proportion to the respective volume and rate components).

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. See "Item 3. Quantitative and Qualitative Disclosures about Market Risk – Interest Rate Risk."

Table of Contents

Farmers & Merchants Bancorp  
 Quarterly Average Balances and Interest Rates  
 (Interest and Rates on a Taxable Equivalent Basis)  
 (in thousands)

	Three Months Ended Sept 30, 2015			Three Months Ended Sept 30, 2014		
	Balance	Interest	Rate	Balance	Interest	Rate
Assets						
Interest Bearing Deposits with Banks	\$55,575	\$36	0.26%	\$7,921	\$5	0.25%
Investment Securities:						
U.S. Treasuries	56,338	190	1.35%	-	-	0.00%
U.S. Agencies	11,393	15	0.53%	17,193	47	1.09%
Municipals - Non-Taxable	63,964	787	4.92%	68,404	912	5.33%
Mortgage Backed Securities	251,550	1,361	2.16%	307,586	1,721	2.24%
Other	2,789	8	1.15%	30,870	80	1.04%
Total Investment Securities	386,034	2,361	2.45%	424,053	2,760	2.60%
Loans & Leases:						
Real Estate	1,298,033	15,122	4.62%	1,073,804	12,966	4.79%
Home Equity Lines & Loans	31,475	445	5.61%	33,716	462	5.44%
Agricultural	227,551	2,335	4.07%	232,929	2,338	3.98%
Commercial	231,184	2,324	3.99%	184,152	1,992	4.29%
Consumer	4,891	68	5.52%	4,742	65	5.44%
Other	428	2	0.00%	-	-	0.00%
Leases	58,361	619	4.21%	34,721	344	3.93%
Total Loans & Leases	1,851,923	20,915	4.48%	1,564,064	18,167	4.61%
Total Earning Assets	2,293,532	\$23,312	4.03%	1,996,038	\$20,932	4.16%
Unrealized (Loss) Gain on Securities						
Available-for-Sale	3,044			2,975		
Allowance for Credit Losses	(39,055 )			(34,297 )		
Cash and Due From Banks	38,363			31,758		
All Other Assets	167,004			167,975		
Total Assets	\$2,462,888			\$2,164,449		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits:						
Interest Bearing DDA	\$345,978	\$55	0.06%	\$323,582	\$47	0.06%
Savings and Money Market	704,878	313	0.18%	626,248	277	0.18%
Time Deposits	490,752	409	0.33%	415,501	297	0.28%
Total Interest Bearing Deposits	1,541,608	777	0.20%	1,365,331	621	0.18%
Federal Home Loan Bank Advances	279	-	0.00%	13,139	5	0.15%
Subordinated Debentures	10,310	83	3.19%	10,310	82	3.16%
Total Interest Bearing Liabilities	1,552,197	\$860	0.22%	1,388,780	\$708	0.20%
Interest Rate Spread			3.81%			3.96%
Demand Deposits (Non-Interest Bearing)	620,391			500,492		
All Other Liabilities	45,440			50,392		
Total Liabilities	2,218,028			1,939,664		

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Shareholders' Equity	244,860		224,785	
Total Liabilities & Shareholders' Equity	\$2,462,888		\$2,164,449	
Impact of Non-Interest Bearing Deposits and Other Liabilities		0.07%		0.06%
Net Interest Income and Margin on Total Earning Assets	22,452	3.88%	20,224	4.02%
Tax Equivalent Adjustment	(275 )		(318 )	
Net Interest Income	\$22,178	3.84%	\$19,906	3.96%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$1.5 million and \$903,000 for the quarters ended September 30, 2015 and 2014, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp  
 Year-to-Date Average Balances and Interest Rates  
 (Interest and Rates on a Taxable Equivalent Basis)  
 (in thousands)

	Nine Months Ended Sept. 30, 2015			Nine Months Ended Sept. 30, 2014		
	Balance	Interest	Rate	Balance	Interest	Rate
Assets						
Interest Bearing Deposits with Banks	\$83,902	\$159	0.25 %	\$57,889	\$110	0.25 %
Investment Securities:						
U.S. Treasuries	34,954	350	1.34 %	-	-	0.00 %
U.S. Agencies	35,173	70	0.27 %	18,918	151	1.06 %
Municipals - Non-Taxable	61,847	2,361	5.09 %	65,425	2,698	5.50 %
Mortgage Backed Securities	264,820	4,301	2.17 %	320,742	5,536	2.30 %
Other	2,680	21	1.04 %	48,083	385	1.07 %
Total Investment Securities	399,474	7,103	2.37 %	453,168	8,770	2.58 %
Loans & Leases:						
Real Estate	1,210,492	42,651	4.71 %	997,216	36,459	4.89 %
Home Equity Lines & Loans	31,290	1,297	5.54 %	34,299	1,429	5.57 %
Agricultural	222,430	6,691	4.02 %	221,024	6,632	4.01 %
Commercial	235,440	7,170	4.07 %	168,332	5,720	4.54 %
Consumer	4,889	199	5.44 %	5,249	210	5.35 %
Other	144	2	1.86 %	23	1	5.81 %
Leases	52,143	1,638	4.20 %	22,957	728	4.24 %
Total Loans & Leases	1,756,828	59,648	4.54 %	1,449,100	51,179	4.72 %
Total Earning Assets	2,240,204	\$66,910	3.99 %	1,960,157	\$60,059	4.10 %
Unrealized Gain on Securities Available-for-Sale	4,695			501		
Allowance for Credit Losses	(37,833 )			(34,280 )		
Cash and Due From Banks	37,387			31,500		
All Other Assets	164,343			164,709		
Total Assets	\$2,408,796			\$2,122,587		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits:						
Interest Bearing DDA	\$343,133	\$147	0.06 %	\$306,693	\$120	0.05 %
Savings and Money Market	692,359	903	0.17 %	621,501	770	0.17 %
Time Deposits	489,185	1,193	0.33 %	421,274	929	0.29 %
Total Interest Bearing Deposits	1,524,677	2,243	0.20 %	1,349,468	1,819	0.18 %
Federal Home Loan Bank Advances	95	-	0.00 %	4,692	5	0.14 %
Subordinated Debentures	10,310	244	3.16 %	10,310	242	3.14 %
Total Interest Bearing Liabilities	1,535,082	\$2,487	0.22 %	1,364,470	\$2,066	0.20 %
Interest Rate Spread			3.78 %			3.89 %
Demand Deposits (Non-Interest Bearing)	590,457			488,677		
All Other Liabilities	41,296			49,772		
Total Liabilities	2,166,835			1,902,919		
Shareholders' Equity	241,961			219,668		

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Total Liabilities & Shareholders' Equity	\$2,408,796		\$2,122,587	
Impact of Non-Interest Bearing Deposits and Other Liabilities		0.07%		0.06%
Net Interest Income and Margin on Total Earning Assets	64,423	3.84%	57,993	3.96%
Tax Equivalent Adjustment	(823 )		(940 )	
Net Interest Income	\$63,600	3.80%	\$57,053	3.89%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$4.1 million and \$2.8 million for the nine months ended September 30, 2015 and 2014, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

## Farmers &amp; Merchants Bancorp

## Volume and Rate Analysis of Net Interest Revenue

(in thousands)	Three Months Ended Sept. 30, 2015 compared to Sept. 30, 2014			Nine Months Ended Sept. 30, 2015 compared to Sept. 30, 2014		
	Volume	Rate	Net Chg.	Volume	Rate	Net Chg.
Interest Earning Assets	\$31	\$-	\$31	\$49	\$-	\$49
Interest Bearing Deposits with Banks						
Investment Securities:						
U.S. Treasuries	190	-	190	350	-	350
U.S. Agencies	(13 )	(19 )	(32 )	77	(158 )	(81 )
Municipals - Non-Taxable	(57 )	(67 )	(124 )	(142 )	(195 )	(337 )
Mortgage Backed Securities	(305 )	(55 )	(360 )	(922 )	(313 )	(1,235 )
Other	(80 )	8	(72 )	(356 )	(8 )	(364 )
Total Investment Securities	(265 )	(133)	(398 )	(993 )	(674 )	(1,667)
Loans & Leases:						
Real Estate	2,620	(464)	2,156	7,562	(1,370)	6,192
Home Equity Lines & Loans	(32 )	15	(17 )	(125 )	(7 )	(132 )
Agricultural	(54 )	51	(3 )	42	17	59
Commercial	479	(147)	332	2,095	(645 )	1,450
Consumer	2	1	3	(15 )	4	(11 )
Other	2	-	2	2	(1 )	1
Leases	249	26	275	917	(7 )	910
Total Loans & Leases	3,266	(518)	2,748	10,478	(2,009)	8,469
Total Earning Assets	3,032	(651)	2,381	9,534	(2,683)	6,851
Interest Bearing Liabilities						
Interest Bearing Deposits:						
Interest Bearing DDA	4	4	8	15	12	27
Savings and Money Market	35	1	36	91	42	133
Time	58	54	112	159	105	264
Total Interest Bearing Deposits	97	59	156	265	159	424
Other Borrowed Funds	(2 )	(3 )	(5 )	(2 )	(3 )	(5 )
Subordinated Debentures	-	1	1	-	2	2
Total Interest Bearing Liabilities	95	57	152	263	158	421
Total Change on a Tax Equivalent Basis	\$2,937	\$(708)	\$2,229	\$9,271	\$(2,841)	\$6,430

Notes: Rate/volume variance is allocated based on the percentage relationship of changes in volume and changes in rate to the total "net change." The above figures have been rounded to the nearest whole number.

Table of Contents

Third Quarter 2015 vs. Third Quarter 2014

Net interest income for the third quarter of 2015 increased 11.4% or \$2.3 million to \$22.2 million. On a fully taxable equivalent basis, net interest income increased 11.0% and totaled \$22.5 million for the third quarter of 2015. As more fully discussed below, the increase in net interest income was primarily due to a \$297.5 million increase in average earning assets.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended September 30, 2015, the Company's net interest margin was 3.88% compared to 4.02% for the quarter ended September 30, 2014. This decrease in net interest margin was due primarily to a decline in earning asset yields.

Average loans & leases totaled \$1.9 billion for the quarter ended September 30, 2015; an increase of \$287.9 million compared to the average balance for the quarter ended September 30, 2014. Loans & leases increased from 78.4% of average earning assets at September 30, 2014 to 80.8% at September 30, 2015. As a result of the continuing impact of the sustained low rate environment since late 2008, the annualized yield on the Company's loan & lease portfolio declined to 4.48% for the quarter ended September 30, 2015, compared to 4.61% for the quarter ended September 30, 2014. Overall, the positive impact on interest revenue from the increase in loan & lease balances resulted in interest revenue from loans & leases increasing 15.1% to \$20.9 million for quarter ended September 30, 2015. The Company has been experiencing aggressive competitor pricing for loans & leases to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Since the risk factor for investments is typically lower than that of loans & leases, the yield earned on investments is generally less than that of loans & leases. Average investment securities totaled \$386.0 million for the quarter ended September 30, 2015; a decrease of \$38.0 million compared to the average balance for the quarter ended September 30, 2014. Tax equivalent interest income on securities decreased \$398,000 to \$2.36 million for the quarter ended September 30, 2015, compared to \$2.76 million for the quarter ended September 30, 2014. The average investment portfolio yield, on a tax equivalent basis, was 2.45% for the quarter ended September 30, 2015, compared to 2.60% for the quarter ended September 30, 2014. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2015. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statement of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest bearing deposits with banks consisted of FRB deposits. Deposits with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest bearing deposits with banks for the quarter ended September 30, 2015, were \$55.6 million, an increase of \$47.7 million compared to the average balance for the quarter ended September 30, 2014. Interest income on interest bearing deposits with banks for the quarter ended September 30, 2015, increased \$31,000 to \$36,000 compared to the quarter ended September 30, 2014.

Average interest-bearing liabilities increased \$163.4 million or 11.8% during the third quarter of 2015. Of that increase: (1) interest-bearing transaction deposits increased \$22.4 million; (2) savings and money market deposits increased \$78.6 million; (3) time deposits increased \$75.3 million; (4) Federal Home Loan Bank ("FHLB") Advances decreased \$12.9 million (see "Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings"); and (5) subordinated debt remained unchanged (see "Financial Condition – Subordinated Debentures").

Total interest expense on interest bearing deposits was \$777,000 for the third quarter of 2015 as compared to \$621,000 for the third quarter of 2014. The average rate paid on interest-bearing deposits was 0.20% for the third



quarter of 2015 compared to 0.18% for the third quarter of 2014.

40

---

## Table of Contents

### Nine Months Ending September 30, 2015 vs. Nine Months Ending September 30, 2014

During the first nine months of 2015, net interest income increased 11.5% to \$63.6 million, compared to \$57.1 million at September 30, 2014. On a fully taxable equivalent basis, net interest income increased 11.1% and totaled \$64.4 million at September 30, 2015, compared to \$58.0 million at September 30, 2014. The increase in net interest income was primarily due to a \$280.0 million increase in average earning assets.

For the nine months ended September 30, 2015, the Company's net interest margin was 3.84% compared to 3.96% for the same period in 2014. This decrease in net interest margin was due primarily to a decline in earning asset yields.

The average balance of loans & leases increased by \$307.7 million for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014. The yield on the loan & lease portfolio decreased 18 basis points to 4.54% for the nine months ended September 30, 2015 compared to 4.72% for the nine months ended September 30, 2014. This decrease in yield was offset by growth of average balance of loans resulting in interest income from loans & leases increasing 16.6% or \$8.5 million for the first nine months of 2015.

Average investment securities were \$399.5 million for the nine months ended September 30, 2015 compared to \$453.2 million for the same period in 2014. The average tax equivalent yield for the nine months ended September 30, 2015 was 2.37% compared to 2.58% for the nine months ended September 30, 2014. This decrease in yield, combined with the decrease in balances, resulted in a decrease in interest income of \$1.7 million or 19.0%, for the nine months ended September 30, 2015.

Average interest bearing deposits with banks consisted of FRB deposits. Deposits with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest bearing deposits with banks for the nine months ended September 30, 2015, was \$83.9 million, an increase of \$26.0 million compared to the average balance for the nine months ended September 30, 2014. Interest income on interest bearing deposits with banks for the nine months ended September 30, 2015, increased \$49,000 to \$159,000 compared to the nine months ended September 30, 2014.

Average interest-bearing liabilities increased \$170.6 million or 12.5% during the nine months ended September 30, 2015 as compared to the nine months ended September 30, 2014. Of that increase: (1) interest-bearing deposits increased \$175.2 million; (2) FHLB advances decreased \$4.6 million; and (3) subordinated debentures remained unchanged.

Total interest expense on interest bearing deposits was \$2.2 million for the first nine months of 2015 compared to \$1.8 million for the first nine months of 2014. The average rate paid on interest-bearing deposits was 0.20% in the first nine months of 2015 and 0.18% in the first nine months of 2014.

### Provision and Allowance for Credit Losses

As a financial institution that assumes lending and credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The Company has established credit management policies and procedures that govern both the approval of new loans & leases and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans & leases to one borrower (the term "borrower" is used herein to describe a customer who has entered into either a loan or lease transaction), and by restricting loans & leases made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc.

Management reports regularly to the Board of Directors regarding trends and conditions in the loan & lease portfolio and regularly conducts credit reviews of individual loans & leases. Loans & leases that are performing but have shown some signs of weakness are subject to more stringent reporting and oversight.



## Table of Contents

### Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance sheet date. The allowance is established through a provision for credit losses, which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components: specific reserves related to impaired loans & leases; general reserves for inherent losses related to loans & leases that are not impaired; and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Loans & leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

A restructuring of a loan or lease constitutes a troubled debt restructuring ("TDR") under ASC 310-40, if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. Restructured loans or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become a TDR, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment.

The determination of the general reserve for loans or leases that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors that include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan & lease portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1<sup>st</sup> mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer & other; and (9) equipment leases. See "Financial Condition – Loans & Leases" for examples of loans & leases made by the Company. The allowance for credit losses attributable to each portfolio segment, which includes both impaired loans & leases and loans & leases that are not impaired, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the

industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

42

---

### Table of Contents

Pass – A pass loan or lease is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan or lease has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or lease position at some future date. Special mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan or lease is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans or leases classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans or leases classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans or leases classified as loss are considered uncollectible. Once a loan or lease becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Bank will estimate its probable loss and immediately charge-off some or all of the balance.

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Real Estate Construction – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agricultural Real Estate and Agricultural – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related

real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Leases – Equipment leases are generally considered to possess a moderate inherent risk of loss. As Lessor, the company is subject to both the credit risk of the borrower and the residual value risk of the equipment. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

### Table of Contents

Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the correction in residential real estate values that occurred between 2007 and 2012. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Consumer & Other – A consumer installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

In addition, the Company's and Bank's regulators, including the FRB, DBO and FDIC, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

### Provision for Credit Losses

Changes in the provision for credit losses between years are the result of management's evaluation, based upon information currently available, of the adequacy of the allowance for credit losses relative to factors such as the credit quality of the loan & lease portfolio, loan & lease growth, current credit losses, and the prevailing economic climate and its effect on borrowers' ability to repay loans & leases in accordance with the terms of the notes.

The Central Valley of California was one of the hardest hit areas in the country during the recession. In many areas, housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has stabilized throughout most of the Central Valley, housing prices for the most part have not fully recovered and unemployment levels remain above those in other areas of the state and country. While, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of September 30, 2015, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

The state of California has experienced drought conditions since 2013. Although management continues to believe that current conditions will not have a material impact on credit quality during the 2015 growing season, the lack of rain continues to have an adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels begin to significantly deteriorate or riparian rights are further curtailed. See "Part II. Other Information, Item 1A. Risk Factors" for additional information.

The Company made a \$650,000 provision for credit losses during the first nine months of 2015 compared to no provision during the first nine months of 2014. Net recoveries during the first nine months of 2015 were \$3.0 million compared to net charge-offs of \$7,000 in the first nine months of 2014. During the first nine months of 2015 the Company was able to fully recover \$2.9 million that was charged-off during 2010 on a restructured commercial real estate loan. In addition to the full recovery of the charged off principal, this transaction also resulted in the recovery of \$353,000 in interest income and the client's payment of a financing fee of \$1.1 million. See "Overview – Looking Forward: 2015 and Beyond", "Critical Accounting Policies and Estimates – Allowance for Credit Losses" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" located in the Company's 2014 Annual Report on Form 10-K.



Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of September 30, 2015, was adequate.

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2015	September 30, 2014	September 30, 2015	September 30, 2014
Balance at Beginning of Period	\$39,037	\$34,290	\$35,401	\$34,274
Charge-Offs	(21 )	(61 )	(67 )	(204 )
Recoveries	74	38	3,106	197
Provision	-	-	650	-
Balance at End of Period	\$39,090	\$34,267	\$39,090	\$34,267

The table below breaks out year-to-date and current quarter activity by portfolio segment (in thousands):

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgage	Home Equity Lines & Loans	Agricultural Commercial	Consumer & Other	Leases	Unallocated	Total	
September 30, 2015											
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2015	\$7,842	\$4,185	\$1,669	\$1,022	\$2,426	\$6,104	\$8,195	\$218	\$2,211	\$1,529	\$35,401
Charge-Offs	-	-	-	-	-	-	(12 )	(55 )	-	-	(67 )
Recoveries	2,939	-	-	4	85	3	24	51	-	-	3,106
Provision	(1,536 )	3,295	719	(274 )	(356 )	(969 )	38	2	860	(1,129 )	650
Ending Balance- September 30, 2015	\$9,245	\$7,480	\$2,388	\$752	\$2,155	\$5,138	\$8,245	\$216	\$3,071	\$400	\$39,090
Third Quarter Allowance for Credit Losses:											
Beginning Balance- July 1, 2015	\$8,591	\$7,272	\$2,177	\$731	\$2,073	\$5,046	\$8,878	\$217	\$2,532	\$1,520	\$39,037
Charge-Offs	-	-	-	-	-	-	-	(21 )	-	-	(21 )
Recoveries	-	-	-	3	37	1	20	13	-	-	74
Provision	654	208	211	18	45	91	(653 )	7	539	(1,120 )	-
Ending Balance- September 30, 2015	\$9,245	\$7,480	\$2,388	\$752	\$2,155	\$5,138	\$8,245	\$216	\$3,071	\$400	\$39,090

The Allowance for Credit Losses at September 30, 2015 increased \$3.7 million from December 31, 2014. The allowance allocated to the following categories of loans did change materially during the first nine months of 2015:

While Commercial Real Estate allowance balances increased \$1.4 million primarily due to increased loan balances, a \$2.9 million recovery on a previously charged off loan resulted in a decrease of \$1.5 million in the required provision.

Agricultural Real Estate allowance balances increased \$3.3 million due to increased loan balances in this segment and increased qualitative factors in the Company's allowance calculation related to the longer-term impact of continuing drought conditions in California.

Real Estate Construction allowance balances increased \$719,000 or 43% due to increased construction lending activity.

See "Management's Discussion and Analysis - Financial Condition – Classified Loans & Leases and Non-Performing Assets" for further discussion regarding these loan categories.

See "Note 3. Allowance for Credit Losses" for additional details regarding the provision and allowance for credit losses.

#### Non-Interest Income

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) increases in the cash surrender value of bank owned life insurance; (4) debit card and ATM fees; (5) net gains and losses on non-qualified deferred compensation plans; and (6) fees from other miscellaneous business services.

Table of Contents

Third Quarter of 2015 vs. Third Quarter of 2014

Non-interest income increased \$790,000 or 27.1% for the three months ended September 30, 2015, compared to the same period of 2014. This increase was primarily due to: (1) a \$262,000 net gain on sale of investment securities; (2) a \$261,000 increase in net gain on deferred compensation investments; and (3) a \$430,000 increase in other non-interest income, primarily comprised of the gain on sale of our Sacramento branch building. This increase was partially offset by a \$182,000 decrease in service charges on deposit accounts related to the Company's overdraft privilege service.

Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

Nine Months Ending September 30, 2015 vs. Nine Months Ending September 30, 2014

Non interest income increased \$1.2 million or 11.7% for the nine months ended September 30, 2015 compared to the same period of 2014. This increase was primarily comprised of: (1) a \$1.1 million financing fee related to the full recovery of a loan previously charged off; (2) a \$284,000 increase in FHLB dividends as a result of the FHLB declaring a one-time special dividend; (3) a \$234,000 net gain on sale of investment securities; and (4) a \$392,000 gain on the sale of our Sacramento branch building. These increases were offset by: (1) a \$341,000 decrease in service charges on deposit accounts related to the Company's overdraft privilege service; and (2) a \$720,000 decrease in net gain on deferred compensation investments.

Non-Interest Expense

Non-interest expense for the Company includes expenses for: (1) salaries and employee benefits; (2) net gains and losses on non-qualified deferred compensation plan investments; (3) occupancy; (4) equipment; (5) ORE holding costs; (6) deposit insurance; (7) supplies; (8) legal fees; (9) professional services; (10) data processing; (11) marketing; and (12) other miscellaneous expenses.

Third Quarter of 2015 vs. Third Quarter of 2014

Overall, non-interest expense increased \$1.9 million or 15.5% for the three months ended September 30, 2015, compared to the same period in 2014. This increase was primarily comprised of: (1) a \$644,000 increase in salaries and employee benefits primarily related to new staff added for the Walnut Creek and Concord offices, increased contributions to employee benefit plans, and administrative officer raises; (2) a \$261,000 increase in net gain on deferred compensation investments; and (3) a \$584,000 increase in marketing, product development and promotional expenses related to the Company's expansion of its branch network in the bay area, development of deposit products, and the Bank's upcoming 100<sup>th</sup> anniversary.

Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

Nine Months Ending September 30, 2015 vs. Nine Months Ending September 30, 2014

Non-interest expense increased \$4.3 million or 11.4% for the nine months ended September 30, 2015, compared to the same period of 2014. This increase was primarily due to: (1) a \$2.9 million increase in salaries and employee benefits related to new staff added for the Walnut Creek and Concord offices, increased contributions to employee benefit plans, and administrative officer raises; (2) a \$757,000 increase in marketing, product development and promotional expenses related to the Company's expansion of its branch network in the bay area, development of deposit products, and the Bank's upcoming 100<sup>th</sup> anniversary; and (3) increased legal fee expense. These increases were partially offset by a \$720,000 decrease in net gain on deferred compensation investments for the first nine months of 2015 when compared to the same period in 2014.



## Table of Contents

### Income Taxes

The provision for income taxes increased 13.2% to \$4.4 million for the third quarter of 2015. The Company's effective tax rate was 38.2% for the third quarter of 2015 and 37.5% for the third quarter of 2014.

The provision for income taxes increased 13.1% to \$12.5 million for the first nine months of 2015. The Company's effective tax rate for the first nine months of 2015 was 38.2% compared to 37.0% for the same period in 2014.

The Company's effective tax rate fluctuates from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt earning sources. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance; California enterprise zone interest income exclusion; and tax-exempt interest income on municipal securities and loans.

Current tax law causes the Company's current taxes payable to approximate or exceed the current provision for taxes on the income statement. Three provisions have had a significant effect on the Company's current income tax liability: (1) the restrictions on the deductibility of loans & lease losses; (2) deductibility of retirement and other long-term employee benefits only when paid; and (3) the statutory deferral of deductibility of California franchise taxes on the Company's federal return.

### Financial Condition

This section discusses material changes in the Company's balance sheet at September 30, 2015, as compared to December 31, 2014 and to September 30, 2014. As previously discussed (see "Overview") the Company's financial condition can be influenced by the seasonal banking needs of its agricultural customers.

### Investment Securities and Federal Funds Sold

The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by US Treasury, government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, at certain times, the Company has selectively added investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities.

The Company's investment portfolio at September 30, 2015 was \$411.0 million compared to \$430.4 million at the end of 2014, a decrease of \$19.4 million or 4.5%. At September 30, 2014, the investment portfolio totaled \$405.9 million. Between September 29, 2015 and September 30, 2015, the Company purchased \$54.7 million of investment securities. These trades had not settled by September 30, 2015. Since the Company accounts for securities purchases and sales using trade date accounting, they are reflected on the quarter-end balance sheet, which resulted in a comparable increase in other liabilities at September 30, 2015. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company currently invests most of its available funds in either shorter term corporate, US Treasury, government agency & government-sponsored entity securities or shorter term (10, 15, and 20 year) mortgage-backed securities.

The Company's total investment portfolio currently represents 16.4% of the Company's total assets as compared to 18.2% at December 31, 2014, and 18.5% at September 30, 2014.

As of September 30, 2015 the Company held \$64.1 million of municipal investments, of which \$46.3 million were bank-qualified municipal bonds, all classified as HTM. In order to comply with Section 939A of the Dodd-Frank Act, the Company: (1) only invests in bonds rated AA or better; and (2) performs its own credit analysis on new purchases of municipal bonds. As of September 30, 2015, ninety-eight percent of the Company's bank-qualified municipal bond

portfolio is rated at either the issue or issuer level, and all of these ratings are “investment grade.” The Company monitors the status of all municipal investments with particular attention paid to the approximately two percent (\$839,000) of the portfolio that is not rated, and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

### Table of Contents

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consisted of FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest bearing deposits with banks totaled \$8.7 million at September 30, 2015, \$34.8 million at December 31, 2014 and \$4.9 million at September 30, 2014.

The Company classifies its investments as HTM, trading, or AFS. Securities are classified as HTM and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of September 30, 2015, December 31, 2014 and September 30, 2014, there were no securities in the trading portfolio. Securities classified as AFS include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

### Loans & Leases

Loans & leases can be categorized by borrowing purpose and use of funds. Common examples of loans & leases made by the Company include:

**Commercial and Agricultural Real Estate** - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties generally within our market area. Commercial mortgage term loans can be made if the property is either income producing or scheduled to become income producing based upon acceptable pre-leasing, and the income will be the Bank's primary source of repayment for the loan. Loans are made both on owner occupied and investor properties; generally do not exceed 10 years (and may have pricing adjustments on a shorter timeframe); have debt service coverage ratios of 1.00 or better with a target of greater than 1.25; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

**Real Estate Construction** - These are loans for development and construction (the Company generally requires the borrower to fund the land acquisition) and are secured by commercial or residential real estate. These loans are generally made only to experienced local developers with whom the Bank has a successful track record; for projects in our service area; with Loan To Value (LTV) below 75%; and where the property can be developed and sold within 2 years. Commercial construction loans are made only when there is a written take-out commitment from the Bank or an acceptable financial institution or government agency. Most acquisition, development and construction loans are tied to the prime rate or LIBOR with an appropriate spread based on the amount of perceived risk in the loan.

**Residential 1<sup>st</sup> Mortgages** - These are loans primarily made on owner occupied residences; generally underwritten to income and LTV guidelines similar to those used by FNMA and FHLMC; however, we will make loans on rural residential properties up to 40 acres. Most residential loans have terms from ten to twenty years and carry fixed rates priced off of treasury rates. The Company has always underwritten mortgage loans based upon traditional underwriting criteria and does not make loans that are known in the industry as "subprime," "no or low doc," or "stated income."

**Home Equity Lines and Loans** - These are loans made to individuals for home improvements and other personal needs. Generally, amounts do not exceed \$250,000; Combined Loan To Value (CLTV) does not exceed 80%; FICO scores are at or above 670; Total Debt Ratios do not exceed 43%; and in some situations the Company is in a 1<sup>st</sup> lien position.

Agricultural - These are loans and lines of credit made to farmers to finance agricultural production. Lines of credit are extended to finance the seasonal needs of farmers during peak growing periods; are usually established for periods no longer than 12 to 36 months; are often secured by general filing liens on livestock, crops, crop proceeds and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a processing plant, or orchard/vineyard development; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.



### Table of Contents

Commercial - These are loans and lines of credit to businesses that are sole proprietorships, partnerships, LLC's and corporations. Lines of credit are extended to finance the seasonal working capital needs of customers during peak business periods; are usually established for periods no longer than 12 to 24 months; are often secured by general filing liens on accounts receivable, inventory and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a plant or purchase of a business; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Consumer - These are loans to individuals for personal use, and primarily include loans to purchase automobiles or recreational vehicles, and unsecured lines of credit. The Company has a very minimal consumer loan portfolio, and loans are primarily made as an accommodation to deposit customers.

Leases - These are leases to businesses or individuals, for the purpose of financing the acquisition of equipment. They can be either "finance leases" where the lessee retains the tax benefits of ownership but obtains 100% financing on their equipment purchases; or "true tax leases" where the Company, as lessor, places reliance on equipment residual value and in doing so obtains the tax benefits of ownership. Leases typically have a maturity of three to ten years, and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

The Company accounts for leases with Investment Tax Credits (ITC) under the deferred method as established in ASC 740-10. ITC are viewed and accounted for as a reduction of the cost of the related assets and presented as deferred income on the Company's financial statement.

See "Item 3. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" for a discussion about the credit risks the Company assumes and its overall credit risk management practices.

Each loan or lease type involves risks specific to the: (1) borrower; (2) collateral; and (3) loan & lease structure. See "Results of Operations - Provision and Allowance for Credit Losses" for a more detailed discussion of risks by loan & lease type. The Company's current underwriting policies and standards are designed to mitigate the risks involved in each loan & lease type. The Company's policies require that loans & leases are approved only to those borrowers exhibiting a clear source of repayment and the ability to service existing and proposed debt. The Company's underwriting procedures for all loan & lease types require careful consideration of the borrower, the borrower's financial condition, the borrower's management capability, the borrower's industry, and the economic environment affecting the loan or lease.

Most loans & leases made by the Company are secured, but collateral is the secondary or tertiary source of repayment; cash flow is our primary source of repayment. The quality and liquidity of collateral are important and must be confirmed before the loan is made.

In order to be responsive to borrower needs, the Company prices loans & leases: (1) on both a fixed rate and adjustable rate basis; (2) over different terms; and (3) based upon different rate indices; as long as these structures are consistent with the Company's interest rate risk management policies and procedures (see Item 3. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk).

Overall, the Company's loan & lease portfolio at September 30, 2015 totaled \$1.9 billion, an increase of \$294.5 million or 18.2% over September 30, 2014. This increase has occurred despite the continuing sluggish economic conditions in the Central Valley of California and is a result of: (1) the Company's intensified business development

efforts directed toward credit-qualified borrowers; (2) entry into the equipment leasing business; and (3) expansion of our service area into Walnut Creek, Concord, and Irvine. No assurances can be made that this growth in the loan & lease portfolio will continue.

Table of Contents

Loans & leases at September 30, 2015 increased \$198.0 million from December 31, 2014, primarily as a result of strong growth in real estate segments offset to some extent by normal seasonal pay downs of loans made to the Company's agricultural customers.

The following table sets forth the distribution of the loan & lease portfolio by type and percent as of the periods indicated.

Loan & Lease Portfolio (in thousands)	September 30, 2015		December 31, 2014		September 30, 2014	
	\$	%	\$	%	\$	%
Commercial Real Estate	\$564,583	29.4 %	\$495,316	28.9 %	\$477,726	30.6 %
Agricultural Real Estate	432,610	22.6 %	357,207	20.8 %	364,161	24.1 %
Real Estate Construction	161,762	8.4 %	96,519	5.6 %	104,463	2.5 %
Residential 1st Mortgages	196,893	10.3 %	171,880	10.0 %	168,310	10.5 %
Home Equity Lines and Loans	31,833	1.7 %	33,017	1.9 %	33,283	2.9 %
Agricultural	249,783	13.0 %	281,963	16.4 %	237,521	16.5 %
Commercial	210,491	11.0 %	230,819	13.5 %	192,804	12.3 %
Consumer & Other	6,735	0.4 %	4,719	0.3 %	4,816	0.4 %
Leases	60,578	3.2 %	44,217	2.6 %	36,908	0.2 %
Total Gross Loans & Leases	1,915,268	100.0 %	1,715,657	100.0 %	1,619,992	100.0 %
Less: Unearned Income	4,998		3,413		4,221	
Subtotal	1,910,270		1,712,244		1,615,771	
Less: Allowance for Credit Losses	39,090		35,401		34,267	
Net Loans & Leases	\$1,871,180		\$1,676,843		\$1,581,504	

## Classified Loans &amp; Leases and Non-Performing Assets

All loans & leases are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See "Results of Operations - Provision and Allowance for Credit Losses" for more detail on risk grades. The Company utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans & leases and review the credit risk grades the Company places on loans & leases. Loans & leases that are judged to exhibit a higher risk profile are referred to as "classified loans & leases," and these loans & leases receive increased management attention. As of September 30, 2015, classified loans totaled \$6.0 million compared to \$3.6 million at December 31, 2014 and \$3.7 million at September 30, 2014.

Classified loans & leases with higher levels of credit risk can be further designated as "impaired" loans & leases. A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. See "Results of Operations - Provision and Allowance for Credit Losses" for further details. Impaired loans & leases consist of: (1) non-accrual loans & leases; and/or (2) restructured loans & leases that are still performing (i.e., accruing interest).

Non-Accrual Loans & Leases - Accrual of interest on loans & leases is generally discontinued when a loan or lease becomes contractually past due by 90 days or more with respect to interest or principal. When loans & leases are 90 days past due, but in management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan or lease is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans & leases is then recognized only to the extent that cash is received and where the future collection of principal is probable. As of September 30, 2015 non-accrual loans & leases totaled \$2.9 million. At December 31, 2014 and September 30, 2014, non-accrual loans totaled \$2.3 million and \$2.5 million, respectively.



Table of Contents

Restructured Loans & Leases - A restructuring of a loan or lease constitutes a TDR under ASC 310-40, if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR loans, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment.

As of September 30, 2015, restructured loans & leases on accrual totaled \$5.0 million as compared to \$5.0 million at December 31, 2014. Restructured loans on accrual at September 30, 2014 were \$4.5 million.

Other Real Estate - Loans where the collateral has been repossessed are classified as other real estate ("ORE") or, if the collateral is personal property, the loan is classified as other assets on the Company's financial statements.

The following table sets forth the amount of the Company's non-performing loans & leases (defined as non-accrual loans & leases plus accruing loans & leases past due 90 days or more) and ORE as of the dates indicated.

Non-Performing Assets

(in thousands)	September 30, 2015	Dec. 31, 2014	September 30, 2014
Non-Performing Loans & Leases	\$ 2,904	\$2,270	\$ 2,497
Other Real Estate	2,441	3,299	3,299
Total Non-Performing Assets	\$ 5,345	\$5,569	\$ 5,796
Non-Performing Loans & Leases as a % of Total Loans & Leases	0.15 %	0.13 %	0.15 %
Restructured Loans & Leases (Performing)	\$ 5,001	\$4,955	\$ 4,476

Although management believes that non-performing loans & leases are generally well-secured and that potential losses are provided for in the Company's allowance for credit losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. Specific reserves of \$755,000, \$940,000, and \$990,000 have been established for non-performing loans & leases at September 30, 2015, December 31, 2014 and September 30, 2014, respectively.

Foregone interest income on non-accrual loans & leases which would have been recognized during the period, if all such loans & leases had been current in accordance with their original terms, totaled \$100,000 for the nine months ended September 30, 2015, \$92,000 for the year ended December 31, 2014, and \$75,000 for the nine months ended September 30, 2014.

The Company reported \$2.4 million of ORE at September 30, 2015, and \$3.3 million at both December 31, 2014, and September 30, 2014. These values are all net of a reserve for ORE valuation adjustments in the amount of \$3.7 million at September 30, 2015, December 31, 2014, and September 30, 2014, respectively.

Except for those classified and non-performing loans & leases discussed above, the Company's management is not aware of any loans & leases as of September 30, 2015, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan or lease

repayment terms, or any known events that would result in the loan or lease being designated as non-performing at some future date. However:

51

---

## Table of Contents

The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has stabilized throughout most of the Central Valley, housing prices for the most part have not fully recovered and unemployment levels remain above those in other areas of the state and country.

The state of California has experienced drought conditions since 2013. Although management continues to believe that current conditions will not have a material impact on credit quality during the 2015 growing season, the lack of rain continues to have an adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels begin to significantly deteriorate or riparian rights are further curtailed. See "Part II. Other Information, Item 1A. Risk Factors" for additional information.

In addition to the other information set forth in this report, readers should carefully consider the factors discussed in "Part I, Item 1A. Risk Factors" in the Company's 2014 Annual Report on Form 10-K.

## Deposits

One of the key sources of funds to support earning assets is the generation of deposits from the Company's customer base. The ability to grow the customer base and subsequently deposits is a significant element in the performance of the Company.

The Company's deposit balances at September 30, 2015 have increased \$256.4 million or 13.7% compared to September 30, 2014. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Federal government's decision to permanently increase FDIC deposit insurance limits from \$100,000 to \$250,000 per depositor; (2) the Company's strong financial results and position and F&M Bank's reputation as one of the most safe and sound banks in its market territory; and (3) the Company's expansion of its service area into Walnut Creek, Concord, and Irvine. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 13.7% since September 30, 2014, the Company continues to focus on increasing low cost transaction and savings accounts:

- Demand and interest-bearing transaction accounts increased \$134.2 million or 15.9% since September 30, 2014.
- Savings and money market accounts have increased \$57.9 million or 9.4% since September 30, 2014.
- Time deposit accounts have increased \$64.4 million or 15.3% since September 30, 2014.

The Company's deposit balances at September 30, 2015 have increased \$68.6 million or 3.3% compared to December 31, 2014. Savings and money market deposits increased 4.3% or \$27.8 million while demand and interest-bearing transaction accounts increased by \$25.1 million or 2.6% and time deposit accounts increased by \$15.7 million or 3.3%. Deposit trends in the first nine months of the year can be impacted by the seasonal needs of our agricultural customers.

## Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings

Lines of credit with the Federal Reserve Bank and the Federal Home Loan Bank are other key sources of funds to support earning assets. These sources of funds are also used to manage the Company's interest rate risk exposure, and as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. FHLB Advances at September 30, 2015 were \$5.5 million and \$0 at December 31, 2014. FHLB advances were \$36.0 million at September 30, 2014. There were no Federal Funds purchased or advances from the FRB at September 30, 2015,

December 31, 2014 or September 30, 2014.

52

---



Table of Contents

As of September 30, 2015 the Company has additional borrowing capacity of \$319.1 million with the Federal Home Loan Bank and \$331.8 million with the Federal Reserve Bank. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

Long-Term Subordinated Debentures

On December 17, 2003, the Company raised \$10.0 million through an offering of trust-preferred securities (“TPS”). See Note 13 located in “Item 8. Financial Statements and Supplementary Data” of the Company’s 2014 Annual Report on Form 10-K. Although this amount is reflected as subordinated debt on the Company’s balance sheet, under current regulatory guidelines, our TPS will continue to qualify as regulatory capital (See “Basel III Regulatory Capital Rules”). These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly and were 3.18% at September 30, 2015, 3.09% at December 31, 2014 and 3.08% at September 30, 2014. The average rate paid for these securities for the first nine months of 2015 was 3.16% compared to 3.14% for the first nine months of 2014. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company’s common stock.

Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders’ Equity totaled \$251.1 million at September 30, 2015, \$233.2 million at December 31, 2014, and \$227.2 million at September 30, 2014.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain actions by regulators that, if undertaken, could have a material effect on the Company and the Bank’s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company’s and the Bank’s assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company’s and the Bank’s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios set forth in the table below (all terms as defined in the regulations). As of September 30, 2015, that the Company and the Bank exceeded all capital adequacy requirements to which they are subject.

In its most recent notification from the FDIC the Bank was categorized as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” the Bank must maintain certain ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed the institution’s categories.

(in thousands)	Actual		Regulatory Capital Requirements		To Be Well Capitalized Under Prompt Corrective Action Provisions	
					Amount	Ratio
The Company:						
As of September 30, 2015						
Total Capital Ratio	\$287,718	12.24%	\$187,999	8.0 %	N/A	N/A

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Common Equity Tier 1 Capital Ratio	\$258,221	10.99%	\$105,749	4.5 %	N/A	N/A
Tier 1 Capital Ratio	\$258,221	10.99%	\$140,999	6.0 %	N/A	N/A
Tier 1 Leverage Ratio	\$258,221	10.44%	\$98,953	4.0 %	N/A	N/A

53

---

Table of Contents

(in thousands)	Actual		Regulatory		To Be Well	
			Capital Requirements		Capitalized Under Prompt Corrective Action Provisions	
The Bank:	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of September 30, 2015						
Total Capital Ratio	\$287,643	12.24%	\$187,987	8.0 %	\$234,984	10.0 %
Common Equity Tier 1 Capital Ratio	\$258,148	10.99%	\$105,743	4.5 %	\$152,740	6.5 %
Tier 1 Capital Ratio	\$258,148	10.99%	\$140,991	6.0 %	\$187,987	8.0 %
Tier 1 Leverage Ratio	\$258,148	10.44%	\$98,922	4.0 %	\$123,653	5.0 %

As previously discussed (see “Long-Term Subordinated Debentures”), in order to supplement its regulatory capital base, during December 2003 the Company issued \$10 million of trust preferred securities. On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities (“TPS”) by bank holding companies (“BHCs”). Under the final rule BHCs may include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. Any portion of trust-preferred securities not qualifying as Tier 1 capital would qualify as Tier 2 capital subject to certain limitations. The Company has received notification from the Federal Reserve Bank of San Francisco that all of the Company’s trust preferred securities currently qualify as Tier 1 capital.

The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability.

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on August 11, 2015, the Board of Directors approved an extension of the \$20 million stock repurchase program over the three-year period ending September 30, 2018. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2014 Annual Report on Form 10-K for additional information.

There were no stock repurchases during the first nine months of 2015 or 2014. The remaining dollar value of shares that may yet be purchased under the Company’s Common Stock Repurchase Plan is approximately \$20 million.

On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Computershare (formerly Registrar and Transfer Company) as Rights Agent. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2014 Annual Report on Form 10-K for further explanation.

In January, 2015, the Company issued 1,700 shares of common stock and in September, 2015, the Company issued 3,200 shares of common stock. All of these shares were contributed to the Bank’s non-qualified defined contribution retirement plans. The shares issued in January had a price of \$450 per share and the shares issued in September had a price of \$515 per share. These share prices were based upon valuations completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, the regulations promulgated thereunder. The proceeds from these issuances were contributed to the Bank as equity capital.

## Basel III Regulatory Capital Rules

Both the FRB and FDIC have approved final rules that substantially amend the regulatory risk-based capital rules previously applicable to the Company and the Bank. These rules would implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

Table of Contents

The final rules include new minimum risk-based capital and leverage ratios, which would be phased in over time. The new minimum capital level requirements applicable to the Company and the Bank under the final rules will be: (i) a common equity Tier 1 capital ratio of 4.5% of Risk Weighted Assets (“RWA”); (ii) a Tier 1 capital ratio of 6% of RWA; (iii) a total capital ratio of 8% of RWA; and (iv) a Tier 1 leverage ratio of 4% of total assets. The final rules also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios, which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0% of RWA; (ii) a Tier 1 capital ratio of 8.5% of RWA, and (iii) a total capital ratio of 10.5% of RWA. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount.

The final rules also implement other revisions to the current capital rules but, in general, those revisions are not as onerous as originally thought when the proposed rules were issued in September 2012. For instance, the Company’s subordinated debentures will continue to qualify for Tier 1 under the rules. The Company believes that it is currently in compliance with all of these new capital requirements (as fully phased-in) and that they will not result in any restrictions on the Company’s business activity.

Critical Accounting Policies and Estimates

This “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing the Company’s financial statements management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. These judgments govern areas such as the allowance for credit losses, the fair value of financial instruments and accounting for income taxes.

For a full discussion of the Company’s critical accounting policies and estimates see “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations” in the Company’s 2014 Annual Report on Form 10-K.

Off Balance Sheet Commitments

In the normal course of business the Company enters into financial instruments with off balance sheet risks in order to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit, letters of credit and other types of financial guarantees. The Company had the following off balance sheet commitments as of the dates indicated.

(in thousands)	September 30, 2015	December 31, 2014	September 30, 2014
Commitments to Extend Credit	\$ 743,030	\$ 539,288	\$ 543,595
Letters of Credit	13,919	9,734	7,470
Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties	3,665	2,042	263

The Company's exposure to credit loss in the event of nonperformance by the other party with regard to standby letters of credit, undisbursed loan commitments, and financial guarantees is represented by the contractual notional amount of those instruments. 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. The Company uses the same credit policies in making commitments and conditional obligations as it does for recorded balance sheet items. The Company may or may not require collateral or other security to support financial instruments with credit risk. Evaluations of each customer's creditworthiness are performed on a case-by-case basis.

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Most standby letters of credit are issued for 18 months or less. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Additionally, the Company

maintains a reserve for off balance sheet commitments which totaled \$167,000 at September 30, 2015 and \$142,000 at December 31, 2014 and September 30, 2014. We do not anticipate any material losses as a result of these transactions.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Risk Management

The Company has adopted risk management policies and procedures, which aim to ensure the proper control and management of all risk factors inherent in the operation of the Company, most importantly credit risk, interest rate risk and liquidity risk. These risk factors are not mutually exclusive. It is recognized that any product or service offered by the Company may expose the Company to one or more of these risk factors.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance.

Credit risk in the investment portfolio and correspondent bank accounts is addressed through defined limits in the Company's policy statements. In addition, certain securities carry insurance to enhance credit quality of the bond.

In order to control credit risk in the loan & lease portfolio the Company has established credit management policies and procedures that govern both the approval of new loans & leases and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans & leases to one borrower, and by restricting loans & leases made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. However, as a financial institution that assumes credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The allowance for credit losses is maintained at a level considered by management to be adequate to provide for risks inherent in the loan & lease portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs.

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans & leases. The systematic methodology consists of three parts.

Part 1 - includes a detailed analysis of the loan & lease portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB ASC. Individual loans & leases are reviewed to identify them for impairment. A loan or lease is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan or lease. Impairment is measured as either the expected future cash flows discounted at each loan's or lease's effective interest rate, the fair value of the loan's or lease's collateral if the loan or lease is collateral dependent, or an observable market price of the loan or lease, if one exists. Upon measuring the impairment, the Company will ensure an appropriate level of allowance is present or established.

Central to the first phase of the analysis of the loan & lease portfolio is the risk rating system. The originating credit officer assigns each borrower an initial risk rating, which is based primarily on a thorough analysis of that borrower's financial position in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior credit administration personnel. Credits are monitored by credit administration personnel for deterioration in a borrower's financial condition, which would impact the ability of the borrower to perform under the contract. Risk ratings are adjusted as necessary. Risk ratings are reviewed by both the Company's independent third-party credit examiners and bank examiners from the DBO and FDIC.

Based on the risk rating system, specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicates that the loan or lease is

impaired and there is a probability of loss. Management performs a detailed analysis of these loans & leases, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral, and assessment of the guarantors. Management then determines the inherent loss potential and allocates a portion of the allowance for losses as a specific allowance for each of these credits.



### Table of Contents

The second phase is conducted by segmenting the loan & lease portfolio by risk rating and into groups of loans & leases with similar characteristics in accordance with the “Contingency” topic of the FASB ASC. In this second phase, groups of loans & leases with similar characteristics are reviewed and the appropriate allowance factor is applied based on the historical average charge-off rate for each particular group of loans or leases.

Part 2 - considers qualitative internal and external factors that may affect a loan or lease’s collectability, is based upon management’s evaluation of various conditions, the effects of which are not directly measured in the determination of the historical and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the second element of the analysis of the allowance include, but are not limited to the following conditions that existed as of the balance sheet date:

- § general economic and business conditions affecting the key service areas of the Company;
- § credit quality trends (including trends in collateral values, delinquencies and non-performing loans & leases);
- § loan & lease volumes, growth rates and concentrations;
- § loan & lease portfolio seasoning;
- § specific industry and crop conditions;
- § recent loss experience; and
- § duration of the current business cycle.

Part 3 - An unallocated allowance often occurs due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the continuing sluggish economic conditions in the Central Valley; and (2) the long term impact of drought conditions currently being experienced in California.

Management reviews all of these conditions in discussion with the Company’s senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management’s estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management’s evaluation of the inherent loss related to such condition is reflected in the second element of the allowance or in the unallocated allowance.

Management believes, that based upon the preceding methodology, and using information currently available, the allowance for credit losses at September 30, 2015 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans & leases, or net loan & lease charge-offs that would require increases in the provision for credit losses and thereby adversely affect the results of operations.

### Interest Rate Risk

The mismatch between maturities of interest bearing assets and liabilities results in uncertainty in the Company’s earnings and economic value and is referred to as interest rate risk. The Company does not attempt to predict interest rates and positions the balance sheet in a manner, which seeks to minimize, to the extent possible, the effects of changing interest rates.

The Company measures interest rate risk in terms of potential impact on both its economic value and earnings. The methods for governing the amount of interest rate risk include: (1) analysis of asset and liability mismatches (Gap analysis); (2) the utilization of a simulation model; and (3) limits on maturities of investment, loan & lease, and deposit and borrowing products, which reduces the market volatility of those instruments.

The Gap analysis measures, at specific time intervals, the divergence between earning assets and interest-bearing liabilities for which repricing opportunities will occur. A positive difference, or Gap, indicates that earning assets will reprice faster than interest-bearing liabilities. This will generally produce a greater net interest margin during periods

of rising interest rates and a lower net interest margin during periods of declining interest rates. Conversely, a negative Gap will generally produce a lower net interest margin during periods of rising interest rates and a greater net interest margin during periods of decreasing interest rates.

### Table of Contents

The interest rates paid on interest bearing liabilities do not always move in unison with the rates charged on loans & leases. In addition, the magnitude of changes in the rates charged on loans & leases is not always proportionate to the magnitude of changes in the rate paid for interest bearing liabilities. Consequently, changes in interest rates do not necessarily result in an increase or decrease in the net interest margin solely as a result of the differences between repricing opportunities of earning assets or interest-bearing liabilities.

The Company also utilizes the results of a dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. The sensitivity of the Company's net interest income is measured over a rolling one-year horizon.

The simulation model estimates the impact of changing interest rates on interest income from all interest-earning assets and the interest expense paid on all interest-bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 100 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At September 30, 2015, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an increase in net interest income of 2.93% if rates increase by 200 basis points and a decrease in net interest income of 0.54% if rates decline 100 basis points. Comparatively, at December 31, 2014, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an increase in net interest income of 2.98% if rates increase by 200 basis points and a decrease in net interest income of 0.17% if rates decline 100 basis points.

The estimated sensitivity does not necessarily represent a Company forecast and the results may not be indicative of actual changes to the Company's net interest income. These estimates are based upon a number of assumptions including: the nature and timing of interest rate levels including yield curve shape; prepayments on loans & leases and securities; pricing strategies on loans & leases and deposits; replacement of asset and liability cash flows; and other assumptions. While the assumptions used are based on current economic and local market conditions, there is no assurance as to the predictive nature of these conditions including how customer preferences or competitor influences might change.

### Liquidity Risk

Liquidity risk is the risk to earnings or capital resulting from the Company's inability to meet its obligations when they come due without incurring unacceptable losses. It includes the ability to manage unplanned decreases or changes in funding sources and to recognize or address changes in market conditions that affect the Company's ability to liquidate assets or acquire funds quickly and with minimum loss of value. The Company endeavors to maintain a cash flow adequate to fund operations, handle fluctuations in deposit levels, respond to the credit needs of borrowers, and to take advantage of investment opportunities as they arise.

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows" of the Company's 2014 Annual Report on Form 10-K) cash and cash equivalents, cash provided by operating activities, principal payments on loans & leases, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of \$71.0 million and repurchase lines of \$100.0 million with major banks. As of September 30, 2015 the Company has additional borrowing capacity of \$319.1 million with the FHLB and \$331.8 million with the FRB. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

At September 30, 2015, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities AFS of approximately \$190 million, which represents 9.58% of total assets.



Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported on a timely basis. Disclosure controls are also designed to reasonably assure that such information is communicated to the Company’s management, including its Chief Executive Officer and its Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

As of the end of the period covered by this report, the Company carried out an evaluation of the effectiveness of Company’s disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer, the Chief Financial Officer and other senior management of the Company. Based on this evaluation, the Company’s Chief Executive Officer and the Chief Financial Officer concluded that the Company’s disclosure controls and procedures were effective.

During the quarter ended September 30, 2015, there were no changes in the Company’s internal controls or in other factors that have materially affected or are reasonably likely to materially affect the Company’s internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

Certain lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Company or its subsidiaries. Based upon information available to the Company, its review of such lawsuits and claims and consultation with its counsel, the Company believes the liability relating to these actions, if any, would not have a material adverse effect on its consolidated financial statements.

There are no material proceedings adverse to the Company to which any director, officer or affiliate of the Company is a party.

ITEM 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed under “Item 1A. Risk Factors” in the Company’s 2014 Annual Report to Shareholders on Form 10-K except for the risks described below.

Our Financial Results Can Be Impacted By The Cyclicity and Seasonality Of Our Agricultural Business And The Risks Related Thereto - The Company has provided financing to agricultural customers in the Central Valley throughout its history. We recognize the cyclical nature of the industry, often caused by fluctuating commodity prices and changing climatic conditions, and manage these risks accordingly. The Company remains committed to providing credit to agricultural customers and will always have a material exposure to this industry. Although the Company’s loan portfolio is believed to be well diversified, at various times during the first nine months of 2015 approximately 37% of the Company’s loan balances were outstanding to agricultural borrowers. Commitments are well diversified across various commodities, including dairy, grapes, walnuts, almonds, cherries, apples, pears, and various row crops. Additionally, many individual borrowers are themselves diversified across commodity types, reducing their exposure, and therefore the Company’s, to cyclical downturns in any one commodity.

The State of California has experienced drought conditions since 2013 and the farming belt of the Central Valley is often cited as an example of an area experiencing extreme drought. However, it is important to understand that not all areas of the state have been impacted equally, and this is particularly true in the Central Valley, which stretches some

450 miles from Bakersfield in the south to Redding in the north. The vast majority of the Company's agricultural customers are located in the more northern portion of the Central Valley, an area that benefits from the drainage of the Sacramento, American, Mokelumne and Stanislaus rivers. As a result, at the current time farmers in this area still have access to reasonable ground water sources that are economical to pump.

### Table of Contents

In addition to pumping water from ground water sources, many of our agricultural customers have senior riparian water rights which provide them the legal right to access surface water from the rivers that abut their property. In the spring of 2015 the State of California took the extreme step of threatening to curtail certain riparian water rights for those farmers taking water from the Delta, and as a result affected growers agreed to voluntarily cutback 25% of their normal water usage as opposed to undertaking a protracted legal fight. Even with these cutbacks, at the current time our agricultural customers still have access to sufficient levels of water to satisfy their needs.

Importantly, the Company has minimal credit exposure in the more southern portion of the Central Valley, defined broadly as an area south of Highway 152, but more importantly the Fresno area and south (including the Westlands Water District). In most of these areas ground water levels have been depleted, making farmers increasingly dependent on the delivery of surface water from the Central Valley Project, which has already begun cutting back deliveries to many farmers.

In order to monitor this situation the Company (i) regularly reviews ground water level reports provided by California's Department of Water Resources, (ii) requires water budgets and plans from all of our agricultural borrowers that detail the sources of their irrigation water and the irrigation requirements to achieve their crop plan; and (iii) in the case of new permanent crop development projects, requires well tests.

Although management continues to believe that current conditions will not have a material impact on credit quality during the 2015 growing season, the lack of rain continues to have an adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels begin to significantly deteriorate or riparian rights are further curtailed.

The Company's service areas can also be significantly impacted by the seasonal operations of the agricultural industry. As a result, the Company's financial results can be influenced by the banking needs of its agricultural customers (e.g., generally speaking during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and the planting of crops. Correspondingly, deposit balances are replenished and loans repaid in late fall and winter as crops are harvested and sold).

### ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

There were no shares repurchased by Farmers & Merchants Bancorp during the first nine months of 2015. The remaining dollar value of shares that may yet be purchased under the Company's Stock Repurchase Plan is approximately \$20.0 million.

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades are reported on the OTCQX (prior to January 12, 2015, the Over the Counter ("OTC") Bulletin Board) under the symbol "FMCB." Additionally, management is aware that there are private transactions in the Company's common stock.

In January, 2015, the Company issued 1,700 shares of common stock and in September, 2015, the Company issued 3,200 shares of common stock. All of these shares were contributed to the Bank's non-qualified defined contribution retirement plans. The shares issued in January had a price of \$450 per share and the shares issued in September had a price of \$515 per share. These share prices were based upon valuations completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, the regulations promulgated thereunder. The proceeds from these issuances were contributed to the Bank as equity capital.

### ITEM 3. Defaults Upon Senior Securities

Not applicable





Table of Contents

ITEM 4. Mine Safety Disclosures

Not applicable

ITEM 5. Other Information

None

ITEM 6. Exhibits

See “Index to Exhibits”

SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FARMERS & MERCHANTS BANCORP

Date: November 6, 2015 /s/ Kent A. Steinwert  
Kent A. Steinwert  
Chairman, President  
& Chief Executive Officer  
(Principal Executive Officer)

Date: November 6, 2015 /s/ Stephen W. Haley  
Stephen W. Haley  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial & Accounting Officer)

Table of Contents

Index to Exhibits

<u>Exhibit No.</u>	<u>Description</u>
<u>31(a)</u>	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>31(b)</u>	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>32</u>	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document
101.DEF	XBRL Definition Linkbase Document