MERCANTILE BANK CORP
Form 10-Q
May 07, 2018

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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2018

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from to .

Commission File No. 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

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

310 Leonard Street, NW, Grand Rapids, MI 49504

(Address of principal executive offices) (Zip Code)

(616) 406-3000

(Registrant's telephone number, including area code)

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

Yes X 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 X No ___

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ___ Accelerated filer X
Non-accelerated filer ___ Smaller reporting company __
Emerging growth company ___

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

Yes ___ No ___

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

Yes ___ No X

At April 30, 2018, there were 16,598,027 shares of common stock outstanding.

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MERCANTILE BANK CORPORATION

PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

	March 31, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$47,278,000	$55,127,000
Interest-earning deposits	163,879,000	144,974,000
Total cash and cash equivalents	211,157,000	200,101,000
Securities available for sale	336,988,000	335,744,000
Federal Home Loan Bank stock	11,036,000	11,036,000
Loans	2,551,204,000	2,558,552,000
Allowance for loan losses	(19,974,000)	(19,501,000)
Loans, net	2,531,230,000	2,539,051,000
Premises and equipment, net	46,300,000	46,034,000
Bank owned life insurance	69,010,000	68,689,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	7,044,000	7,600,000
Other assets	31,662,000	28,976,000
Total assets	$3,293,900,000	$3,286,704,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	$830,187,000	$866,380,000
Interest-bearing	1,709,866,000	1,655,985,000
Total deposits	2,540,053,000	2,522,365,000
Securities sold under agreements to repurchase	104,894,000	118,748,000
Federal Home Loan Bank advances	220,000,000	220,000,000
Subordinated debentures	45,688,000	45,517,000

Accrued interest and other liabilities	14,925,000	14,204,000
Total liabilities	2,925,560,000	2,920,834,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized; none issued	0	0
Common stock, no par value; 40,000,000 shares authorized; 16,598,466 shares outstanding at March 31, 2018 and 16,592,125 shares outstanding at December 31, 2017	310,601,000	309,772,000
Retained earnings	68,241,000	61,001,000
Accumulated other comprehensive income (loss)	(10,502,000)	(4,903,000)
Total shareholders' equity	368,340,000	365,870,000
Total liabilities and shareholders' equity	$3,293,900,000	$3,286,704,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
Interest income		
Loans, including fees	$32,315,000	$26,733,000
Securities, taxable	1,602,000	1,278,000
Securities, tax-exempt	594,000	550,000
Other interest-earning assets	470,000	143,000
Total interest income	34,981,000	28,704,000
Interest expense		
Deposits	3,085,000	1,868,000
Short-term borrowings	57,000	51,000
Federal Home Loan Bank advances	945,000	655,000
Subordinated debentures and other borrowings	695,000	621,000
Total interest expense	4,782,000	3,195,000
Net interest income	30,199,000	25,509,000
Provision for loan losses	0	600,000
Net interest income after provision for loan losses	30,199,000	24,909,000
Noninterest income		
Service charges on deposit and sweep accounts	1,053,000	1,018,000
Credit and debit card income	1,243,000	1,106,000
Mortgage banking income	884,000	1,123,000
Earnings on bank owned life insurance	331,000	1,738,000
Other income	870,000	866,000
Total noninterest income	4,381,000	5,851,000
Noninterest expense		
Salaries and benefits	12,337,000	11,272,000
Occupancy	1,772,000	1,554,000
Furniture and equipment depreciation, rent and maintenance	548,000	535,000

Data processing costs	2,128,000	2,011,000
Other expense	4,362,000	4,404,000
Total noninterest expenses	21,147,000	19,776,000
Income before federal income tax expense	13,433,000	10,984,000
Federal income tax expense	2,552,000	3,369,000
Net income	$10,881,000	$7,615,000
Basic earnings per share	$0.66	$0.46
Diluted earnings per share	$0.66	$0.46
Cash dividends per share	$0.22	$0.18
Average basic shares outstanding	16,595,115	16,434,647
Average diluted shares outstanding	16,604,325	16,449,210

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
Net income	$10,881,000	$7,615,000
Other comprehensive income (loss):		
Unrealized holding gains (losses) on securities available for sale	(7,142,000)	980,000
Fair value of interest rate swap	2,000	42,000
Total other comprehensive income (loss)	(7,140,000)	1,022,000
Tax effect of unrealized holding gains (losses) on securities available for sale	1,500,000	(343,000)
Tax effect of fair value of interest rate swap	(1,000)	(15,000)
Total tax effect of other comprehensive income	1,499,000	(358,000)
Other comprehensive income (loss), net of tax effect	(5,641,000)	664,000
Comprehensive income	$5,240,000	$8,279,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY

(Unaudited)

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2018	$ 0	$309,772	$61,001	$ (4,903)	$ 365,870
Reclassification of equity securities related to ASU 2016-01 adoption			(42)	42	0
Employee stock purchase plan (426 shares)		14			14
Dividend reinvestment plan (4,624 shares)		164			164
Stock option exercises (7,000 shares)		54			54
Stock-based compensation expense		597			597
Cash dividends ($0.22 per common share)			(3,599)		(3,599)
Net income for the three months ended March 31, 2018			10,881		10,881
Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect				(5,642)	(5,642)
Change in fair value of interest rate swap, net of tax effect				1	1
Balances, March 31, 2018	$ 0	$310,601	$68,241	$ (10,502)	$ 368,340

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF

CHANGES IN SHAREHOLDERS' EQUITY (Continued)

(Unaudited)

($ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balances, January 1, 2017	$ 0	$305,488	$40,904	$ (5,581)	$ 340,811
Employee stock purchase plan (338 shares)		12			12
Dividend reinvestment plan (35,319 shares)		1,145			1,145
Stock option exercises (20,000 shares)		248			248
Stock grant for director fees (62 shares)		2			2
Stock-based compensation expense		476			476
Cash dividends ($0.18 per common share)			(2,923)		(2,923)
Net income for the three months ended March 31, 2017			7,615		7,615
Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect				637	637
Change in fair value of interest rate swap, net of tax effect				27	27
Balances, March 31, 2017	$ 0	$307,371	$45,596	$ (4,917)	$ 348,050

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
Cash flows from operating activities		
Net income	$10,881,000	$7,615,000
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	2,483,000	2,548,000
Accretion of acquired loans	(357,000)	(483,000)
Provision for loan losses	0	600,000
Stock-based compensation expense	597,000	476,000
Stock grants to directors for retainer fees	0	2,000
Proceeds from sales of mortgage loans held for sale	21,010,000	19,317,000
Origination of mortgage loans held for sale	(19,585,000)	(19,342,000)
Net gain from sales of mortgage loans held for sale	(736,000)	(867,000)
Net gain from sales and valuation write-downs of foreclosed assets	(105,000)	(43,000)
Net loss from sales and valuation write-downs of former bank premises	99,000	15,000
Net loss from sales and write-downs of fixed assets	53,000	40,000
Earnings on bank owned life insurance	(331,000)	(1,738,000)
Net change in:		
Accrued interest receivable	(820,000)	(828,000)
Other assets	(866,000)	(321,000)
Accrued interest and other liabilities	722,000	980,000
Net cash from operating activities	13,045,000	7,971,000
Cash flows from investing activities		
Loan originations and payments, net	7,257,000	(61,701,000)
Purchases of securities available for sale	(13,303,000)	(14,701,000)
Proceeds from maturities, calls and repayments of securities available for sale	4,609,000	10,858,000
Purchases of Federal Home Loan Bank stock	0	(1,210,000)
Proceeds from sales of foreclosed assets	410,000	99,000
Proceeds from bank owned life insurance cash value release and death benefits	0	2,720,000
Net purchases of premises and equipment	(1,429,000)	(1,138,000)
Net cash for investing activities	(2,456,000)	(65,073,000)
Cash flows from financing activities		
Net decrease in time deposits	(8,412,000)	(55,203,000)

Net increase (decrease) in all other deposits	26,100,000	(41,766,000)
Net decrease in securities sold under agreements to repurchase	(13,854,000)	(5,031,000)
Maturities of Federal Home Loan Bank advances	0	(10,000,000)
Proceeds from Federal Home Loan Bank advances	0	40,000,000
Proceeds from stock option exercises	54,000	248,000
Employee stock purchase plan	14,000	12,000
Dividend reinvestment plan	164,000	1,145,000
Payment of cash dividends to common shareholders	(3,599,000)	(2,923,000)
Net cash from (for) financing activities	467,000	(73,518,000)
Net change in cash and cash equivalents	11,056,000	(130,620,000)
Cash and cash equivalents at beginning of period	200,101,000	183,596,000
Cash and cash equivalents at end of period	$211,157,000	$52,976,000

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(Unaudited)

	Three Months Ended March 31, 2018	Three Months Ended March 31, 2017
Supplemental disclosures of cash flows information		
Cash paid during the period for:		
Interest	$4,529,000	$3,322,000
Federal income tax	0	0
Noncash financing and investing activities:		
Transfers from loans to foreclosed assets	232,000	97,000
Transfers from bank premises to other real estate owned	296,000	0

See accompanying notes to condensed consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three months ended March 31, 2018 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ("our bank") and our bank's two subsidiaries, Mercantile Bank Real Estate Co., LLC ("our real estate company") and Mercantile Insurance Center, Inc. ("our insurance center"). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the period ended March 31, 2018 should not be considered as indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2017.

We have five separate business trusts that were formed to issue trust preferred securities. Subordinated debentures were issued to the trusts in return for the proceeds raised from the issuance of the trust preferred securities. The trusts are not consolidated, but instead we report the subordinated debentures issued to the trusts as a liability.

Earnings Per Share: Basic earnings per share is based on the weighted average number of common shares and participating securities outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under our stock-based compensation plans and are determined using the treasury stock method. Our unvested restricted shares, which contain non-forfeitable rights to dividends whether paid or accrued (i.e., participating securities), are included in the number of shares outstanding for both basic and diluted earnings per share calculations. In the event of a net loss, our unvested restricted shares are excluded from the calculation of both basic and diluted earnings per share.

Approximately 236,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2018. In addition, stock options for approximately 17,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2018. Stock options for approximately 7,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2018.

Approximately 225,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three months ended March 31, 2017. In addition, stock options for approximately 34,000 shares of common stock were included in determining diluted earnings per share for the three months ended March 31, 2017. Stock options for approximately 7,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three months ended March 31, 2017.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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

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

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

(Continued)

MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. As of March 31, 2018 and December 31, 2017, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of $1.9 million and $2.6 million, respectively. Loans held for sale are reported as part of our total loans on the balance sheet.

Mortgage loans held for sale are generally sold with servicing rights retained. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold, which is reduced by the cost allocated to the servicing right. We generally lock in the sale price to the purchaser of the loan at the same time we make a rate commitment to the borrower. These mortgage banking activities are not designated as hedges and are carried at fair value. The net gain or loss on mortgage banking derivatives is included in the gain on sale of loans. Mortgage loans serviced for others totaled approximately $611 million as of March 31, 2018.

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses: The allowance for loan losses ("allowance") is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when we believe the uncollectability of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. We estimate the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in our judgment, should be charged-off.

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill and Core Deposit Intangible: Goodwill results from business acquisitions and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. The quantitative test is a two-step process consisting of comparing the carrying value of the reporting unit to an estimate of its fair value. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2016 and 2017, we elected to perform a qualitative assessment for our annual impairment test and concluded it is more likely than not our fair value was greater than its carrying amount; therefore, no further testing was required.

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

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

Our primary sources of revenue are derived from interest and dividends earned on loans, securities and other financial instruments that are not within the scope of Topic 606. We have evaluated the nature of our contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Condensed Consolidated Statements of Income was not necessary. We generally satisfy our performance obligations on contracts with customers as services are rendered, and the transaction prices are typically fixed and charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is little judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Adoption of New Accounting Standards: In May 2014, the FASB issued ASU 2014-09, *Revenue from Contracts with Customers*. This ASU establishes a comprehensive revenue recognition standard for virtually all industries under U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The revenue standard’s core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. We adopted this ASU effective January 1, 2018 using the modified retrospective approach.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. **SIGNIFICANT ACCOUNTING POLICIES** (Continued)

Adoption of ASU 2014-09 did not have a material impact on our consolidated financial statements and related disclosures as the primary sources of revenues are derived from interest and dividends earned on loans, securities and other financial instruments that are not within the scope of the new standard. Our revenue recognition pattern for revenue streams within the scope of the new standard, including but not limited to service charges on deposit accounts, credit and debit card interchange fees and payroll service income, did not change significantly from prior practice. The modified retrospective method requires application of ASU 2014-09 to uncompleted contracts at the date of adoption; however, periods prior to the date of adoption have not been retrospectively revised as the impact of the new standard on uncompleted contracts as the date of adoption was not material, and therefore a cumulative effective adjustment to opening retained earnings was not deemed necessary.

In January 2016, the FASB issued ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU requires an entity to (i) measure equity investments at fair value through net income, with certain exceptions; (ii) present in OCI the changes in instrument-specific credit risk for financial liabilities measured using the fair value option; (iii) present financial assets and financial liabilities by measurement category and form of financial asset; (iv) calculate the fair value of financial instruments for disclosure purposes based on an exit price; and (v) assess a valuation allowance on deferred tax assets related to unrealized losses on available for sale debt securities in combination with other deferred tax assets. This ASU provides an election to subsequently measure certain nonmarketable equity investments at cost less any impairment and adjusted for certain observable price changes. This ASU also requires a qualitative impairment assessment of such equity investments and amends certain fair value disclosure requirements. Our adoption of this ASU effective January 1, 2018 did not have a material effect on our financial position or results of operations. The adoption of this guidance resulted in an insignificant cumulative-effect adjustment that decreased retained earnings, with offsetting-related adjustments to deferred taxes and AOCI. In addition, the fair value of loans has been estimated using an exit price notion as disclosed in Note 10.

In February 2016, the FASB issued ASU 2016-02, *Leases*. This ASU establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The ASU is effective for annual and interim periods beginning after December 15, 2018. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. Adoption of this ASU is not expected to have a material effect on our financial position or results of operations.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

In August 2016, the FASB issued ASU No. 2016-15, *Classification of Certain Cash Receipts and Cash Payments*. This ASU made eight targeted changes to how cash receipts and cash payments are presented and classified in the statement of cash flows and is effective for fiscal years beginning after December 15, 2017. The new standard required adoption on a retrospective basis unless it was impractical to apply, in which case it was required to apply the amendments prospectively as of the earliest date practicable. Adoption of this ASU did not have a material effect on our financial position or results of operations.

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. **SIGNIFICANT ACCOUNTING POLICIES** (Continued)

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

2. **SECURITIES**

The amortized cost and fair value of available for sale securities and the related pre-tax gross unrealized gains and losses recognized in accumulated other comprehensive income are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2018				
U.S. Government agency debt obligations	$184,422,000	$4,000	$(11,257,000)	$173,169,000
Mortgage-backed securities	41,104,000	278,000	(1,031,000)	40,351,000
Municipal general obligation bonds	118,881,000	404,000	(1,625,000)	117,660,000
Municipal revenue bonds	3,910,000	6,000	(73,000)	3,843,000

Other investments	2,018,000	0	(53,000)	1,965,000
	$350,335,000	$692,000	$(14,039,000)	$336,988,000
December 31, 2017				
U.S. Government agency debt obligations	$175,953,000	$99,000	$(6,352,000)	$169,700,000
Mortgage-backed securities	38,967,000	335,000	(510,000)	38,792,000
Municipal general obligation bonds	121,040,000	891,000	(638,000)	121,293,000
Municipal revenue bonds	3,978,000	30,000	(30,000)	3,978,000
Other investments	2,010,000	0	(29,000)	1,981,000
	$341,948,000	$1,355,000	$(7,559,000)	$335,744,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

Securities with unrealized losses at March 31, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
March 31, 2018						
U.S. Government agency debt obligations	$44,594,000	$1,464,000	$126,600,000	$9,793,000	$171,194,000	$11,257,000
Mortgage-backed securities	14,519,000	479,000	18,867,000	552,000	33,386,000	1,031,000
Municipal general obligation bonds	43,826,000	615,000	43,537,000	1,010,000	87,363,000	1,625,000
Municipal revenue bonds	1,499,000	16,000	1,159,000	57,000	2,658,000	73,000
Other investments	1,518,000	53,000	0	0	1,518,000	53,000
	$105,956,000	$2,627,000	$190,163,000	$11,412,000	$296,119,000	$14,039,000

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2017						
U.S. Government agency debt obligations	$35,677,000	$434,000	$115,374,000	$5,918,000	$151,051,000	$6,352,000
Mortgage-backed securities	10,179,000	156,000	21,084,000	354,000	31,263,000	510,000
Municipal general obligation bonds	12,807,000	114,000	54,703,000	524,000	67,510,000	638,000
Municipal revenue bonds	0	0	1,187,000	30,000	1,187,000	30,000
Other investments	1,510,000	29,000	0	0	1,510,000	29,000

$60,173,000	$733,000	$192,348,000	$6,826,000	$252,521,000	$7,559,000

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

2. SECURITIES (Continued)

At March 31, 2018, 394 debt securities and one mutual fund with fair values totaling $296 million have unrealized losses aggregating $14.0 million. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that the unrealized losses were due to changing interest rate environments. As we do not intend to sell our debt securities before recovery of their cost basis and we believe it is more likely than not that we will not be required to sell our debt securities before recovery of the cost basis, no unrealized losses are deemed to be other-than-temporary.

The amortized cost and fair value of debt securities at March 31, 2018, by maturity, are shown in the following table. The contractual maturity is utilized for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage-backed securities, are shown separately. Weighted average yields are also reflected, with yields for municipal securities shown at their tax equivalent yield.

	Weighted Average Yield (%)	Amortized Cost	Fair Value
Due in 2018	1.86	$28,193,000	$28,181,000
Due in 2019 through 2023	2.12	65,051,000	64,576,000
Due in 2024 through 2028	2.52	99,189,000	94,685,000
Due in 2029 and beyond	2.95	114,780,000	107,230,000
Mortgage-backed securities	2.33	41,104,000	40,351,000
Other investments	2.84	2,018,000	1,965,000
Total available for sale securities	2.51	$350,335,000	$336,988,000

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of $112 million at March 31, 2018 and December 31, 2017, with estimated market values of $111 million and $112 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of $10.8 million and $12.9 million at March 31, 2018 and December 31, 2017, respectively, with estimated market values of $10.7 million and $13.0 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies and the State of Michigan and all its political subdivisions, did not exceed 10% of shareholders' equity.

The carrying value of U.S. Government agency debt obligations and mortgage-backed securities that are pledged to secure repurchase agreements was $105 million and $119 million at March 31, 2018 and December 31, 2017, respectively. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

Our total loans at March 31, 2018 were $2.55 billion compared to $2.56 billion at December 31, 2017, a decrease of $7.3 million, or 0.3%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at March 31, 2018 and December 31, 2017, and the percentage change in loans from the end of 2017 to the end of the first quarter of 2018, are as follows:

	March 31, 2018 Balance	%	December 31, 2017 Balance	%	Percent Increase (Decrease)
Originated loans					
Commercial:					
Commercial and industrial	$675,188,000	30.8 %	$680,805,000	31.3 %	(0.8 %)
Vacant land, land development, and residential construction	25,514,000	1.2	23,682,000	1.1	7.7
Real estate – owner occupied	468,777,000	21.4	456,065,000	21.0	2.8
Real estate – non-owner occupied	715,725,000	32.6	708,824,000	32.7	1.0
Real estate – multi-family and residential rental	61,762,000	2.8	64,852,000	3.0	(4.8)
Total commercial	1,946,966,000	88.8	1,934,228,000	89.1	0.7
Retail:					
Home equity and other	65,604,000	3.0	69,675,000	3.2	(5.8)
1-4 family mortgages	179,281,000	8.2	166,054,000	7.7	8.0
Total retail	244,885,000	11.2	235,729,000	10.9	3.9
Total originated loans	$2,191,851,000	100.0%	$2,169,957,000	100.0%	1.0 %

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	March 31, 2018 Balance	%	December 31, 2017 Balance	%	Percent Increase (Decrease)
Acquired loans					
Commercial:					
Commercial and industrial	$64,617,000	18.0 %	$72,959,000	18.8 %	(11.4 %)
Vacant land, land development, and residential construction	5,924,000	1.6	6,191,000	1.6	(4.3)
Real estate – owner occupied	62,375,000	17.5	70,263,000	18.1	(11.2)
Real estate – non-owner occupied	78,481,000	21.8	82,861,000	21.3	(5.3)
Real estate – multi-family and residential rental	34,666,000	9.6	37,066,000	9.5	(6.5)
Total commercial	246,063,000	68.5	269,340,000	69.3	(8.6)
Retail:					
Home equity and other	27,575,000	7.7	30,750,000	7.9	(10.3)
1-4 family mortgages	85,715,000	23.8	88,505,000	22.8	(3.2)
Total retail	113,290,000	31.5	119,255,000	30.7	(5.0)
Total acquired loans	$359,353,000	100.0%	$388,595,000	100.0%	(7.5 %)

	March 31, 2018 Balance	%	December 31, 2017 Balance	%	Percent Increase (Decrease)
Total loans					
Commercial:					
Commercial and industrial	$739,805,000	29.0 %	$753,764,000	29.4 %	(1.9 %)
Vacant land, land development, and residential construction	31,438,000	1.2	29,873,000	1.2	5.2
Real estate – owner occupied	531,152,000	20.8	526,328,000	20.6	0.9
Real estate – non-owner occupied	794,206,000	31.2	791,685,000	30.9	0.3
Real estate – multi-family and residential rental	96,428,000	3.8	101,918,000	4.0	(5.4)

Total commercial	2,193,029,000	86.0	2,203,568,000	86.1	(0.5)
Retail:					
Home equity and other	93,179,000	3.6	100,425,000	3.9	(7.2)
1-4 family mortgages	264,996,000	10.4	254,559,000	10.0	4.1
Total retail	358,175,000	14.0	354,984,000	13.9	0.9
Total loans	$2,551,204,000	100.0%	$2,558,552,000	100.0%	(0.3 %)

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The total contractually required payments due on and carrying value of acquired impaired loans were $9.2 million and $5.0 million, respectively, as of March 31, 2018. The total contractually required payments due on and carrying value of acquired impaired loans were $11.9 million and $5.2 million, respectively, as of December 31, 2017. Changes in the accretable yield for acquired impaired loans for the three months ended March 31, 2018 and March 31, 2017 were as follows:

Balance at December 31, 2017	$1,404,000
Additions	0
Accretion income	(131,000)
Net reclassification from nonaccretable to accretable	86,000
Reductions (1)	(40,000)
Balance at March 31, 2018	$1,319,000
Balance at December 31, 2016	$1,726,000
Additions	1,000
Accretion income	(147,000)
Net reclassification from nonaccretable to accretable	63,000
Reductions (1)	(179,000)
Balance at March 31, 2017	$1,464,000

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

Nonperforming originated loans as of March 31, 2018 and December 31, 2017 were as follows:

	March 31, 2018	December 31, 2017
Loans past due 90 days or more still accruing interest	$0	$0
Nonaccrual loans	2,763,000	3,672,000
Total nonperforming originated loans	$2,763,000	$3,672,000

Nonperforming acquired loans as of March 31, 2018 and December 31, 2017 were as follows:

	March 31, 2018	December 31, 2017
Loans past due 90 days or more still accruing interest	$0	$0
Nonaccrual loans	2,979,000	3,471,000
Total nonperforming acquired loans	$2,979,000	$3,471,000

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

	March 31, 2018	December 31, 2017
Commercial:		
Commercial and industrial	$619,000	$1,444,000
Vacant land, land development, and residential construction	0	35,000
Real estate – owner occupied	1,831,000	2,241,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	154,000	178,000
Total commercial	2,604,000	3,898,000
Retail:		
Home equity and other	512,000	577,000
1-4 family mortgages	2,626,000	2,668,000
Total retail	3,138,000	3,245,000
Total nonperforming loans	$5,742,000	$7,143,000

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

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MERCANTILE BANK CORPORATION

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(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Originated loans							
Commercial:							
Commercial and industrial	$1,350,000	$929,000	$0	$2,279,000	$672,909,000	$675,188,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	25,514,000	25,514,000	0
Real estate – owner occupied	0	0	251,000	251,000	468,526,000	468,777,000	0
Real estate – non-owner occupied	0	0	0	0	715,725,000	715,725,000	0
Real estate – multi-family and residential rental	0	0	0	0	61,762,000	61,762,000	0
Total commercial	1,350,000	929,000	251,000	2,530,000	1,944,436,000	1,946,966,000	0
Retail:							
Home equity and other	65,000	0	0	65,000	65,539,000	65,604,000	0
1-4 family mortgages	0	246,000	220,000	466,000	178,815,000	179,281,000	0
Total retail	65,000	246,000	220,000	531,000	244,354,000	244,885,000	0

Total past due loans	$1,415,000	$1,175,000	$471,000	$3,061,000	$2,188,790,000	$2,191,851,000	$ 0

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Acquired loans							
Commercial:							
Commercial and industrial	$0	$0	$113,000	$113,000	$64,504,000	$64,617,000	$ 0
Vacant land, land development, and residential construction	0	0	0	0	5,924,000	5,924,000	0
Real estate – owner occupied	0	156,000	243,000	399,000	61,976,000	62,375,000	0
Real estate – non-owner occupied	0	0	0	0	78,481,000	78,481,000	0
Real estate – multi-family and residential rental	27,000	0	9,000	36,000	34,630,000	34,666,000	0
Total commercial	27,000	156,000	365,000	548,000	245,515,000	246,063,000	0
Retail:							
Home equity and other	163,000	44,000	42,000	249,000	27,326,000	27,575,000	0
1-4 family mortgages	645,000	231,000	475,000	1,351,000	84,364,000	85,715,000	0
Total retail	808,000	275,000	517,000	1,600,000	111,690,000	113,290,000	0
Total past due loans	$835,000	$431,000	$882,000	$2,148,000	$357,205,000	$359,353,000	$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Originated loans							
Commercial:							
Commercial and industrial	$0	$0	$178,000	$178,000	$680,627,000	$680,805,000	$ 0
Vacant land, land development, and residential construction	0	0	35,000	35,000	23,647,000	23,682,000	0
Real estate – owner occupied	0	0	1,244,000	1,244,000	454,821,000	456,065,000	0
Real estate – non-owner occupied	0	0	0	0	708,824,000	708,824,000	0
Real estate – multi-family and residential rental	0	0	0	0	64,852,000	64,852,000	0
Total commercial	0	0	1,457,000	1,457,000	1,932,771,000	1,934,228,000	0
Retail:							
Home equity and other	647,000	11,000	86,000	744,000	68,931,000	69,675,000	0
1-4 family mortgages	0	0	250,000	250,000	165,804,000	166,054,000	0
Total retail	647,000	11,000	336,000	994,000	234,735,000	235,729,000	0
Total past due loans	$647,000	$11,000	$1,793,000	$2,451,000	$2,167,506,000	$2,169,957,000	$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	30 – 59 Days Past Due	60 – 89 Days Past Due	Greater Than 89 Days Past Due	Total Past Due	Current	Total Loans	Recorded Balance > 89 Days and Accruing
Acquired Loans							
Commercial:							
Commercial and industrial	$40,000	$0	$114,000	$154,000	$72,805,000	$72,959,000	$ 0
Vacant land, land development, and residential construction	14,000	0	0	14,000	6,177,000	6,191,000	0
Real estate – owner occupied	634,000	0	271,000	905,000	69,358,000	70,263,000	0
Real estate – non-owner occupied	0	0	0	0	82,861,000	82,861,000	0
Real estate – multi-family and residential rental	0	0	108,000	108,000	36,958,000	37,066,000	0
Total commercial	688,000	0	493,000	1,181,000	268,159,000	269,340,000	0
Retail:							
Home equity and other	408,000	52,000	154,000	614,000	30,136,000	30,750,000	0
1-4 family mortgages	690,000	333,000	661,000	1,684,000	86,821,000	88,505,000	0
Total retail	1,098,000	385,000	815,000	2,298,000	116,957,000	119,255,000	0
Total past due loans	$1,786,000	$385,000	$1,308,000	$3,479,000	$385,116,000	$388,595,000	$ 0

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired originated loans as of March 31, 2018, and average originated impaired loans for the three months ended March 31, 2018, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$234,000	$234,000		$206,000
Vacant land, land development and residential construction	0	0		17,000
Real estate – owner occupied	2,937,000	2,875,000		2,164,000
Real estate – non-owner occupied	0	0		0
Real estate – multi-family and residential rental	337,000	337,000		343,000
Total commercial	3,508,000	3,446,000		2,730,000
Retail:				
Home equity and other	768,000	751,000		716,000
1-4 family mortgages	1,106,000	419,000		437,000
Total retail	1,874,000	1,170,000		1,153,000
Total with no related allowance recorded	$5,382,000	$4,616,000		$3,883,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$2,623,000	$2,133,000	$304,000	$2,561,000
Vacant land, land development and residential construction	0	0	0	0
Real estate – owner occupied	1,717,000	1,674,000	226,000	1,532,000
Real estate – non-owner occupied	0	0	0	0
Real estate – multi-family and residential rental	145,000	145,000	17,000	72,000
Total commercial	4,485,000	3,952,000	547,000	4,165,000
Retail:				
Home equity and other	508,000	498,000	258,000	823,000
1-4 family mortgages	412,000	354,000	58,000	232,000
Total retail	920,000	852,000	316,000	1,055,000
Total with an allowance recorded	$5,405,000	$4,804,000	$863,000	$5,220,000
Total impaired loans:				
Commercial	$7,993,000	$7,398,000	$547,000	$6,895,000
Retail	2,794,000	2,022,000	316,000	2,208,000
Total impaired loans	$10,787,000	$9,420,000	$863,000	$9,103,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of March 31, 2018, and average impaired acquired loans for the three months ended March 31, 2018, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$743,000	$733,000		$877,000
Vacant land, land development and residential construction	0	0		0
Real estate – owner occupied	1,110,000	715,000		687,000
Real estate – non-owner occupied	232,000	232,000		235,000
Real estate – multi-family and residential rental	62,000	44,000		131,000
Total commercial	2,147,000	1,724,000		1,930,000
Retail:				
Home equity and other	690,000	649,000		578,000
1-4 family mortgages	2,586,000	2,007,000		2,080,000
Total retail	3,276,000	2,656,000		2,658,000
Total with no related allowance recorded	$5,423,000	$4,380,000		$4,588,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$0	$0	$0	$0
Vacant land, land development and residential construction	0	0	0	0
Real estate – owner occupied	1,597,000	1,597,000	307,000	799,000
Real estate – non-owner occupied	0	0	0	0
Real estate – multi-family and residential rental	0	0	0	0
Total commercial	1,597,000	1,597,000	307,000	799,000
Retail:				
Home equity and other	0	0	0	0
1-4 family mortgages	0	0	0	0
Total retail	0	0	0	0
Total with an allowance recorded	$1,597,000	$1,597,000	$307,000	$799,000
Total impaired loans:				
Commercial	$3,744,000	$3,321,000	$307,000	$2,729,000
Retail	3,276,000	2,656,000	0	2,658,000
Total impaired loans	$7,020,000	$5,977,000	$307,000	$5,387,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. **LOANS AND ALLOWANCE FOR LOAN LOSSES** (Continued)

Impaired originated loans as of December 31, 2017, and average impaired originated loans for the three months ended March 31, 2017, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$765,000	$178,000		$1,589,000
Vacant land, land development and residential construction	454,000	35,000		88,000
Real estate – owner occupied	1,528,000	1,452,000		113,000
Real estate – non-owner occupied	0	0		0
Real estate – multi-family and residential rental	349,000	349,000		197,000
Total commercial	3,096,000	2,014,000		1,987,000
Retail:				
Home equity and other	693,000	680,000		247,000
1-4 family mortgages	1,126,000	456,000		649,000
Total retail	1,819,000	1,136,000		896,000
Total with no related allowance recorded	$4,915,000	$3,150,000		$2,883,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$3,038,000	$2,989,000	$963,000	$2,690,000
Vacant land, land development and residential construction	0	0	0	749,000
Real estate – owner occupied	1,409,000	1,391,000	239,000	1,144,000
Real estate – non-owner occupied	0	0	0	4,745,000
Real estate – multi-family and residential rental	0	0	0	751,000
Total commercial	4,447,000	4,380,000	1,202,000	10,079,000
Retail:				
Home equity and other	1,225,000	1,147,000	652,000	697,000
1-4 family mortgages	165,000	110,000	13,000	137,000
Total retail	1,390,000	1,257,000	665,000	834,000
Total with an allowance recorded	$5,837,000	$5,637,000	$1,867,000	$10,913,000
Total impaired loans:				
Commercial	$7,543,000	$6,394,000	$1,202,000	$12,066,000
Retail	3,209,000	2,393,000	665,000	1,730,000
Total impaired loans	$10,752,000	$8,787,000	$1,867,000	$13,796,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. <u>LOANS AND ALLOWANCE FOR LOAN LOSSES</u> (Continued)

Impaired acquired loans as of December 31, 2017, and average impaired acquired loans for the three months ended March 31, 2017, were as follows:

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With no related allowance recorded:				
Commercial:				
Commercial and industrial	$1,039,000	$1,021,000		$892,000
Vacant land, land development and residential construction	0	0		0
Real estate – owner occupied	1,027,000	659,000		1,151,000
Real estate – non-owner occupied	238,000	237,000		751,000
Real estate – multi-family and residential rental	237,000	218,000		160,000
Total commercial	2,541,000	2,135,000		2,954,000
Retail:				
Home equity and other	694,000	507,000		336,000
1-4 family mortgages	2,703,000	2,153,000		1,662,000
Total retail	3,397,000	2,660,000		1,998,000
Total with no related allowance recorded	$5,938,000	$4,795,000		$4,952,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

	Unpaid Contractual Principal Balance	Recorded Principal Balance	Related Allowance	First Quarter Average Recorded Principal Balance
With an allowance recorded:				
Commercial:				
Commercial and industrial	$0	$0	$ 0	$19,000
Vacant land, land development and residential construction	0	0	0	0
Real estate – owner occupied	0	0	0	48,000
Real estate – non-owner occupied	0	0	0	0
Real estate – multi-family and residential rental	0	0	0	0
Total commercial	0	0	0	67,000
Retail:				
Home equity and other	0	0	0	0
1-4 family mortgages	0	0	0	172,000
Total retail	0	0	0	172,000
Total with an allowance recorded	$0	$0	$ 0	$239,000
Total impaired loans:				
Commercial	$2,541,000	$2,135,000	$ 0	$3,021,000
Retail	3,397,000	2,660,000	0	2,170,000
Total impaired loans	$5,938,000	$4,795,000	$ 0	$5,191,000

Impaired loans for which no allocation of the allowance for loan losses has been made generally reflect situations whereby the loans have been charged-down to estimated collateral value. Interest income recognized on accruing troubled debt restructurings totaled $0.3 million and $0.2 million during the first quarters of 2018 and 2017, respectively. No interest income was recognized on nonaccrual loans during either the first quarter of 2018 or 2017.

Lost interest income on nonaccrual loans totaled $0.1 million during both the first quarter of 2018 and the respective 2017 period.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

Credit quality indicators were as follows as of March 31, 2018:

Originated loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$468,826,000	$17,645,000	$313,933,000	$564,093,000	$39,571,000

Grades 5 – 7	187,118,000	7,767,000	140,088,000	151,632,000	21,709,000
Grades 8 – 9	19,244,000	102,000	14,756,000	0	482,000
Total commercial	$675,188,000	$25,514,000	$468,777,000	$715,725,000	$61,762,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	$65,604,000	$179,281,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Acquired loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$39,543,000	$ 1,412,000	$28,823,000	$54,951,000	$ 17,376,000
Grades 5 – 7	24,591,000	4,512,000	30,940,000	23,448,000	17,132,000
Grades 8 – 9	483,000	0	2,612,000	82,000	158,000
Total commercial	$64,617,000	$ 5,924,000	$62,375,000	$78,481,000	$ 34,666,000

Retail credit exposure – credit risk profiled by collateral type:

Retail Retail

	Home Equity and Other	1-4 Family Mortgages
Total retail	$27,575,000	$85,715,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit quality indicators were as follows as of December 31, 2017:

Originated loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$469,537,000	$ 15,090,000	$326,700,000	$559,388,000	$42,951,000
Grades 5 – 7	189,851,000	8,557,000	123,024,000	149,135,000	21,552,000
Grades 8 – 9	21,417,000	35,000	6,341,000	301,000	349,000
Total commercial	$680,805,000	$ 23,682,000	$456,065,000	$708,824,000	$64,852,000

Retail credit exposure – credit risk profiled by collateral type:

	Retail Home Equity and Other	Retail 1-4 Family Mortgages
Total retail	$69,675,000	$166,054,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Acquired loans

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

	Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied	Commercial Real Estate - Non-Owner Occupied	Commercial Real Estate - Multi-Family and Residential Rental
Internal credit risk grade groupings:					
Grades 1 – 4	$46,263,000	$ 1,446,000	$28,706,000	$52,674,000	$ 17,499,000
Grades 5 – 7	25,654,000	4,745,000	39,565,000	30,102,000	19,212,000
Grades 8 – 9	1,042,000	0	1,992,000	85,000	355,000
Total commercial	$72,959,000	$ 6,191,000	$70,263,000	$82,861,000	$ 37,066,000

Retail credit exposure – credit risk profiled by collateral type:

Retail Home Equity	Retail 1-4 Family

	and Other	Mortgages
Total retail	$30,750,000	$88,505,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

All commercial loans are graded using the following criteria:

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses and the recorded investments in originated loans as of and during the three months ended March 31, 2018 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$16,456,000	$2,584,000	$ 93,000	$19,133,000
Provision for loan losses	(341,000)	(563,000)	122,000	(782,000)
Charge-offs	(258,000)	(135,000)	0	(393,000)
Recoveries	1,008,000	115,000	0	1,123,000
Ending balance	$16,865,000	$2,001,000	$ 215,000	$19,081,000
Ending balance: individually evaluated for impairment	$547,000	$316,000	$ 0	$863,000
Ending balance: collectively evaluated for impairment	$16,318,000	$1,685,000	$ 215,000	$18,218,000
Total loans:				
Ending balance	$1,946,966,000	$244,885,000		$2,191,851,000
Ending balance: individually evaluated for impairment	$7,398,000	$2,022,000		$9,420,000
Ending balance: collectively evaluated for impairment	$1,939,568,000	$242,863,000		$2,182,431,000

Activity in the allowance for loan losses for acquired loans during the three months ended March 31, 2018 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$ 291,000	$ 77,000	$ 0	$ 368,000
Provision for loan losses	314,000	468,000	0	782,000
Charge-offs	(246,000)	(15,000)	0	(261,000)
Recoveries	0	4,000	0	4,000
Ending balance	$ 359,000	$ 534,000	$ 0	$ 893,000

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses and the recorded investments in originated loans as of and during the twelve months ended December 31, 2017 are as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$16,026,000	$1,882,000	$ (40,000)	$17,868,000
Provision for loan losses	1,148,000	1,360,000	133,000	2,641,000
Charge-offs	(2,292,000)	(891,000)	0	(3,183,000)
Recoveries	1,574,000	233,000	0	1,807,000
Ending balance	$16,456,000	$2,584,000	$ 93,000	$19,133,000
Ending balance: individually evaluated for impairment	$1,202,000	$665,000	$ 0	$1,867,000
Ending balance: collectively evaluated for impairment	$15,254,000	$1,919,000	$ 93,000	$17,266,000
Total loans:				
Ending balance	$1,934,228,000	$235,729,000		$2,169,957,000
Ending balance: individually evaluated for impairment	$6,394,000	$2,393,000		$8,787,000
Ending balance: collectively evaluated for impairment	$1,927,834,000	$233,336,000		$2,161,170,000

Activity in the allowance for loan losses for acquired loans during the twelve months ended December 31, 2017 is as follows:

	Commercial Loans	Retail Loans	Unallocated	Total
Allowance for loan losses:				
Beginning balance	$ 75,000	$ 18,000	$ 0	$ 93,000
Provision for loan losses	210,000	99,000	0	309,000
Charge-offs	(12,000)	(40,000)	0	(52,000)
Recoveries	18,000	0	0	18,000
Ending balance	$ 291,000	$ 77,000	$ 0	$ 368,000

In accordance with acquisition accounting rules, acquired loans were recorded at fair value at the merger date and the prior allowance was eliminated.

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the three months ended March 31, 2018 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Originated loans			
Commercial:			
Commercial and industrial	3	$ 107,000	$ 96,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	4	3,865,000	3,854,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	7	3,972,000	3,950,000
Retail:			
Home equity and other	1	50,000	50,000
1-4 family mortgages	0	0	0
Total originated retail	1	50,000	50,000
Total originated loans	8	$ 4,022,000	$ 4,000,000
Acquired loans			
Commercial:			
Commercial and industrial	0	$ 0	$ 0
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	3	1,597,000	1,597,000
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total acquired commercial	3	1,597,000	1,597,000

Retail:			
Home equity and other	6	118,000	119,000
1-4 family mortgages	0	0	0
Total acquired retail	6	118,000	119,000
Total acquired loans	9	$ 1,715,000	$ 1,716,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Loans modified as troubled debt restructurings during the three months ended March 31, 2017 were as follows:

	Number of Contracts	Pre-Modification Recorded Principal Balance	Post-Modification Recorded Principal Balance
Originated loans			
Commercial:			
Commercial and industrial	0	$ 0	$ 0
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total originated commercial	0	0	0
Retail:			
Home equity and other	4	328,000	329,000
1-4 family mortgages	0	0	0
Total originated retail	4	328,000	329,000
Total originated loans	4	$ 328,000	$ 329,000
Acquired loans			
Commercial:			
Commercial and industrial	1	$ 31,000	$ 31,000
Vacant land, land development and residential construction	0	0	0
Real estate – owner occupied	0	0	0
Real estate – non-owner occupied	0	0	0
Real estate – multi-family and residential rental	0	0	0
Total acquired commercial	1	31,000	31,000

Retail:			
Home equity and other	2	6,000	7,000
1-4 family mortgages	1	57,000	57,000
Total acquired retail	3	63,000	64,000
Total acquired loans	4	$ 94,000	$ 95,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended March 31, 2018 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	0	$0
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	1	251,000
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	251,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$251,000

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended March 31, 2018 (amounts as of period end):

Recorded
Principal

	Number of Contracts	Balance
Commercial:		
Commercial and industrial	1	$113,000
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	113,000
Retail:		
Home equity and other	2	20,000
1-4 family mortgages	0	0
Total retail	2	20,000
Total	3	$133,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended March 31, 2017 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance
Commercial:		
Commercial and industrial	2	$34,000
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	1	130,000
Total commercial	3	164,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	3	$164,000

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the three months ended March 31, 2017 (amounts as of period end):

	Number of Contracts	Recorded Principal Balance

Commercial:		
Commercial and industrial	1	$ 24,000
Vacant land, land development and residential construction	0	0
Real estate – owner occupied	0	0
Real estate – non-owner occupied	0	0
Real estate – multi-family and residential rental	0	0
Total commercial	1	24,000
Retail:		
Home equity and other	0	0
1-4 family mortgages	0	0
Total retail	0	0
Total	1	$ 24,000

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MERCANTILE BANK CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for originated loans categorized as troubled debt restructurings during the three months ended March 31, 2018 is as follows:

Commercial and Industrial	Commercial Vacant Land, Land Development, and Residential Construction	Commercial Real Estate - Owner Occupied