

Section 1: 10-Q (FORM 10-Q)

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U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, DC 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 June 30, 2019

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
(State or other jurisdiction of incorporation or organization)

38-3360865
(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 No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes 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

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|---------------------|-------------------|---|
| Common Stock | MBWM | The Nasdaq Stock Market LLC |

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

At July 31, 2019, there were 16,424,433 shares of common stock outstanding.

MERCANTILE BANK CORPORATION
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MERCANTILE BANK CORPORATION
PART I --- FINANCIAL INFORMATION

Item 1. Financial Statements

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

| | June 30, 2019 | December 31, 2018 |
|---|-------------------------|-------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 57,675,000 | \$ 64,872,000 |
| Interest-earning deposits | 92,750,000 | 10,482,000 |
| Total cash and cash equivalents | 150,425,000 | 75,354,000 |
| Securities available for sale | 347,924,000 | 337,366,000 |
| Federal Home Loan Bank stock | 18,002,000 | 16,022,000 |
| Loans | 2,881,493,000 | 2,753,085,000 |
| Allowance for loan losses | (24,053,000) | (22,380,000) |
| Loans, net | 2,857,440,000 | 2,730,705,000 |
| Premises and equipment, net | 51,823,000 | 48,321,000 |
| Bank owned life insurance | 67,678,000 | 69,647,000 |
| Goodwill | 49,473,000 | 49,473,000 |
| Core deposit intangible, net | 4,634,000 | 5,561,000 |
| Other assets | 28,740,000 | 31,458,000 |
| Total assets | <u>\$ 3,576,139,000</u> | <u>\$ 3,363,907,000</u> |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Deposits | | |
| Noninterest-bearing | \$ 918,581,000 | \$ 889,784,000 |
| Interest-bearing | 1,700,628,000 | 1,573,924,000 |
| Total deposits | 2,619,209,000 | 2,463,708,000 |
| Securities sold under agreements to repurchase | 119,669,000 | 103,519,000 |
| Federal Home Loan Bank advances | 374,000,000 | 350,000,000 |
| Subordinated debentures | 46,540,000 | 46,199,000 |
| Accrued interest and other liabilities | 16,604,000 | 25,232,000 |
| Total liabilities | 3,176,022,000 | 2,988,658,000 |
| Commitments and contingent liabilities (Note 8) | | |
| 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; 16,440,356 shares issued and outstanding at June 30, 2019 and 16,534,256 shares issued and outstanding at December 31, 2018 | 306,669,000 | 308,005,000 |
| Retained earnings | 90,618,000 | 75,483,000 |
| Accumulated other comprehensive gain/(loss) | 2,830,000 | (8,239,000) |
| Total shareholders' equity | 400,117,000 | 375,249,000 |
| Total liabilities and shareholders' equity | <u>\$ 3,576,139,000</u> | <u>\$ 3,363,907,000</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

| | Three Months Ended June 30, 2019 | Three Months Ended June 30, 2018 | Six Months Ended June 30, 2019 | Six Months Ended June 30, 2018 |
|--|--|--|--------------------------------------|--------------------------------------|
| Interest income | | | | |
| Loans, including fees | \$ 36,765,000 | \$ 31,855,000 | \$ 72,555,000 | \$ 64,170,000 |
| Securities, taxable | 1,945,000 | 1,618,000 | 3,825,000 | 3,220,000 |
| Securities, tax-exempt | 540,000 | 559,000 | 1,101,000 | 1,153,000 |
| Other interest-earning assets | 569,000 | 287,000 | 976,000 | 757,000 |
| Total interest income | <u>39,819,000</u> | <u>34,319,000</u> | <u>78,457,000</u> | <u>69,300,000</u> |
| Interest expense | | | | |
| Deposits | 5,529,000 | 3,262,000 | 10,334,000 | 6,347,000 |
| Short-term borrowings | 68,000 | 61,000 | 173,000 | 118,000 |
| Federal Home Loan Bank advances | 2,261,000 | 988,000 | 4,494,000 | 1,933,000 |
| Subordinated debentures and other borrowings | 845,000 | 783,000 | 1,695,000 | 1,478,000 |
| Total interest expense | <u>8,703,000</u> | <u>5,094,000</u> | <u>16,696,000</u> | <u>9,876,000</u> |
| Net interest income | <u>31,116,000</u> | <u>29,225,000</u> | <u>61,761,000</u> | <u>59,424,000</u> |
| Provision for loan losses | <u>900,000</u> | <u>700,000</u> | <u>1,750,000</u> | <u>700,000</u> |
| Net interest income after provision for loan losses | <u>30,216,000</u> | <u>28,525,000</u> | <u>60,011,000</u> | <u>58,724,000</u> |
| Noninterest income | | | | |
| Services charges on deposit and sweep accounts | 1,143,000 | 1,079,000 | 2,220,000 | 2,132,000 |
| Credit and debit card income | 1,513,000 | 1,334,000 | 2,850,000 | 2,577,000 |
| Mortgage banking income | 1,345,000 | 995,000 | 2,402,000 | 1,879,000 |
| Earnings on bank owned life insurance | 1,608,000 | 321,000 | 3,238,000 | 652,000 |
| Payroll services income | 355,000 | 317,000 | 860,000 | 800,000 |
| Other income | 370,000 | 504,000 | 1,397,000 | 891,000 |
| Total noninterest income | <u>6,334,000</u> | <u>4,550,000</u> | <u>12,967,000</u> | <u>8,931,000</u> |
| Noninterest expense | | | | |
| Salaries and benefits | 13,286,000 | 12,757,000 | 26,302,000 | 25,094,000 |
| Occupancy | 1,629,000 | 1,629,000 | 3,391,000 | 3,401,000 |
| Furniture and equipment depreciation, rent and maintenance | 621,000 | 582,000 | 1,257,000 | 1,130,000 |
| Data processing costs | 2,295,000 | 2,137,000 | 4,511,000 | 4,265,000 |
| Other expense | 4,256,000 | 4,309,000 | 8,456,000 | 8,671,000 |
| Total noninterest expenses | <u>22,087,000</u> | <u>21,414,000</u> | <u>43,917,000</u> | <u>42,561,000</u> |
| Income before federal income tax expense | <u>14,463,000</u> | <u>11,661,000</u> | <u>29,061,000</u> | <u>25,094,000</u> |
| Federal income tax expense | <u>2,748,000</u> | <u>2,215,000</u> | <u>5,522,000</u> | <u>4,767,000</u> |
| Net income | <u>\$ 11,715,000</u> | <u>\$ 9,446,000</u> | <u>\$ 23,539,000</u> | <u>\$ 20,327,000</u> |
| Basic earnings per share | <u>\$ 0.71</u> | <u>\$ 0.57</u> | <u>\$ 1.43</u> | <u>\$ 1.22</u> |
| Diluted earnings per share | <u>\$ 0.71</u> | <u>\$ 0.57</u> | <u>\$ 1.43</u> | <u>\$ 1.22</u> |
| Cash dividends per share | <u>\$ 0.26</u> | <u>\$ 0.22</u> | <u>\$ 0.52</u> | <u>\$ 0.44</u> |
| Average basic shares outstanding | <u>16,428,187</u> | <u>16,601,400</u> | <u>16,428,875</u> | <u>16,598,274</u> |
| Average diluted shares outstanding | <u>16,434,714</u> | <u>16,610,819</u> | <u>16,434,941</u> | <u>16,607,593</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

| | Three Months Ended June 30, 2019 | Three Months Ended June 30, 2018 | Six Months Ended June 30, 2019 | Six Months Ended June 30, 2018 |
|--|--|--|--------------------------------------|--------------------------------------|
| Net income | \$ 11,715,000 | \$ 9,446,000 | \$ 23,539,000 | \$ 20,327,000 |
| Other comprehensive income (loss): | | | | |
| Unrealized holding gains (losses) on securities available for sale | 9,562,000 | (432,000) | 14,011,000 | (7,574,000) |
| Fair value of interest rate swap | 0 | 0 | 0 | 2,000 |
| Total other comprehensive income (loss) | 9,562,000 | (432,000) | 14,011,000 | (7,572,000) |
| Tax effect of unrealized holding gains (losses) on securities available for sale | (2,008,000) | 49,000 | (2,942,000) | 1,549,000 |
| Tax effect of fair value of interest rate swap | 0 | 0 | 0 | (1,000) |
| Total tax effect of other comprehensive income | (2,008,000) | 49,000 | (2,942,000) | 1,548,000 |
| Other comprehensive income (loss), net of tax | 7,554,000 | (383,000) | 11,069,000 | (6,024,000) |
| Comprehensive income | <u>\$ 19,269,000</u> | <u>\$ 9,063,000</u> | <u>\$ 34,608,000</u> | <u>\$ 14,303,000</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF
CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited)

| (\$ in thousands except per share amounts) | <u>Preferred Stock</u> | <u>Common Stock</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Shareholders' Equity</u> |
|--|----------------------------|-------------------------|------------------------------|--|---|
| Balances, March 31, 2019 | \$ 0 | \$ 305,346 | \$ 83,107 | \$ (4,724) | \$ 383,729 |
| Employee stock purchase plan (383 shares) | | 12 | | | 12 |
| Dividend reinvestment plan (5,522 shares) | | 179 | | | 179 |
| Stock option exercises (2,000 shares) | | 14 | | | 14 |
| Stock grants to directors for retainer fees (11,905 shares) | | 374 | | | 374 |
| Stock-based compensation expense | | 744 | | | 744 |
| Cash dividends (\$0.26 per common share) | | | (4,204) | | (4,204) |
| Net income for the three months ended June 30, 2019 | | | 11,715 | | 11,715 |
| Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect | | | | 7,554 | 7,554 |
| Balances, June 30, 2019 | <u>\$ 0</u> | <u>\$ 306,669</u> | <u>\$ 90,618</u> | <u>\$ 2,830</u> | <u>\$ 400,117</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF
CHANGES IN SHAREHOLDERS' EQUITY (Continued)
(Unaudited)

| (\$ in thousands except per share amounts) | <u>Preferred Stock</u> | <u>Common Stock</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Shareholders' Equity</u> |
|--|----------------------------|-------------------------|------------------------------|--|---|
| Balances, January 1, 2019 | \$ 0 | \$ 308,005 | \$ 75,483 | \$ (8,239) | \$ 375,249 |
| Employee stock purchase plan (799 shares) | | 26 | | | 26 |
| Dividend reinvestment plan (10,947 shares) | | 361 | | | 361 |
| Stock option exercises (2,500 shares) | | 16 | | | 16 |
| Stock grants to directors for retainer fees (11,905 shares) | | 374 | | | 374 |
| Stock-based compensation expense | | 1,488 | | | 1,488 |
| Share repurchase program (119,120 shares) | | (3,601) | | | (3,601) |
| Cash dividends (\$0.52 per common share) | | | (8,404) | | (8,404) |
| Net income for the six months ended June 30, 2019 | | | 23,539 | | 23,539 |
| Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect | | | | 11,069 | 11,069 |
| Balances, June 30, 2019 | <u>\$ 0</u> | <u>\$ 306,669</u> | <u>\$ 90,618</u> | <u>\$ 2,830</u> | <u>\$ 400,117</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF
CHANGES IN SHAREHOLDERS' EQUITY (Continued)
(Unaudited)

| (\$ in thousands except per share amounts) | <u>Preferred Stock</u> | <u>Common Stock</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Shareholders' Equity</u> |
|--|----------------------------|-------------------------|------------------------------|--|---|
| Balances, March 31, 2018 | \$ 0 | \$ 310,601 | \$ 68,241 | \$ (10,502) | \$ 368,340 |
| Employee stock purchase plan (329 shares) | | 12 | | | 12 |
| Dividend reinvestment plan (4,439 shares) | | 164 | | | 164 |
| Stock grants to directors for retainer fees (11,171 shares) | | 403 | | | 403 |
| Stock-based compensation expense | | 540 | | | 540 |
| Cash dividends (\$0.22 per common share) | | | (3,603) | | (3,603) |
| Net income for the three months ended June 30, 2018 | | | 9,446 | | 9,446 |
| Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect | | | | (383) | (383) |
| Balances, June 30, 2018 | <u>\$ 0</u> | <u>\$ 311,720</u> | <u>\$ 74,084</u> | <u>\$ (10,885)</u> | <u>\$ 374,919</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF
CHANGES IN SHAREHOLDERS' EQUITY (Continued)
(Unaudited)

| (\$ in thousands except per share amounts) | <u>Preferred Stock</u> | <u>Common Stock</u> | <u>Retained Earnings</u> | <u>Accumulated Other Comprehensive Income (Loss)</u> | <u>Total Shareholders' Equity</u> |
|--|----------------------------|-------------------------|------------------------------|--|---|
| 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 (755 shares) | | 26 | | | 26 |
| Dividend reinvestment plan (9,063 shares) | | 328 | | | 328 |
| Stock option exercises (7,000 shares) | | 55 | | | 55 |
| Stock grants to directors for retainer fees (11,171 shares) | | 403 | | | 403 |
| Stock-based compensation expense | | 1,136 | | | 1,136 |
| Cash dividends (\$0.44 per common share) | | | (7,202) | | (7,202) |
| Net income for the six months ended June 30, 2018 | | | 20,327 | | 20,327 |
| Change in net unrealized holding gain/(loss) on securities available for sale, net of tax effect | | | | (6,025) | (6,025) |
| Change in fair value of interest rate swap, net of tax effect | | | | 1 | 1 |
| Balances, June 30, 2018 | <u>\$ 0</u> | <u>\$ 311,720</u> | <u>\$ 74,084</u> | <u>\$ (10,885)</u> | <u>\$ 374,919</u> |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30, 2019 | Six Months Ended June 30, 2018 |
|---|--------------------------------------|--------------------------------------|
| Cash flows from operating activities | | |
| Net income | \$ 23,539,000 | \$ 20,327,000 |
| Adjustments to reconcile net income to net cash from operating activities | | |
| Depreciation and amortization | 4,723,000 | 4,928,000 |
| Accretion of acquired loans | (314,000) | (868,000) |
| Provision for loan losses | 1,750,000 | 700,000 |
| Stock-based compensation expense | 1,488,000 | 1,136,000 |
| Stock grants to directors for retainer fee | 374,000 | 403,000 |
| Proceeds from sales of mortgage loans held for sale | 67,859,000 | 44,586,000 |
| Origination of mortgage loans held for sale | (69,107,000) | (43,509,000) |
| Net gain from sales of mortgage loans held for sale | (2,129,000) | (1,587,000) |
| Net gain from sales and valuation write-downs of foreclosed assets | (31,000) | (126,000) |
| Net gain from sales and valuation write-downs of former bank premises | (558,000) | (78,000) |
| Net loss from sales and write-downs of fixed assets | 1,000 | 55,000 |
| Earnings on bank owned life insurance | (3,238,000) | (652,000) |
| Net change in: | | |
| Accrued interest receivable | (534,000) | (490,000) |
| Other assets | (1,278,000) | (2,629,000) |
| Accrued interest payable and other liabilities | (8,628,000) | (843,000) |
| Net cash from operating activities | 13,917,000 | 21,353,000 |
| Cash flows from investing activities | | |
| Loan originations and payments, net | (124,964,000) | (76,457,000) |
| Purchases of securities available for sale | (24,182,000) | (31,122,000) |
| Proceeds from maturities, calls and repayments of securities available for sale | 27,258,000 | 26,069,000 |
| Proceeds from sales of foreclosed assets | 270,000 | 451,000 |
| Proceeds from sales of former bank premises | 854,000 | 1,964,000 |
| Purchases of Federal Home Loan Bank stock | (1,980,000) | 0 |
| Purchases of bank owned life insurance | (2,500,000) | 0 |
| Proceeds from bank owned life insurance cash value release and death benefits | 7,708,000 | 0 |
| Net purchases of premises and equipment | (5,359,000) | (3,097,000) |
| Net cash for investing activities | (122,895,000) | (82,192,000) |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
(Unaudited)

| | Six Months Ended June 30, 2019 | Six Months Ended June 30, 2018 |
|---|--------------------------------------|--------------------------------------|
| Cash flows from financing activities | | |
| Net increase (decrease) in time deposits | 175,869,000 | (42,376,000) |
| Net increase (decrease) in all other deposits | (20,368,000) | 49,822,000 |
| Net increase (decrease) in securities sold under agreements to repurchase | 16,150,000 | (24,175,000) |
| Maturities of Federal Home Loan Bank advances | (20,000,000) | (30,000,000) |
| Proceeds from Federal Home Loan Bank advances | 44,000,000 | 40,000,000 |
| Proceeds from stock option exercises | 16,000 | 55,000 |
| Employee stock purchase plan | 26,000 | 26,000 |
| Dividend reinvestment plan | 361,000 | 328,000 |
| Repurchases of common stock shares | (3,601,000) | 0 |
| Payment of cash dividends to common shareholders | (8,404,000) | (7,202,000) |
| Net cash from (for) financing activities | <u>184,049,000</u> | <u>(13,522,000)</u> |
| Net change in cash and cash equivalents | 75,071,000 | (74,361,000) |
| Cash and cash equivalents at beginning of period | 75,354,000 | 200,101,000 |
| Cash and cash equivalents at end of period | <u>\$ 150,425,000</u> | <u>\$ 125,740,000</u> |
| Supplemental disclosures of cash flows information | | |
| Cash paid during the period for: | | |
| Interest | \$ 14,956,000 | \$ 9,942,000 |
| Federal income tax | 6,275,000 | 5,450,000 |
| Noncash financing and investing activities: | | |
| Transfers from loans to foreclosed assets | 170,000 | 497,000 |
| Transfers from bank premises to other real estate owned | 0 | 296,000 |

See accompanying notes to condensed consolidated financial statements.

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the six months ended June 30, 2019 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 and Mercantile Insurance Center, Inc. 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 June 30, 2019 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, 2018.

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 261,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2019. In addition, stock options for approximately 10,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 2019. Stock options for approximately 7,000 shares of common stock were antidilutive and not included in determining diluted earnings per share for the three and six months ended June 30, 2019.

Approximately 234,000 unvested restricted shares were included in determining both basic and diluted earnings per share for the three and six months ended June 30, 2018. In addition, stock options for approximately 17,000 shares of common stock were included in determining diluted earnings per share for the three and six months ended June 30, 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 and six months ended June 30, 2018.

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

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

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

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

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

Loans Held for Sale: Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or 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 June 30, 2019 and December 31, 2018, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$4.5 million and \$1.1 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 an interest 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 \$629 million as of June 30, 2019.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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.

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. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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 the derivatives and 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.

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

The core deposit intangible that arose from the 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.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

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

In June 2016, the FASB issued ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments*. This ASU (as subsequently amended by ASU 2018-19) significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. The standard will replace the current “incurred loss” approach with an “expected loss” model. The new model, referred to as the current expected credit loss (“CECL”) model, will apply to: (i) financial assets subject to credit losses and measured at amortized cost, and (ii) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments and financial guarantees. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans, and expands the disclosure requirements regarding an entity’s assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. This ASU is effective for interim and annual reporting periods beginning after December 15, 2019, and early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard’s provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). We have completed our initial framework and developed our initial assumptions. We are now finalizing and documenting new processes and controls, challenging assumptions and outputs, refining the qualitative inputs and drafting policies and disclosures. Additionally, parallel runs will be enhanced throughout the remainder of 2019 as the processes, controls and policies are finalized.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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 |
|---|-----------------------|------------------------------|-------------------------------|-----------------------|
| June 30, 2019 | | | | |
| U.S. Government agency debt obligations | \$ 199,719,000 | \$ 2,489,000 | \$ (1,498,000) | \$ 200,710,000 |
| Mortgage-backed securities | 45,380,000 | 449,000 | (142,000) | 45,687,000 |
| Municipal general obligation bonds | 94,896,000 | 2,297,000 | (58,000) | 97,135,000 |
| Municipal revenue bonds | 3,847,000 | 50,000 | (5,000) | 3,892,000 |
| Other investments | 500,000 | 0 | 0 | 500,000 |
| | <u>\$ 344,342,000</u> | <u>\$ 5,285,000</u> | <u>\$ (1,703,000)</u> | <u>\$ 347,924,000</u> |
| December 31, 2018 | | | | |
| U.S. Government agency debt obligations | \$ 196,109,000 | \$ 310,000 | \$ (9,342,000) | \$ 187,077,000 |
| Mortgage-backed securities | 44,263,000 | 187,000 | (792,000) | 43,658,000 |
| Municipal general obligation bonds | 103,235,000 | 427,000 | (1,165,000) | 102,497,000 |
| Municipal revenue bonds | 3,688,000 | 4,000 | (58,000) | 3,634,000 |
| Other investments | 500,000 | 0 | 0 | 500,000 |
| | <u>\$ 347,795,000</u> | <u>\$ 928,000</u> | <u>\$ (11,357,000)</u> | <u>\$ 337,366,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

2. **SECURITIES** (Continued)

Securities with unrealized losses at June 30, 2019 and December 31, 2018, 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 |
| June 30, 2019 | | | | | | |
| U.S. Government agency debt obligations | \$ 0 | \$ 0 | \$ 82,942,000 | \$ 1,498,000 | \$ 82,942,000 | \$ 1,498,000 |
| Mortgage-backed securities | 0 | 0 | 20,419,000 | 142,000 | 20,419,000 | 142,000 |
| Municipal general obligation bonds | 797,000 | 4,000 | 7,614,000 | 54,000 | 8,411,000 | 58,000 |
| Municipal revenue bonds | 0 | 0 | 1,108,000 | 5,000 | 1,108,000 | 5,000 |
| Other investments | 0 | 0 | 0 | 0 | 0 | 0 |
| | <u>\$ 797,000</u> | <u>\$ 4,000</u> | <u>\$ 112,083,000</u> | <u>\$ 1,699,000</u> | <u>\$ 112,880,000</u> | <u>\$ 1,703,000</u> |

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|----------------------|---------------------|-----------------------|---------------------|-----------------------|----------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| December 31, 2018 | | | | | | |
| U.S. Government agency debt obligations | \$ 31,220,000 | \$ 1,136,000 | \$ 136,445,000 | \$ 8,206,000 | \$ 167,665,000 | \$ 9,342,000 |
| Mortgage-backed securities | 11,460,000 | 136,000 | 23,762,000 | 656,000 | 35,222,000 | 792,000 |
| Municipal general obligation bonds | 28,923,000 | 299,000 | 43,961,000 | 866,000 | 72,884,000 | 1,165,000 |
| Municipal revenue bonds | 1,188,000 | 11,000 | 1,372,000 | 47,000 | 2,560,000 | 58,000 |
| Other investments | 0 | 0 | 0 | 0 | 0 | 0 |
| | <u>\$ 72,791,000</u> | <u>\$ 1,582,000</u> | <u>\$ 205,540,000</u> | <u>\$ 9,775,000</u> | <u>\$ 278,331,000</u> | <u>\$ 11,357,000</u> |

We evaluate securities for other-than-temporary impairment at least on a quarterly basis. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability we have to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. For those 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.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

2. **SECURITIES** (Continued)

At June 30, 2019, 123 debt securities with fair values totaling \$113 million have unrealized losses aggregating \$1.7 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 June 30, 2019, 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 2019 | 2.02% | \$ 6,087,000 | \$ 6,085,000 |
| Due in 2020 through 2024 | 2.29 | 67,392,000 | 67,859,000 |
| Due in 2025 through 2029 | 2.72 | 115,087,000 | 116,683,000 |
| Due in 2030 and beyond | 3.20 | 109,896,000 | 111,110,000 |
| Mortgage-backed securities | 2.87 | 45,380,000 | 45,687,000 |
| Other investments | 6.00 | 500,000 | 500,000 |
| Total available for sale securities | 2.80% | <u>\$ 344,342,000</u> | <u>\$ 347,924,000</u> |

Securities issued by the State of Michigan and all its political subdivisions had a combined amortized cost of \$91.2 million and \$98.2 million at June 30, 2019 and December 31, 2018, respectively, with estimated market values of \$93.5 million and \$97.4 million, respectively. Securities issued by all other states and their political subdivisions had a combined amortized cost of \$7.5 million and \$8.7 million at June 30, 2019 and December 31, 2018, respectively, with estimated market values of \$7.5 million and \$8.7 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 \$120 million and \$104 million at June 30, 2019 and December 31, 2018, respectively. Investments in Federal Home Loan Bank stock are restricted and may only be resold or redeemed by the issuer.

(Continued)

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 June 30, 2019 were \$2.88 billion compared to \$2.75 billion at December 31, 2018, an increase of \$128 million, or 4.7%. The components of our loan portfolio disaggregated by class of loan within the loan portfolio segments at June 30, 2019 and December 31, 2018, and the percentage change in loans from the end of 2018 to the end of the second quarter of 2019, are as follows:

| | June 30, 2019 | | December 31, 2018 | | Percent Increase (Decrease) |
|---|-------------------------|---------------|-------------------------|---------------|-----------------------------------|
| | Balance | % | Balance | % | |
| Originated loans | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 833,589,000 | 31.9% | \$ 768,698,000 | 31.3% | 8.4% |
| Vacant land, land development, and residential construction | 40,609,000 | 1.6 | 39,950,000 | 1.6 | 1.6 |
| Real estate – owner occupied | 513,016,000 | 19.7 | 500,188,000 | 20.4 | 2.6 |
| Real estate – non-owner occupied | 786,666,000 | 30.1 | 745,127,000 | 30.4 | 5.6 |
| Real estate – multi-family and residential rental | 101,051,000 | 3.9 | 98,035,000 | 4.0 | 3.1 |
| Total commercial | 2,274,931,000 | 87.2 | 2,151,998,000 | 87.7 | 5.7 |
| Retail: | | | | | |
| Home equity and other | 64,247,000 | 2.4 | 65,023,000 | 2.7 | (1.2) |
| 1-4 family mortgages | 270,508,000 | 10.4 | 235,425,000 | 9.6 | 14.9 |
| Total retail | 334,755,000 | 12.8 | 300,448,000 | 12.3 | 11.4 |
| Total originated loans | <u>\$ 2,609,686,000</u> | <u>100.0%</u> | <u>\$ 2,452,446,000</u> | <u>100.0%</u> | <u>6.4%</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

| | June 30, 2019 | | December 31, 2018 | | Percent Increase (Decrease) |
|---|-----------------------|---------------|-----------------------|---------------|-----------------------------------|
| | Balance | % | Balance | % | |
| <u>Acquired loans</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 47,607,000 | 17.5% | \$ 54,025,000 | 18.0% | (11.9%) |
| Vacant land, land development, and residential construction | 4,549,000 | 1.7 | 4,935,000 | 1.6 | (7.8) |
| Real estate – owner occupied | 43,852,000 | 16.2 | 48,431,000 | 16.1 | (9.5) |
| Real estate – non-owner occupied | 66,178,000 | 24.3 | 71,155,000 | 23.7 | (7.0) |
| Real estate – multi-family and residential rental | 27,438,000 | 10.1 | 29,562,000 | 9.8 | (7.2) |
| Total commercial | 189,624,000 | 69.8 | 208,108,000 | 69.2 | (8.9) |
| Retail: | | | | | |
| Home equity and other | 17,073,000 | 6.3 | 20,416,000 | 6.8 | (16.4) |
| 1-4 family mortgages | 65,110,000 | 23.9 | 72,115,000 | 24.0 | (9.7) |
| Total retail | 82,183,000 | 30.2 | 92,531,000 | 30.8 | (11.2) |
| Total acquired loans | <u>\$ 271,807,000</u> | <u>100.0%</u> | <u>\$ 300,639,000</u> | <u>100.0%</u> | <u>(9.6%)</u> |

| | June 30, 2019 | | December 31, 2018 | | Percent Increase (Decrease) |
|---|-------------------------|---------------|-------------------------|---------------|-----------------------------------|
| | Balance | % | Balance | % | |
| <u>Total loans</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 881,196,000 | 30.6% | \$ 822,723,000 | 29.9% | 7.1% |
| Vacant land, land development, and residential construction | 45,158,000 | 1.6 | 44,885,000 | 1.6 | 0.6 |
| Real estate – owner occupied | 556,868,000 | 19.3 | 548,619,000 | 19.9 | 1.5 |
| Real estate – non-owner occupied | 852,844,000 | 29.6 | 816,282,000 | 29.7 | 4.5 |
| Real estate – multi-family and residential rental | 128,489,000 | 4.4 | 127,597,000 | 4.6 | 0.7 |
| Total commercial | 2,464,555,000 | 85.5 | 2,360,106,000 | 85.7 | 4.4 |
| Retail: | | | | | |
| Home equity and other | 81,320,000 | 2.8 | 85,439,000 | 3.1 | (4.8) |
| 1-4 family mortgages | 335,618,000 | 11.7 | 307,540,000 | 11.2 | 9.1 |
| Total retail | 416,938,000 | 14.5 | 392,979,000 | 14.3 | 6.1 |
| Total loans | <u>\$ 2,881,493,000</u> | <u>100.0%</u> | <u>\$ 2,753,085,000</u> | <u>100.0%</u> | <u>4.7%</u> |

(Continued)

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 \$6.9 million and \$4.0 million, respectively, as of June 30, 2019. The total contractually required payments due on and carrying value of acquired impaired loans were \$8.0 million and \$4.6 million, respectively, as of December 31, 2018. Changes in the accretable yield for acquired impaired loans for the three and six months ended June 30, 2019 and June 30, 2018 were as follows:

| | |
|---|---------------------|
| Balance at March 31, 2019 | \$ 1,270,000 |
| Additions | 7,000 |
| Accretion income | (106,000) |
| Net reclassification from nonaccretable to accretable | 83,000 |
| Reductions (1) | (19,000) |
| Balance at June 30, 2019 | <u>\$ 1,235,000</u> |
| Balance at December 31, 2018 | \$ 1,274,000 |
| Additions | 9,000 |
| Accretion income | (225,000) |
| Net reclassification from nonaccretable to accretable | 204,000 |
| Reductions (1) | (27,000) |
| Balance at June 30, 2019 | <u>\$ 1,235,000</u> |
| Balance at March 31, 2018 | \$ 1,319,000 |
| Additions | 0 |
| Accretion income | (123,000) |
| Net reclassification from nonaccretable to accretable | 86,000 |
| Reductions (1) | (35,000) |
| Balance at June 30, 2018 | <u>\$ 1,247,000</u> |
| Balance at December 31, 2017 | \$ 1,404,000 |
| Additions | 0 |
| Accretion income | (254,000) |
| Net reclassification from nonaccretable to accretable | 172,000 |
| Reductions (1) | (75,000) |
| Balance at June 30, 2018 | <u>\$ 1,247,000</u> |

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

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Nonperforming originated loans as of June 30, 2019 and December 31, 2018 were as follows:

| | June 30, 2019 | December 31, 2018 |
|--|-------------------|----------------------|
| Loans past due 90 days or more still accruing interest | \$ 0 | \$ 0 |
| Nonaccrual loans | 723,000 | 803,000 |
| Total nonperforming originated loans | \$ 723,000 | \$ 803,000 |

Nonperforming acquired loans as of June 30, 2019 and December 31, 2018 were as follows:

| | June 30, 2019 | December 31, 2018 |
|--|---------------------|----------------------|
| Loans past due 90 days or more still accruing interest | \$ 0 | \$ 0 |
| Nonaccrual loans | 2,782,000 | 3,338,000 |
| Total nonperforming acquired loans | \$ 2,782,000 | \$ 3,338,000 |

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

| | June 30, 2019 | December 31, 2018 |
|---|---------------------|----------------------|
| Commercial: | | |
| Commercial and industrial | \$ 2,000 | \$ 17,000 |
| Vacant land, land development, and residential construction | 0 | 0 |
| Real estate – owner occupied | 642,000 | 950,000 |
| Real estate – non-owner occupied | 26,000 | 0 |
| Real estate – multi-family and residential rental | 130,000 | 141,000 |
| Total commercial | 800,000 | 1,108,000 |
| Retail: | | |
| Home equity and other | 419,000 | 454,000 |
| 1-4 family mortgages | 2,286,000 | 2,579,000 |
| Total retail | 2,705,000 | 3,033,000 |
| Total nonperforming loans | \$ 3,505,000 | \$ 4,141,000 |

Acquired impaired loans are generally 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.

(Continued)

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 June 30, 2019:

| | 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 | \$ 0 | \$ 0 | \$ 833,589,000 | \$ 833,589,000 | \$ 0 |
| Vacant land, land development, and residential construction | 0 | 0 | 0 | 0 | 40,609,000 | 40,609,000 | 0 |
| Real estate – owner occupied | 0 | 0 | 0 | 0 | 513,016,000 | 513,016,000 | 0 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 786,666,000 | 786,666,000 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 0 | 101,051,000 | 101,051,000 | 0 |
| Total commercial | 0 | 0 | 0 | 0 | 2,274,931,000 | 2,274,931,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 7,000 | 0 | 0 | 7,000 | 64,240,000 | 64,247,000 | 0 |
| 1-4 family mortgages | 0 | 0 | 108,000 | 108,000 | 270,400,000 | 270,508,000 | 0 |
| Total retail | 7,000 | 0 | 108,000 | 115,000 | 334,640,000 | 334,755,000 | 0 |
| Total past due loans | \$ 7,000 | \$ 0 | \$ 108,000 | \$ 115,000 | \$ 2,609,571,000 | \$ 2,609,686,000 | \$ 0 |

(Continued)

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 | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 47,607,000 | \$ 47,607,000 | \$ 0 |
| Vacant land, land development, and residential construction | 122,000 | 0 | 0 | 122,000 | 4,427,000 | 4,549,000 | 0 |
| Real estate – owner occupied | 0 | 105,000 | 0 | 105,000 | 43,747,000 | 43,852,000 | 0 |
| Real estate – non-owner occupied | 96,000 | 0 | 26,000 | 122,000 | 66,056,000 | 66,178,000 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 0 | 27,438,000 | 27,438,000 | 0 |
| Total commercial | 218,000 | 105,000 | 26,000 | 349,000 | 189,275,000 | 189,624,000 | 0 |
| Retail: | | | | | | | |
| Home equity and other | 126,000 | 13,000 | 20,000 | 159,000 | 16,914,000 | 17,073,000 | 0 |
| 1-4 family mortgages | 187,000 | 141,000 | 413,000 | 741,000 | 64,369,000 | 65,110,000 | 0 |
| Total retail | 313,000 | 154,000 | 433,000 | 900,000 | 81,283,000 | 82,183,000 | 0 |
| Total past due loans | <u>\$ 531,000</u> | <u>\$ 259,000</u> | <u>\$ 459,000</u> | <u>\$ 1,249,000</u> | <u>\$ 270,558,000</u> | <u>\$ 271,807,000</u> | <u>\$ 0</u> |

(Continued)

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

(Continued)

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

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired originated loans as of June 30, 2019, and average originated impaired loans for the three and six months ended June 30, 2019, were as follows:

| | Unpaid Contractual Principal Balance | Recorded Principal Balance | Related Allowance | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With no related allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 10,007,000 | \$ 10,007,000 | | \$ 9,792,000 | \$ 9,396,000 |
| Vacant land, land development and residential construction | 88,000 | 88,000 | | 90,000 | 91,000 |
| Real estate – owner occupied | 2,059,000 | 2,059,000 | | 1,281,000 | 1,064,000 |
| Real estate – non-owner occupied | 0 | 0 | | 0 | 0 |
| Real estate – multi-family and residential rental | 135,000 | 126,000 | | 63,000 | 42,000 |
| Total commercial | 12,289,000 | 12,280,000 | | 11,226,000 | 10,593,000 |
| Retail: | | | | | |
| Home equity and other | 829,000 | 807,000 | | 707,000 | 667,000 |
| 1-4 family mortgages | 910,000 | 338,000 | | 351,000 | 364,000 |
| Total retail | 1,739,000 | 1,145,000 | | 1,058,000 | 1,031,000 |
| Total with no related allowance recorded | <u>\$ 14,028,000</u> | <u>\$ 13,425,000</u> | | <u>\$ 12,284,000</u> | <u>\$ 11,624,000</u> |

(Continued)

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 | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With an allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 13,656,000 | \$ 13,656,000 | \$ 2,051,000 | \$ 9,581,000 | \$ 8,058,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 | 0 | 0 |
| Real estate – owner occupied | 0 | 0 | 0 | 1,348,000 | 1,785,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 65,000 | 89,000 |
| Total commercial | 13,656,000 | 13,656,000 | 2,051,000 | 10,994,000 | 9,932,000 |
| Retail: | | | | | |
| Home equity and other | 386,000 | 373,000 | 158,000 | 377,000 | 395,000 |
| 1-4 family mortgages | 406,000 | 331,000 | 18,000 | 334,000 | 336,000 |
| Total retail | 792,000 | 704,000 | 176,000 | 711,000 | 731,000 |
| Total with an allowance recorded | <u>\$ 14,448,000</u> | <u>\$ 14,360,000</u> | <u>\$ 2,227,000</u> | <u>\$ 11,705,000</u> | <u>\$ 10,663,000</u> |
| Total impaired loans: | | | | | |
| Commercial | \$ 25,945,000 | \$ 25,936,000 | \$ 2,051,000 | \$ 22,220,000 | \$ 20,525,000 |
| Retail | 2,531,000 | 1,849,000 | 176,000 | 1,769,000 | 1,762,000 |
| Total impaired loans | <u>\$ 28,476,000</u> | <u>\$ 27,785,000</u> | <u>\$ 2,227,000</u> | <u>\$ 23,989,000</u> | <u>\$ 22,287,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of June 30, 2019, and average impaired acquired loans for the three and six months ended June 30, 2019, were as follows:

| | Unpaid Contractual Principal Balance | Recorded Principal Balance | Related Allowance | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With no related allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 360,000 | \$ 353,000 | | \$ 422,000 | \$ 414,000 |
| Vacant land, land development and residential construction | 0 | 0 | | 0 | 0 |
| Real estate – owner occupied | 944,000 | 916,000 | | 802,000 | 932,000 |
| Real estate – non-owner occupied | 213,000 | 211,000 | | 175,000 | 117,000 |
| Real estate – multi-family and residential rental | 40,000 | 21,000 | | 26,000 | 26,000 |
| Total commercial | 1,557,000 | 1,501,000 | | 1,425,000 | 1,489,000 |
| Retail: | | | | | |
| Home equity and other | 686,000 | 628,000 | | 653,000 | 555,000 |
| 1-4 family mortgages | 2,462,000 | 1,734,000 | | 1,850,000 | 1,850,000 |
| Total retail | 3,148,000 | 2,362,000 | | 2,503,000 | 2,405,000 |
| Total with no related allowance recorded | <u>\$ 4,705,000</u> | <u>\$ 3,863,000</u> | | <u>\$ 3,928,000</u> | <u>\$ 3,894,000</u> |

(Continued)

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 | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With an allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 140,000 | \$ 138,000 | \$ 32,000 | \$ 106,000 | \$ 126,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 | 0 | 0 |
| Real estate – owner occupied | 0 | 0 | 0 | 36,000 | 73,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 47,000 | 101,000 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 | 0 | 1,000 |
| Total commercial | 140,000 | 138,000 | 32,000 | 189,000 | 301,000 |
| Retail: | | | | | |
| Home equity and other | 243,000 | 241,000 | 107,000 | 195,000 | 277,000 |
| 1-4 family mortgages | 408,000 | 385,000 | 83,000 | 305,000 | 327,000 |
| Total retail | 651,000 | 626,000 | 190,000 | 500,000 | 604,000 |
| Total with an allowance recorded | \$ 791,000 | \$ 764,000 | \$ 222,000 | \$ 689,000 | \$ 905,000 |
| Total impaired loans: | | | | | |
| Commercial | \$ 1,697,000 | \$ 1,639,000 | \$ 32,000 | \$ 1,614,000 | \$ 1,790,000 |
| Retail | 3,799,000 | 2,988,000 | 190,000 | 3,003,000 | 3,009,000 |
| Total impaired loans | \$ 5,496,000 | \$ 4,627,000 | \$ 222,000 | \$ 4,617,000 | \$ 4,799,000 |

(Continued)

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, 2018, and average impaired originated loans for the three and six months ended June 30, 2018, were as follows:

| | Unpaid Contractual Principal Balance | Recorded Principal Balance | Related Allowance | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With no related allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 8,604,000 | \$ 8,604,000 | | \$ 373,000 | \$ 308,000 |
| Vacant land, land development and residential construction | 94,000 | 94,000 | | 50,000 | 45,000 |
| Real estate – owner occupied | 632,000 | 632,000 | | 1,453,000 | 1,453,000 |
| Real estate – non-owner occupied | 0 | 0 | | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | | 283,000 | 305,000 |
| Total commercial | 9,330,000 | 9,330,000 | | 2,159,000 | 2,111,000 |
| Retail: | | | | | |
| Home equity and other | 607,000 | 586,000 | | 684,000 | 683,000 |
| 1-4 family mortgages | 1,053,000 | 390,000 | | 405,000 | 422,000 |
| Total retail | 1,660,000 | 976,000 | | 1,089,000 | 1,105,000 |
| Total with no related allowance recorded | <u>\$ 10,990,000</u> | <u>\$ 10,306,000</u> | | <u>\$ 3,248,000</u> | <u>\$ 3,216,000</u> |

(Continued)

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 | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With an allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 5,011,000 | \$ 5,011,000 | \$ 83,000 | \$ 2,089,000 | \$ 2,389,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 | 0 | 0 |
| Real estate – owner occupied | 2,658,000 | 2,658,000 | 363,000 | 1,713,000 | 1,606,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 140,000 | 135,000 | 5,000 | 143,000 | 96,000 |
| Total commercial | 7,809,000 | 7,804,000 | 451,000 | 3,945,000 | 4,091,000 |
| Retail: | | | | | |
| Home equity and other | 442,000 | 431,000 | 194,000 | 494,000 | 712,000 |
| 1-4 family mortgages | 409,000 | 341,000 | 44,000 | 351,000 | 270,000 |
| Total retail | 851,000 | 772,000 | 238,000 | 845,000 | 982,000 |
| Total with an allowance recorded | <u>\$ 8,660,000</u> | <u>\$ 8,576,000</u> | <u>\$ 689,000</u> | <u>\$ 4,790,000</u> | <u>\$ 5,073,000</u> |
| Total impaired loans: | | | | | |
| Commercial | \$ 17,139,000 | \$ 17,134,000 | \$ 451,000 | \$ 6,104,000 | \$ 6,202,000 |
| Retail | 2,511,000 | 1,748,000 | 238,000 | 1,934,000 | 2,087,000 |
| Total impaired loans | <u>\$ 19,650,000</u> | <u>\$ 18,882,000</u> | <u>\$ 689,000</u> | <u>\$ 8,038,000</u> | <u>\$ 8,289,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Impaired acquired loans as of December 31, 2018, and average impaired acquired loans for the three and six months ended June 30, 2018, were as follows:

| | Unpaid Contractual Principal Balance | Recorded Principal Balance | Related Allowance | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| <u>With no related allowance recorded</u> | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 398,000 | \$ 398,000 | | \$ 720,000 | \$ 821,000 |
| Vacant land, land development and residential construction | 0 | 0 | | 0 | 0 |
| Real estate – owner occupied | 1,193,000 | 1,193,000 | | 677,000 | 671,000 |
| Real estate – non-owner occupied | 0 | 0 | | 228,000 | 231,000 |
| Real estate – multi-family and residential rental | 45,000 | 26,000 | | 42,000 | 101,000 |
| Total commercial | 1,636,000 | 1,617,000 | | 1,667,000 | 1,824,000 |
| Retail: | | | | | |
| Home equity and other | 388,000 | 361,000 | | 710,000 | 642,000 |
| 1-4 family mortgages | 2,494,000 | 1,849,000 | | 2,000,000 | 2,051,000 |
| Total retail | 2,882,000 | 2,210,000 | | 2,710,000 | 2,693,000 |
| Total with no related allowance recorded | <u>\$ 4,518,000</u> | <u>\$ 3,827,000</u> | | <u>\$ 4,377,000</u> | <u>\$ 4,517,000</u> |

(Continued)

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 | Second Quarter Average Recorded Principal Balance | Year-To- Date Average Recorded Principal Balance |
|--|---|----------------------------------|----------------------|--|---|
| With an allowance recorded | | | | | |
| Commercial: | | | | | |
| Commercial and industrial | \$ 175,000 | \$ 166,000 | \$ 43,000 | \$ 0 | \$ 0 |
| Vacant land, land development and residential construction | 0 | 0 | 0 | 0 | 0 |
| Real estate – owner occupied | 147,000 | 147,000 | 0 | 799,000 | 533,000 |
| Real estate – non-owner occupied | 210,000 | 210,000 | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 3,000 | 3,000 | 0 | 0 | 0 |
| Total commercial | 535,000 | 526,000 | 43,000 | 799,000 | 533,000 |
| Retail: | | | | | |
| Home equity and other | 462,000 | 440,000 | 178,000 | 17,000 | 12,000 |
| 1-4 family mortgages | 418,000 | 371,000 | 89,000 | 0 | 0 |
| Total retail | 880,000 | 811,000 | 267,000 | 17,000 | 12,000 |
| Total with an allowance recorded | <u>\$ 1,415,000</u> | <u>\$ 1,337,000</u> | <u>\$ 310,000</u> | <u>\$ 816,000</u> | <u>\$ 545,000</u> |
| Total impaired loans: | | | | | |
| Commercial | \$ 2,171,000 | \$ 2,143,000 | \$ 43,000 | \$ 2,466,000 | \$ 2,357,000 |
| Retail | 3,762,000 | 3,021,000 | 267,000 | 2,727,000 | 2,705,000 |
| Total impaired loans | <u>\$ 5,933,000</u> | <u>\$ 5,164,000</u> | <u>\$ 310,000</u> | <u>\$ 5,193,000</u> | <u>\$ 5,062,000</u> |

Impaired loans for which no allocation of the allowance for loan losses has been made generally reflect situations whereby the loans have been charged-down to estimated collateral value. Interest income recognized on accruing troubled debt restructurings totaled \$0.2 million and \$0.1 million during the second quarters of 2019 and 2018, respectively, and \$0.5 million during the first six months of 2019 and 2018. No interest income was recognized on nonaccrual loans during the second quarter and first six months of 2019 or during the respective 2018 periods. Lost interest income on nonaccrual loans totaled less than \$0.1 million during the second quarters of 2019 and 2018, and less than \$0.1 million and \$0.1 million during the first six months of 2019 and 2018, respectively.

(Continued)

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 and delinquency.

Credit quality indicators were as follows as of June 30, 2019:

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 | \$ 521,211,000 | \$ 24,520,000 | \$ 320,067,000 | \$ 544,164,000 | \$ 72,767,000 |
| Grades 5 – 7 | 288,248,000 | 16,001,000 | 190,466,000 | 242,415,000 | 28,109,000 |
| Grades 8 – 9 | 24,130,000 | 88,000 | 2,483,000 | 87,000 | 175,000 |
| Total commercial | \$ 833,589,000 | \$ 40,609,000 | \$ 513,016,000 | \$ 786,666,000 | \$ 101,051,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|---------------------|------------------------------------|-----------------------------------|
| Total retail | \$ 64,247,000 | \$ 270,508,000 |

(Continued)

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 | \$ 28,882,000 | \$ 1,126,000 | \$ 19,972,000 | \$ 51,606,000 | \$ 16,409,000 |
| Grades 5 – 7 | 18,213,000 | 3,176,000 | 22,750,000 | 14,404,000 | 10,987,000 |
| Grades 8 – 9 | 512,000 | 247,000 | 1,130,000 | 168,000 | 42,000 |
| Total commercial | \$ 47,607,000 | \$ 4,549,000 | \$ 43,852,000 | \$ 66,178,000 | \$ 27,438,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|--------------|------------------------------------|-----------------------------------|
| Total retail | \$ 17,073,000 | \$ 65,110,000 |

(Continued)

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, 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 | \$ 508,611,000 | \$ 28,170,000 | \$ 325,459,000 | \$ 526,445,000 | \$ 75,051,000 |
| Grades 5 – 7 | 238,942,000 | 11,686,000 | 163,455,000 | 218,682,000 | 22,798,000 |
| Grades 8 – 9 | 21,145,000 | 94,000 | 11,274,000 | 0 | 186,000 |
| Total commercial | \$ 768,698,000 | \$ 39,950,000 | \$ 500,188,000 | \$ 745,127,000 | \$ 98,035,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|---------------------|------------------------------------|-----------------------------------|
| Total retail | \$ 65,023,000 | \$ 235,425,000 |

(Continued)

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 | \$ 34,678,000 | \$ 1,246,000 | \$ 21,595,000 | \$ 54,401,000 | \$ 16,050,000 |
| Grades 5 – 7 | 19,122,000 | 3,431,000 | 25,485,000 | 16,687,000 | 13,460,000 |
| Grades 8 – 9 | 225,000 | 258,000 | 1,351,000 | 67,000 | 52,000 |
| Total commercial | \$ 54,025,000 | \$ 4,935,000 | \$ 48,431,000 | \$ 71,155,000 | \$ 29,562,000 |

Retail credit exposure – credit risk profiled by collateral type:

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|---------------------|------------------------------------|-----------------------------------|
| Total retail | \$ 20,416,000 | \$ 72,115,000 |

(Continued)

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.

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

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 and six months ended June 30, 2019 are as follows:

| | Commercial Loans | Retail Loans | Unallocated | Total |
|---|-------------------------|-----------------------|------------------|-------------------------|
| Allowance for loan losses: | | | | |
| Balance at March 31, 2019 | \$ 20,050,000 | \$ 2,140,000 | \$ 228,000 | \$ 22,418,000 |
| Provision for loan losses | 979,000 | 50,000 | (131,000) | 898,000 |
| Charge-offs | (2,000) | (75,000) | 0 | (77,000) |
| Recoveries | 46,000 | 46,000 | 0 | 92,000 |
| Ending balance | <u>\$ 21,073,000</u> | <u>\$ 2,161,000</u> | <u>\$ 97,000</u> | <u>\$ 23,331,000</u> |
| Allowance for loan losses: | | | | |
| Balance at December 31, 2018 | \$ 19,442,000 | \$ 2,068,000 | \$ 44,000 | \$ 21,554,000 |
| Provision for loan losses | 1,559,000 | 255,000 | 53,000 | 1,867,000 |
| Charge-offs | (2,000) | (250,000) | 0 | (252,000) |
| Recoveries | 74,000 | 88,000 | 0 | 162,000 |
| Ending balance | <u>\$ 21,073,000</u> | <u>\$ 2,161,000</u> | <u>\$ 97,000</u> | <u>\$ 23,331,000</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 2,051,000</u> | <u>\$ 176,000</u> | <u>\$ 0</u> | <u>\$ 2,227,000</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 19,022,000</u> | <u>\$ 1,985,000</u> | <u>\$ 97,000</u> | <u>\$ 21,104,000</u> |
| Total loans: | | | | |
| Ending balance | <u>\$ 2,274,931,000</u> | <u>\$ 334,755,000</u> | | <u>\$ 2,609,686,000</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 25,936,000</u> | <u>\$ 1,849,000</u> | | <u>\$ 27,785,000</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 2,248,995,000</u> | <u>\$ 332,906,000</u> | | <u>\$ 2,581,901,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Activity in the allowance for loan losses for acquired loans during the three and six months ended June 30, 2019 is as follows:

| | Commercial Loans | Retail Loans | Unallocated | Total |
|-----------------------------------|---------------------|-------------------|-------------|-------------------|
| Allowance for loan losses: | | | | |
| Balance at March 31, 2019 | \$ 161,000 | \$ 556,000 | \$ 0 | \$ 717,000 |
| Provision for loan losses | 36,000 | (34,000) | 0 | 2,000 |
| Charge-offs | 0 | 0 | 0 | 0 |
| Recoveries | 1,000 | 2,000 | 0 | 3,000 |
| Ending balance | <u>\$ 198,000</u> | <u>\$ 524,000</u> | <u>\$ 0</u> | <u>\$ 722,000</u> |
| Allowance for loan losses: | | | | |
| Balance at December 31, 2018 | \$ 177,000 | \$ 649,000 | \$ 0 | \$ 826,000 |
| Provision for loan losses | 20,000 | (137,000) | 0 | (117,000) |
| Charge-offs | 0 | 0 | 0 | 0 |
| Recoveries | 1,000 | 12,000 | 0 | 13,000 |
| Ending balance | <u>\$ 198,000</u> | <u>\$ 524,000</u> | <u>\$ 0</u> | <u>\$ 722,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity in the allowance for loan losses for originated loans during the three and six months ended June 30, 2018 and the recorded investments in originated loans as of December 31, 2018 are as follows:

| | <u>Commercial Loans</u> | <u>Retail Loans</u> | <u>Unallocated</u> | <u>Total</u> |
|---|-----------------------------|-------------------------|--------------------|-------------------------|
| Allowance for loan losses: | | | | |
| Balance at March 31, 2018 | \$ 16,865,000 | \$ 2,001,000 | \$ 215,000 | \$ 19,081,000 |
| Provision for loan losses | 892,000 | 297,000 | (275,000) | 914,000 |
| Charge-offs | (85,000) | (189,000) | 0 | (274,000) |
| Recoveries | 654,000 | 107,000 | 0 | 761,000 |
| Ending balance | <u>\$ 18,326,000</u> | <u>\$ 2,216,000</u> | <u>\$ (60,000)</u> | <u>\$ 20,482,000</u> |
| Allowance for loan losses: | | | | |
| Balance at December 31, 2017 | \$ 16,456,000 | \$ 2,584,000 | \$ 93,000 | \$ 19,133,000 |
| Provision for loan losses | 551,000 | (266,000) | (153,000) | 132,000 |
| Charge-offs | (342,000) | (324,000) | 0 | (666,000) |
| Recoveries | 1,661,000 | 222,000 | 0 | 1,883,000 |
| Ending balance | <u>\$ 18,326,000</u> | <u>\$ 2,216,000</u> | <u>\$ (60,000)</u> | <u>\$ 20,482,000</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 391,000</u> | <u>\$ 283,000</u> | <u>\$ 0</u> | <u>\$ 674,000</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 17,935,000</u> | <u>\$ 1,933,000</u> | <u>\$ (60,000)</u> | <u>\$ 19,808,000</u> |
| Total loans: | | | | |
| Ending balance | <u>\$ 2,151,998,000</u> | <u>\$ 300,448,000</u> | | <u>\$ 2,452,446,000</u> |
| Ending balance: individually evaluated for impairment | <u>\$ 17,134,000</u> | <u>\$ 1,748,000</u> | | <u>\$ 18,882,000</u> |
| Ending balance: collectively evaluated for impairment | <u>\$ 2,134,864,000</u> | <u>\$ 298,700,000</u> | | <u>\$ 2,433,564,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

Activity in the allowance for loan losses for acquired loans during the three and six months ended June 30, 2018 is as follows:

| | Commercial Loans | Retail Loans | Unallocated | Total |
|-----------------------------------|---------------------|-------------------|-------------|-------------------|
| Allowance for loan losses: | | | | |
| Balance at March 31, 2018 | \$ 359,000 | \$ 534,000 | \$ 0 | \$ 893,000 |
| Provision for loan losses | (254,000) | 40,000 | 0 | (214,000) |
| Charge-offs | 0 | 0 | 0 | 0 |
| Recoveries | 0 | 6,000 | 0 | 6,000 |
| Ending balance | <u>\$ 105,000</u> | <u>\$ 580,000</u> | <u>\$ 0</u> | <u>\$ 685,000</u> |
| Allowance for loan losses: | | | | |
| Balance at December 31, 2017 | \$ 291,000 | \$ 77,000 | \$ 0 | \$ 368,000 |
| Provision for loan losses | 60,000 | 508,000 | 0 | 568,000 |
| Charge-offs | (246,000) | (15,000) | 0 | (261,000) |
| Recoveries | 0 | 10,000 | 0 | 10,000 |
| Ending balance | <u>\$ 105,000</u> | <u>\$ 580,000</u> | <u>\$ 0</u> | <u>\$ 685,000</u> |

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

(Continued)

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 June 30, 2019 were as follows:

| | Number of Contracts | Pre- Modification Recorded Principal Balance | Post- Modification Recorded Principal Balance |
|--|------------------------|--|---|
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 3 | \$ 14,040,000 | \$ 14,337,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 1 | 1,567,000 | 1,567,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total originated commercial | 4 | 15,607,000 | 15,904,000 |
| Retail: | | | |
| Home equity and other | 2 | 23,000 | 23,000 |
| 1-4 family mortgages | 0 | 0 | 0 |
| Total originated retail | 2 | 23,000 | 23,000 |
| Total originated loans | 6 | \$ 15,630,000 | \$ 15,927,000 |
| <u>Acquired loans</u> | | | |
| 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 acquired commercial | 0 | 0 | 0 |
| Retail: | | | |
| Home equity and other | 2 | 70,000 | 71,000 |
| 1-4 family mortgages | 3 | 122,000 | 122,000 |
| Total acquired retail | 5 | 192,000 | 193,000 |
| Total acquired loans | 5 | \$ 192,000 | \$ 193,000 |

(Continued)

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 six months ended June 30, 2019 were as follows:

| | Number of Contracts | Pre- Modification Recorded Principal Balance | Post- Modification Recorded Principal Balance |
|--|------------------------|--|---|
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 6 | \$ 14,429,000 | \$ 14,726,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 1 | 1,567,000 | 1,567,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total originated commercial | 7 | 15,996,000 | 16,293,000 |
| Retail: | | | |
| Home equity and other | 2 | 23,000 | 23,000 |
| 1-4 family mortgages | 0 | 0 | 0 |
| Total originated retail | 2 | 23,000 | 23,000 |
| Total originated loans | 9 | \$ 16,019,000 | \$ 16,316,000 |
| <u>Acquired loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 0 | \$ 0 | \$ 0 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 1 | 690,000 | 679,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total acquired commercial | 1 | 690,000 | 679,000 |
| Retail: | | | |
| Home equity and other | 6 | 140,000 | 141,000 |
| 1-4 family mortgages | 4 | 154,000 | 154,000 |
| Total acquired retail | 10 | 294,000 | 295,000 |
| Total acquired loans | 11 | \$ 984,000 | \$ 974,000 |

(Continued)

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 June 30, 2018 were as follows:

| | Number of Contracts | Pre- Modification Recorded Principal Balance | Post- Modification Recorded Principal Balance |
|--|------------------------|--|---|
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 2 | \$ 974,000 | \$ 1,079,000 |
| 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 originated commercial | 2 | 974,000 | 1,079,000 |
| Retail: | | | |
| Home equity and other | 0 | 0 | 0 |
| 1-4 family mortgages | 0 | 0 | 0 |
| Total originated retail | 0 | 0 | 0 |
| Total originated loans | 2 | \$ 974,000 | \$ 1,079,000 |
| <u>Acquired loans</u> | | | |
| 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 acquired commercial | 0 | 0 | 0 |
| Retail: | | | |
| Home equity and other | 5 | 113,000 | 114,000 |
| 1-4 family mortgages | 1 | 24,000 | 24,000 |
| Total acquired retail | 6 | 137,000 | 138,000 |
| Total acquired loans | 6 | \$ 137,000 | \$ 138,000 |

(Continued)

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 six months ended June 30, 2018 were as follows:

| | Number of Contracts | Pre- Modification Recorded Principal Balance | Post- Modification Recorded Principal Balance |
|--|------------------------|--|---|
| <u>Originated loans</u> | | | |
| Commercial: | | | |
| Commercial and industrial | 4 | \$ 1,068,000 | \$ 1,162,000 |
| Vacant land, land development and residential construction | 0 | 0 | 0 |
| Real estate – owner occupied | 2 | 1,192,000 | 1,180,000 |
| Real estate – non-owner occupied | 0 | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 | 0 |
| Total originated commercial | 6 | 2,260,000 | 2,342,000 |
| 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 | 7 | \$ 2,310,000 | \$ 2,392,000 |
| <u>Acquired loans</u> | | | |
| 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 acquired commercial | 0 | 0 | 0 |
| Retail: | | | |
| Home equity and other | 10 | 217,000 | 218,000 |
| 1-4 family mortgages | 1 | 24,000 | 24,000 |
| Total acquired retail | 11 | 241,000 | 242,000 |
| Total acquired loans | 11 | \$ 241,000 | \$ 242,000 |

(Continued)

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 June 30, 2019 (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 | 0 | 0 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 0 | 0 |
| Retail: | | |
| Home equity and other | 0 | 0 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 0 | 0 |
| Total | 0 | \$ 0 |

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2019 (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 | 0 | 0 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 0 | 0 |
| Retail: | | |
| Home equity and other | 0 | 0 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 0 | 0 |
| Total | 0 | \$ 0 |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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 June 30, 2019 (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 | 0 | 0 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 0 | 0 |
| Retail: | | |
| Home equity and other | 0 | 0 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 0 | 0 |
| Total | 0 | \$ 0 |

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 2019 (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 | 0 | 0 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 0 | 0 |
| Retail: | | |
| Home equity and other | 0 | 0 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 0 | 0 |
| Total | 0 | \$ 0 |

(Continued)

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 June 30, 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 | 195,000 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 1 | 195,000 |
| Retail: | | |
| Home equity and other | 0 | 0 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 0 | 0 |
| Total | 1 | \$ 195,000 |

The following originated loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 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 | 195,000 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 1 | 195,000 |
| Retail: | | |
| Home equity and other | 0 | 0 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 0 | 0 |
| Total | 1 | \$ 195,000 |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

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 June 30, 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 | 0 | 0 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 0 | 0 |
| Retail: | | |
| Home equity and other | 1 | 5,000 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 1 | 5,000 |
| Total | 1 | \$ 5,000 |

The following acquired loans, modified as troubled debt restructurings within the previous twelve months, became over 30 days past due within the six months ended June 30, 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 | 0 | 0 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 0 | 0 |
| Retail: | | |
| Home equity and other | 1 | 5,000 |
| 1-4 family mortgages | 0 | 0 |
| Total retail | 1 | 5,000 |
| Total | 1 | \$ 5,000 |

(Continued)

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 June 30, 2019 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 15,072,000 | \$ 0 | \$ 2,713,000 | \$ 0 | \$ 0 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (3,099,000) | 0 | (2,311,000) | 0 | 0 |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 11,672,000 | 0 | 1,180,000 | 0 | 0 |
| Ending Balance | <u>\$ 23,645,000</u> | <u>\$ 0</u> | <u>\$ 1,582,000</u> | <u>\$ 0</u> | <u>\$ 0</u> |
| | | | | | |
| | | | Retail Home Equity and Other | Retail 1-4 Family Mortgages | |
| Retail Loan Portfolio: | | | | | |
| Beginning Balance | | | \$ 915,000 | \$ 142,000 | |
| Charge-Offs | | | 0 | 0 | |
| Payments | | | (25,000) | (1,000) | |
| Transfers to ORE | | | 0 | 0 | |
| Net Additions/Deletions | | | 23,000 | 0 | |
| Ending Balance | | | <u>\$ 913,000</u> | <u>\$ 141,000</u> | |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the three months ended June 30, 2019 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 538,000 | \$ 0 | \$ 982,000 | \$ 189,000 | \$ 21,000 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (49,000) | 0 | (66,000) | (4,000) | (4,000) |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 0 | 0 | 0 | 0 | 0 |
| Ending Balance | <u>\$ 489,000</u> | <u>\$ 0</u> | <u>\$ 916,000</u> | <u>\$ 185,000</u> | <u>\$ 17,000</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 529,000 | \$ 458,000 |
| Charge-Offs | (18,000) | 0 |
| Payments | (37,000) | (13,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 79,000 | 120,000 |
| Ending Balance | <u>\$ 553,000</u> | <u>\$ 565,000</u> |

(Continued)

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 six months ended June 30, 2019 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 13,590,000 | \$ 0 | \$ 2,682,000 | \$ 0 | \$ 0 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (4,755,000) | 0 | (2,350,000) | 0 | 0 |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 14,810,000 | 0 | 1,250,000 | 0 | 0 |
| Ending Balance | <u>\$ 23,645,000</u> | <u>\$ 0</u> | <u>\$ 1,582,000</u> | <u>\$ 0</u> | <u>\$ 0</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 938,000 | \$ 142,000 |
| Charge-Offs | 0 | 0 |
| Payments | (48,000) | (1,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 23,000 | 0 |
| Ending Balance | <u>\$ 913,000</u> | <u>\$ 141,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the six months ended June 30, 2019 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 548,000 | \$ 0 | \$ 418,000 | \$ 210,000 | \$ 24,000 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (59,000) | 0 | (75,000) | (25,000) | (7,000) |
| Transfers to ORE | 0 | 0 | (97,000) | 0 | 0 |
| Net Additions/Deletions | 0 | 0 | 670,000 | 0 | 0 |
| Ending Balance | <u>\$ 489,000</u> | <u>\$ 0</u> | <u>\$ 916,000</u> | <u>\$ 185,000</u> | <u>\$ 17,000</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 464,000 | \$ 436,000 |
| Charge-Offs | (18,000) | 0 |
| Payments | (42,000) | (23,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 149,000 | 152,000 |
| Ending Balance | <u>\$ 553,000</u> | <u>\$ 565,000</u> |

(Continued)

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 June 30, 2018 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 1,982,000 | \$ 338,000 | \$ 4,548,000 | \$ 0 | \$ 0 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (53,000) | (109,000) | (2,764,000) | 0 | 0 |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 496,000 | 0 | 0 | 0 | 0 |
| Ending Balance | <u>\$ 2,425,000</u> | <u>\$ 229,000</u> | <u>\$ 1,784,000</u> | <u>\$ 0</u> | <u>\$ 0</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 1,169,000 | \$ 144,000 |
| Charge-Offs | 0 | 0 |
| Payments | (150,000) | (1,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 0 | 0 |
| Ending Balance | <u>\$ 1,019,000</u> | <u>\$ 143,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the three months ended June 30, 2018 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 716,000 | \$ 0 | \$ 2,007,000 | \$ 232,000 | \$ 36,000 |
| Charge-Offs | 0 | 0 | 0 | 0 | 0 |
| Payments | (22,000) | 0 | (1,614,000) | (7,000) | (4,000) |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 0 | 0 | 0 | 0 | 0 |
| Ending Balance | <u>\$ 694,000</u> | <u>\$ 0</u> | <u>\$ 393,000</u> | <u>\$ 225,000</u> | <u>\$ 32,000</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 240,000 | \$ 384,000 |
| Charge-Offs | (15,000) | 0 |
| Payments | (36,000) | (8,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 113,000 | 24,000 |
| Ending Balance | <u>\$ 302,000</u> | <u>\$ 400,000</u> |

(Continued)

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 six months ended June 30, 2018 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 2,989,000 | \$ 383,000 | \$ 1,599,000 | \$ 0 | \$ 0 |
| Charge-Offs | (230,000) | 0 | 0 | 0 | 0 |
| Payments | (935,000) | (154,000) | (3,619,000) | 0 | 0 |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 601,000 | 0 | 3,804,000 | 0 | 0 |
| Ending Balance | <u>\$ 2,425,000</u> | <u>\$ 229,000</u> | <u>\$ 1,784,000</u> | <u>\$ 0</u> | <u>\$ 0</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 1,127,000 | \$ 146,000 |
| Charge-Offs | 0 | 0 |
| Payments | (158,000) | (3,000) |
| Transfers to ORE | 0 | 0 |
| Net Additions/Deletions | 50,000 | 0 |
| Ending Balance | <u>\$ 1,019,000</u> | <u>\$ 143,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

3. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Activity for acquired loans categorized as troubled debt restructurings during the six months ended June 30, 2018 is as follows:

| | 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 |
|-----------------------------------|---------------------------------|--|--|--|---|
| Commercial Loan Portfolio: | | | | | |
| Beginning Balance | \$ 1,001,000 | \$ 0 | \$ 427,000 | \$ 237,000 | \$ 41,000 |
| Charge-Offs | (275,000) | 0 | 0 | 0 | 0 |
| Payments | (32,000) | 0 | (1,633,000) | (12,000) | (9,000) |
| Transfers to ORE | 0 | 0 | 0 | 0 | 0 |
| Net Additions/Deletions | 0 | 0 | 1,599,000 | 0 | 0 |
| Ending Balance | <u>\$ 694,000</u> | <u>\$ 0</u> | <u>\$ 393,000</u> | <u>\$ 225,000</u> | <u>\$ 32,000</u> |

| | Retail Home Equity and Other | Retail 1-4 Family Mortgages |
|-------------------------------|------------------------------------|-----------------------------------|
| Retail Loan Portfolio: | | |
| Beginning Balance | \$ 219,000 | \$ 393,000 |
| Charge-Offs | (30,000) | 0 |
| Payments | (37,000) | (17,000) |
| Transfers to ORE | (82,000) | 0 |
| Net Additions/Deletions | 232,000 | 24,000 |
| Ending Balance | <u>\$ 302,000</u> | <u>\$ 400,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

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

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

| | June 30, 2019 | December 31, 2018 |
|---|---------------------|----------------------|
| Commercial: | | |
| Commercial and industrial | \$ 2,083,000 | \$ 126,000 |
| Vacant land, land development, and residential construction | 0 | 0 |
| Real estate – owner occupied | 0 | 363,000 |
| Real estate – non-owner occupied | 0 | 0 |
| Real estate – multi-family and residential rental | 0 | 0 |
| Total commercial | 2,083,000 | 489,000 |
| Retail: | | |
| Home equity and other | 234,000 | 337,000 |
| 1-4 family mortgages | 95,000 | 110,000 |
| Total retail | 329,000 | 447,000 |
| Total related allowance | <u>\$ 2,412,000</u> | <u>\$ 936,000</u> |

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

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

4. PREMISES AND EQUIPMENT, NET

Premises and equipment are comprised of the following:

| | June 30, 2019 | December 31, 2018 |
|------------------------------------|----------------------|----------------------|
| Land and improvements | \$ 18,140,000 | \$ 18,198,000 |
| Buildings | 49,120,000 | 45,362,000 |
| Furniture and equipment | 19,762,000 | 18,139,000 |
| | 87,022,000 | 81,699,000 |
| Less: accumulated depreciation | 35,199,000 | 33,378,000 |
| Premises and equipment, net | \$ 51,823,000 | \$ 48,321,000 |

Depreciation expense totaled \$0.9 million during the second quarter of 2019 and 2018. Depreciation expense totaled \$1.9 million during the first six months of 2019, compared to \$1.7 million during the first six months of 2018.

5. DEPOSITS

Our total deposits at June 30, 2019 totaled \$2.62 billion, an increase of \$156 million, or 6.3%, from December 31, 2018. The components of our outstanding balances at June 30, 2019 and December 31, 2018, and percentage change in deposits from the end of 2018 to the end of the second quarter of 2019, are as follows:

| | June 30, 2019 | | December 31, 2018 | | Percent Increase (Decrease) |
|--------------------------------------|-------------------------|---------------|-------------------------|---------------|-----------------------------------|
| | Balance | % | Balance | % | |
| Noninterest-bearing checking | \$ 918,581,000 | 35.1% | \$ 889,784,000 | 36.1% | 3.2% |
| Interest-bearing checking | 286,531,000 | 10.9 | 339,089,000 | 13.8 | (15.5) |
| Money market | 484,177,000 | 18.5 | 434,333,000 | 17.6 | 11.5 |
| Savings | 270,563,000 | 10.3 | 317,014,000 | 12.9 | (14.7) |
| Time, under \$100,000 | 205,452,000 | 7.8 | 160,092,000 | 6.5 | 28.3 |
| Time, \$100,000 and over | 284,460,000 | 10.9 | 210,164,000 | 8.5 | 35.4 |
| Total local deposits | 2,449,764,000 | 93.5 | 2,350,476,000 | 95.4 | 4.2 |
| Out-of-area time, under \$100,000 | 0 | NA | 0 | NA | NA |
| Out-of-area time, \$100,000 and over | 169,445,000 | 6.5 | 113,232,000 | 4.6 | 49.6 |
| Total out-of-area deposits | 169,445,000 | 6.5 | 113,232,000 | 4.6 | 49.6 |
| Total deposits | \$ 2,619,209,000 | 100.0% | \$ 2,463,708,000 | 100.0% | 6.3% |

Total time deposits of more than \$250,000 totaled \$319 million and \$232 million at June 30, 2019 and December 31, 2018, respectively.

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MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

6. SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase (“repurchase agreements”) are offered principally to certain large deposit customers. Information relating to our repurchase agreements follows:

| | Six Months Ended June 30, 2019 | Twelve Months Ended December 31, 2018 |
|---|---|--|
| Outstanding balance at end of period | \$ 119,669,000 | \$ 103,519,000 |
| Average interest rate at end of period | 0.26% | 0.26% |
| Average daily balance during the period | \$ 103,172,000 | \$ 101,005,000 |
| Average interest rate during the period | 0.25% | 0.24% |
| Maximum daily balance during the period | \$ 124,288,000 | \$ 123,046,000 |

Repurchase agreements generally have maturities of one business day. Repurchase agreements are treated as financings and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the agreements are recorded as assets of our bank and are held in safekeeping by a correspondent bank. Repurchase agreements are secured by securities with an aggregate market value equal to the aggregate outstanding balance.

7. FEDERAL HOME LOAN BANK OF INDIANAPOLIS ADVANCES

Federal Home Loan Bank of Indianapolis (“FHLBI”) advances totaled \$374 million at June 30, 2019, and mature at varying dates from August 2019 through June 2025, with fixed rates of interest from 1.20% to 3.18% and averaging 2.39%. FHLBI advances totaled \$350 million at December 31, 2018, and were expected to mature at varying dates from January 2019 through June 2025, with fixed rates of interest from 1.20% to 3.18% and averaging 2.30%.

Each advance is payable at its maturity date and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of June 30, 2019 totaled about \$743 million, with remaining availability based on collateral approximating \$363 million.

Maturities of currently outstanding FHLBI advances are as follows:

| | |
|------------|---------------|
| 2019 | \$ 20,000,000 |
| 2020 | 40,000,000 |
| 2021 | 70,000,000 |
| 2022 | 94,000,000 |
| 2023 | 80,000,000 |
| Thereafter | 70,000,000 |

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MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

8. COMMITMENTS AND OFF-BALANCE SHEET RISK

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

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and property and equipment, is generally obtained based on our credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. There was no liability balance for these instruments as of June 30, 2019 and December 31, 2018.

A summary of the contractual amounts of our financial instruments with off-balance sheet risk at June 30, 2019 and December 31, 2018 follows:

| | June 30, 2019 | December 31, 2018 |
|---|-------------------------|-------------------------|
| Commercial unused lines of credit | \$ 773,984,000 | \$ 784,895,000 |
| Unused lines of credit secured by 1 – 4 family residential properties | 58,910,000 | 57,378,000 |
| Credit card unused lines of credit | 53,475,000 | 47,432,000 |
| Other consumer unused lines of credit | 19,178,000 | 20,231,000 |
| Commitments to make loans | 91,263,000 | 101,517,000 |
| Standby letters of credit | 22,515,000 | 25,322,000 |
| | <u>\$ 1,019,325,000</u> | <u>\$ 1,036,775,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

9. FAIR VALUES OF FINANCIAL INSTRUMENTS

The carrying amounts, estimated fair values and level within the fair value hierarchy of financial instruments were as follows as of June 30, 2019 and December 31, 2018 (dollars in thousands):

| | Level in Fair Value Hierarchy | June 30, 2019 | | December 31, 2018 | |
|-------------------------------|-------------------------------------|--------------------|----------------|--------------------|----------------|
| | | Carrying Values | Fair Values | Carrying Values | Fair Values |
| Financial assets: | | | | | |
| Cash | Level 1 | \$ 14,055 | \$ 14,055 | \$ 15,656 | \$ 15,656 |
| Cash equivalents | Level 2 | 136,370 | 136,370 | 59,698 | 59,698 |
| Securities available for sale | (1) | 347,924 | 347,924 | 337,366 | 337,366 |
| FHLBI stock | (2) | 18,002 | 18,002 | 16,022 | 16,022 |
| Loans, net | Level 3 | 2,852,940 | 2,876,906 | 2,729,583 | 2,711,687 |
| Loans held for sale | Level 2 | 4,500 | 4,500 | 1,122 | 1,122 |
| Mortgage servicing rights | Level 2 | 4,201 | 7,239 | 4,436 | 8,444 |
| Accrued interest receivable | Level 2 | 10,430 | 10,430 | 9,896 | 9,896 |
| Financial liabilities: | | | | | |
| Deposits | Level 2 | 2,619,209 | 2,516,965 | 2,463,708 | 2,471,617 |
| Repurchase agreements | Level 2 | 119,669 | 119,669 | 103,519 | 103,519 |
| FHLBI advances | Level 2 | 374,000 | 380,720 | 350,000 | 348,428 |
| Subordinated debentures | Level 2 | 46,540 | 46,248 | 46,199 | 46,543 |
| Accrued interest payable | Level 2 | 3,989 | 3,989 | 2,249 | 2,249 |

(1) See Note 10 for a description of the fair value hierarchy as well as a disclosure of levels for classes of financial assets and liabilities.

(2) It is not practical to determine the fair value of FHLBI stock due to transferability restrictions; therefore, fair value is estimated at carrying amount.

Carrying amount is the estimated fair value for cash and cash equivalents, FHLBI stock, accrued interest receivable and payable, noninterest-bearing checking accounts and securities sold under agreements to repurchase. Security fair values are based on market prices or dealer quotes, and if no such information is available, on the rate and term of the security and information about the issuer. Fair value for loans is based on an exit price model as required by ASU 2016-01, taking into account inputs such as discounted cash flows, probability of default and loss given default assumptions. Fair value for deposits accounts other than noninterest-bearing checking accounts is based on discounted cash flows using current market rates applied to the estimated life. The fair value of mortgage servicing rights is estimated using a valuation model that calculates the present value of estimated future net servicing cash flows, taking into consideration expected mortgage loan prepayment rates, discount rates, servicing costs and other economic factors, which are determined based on current market conditions. The fair values of subordinated debentures and FHLBI advances are based on current rates for similar financing. The fair value of off-balance sheet items is estimated to be nominal.

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

10. FAIR VALUES

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

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

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

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

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

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

Securities available for sale. Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government agencies, and municipal general obligation and revenue bonds. Level 3 securities include bonds issued by certain relatively small municipalities located within our markets that have very limited marketability due to their size and lack of ratings from a recognized rating service. We carry these bonds at historical cost, which we believe approximates fair value, unless our periodic financial analysis or other information that becomes known to us necessitates an impairment. There was no such impairment as of June 30, 2019 or December 31, 2018. We have no Level 1 securities available for sale.

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

10. FAIR VALUES (Continued)

Derivatives. We measure fair value utilizing models that use primarily market observable inputs, such as forecasted yield curves.

Mortgage 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, and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of June 30, 2019 and December 31, 2018, we determined that the fair value of our mortgage loans held for sale approximated the recorded cost of \$4.5 million and \$1.1 million, respectively.

Loans. We do not record loans at fair value on a recurring basis. However, from time to time, we record nonrecurring fair value adjustments to collateral dependent loans to reflect partial write-downs or specific reserves that are based on the observable market price or current estimated value of the collateral. These loans are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge-off. The fair values of impaired loans are determined using either the sales comparison approach or income approach; respective unobservable inputs for the approaches consist of adjustments for differences between comparable sales and the utilization of appropriate capitalization rates.

Foreclosed Assets. At time of foreclosure or repossession, foreclosed and repossessed assets are adjusted to fair value less costs to sell upon transfer of the loans to foreclosed and repossessed assets, establishing a new cost basis. We subsequently adjust estimated fair value of foreclosed assets on a nonrecurring basis to reflect write-downs based on revised fair value estimates. The fair values of parcels of other real estate owned are determined using either the sales comparison approach or income approach; respective unobservable inputs for the approaches consist of adjustments for differences between comparable sales and the utilization of appropriate capitalization rates.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2019 are as follows:

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|-----------------------|---|---|--|
| Available for sale securities | | | | |
| U.S. Government agency debt obligations | \$ 200,710,000 | \$ 0 | \$ 200,710,000 | \$ 0 |
| Mortgage-backed securities | 45,687,000 | 0 | 45,687,000 | 0 |
| Municipal general obligation bonds | 97,135,000 | 0 | 94,440,000 | 2,695,000 |
| Municipal revenue bonds | 3,892,000 | 0 | 3,892,000 | 0 |
| Other investments | 500,000 | 0 | 500,000 | 0 |
| Total | \$ 347,924,000 | \$ 0 | \$ 345,229,000 | \$ 2,695,000 |

There were no transfers in or out of Level 1, Level 2 or Level 3 during the first six months of 2019. The \$1.0 million reduction in Level 3 municipal general obligation bonds during the first six months of 2019 reflects the scheduled maturities of such bonds.

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

10. FAIR VALUES (Continued)

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2018 are as follows:

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|-----------------------|---|---|--|
| Available for sale securities | | | | |
| U.S. Government agency debt obligations | \$ 187,077,000 | \$ 0 | \$ 187,077,000 | \$ 0 |
| Mortgage-backed securities | 43,658,000 | 0 | 43,658,000 | 0 |
| Municipal general obligation bonds | 102,497,000 | 0 | 98,768,000 | 3,729,000 |
| Municipal revenue bonds | 3,634,000 | 0 | 3,634,000 | 0 |
| Other investments | 500,000 | 0 | 500,000 | 0 |
| Total | <u>\$ 337,366,000</u> | <u>\$ 0</u> | <u>\$ 333,637,000</u> | <u>\$ 3,729,000</u> |

There were no transfers in or out of Level 1, Level 2 or Level 3 during 2018. The \$1.5 million reduction in Level 3 municipal general obligation bonds during 2018 reflects the scheduled maturities of such bonds.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of June 30, 2019 are as follows:

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|-------------------|----------------------|---|---|--|
| Impaired loans | \$ 15,395,000 | \$ 0 | \$ 0 | \$ 15,395,000 |
| Foreclosed assets | 446,000 | 0 | 0 | 446,000 |
| Total | <u>\$ 15,841,000</u> | <u>\$ 0</u> | <u>\$ 0</u> | <u>\$ 15,841,000</u> |

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

10. FAIR VALUES (Continued)

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2018 are as follows:

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|-------------------|---------------------|--|---|--|
| Impaired loans | \$ 8,181,000 | \$ 0 | \$ 0 | \$ 8,181,000 |
| Foreclosed assets | 811,000 | 0 | 0 | 811,000 |
| Total | <u>\$ 8,992,000</u> | <u>\$ 0</u> | <u>\$ 0</u> | <u>\$ 8,992,000</u> |

The carrying values are based on the estimated value of the property or other assets. Fair value estimates of collateral on impaired loans and foreclosed assets are reviewed periodically. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside appraisals and internal evaluations based on identifiable trends within our markets, such as sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address current distressed market conditions. For real estate dependent loans and foreclosed assets, we generally assign a 15% to 25% discount factor for commercial-related properties, and a 25% to 50% discount factor for residential-related properties. In a vast majority of cases, we assign a 10% discount factor for estimated selling costs.

11. REGULATORY MATTERS

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

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to close monitoring by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At June 30, 2019 and December 31, 2018, our bank was in the well capitalized category under the regulatory framework for prompt corrective action. There are no conditions or events since June 30, 2019 that we believe have changed our bank's categorization.

(Continued)

MERCANTILE BANK CORPORATION
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited)

11. REGULATORY MATTERS (Continued)

Our actual capital levels (dollars in thousands) and the minimum levels required to be categorized as adequately and well capitalized were:

| | Actual | | Minimum Required for Capital Adequacy Purposes | | Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations | |
|--|------------|-------|--|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2019 | | | | | | |
| Total capital (to risk weighted assets) | | | | | | |
| Consolidated | \$ 412,841 | 12.6% | \$ 263,197 | 8.0% | NA | NA |
| Bank | 406,912 | 12.4 | 263,153 | 8.0 | 328,941 | 10.0% |
| Tier 1 capital (to risk weighted assets) | | | | | | |
| Consolidated | 388,788 | 11.8 | 197,398 | 6.0 | NA | NA |
| Bank | 382,859 | 11.6 | 197,365 | 6.0 | 263,153 | 8.0 |
| Common equity tier 1 (to risk weighted assets) | | | | | | |
| Consolidated | 344,323 | 10.5 | 148,049 | 4.5 | NA | NA |
| Bank | 382,859 | 11.6 | 148,024 | 4.5 | 213,812 | 6.5 |
| Tier 1 capital (to average assets) | | | | | | |
| Consolidated | 388,788 | 11.2 | 139,236 | 4.0 | NA | NA |
| Bank | 382,859 | 11.0 | 139,219 | 4.0 | 174,024 | 5.0 |
| December 31, 2018 | | | | | | |
| Total capital (to risk weighted assets) | | | | | | |
| Consolidated | \$ 396,102 | 12.5% | \$ 253,413 | 8.0% | NA | NA |
| Bank | 388,591 | 12.3 | 253,225 | 8.0 | 316,531 | 10.0% |
| Tier 1 capital (to risk weighted assets) | | | | | | |
| Consolidated | 373,721 | 11.8 | 190,060 | 6.0 | NA | NA |
| Bank | 366,211 | 11.6 | 189,919 | 6.0 | 253,225 | 8.0 |
| Common equity tier 1 (to risk weighted assets) | | | | | | |
| Consolidated | 329,596 | 10.4 | 142,545 | 4.5 | NA | NA |
| Bank | 366,211 | 11.6 | 142,439 | 4.5 | 205,745 | 6.5 |
| Tier 1 capital (to average assets) | | | | | | |
| Consolidated | 373,721 | 11.4 | 131,014 | 4.0 | NA | NA |
| Bank | 366,211 | 11.2 | 130,913 | 4.0 | 163,641 | 5.0 |

(Continued)

MERCANTILE BANK CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

11. REGULATORY MATTERS (Continued)

Our consolidated capital levels as of June 30, 2019 and December 31, 2018 include \$46.5 million and \$44.1 million, respectively, of trust preferred securities. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in our Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. Our ability to include the trust preferred securities in Tier 1 capital in accordance with the guidelines is not affected by the provision of the Dodd-Frank Act generally restricting such treatment, because (i) the trust preferred securities were issued before May 19, 2010, and (ii) our total consolidated assets as of December 31, 2009 were less than \$15.0 billion. As of June 30, 2019 and December 31, 2018, all \$46.5 million and \$44.1 million, respectively, of the trust preferred securities were included in our consolidated Tier 1 capital.

Under the final BASEL III capital rules that became effective on January 1, 2015, there is a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not meet this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in cash dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement was phased in over three years beginning in 2016. The capital buffer requirement effectively raised the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5% and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. We believe that, as of June 30, 2019, our bank meets all capital adequacy requirements under the BASEL III capital rules on a fully phased-in basis.

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. On January 17, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.26 per share that was paid on March 20, 2019 to shareholders of record as of March 8, 2019. On April 11, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.26 per share that was paid on June 19, 2019 to shareholders of record as of June 7, 2019. On July 11, 2019, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.27 per share that will be paid on September 18, 2019 to shareholders of record as of September 6, 2019.

We announced on January 30, 2015 that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase program. On May 7, 2019, we announced that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. This latest authorization included a termination of the existing authorization as detailed above. During the first six months of 2019, we purchased a total of 119,120 shares at a total price of \$3.6 million, at an average price per share of \$30.23. Since January 30, 2015 through June 30, 2019, we have purchased a total of 1,275,444 shares at a total price of \$29.0 million, at an average price per share of \$22.77. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan, which would also likely be funded from cash dividends paid to us from our bank.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Forward Looking Statements

This report contains forward-looking statements that are based on management’s beliefs, assumptions, current expectations, estimates and projections about the financial services industry, the economy, and our company. Words such as “anticipates,” “believes,” “estimates,” “expects,” “forecasts,” “intends,” “is likely,” “plans,” “projects,” and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions (“Future Factors”) that are difficult to predict with regard to timing, extent, likelihood and degree of occurrence. Therefore, actual results and outcomes may materially differ from what may be expressed or forecasted in such forward-looking statements. We undertake no obligation to update, amend, or clarify forward looking-statements, whether as a result of new information, future events (whether anticipated or unanticipated), or otherwise.

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; changes in the method of determining Libor, or the replacement of Libor with an alternative reference rate; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and risk factors described in our annual report on Form 10-K for the year ended December 31, 2018 or in this report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

Introduction

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, including Mercantile Bank of Michigan (“our bank”) and our bank’s two subsidiaries, Mercantile Bank Real Estate Co., LLC and Mercantile Insurance Center, Inc., at June 30, 2019 and December 31, 2018 and the results of operations for the three months and six months ended June 30, 2019 and June 30, 2018. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to “us,” “we,” “our” or “the company” include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

Critical Accounting Policies

Accounting principles generally accepted in the United States of America are complex and require us to apply significant judgment to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management’s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a discussion of our significant accounting policies, see Note 1 of the Notes to our Consolidated Financial Statements included in our Form 10-K for the fiscal year ended December 31, 2018 (Commission file number 000-26719). Our critical accounting policies are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements, and actual results may differ from those estimates. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

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

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

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

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

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

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

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

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 if conditions in the market place or changes in the company’s organizational structure occur. We use a discounted income approach and a market valuation model, which compares the inherent value of our company to valuations of recent transactions in the market place to determine if our goodwill has been impaired.

Financial Overview

We reported net income of \$11.7 million, or \$0.71 per diluted share, for the second quarter of 2019, compared to net income of \$9.4 million, or \$0.57 per diluted share, during the second quarter of 2018. Net income for the first six months of 2019 totaled \$23.5 million, or \$1.43 per diluted share, compared to \$20.3 million, or \$1.22 per diluted share, during the first six months of 2018.

A bank owned life insurance claim during the second quarter of 2019 increased net income by \$1.3 million, or \$0.08 per diluted share. Excluding the impact of this transaction, diluted earnings per share increased \$0.06, or almost 11% during the second quarter of 2019 compared to the second quarter of 2018. Bank owned life insurance claims and a gain on the sale of a former branch facility during the first six months of 2019 increased reported net income by \$3.1 million, or \$0.19 per diluted share, while the successful collection of certain nonperforming commercial loan relationships during the respective period in 2018 increased reported net income by \$1.7 million, or \$0.10 per diluted share. Excluding the impacts of these specific transactions, diluted earnings per share increased \$0.12, or nearly 11%, during the first six months of 2019 compared to the first six months of 2018.

The overall quality of our loan portfolio remains strong, with nonperforming loans equaling only 0.12% of total loans as of June 30, 2019. Gross loan charge-offs totaled \$0.1 million during the second quarter of 2019, and totaled \$0.3 million for the first six months of the year, while recoveries of prior period loan charge-offs equaled \$0.1 million and \$0.2 million during the respective time periods. Net loan recoveries, as a percent of average total loans, equaled an annualized 0.01% during the second quarter, while net loan charge-offs equaled an annualized 0.01% during the first six months of 2019. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries.

New commercial term loan originations totaled \$134 million during the second quarter of 2019, bringing the year-to-date total to \$259 million. The new commercial loan pipeline remains strong, and at June 30, 2019, we had \$129 million in unfunded loan commitments on commercial construction and development loans that are in the construction phase. We believe our loan portfolio remains well diversified, with commercial and industrial loans equaling 31%, non-owner occupied commercial real estate ("CRE") loans equaling 30%, owner occupied CRE loans equaling 19% and residential mortgage and consumer loans aggregating 15% of total loans at June 30, 2019. As a percent of total commercial loans, commercial and industrial loans and owner occupied CRE loans combined equaled 58% at June 30, 2019. We recorded a provision for loan losses of \$0.9 million during the second quarter of 2019, bringing the year-to-date total to \$1.8 million. The provision for loan losses recorded during 2019 primarily reflects commercial loan growth.

We believe our funding structure also remains well diversified. As of June 30, 2019, noninterest-bearing checking accounts comprised 30% of total funds, interest-bearing checking and securities sold under agreements to repurchase ("sweep accounts") combined for 13%, savings deposits and money market accounts aggregated to 24% and local time deposits accounted for 16%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank of Indianapolis ("FHLBI") advances, represented 17% of total funds.

Financial Condition

Our total assets increased \$212 million during the first six months of 2019, and totaled \$3.58 billion as of June 30, 2019. Total loans increased \$128 million, interest-earning deposits grew by \$82.3 million and securities available for sale increased \$10.6 million. Total deposits increased \$156 million, FHLBI advances were up \$24.0 million and sweep accounts increased \$16.2 million during the first six months of 2019.

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Commercial loans increased \$104 million during the first six months of 2019, and at June 30, 2019 totaled \$2.46 billion, or 85.5% of the loan portfolio. As of December 31, 2018, the commercial loan portfolio comprised 85.7% of total loans. The increase in commercial loans during the first six months of 2019 primarily reflects new commercial term loans to existing and new borrowers. Commercial and industrial loans were up \$58.5 million, non-owner occupied CRE loans increased \$36.6 million, owner occupied CRE loans were up \$8.2 million, multi-family and residential rental loans increased \$0.9 million and vacant land, land development and residential construction loans were up \$0.3 million. As a percent of total commercial loans, commercial and industrial loans and owner occupied CRE combined equaled 58.3% as of June 30, 2019, compared to 58.1% at December 31, 2018.

We are very pleased with the \$2.4 billion in new commercial term loan fundings since the beginning of 2015, including \$259 million during the first six months of 2019. As of June 30, 2019, availability on existing construction and development loans totaled \$129 million, with most of those funds expected to be drawn over the next 12 to 18 months. Our loan pipeline reports indicate continued strong commercial loan funding opportunities in future periods, including approximately \$91.3 million in new lending commitments, a majority of which we expect to be accepted and funded over the next 12 to 18 months. Our commercial lenders also report substantial additional opportunities they are currently discussing with existing and potentially new borrowers.

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

Residential mortgage loans increased \$28.1 million during the first six months of 2019, totaling \$336 million, or 11.7% of total loans, as of June 30, 2019. We originated \$125 million in residential mortgage loans during the first six months of 2019, which was over 21% higher than originations during the first six months of 2018. Residential mortgage loans originated for sale, generally consisting of longer-term fixed rate residential mortgage loans, during the first six months of 2019 totaled \$70.9 million, or almost 57% of total mortgage loans originated. The remaining portion, in large part comprised of adjustable rate residential mortgage loans, was added to our balance sheet. Despite the headwinds of an ongoing housing inventory shortage in most of our larger markets, we are pleased with the success of our strategic initiative to grow our residential mortgage banking operation over the past few years, and remain optimistic that origination volumes will continue to grow in future periods. As of June 30, 2019, the level of residential mortgage loan pre-qualifications was near an all-time high. Other consumer-related loans declined \$4.1 million during the first six months of 2019, and at June 30, 2019 totaled \$81.3 million, or 2.8% of total loans. Other consumer-related loans comprised 3.1% of total loans as of December 31, 2018. We expect this loan portfolio segment to decline in future periods as scheduled principal payments exceed anticipated new loan origination volumes.

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The following table summarizes our loan portfolio over the past twelve months:

| | 6/30/19 | 3/31/19 | 12/31/18 | 9/30/18 | 6/30/18 |
|------------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| Commercial: | | | | | |
| Commercial & Industrial | \$ 881,196,000 | \$ 839,207,000 | \$ 822,723,000 | \$ 818,112,000 | \$ 776,995,000 |
| Land Development & Construction | 45,158,000 | 45,892,000 | 44,885,000 | 39,396,000 | 37,868,000 |
| Owner Occupied Commercial RE | 556,868,000 | 551,518,000 | 548,619,000 | 542,731,000 | 533,075,000 |
| Non-Owner Occupied Commercial RE | 852,844,000 | 835,678,000 | 816,282,000 | 811,767,000 | 818,376,000 |
| Multi-Family & Residential Rental | 128,489,000 | 127,903,000 | 127,597,000 | 94,101,000 | 95,656,000 |
| Total Commercial | 2,464,555,000 | 2,400,198,000 | 2,360,106,000 | 2,306,107,000 | 2,261,970,000 |
| Retail: | | | | | |
| 1-4 Family Mortgages | 335,618,000 | 316,314,000 | 307,540,000 | 301,765,000 | 283,657,000 |
| Home Equity & Other Consumer Loans | 81,320,000 | 83,127,000 | 85,439,000 | 89,545,000 | 91,229,000 |
| Total Retail | 416,938,000 | 399,441,000 | 392,979,000 | 391,310,000 | 374,886,000 |
| Total | \$ 2,881,493,000 | \$ 2,799,639,000 | \$ 2,753,085,000 | \$ 2,697,417,000 | \$ 2,636,856,000 |

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans to provide effective loan portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans, which exhibit characteristics (financial or otherwise) that could cause the loans to become nonperforming or require restructuring in the future, are included on an internal watch list. Senior management and the Board of Directors review this list regularly. Market value estimates of collateral on impaired loans, as well as on foreclosed and repossessed assets, are reviewed periodically; however, we have a process in place to monitor whether value estimates at each quarter-end are reflective of current market conditions. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside and internal valuations based on identifiable trends within our markets, such as recent sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address distressed market conditions.

Nonperforming assets, comprised of nonaccrual loans, loans past due 90 days or more and accruing interest and foreclosed properties, totaled \$4.0 million (0.1% of total assets) as of June 30, 2019, compared to \$5.0 million (0.2% of total assets) as of December 31, 2018. Given the low level of nonperforming loans and accruing loans 30 to 89 days delinquent, combined with the manageable and steady level of watch list credits and what we believe are strong credit administration practices, we remain pleased with the overall quality of the loan portfolio.

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

NONPERFORMING LOANS

| | 6/30/19 | 3/31/19 | 12/31/18 | 9/30/18 | 6/30/18 |
|---------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| Residential Real Estate: | | | | | |
| Land Development | \$ 33,000 | \$ 45,000 | \$ 0 | \$ 0 | \$ 0 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied / Rental | 2,779,000 | 3,032,000 | 3,157,000 | 3,498,000 | 3,104,000 |
| | <u>2,812,000</u> | <u>3,077,000</u> | <u>3,157,000</u> | <u>3,498,000</u> | <u>3,104,000</u> |
| Commercial Real Estate: | | | | | |
| Land Development | 0 | 0 | 0 | 0 | 0 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied | 642,000 | 767,000 | 950,000 | 1,005,000 | 1,661,000 |
| Non-Owner Occupied | 26,000 | 62,000 | 0 | 0 | 0 |
| | <u>668,000</u> | <u>829,000</u> | <u>950,000</u> | <u>1,005,000</u> | <u>1,661,000</u> |
| Non-Real Estate: | | | | | |
| Commercial Assets | 2,000 | 207,000 | 17,000 | 331,000 | 180,000 |
| Consumer Assets | 23,000 | 25,000 | 17,000 | 18,000 | 20,000 |
| | <u>25,000</u> | <u>232,000</u> | <u>34,000</u> | <u>349,000</u> | <u>200,000</u> |
| Total | <u>\$ 3,505,000</u> | <u>\$ 4,138,000</u> | <u>\$ 4,141,000</u> | <u>\$ 4,852,000</u> | <u>\$ 4,965,000</u> |

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

| | 6/30/19 | 3/31/19 | 12/31/18 | 9/30/18 | 6/30/18 |
|---------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| Residential Real Estate: | | | | | |
| Land Development | \$ 0 | \$ 0 | \$ 0 | \$ 0 | \$ 0 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied / Rental | 446,000 | 372,000 | 398,000 | 410,000 | 546,000 |
| | <u>446,000</u> | <u>372,000</u> | <u>398,000</u> | <u>410,000</u> | <u>546,000</u> |
| Commercial Real Estate: | | | | | |
| Land Development | 0 | 0 | 0 | 0 | 0 |
| Construction | 0 | 0 | 0 | 0 | 0 |
| Owner Occupied | 0 | 24,000 | 413,000 | 538,000 | 296,000 |
| Non-Owner Occupied | 0 | 0 | 0 | 0 | 0 |
| | <u>0</u> | <u>24,000</u> | <u>413,000</u> | <u>538,000</u> | <u>296,000</u> |
| Non-Real Estate: | | | | | |
| Commercial Assets | 0 | 0 | 0 | 0 | 0 |
| Consumer Assets | 0 | 0 | 0 | 0 | 0 |
| | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> |
| Total | <u>\$ 446,000</u> | <u>\$ 396,000</u> | <u>\$ 811,000</u> | <u>\$ 948,000</u> | <u>\$ 842,000</u> |

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The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

| | 2nd Qtr 2019 | 1st Qtr 2019 | 4th Qtr 2018 | 3rd Qtr 2018 | 2nd Qtr 2018 |
|------------------------------------|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Beginning balance | \$ 4,138,000 | \$ 4,141,000 | \$ 4,852,000 | \$ 4,965,000 | \$ 5,742,000 |
| Additions, net of transfers to ORE | (85,000) | 525,000 | 1,181,000 | 748,000 | 51,000 |
| Returns to performing status | 0 | 0 | 0 | 0 | 0 |
| Principal payments | (512,000) | (382,000) | (1,835,000) | (857,000) | (778,000) |
| Loan charge-offs | (36,000) | (146,000) | (57,000) | (4,000) | (50,000) |
| Total | <u>\$ 3,505,000</u> | <u>\$ 4,138,000</u> | <u>\$ 4,141,000</u> | <u>\$ 4,852,000</u> | <u>\$ 4,965,000</u> |

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION

| | 2nd Qtr 2019 | 1st Qtr 2019 | 4th Qtr 2018 | 3rd Qtr 2018 | 2nd Qtr 2018 |
|-----------------------|--------------------------|--------------------------|--------------------------|--------------------------|--------------------------|
| Beginning balance | \$ 396,000 | \$ 811,000 | \$ 948,000 | \$ 842,000 | \$ 2,384,000 |
| Additions | 145,000 | 15,000 | 65,000 | 257,000 | 266,000 |
| Sale proceeds | (74,000) | (429,000) | (128,000) | (147,000) | (1,807,000) |
| Valuation write-downs | (21,000) | (1,000) | (74,000) | (4,000) | (1,000) |
| Total | <u>\$ 446,000</u> | <u>\$ 396,000</u> | <u>\$ 811,000</u> | <u>\$ 948,000</u> | <u>\$ 842,000</u> |

Gross loan charge-offs equaled \$0.1 million during the second quarter of 2019, and totaled \$0.3 million for the first six months of the year, while recoveries of prior period loan charge-offs equaled \$0.1 million and \$0.2 million during the respective time periods. Net loan recoveries, as a percent of average total loans, equaled an annualized 0.01% during the second quarter of 2019, while net loan charge-offs equaled an annualized 0.01% during the first six months of 2019. We continue our collection efforts on charged-off loans, and expect to record recoveries in future periods; however, given the nature of these efforts, it is not practical to forecast the dollar amount and timing of the recoveries.

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

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

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration analysis takes into account various time periods, with most weight placed on the time frame from December 31, 2010 through June 30, 2019. We believe this time period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general consensus of economic conditions in the near future.

Although the migration analysis provides a historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our commercial loans as of any quarter-end date. Therefore, we incorporate the environmental factors as adjustments to the historical data. Environmental factors include both internal and external items. We believe the most significant internal environmental factor is our credit culture and the relative aggressiveness in assigning and revising commercial loan risk ratings, with the most significant external environmental factor being the assessment of the current economic environment and the resulting implications on our commercial loan portfolio.

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

The allowance for originated loans equaled \$23.3 million as of June 30, 2019, or 0.9% of total originated loans outstanding, compared to \$21.6 million, or 0.9% of total originated loans outstanding at December 31, 2018. We also had an allowance for acquired loans as of June 30, 2019 and December 31, 2018, equaling \$0.7 million and \$0.8 million, respectively. The allowance equaled 686% of nonperforming loans as of June 30, 2019, compared to 540% as of December 31, 2018. The increase in this coverage ratio during the first six months of 2019 in large part reflects a combination of a \$0.6 million reduction in nonperforming loans and a \$1.7 million balance increase in the allowance.

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As of June 30, 2019, the allowance for originated loans was comprised of \$21.1 million in general reserves relating to non-impaired loans, less than \$0.1 million in specific reserve allocations relating to nonaccrual loans, and \$2.2 million in specific reserves on other loans, primarily accruing loans designated as troubled debt restructurings. Troubled debt restructurings totaled \$29.0 million at June 30, 2019, consisting of \$0.9 million that are on nonaccrual status and \$28.1 million that are on accrual status. The latter, while considered and accounted for as impaired loans in accordance with accounting guidelines, are not included in our nonperforming loan totals. Impaired loans with an aggregate carrying value of \$0.2 million as of June 30, 2019 had been subject to previous partial charge-offs aggregating \$0.5 million. Those partial charge-offs were recorded as follows: less than \$0.1 million in 2018, 2017, 2016 and 2013, \$0.1 million in 2015 and \$0.4 million in 2011. As of June 30, 2019, there were no specific reserves allocated to impaired loans that had been subject to a previous partial charge-off.

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

| | 6/30/19 | 3/31/19 | 12/31/18 | 9/30/18 | 6/30/18 |
|---------------|----------------------|----------------------|----------------------|----------------------|---------------------|
| Performing | \$ 28,129,000 | \$ 20,363,000 | \$ 19,223,000 | \$ 11,300,000 | \$ 5,985,000 |
| Nonperforming | 877,000 | 1,195,000 | 229,000 | 1,129,000 | 1,661,000 |
| Total | <u>\$ 29,006,000</u> | <u>\$ 21,558,000</u> | <u>\$ 19,452,000</u> | <u>\$ 12,429,000</u> | <u>\$ 7,646,000</u> |

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

Securities available for sale increased \$10.6 million during the first six months of 2019, totaling \$348 million as of June 30, 2019. Purchases during the first six months of 2019, consisting of U.S. Government agency bonds (\$8.0 million), U.S. Government agency issued or guaranteed mortgage-backed securities (\$5.6 million) and municipal bonds (\$10.6 million), totaled \$24.2 million. Proceeds from matured and called U.S. Government agency bonds and municipal bonds during the first six months of 2019 totaled \$4.5 million and \$18.4 million, respectively, with another \$4.3 million from principal paydowns on mortgage-backed securities. At June 30, 2019, the portfolio was primarily comprised of U.S. Government agency bonds (58%), municipal bonds (29%) and U.S. Government agency issued or guaranteed mortgage-backed securities (13%). All of our securities are currently designated as available for sale, and are therefore stated at fair value. The fair value of securities designated as available for sale at June 30, 2019 totaled \$348 million, including a net unrealized gain of \$3.6 million. We maintain the securities portfolio at levels to provide adequate pledging and secondary liquidity for our daily operations. In addition, the securities portfolio serves a primary interest rate risk management function. We expect purchases during the remainder of 2019 to generally consist of U.S. Government agency bonds, U.S. Government agency issued or guaranteed mortgage-backed securities and municipal bonds, with the securities portfolio maintained at about 10% of total assets.

FHLBI stock totaled \$18.0 million as of June 30, 2019, an increase of \$2.0 million compared to the balance at December 31, 2018. The increase reflects additional FHLBI stock purchased in conjunction with an increase in advances outstanding. Our investment in FHLBI stock is necessary to engage in their advance and other financing programs. We have regularly received quarterly cash dividends, and we expect a cash dividend will continue to be paid in future quarterly periods.

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

Interest-earning deposit balances, primarily consisting of excess funds deposited at the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate sensitivity. During the first six months of 2019, the average balance of these funds equaled \$81.3 million, or 2.5% of average earning assets. We expect the level of these funds to average approximately 1% to 2% of average earning assets in future quarters.

Net premises and equipment equaled \$51.8 million at June 30, 2019, an increase of \$3.5 million during the first six months of 2019. The increase was attributable to net purchases of \$5.4 million, in large part associated with an expansion project at our bank's main office. Depreciation expense totaled \$1.9 million during the first six months of 2019. Foreclosed and repossessed assets equaled \$0.4 million as of June 30, 2019, compared to \$0.8 million as of December 31, 2018. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on some impaired lending relationships, we believe the overall strong quality of our loan portfolio will limit any overall increase in, and average balance of, this particular nonperforming asset category in future periods.

Total deposits increased \$156 million during the first six months of 2019, totaling \$2.62 billion at June 30, 2019. Local deposits and out-of-area deposits increased \$99.3 million and \$56.2 million, respectively, during the first six months of 2019. As a percent of total deposits, out-of-area deposits equaled 6.5% as of June 30, 2019, compared to 4.6% as of December 31, 2018.

Noninterest-bearing checking accounts increased \$28.8 million during the first six months of 2019, in large part reflecting growth from deposit account openings as part of recently established commercial lending relationships. Interest-bearing checking accounts decreased \$52.6 million and savings deposits were down \$46.5 million, primarily reflecting the cyclical nature of deposit balances of many local governmental depositors. Money market deposit accounts increased \$49.8 million, primarily reflecting new funds being deposited into relatively high-paying accounts from current customers. Local time deposits increased \$120 million during the first six months of 2019, generally reflecting a new money time deposit campaign we ran during February, March and early April.

Sweep accounts increased \$16.2 million during the first six months of 2019, totaling \$120 million as of June 30, 2019. The aggregate balance of this funding type can be subject to relatively large fluctuations given the nature of the customers utilizing this product and the sizable balances of many of the customers. The average balance of the sweep account was \$103 million during the first six months of 2019. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts and savings deposits into over-night interest-bearing repurchase agreements. Such sweep accounts are not deposit accounts and are not afforded federal deposit insurance, and are accounted for as secured borrowings.

FHLBI advances increased \$24.0 million during the first six months of 2019, reflecting new advances obtained primarily to replace maturities and fund loan growth. As of June 30, 2019, FHLBI advances totaled \$374 million. The FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio and certain commercial real estate loans. Our borrowing line of credit as of June 30, 2019 totaled \$743 million, with remaining availability of \$363 million.

Shareholders' equity was \$400 million at June 30, 2019, compared to \$375 million at December 31, 2018. The \$24.9 million increase during the first six months of 2019 primarily reflects the positive impact of net income totaling \$23.5 million, compared to the negative impact of cash dividends and common stock repurchases totaling \$8.4 million and \$3.6 million, respectively. Reflecting the decline in market interest rates, the change in net unrealized holding gain/loss on securities available for sale, net of tax effect, had an \$11.1 million positive impact on shareholders' equity during the first six months of 2019.

Liquidity

Liquidity is measured by our ability to raise funds through deposits, borrowed funds, and capital, or cash flow from the repayment of loans and securities. These funds are used to fund loans, meet deposit withdrawals, maintain reserve requirements and operate our company. Liquidity is primarily achieved through local and out-of-area deposits and liquid assets such as securities available for sale, matured and called securities, federal funds sold and interest-earning deposit balances. Asset and liability management is the process of managing our balance sheet to achieve a mix of earning assets and liabilities that maximizes profitability, while providing adequate liquidity.

To assist in providing needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of deposits from customers outside of our market areas and advances from the FHLBI, totaled \$543 million, or 17.5% of combined deposits and borrowed funds, as of June 30, 2019, compared to \$474 million, or 16.2% of combined deposits and borrowed funds, as of December 31, 2018.

Sweep accounts increased \$16.2 million during the first six months of 2019, totaling \$120 million as of June 30, 2019. The aggregate balance of this funding type can be subject to relatively large fluctuations given the nature of the customers utilizing this product and the sizable balances of many of the customers. The average balance of the sweep account was \$103 million during the first six months of 2019. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts and savings deposits into over-night interest-bearing repurchase agreements. Such sweep accounts are not deposit accounts and are not afforded federal deposit insurance, and are accounted for as secured borrowings. Information regarding our repurchase agreements as of June 30, 2019 and during the first six months of 2019 is as follows:

| | | |
|---|----|-------------|
| Outstanding balance at June 30, 2019 | \$ | 119,669,000 |
| Weighted average interest rate at June 30, 2019 | | 0.26% |
| Maximum daily balance six months ended June 30, 2019 | \$ | 124,288,000 |
| Average daily balance for six months ended June 30, 2019 | \$ | 103,172,000 |
| Weighted average interest rate for six months ended June 30, 2019 | | 0.25% |

As a member of FHLBI, we have access to FHLBI advance borrowing programs. FHLBI advances increased \$24.0 million during the first six months of 2019, reflecting new advances obtained to replace maturing advances and assist in funding loan growth. As of June 30, 2019, FHLBI advances totaled \$374 million, and based on available collateral we could borrow an additional \$363 million.

We also have the ability to borrow up to \$70.0 million on a daily basis through correspondent banks using established unsecured federal funds purchased lines of credit. We accessed a line of credit on several occasions during the initial part of the first quarter of 2019 to provide short-term assistance in funding strong loan growth and business checking account withdrawals. Federal funds purchased averaged \$2.8 million during the first six months of 2019, compared to our interest-earning deposit balance with the Federal Reserve Bank of Chicago that averaged \$71.6 million. We also have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using certain municipal bonds as collateral, we could have borrowed up to \$32.6 million as of June 30, 2019. We did not utilize this line of credit during the first six months of 2019 or at any time during the previous ten fiscal years, and do not plan to access this line of credit in future periods.

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The following table reflects, as of June 30, 2019, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

| | One Year or Less | One to Three Years | Three to Five Years | Over Five Years | Total |
|------------------------------------|---------------------|-----------------------|------------------------|--------------------|------------------|
| Deposits without a stated maturity | \$ 1,959,852,000 | \$ 0 | \$ 0 | \$ 0 | \$ 1,959,852,000 |
| Time deposits | 355,889,000 | 273,947,000 | 29,521,000 | 0 | 659,357,000 |
| Short-term borrowings | 119,669,000 | 0 | 0 | 0 | 119,669,000 |
| Federal Home Loan Bank advances | 40,000,000 | 120,000,000 | 164,000,000 | 50,000,000 | 374,000,000 |
| Subordinated debentures | 0 | 0 | 0 | 46,540,000 | 46,540,000 |
| Other borrowed money | 0 | 0 | 0 | 2,889,000 | 2,889,000 |
| Property leases | 408,000 | 670,000 | 553,000 | 1,320,000 | 2,951,000 |

In addition to normal loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. As of June 30, 2019, we had a total of \$997 million in unfunded loan commitments and \$22.5 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$906 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$91.3 million were for loan commitments generally expected to close and become funded within the next 12 to 18 months. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

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

Capital Resources

Shareholders' equity was \$400 million at June 30, 2019, compared to \$375 million at December 31, 2018. The \$24.9 million increase during the first six months of 2019 primarily reflects the positive impact of net income totaling \$23.5 million, compared to the negative impact of cash dividends and common stock repurchases totaling \$8.4 million and \$3.6 million, respectively. Reflecting the decline in market interest rates, the change in net unrealized holding gain/loss on securities available for sale, net of tax effect, had an \$11.1 million positive impact on shareholders' equity during the first six months of 2019.

We announced on January 30, 2015 that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase program. On May 7, 2019, we announced that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. This latest authorization included a termination of the existing authorization as detailed above. During the first six months of 2019, we purchased a total of 119,120 shares of common stock at a total price of \$3.6 million, at an average price per share of \$30.23. Since January 30, 2015 through June 30, 2019, we have purchased a total of 1,275,444 shares of common stock at a total price of \$29.0 million, at an average price per share of \$22.77. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made in future periods under the authorized plan, which would also likely be funded from cash dividends paid to us from our bank.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. Under the BASEL III capital rules that became effective on January 1, 2015, there is a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not meet this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in cash dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement was phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5% and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. We believe that, as of June 30, 2019, our bank met all capital adequacy requirements under the BASEL III capital rules on a fully phased-in basis as if all such requirements were currently in effect.

As of June 30, 2019, our bank's total risk-based capital ratio was 12.4%, compared to 12.3% at December 31, 2018. Our bank's total regulatory capital increased \$18.3 million during the first six months of 2019, in large part reflecting the net impact of net income totaling \$26.8 million and cash dividends paid to us aggregating \$11.1 million. Our bank's total risk-based capital ratio was also impacted by a \$124 million increase in total risk-weighted assets, primarily resulting from commercial loan growth. As of June 30, 2019, our bank's total regulatory capital equaled \$407 million, or \$78.0 million in excess of the 10.0% minimum which is among the requirements to be categorized as "well capitalized." Our and our bank's capital ratios as of June 30, 2019 and December 31, 2018 are disclosed in Note 11 of the Notes to Condensed Consolidated Financial Statements.

Results of Operations

We recorded net income of \$11.7 million, or \$0.71 per basic and diluted share, for the second quarter of 2019, compared to net income of \$9.4 million, or \$0.57 per basic and diluted share, for the second quarter of 2018. We recorded net income of \$23.5 million, or \$1.43 per basic and diluted share, for the first six months of 2019, compared to net income of \$20.3 million, or \$1.22 per basic and diluted share, for the first six months of 2018.

A bank owned life insurance claim increased reported net income during the second quarter of 2019 by approximately \$1.3 million, or \$0.08 per diluted share. Excluding the impact of this transaction, diluted earnings per share increased \$0.06, or 10.5%, during the second quarter of 2019 compared to the prior-year second quarter. Bank owned life insurance claims and a gain on the sale of a former branch facility increased reported net income during the first six months of 2019 by approximately \$3.1 million, or \$0.19 per diluted share, while the successful collection of certain nonperforming commercial loans increased reported net income during the respective 2018 period by approximately \$1.7 million, or \$0.10 per diluted share. Excluding the impacts of these transactions, diluted earnings per share increased \$0.12, or 10.7%, during the first six months of 2019 compared to the respective prior-year period.

The higher level of net income during the second quarter of 2019 compared to the prior-year second quarter resulted from increased net interest income and noninterest income, which more than offset increased noninterest expense. The growth in net interest income stemmed from a higher level of earning assets, and the improved noninterest income primarily resulted from a bank owned life insurance claim and increases in key fee income categories, most notably mortgage banking activity income and credit and debit card income. Excluding the impact of the bank owned life insurance claim, noninterest income in the current-year second quarter grew when compared to the respective 2018 period. The increased noninterest expense mainly resulted from higher salary costs.

The improved net income in the first six months of 2019 compared to the respective prior-year period primarily reflects increased net interest income and noninterest income, which more than offset higher noninterest expense and provision expense. The increase in net interest income resulted from a higher level of earning assets. Noninterest income during the first six months of 2019 was elevated primarily as a result of the bank owned life insurance claims and gain on the sale of a former branch facility. Excluding these transactions, noninterest income during the first six months of 2019 increased compared to the respective 2018 period, mainly reflecting higher mortgage banking activity income, credit and debit card income, service charges on accounts, and payroll processing revenue. The higher level of noninterest expense primarily reflects increased salary costs.

Interest income during the second quarter of 2019 was \$39.8 million, an increase of \$5.5 million, or 16.0%, from the \$34.3 million earned during the second quarter of 2018. The increase in interest income resulted from growth in, and a higher yield on, average earning assets. Average earning assets equaled \$3.30 billion during the second quarter of 2019, up \$300 million, or 10.0%, from the level of \$3.00 billion during the second quarter of 2018; average loans increased \$252 million, average interest-earning deposit balances were up \$31.3 million, and average securities increased \$16.7 million. The yield on average earning assets was 4.85% during the second quarter of 2019, compared to 4.60% during the prior-year second quarter. The increased yield on average earning assets primarily resulted from a higher yield on loans. The increase in the yield on loans from 4.92% during the second quarter of 2018 to 5.18% during the second quarter of 2019 was primarily due to a higher yield on commercial loans, which equaled 5.27% in the current-year second quarter compared to 4.99% during the prior-year second quarter. The increased commercial loan yield primarily resulted from higher interest rates on variable-rate loans stemming from the Federal Open Market Committee (“FOMC”) raising the targeted federal funds rate by 25 basis points in each of June, September, and December 2018.

Interest income during the first six months of 2019 was \$78.5 million, an increase of \$9.2 million, or 13.2%, from the \$69.3 million earned during the first six months of 2018. The increase in interest income resulted from growth in, and a higher yield on, average earning assets. Average earning assets equaled \$3.26 billion during the first six months of 2019, up \$243 million, or 8.1%, from the level of \$3.01 billion during the respective 2018 period; average loans were up \$243 million, average interest-earning deposit balances decreased \$12.0 million, and average securities were up \$11.4 million. The yield on average earning assets was 4.87% during the first six months of 2019, compared to 4.65% during the first six months of 2018. The higher yield on average earning assets primarily resulted from an increased yield on loans, which equaled 5.19% during the first six months of 2019, compared to 5.03% during the respective 2018 period. The increased yield on loans mainly stemmed from a higher yield on commercial loans, which equaled 5.30% and 5.11% during the first six months of 2019 and 2018, respectively. The higher yield on commercial loans primarily resulted from higher interest rates on variable-rate commercial loans resulting from the FOMC raising the targeted federal funds by 25 basis points in each of March, June, September, and December 2018. The collection of interest on certain nonperforming commercial loans that paid in full positively impacted the yield on commercial loans by approximately 20 basis points during the first six months of 2018. Purchased credit-impaired (“PCI”) loan accretion and payments received on PCI commercial real estate-pooled loans, which are both reported as interest income, totaled \$0.8 million during the first six months of 2019, compared to \$3.0 million during the respective 2018 period.

Interest expense during the second quarter of 2019 was \$8.7 million, an increase of \$3.6 million, or 70.8%, from the \$5.1 million expensed during the second quarter of 2018. The increase in interest expense is primarily attributable to a higher weighted average cost of interest-bearing liabilities, which equaled 1.55% in the second quarter of 2019, compared to 1.02% in the second quarter of 2018. The increase in the weighted average cost of interest-bearing liabilities primarily reflects higher costs of time deposits, certain interest-bearing non-time deposit accounts, and borrowed funds and a change in funding mix. The cost of time deposits increased from 1.46% during the prior-year second quarter to 2.31% during the current-year second quarter, mainly reflecting the rising interest rate environment during 2018. A higher-costing time deposit special campaign, which was introduced in mid-first quarter 2019 and ended in early April 2019, also contributed to the increased cost of time deposits. The cost of interest-bearing non-time deposit accounts increased from 0.53% during the second quarter of 2018 to 0.65% during the second quarter of 2019, primarily reflecting higher rates paid on money market accounts and a change in funding mix. The increased rates mainly reflect the rising interest rate environment during 2018. On an average basis, higher-costing money market accounts represented 44.6% of interest-bearing non-time deposits during the second quarter of 2019, up from 40.3% during the prior-year second quarter. The cost of borrowed funds increased from 2.01% during the second quarter of 2018 to 2.40% during the respective 2019 period, mainly reflecting a higher cost of FHLBI advances, which equaled 2.39% during the second quarter of 2019 compared to 1.77% during the prior-year second quarter. The higher cost primarily reflects the rising interest rate during 2018 and the lengthening of the average weighted maturity of the advance portfolio. Longer-term FHLBI advances totaling \$194 million were obtained during the last eight months of 2018 and first month of 2019 to meet ongoing loan funding and interest rate risk management needs and to offset typical and expected seasonal business deposit withdrawals in early 2019 that were used for bonus and tax payments. On an average basis, higher-costing time deposits and borrowed funds represented 29.4% and 23.6%, respectively, of average interest-bearing liabilities during the second quarter of 2019, compared to 23.8% and 18.2%, respectively, during the prior-year second quarter.

Average lower-costing interest-bearing non-time deposits represented 47.0% of average interest-bearing liabilities during the current-year second quarter, down from 58.0% during the respective 2018 period. An increase in average interest-bearing liabilities also contributed to the higher level of interest expense during the second quarter of 2019 compared to the prior-year second quarter. Average interest-bearing liabilities were \$2.25 billion during the second quarter of 2019, up \$249 million, or 12.5%, from the \$2.00 billion average during the second quarter of 2018.

Interest expense during the first six months of 2019 was \$16.7 million, an increase of \$6.8 million, or 69.1%, from the \$9.9 million expensed during the first six months of 2018. The increase in interest expense is primarily attributable to a higher weighted average cost of interest-bearing liabilities, which equaled 1.51% during the first six months of 2019 compared to 0.98% during the respective 2018 period. The increase in the weighted average cost of interest-bearing liabilities primarily reflects higher costs of time deposits, borrowed funds, and certain non-time deposit account categories and a change in funding mix. The cost of time deposits increased from 1.43% during the first six months of 2018 to 2.24% during the respective current-year period, primarily reflecting the rising interest rate environment during 2018. The previously-mentioned higher-costing time deposit special also contributed to the increased cost. The cost of borrowed funds increased from 1.92% during the first six months of 2018 to 2.41% during the first six months of 2019, mainly reflecting a higher cost of FHLBI advances, which equaled 2.37% during the first six months of 2019 compared to 1.74% during the respective 2018 period. The higher cost primarily reflects the rising interest rate during 2018 and the lengthening of the average weighted maturity of the advance portfolio. As noted previously, longer-term FHLBI advances totaling \$194 million were obtained during the last eight months of 2018 and first month of 2019 to meet various funding needs. The cost of interest-bearing non-time deposit accounts increased from 0.49% during the first six months of 2018 to 0.65% during the first six months of 2019, mainly reflecting higher rates paid on money market accounts and a change in funding mix. The increased rates mainly reflect the rising interest rate environment during 2018. On an average basis, higher-costing money market accounts represented 43.3% of interest-bearing non-time deposits during the first six months of 2019, up from 39.8% during the respective 2018 period. On an average basis, higher-costing time deposits and borrowed funds represented 27.9% and 23.9%, respectively, of average interest-bearing liabilities during the first six months of 2019, compared to 24.1% and 18.2%, respectively, during the first six months of 2018. Average lower-costing interest-bearing non-time deposits represented 48.2% of average interest-bearing liabilities during the first six months of 2019, down from 57.7% during the respective 2018 period. An increase in interest-bearing liabilities also contributed to the higher level of interest expense during the first six months of 2019 compared to the same time period in 2018. Average interest-bearing liabilities were \$2.23 billion during the first six months of 2019, up \$192 million, or 9.5%, from the \$2.03 billion average during the first six months of 2018.

Net interest income during the second quarter of 2019 was \$31.1 million, an increase of \$1.9 million, or 6.5%, from the \$29.2 million earned during the second quarter of 2018. The increase was due to growth in average earning assets. The net interest margin was 3.79% in the second quarter of 2019, compared to 3.92% in the prior-year second quarter. The yield on average earning assets equaled 4.85% during the second quarter of 2019, up from 4.60% during the respective 2018 period mainly due to an increased yield on commercial loans. The improved yield on commercial loans primarily reflects the positive impact of higher interest rates on variable-rate commercial loans stemming from the FOMC's raising of the targeted federal funds rate by 25 basis points in each of June, September, and December 2018. The cost of funds equaled 1.06% during the second quarter of 2019, up from 0.68% during the prior-year second quarter mainly due to increased costs of time deposits, borrowed funds, and non-time deposits and a change in funding mix. Increased reliance on more costly wholesale funds during the twelve months ended June, 30, 2019, most of which occurred in the second half of 2018 and January 2019, was necessitated by various funding requirements, including ongoing loan growth and seasonal deposit withdrawals by certain business customers for bonus and tax payments.

Net interest income during the first six months of 2019 was \$61.8 million, an increase of \$2.4 million, or 3.9%, from the \$59.4 million earned during the first six months of 2018. The increase was due to a higher level of average earning assets. The net interest margin was 3.83% during the first six months of 2019, compared to 3.99% during the respective 2018 period. The yield on average earning assets equaled 4.87% during the first six months of 2019, up from 4.65% during the respective 2018 period mainly due to an increased yield on commercial loans. The improved yield on commercial loans primarily reflects the positive impact of higher interest rates on variable-rate commercial loans stemming from the FOMC's raising of the targeted federal funds rate by 25 basis points in each of March, June, September, and December 2018.

The collection of interest on certain nonperforming commercial loans that paid in full positively impacted the yield on commercial loans by approximately 20 basis points during the first six months of 2018. The cost of funds equaled 1.04% during the first six months of 2019, up from 0.66% during the respective prior-year period primarily due to increased costs of time deposits, borrowed funds, and non-time deposits and a change in funding mix. As noted previously, increased reliance on more costly wholesale funds during the twelve months ended June, 30, 2019, most of which occurred in the second half of 2018 and January 2019, was necessitated by certain funding requirements.

The following tables set forth certain information relating to our consolidated average interest-earning assets and interest-bearing liabilities and reflects the average yield on assets and average cost of liabilities for the second quarters and first six months of 2019 and 2018. Such yields and costs are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the period presented. Tax-exempt securities interest income and yield for the second quarters and first six months of 2019 and 2018 have been computed on a tax equivalent basis using a marginal tax rate of 21%. Securities interest income was increased by \$60,000 and \$75,000 in the second quarters of 2019 and 2018, respectively, and \$120,000 and \$150,000 in the first six months of 2019 and 2018, respectively, for this non-GAAP, but industry standard, adjustment. These adjustments equated to one basis point increases in our net interest margin for each of the 2019 and 2018 periods.

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| | Quarters ended June 30, | | | | | |
|---|-------------------------|-----------|-----------------|--------------------|-----------|-----------------|
| | 2019 | | 2018 | | | |
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| | (dollars in thousands) | | | | | |
| ASSETS | | | | | | |
| Loans | \$ 2,848,343 | \$ 36,765 | 5.18% | \$ 2,596,828 | \$ 31,855 | 4.92% |
| Investment securities | 357,718 | 2,545 | 2.85 | 340,990 | 2,252 | 2.64 |
| Other interest-earning assets | 94,616 | 569 | 2.38 | 63,336 | 287 | 1.80 |
| Total interest - earning assets | 3,300,677 | 39,879 | 4.85 | 3,001,154 | 34,394 | 4.60 |
| Allowance for loan losses | (23,549) | | | (20,583) | | |
| Other assets | 252,470 | | | 251,467 | | |
| Total assets | \$ 3,529,598 | | | \$ 3,232,038 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Interest-bearing deposits | \$ 1,719,433 | \$ 5,529 | 1.29% | \$ 1,635,755 | \$ 3,262 | 0.80% |
| Short-term borrowings | 107,423 | 68 | 0.26 | 95,475 | 61 | 0.26 |
| Federal Home Loan Bank advances | 374,000 | 2,261 | 2.39 | 220,659 | 988 | 1.77 |
| Other borrowings | 49,379 | 845 | 6.77 | 48,990 | 783 | 6.32 |
| Total interest-bearing liabilities | 2,250,235 | 8,703 | 1.55 | 2,000,879 | 5,094 | 1.02 |
| Noninterest-bearing deposits | 875,645 | | | 848,650 | | |
| Other liabilities | 14,586 | | | 12,722 | | |
| Shareholders' equity | 389,132 | | | 369,787 | | |
| Total liabilities and shareholders' equity | \$ 3,529,598 | | | \$ 3,232,038 | | |
| Net interest income | | \$ 31,176 | | | \$ 29,300 | |
| Net interest rate spread | | | 3.30% | | | 3.58% |
| Net interest spread on average assets | | | 3.54% | | | 3.64% |
| Net interest margin on earning assets | | | 3.79% | | | 3.92% |

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| | 2019 | | Six months ended June 30, | | 2018 | |
|---|-----------------|-----------|---------------------------|-----------------|-----------|--------------|
| | Average Balance | Interest | Average Rate | Average Balance | Interest | Average Rate |
| (dollars in thousands) | | | | | | |
| ASSETS | | | | | | |
| Loans | \$ 2,818,055 | \$ 72,555 | 5.19% | \$ 2,574,573 | \$ 64,170 | 5.03% |
| Investment securities | 356,098 | 5,046 | 2.83 | 344,690 | 4,523 | 2.62 |
| Other interest-earning assets | 81,339 | 976 | 2.42 | 93,318 | 757 | 1.64 |
| Total interest - earning assets | 3,255,492 | 78,577 | 4.87 | 3,012,581 | 69,450 | 4.65 |
| Allowance for loan losses | (23,140) | | | (20,399) | | |
| Other assets | 253,577 | | | 248,685 | | |
| Total assets | \$ 3,485,929 | | | \$ 3,240,867 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Interest-bearing deposits | \$ 1,694,138 | \$ 10,334 | 1.23% | \$ 1,662,795 | \$ 6,347 | 0.77% |
| Short-term borrowings | 105,987 | 173 | 0.33 | 101,727 | 118 | 0.23 |
| Federal Home Loan Bank advances | 376,519 | 4,494 | 2.37 | 220,331 | 1,933 | 1.74 |
| Other borrowings | 49,321 | 1,695 | 6.84 | 48,916 | 1,478 | 6.01 |
| Total interest-bearing liabilities | 2,225,965 | 16,696 | 1.51 | 2,033,769 | 9,876 | 0.98 |
| Noninterest-bearing deposits | 864,011 | | | 827,052 | | |
| Other liabilities | 13,299 | | | 12,380 | | |
| Shareholders' equity | 382,654 | | | 367,666 | | |
| Total liabilities and shareholders' equity | \$ 3,485,929 | | | \$ 3,240,867 | | |
| Net interest income | | \$ 61,881 | | | \$ 59,574 | |
| Net interest rate spread | | | 3.36% | | | 3.67% |
| Net interest spread on average assets | | | 3.58% | | | 3.71% |
| Net interest margin on earning assets | | | 3.83% | | | 3.99% |

A loan loss provision expense of \$0.9 million was recorded during the second quarter of 2019, compared to \$0.7 million during the second quarter of 2018. A loan loss provision expense of \$1.8 million was recorded during the first six months of 2019, compared to \$0.7 million during the first six months of 2018. The provision expense recorded during the 2019 periods primarily reflects ongoing net loan growth, while the provision expense recorded during the prior-year periods mainly reflects net loan growth and an increased allocation related to a certain environmental factor. No provision expense was made during the first quarter of 2018 in light of net loan recoveries being recorded and the lack of net loan growth.

Nominal net loan recoveries and net loan charge-offs of less than \$0.1 million were recorded during the second quarter and first six months of 2019, respectively, compared to net loan recoveries of \$0.5 million and \$1.0 million during the respective 2018 periods. The allowance for originated loans, as a percentage of total originated loans, was 0.9% as of both June 30, 2019, and June 30, 2018. Our allowances for originated loans and acquired loans totaled \$23.3 million and \$0.7 million, respectively, as of June 30, 2019, compared to \$20.5 million and \$0.7 million, respectively, as of June 30, 2018.

Noninterest income during the second quarter of 2019 was \$6.3 million, compared to \$4.6 million during the prior-year second quarter. Noninterest income during the second quarter of 2019 included a bank owned life insurance claim of \$1.3 million. Excluding the impact of this transaction, noninterest income increased \$0.5 million, or 10.9%, during the current-year second quarter compared to the respective 2018 period. The higher level of noninterest income primarily reflected increased mortgage banking activity income and credit and debit card income. The increased mortgage banking activity income mainly reflected the success of ongoing strategic initiatives that were instituted to increase market penetration, along with a higher level of refinance activity stemming from declining residential mortgage loan interest rates. Increased service charges on accounts and payroll processing fees also contributed to the improved level of noninterest income.

Noninterest income during the first six months of 2019 was \$13.0 million, compared to \$8.9 million during the same time period in 2018. Noninterest income during the first six months of 2019 included bank owned life insurance claims aggregating \$2.6 million and a gain on the sale of a former branch facility of \$0.6 million. Excluding the impacts of these transactions, noninterest income increased \$0.9 million, or 9.6%, in the first six months of 2019 compared to the respective 2018 period. The increase in noninterest income primarily reflects higher mortgage banking activity income and credit and debit card income. As noted previously, continuing strategic initiatives designed to increase market presence, along with increased refinance activity stemming from interest rate declines, have enhanced mortgage banking activity income. Growth in service charges on accounts and payroll processing revenue also contributed to the higher level of noninterest income.

Noninterest expense totaled \$22.1 million during the second quarter of 2019, up \$0.7 million, or 3.1%, from the prior-year second quarter. Noninterest expense during the first six months of 2019 was \$43.9 million, an increase of \$1.3 million, or 3.2%, from the \$42.6 million expensed during the first six months of 2018. The higher level of expense in both periods primarily resulted from increased salary costs, mainly reflecting annual employee merit pay increases and higher stock-based compensation expense. Pay increases for all hourly employees, which went into effect on April 1, 2018, also contributed to the higher level of salary costs during the first six months of 2019.

During the second quarter of 2019, we recorded income before federal income tax of \$14.5 million and a federal income tax expense of \$2.8 million. During the second quarter of 2018, we recorded income before federal income tax of \$11.6 million and a federal income tax expense of \$2.2 million. During the first six months of 2019, we recorded income before federal income tax of \$29.1 million and a federal income tax expense of \$5.6 million. During the first six months of 2018, we recorded income before federal income tax of \$25.1 million and a federal income tax expense of \$4.8 million. The increased federal income tax expense in the 2019 periods compared to the respective 2018 periods resulted from higher levels of income before federal income tax. Our effective tax rate was 19.0% during both the second quarter and first six months of 2019 and the respective 2018 periods.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. We have only limited agricultural-related loan assets and therefore have no significant exposure to changes in commodity prices. Any impact that changes in foreign exchange rates and commodity prices would have on interest rates is assumed to be insignificant. Interest rate risk is the exposure of our financial condition to adverse movements in interest rates. We derive our income primarily from the excess of interest collected on our interest-earning assets over the interest paid on our interest-bearing liabilities. The rates of interest we earn on our assets and owe on our liabilities generally are established contractually for a period of time. Since market interest rates change over time, we are exposed to lower profitability if we cannot adapt to interest rate changes. Accepting interest rate risk can be an important source of profitability and shareholder value; however, excessive levels of interest rate risk could pose a significant threat to our earnings and capital base. Accordingly, effective risk management that maintains interest rate risk at prudent levels is essential to our safety and soundness.

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal control procedures are in place to maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, we assess the existing and potential future effects of changes in interest rates on our financial condition, including capital adequacy, earnings, liquidity and asset quality.

We use two interest rate risk measurement techniques. The first, which is commonly referred to as GAP analysis, measures the difference between the dollar amounts of interest sensitive assets and liabilities that will be refinanced or repriced during a given time period. A significant repricing gap could result in a negative impact to our net interest margin during periods of changing market interest rates.

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The following table depicts our GAP position as of June 30, 2019:

| | Within Three Months | Three to Twelve Months | One to Five Years | After Five Years | Total |
|---|---------------------------|------------------------------|-------------------------|-------------------------|-------------------------|
| Assets: | | | | | |
| Commercial loans (1) | \$ 1,256,916,000 | \$ 92,404,000 | \$ 838,140,000 | \$ 265,239,000 | \$ 2,452,699,000 |
| Residential real estate loans | 56,952,000 | 15,021,000 | 156,102,000 | 174,731,000 | 402,806,000 |
| Consumer loans | 3,282,000 | 1,085,000 | 18,732,000 | 2,889,000 | 25,988,000 |
| Securities (2) | 21,142,000 | 17,681,000 | 69,905,000 | 257,198,000 | 365,926,000 |
| Other interest-earning assets | 88,750,000 | 1,250,000 | 2,750,000 | 0 | 92,750,000 |
| Allowance for loan losses | 0 | 0 | 0 | 0 | (24,053,000) |
| Other assets | 0 | 0 | 0 | 0 | 260,023,000 |
| Total assets | 1,427,042,000 | 127,441,000 | 1,085,629,000 | 700,057,000 | \$ 3,576,139,000 |
| Liabilities: | | | | | |
| Interest-bearing checking | 286,531,000 | 0 | 0 | 0 | 286,531,000 |
| Savings deposits | 270,563,000 | 0 | 0 | 0 | 270,563,000 |
| Money market accounts | 484,177,000 | 0 | 0 | 0 | 484,177,000 |
| Time deposits under \$100,000 | 19,928,000 | 93,355,000 | 92,169,000 | 0 | 205,452,000 |
| Time deposits \$100,000 & over | 57,990,000 | 184,617,000 | 211,298,000 | 0 | 453,905,000 |
| Short-term borrowings | 119,669,000 | 0 | 0 | 0 | 119,669,000 |
| Federal Home Loan Bank advances | 10,000,000 | 30,000,000 | 284,000,000 | 50,000,000 | 374,000,000 |
| Other borrowed money | 49,429,000 | 0 | 0 | 0 | 49,429,000 |
| Noninterest-bearing checking | 0 | 0 | 0 | 0 | 918,581,000 |
| Other liabilities | 0 | 0 | 0 | 0 | 13,715,000 |
| Total liabilities | 1,298,287,000 | 307,972,000 | 587,467,000 | 50,000,000 | 3,176,022,000 |
| Shareholders' equity | 0 | 0 | 0 | 0 | 400,117,000 |
| Total liabilities & shareholders' equity | 1,298,287,000 | 307,972,000 | 587,467,000 | 50,000,000 | \$ 3,576,139,000 |
| Net asset (liability) GAP | \$ 128,755,000 | \$ (180,531,000) | \$ 498,162,000 | \$ 650,057,000 | |
| Cumulative GAP | \$ 128,755,000 | \$ (51,776,000) | \$ 446,386,000 | \$ 1,096,443,000 | |
| Percent of cumulative GAP to total assets | 3.6% | (1.4%) | 12.5% | 30.7% | |

- (1) Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.
- (2) Mortgage-backed securities are categorized by average life calculations based upon prepayment trends as of June 30, 2019.

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

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

We conducted multiple simulations as of June 30, 2019, in which it was assumed that changes in market interest rates occurred ranging from up 300 basis points to down 200 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on net interest income over the next twelve months in comparison to estimated net interest income based on our balance sheet structure, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of June 30, 2019. The resulting estimates are within our policy parameters established to manage and monitor interest rate risk.

| Interest Rate Scenario | Dollar Change In Net Interest Income | Percent Change In Net Interest Income |
|--------------------------------------|--|---|
| Interest rates down 200 basis points | \$ (12,600,000) | (11.4%) |
| Interest rates down 100 basis points | (6,300,000) | (5.4) |
| Interest rates up 100 basis points | 4,900,000 | 3.9 |
| Interest rates up 200 basis points | 9,600,000 | 7.8 |
| Interest rates up 300 basis points | 14,400,000 | 11.6 |

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

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

Item 4. Controls and Procedures

As of June 30, 2019, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of June 30, 2019.

There have been no changes in our internal control over financial reporting during the quarter ended June 30, 2019 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION**Item 1. Legal Proceedings.**

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

Item 1A. Risk Factors.

There have been no material changes in our risk factors from those previously disclosed in our annual report on Form 10-K for the year ended December 31, 2018, and incorporated therein by reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

We made no unregistered sales of equity securities during the quarter ended June 30, 2019.

Issuer Purchases of Equity Securities

We announced on January 30, 2015 that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase program. On May 7, 2019, we announced that our Board of Directors had authorized a program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. This latest authorization included a termination of the existing authorization as detailed above. As reflected in the table below, no shares were repurchased during the second quarter of 2019.

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number of Shares or Approximate Dollar Value that May Yet Be Purchased Under the Plans or Programs |
|--------------|--------------------------------------|----------------------------------|--|--|
| April 1 – 30 | 0 | NA | \$ 0 | \$ 5,962,000 |
| May 1 – 31 | 0 | NA | 0 | 20,000,000 |
| June 1 – 30 | 0 | NA | 0 | 20,000,000 |
| Total | 0 | NA | \$ 0 | \$ 20,000,000 |

Item 3. Defaults Upon Senior Securities.

Not applicable.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

Not applicable.

Item 6. Exhibits

| <u>EXHIBIT NO.</u> | <u>EXHIBIT DESCRIPTION</u> |
|--------------------|--|
| 3.1 | Our Articles of Incorporation are incorporated by reference to Exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2009 |
| 3.2 | Our Amended and Restated Bylaws dated as of February 26, 2015 are incorporated by reference to Exhibit 3.1 to our Current Report on Form 8-K filed February 26, 2015 |
| 10.1 | 2019 Mercantile Executive Officer Bonus Plan, incorporated by reference to Exhibit 10.1 of our Form 8-K filed May 24, 2019 |
| 31 | Rule 13a-14(a) Certifications |
| 32.1 | Section 1350 Chief Executive Officer Certification |
| 32.2 | Section 1350 Chief Financial Officer Certification |
| 101 | The following financial information from Mercantile's Quarterly Report on Form 10-Q for the quarter ended June 30, 2019, formatted in XBRL (eXtensible Business Reporting Language): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Comprehensive Income, (iv) the Condensed Consolidated Statements of Changes in Shareholders' Equity, (v) the Condensed Consolidated Statements of Cash Flows, and (vi) the Notes to Condensed Consolidated Financial Statements |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on August 5, 2019.

MERCANTILE BANK CORPORATION

By: /s/ Robert B. Kaminski, Jr.
Robert B. Kaminski, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

By: /s/ Charles E. Christmas
Charles E. Christmas
Executive Vice President, Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

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Section 2: EX-31 (EXHIBIT 31)

EXHIBIT 31

RULE 13a-14(a) CERTIFICATIONS

I, Robert B. Kaminski, Jr., President and Chief Executive Officer of Mercantile Bank Corporation, certify that:

1. I have reviewed this report on Form 10-Q of Mercantile Bank Corporation (the "registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2019

/s/ Robert B. Kaminski, Jr.
Robert B. Kaminski, Jr.
President and Chief Executive Officer

I, Charles E. Christmas, Executive Vice President, Chief Financial Officer and Treasurer of Mercantile Bank Corporation, certify that:

1. I have reviewed this report on Form 10-Q of Mercantile Bank Corporation (the "registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2019

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

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Section 3: EX-32.1 (EXHIBIT 32.1)

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

This certification is provided pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1350, and accompanies the quarterly report on Form 10-Q for the quarter ended June 30, 2019 (the "Form 10-Q") of Mercantile Bank Corporation (the "Issuer").

I, Robert B. Kaminski, Jr., President and Chief Executive Officer of the Issuer, certify that to my knowledge:

- (i) the Form 10-Q fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (ii) the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Issuer.

Dated: August 5, 2019

/s/ Robert B. Kaminski, Jr.
Robert B. Kaminski, Jr.
President and Chief Executive Officer

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Section 4: EX-32.2 (EXHIBIT 32.2)

EXHIBIT 32.2

CERTIFICATION PURSUANT TO

**18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

This certification is provided pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1350, and accompanies the quarterly report on Form 10-Q for the quarter ended June 30, 2019 (the "Form 10-Q") of Mercantile Bank Corporation (the "Issuer").

I, Charles E. Christmas, Executive Vice President, Chief Financial Officer and Treasurer of the Issuer, certify that to my knowledge:

- (i) the Form 10-Q fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (ii) the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Issuer.

Dated: August 5, 2019

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

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