

MERCANTILE BANK CORP
Form 10-K
March 06, 2017
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2016

or

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

For the transition period from _____ to _____

Commission file number 000-26719

MERCANTILE BANK CORPORATION

(Exact name of registrant as specified in its charter)

Michigan

(State or other jurisdiction of incorporation or organization)

38-3360865

(I.R.S. Employer Identification No.)

310 Leonard Street NW, Grand Rapids, Michigan

(Address of principal executive offices)

49504

(Zip Code)

(616) 406-3000

(Registrant's telephone number, including area code)

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

Title of each class Name of each exchange on which registered
Common Stock The Nasdaq Stock Market LLC

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ___ No X

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

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

Large accelerated filer ___ Accelerated filer X

Non-accelerated filer ___ Smaller reporting company ___

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

The aggregate value of the common equity held by non-affiliates (persons other than directors and executive officers) of the registrant, computed by reference to the closing price of the common stock as of the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$379 million.

As of March 1, 2017, there were issued and outstanding 16,428,161 shares of the registrant's common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's proxy statement for the Annual Meeting of Shareholders to be held May 25, 2017 are incorporated by reference into Part III of this report.

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PART I

Item 1. Business.

The Company

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

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

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

Firstbank Corporation Merger

We completed our merger with Firstbank Corporation (“Firstbank”), a Michigan corporation with approximately \$1.5 billion in total assets and 46 branch locations, into Mercantile Bank Corporation as of June 1, 2014 (“Merger Date”). The merger substantially expanded our geographic footprint and increased the size of our balance sheet.

In conjunction with the completion of the merger, Mercantile assumed the obligations of Firstbank Capital Trust I, Firstbank Capital Trust II, Firstbank Capital Trust III and Firstbank Capital Trust IV, all of which are business trust subsidiaries formed to issue trust preferred securities. At the Merger Date, Firstbank had two Michigan-chartered

bank subsidiaries that were consolidated into Mercantile Bank of Michigan effective June 30, 2014.

Our Bank

Our bank is a state banking company that operates under the laws of the State of Michigan, pursuant to a charter issued by the Michigan Office of Financial and Insurance Regulation. Our bank's deposits are insured to the maximum extent permitted by law by the Federal Deposit Insurance Corporation ("FDIC"). Our bank, through its 49 office locations, provides commercial banking services primarily to small- to medium-sized businesses and retail banking services. Our bank's main office is located in Grand Rapids, and our operations are centered around the West and Central portions of Michigan, with branch office locations in Alma, Belding, Cadillac, Canadian Lakes, Clare, Comstock Park, DeWitt, Fairview, Grand Rapids, Hale, Hastings, Holland, Howard City, Ionia, Ithaca, Kalamazoo, Kentwood, Lakeview, Lansing, Lowell, Merrill, Mt. Pleasant, Paw Paw, Portage, Remus, Rose City, Shepherd, St. Charles, St. Helen, St. Johns, Vestaburg, West Branch, and Wyoming. We also recently expanded into Southeast Michigan, opening a banking office in Troy during the first quarter of 2017.

Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns 49 automated teller machines ("ATM") located at certain of our office locations and at one off-site location that participate in the ACCEL/EXCHANGE and PLUS regional network systems, as well as other ATM networks throughout the country. Our bank also enables customers to conduct certain loan and deposit transactions by personal computer and through mobile applications. Courier service is provided to certain commercial customers, and safe deposit facilities are available at a vast majority of our office locations. Our bank does not have trust powers.

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Our Insurance Company

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent. To date, we have not provided the insurance products noted above and currently have no plans to do so.

Our Real Estate Company

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

Our Trusts

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

Effect of Government Monetary Policies

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

Regulation and Supervision

Banks and bank holding companies, among other financial institutions, are regulated under federal and state law. These include, among others, minimum capital requirements, state usury laws, state laws relating to fiduciaries, the Dodd Frank Act, the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Expedited Funds Availability Act, the Community Reinvestment Act, the Real Estate Settlement Procedures Act, the USA PATRIOT Act, the FACT Act, the Gramm-Leach-Bliley Act, the Sarbanes Oxley Act, the Bank Secrecy Act, electronic funds transfer laws, redlining laws, predatory lending laws, antitrust laws, environmental laws, money laundering laws and privacy laws. Our growth and earnings performance may be impacted by the statutes administered by, and the regulations and policies of, various governmental regulatory authorities. Those regulatory authorities include, but are not limited to, the Federal Reserve Board, the FDIC, the Michigan Department of Insurance and Financial Services, the Internal Revenue Service and state taxing authorities. The effect of such statutes, regulations and policies, and any changes thereto, can be significant and cannot necessarily be predicted.

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

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

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

Our bank is subject to restrictions imposed by federal and state law and regulations. Among other things, these restrictions apply to any extension of credit to us or to our other subsidiaries, to securities borrowing or lending, derivatives, and repurchase transactions with us or our other subsidiaries, to investments in stock or other securities that we issue, to the taking of such stock or securities as collateral for loans to any borrower, and to acquisitions of assets or services from, and sales of certain types of assets to, us or our other subsidiaries. Michigan banking laws place restrictions on various aspects of banking, including branching, payment of dividends, loan interest rates and capital and surplus requirements. Federal law restricts our ability to borrow from our bank by limiting the aggregate amount we may borrow and by requiring that all loans to us be secured in designated amounts by specified forms of collateral.

With respect to the acquisition of banking organizations, we are generally required to obtain the prior approval of the Federal Reserve Board before we can acquire all or substantially all of the assets of any bank, or acquire ownership or control of any voting shares of any bank or bank holding company, if, after the acquisition, we would own or control more than 5% of the voting shares of the bank or bank holding company. Acquisitions of banking organizations across state lines are subject to restrictions imposed by federal and state laws and regulations.

The scope of regulations and supervision of various aspects of our business has expanded as a result of the adoption in July, 2010 of the Dodd Frank Wall Street Reform and Consumer Protection Act (the “Dodd Frank Act”), and may continue to expand as the result of implementing regulations being adopted by federal regulators. However, the new federal administration has indicated its intention to repeal or amend certain aspects of the Dodd Frank Act and the precise scope of those changes has not yet been determined. For additional information on this legislation and its potential impact, refer to the Risk Factor entitled “The effect of financial services legislation and regulations remains uncertain” in Item 1A- Risk Factors in this Annual Report.

Employees

As of December 31, 2016, we employed 552 full-time and 130 part-time persons. Management believes that relations with employees are good.

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Lending Policy

As a routine part of our business, we make loans to businesses and individuals located within our market areas. Our lending policy states that the function of the lending operation is twofold: to provide a means for the investment of funds at a profitable rate of return with an acceptable degree of risk, and to meet the credit needs of the creditworthy businesses and individuals who are our customers. We recognize that in the normal business of lending, some losses on loans will be inevitable and should be considered a part of the normal cost of doing business.

Our lending policy anticipates that priorities in extending loans will be modified from time to time as interest rates, market conditions and competitive factors change. The policy sets forth guidelines on a nondiscriminatory basis for lending in accordance with applicable laws and regulations. The policy describes various criteria for granting loans, including the ability to pay; the character of the customer; evidence of financial responsibility; purpose of the loan; knowledge of collateral and its value; terms of repayment; source of repayment; payment history; and economic conditions.

The lending policy further limits the amount of funds that may be loaned against specified types of real estate collateral. For certain loans secured by real estate, the policy requires an appraisal of the property offered as collateral by a state certified independent appraiser. The policy also provides general guidelines for loan to value for other types of collateral, such as accounts receivable and machinery and equipment. In addition, the policy provides general guidelines as to environmental analysis, loans to employees, executive officers and directors, problem loan identification, maintenance of an allowance for loan losses, loan review and grading, mortgage and consumer lending, and other matters relating to our lending practices.

The Board of Directors has delegated significant lending authority to officers of our bank. The Board of Directors believes this empowerment, supported by our strong credit culture and the significant experience of our commercial lending staff, enables us to be responsive to our customers. The loan policy specifies lending authority for our lending officers with amounts based on the experience level and ability of each lender. Our loan officers and loan managers are able to approve loans up to \$1.0 million and \$2.5 million, respectively. We have established higher approval limits for our bank's Senior Lender, President and Chief Executive Officer, and Executive Chairman of the Board ranging from \$4.0 million up to \$10.0 million. These lending authorities, however, are typically used only in rare circumstances where timing is of the essence. Generally, loan requests exceeding \$2.5 million require approval by the Officers Loan Committee, and loan requests exceeding \$7.5 million, up to the legal lending limit of approximately \$80.2 million, require approval by the bank's Board of Directors. We apply an in-house lending limit that is significantly less than our bank's legal lending limit.

Provisions of recent legislation, including the Dodd-Frank Act, when fully implemented by regulations to be adopted by federal agencies, may have a significant impact on our lending policy, especially in the areas of single-family

residential real estate and other consumer lending. For additional information on this legislation and its potential impact, refer to the Risk Factor entitled “The effect of financial services legislation and regulations remains uncertain” in Item 1A- Risk Factors in this Annual Report.

Lending Activity

Commercial Loans. Our commercial lending group originates commercial loans primarily in our market areas. Our commercial lenders have extensive commercial lending experience, with most having at least ten years’ experience. Loans are originated for general business purposes, including working capital, accounts receivable financing, machinery and equipment acquisition, and commercial real estate financing, including new construction and land development.

Working capital loans are often structured as a line of credit and are reviewed periodically in connection with the borrower’s year-end financial reporting. These loans are generally secured by substantially all of the assets of the borrower and have a floating interest rate tied to the Wall Street Journal Prime Rate or 30-day Libor Rate. Loans for machinery and equipment purposes typically have a maturity of three to five years and are fully amortizing, while commercial real estate loans are usually written with a five-year maturity and amortize over a 10- to 20-year period. Commercial loans typically have an interest rate that is fixed to maturity or is tied to the Wall Street Journal Prime Rate or 30-day Libor Rate.

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We evaluate many aspects of a commercial loan transaction in order to minimize credit and interest rate risk. Underwriting includes an assessment of the management, products, markets, cash flow, capital, income and collateral of the borrowing entity. This analysis includes a review of the borrower's historical and projected financial results. Appraisals are generally required to be performed by certified independent appraisers where real estate is the primary collateral, and in some cases, where equipment is the primary collateral. In certain situations, for creditworthy customers, we may accept title reports instead of requiring lenders' policies of title insurance.

Commercial real estate lending involves more risk than residential lending because loan balances are typically greater and repayment is dependent upon the borrower's business operations. We attempt to minimize the risks associated with these transactions by generally limiting our commercial real estate lending to owner-operated properties and to owners of non-owner occupied properties who have an established profitable history and satisfactory tenant structure. In many cases, risk is further reduced by requiring personal guarantees, limiting the amount of credit to any one borrower to an amount considerably less than our legal lending limit and avoiding certain types of commercial real estate financings.

We have no material foreign loans, and only limited exposure to companies engaged in energy producing and agricultural-related activities.

Single-Family Residential Real Estate Loans. We originate single-family residential real estate loans in our market areas, generally according to secondary market underwriting standards. Loans not conforming to those standards are made in certain circumstances. Single-family residential real estate loans provide borrowers with a fixed or adjustable interest rate with terms up to 30 years and are generally sold to certain investors.

Our bank has a home equity line of credit program. Home equity lines of credit are generally secured by either a first or second mortgage on the borrower's primary residence. The program provides revolving credit at a rate tied to the Wall Street Journal Prime Rate.

Consumer Loans. We originate consumer loans for a variety of personal financial needs, including new and used automobiles, boats, credit cards and overdraft protection for our checking account customers. Consumer loans generally have shorter terms and higher interest rates and usually involve more credit risk than single-family residential real estate loans because of the type and nature of the collateral.

We believe our consumer loans are underwritten carefully, with a strong emphasis on the amount of the down payment, credit quality, employment stability and monthly income of the borrower. These loans are generally repaid on a monthly repayment schedule with the source of repayment tied to the borrower's periodic income. In addition, consumer lending collections are dependent on the borrower's continuing financial stability, and are thus likely to be

adversely affected by job loss, illness and personal bankruptcy. In many cases, repossessed collateral for a defaulted consumer loan will not provide an adequate source of repayment of the outstanding loan balance because of depreciation of the underlying collateral. We believe that the generally higher yields earned on consumer loans compensate for the increased credit risk associated with such loans, and that consumer loans are important to our efforts to serve the credit needs of the communities and customers that we serve.

Loan Portfolio Quality

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

Our independent loan review program is primarily responsible for the administration of the grading system and ensuring adherence to established lending policies and procedures. The loan review program is an integral part of maintaining our strong asset quality culture. The loan review function works closely with senior management, although it functionally reports to the Board of Directors. Using a risk-based approach to selecting credits for review, our loan review program has covered approximately 65% to 75% of total commercial loans outstanding during the past two years. In addition, a random sampling of retail loans are reviewed each quarter. Our watch list credits are reviewed monthly by our Board of Directors and our Watch List Committee, the latter of which is comprised of senior level officers from the administration, lending and loan review functions.

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Loans are placed in a nonaccrual status when, in our opinion, uncertainty exists as to the ultimate collection of all principal and interest. As of December 31, 2016, loans placed in nonaccrual status totaled \$5.9 million, or 0.2% of total loans, compared to \$5.4 million, or 0.2% of total loans, at December 31, 2015. No loans were past due 90 days or more and still accruing interest at year-end 2016, and only a nominal amount of such loans existed at year-end 2015.

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

Allowance for Loan Losses

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

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

A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2016 we placed most weight on the period starting December 31, 2010 through December 31, 2016. We believe this period represents an

appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our 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 loan portfolio.

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

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

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Investments

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

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

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

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

Competition

We face substantial competition in all phases of our operations from a variety of different competitors. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks, savings banks, thrifts, credit unions and other financial institutions as well as from other entities that provide financial services. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our primary competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do, and offer larger branch networks and other services which we do not. Most of these same entities have greater capital resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. Under specified circumstances (that have been modified by the Dodd-Frank Act), securities firms and insurance companies that elect to become financial holding companies under the Bank Holding Company Act may acquire banks and other financial institutions. Federal banking law affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. We will also face new competition as we expand into the Southeast Michigan marketplace.

Selected Statistical Information

Management's Discussion and Analysis beginning on Page F-4 in this Annual Report includes selected statistical information.

Return on Equity and Assets

Return on Equity and Asset information is included in Management's Discussion and Analysis beginning on Page F-4 in this Annual Report.

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Available Information

We maintain an internet website at www.mercbank.com. We make available on or through our website, free of charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practical after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. We do not intend the address of our website to be an active link or to otherwise incorporate the contents of our website into this Annual Report.

Item 1A. Risk Factors.

The following risk factors could affect our business, financial condition or results of operations. These risk factors should be considered in connection with evaluating the forward-looking statements contained in this Annual Report because they could cause the actual results and conditions to differ materially from those projected in forward-looking statements. Before you buy our common stock, you should know that investing in our common stock involves risks, including the risks described below. The risks that are highlighted here are not the only ones we face. If the adverse matters referred to in any of the risks actually occur, our business, financial condition or operations could be adversely affected. In that case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Adverse changes in economic conditions or interest rates may negatively affect our earnings, capital and liquidity.

The results of operations for financial institutions, including our bank, may be materially and adversely affected by changes in prevailing local and national economic conditions, including declines in real estate market values and the related declines in value of our real estate collateral, rapid increases or decreases in interest rates and changes in the monetary and fiscal policies of the federal government. Our profitability is heavily influenced by the spread between the interest rates we earn on loans and investments and the interest rates we pay on deposits and other interest-bearing liabilities. Substantially all of our loans are to businesses and individuals in Western or Central Michigan, and any decline in the economy of these areas could adversely affect us. Like most banking institutions, our net interest spread and margin will be affected by general economic conditions and other factors that influence market interest rates and our ability to respond to changes in these rates. At any given time, our assets and liabilities may be such that they will be affected differently by a given change in interest rates.

Significant declines in the value of commercial real estate could adversely impact us.

Approximately 65% of our total commercial loans, or about 57% of our total loans, relate to commercial real estate. Stressed economic conditions may reduce the value of commercial real estate and strain the financial condition of our commercial real estate borrowers, especially in the land development and non-owner occupied commercial real estate segments of our loan portfolio. Those difficulties could adversely affect us and could produce losses and other adverse effects on our business.

Market volatility may adversely affect us.

The capital and credit markets may experience volatility and disruption. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without apparent regard to those issuers' underlying financial strength. Future levels of market disruption and volatility may have an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

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Our future success is dependent on our ability to compete effectively in the highly competitive banking industry.

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. We compete for deposits, loans and other financial services with numerous Michigan-based and national and regional banks, thrifts, credit unions and other financial institutions as well as other entities that provide financial services, including securities firms and mutual funds. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Most of our competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do and offer larger branch networks and other services which we do not, including trust and international banking services. Most of these entities have greater capital and other resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. This competition may limit our growth or earnings. Under specified circumstances (that have been modified by the Dodd-Frank Act), securities firms and insurance companies that elect to become financial holding companies under the Bank Holding Company Act may acquire banks and other financial institutions. Federal banking law affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.

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

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

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

Our success depends, in part, on the ability to adapt products and services to evolving industry standards. There is increasing pressure to provide products and services at lower prices. This can reduce net interest income and noninterest income from fee-based products and services. In addition, the widespread adoption of new technologies could require us to make substantial capital expenditures to modify or adapt existing products and services or develop

new products and services. We may not be successful in introducing new products and services in response to industry trends or developments in technology, or those new products may not achieve market acceptance. As a result, we could lose business, be forced to price products and services on less advantageous terms to retain or attract clients, or be subject to cost increases. As a result, our business, financial condition, or results of operations may be adversely affected.

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

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

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

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

The soundness of other financial institutions could adversely affect us.

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

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

In September, 2014, the Federal Reserve Board announced principles it would follow to implement monetary policy normalization, that is, to raise the Federal funds rate and other short-term interest rates to more historically normal levels and to reduce the Federal Reserve's securities holdings, so as to promote its statutory mandate of maximum employment and price stability. The Federal Open Market Committee raised the Federal funds rate by 25 basis points in December 2016, and announced its intention to raise the Federal funds rate gradually over the next few years. There can be no assurance that these rate increases will continue to occur or as to the actual impact of those policies on the financial markets, the broader economy, or on our business, financial condition, results of operations, access to credit or the trading price of our common stock.

The effect of financial services legislation and regulations remains uncertain.

In response to the financial crisis, on July 21, 2010, President Obama signed the Dodd-Frank Act, the most comprehensive reform of the regulation of the financial services industry since the Great Depression of the 1930's. Among many other things, the Dodd-Frank Act provides for increased supervision of financial institutions by regulatory agencies, more stringent capital requirements for financial institutions, major changes to deposit insurance assessments by the FDIC, prohibitions on proprietary trading and sponsorship or investment in hedge funds and

private equity funds by insured depository institutions, holding companies, and their affiliates, heightened regulation of hedging and derivatives activities, a greater focus on consumer protection issues, in part through the formation of a new Consumer Financial Protection Bureau (“CFPB”) having powers formerly split among different regulatory agencies, extensive changes to the regulation of residential mortgage lending, imposition of limits on interchange transaction and network fees for electronic debit transactions and repeal of the prohibition on payment of interest on demand deposits. Many of the Dodd-Frank Act’s provisions have delayed effective dates, while other provisions require implementing regulations of various federal agencies, some of which have not yet been adopted in final form. More recently, the new federal administration has indicated its intention to repeal or amend certain aspects of the Dodd-Frank Act and the precise scope of those changes has not yet been determined. Thus the effect of financial services legislation and its implementation, amendment or repeal remains uncertain. The implementation of federal regulation or amendment or repeal of the same may limit our business opportunities, impose additional costs on us, impact our revenues or the value of our assets, or otherwise adversely affect our business.

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Our credit losses could increase and our allowance may not be adequate to cover actual loan losses.

The risk of nonpayment of loans is inherent in all lending activities, and nonpayment, when it occurs, may have a materially adverse effect on our earnings and overall financial condition as well as the value of our common stock. Our focus on commercial lending may result in a larger concentration of loans to small businesses. As a result, we may assume different or greater lending risks than other banks. We make various assumptions and judgments about the collectability of our loan portfolio and provide an allowance for losses based on several factors. If our assumptions are wrong, our allowance may not be sufficient to cover our losses, which would have an adverse effect on our operating results. The actual amounts of future provisions for loan losses cannot be determined at this time and may exceed the amounts of past provisions. Additions to our allowance decrease our net income.

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

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

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

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

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

In many situations, our Board of Directors has the authority, without any vote of our shareholders, to issue shares of our authorized but unissued preferred or common stock, including shares authorized and unissued under our equity incentive plans. In the future, we may issue additional securities, through public or private offerings, in order to raise additional capital. Any such issuance would dilute the percentage of ownership interest of existing shareholders and may dilute the per share book value of the common stock. In addition, option holders under our stock-based incentive plans may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

We are subject to significant government regulation, and any regulatory changes may adversely affect us.

The banking industry is heavily regulated under both federal and state law. These regulations are primarily intended to protect customers, the federal deposit insurance fund, and the stability of the U.S. financial system, not our creditors or shareholders. Existing state and federal banking laws subject us to substantial limitations with respect to the making of loans, the purchase of securities, the payment of dividends and many other aspects of our business. Some of these laws may benefit us, others may increase our costs of doing business, or otherwise adversely affect us and create competitive advantages for others. Regulations affecting banks and financial services companies undergo continuous change, which may be accelerated by the recent change in the federal administration, and we cannot predict the ultimate effect of these changes, which could have a material adverse effect on our profitability or financial condition. Federal economic and monetary policy may also affect our ability to attract deposits, make loans and achieve satisfactory interest spreads.

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Minimum capital requirements have increased.

The provisions of the Dodd-Frank Act relating to capital to be maintained by financial institutions approach convergence with the standards (generally known as Basel III) adopted in December, 2010 by the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision. Among other things, those standards contain a narrower definition of elements qualifying for inclusion as Tier 1 capital and higher minimum risk-based capital levels than those specified in previous U.S. law and regulations. In July, 2013, the U.S. federal bank regulatory agencies adopted regulations to implement the provisions of the Dodd-Frank Act and Basel III for U.S. financial institutions. The new regulations became applicable to us and our bank effective January 1, 2015.

The new regulations implemented (i) revised definitions of regulatory capital elements, (ii) a new common equity Tier 1 (“CET 1”) minimum capital ratio requirement, (iii) an increase in the existing minimum Tier 1 capital ratio requirement, (iv) new limits on capital distributions and certain discretionary bonus payments if an institution does not hold a specified amount of CET 1 (called a capital conservation buffer) in addition to the amount required to meet its minimum risk-based capital requirements, (v) new risk-weightings for certain categories of assets, and (vi) other requirements applicable to banking organizations which have total consolidated assets of \$250 billion or more, total consolidated on-balance sheet foreign exposure of \$10 billion or more, elect to use the advanced measurement approach for calculating risk-weighted assets, or are subsidiaries of banking organizations that use the advanced measurement approach (“Advanced Approaches Entities”).

Among other things, the new regulations generally require banking organizations to recognize in regulatory capital most components of accumulated other comprehensive income (“AOCI”), including accumulated unrealized gains and losses on available for sale securities. This requirement, which was not imposed under previous risk-based capital regulations, may be avoided by banking organizations, such as us and our bank, that are not Advanced Approaches Entities, by making a one-time, irrevocable election on the first quarterly regulatory report following the date on which the regulations become effective as to them. We made the one-time, irrevocable election regarding the treatment of AOCI on March 31, 2015.

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

On January 1, 2015, for banking organizations such as us and our bank that are not Advanced Approaches Entities, the new regulations mandated a minimum ratio of CET 1 to standardized total risk-weighted assets (“RWA”) of 4.5%, an increased ratio of Tier 1 capital to RWA of 6.0% (compared to the prior requirement of 4.0%), a total capital ratio (that is, the sum of Tier 1 and Tier 2 capital to RWA) of 8.0%, and a minimum leverage ratio (that is, Tier 1 capital to adjusted average total consolidated assets) of 4.0%. The calculation of these amounts is affected by the new

definitions of certain capital elements. The capital conservation buffer comprised solely of CET 1 will be phased-in commencing January 1, 2016, beginning at 0.625% of RWA and rising to 2.5% of RWA on January 1, 2019. Failure by a banking organization to maintain the aggregate required minimum capital ratios and capital conservation buffer will impair its ability to make certain distributions (including dividends and stock repurchases) and discretionary bonus payments to executive officers.

These increased minimum capital requirements may adversely affect our ability (and that of our bank) to pay cash dividends, reduce our profitability, or otherwise adversely affect our business, financial condition or results of operations. In the event of a need for additional capital to meet these requirements, there can be no assurance of our ability to raise funding in the equity and capital markets. Factors that we cannot control, such as the disruption of financial markets or negative views of the financial services industry generally, could impair our ability to raise qualifying equity capital. In addition, our ability to raise qualifying equity capital could be impaired if investors develop a negative perception of our financial prospects. If we were unable to raise qualifying equity capital, it might be necessary for us to sell assets in order to maintain required capital ratios. We may be unable to sell some of our assets, or we may have to sell assets at a discount from market value, either of which could adversely affect our results of operations, cash flow and financial condition.

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We may need to raise additional capital in the future, and such capital may not be available when needed or at all.

We may need or want to raise additional capital in the future to provide us with sufficient capital resources and liquidity to meet our commitments and business needs, particularly if our asset quality or earnings were to deteriorate significantly. Our ability to raise additional capital will depend on, among other things, conditions in the capital markets at that time, which are outside of our control, and our financial performance. Economic conditions and any loss of confidence in financial institutions generally may increase our cost of funding and limit access to certain customary sources of capital.

There can be no assurance that capital will be available on acceptable terms or at all. Any occurrence that may limit our access to the capital markets, such as a decline in the confidence of equity or debt purchasers, or counterparties participating in the capital markets, may adversely affect our capital costs and our ability to raise capital and, potentially, our liquidity. Also, if we need to raise capital in the future, we may have to do so when many other financial institutions are also seeking to raise capital and would have to compete with those institutions for investors. An inability to raise additional capital on acceptable terms when needed could have a materially adverse effect on our business, financial condition and results of operations.

We continually encounter technological change, and we may have fewer resources than our competitors to continue to invest in technological improvements.

The banking industry is undergoing technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, on our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements than we do. There can be no assurance that we will be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

Our Articles of Incorporation and By-laws and the laws of the State of Michigan contain provisions that may discourage or prevent a takeover of our company and reduce any takeover premium.

Our Articles of Incorporation and By-laws, and the corporate laws of the State of Michigan, include provisions which are designed to provide our Board of Directors with time to consider whether a hostile takeover offer is in our and our

shareholders' best interest. These provisions, however, could discourage potential acquisition proposals and could delay or prevent a change in control. The provisions also could diminish the opportunities for a holder of our common stock to participate in tender offers, including tender offers at a price above the then-current market price for our common stock. These provisions could also prevent transactions in which our shareholders might otherwise receive a premium for their shares over then-current market prices, and may limit the ability of our shareholders to approve transactions that they may deem to be in their best interest.

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

There is a limited trading market for our common stock.

The price of our common stock has been, and will likely continue to be, subject to fluctuations based on, among other things, economic and market conditions for bank holding companies and the stock market in general, as well as changes in investor perceptions of our company. The issuance of new shares of our common stock also may affect the market for our common stock.

Our common stock is traded on the Nasdaq Global Select Market under the symbol "MBWM." The development and maintenance of an active public trading market depends upon the existence of willing buyers and sellers, the presence of which is beyond our control. While we are a publicly-traded company, the volume of trading activity in our stock is still relatively limited. Even if a more active market develops, there can be no assurance that such a market will continue, or that our shareholders will be able to sell their shares at or above the price at which they acquired shares.

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Our business is subject to operational risks.

We, like most financial institutions, are exposed to many types of operational risks, including the risk of fraud by employees or outsiders, unauthorized transactions by employees or operational errors. Operational errors may include clerical or record keeping errors or those resulting from faulty or disabled computer or telecommunications systems. Given our volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully corrected. Our necessary dependence upon automated systems to record and process our transaction volume may further increase the risk that technical system flaws or employee tampering or manipulation of those systems will result in losses that are difficult to detect.

We may also be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control, including, for example, computer viruses or electrical or telecommunications outages, which may give rise to losses in service to customers and to loss or liability to us. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations to us, or will be subject to the same risk of fraud or operational errors by their respective employees as are we, and to the risk that our or our vendors' business continuity and data security systems prove not to be adequate. We also face the risk that the design of our controls and procedures proves inadequate or is circumvented, causing delays in detection or errors in information. Although we maintain a system of controls designed to keep operational risks at appropriate levels, there can be no assurance that we will not suffer losses from operational risks in the future that may be material in amount.

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

Our computer systems, software and networks have been and will continue to be vulnerable to unauthorized access, loss or destruction of data (including confidential client information), account takeovers, unavailability of service, computer viruses or other malicious code, cyber-attacks and other events. These threats may derive from human error, fraud or malice on the part of employees or third parties, or may result from accidental technological failure. If one or more of these events occurs, it could result in the disclosure of confidential client information, damage to our reputation with our clients and the market, additional costs to us (such as repairing systems or adding new personnel or protection technologies), regulatory penalties and financial losses, to both us and our clients and customers. Such events could also cause interruptions or malfunctions in our operations (such as the lack of availability of our online banking system), as well as the operations of our clients, customers or other third parties. Although we maintain safeguards to protect against these risks, there can be no assurance that we will not suffer losses in the future that may be material in amount.

Damage to our reputation could materially harm our business.

Our relationship with many of our clients is predicated upon our reputation as a fiduciary and a service provider that adheres to the highest standards of ethics, service quality and regulatory compliance. Adverse publicity, regulatory actions, litigation, operational failures, the failure to meet client expectations and other issues with respect to one or more of our businesses could materially and adversely affect our reputation, our ability to attract and retain clients or our sources of funding for the same or other businesses. Preserving and enhancing our reputation also depends on maintaining systems and procedures that address known risks and regulatory requirements, as well as our ability to identify and mitigate additional risks that arise due to changes in our businesses and the marketplaces in which we operate, the regulatory environment and client expectations. If any of these developments has a material effect on our reputation, our business will suffer.

Item 1B. Unresolved Staff Comments

We have received no written comments regarding our periodic or current reports from the staff of the Securities and Exchange Commission that were issued 180 days or more before the end of our 2016 fiscal year and that remain unresolved.

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Item 2. Properties.

Our headquarters is located in our bank's main office facility in Grand Rapids, Michigan. Our bank operates 48 banking offices concentrated throughout Western and Central Michigan, most of which are full-service facilities. We also recently opened a banking office in Troy, Michigan. We have larger banking facilities in Alma, Holland, Ionia, Kalamazoo, Lansing, Mt. Pleasant and West Branch. The remaining banking offices generally range in size from 1,200 to 3,200 square feet, based on the location and number of employees located at the facility. All but five of the banking offices are owned by our bank, with the remaining facilities rented under various operating lease agreements. In several instances, the banking offices contain more usable space than what is needed for current banking operations. This excess space, totaling approximately 23,500 square feet, is generally leased to unrelated businesses. In addition, certain functions operate out of our standalone facility located in Alma.

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

Item 3. Legal Proceedings.

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

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

Item 5.

Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

Our common stock is traded on the Nasdaq Global Select Market under the symbol “MBWM.” At March 1, 2017, there were approximately 1,600 record holders of our common stock. In addition, we estimate that there were approximately 7,000 beneficial owners of our common stock who own their shares through brokers or banks. The following table shows the high and low sales prices for our common stock as reported by the Nasdaq Global Select Market for the periods indicated and the quarterly and special cash dividends paid by us during those periods.

	High	Low	Dividend
2016			
First Quarter	\$24.37	\$20.84	\$ 0.16
Second Quarter	25.40	21.05	0.16
Third Quarter	27.99	23.42	0.17
Fourth Quarter	38.68	26.48	0.67
2015			
First Quarter	\$21.23	\$18.75	\$ 0.14
Second Quarter	22.00	19.35	0.14
Third Quarter	21.96	18.42	0.15
Fourth Quarter	26.27	19.27	0.15

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

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

On January 14, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.16 per share that was paid on March 23, 2016 to shareholders of record as of March 11, 2016. On April 14, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.16 per share that was paid on June 23, 2016 to shareholders of record as of June 10, 2016. On July 14, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.17 per share that was paid on September 21, 2016 to shareholders of record as of September 9, 2016. On October 13, 2016, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.17 per share that was paid on December 21, 2016 to shareholders of record as of December 9, 2016. In addition, on October 13, 2016, our Board of Directors declared a special cash dividend on our common stock in the amount of \$0.50 per share that was paid on December 21, 2016 to shareholders of record as of December 9, 2016.

On January 15, 2015, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.14 per share that was paid on March 25, 2015 to shareholders of record as of March 13, 2015. On April 16, 2015, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.14 per share that was paid on June 24, 2015 to shareholders of record as of June 12, 2015. On July 16, 2015, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.15 per share that was paid on September 23, 2015 to shareholders of record as of September 11, 2015. On October 15, 2015, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.15 per share that was paid on December 23, 2015 to shareholders of record as of December 11, 2015.

On January 30, 2015, we announced that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by

other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase plan. During 2016, we repurchased 167,878 shares at a total price of \$3.7 million, at an average price per share of \$22.23. Since inception, we have purchased a total of 956,419 shares at a total price of \$19.5 million, at an average price per share of \$20.38. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made during 2017 under the authorized plan, which would also likely be funded from cash dividends paid to us from our bank.

On January 12, 2017, our Board of Directors declared a cash dividend on our common stock in the amount of \$0.18 per share that will be paid on March 22, 2017 to shareholders of record as of March 10, 2017.

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Issuer Purchases of Equity Securities

We announced on January 30, 2015 that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase plan. No shares of our common stock were repurchased during the fourth quarter of 2016.

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
October 1 – 31	0	\$ NA	0	\$ 15,505,000
November 1 – 30	0	NA	0	15,505,000
December 1 – 31	0	NA	0	15,505,000
Total	0	\$ NA	0	\$ 15,505,000

Shareholder Return Performance Graph

Set forth below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on our common stock (based on the last reported sales price of the respective year) with the cumulative total return of the Nasdaq Composite Index and the SNL Bank Nasdaq Index from December 31, 2011 through December 31, 2016. The following is based on an investment of \$100 on December 31, 2011 in our common stock, the Nasdaq Composite Index and the SNL Bank Nasdaq Index, with dividends reinvested where applicable.

<i>Index</i>	<i>Period Ending</i>					
	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16
Mercantile Bank Corporation	100.00	170.27	228.14	249.26	299.20	477.96
NASDAQ Composite	100.00	117.45	164.57	188.84	201.98	219.89
SNL Bank NASDAQ	100.00	119.19	171.31	177.42	191.53	265.56

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Item 6. Selected Financial Data.

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

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

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

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

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

Item 8. Financial Statements and Supplementary Data.

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

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

None

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Item 9A. Controls and Procedures.

As of December 31, 2016, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of December 31, 2016.

There have been no significant changes in our internal control over financial reporting during the quarter ended December 31, 2016, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). There are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2016. This evaluation was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”). Based on our evaluation under the COSO framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2016. Refer to page F-33 for management’s report.

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

Item 9B. Other Information.

None

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The information presented under the captions “Election of Directors,” “Executive Officers,” “Section 16(a) Beneficial Ownership Reporting Compliance” and “Corporate Governance – Code of Ethics” in the definitive Proxy Statement of Mercantile for our May 25, 2017 Annual Meeting of Shareholders (the “Proxy Statement”), a copy of which will be filed with the Securities and Exchange Commission before April 30, 2017, is incorporated here by reference.

We have a separately-designated standing audit committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934. The members of the Audit Committee consist of David M. Cassard, Edward J. Clark, Michelle L. Eldridge, Jeff A. Gardner and Edward B. Grant. The Board of Directors has determined that Messrs. Cassard and Grant, members of the Audit Committee, are qualified as audit committee financial experts, as that term is defined in the rules of the Securities and Exchange Commission. All five members of the committee are independent, as independence for audit committee members is defined in the Nasdaq listing standards and the rules of the Securities and Exchange Commission.

Item 11. Executive Compensation.

The information presented under the captions “Executive Compensation,” “Corporate Governance – Compensation Committee Interlocks and Insider Participation” and “Compensation Committee Report” in the Proxy Statement is incorporated here by reference.

Table of Contents**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information presented under the caption “Stock Ownership of Certain Beneficial Owners and Management” in the Proxy Statement is incorporated here by reference.

Equity Compensation Plan Information

The following table summarizes information, as of December 31, 2016, relating to compensation plans under which equity securities are authorized for issuance.

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))	
	(a)	(b)	(c)	(2)
Equity compensation plans approved by security holders (1)	61,083	\$ 15.17	407,000	(2)
Equity compensation plans not approved by security holders	0	0	0	
Total	61,083	\$ 15.17	407,000	

(1) Includes Mercantile's Stock Incentive Plan of 2006 and Stock Incentive Plan of 2016. Also, in conjunction with the merger with Firstbank, we issued Mercantile stock options in replacement of all outstanding stock option grants that had been issued to Firstbank employees under the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 and the Firstbank Corporation Stock Compensation Plan.

(2) These securities are available under the Stock Incentive Plan of 2016. Incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards. No further issuances will be made under Mercantile's Stock Incentive Plan of 2006, the Firstbank Corporation Stock Option and Restricted Stock Plan of 1997 or the Firstbank Corporation Stock Compensation Plan.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information presented under the captions "Transactions with Related Persons" and "Corporate Governance – Director Independence" in the Proxy Statement is incorporated here by reference.

Item 14. Principal Accountant Fees and Services.

The information presented under the caption "Principal Accountant Fees and Services" in the Proxy Statement is incorporated here by reference.

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PART IV

Item 15. Exhibits and Financial Statement Schedules

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

Reports of Independent Registered Public Accounting Firm dated March 6, 2017 – BDO USA, LLP

Consolidated Balance Sheets --- December 31, 2016 and 2015

Consolidated Statements of Income for each of the three years in the period ended December 31, 2016

Consolidated Statements of Comprehensive Income for each of the three years in the period ended December 31, 2016

Consolidated Statements of Changes in Shareholders' Equity for each of the three years in the period ended December 31, 2016

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2016

Notes to Consolidated Financial Statements

The Consolidated Financial Statements, the Notes to the Consolidated Financial Statements, and the Reports of Independent Registered Public Accounting Firm listed above are incorporated by reference in Item 8 of this report.

(2) Financial Statement Schedules

Not applicable

(b)Exhibits:

The Exhibit Index following the Signatures Page hereto is incorporated by reference under this item.

(c)Financial Statements Not Included In Annual Report

Not applicable

Item 16. Form 10-K Summary

None.

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MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION

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MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION

December 31, 2016 and 2015

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Table of Contents**SELECTED FINANCIAL DATA**

Consolidated Results of Operations:	2016	2015	2014(*)	2013	2012
	(Dollars in thousands except per share data)				
Interest income	\$ 118,457	\$ 112,328	\$ 89,118	\$ 58,242	\$ 59,917
Interest expense	12,590	11,154	11,340	10,786	13,216
Net interest income	105,867	101,174	77,778	47,456	46,701
Provision for loan losses	2,900	(1,000)	(3,000)	(7,200)	(3,100)
Noninterest income	21,038	16,038	10,028	6,872	7,994
Noninterest expense	77,118	79,381	65,610	36,403	39,624
Income before income tax expense	46,887	38,831	25,196	25,125	18,171
Income tax expense	14,974	11,811	7,865	8,092	5,636
Net income	31,913	27,020	17,331	17,033	12,535
Preferred stock dividends and accretion	0	0	0	0	1,030
Net income attributable to common shares	\$ 31,913	\$ 27,020	\$ 17,331	\$ 17,033	\$ 11,505

Consolidated Balance Sheet Data:

Total assets	\$ 3,082,571	\$ 2,903,556	\$ 2,893,379	\$ 1,426,966	\$ 1,422,926
Cash and cash equivalents	183,596	89,891	172,738	146,965	136,003
Securities	336,086	354,559	446,611	143,139	150,275
Loans	2,378,620	2,277,727	2,089,277	1,053,243	1,041,189
Allowance for loan losses	17,961	15,681	20,041	22,821	28,677
Bank owned life insurance	67,198	58,971	57,861	51,377	50,048
Deposits	2,374,985	2,275,382	2,276,915	1,118,911	1,135,204
Securities sold under agreements to repurchase	131,710	154,771	167,569	69,305	64,765
Federal Home Loan Bank advances	175,000	68,000	54,022	45,000	35,000
Subordinated debentures	44,835	55,154	54,472	32,990	32,990
Shareholders' equity	340,811	333,804	328,138	153,325	146,590

Consolidated Financial Ratios:

Return on average assets	1.07	%	0.94	%	0.76	%	1.22	%	0.82	%
Return on average shareholders' equity	9.35	%	8.19	%	6.91	%	11.36	%	7.51	%
Average shareholders' equity to average assets	11.42	%	11.45	%	11.05	%	10.77	%	10.90	%
Nonperforming loans to total loans	0.25	%	0.24	%	1.41	%	0.64	%	1.82	%
Allowance for loan losses to total originated loans	0.95	%	0.94	%	1.55	%	2.17	%	2.75	%
Tier 1 leverage capital	11.17	%	11.56	%	11.15	%	12.53	%	11.31	%
Common equity risk-based capital	10.88	%	10.89	%	NA		NA		NA	

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Tier 1 risk-based capital	12.47	%	12.83	%	13.57	%	14.65	%	13.37	%
Total risk-based capital	13.13	%	13.45	%	14.43	%	15.91	%	14.63	%

Per Common Share Data:

Net income:

Basic	\$1.96		\$1.63		\$1.28		\$1.96		\$1.33	
Diluted	1.96		1.62		1.28		1.95		1.30	

Tangible book value per share at end of period	17.14		16.61		15.49		17.54		16.84	
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Dividends declared	1.16		0.58		2.48		0.45		0.09	
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Dividend payout ratio	58.70	%	35.22	%	141.16	%	22.83	%	6.73	%
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(*) – Merger with Firstbank effective June 1, 2014.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

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

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation or actions by bank regulators; changes in tax laws; changes in prices, levies, and assessments; impact of technological advances; governmental and regulatory policy changes; outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; changes in local real estate values; changes in the national and local economies; and other risk factors described in Item 1A of this Annual Report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

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

We complete a migration analysis quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2016 we placed most weight on the period starting December 31, 2010 through December 31, 2016. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

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Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our 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 loan portfolio.

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

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

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

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

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

Goodwill: Generally accepted 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 revenue streams. For certain items that we believe we have the appropriate expertise to determine the fair value, we may choose to use our own calculation of the value. In other cases, where the value is not easily determined, we consult with outside parties to determine the fair value of the asset or liability. Once valuations have been adjusted, the net difference between the price paid for the acquired company and the fair value of its balance sheet is recorded as goodwill.

Goodwill is assessed at least annually for impairment and any such impairment is recognized in the period identified. A more frequent assessment is performed should events or changes in circumstances indicate the carrying value of the goodwill may not be recoverable. We may elect to perform a qualitative assessment for the annual impairment test. If the qualitative assessment indicates it is more likely than not that the fair value of a reporting unit is less than its carrying amount, or if we elect not to perform a qualitative assessment, then we would be required to perform a quantitative test for goodwill impairment. The quantitative test is a two-step process consisting of comparing the carrying value of the reporting unit to an estimate of its fair value. If the estimated fair value of the reporting unit is less than the carrying value, goodwill is impaired and is written down to its estimated fair value. In 2015 and 2016, 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. Our qualitative assessment

considered factors such as macroeconomic conditions, market conditions specifically related to the banking industry and our overall financial condition and results of operations.

INTRODUCTION

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

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FINANCIAL OVERVIEW

We recorded net income of \$31.9 million, or \$1.96 per diluted share, for 2016. For 2015, we recorded net income of \$27.0 million, or \$1.62 per diluted share. Our earnings performance during 2016 reflects a 21% increase in diluted earnings per share when compared to 2015. Our net interest income during 2016 was positively impacted by calls on U.S. Government agency bonds that had been purchased at a discounted price, allowing us to record accelerated discount accretion totaling \$2.2 million. In addition, in January we repurchased \$11.0 million in trust preferred securities at a 27% discount, resulting in a pre-tax gain of \$3.0 million. Provision expense during 2016 totaled \$2.9 million, compared to a negative \$1.0 million in 2015.

The overall quality of our loan portfolio remains strong, with nonperforming loans equaling only 0.25% of total loans as of December 31, 2016. The strength of our loan portfolio, combined with recoveries of prior loan charge-offs and the eliminations of and reductions in specific reserves, had produced a positive impact on our allowance calculations and allowed us to make negative provisions during the prior four calendar years. While our loan portfolio remains as strong, ongoing loan growth, lower eliminations of and reductions in specific reserves and a change in the economic and concentration environmental factors resulted in us recording a positive provision expense in 2016. We believe the provision expense recorded during 2016 reflects a more normalized economic and operating environment, and expect to record a similar provision expense during 2017. Gross loan charge-offs during 2016 totaled \$2.2 million, while recoveries of prior period loan charge-offs totaled \$1.6 million, providing for net loan charge-offs of \$0.6 million, or only 0.03% of average total loans. 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. Accruing loans past due 30 to 89 days remain very low.

New commercial term loan originations totaled approximately \$549 million during 2016, slightly greater than the \$532 million we booked during 2015. We also experienced net increases in commercial lines of credit during both years, in large part reflecting lines that are part of new commercial lending relationships established during recent quarterly periods. Net loan growth equaled \$101 million during 2016, compared to \$188 million during 2015, with both years reflecting the impact of scheduled monthly payments as well as expected and unexpected commercial loan payoffs. Commercial loan payoffs during the fourth quarter of 2016 were higher than typical, in large part reflecting the impact of credit decisions and the competitive operating environment. During 2016, total commercial loans grew \$119 million, or 6.1%, with commercial real estate non-owner occupied loans growing \$104 million. The new loan pipeline remains strong, and at year-end 2016, we had \$102 million in unfunded loan commitments on commercial construction and development projects that are in the construction phase. We believe our loan portfolio is well diversified, with commercial real estate non-owner occupied loans comprising 32%, commercial and industrial loans equaling 30%, commercial real estate owner occupied loans comprising 19% and residential mortgage and consumer loans aggregating 13% of total loans as of December 31, 2016. As a percent of total commercial loans, commercial and industrial loans and commercial real estate owner occupied loans combined equaled 56% at year-end 2016, compared to 59% at December 31, 2015.

Our funding structure is also well diversified. As of December 31, 2016, noninterest-bearing checking accounts comprised 30% of total funds, interest-bearing checking and securities sold under agreements to repurchase (“sweep accounts”) combined for 19%, savings and money market deposit accounts aggregated to 23% and local time deposits accounted for 19%. Wholesale funds, comprised of brokered deposits and Federal Home Loan Bank of Indianapolis (“FHLBI”) advances, represented 9% of total funds.

SUBSEQUENT EVENT

On February 27, 2017, we filed a Form 8-K with the SEC announcing our expansion into the Southeast Michigan market with the opening of a loan production office located in Troy, Michigan. We will soon be filing a branch application with the Federal Deposit Insurance Corporation and Michigan Department of Insurance and Financial Services, and expect to expand the activities of the new loan production office to a full service branch once the necessary regulatory approvals are received.

Table of Contents**FINANCIAL CONDITION**

Our total assets increased \$179 million during 2016, and totaled \$3.08 billion as of December 31, 2016. Total loans increased \$101 million and interest-earning deposits were up \$86.9 million, while securities available for sale declined \$18.9 million. Total deposits increased \$99.6 million and FHLBI advances were up \$107 million, while sweep accounts were down \$23.1 million during 2016. We maintained a relatively high balance of funds in our interest-earning deposit account at the Federal Reserve Bank of Chicago during the fourth quarter of 2016, primarily reflecting an excess liquidity position resulting from the reduction in total loans and an increase in local deposits. During the first quarter of 2017, our liquidity position returned to the more typical level such as it was at year-end 2015 primarily due to net loan growth, brokered deposit maturities and a reduction in checking account products reflecting estimated federal income tax payments from certain commercial customers.

Earning Assets

Average earning assets equaled 92.5% of average total assets during 2016, similar to the 92.1% during 2015. The loan portfolio continued to comprise a majority and increasing level of earning assets, followed by securities and interest-earning deposits. Average total loans equaled 84.9% of average earning assets during 2016, compared to 82.1% in 2015, while securities and other interest-earning assets combined comprised 15.1% of average earning assets during 2016, compared to 17.9% in 2015. The loan component of earning assets has increased since the effective date of the merger with Firstbank reflecting our strategy to fund a majority of the net loan growth with monies from maturities and calls of U.S. Government agency and municipal bonds and paydowns on mortgage-backed securities as the securities portfolio as a percent of earning assets was larger than desired. The securities portfolio reached the desired level during the second quarter of 2016; therefore, we expect to fund future net loan growth with increases in local deposits and FHLBI advances. We further anticipate the level of earning assets to total assets remaining relatively stable at approximately 93%.

Our loan portfolio has historically been primarily comprised of commercial loans, although less so now following the merger with Firstbank. Commercial loans increased \$119 million during 2016, and at December 31, 2016 totaled \$2.07 billion, or 86.8% of the loan portfolio. As of December 31, 2015, the commercial loan portfolio comprised 85.5% of total loans. Non-owner occupied commercial real estate (“CRE”) loans increased \$104 million, commercial and industrial loans were up \$17.6 million, owner occupied CRE loans increased \$4.5 million and multi-family and residential rental loans grew \$2.9 million, while vacant land, land development and residential construction loans were down \$10.3 million. As a percent of total commercial loans, commercial and industrial loans and owner occupied CRE loans combined equaled 56.4% as of December 31, 2016, compared to 58.7% as of December 31, 2015.

We have significantly enhanced our commercial loan calling efforts over the past several years. We are very pleased with the \$1.8 billion in new commercial term loan fundings over the past five years, and our current commercial loan pipeline reports indicate continued strong commercial loan funding opportunities in future periods. Also, as of December 31, 2016, availability on existing construction and development loans totaled \$102 million, with most of

those commitments expected to be drawn during 2017. Further, we have made additional lending commitments totaling \$154 million, a majority of which we expect to be accepted and funded over the next 12 to 18 months. Our commercial loan officers also report substantial additional opportunities they are currently discussing with existing borrowers and potential new customers.

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

One-to-four family mortgage loans and other consumer loans declined a combined \$17.8 million during 2016, and at December 31, 2016 totaled a combined \$313 million, or 13.2% of the loan portfolio. One-to-four family mortgage loans and other consumer-related loans combined equated to 14.5% of total loans as of December 31, 2015.

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The following table summarizes our loan portfolio:

	12/31/16	12/31/15	12/31/14	12/31/13	12/31/12
Commercial:					
Commercial & Industrial	\$713,903,000	\$696,303,000	\$550,629,000	\$286,373,000	\$285,322,000
Land Development & Construction	34,828,000	45,120,000	51,977,000	36,741,000	48,099,000
Owner Occupied Commercial Real Estate	450,464,000	445,919,000	430,406,000	261,877,000	259,277,000
Non-Owner Occupied Commercial Real Estate	748,269,000	644,351,000	559,594,000	364,066,000	324,886,000
Multi-Family & Residential Rental	117,883,000	115,003,000	122,772,000	37,639,000	50,922,000
Total Commercial	2,065,347,000	1,946,696,000	1,715,378,000	986,696,000	968,506,000
Retail:					
1-4 Family Mortgages	195,226,000	190,385,000	214,695,000	31,467,000	33,766,000
Home Equity & Other Consumer Loans	118,047,000	140,646,000	159,204,000	35,080,000	38,917,000
Total Retail	313,273,000	331,031,000	373,899,000	66,547,000	72,683,000
Total Loans	\$2,378,620,000	\$2,277,727,000	\$2,089,277,000	\$1,053,243,000	\$1,041,189,000

The following table presents total loans outstanding as of December 31, 2016, according to scheduled repayments of principal on fixed rate loans and repricing frequency on variable rate loans. Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.

	Less Than One Year	One Through Five Years	More Than Five Years	Total
Construction and land development	\$87,867,000	\$33,385,000	\$18,164,000	\$139,416,000
Real estate - residential properties	50,277,000	146,810,000	109,650,000	306,737,000
Real estate - multi-family properties	8,003,000	21,535,000	29,448,000	58,986,000
Real estate - commercial properties	477,313,000	466,040,000	207,752,000	1,151,105,000
Commercial and industrial	505,809,000	143,632,000	31,072,000	680,513,000
Consumer	3,538,000	30,605,000	7,720,000	41,863,000
Total loans	\$1,132,807,000	\$842,007,000	\$403,806,000	\$2,378,620,000
Fixed rate loans	\$241,609,000	\$803,259,000	\$378,680,000	\$1,423,548,000
Floating rate loans	891,198,000	38,748,000	25,126,000	955,072,000

Total loans	\$1,132,807,000	\$842,007,000	\$403,806,000	\$2,378,620,000
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Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans to provide effective loan portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans, which exhibit characteristics (financial or otherwise) that could cause the loans to become nonperforming or require restructuring in the future, are included on the internal loan watch list. Senior management and the Board of Directors review this list regularly. Market value estimates of collateral on impaired loans, as well as on foreclosed and repossessed assets, are reviewed periodically; however, we have a process in place to monitor whether value estimates at each quarter-end are reflective of current market conditions. Our credit policies establish criteria for obtaining appraisals and determining internal value estimates. We may also adjust outside and internal valuations based on identifiable trends within our markets, such as recent sales of similar properties or assets, listing prices and offers received. In addition, we may discount certain appraised and internal value estimates to address distressed market conditions.

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Nonperforming assets, comprised of nonaccrual loans, loans past due 90 days or more and accruing interest and foreclosed properties, totaled \$6.4 million (0.2% of total assets) as of December 31, 2016, compared to \$6.7 million (0.2% of total assets) as of December 31, 2015. The volume of nonperforming assets has generally been on a declining trend since the peak of \$118 million on March 31, 2010. Reductions in nonperforming assets over the past couple of years primarily reflect principal payments on nonaccrual loans and sales proceeds on foreclosed properties. One commercial loan relationship, which was placed on nonaccrual during late 2014, accounted for approximately 70% of total nonperforming assets at year-end 2014. This relationship was resolved during mid-2015. Given the low level of nonperforming loans and accruing loans 30 to 89 days delinquent, combined with the declining level of watch list credits and what we believe are strong credit administration practices, we are pleased with the overall quality of the loan portfolio.

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

NONPERFORMING LOANS

	12/31/16	12/31/15	12/31/14	12/31/13	12/31/12
Residential Real Estate:					
Land Development	\$16,000	\$23,000	\$84,000	\$40,000	\$1,188,000
Construction	0	0	0	0	319,000
Owner Occupied / Rental	2,739,000	2,917,000	4,229,000	4,219,000	4,321,000
	2,755,000	2,940,000	4,313,000	4,259,000	5,828,000
Commercial Real Estate:					
Land Development	95,000	155,000	209,000	389,000	737,000
Construction	0	0	0	0	0
Owner Occupied	285,000	2,131,000	18,091,000	885,000	2,577,000
Non-Owner Occupied	488,000	108,000	378,000	169,000	9,093,000
	868,000	2,394,000	18,678,000	1,443,000	12,407,000
Non-Real Estate:					
Commercial Assets	2,293,000	69,000	6,401,000	1,016,000	734,000
Consumer Assets	23,000	41,000	42,000	0	1,000
	2,316,000	110,000	6,443,000	1,016,000	735,000
Total	\$5,939,000	\$5,444,000	\$29,434,000	\$6,718,000	\$18,970,000

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OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS

	12/31/16	12/31/15	12/31/14	12/31/13	12/31/12
Residential Real Estate:					
Land Development	\$0	\$0	\$329,000	\$427,000	\$1,174,000
Construction	0	0	0	22,000	157,000
Owner Occupied / Rental	144,000	598,000	722,000	207,000	491,000
	144,000	598,000	1,051,000	656,000	1,822,000
Commercial Real Estate:					
Land Development	0	0	0	92,000	52,000
Construction	0	0	0	0	0
Owner Occupied	325,000	612,000	247,000	164,000	957,000
Non-Owner Occupied	0	83,000	697,000	1,939,000	4,139,000
	325,000	695,000	944,000	2,195,000	5,148,000
Non-Real Estate:					
Commercial Assets	0	0	0	0	0
Consumer Assets	0	0	0	0	0
	0	0	0	0	0
Total	\$469,000	\$1,293,000	\$1,995,000	\$2,851,000	\$6,970,000

The following tables provide a reconciliation of nonperforming assets:

NONPERFORMING LOANS RECONCILIATION

	2016	2015	2014	2013	2012
Beginning balance	\$5,444,000	\$29,434,000	\$6,718,000	\$18,970,000	\$45,074,000
Additions, net of transfers to other real estate owned	5,655,000	4,543,000	25,871,000	1,726,000	4,998,000
Returns to performing status	(13,000)	(48,000)	(779,000)	0	(774,000)
Principal payments	(4,166,000)	(23,641,000)	(2,063,000)	(10,934,000)	(25,095,000)
Loan charge-offs	(981,000)	(4,844,000)	(313,000)	(3,044,000)	(5,233,000)
Total	\$5,939,000	\$5,444,000	\$29,434,000	\$6,718,000	\$18,970,000

OTHER REAL ESTATE OWNED & REPOSSESSED ASSETS RECONCILIATION

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	2016	2015	2014	2013	2012
Beginning balance	\$1,293,000	\$1,995,000	\$2,851,000	\$6,970,000	\$15,282,000
Additions	725,000	2,186,000	2,593,000	2,181,000	11,808,000
Sale proceeds	(1,428,000)	(2,377,000)	(3,183,000)	(5,585,000)	(16,916,000)
Valuation write-downs	(121,000)	(511,000)	(266,000)	(715,000)	(3,204,000)
Total	\$469,000	\$1,293,000	\$1,995,000	\$2,851,000	\$6,970,000

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Gross loan charge-offs equaled \$2.2 million during 2016, while recoveries of prior period charge-offs totaled \$1.6 million. Resulting net loan charge-offs equaled \$0.6 million, or only 0.03% of average total loans. The increase in gross loan charge-offs during 2015 was associated with the aforementioned large distressed commercial loan relationship that was resolved in mid-2015. 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 recoveries.

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

	2016	2015	2014	2013	2012
Originated loans outstanding at year-end	\$1,884,548,000	\$1,616,587,000	\$1,246,116,000	\$1,053,243,000	\$1,041,189,000
Daily average balance of originated loans outstanding during the year	\$1,784,978,000	\$1,428,150,000	\$1,141,682,000	\$1,050,961,000	\$1,049,315,000
Balance of allowance for originated loans at beginning of year	\$15,233,000	\$19,299,000	\$22,821,000	\$28,677,000	\$36,532,000
Originated loans charged-off:					
Commercial, financial and agricultural	(980,000)	(4,910,000)	(840,000)	(3,596,000)	(11,311,000)
Construction and land development	0	(4,000)	(36,000)	(822,000)	(348,000)
Residential real estate	(809,000)	(1,053,000)	(484,000)	(862,000)	(938,000)
Instalment loans to individuals	(344,000)	(228,000)	(70,000)	(10,000)	(46,000)
Total charge-offs	(2,133,000)	(6,195,000)	(1,430,000)	(5,290,000)	(12,643,000)
Recoveries of previously charged-off originated loans:					

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Commercial, financial and agricultural	754,000	2,535,000	1,117,000	4,795,000	7,076,000
Construction and land development	334,000	122,000	180,000	897,000	285,000
Residential real estate	522,000	122,000	404,000	933,000	469,000
Instalment loans to individuals	60,000	51,000	0	9,000	58,000
Total recoveries	1,670,000	2,830,000	1,701,000	6,634,000	7,888,000
Net loan (charge-offs) recoveries	(463,000)	(3,365,000)	271,000	1,344,000	(4,755,000)
Provision for loan losses for originated loans	3,098,000	(701,000)	(3,793,000)	(7,200,000)	(3,100,000)
Balance of allowance for originated loans at end of year	\$17,868,000	\$15,233,000	\$19,299,000	\$22,821,000	\$28,677,000
Ratio of net loan (charge-offs) recoveries to average loans outstanding during the year	(0.03 %)	(0.24 %)	0.02 %	0.13 %	(0.45 %)
Ratio of allowance to originated loans outstanding at year-end	0.95 %	0.94 %	1.55 %	2.17 %	2.75 %

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

	12/31/2016		12/31/2015		12/31/2014		12/31/2013		12/31/2012	
	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio
Commercial, financial and agricultural	\$15,035	85.8 %	\$12,017	80.7 %	\$16,112	82.8 %	\$17,860	84.0 %	\$22,646	85.3 %
Construction and land development	991	6.0	1,655	10.9	1,012	8.8	1,858	8.9	2,246	6.2
Residential real estate	1,374	6.4	1,235	6.4	1,974	7.2	3,027	6.8	3,646	8.1
Instalment loans to individuals	508	1.8	186	2.0	125	1.2	68	0.3	139	0.4
Unallocated	(40)	0.0	140	0.0	76	0.0	8	0.0	0	0.0
Total	\$17,868	100.0 %	\$15,233	100.0 %	\$19,299	100.0 %	\$22,821	100.0 %	\$28,677	100.0 %

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

	12/31/16	12/31/15	12/31/14	12/31/13	12/31/12
Ratio of allowance to nonperforming loans	302.4 %	288.0 %	68.1 %	339.7 %	151.2 %

The decline in the ratio of our allowance to nonperforming loans during 2014 primarily reflects the aforementioned one distressed commercial loan relationship that was placed into nonaccrual status in late 2014 but resolved during mid-2015.

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

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

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A migration analysis is completed quarterly to assist us in determining appropriate reserve allocation factors for non-impaired loans. Our migration takes into account various time periods; however, at year-end 2016 we placed most weight on the period starting December 31, 2010 through December 31, 2016. We believe this period represents an appropriate range of economic conditions, and that it provides for an appropriate basis in determining reserve allocation factors given current economic conditions and the general market consensus of economic conditions in the near future.

Although the migration analysis provides an accurate historical accounting of our net loan losses, it is not able to fully account for environmental factors that will also very likely impact the collectability of our 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 loan portfolio.

The primary risk elements with respect to commercial loans are the financial condition of the borrower, the sufficiency of collateral, and the 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 \$17.9 million as of December 31, 2016, or 1.0% of total originated loans outstanding, compared to 0.9% at year-end 2015. The allowance for acquired loans equaled \$0.1 million as of December 31, 2016, compared to \$0.4 million at year-end 2015. As of December 31, 2016, the allowance for originated loans was comprised of \$16.3 million in general reserves relating to non-impaired loans, \$0.9 million in specific reserve allocations relating to nonaccrual loans, and \$0.7 million in specific allocations on other loans, primarily accruing loans designated as troubled debt restructurings.

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

Troubled debt restructurings totaled \$13.6 million at December 31, 2016, consisting of \$1.1 million that are on nonaccrual status and \$12.5 million that are on accrual status. The latter, while considered and accounted for as impaired loans in accordance with accounting guidelines, is not included in our nonperforming loan totals. Impaired loans with an aggregate carrying value of \$0.6 million as of December 31, 2016 had been subject to previous partial charge-offs aggregating \$0.6 million. Those partial charge-offs were recorded as follows: less than \$0.1 million in

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2016, \$0.1 million in 2015, less than \$0.1 million in 2013 and 2012, \$0.4 million in 2011 and \$0.1 million in 2010. As of December 31, 2016, specific reserves allocated to impaired loans that had been subject to a previous partial charge-off totaled less than \$0.1 million.

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

	12/31/16	12/31/15	12/31/14	12/31/13	12/31/12
Performing	\$12,480,000	\$19,336,000	\$24,001,000	\$30,247,000	\$38,148,000
Nonperforming	1,132,000	2,358,000	26,433,000	4,645,000	12,612,000
Total	\$13,612,000	\$21,694,000	\$50,434,000	\$34,892,000	\$50,760,000

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Securities available for sale decreased \$18.9 million during 2016, totaling \$328 million as of December 31, 2016. The securities portfolio equaled 12.0% of average earning assets during 2016. Purchases during 2016, generally limited to U.S. Government agency and municipal bonds, totaled \$164 million. Proceeds from matured and called U.S. Government agency and municipal bonds during 2016 totaled \$134 million and \$19.6 million, respectively, with another \$18.6 million from principal paydowns on mortgage-backed securities. In addition, proceeds from the sales of municipal bonds totaled \$0.3 million. At December 31, 2016, the securities portfolio was primarily comprised of U.S. Government agency bonds (46%), municipal bonds (39%) and U.S. Government agency issued or guaranteed mortgage-backed securities (14%). All of our securities are currently designated as available for sale, and therefore are stated at fair value. The fair value of securities designated as available for sale at December 31, 2016 totaled \$328 million, including a net unrealized loss of \$8.5 million. We maintain the securities portfolio at levels to provide adequate pledging and secondary liquidity for our daily operations. In addition, the securities portfolio serves a primary interest rate risk management function.

The following table reflects the composition of the securities portfolio:

	12/31/16 Carrying Value	Percent	%	12/31/15 Carrying Value	Percent	%	12/31/14 Carrying Value	Percent
U.S. Government agency debt obligations	\$ 152,040,000	46.3	%	\$ 147,040,000	42.4	%	\$ 193,468,000	44.7 %
Mortgage-backed securities	47,392,000	14.5		67,074,000	19.3		93,561,000	21.6
Municipal general obligations	119,047,000	36.3		122,023,000	35.2		133,082,000	30.8
Municipal revenue bonds	7,631,000	2.3		8,914,000	2.6		10,873,000	2.5
Other investments	1,950,000	0.6		1,941,000	0.5		1,928,000	0.4
Totals	\$328,060,000	100.0	%	\$346,992,000	100.0	%	\$432,912,000	100.0 %

FHLBI stock totaled \$8.0 million as of December 31, 2016, compared to \$7.6 million as of December 31, 2015. The \$0.4 million increase reflects stock purchases to support our level of FHLBI advances. Our investment in FHLBI stock is necessary to engage in their advance and other financing programs. We continue to receive regular quarterly cash dividends, and we expect a cash dividend will continue in future quarterly periods.

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

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The following table shows by class of maturities as of December 31, 2016, the amounts and weighted average yields (on a fully taxable-equivalent basis) of investment securities:

	Carrying Value	Average Yield	
Obligations of U.S. Government agencies:			
One year or less	\$16,867,000	1.01	%
Over one through five years	20,891,000	1.59	
Over five through ten years	47,510,000	2.14	
Over ten years	66,772,000	2.65	
	152,040,000	2.16	
Obligations of states and political subdivisions:			
One year or less	18,771,000	1.45	
Over one through five years	59,981,000	2.27	
Over five through ten years	34,077,000	3.42	
Over ten years	13,849,000	3.88	
	126,678,000	2.63	
Mortgage-backed securities	47,392,000	1.77	
Other investments	1,950,000	2.66	
Totals	\$328,060,000	2.31	%

Other interest-earning assets, primarily consisting of excess funds deposited with the Federal Reserve Bank of Chicago, are used to manage daily liquidity needs and interest rate sensitivity. The average balance of these funds equaled 2.8% of average earning assets during 2016, compared to 3.0% during 2015. We anticipate the level of these earning assets to average approximately 2% of average earning assets in future periods.

Non-Earning Assets

Cash and due from bank balances averaged 1.5% of total assets during 2016, with no significant changes expected in future periods. Net premises and fixed assets equaled \$45.5 million as of December 31, 2016, or 1.5% of total assets. Net purchases during 2016 totaled \$2.0 million, while depreciation expense aggregated to \$2.9 million. Foreclosed and repossessed assets totaled \$0.5 million at December 31, 2016, compared to \$1.3 million at December 31, 2015. While we expect further transfers from loans to foreclosed and repossessed assets in future periods reflecting our collection efforts on some impaired lending relationships, we believe the strong quality of our loan portfolio will limit any overall increase in, and average balance of, this nonperforming asset category.

Source of Funds

Total deposits increased \$99.6 million during 2016, totaling \$2.37 billion as of December 31, 2016. Out-of-area deposits decreased \$45.2 million during 2016, and equaled 3.2% of total deposits at year-end 2016, compared to 5.3% as of December 31, 2015. FHLBI advances increased \$107 million during 2016, totaling \$175 million as of December 31, 2016.

Noninterest-bearing checking accounts increased \$136 million during 2016, generally due to deposit account openings as part of recently established commercial lending relationships and transfers from business-related interest-bearing checking accounts and sweep accounts to new noninterest-bearing checking accounts reflecting updated interest rate and fee structures. Interest-bearing checking accounts decreased \$25.4 million, savings deposits grew \$12.2 million and money market deposit accounts declined \$2.3 million. Local time deposits increased \$24.3 million, in large part reflecting a commercial customer transferring excess funds from a noninterest-bearing checking account to certificates of deposit and a certificate of deposit special offered during the third quarter of 2016.

Sweep accounts decreased \$23.1 million during 2016, totaling \$132 million at December 31, 2016. The decline primarily reflects certain customers transferring funds from the sweep product to noninterest-bearing checking accounts reflecting updated interest rate and fee structures. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings.

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FHLBI advances increased \$107 million during 2016, totaling \$175 million as of December 31, 2016. The additional monies were generally used to fund brokered deposit maturities and loan growth. FHLBI advances are primarily used to assist in funding loan demand, as well as playing an integral role in our interest rate risk management program. FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit at year-end 2016 totaled \$517 million, with availability of \$342 million.

Shareholders' equity increased \$7.0 million during 2016, totaling \$341 million as of December 31, 2016. Positively impacting shareholders' equity was net income of \$31.9 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling \$18.7 million, our share repurchase program that aggregated \$3.7 million and a change in the net unrealized gains and losses, net of tax effect, on our available for sales securities portfolio of \$6.9 million. Activity relating to the issuance and sale of common stock through various stock-based compensation programs and our dividend reinvestment plan positively impacted shareholders' equity by a total of \$2.9 million.

RESULTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2016 and 2015

Summary

We recorded net income of \$31.9 million, or \$1.96 per basic and diluted share, for 2016, compared to net income of \$27.0 million, or \$1.63 per basic share and \$1.62 per diluted share, for 2015. The repurchase of \$11.0 million in trust preferred securities at a 27% discount during the first quarter of 2016 increased net income during 2016 by \$1.8 million, or \$0.11 per basic and diluted share. This unique opportunity resulted from a private investment fund that voluntarily liquidated and auctioned all of its investments. We also recorded accelerated discount accretion on called U.S. Government agency bonds that increased net income by \$1.4 million, or \$0.09 per basic and diluted share. Provision expense was \$2.9 million, or \$0.12 per basic and diluted share after tax in 2016, compared to negative \$1.0 million, or \$0.04 per basic and diluted share after tax in 2015.

The improved earnings performance in 2016 compared to 2015 resulted from increased net interest income and noninterest income and decreased overhead costs, which more than offset increased provision expense. The increased net interest income primarily resulted from a higher level of average earning assets; an improved net interest margin, resulting from an increased yield on total earning assets, also contributed to the higher level of net interest income. The increased noninterest income mainly resulted from the recording of a pre-tax gain associated with the trust preferred securities repurchase transaction in January of 2016 and higher service charges on deposit and sweep accounts. The decreased noninterest expense was primarily attributable to decreased problem asset costs, loan processing costs, and Federal Deposit Insurance Corporation ("FDIC") insurance premiums and various cost reduction

initiatives, including the cost efficiency program announced during the fourth quarter of 2015; the quarterly cost savings associated with the program were fully realized beginning in the second quarter of 2016. The higher provision expense mainly resulted from ongoing loan growth and increased allocations related to environmental factors.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2016 and 2015:

	2016	2015
Return on average assets	1.07 %	0.94 %
Return on average shareholders' equity	9.35 %	8.19 %
Average shareholders' equity to average assets	11.42 %	11.45 %

Net Interest Income

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled \$119 million and \$12.6 million during 2016, respectively, providing for net interest income of \$107 million. During 2015, interest income and interest expense equaled \$113 million and \$11.2 million, respectively, providing for net interest income of \$102 million.

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In comparing 2016 with 2015, interest income increased 5.6%, interest expense was up 12.9%, and net interest income increased 4.8%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The \$4.9 million increase in net interest income in 2016 compared to 2015 resulted from a higher level of average earning assets, and to a lesser degree, an improved net interest margin. During 2016, earning assets averaged \$2.76 billion, or \$110 million higher than average earning assets during 2015. Average loans increased \$167 million, average securities decreased \$55.9 million, and average other interest-earning assets decreased \$1.1 million. During 2016, the net interest margin equaled 3.86%, up from 3.83% during 2015 due to an increased yield on average earning assets, which more than offset a higher cost of funds. The increased yield on average earning assets primarily resulted from a higher yield on securities and a reallocation of earning assets, which more than offset a decreased yield on loans. The higher yield on securities mainly reflects a significant level of accelerated discount accretion on called U.S. Government agency bonds being recorded as interest income, while the decreased yield on loans primarily reflects the ongoing low interest rate environment and competitive industry pressures. The yield on loans generally declined over the past ten quarters, consistent with the industry; however, the negative impact of the lower loan yield on the yield on average earning assets was somewhat offset by the aforementioned reallocation of earning assets. Capitalizing on an opportunity stemming from the 2014 merger with Firstbank, the earning asset mix was reallocated by reinvesting cash flows from monthly paydowns on lower-yielding mortgage-backed securities and matured and called U.S. Government Agency bonds into the higher-yielding loan portfolio. The reallocation of earning assets strategy was completed during the second quarter of 2016 as the level of investments reached our internal policy guideline.

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The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders' equity during 2016, 2015 and 2014. The subsequent table also depicts the dollar amount of change in interest income and interest expense of interest-earning assets and interest-bearing liabilities, respectively, segregated between change due to volume and change due to rate. For tax-exempt investment securities, interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 35%. Securities interest income was increased by \$0.8 million in 2016, \$0.6 million in 2015, and \$0.5 million in 2014 for this non-GAAP, but industry standard, adjustment. This adjustment equated to a three basis point increase in our net interest margin during 2016, a two basis point increase in our net interest margin during 2015, and a three basis point increase in our net interest margin during 2014.

(Dollars in thousands)	Years ended December 31,								
	2016			2015			2014		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Taxable securities	\$224,297	\$6,842	3.05 %	\$281,476	\$5,919	2.10 %	\$262,696	\$6,417	2.44 %
Tax-exempt securities	115,875	2,932	2.53	114,603	2,649	2.31	78,075	2,157	2.76
Total securities	340,172	9,774	2.87	396,079	8,568	2.16	340,771	8,574	2.52
Loans	2,345,308	109,049	4.65	2,178,276	104,106	4.78	1,653,605	80,824	4.89
Interest-earning deposits	77,852	401	0.51	68,234	188	0.28	46,161	110	0.24
Federal funds sold	11	<1	0.25	10,719	27	0.25	48,690	124	0.25
Total earning assets	2,763,343	119,224	4.31	2,653,308	112,889	4.25	2,089,227	89,632	4.29
Allowance for loan losses	(16,895)			(18,082)			(21,214)		
Cash and due from banks	45,890			46,714			35,248		
Other non-earning assets	195,446			199,557			166,652		
Total assets	\$2,987,784			\$2,881,497			\$2,269,913		
Interest-bearing demand deposits	\$360,180	\$336	0.09 %	\$404,866	\$721	0.18 %	\$323,335	\$1,141	0.35 %
Savings deposits	340,076	296	0.09	341,265	401	0.12	223,658	405	0.18
Money market accounts	290,528	360	0.12	268,071	420	0.16	196,723	364	0.19

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Time deposits	577,062	6,557	1.14	657,938	6,048	0.92	648,102	6,468	1.00
Total interest-bearing deposits	1,567,846	7,549	0.48	1,672,140	7,590	0.45	1,391,818	8,378	0.60
Short-term borrowings	149,079	211	0.14	146,826	157	0.11	105,474	122	0.12
Federal Home Loan Bank advances	149,344	2,263	1.51	55,556	765	1.38	51,456	636	1.24
Other borrowings	48,711	2,567	5.27	58,509	2,642	4.52	51,642	2,204	4.27
Total interest-bearing liabilities	1,914,980	12,590	0.66	1,933,031	11,154	0.58	1,600,390	11,340	0.71
Demand deposits	715,550			606,750			407,870		
Other liabilities	15,914			11,929			10,774		
Total liabilities	2,646,444			2,551,710			2,019,034		
Average equity	341,340			329,787			250,879		
Total liabilities and equity	\$2,987,784			\$2,881,497			\$2,269,913		
Net interest income		\$106,634			\$101,735			\$78,292	
Rate spread			3.65 %			3.67 %			3.58 %
Net interest margin			3.86 %			3.83 %			3.75 %

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	Years ended December 31, 2016 over 2015			2015 over 2014		
	Total	Volume	Rate	Total	Volume	Rate
Increase (decrease) in interest income						
Taxable securities	\$923,000	\$(1,371,000)	\$2,294,000	\$(498,000)	\$437,000	\$(935,000)
Tax exempt securities	283,000	30,000	253,000	492,000	887,000	(395,000)
Loans	4,943,000	7,823,000	(2,880,000)	23,282,000	25,113,000	(1,831,000)
Interest-earning deposit balances	213,000	30,000	183,000	78,000	59,000	19,000
Federal funds sold	(27,000)	(20,000)	(7,000)	(97,000)	(97,000)	0
Net change in tax-equivalent interest income	6,335,000	6,492,000	(157,000)	23,257,000	26,399,000	(3,142,000)
Increase (decrease) in interest expense						
Interest-bearing demand deposits	(385,000)	(72,000)	(313,000)	(420,000)	239,000	(659,000)
Savings deposits	(105,000)	(1,000)	(104,000)	(4,000)	168,000	(172,000)
Money market accounts	(60,000)	33,000	(93,000)	56,000	118,000	(62,000)
Time deposits	509,000	(804,000)	1,313,000	(420,000)	97,000	(517,000)
Short-term borrowings	54,000	2,000	52,000	35,000	45,000	(10,000)
Federal Home Loan Bank advances	1,498,000	1,414,000	84,000	129,000	53,000	76,000
Other borrowings	(75,000)	(479,000)	404,000	438,000	305,000	133,000
Net change in interest expense	1,436,000	93,000	1,343,000	(186,000)	1,025,000	(1,211,000)
Net change in tax-equivalent net interest income	\$4,899,000	\$6,399,000	\$(1,500,000)	\$23,443,000	\$25,374,000	\$(1,931,000)

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities and other interest-earning assets. Interest income increased \$6.3 million during 2016 from that earned in 2015, totaling \$119 million in 2016 compared to \$113 million in the previous year. The increase in interest income is attributable to a higher level of average earning assets and an increased yield on average earning assets. During 2016 and 2015, earning assets had an average yield (tax equivalent-adjusted basis) of 4.31% and 4.25%, respectively. The higher yield on average earning assets in 2016 primarily resulted from an increased yield on securities and a reallocation of earning assets, which more than offset a decreased yield on loans. The higher-yielding loan portfolio averaged \$2.35 billion, or 84.9% of average earning assets, during 2016, compared to \$2.18 billion, or 82.1% of average earning assets, during 2015.

Interest income generated from the loan portfolio increased \$4.9 million in 2016 compared to the level earned in 2015; growth in the loan portfolio during 2016 resulted in a \$7.8 million increase in interest income, while a decline in loan yield from 4.78% in 2015 to 4.65% in 2016 resulted in a \$2.9 million decrease in interest income. The lower yield on average loans mainly resulted from a decreased yield on average commercial loans, which equaled 4.60% in 2016 compared to 4.70% in 2015. The decreased commercial loan yield primarily reflects the ongoing low interest rate

environment and competitive pressures. Accretion of acquired loans totaled \$4.9 million during 2016, compared to \$5.3 million during 2015.

Interest income generated from the securities portfolio increased \$1.2 million in 2016 compared to the level earned in 2015; an increase in the yield on securities from 2.16% during 2015 to 2.87% during 2016 resulted in a \$2.5 million increase in interest income, while a reduction in the securities portfolio resulted in a \$1.3 million decrease in interest income. The increased yield on securities mainly reflects a significant level of accelerated discount accretion on called U.S. Government agency bonds being recorded as interest income. The accelerated discount accretion totaled \$2.2 million during 2016, positively impacting the net interest margin by eight basis points. A nominal level of accelerated discount accretion on called U.S. Government agency bonds was recorded as interest income during 2015. Interest income on interest-earning deposits increased \$0.2 million primarily due to an increased yield.

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Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from subordinated debentures, FHLBI advances, sweep accounts, and other borrowings. Interest expense increased \$1.4 million during 2016 from that expensed in 2015, totaling \$12.6 million in 2016 compared to \$11.2 million in the previous year. The increase in interest expense is attributable to a higher cost of funds. During 2016 and 2015, interest-bearing liabilities had a weighted average rate of 0.66% and 0.58%, respectively; an increase in interest expense of \$1.3 million was recorded during 2016 due to the higher cost of funds. The higher weighted average cost of interest-bearing liabilities mainly resulted from an increased cost of certificates of deposit, which more than offset decreases in the costs of certain interest-bearing non-certificate of deposit account categories. The higher cost of certificates of deposit was expected in light of purchase accounting amortization entries, which were associated with fair value measurements recorded on the merger date, ending in July of 2015. A \$1.4 million reduction in interest expense on certificates of deposit related to purchase accounting entries was recorded during 2015; no reduction in interest expense was recorded during 2016. Increased rates paid on certificates of deposit, subordinated debentures, and FHLBI advances also contributed to the higher weighted average cost of interest-bearing liabilities during 2016. The cost of interest-bearing non-certificate of deposit accounts decreased from 0.15% during 2015 to 0.10% during 2016 in light of rates being lowered during the latter part of 2015. Average interest-bearing liabilities were \$1.91 billion during 2016, down \$18.1 million, or 0.9%, from the \$1.93 billion average during 2015.

Average certificates of deposit decreased \$80.9 million during 2016, which equated to a decline in interest expense of \$0.8 million. A \$1.3 million increase in interest expense resulted from a higher average rate paid on certificates of deposit, primarily reflecting the impact of the purchase accounting amortization entries ending in July of 2015. A decrease in other average interest-bearing deposit accounts, totaling \$23.4 million, equated to a decrease in interest expense of less than \$0.1 million, while a decrease in the average rate paid on these deposit accounts resulted in a \$0.5 million decline in interest expense.

Average short-term borrowings, comprised entirely of sweep accounts, increased \$2.3 million during 2016, resulting in a nominal increase in interest expense, while a higher average rate paid on these accounts resulted in a \$0.1 million increase in interest expense. Average FHLBI advances increased \$93.8 million, resulting in a \$1.4 million increase in interest expense, while a higher average rate paid on the advances resulted in a \$0.1 million increase in interest expense. A \$9.8 million decrease in average other borrowings, which is comprised of subordinated debentures and deferred director and officer compensation programs, equated to a \$0.5 million decline in interest expense, while a higher average rate paid on these borrowings resulted in a \$0.4 million increase in interest expense.

Net interest income and the net interest margin during 2016 and 2015 were affected by purchase accounting accretion and amortization entries associated with the fair value measurements recorded on June 1, 2014. An increase in interest income on loans totaling \$4.9 million and an increase in interest expense on subordinated debentures totaling \$0.7 million were recorded during 2016. During 2015, we recorded an increase in interest income on loans totaling \$5.3 million and a decrease in interest expense on deposits and FHLBI advances totaling \$1.4 million. In addition, we recorded an increase in interest expense on subordinated debentures totaling \$0.7 million during the same time period. We expect to continue to record adjustments in interest income on loans and interest expense on subordinated debentures in future periods; however, the adjustments to interest expense on deposits and FHLBI advances ended in July and June of 2015, respectively. The resulting increase in interest expense negatively impacted the net interest

margin by approximately eight to ten basis points after July 31, 2015.

Provision for Loan Losses

A loan loss provision expense of \$2.9 million was recorded in 2016, compared to a negative provision expense of \$1.0 million recorded in 2015. The provision expense recorded during 2016 primarily reflects ongoing loan growth and assessment changes in our economic and concentration environmental factors, while the negative provision expense recorded during 2015 resulted from multiple factors, including recoveries of previously charged-off loans, reversals of specific reserves, a reduced level of loan-rating downgrades and ongoing loan-rating upgrades.

Net loan charge-offs of \$0.6 million were recorded during 2016, compared to \$3.4 million during the prior year. Of the \$6.3 million in gross loan charge-offs recorded during 2015, \$4.2 million was related to one commercial loan relationship that was resolved during the second quarter of that year. The allowance for originated loans, as a percentage of total originated loans, was 0.9% as of December 31, 2016 and December 31, 2015. Our allowance for acquired loans totaled \$0.1 million and \$0.5 million as of December 31, 2016 and December 31, 2015, respectively.

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Noninterest income totaled \$21.0 million in 2016, an increase of \$5.0 million, or 31.2%, from the \$16.0 million earned in 2015. The increase mainly resulted from a \$2.9 million pre-tax gain being recorded in the first quarter of 2016 in association with a trust preferred securities repurchase transaction and higher service charges on deposit and sweep accounts and mortgage banking income. Service charges on deposit and sweep accounts totaled \$4.3 million during 2016, an increase of \$1.0 million, or 28.6%, from the \$3.3 million recorded during 2015. The increase in service charges on deposit and sweep accounts mainly reflects an ongoing project to ensure all depositors are in a product that best meets their needs and is priced appropriately as well as increased cash management fee income. Mortgage banking income was \$3.9 million in 2016, an increase of \$0.3 million, or 6.8%, from the \$3.6 million recorded during 2015. The increase in mortgage banking income primarily reflects the positive impact of recently-implemented strategic initiatives, including the hiring of additional loan originators, introduction of new and enhanced products, loan programs, and increased marketing efforts. Reimbursements totaling \$0.4 million recorded in the third quarter of 2016 related to certain medical insurance premiums charged in prior years also contributed to the increase in noninterest income.

Noninterest Expense

Noninterest expense during 2016 totaled \$77.1 million, a decrease of \$2.3 million, or 2.9%, from the \$79.4 million expensed in 2015. The decrease was mainly attributable to lower problem asset costs, loan processing costs, FDIC insurance premiums, core deposit intangible amortization expense, printing and supply costs, furniture and equipment costs, and miscellaneous expenses, which more than offset increased employee benefit and data processing costs. Problem asset costs during 2016 were \$0.9 million lower than the amount expensed during 2015. Loan processing costs were \$0.5 million during 2016, a decrease of \$0.6 million, or 50.8%, from the \$1.1 million expensed during 2015, primarily reflecting the elimination of certain retail loan promotion programs. FDIC insurance premiums during 2016 were \$1.2 million, a decrease of \$0.5 million, or 28.0%, from the \$1.7 million expensed during 2015; the decrease resulted from improvements in certain financial ratios and changes to the deposit insurance assessment calculation that became effective in the third quarter of 2016. Core deposit intangible amortization expense totaled \$2.7 million during 2016, compared to \$3.0 million during 2015. Printing and supply costs were \$1.1 million in 2016, a decrease of \$0.3 million, or 21.3%, from the \$1.4 million expensed during 2015; the decrease primarily resulted from an initiative to convert deposit customers from receiving physical account statements to receiving electronic statements and the implementation of a central purchasing program. Furniture and equipment costs were \$2.1 million during 2016, a decrease of \$0.2 million, or 9.1%, from the \$2.3 million in costs incurred during 2015, mainly reflecting lower depreciation expense. Miscellaneous expenses in 2015 included the recording of \$0.5 million in costs related to an embezzlement committed by an employee at a branch location. Noninterest expense during 2016 was positively impacted by the cost efficiency program, which will save approximately \$2.7 million per year on a pre-tax basis beginning in 2017; the quarterly cost savings were fully realized starting in the second quarter of 2016. Employee benefit costs during 2016 were \$9.0 million, an increase of \$0.4 million, or 4.2%, from the \$8.6 million expensed in 2015, primarily resulting from higher health insurance costs. Data processing costs during 2016 totaled \$7.9 million, an increase of \$0.2 million, or 3.2%, from the \$7.7 million expensed during 2015, primarily reflecting higher costs related to debit and credit card services.

Federal Income Tax Expense

During 2016, we recorded income before federal income tax of \$46.9 million and a federal income tax expense of \$15.0 million, compared to income before federal income tax of \$38.8 million and a federal income tax expense of \$11.8 million during 2015. The increase in federal income tax expense resulted from the higher level of income before federal income tax. Our effective tax rate was 31.9% during 2016, compared to 30.4% during 2015.

RESULTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2015 and 2014

Summary

We recorded net income of \$27.0 million, or \$1.63 per basic share and \$1.62 per diluted share, for 2015, compared to net income of \$17.3 million, or \$1.28 per basic and diluted share, for 2014. The results for 2014 were impacted by the merger with Firstbank, which was consummated on June 1, 2014; operating results for 2014 include seven months of operations as a combined organization. After-tax merger-related costs totaled \$3.8 million, or \$0.28 per basic and diluted share, during 2014. No merger-related costs were recorded in 2015. Our projected annual cost savings as disclosed at the time the merger was announced were \$5.5 million, or approximately \$1.4 million quarterly. The targeted quarterly cost savings were substantially realized during the fourth quarter of 2014 and fully realized during each quarter of 2015.

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The improved earnings performance in 2015 compared to 2014 primarily resulted from increased net interest income, which more than offset increased overhead costs. The increased net interest income primarily resulted from the higher level of average earning assets associated with the completion of the merger; an increased net interest margin, resulting from a decreased cost of funds, also contributed to the higher level of net interest income. The decreased cost of funds in large part reflects the absorption of Firstbank's lower-costing deposit base; the full benefit of the lower-costing deposit base was realized during the 2015 period, while the 2014 period received partial benefit in light of the effective date of the merger. The continued improvement in the quality of our loan portfolio and associated recoveries of previously charged-off loans, reversals of specific reserves, reduced level of loan-rating downgrades and ongoing loan-rating upgrades produced a positive impact on our loan loss reserve calculations and allowed us to make negative provisions to the loan loss reserve during 2015 and 2014. Increased noninterest income also contributed to the improved earnings performance in 2015; substantially all categories of noninterest income benefitted from the consummation of the merger. The increased noninterest expense was mainly attributable to higher costs necessary to operate the combined company.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2015 and 2014:

	2015	2014
Return on average assets	0.94 %	0.76 %
Return on average shareholders' equity	8.19 %	6.91 %
Average shareholders' equity to average assets	11.45 %	11.05 %

Net Interest Income

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled \$113 million and \$11.2 million during 2015, respectively, providing for net interest income of \$102 million. During 2014, interest income and interest expense equaled \$89.6 million and \$11.3 million, respectively, providing for net interest income of \$78.3 million.

In comparing 2015 with 2014, interest income increased 25.9%, interest expense was down 1.6%, and net interest income increased 29.9%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, the interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The \$23.4 million increase in net interest income in 2015 compared to 2014 primarily resulted from a higher level of average earning assets. Average earning assets include Firstbank's assets from the date of acquisition. During 2015, the

net interest margin equaled 3.83%, up from 3.75% during 2014. Although our yield on earning assets declined slightly in 2015 compared to 2014 primarily due to decreased yields on average loans and securities, our cost of funds declined at a greater rate, resulting in the improved net interest margin. The decreased yield on loans reflects the ongoing low interest rate environment and competitive pressures, while the decline in the yield on securities mainly reflects the boarding of Firstbank's lower-yielding portfolio. The decreased cost of funds was positively impacted by the absorption of Firstbank's lower-costing interest-bearing liability base.

Interest income is primarily generated from the loan portfolio, and to a significantly lesser degree, from securities and other interest-earning assets. Interest income increased \$23.3 million during 2015 from that earned in 2014, totaling \$113 million in 2015 compared to \$89.6 million in the previous year. The increase in interest income is attributable to a higher level of average earning assets, which more than offset a slight decrease in the yield on average earning assets. During 2015, earning assets averaged \$2.65 billion, or \$564 million higher than average earning assets during 2014; average earning assets include Firstbank's assets from the date of acquisition. Average loans increased \$525 million, average securities increased \$55.3 million, and average other interest-earning assets decreased \$15.9 million. During 2015 and 2014, earning assets had an average yield (tax equivalent-adjusted basis) of 4.25% and 4.29%, respectively. The lower yield on average earning assets in 2015 primarily resulted from decreased yields on loans and securities, which more than offset the impact of a change in earning asset mix. The decreased yield on loans reflects the ongoing low interest rate environment and competitive pressures, while the decline in the yield on securities mainly reflects the boarding of Firstbank's lower-yielding portfolio.

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The negative impacts of the lower yields on loans and securities on the yield on average earning assets were largely offset by assets shifting out of the lower-yielding securities portfolio and other interest-earning asset category and into the higher-yielding loan portfolio, capitalizing on an opportunity growing out of the merger with Firstbank; the yield on average earning assets was relatively stable during 2015, ranging from 4.23% to 4.30% on a quarterly basis. Average loans represented about 82% of average earning assets during 2015, up from approximately 79% during 2014.

Interest income generated from the loan portfolio increased \$23.3 million in 2015 compared to the level earned in 2014; growth in the loan portfolio during 2015 resulted in a \$25.1 million increase in interest income, while a decline in loan yield from 4.89% in 2014 to 4.78% in 2015 resulted in a \$1.8 million decrease in interest income. The lower yield on average loans mainly resulted from a decreased yield on average commercial loans, which equaled 4.70% in 2015 compared to 4.83% in 2014. The commercial loan yield was negatively impacted by the lowering of rates on certain commercial loans throughout 2015 and 2014 as a result of borrowers warranting decreased loan rates due to improved financial performance, the renewal of certain maturing term loans at lower rates, and competitive pricing pressures. Accretion of acquired loans totaled \$5.3 million during 2015, compared to \$3.2 million during 2014.

Interest income generated from the securities portfolio in 2015 was virtually the same as the amount recorded during 2014 as the impact of a lower yield was substantially offset by the impact of portfolio growth associated with the merger with Firstbank. The lower yield on average securities equated to a decrease in interest income of \$1.3 million, while the higher average portfolio balance resulted in a \$1.3 million increase in interest income. Average securities equaled \$396 million during 2015, up from \$341 million during 2014. The yield on securities equaled 2.16% in 2015 compared to 2.52% in 2014; the lower yield on average securities primarily resulted from the boarding of Firstbank's lower-yielding portfolio. Interest income earned on federal funds sold decreased \$0.1 million in 2015 compared to 2014 due to a lower average balance, while interest income earned on interest-bearing deposits increased \$0.1 million due to a higher average balance, and to a lesser extent, a slight increase in yield.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from subordinated debentures, FHLBI advances, sweep accounts, and other borrowings. Interest expense decreased \$0.1 million during 2015 from that expensed in 2014, totaling \$11.2 million in 2015 compared to \$11.3 million in the previous year. The decrease in interest expense is attributable to a lower cost of funds, which more than offset a higher level of average interest-bearing liabilities, primarily reflecting the completion of the merger. During 2015 and 2014, interest-bearing liabilities had a weighted average rate of 0.58% and 0.71%, respectively; a decline in interest expense of \$1.2 million was recorded during 2015 due to the decreased cost of funds. The decline in the weighted average cost of interest-bearing liabilities primarily reflects the absorption of Firstbank's lower-costing interest-bearing liability base, maturing fixed-rate certificates of deposit being renewed at lower rates, replaced by lower-costing funds, or allowed to runoff during 2014 and 2015, and the lowering of interest rates on certain deposit account categories during 2015. The weighted average cost of interest-bearing liabilities, equaling 0.56%, 0.54%, 0.60%, and 0.61% during the first, second, third, and fourth quarters of 2015, respectively, remained relatively stable during 2015. During 2015, interest-bearing liabilities averaged \$1.93 billion, or \$333 million higher than average interest-bearing liabilities of \$1.60 billion during the prior year. Growth in these liabilities resulted in increased interest expense of \$1.1 million. Interest-bearing liabilities include Firstbank's liabilities from the date of acquisition. Average interest-bearing deposits

were up \$280 million, while average short-term borrowings increased \$41.3 million, average other borrowings increased \$6.9 million, and average FHLBI advances increased \$4.1 million.

Average certificates of deposit increased \$9.8 million during 2015, which equated to an increase in interest expense of \$0.1 million. A \$0.5 million reduction in interest expense resulted from a decrease in the average rate paid as higher-rate certificates of deposit matured and were renewed at lower rates, replaced with lower-costing funds, or allowed to runoff throughout 2014 and 2015. An increase in other average interest-bearing deposit accounts, totaling \$271 million, equated to a \$0.5 million increase in interest expense, while a decrease in the average rate paid on these deposit accounts resulted in a \$0.9 million decline in interest expense.

Average short-term borrowings, comprised entirely of sweep accounts, increased \$41.4 million during 2015, resulting in a slight increase in interest expense. Average FHLBI advances increased \$4.1 million, resulting in a \$0.1 million increase in interest expense, while a higher average rate paid on the advances resulted in a \$0.1 million increase in interest expense. A \$6.9 million increase in average other borrowings, which is comprised of subordinated debentures and deferred director and officer compensation programs, equated to a \$0.3 million increase in interest expense, while a higher average rate paid on these borrowings resulted in a \$0.1 million increase in interest expense.

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As expected, net interest income and the net interest margin were affected during 2014 and 2015 by purchase accounting accretion and amortization entries associated with the fair value measurements recorded on June 1, 2014. An increase in interest income on loans totaling \$3.2 million, as well as a decrease in interest expense on deposits and FHLBI advances aggregating \$1.4 million, were recorded during the last seven months of 2014. An increase in interest expense on subordinated debentures totaling \$0.4 million was also recorded during the same time period. An increase of \$5.3 million in interest income on loans and a decrease of \$1.4 million in interest expense on deposits and FHLBI advances were recorded during 2015; in addition, an increase in interest expense on subordinated debentures totaling \$0.7 million was recorded. We expect to continue to record adjustments in interest income on loans and interest expense on subordinated debentures in future periods; however, the adjustments to interest expense on deposits and FHLBI advances ended in July and June of 2015, respectively, in accordance with our fair value measurements at the time of the merger. The resulting increase in interest expense negatively impacted the net interest margin by approximately eight to ten basis points after July 31, 2015. We partially mitigated this negative impact by reallocating the earning asset mix by investing excess lower-yielding overnight funds and cash flows from lower-yielding investments into higher-yielding loans.

Provision for Loan Losses

A negative loan loss provision expense of \$1.0 million was recorded in 2015, compared to a negative provision expense of \$3.0 million recorded in 2014. The negative provision expense reflects recoveries of previously charged-off loans, reversals of specific reserves, a reduced level of loan-rating downgrades, and ongoing loan-rating upgrades as the quality of the loan portfolio continued to improve. Continued progress in the stabilization of economic and real estate market conditions and resulting collateral valuations also positively impacted provision expense. Negative provision expense was recorded during the first three quarters of 2015; however, a provision expense of \$0.5 million was recorded during the fourth quarter of 2015. The provision expense was primarily necessitated by loan growth, which more than offset reductions in the required allowance stemming from the previously mentioned factors.

Net loan charge-offs of \$3.4 million were recorded during 2015, compared to net loan recoveries of \$0.2 million recorded during the prior year. Of the \$6.3 million in gross loan charge-offs recorded during 2015, \$4.2 million was related to one commercial loan relationship that was resolved during the second quarter. The allowance for originated loans, as a percentage of total originated loans, was 0.9% as of December 31, 2015, compared to 1.5% as of December 31, 2014. Our allowance for acquired loans totaled \$0.5 million and \$0.7 million as of December 31, 2015 and December 31, 2014, respectively.

Noninterest Income

Noninterest income totaled \$16.0 million in 2015, an increase of \$6.0 million, or 59.9%, from the \$10.0 million earned in 2014. Substantially all categories of noninterest income were higher in 2015 compared to 2014 as a result of the merger, most notably mortgage banking income, credit and debit card income, and service charges on accounts. A higher level of income stemming from payments received on acquired loans that had been charged-off prior to the merger date also contributed to the increased noninterest income. The increased mortgage banking income during 2015 also resulted from the ongoing low interest rate environment and increased purchase activity in our market areas.

Noninterest Expense

Noninterest expense during 2015 totaled \$79.4 million, an increase of \$13.8 million, or 21.0%, from the \$65.6 million expensed in 2014. The increase in noninterest expense was mainly attributable to higher costs necessary to operate the combined company, as 2014 results included only seven months of costs operating as a combined entity. Core deposit intangible amortization expense totaled \$3.0 million during 2015, compared to \$1.9 million during 2014. During 2015, we recorded \$0.5 million in costs related to an embezzlement committed by an employee at a branch location that was discovered through our internal audit procedures near the end of the first quarter of 2015.

Pre-tax merger-related costs totaled \$5.4 million during 2014; no merger-related costs were recorded during 2015. Expenses related to the cost efficiency program, which was announced in the fourth quarter of 2015, totaled \$0.8 million during 2015. Excluding cost efficiency program-related expenses and merger-related costs, noninterest expense totaled \$78.6 million and \$60.2 million in 2015 and 2014, respectively.

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Federal Income Tax Expense

During 2015, we recorded income before federal income tax of \$38.8 million and a federal income tax expense of \$11.8 million, compared to income before federal income tax of \$25.2 million and a federal income tax expense of \$7.9 million during 2014. The increase in federal income tax expense resulted from the higher level of income before federal income tax. Our effective tax rate was 30.4% during 2015, down from 31.2% during 2014. The elevated tax rate during 2014 primarily resulted from the recording of nondeductible merger-related expenses.

CAPITAL RESOURCES

Shareholders' equity increased \$7.0 million during 2016, totaling \$341 million as of December 31, 2016. Positively impacting shareholders' equity was net income of \$31.9 million, while negatively affecting shareholders' equity were cash dividends on our common stock totaling \$18.7 million, our share repurchase program that aggregated \$3.7 million and a change in the net unrealized gains and losses, net of tax effect, on our available for sales securities portfolio of \$6.9 million. Activity relating to the issuance and sale of common stock through various stock-based compensation programs and our dividend reinvestment plan positively impacted shareholders' equity by a total of \$2.9 million.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. As of December 31, 2016, our bank's total risk-based capital ratio was 13.1%, compared to 13.5% at December 31, 2015. Our bank's total regulatory capital increased \$5.8 million during 2016, primarily reflecting the net impact of net income totaling \$33.2 million and cash dividends paid to Mercantile Bank Corporation aggregating \$29.2 million. Our bank's total risk-based capital ratio was also impacted by a \$125 million increase in total risk-weighted assets, primarily resulting from net loan growth. As of December 31, 2016, our bank's total regulatory capital equaled \$353 million, or \$83.7 million in excess of the amount necessary to attain the 10.0% minimum total risk-based capital ratio, which is among the requirements to be categorized as "well capitalized."

On January 30, 2015, we announced that our Board of Directors had authorized a new program to repurchase up to \$20.0 million of our common stock from time to time in open market transactions at prevailing market prices or by other means in accordance with applicable regulations. On April 19, 2016, we announced a \$15.0 million expansion of the stock repurchase plan. During 2016, we repurchased 167,878 shares at a total price of \$3.7 million, at an average price per share of \$22.23. Since inception, we have purchased a total of 956,419 shares at a total price of \$19.5 million, at an average price per share of \$20.38. The stock buybacks have been funded from cash dividends paid to us from our bank. Additional repurchases may be made during 2017 under the authorized plan, which would also likely be funded from cash dividends paid to us from our bank.

On January 26, 2016, we closed on a repurchase of trust preferred securities that were auctioned as part of a pooled collateralized debt obligation (“Fund”). The Fund owned \$11.0 million of the \$32.0 million in trust preferred securities that had been issued by Mercantile Bank Capital Trust I, a wholly-owned business trust subsidiary. The \$11.0 million in trust preferred securities was retired upon the repurchase, resulting in a commensurate reduction in the related Floating Rate Junior Subordinate Note, leaving \$21.0 million outstanding. Our winning bid equated to 73% of the \$11.0 million par value, with the 27% discount resulting in an after-tax gain of approximately \$1.8 million, or \$0.11 per diluted share. On a pro forma basis as of December 31, 2015, the repurchase resulted in a nine basis point increase in our tangible equity to tangible assets ratio and an \$0.11 increase in our tangible book value per share, but an approximately 35 basis point decline in our regulatory tier 1 capital and total risk-based capital ratios. The repurchase was funded via a \$9.1 million cash dividend from our bank, resulting in an approximately 35 basis point decline in the regulatory capital ratios. Subsequent to the repurchase, our and our bank’s regulatory capital ratios remained well above the minimum thresholds to be categorized as well capitalized.

LIQUIDITY

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

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To assist in providing needed funds, we regularly 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 \$251 million, or 9.4% of combined deposits and borrowed funds as of December 31, 2016, compared to \$189 million, or 7.6% of combined deposits and borrowed funds, as of December 31, 2015.

Sweep accounts decreased \$23.1 million during 2016, totaling \$132 million at December 31, 2016. The decline primarily reflects certain customers transferring funds from the sweep product to noninterest-bearing checking accounts reflecting updated interest rate and fee structures. Our sweep account program entails transferring collected funds from certain business noninterest-bearing checking accounts to overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance. All of our repurchase agreements are accounted for as secured borrowings. Information regarding our repurchase agreements as of December 31, 2016 and during 2016 is as follows:

Outstanding balance at December 31, 2016	\$ 131,710,000
Weighted average interest rate at December 31, 2016	0.16 %
Maximum daily balance twelve months ended December 31, 2016	\$ 175,088,000
Average daily balance for twelve months ended December 31, 2016	\$ 149,079,000
Weighted average interest rate for twelve months ended December 31, 2016	0.14 %

FHLBI advances increased \$107 million during 2016, totaling \$175 million as of December 31, 2016. The additional monies were generally used to fund brokered deposit maturities and loan growth. FHLBI advances are primarily used to assist in funding loan demand, as well as playing an integral role in our interest rate risk management program. FHLBI advances are generally collateralized by a blanket lien on our residential mortgage loan portfolio. Our borrowing line of credit at year-end 2016 totaled \$517 million, with availability of \$342 million.

We also have the ability to borrow up to \$30.0 million on a daily basis through a correspondent bank using an established unsecured federal funds purchased line of credit. We did not access this line of credit during 2016; in fact, we have not accessed any federal funds purchased lines of credit since January of 2010. In contrast, our interest-earning deposit account at the Federal Reserve Bank of Chicago averaged \$75.4 million during 2016. We have a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using certain municipal bonds as collateral, we could have borrowed up to \$21.9 million at December 31, 2016. We did not utilize this line of credit during the past seven years, and do not plan to access this line of credit in future periods.

The following table reflects, as of December 31, 2016, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

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	One Year or Less	One to Three Years	Three to Five Years	Over Five Years	Total
Deposits without a stated maturity	\$1,805,568,000	\$0	\$0	\$0	\$1,805,568,000
Certificates of deposit	358,259,000	126,246,000	84,912,000	0	569,417,000
Short-term borrowings	131,710,000	0	0	0	131,710,000
Federal Home Loan Bank advances	45,000,000	40,000,000	50,000,000	40,000,000	175,000,000
Subordinated debentures	0	0	0	44,835,000	44,835,000
Other borrowed money	0	0	0	3,357,000	3,357,000
Property leases	415,000	451,000	167,000	0	1,033,000

In addition to normal loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. At December 31, 2016, we had a total of \$795 million in unfunded loan commitments and \$26.2 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$641 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$154 million were for loan commitments generally expected to close and become funded within the next twelve months. We regularly monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

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

	12/31/16	12/31/15	12/31/14
Commercial unused lines of credit	\$553,345,000	\$522,658,000	\$554,856,000
Unused lines of credit secured by 1-4 family residential properties	56,275,000	61,905,000	60,983,000
Credit card unused lines of credit	22,689,000	15,612,000	11,649,000
Other consumer unused lines of credit	8,489,000	8,583,000	8,673,000
Commitments to make loans	154,338,000	178,034,000	110,126,000
Standby letters of credit	26,202,000	34,946,000	35,461,000
Total	\$821,338,000	\$821,738,000	\$781,748,000

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

MARKET RISK ANALYSIS

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

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to

maintain interest rate risk at prudent levels with consistency and continuity. In evaluating the quantitative level of interest rate risk, we assess the existing and potential future effects of changes in interest rates on our financial condition, including capital adequacy, earnings, liquidity and asset quality.

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

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The following table depicts our GAP position as of December 31, 2016:

	Within Three Months	Three to Twelve Months	One to Five Years	After Five Years	Total	
Assets:						
Commercial loans (1)	\$916,178,000	\$162,814,000	\$664,592,000	\$286,436,000	\$2,030,020,000	
Residential real estate loans	31,511,000	18,766,000	146,810,000	109,650,000	306,737,000	
Consumer loans	2,053,000	1,485,000	30,605,000	7,720,000	41,863,000	
Securities (2)	17,415,000	29,026,000	121,778,000	167,867,000	336,086,000	
Interest-earning deposits	131,396,000	250,000	1,750,000	0	133,396,000	
Allowance for loan losses	0	0	0	0	(17,961,000)	
Other assets	0	0	0	0	252,430,000	
Total assets	1,098,553,000	212,341,000	965,535,000	571,673,000	\$3,082,571,000	
Liabilities:						
Interest-bearing checking	377,929,000	0	0	0	377,929,000	
Savings deposits	344,988,000	0	0	0	344,988,000	
Money market accounts	272,051,000	0	0	0	272,051,000	
Time deposits under \$100,000	21,947,000	67,935,000	56,287,000	0	146,169,000	
Time deposits \$100,000 & over	101,444,000	166,933,000	154,871,000	0	423,248,000	
Short-term borrowings	131,710,000	0	0	0	131,710,000	
Federal Home Loan Bank advances	10,000,000	35,000,000	90,000,000	40,000,000	175,000,000	
Other borrowed money	48,193,000	0	0	0	48,193,000	
Noninterest-bearing checking	0	0	0	0	810,600,000	
Other liabilities	0	0	0	0	11,872,000	
Total liabilities	1,308,262,000	269,868,000	301,158,000	40,000,000	2,741,760,000	
Shareholders' equity	0	0	0	0	340,811,000	
Total liabilities & shareholders' equity	1,308,262,000	269,868,000	301,158,000	40,000,000	\$3,082,571,000	
Net asset (liability) GAP	\$(209,709,000)	\$(57,527,000)	\$664,377,000	\$531,673,000		
Cumulative GAP	\$(209,709,000)	\$(267,236,000)	\$397,141,000	\$928,814,000		
Percent of cumulative GAP to total assets	(6.8	%)	(8.7	%)	12.9	%
				30.1	%	

(1)

Floating rate loans that are currently at interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.

- (2) Mortgage-backed securities are categorized by expected maturities based upon prepayment trends as of December 31, 2016.

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

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

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We conducted multiple simulations as of December 31, 2016, in which it was assumed that changes in market interest rates occurred ranging from up 400 basis points to down 400 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on net interest income over the next twelve months in comparison to estimated net interest income based on our balance sheet structure, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of December 31, 2016.

Interest Rate Scenario	Dollar Change In Net Interest Income	Percent Change In Net Interest Income
Interest rates down 400 basis points	\$(14,220,000)	(14.3%)
Interest rates down 300 basis points	(12,235,000)	(12.3)
Interest rates down 200 basis points	(9,590,000)	(9.6)
Interest rates down 100 basis points	(5,395,000)	(5.4)
No change in interest rates	(310,000)	(0.3)
Interest rates up 100 basis points	2,115,000	2.1
Interest rates up 200 basis points	4,460,000	4.5
Interest rates up 300 basis points	6,825,000	6.8
Interest rates up 400 basis points	9,170,000	9.2

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

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

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Mercantile Bank Corporation

Grand Rapids, Michigan

We have audited the accompanying Consolidated Balance Sheets of Mercantile Bank Corporation as of December 31, 2016 and 2015, and the related Consolidated Statements of Income, Comprehensive Income, Changes in Shareholders' Equity and Cash Flows for each of the three years in the period ended December 31, 2016. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercantile Bank Corporation as of December 31, 2016 and 2015, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Mercantile Bank Corporation's internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") and our report dated March 6, 2017 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

BDO USA, LLP

Grand Rapids, Michigan

March 6, 2017

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders

Mercantile Bank Corporation

Grand Rapids, Michigan

We have audited Mercantile Bank Corporation's internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Mercantile Bank Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report by Mercantile Bank Corporation's Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become

inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Mercantile Bank Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Consolidated Balance Sheets of Mercantile Bank Corporation as of December 31, 2016 and 2015, and the related Consolidated Statements of Income, Comprehensive Income, Changes in Shareholders' Equity and Cash Flows for each of the three years in the period ended December 31, 2016, and our report dated March 6, 2017 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

BDO USA, LLP

Grand Rapids, Michigan

March 6, 2017

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March 6, 2017

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

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles. There are inherent limitations in the effectiveness of any system of internal control.

Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Company's system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles as of December 31, 2016. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2016, Mercantile Bank Corporation maintained an effective system of internal control over financial reporting that is designed to produce reliable financial statements presented in conformity with generally accepted accounting principles based on those criteria.

The Company's independent auditors have issued an audit report on the effectiveness of the Company's internal control over financial reporting as found on page F-32.

Mercantile Bank Corporation

/s/ Robert B. Kaminski, Jr.

Robert B. Kaminski, Jr.

President and Chief Executive Officer

/s/ Charles E. Christmas

Charles E. Christmas

Executive Vice President, Chief Financial Officer and Treasurer

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MERCANTILE BANK CORPORATION

CONSOLIDATED BALANCE SHEETS

December 31, 2016 and 2015

	2016	2015
ASSETS		
Cash and due from banks	\$50,200,000	\$42,829,000
Interest-earning deposits	133,396,000	46,463,000
Federal funds sold	0	599,000
Total cash and cash equivalents	183,596,000	89,891,000
Securities available for sale	328,060,000	346,992,000
Federal Home Loan Bank stock	8,026,000	7,567,000
Loans	2,378,620,000	2,277,727,000
Allowance for loan losses	(17,961,000)	(15,681,000)
Loans, net	2,360,659,000	2,262,046,000
Premises and equipment, net	45,456,000	46,862,000
Bank owned life insurance	67,198,000	58,971,000
Goodwill	49,473,000	49,473,000
Core deposit intangible	9,957,000	12,631,000
Other assets	30,146,000	29,123,000
Total assets	\$3,082,571,000	\$2,903,556,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest-bearing	\$810,600,000	\$674,568,000
Interest-bearing	1,564,385,000	1,600,814,000
Total deposits	2,374,985,000	2,275,382,000
Securities sold under agreements to repurchase	131,710,000	154,771,000
Federal Home Loan Bank advances	175,000,000	68,000,000
Subordinated debentures	44,835,000	55,154,000
Accrued interest and other liabilities	15,230,000	16,445,000
Total liabilities	2,741,760,000	2,569,752,000
Shareholders' equity		

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Preferred stock, no par value; 1,000,000 shares authorized; 0 shares outstanding at December 31, 2016 and December 31, 2015	0	0
Common stock, no par value; 40,000,000 shares authorized; 16,416,695 shares outstanding at December 31, 2016 and 16,358,711 shares outstanding at December 31, 2015	305,488,000	304,819,000
Retained earnings	40,904,000	27,722,000
Accumulated other comprehensive income (loss)	(5,581,000)	1,263,000
Total shareholders' equity	340,811,000	333,804,000
Total liabilities and shareholders' equity	\$3,082,571,000	\$2,903,556,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

Years ended December 31, 2016, 2015 and 2014

	2016	2015	2014
Interest income			
Loans, including fees	\$ 109,049,000	\$ 104,106,000	\$ 80,824,000
Securities, taxable	6,842,000	5,918,000	6,417,000
Securities, tax-exempt	2,165,000	2,089,000	1,643,000
Other interest-earning assets	401,000	215,000	234,000
Total interest income	118,457,000	112,328,000	89,118,000
Interest expense			
Deposits	7,549,000	7,590,000	8,378,000
Short-term borrowings	211,000	157,000	122,000
Federal Home Loan Bank advances	2,263,000	765,000	636,000
Subordinated debentures and other borrowings	2,567,000	2,642,000	2,204,000
Total interest expense	12,590,000	11,154,000	11,340,000
Net interest income	105,867,000	101,174,000	77,778,000
Provision for loan losses	2,900,000	(1,000,000)	(3,000,000)
Net interest income after provision for loan losses	102,967,000	102,174,000	80,778,000
Noninterest income			
Service charges on deposit and sweep accounts	4,253,000	3,308,000	2,586,000
Credit and debit card fees	4,278,000	4,329,000	2,494,000
Mortgage banking activities	3,866,000	3,619,000	1,672,000
Earnings on bank owned life insurance	1,264,000	1,113,000	1,184,000
Payroll processing	1,016,000	969,000	782,000
Letter of credit fees	493,000	457,000	335,000
Gain on trust preferred securities repurchase	2,970,000	0	0
Other income	2,898,000	2,243,000	975,000
Total noninterest income	21,038,000	16,038,000	10,028,000
Noninterest expense			
Salaries and benefits	43,524,000	42,594,000	33,703,000
Occupancy	6,063,000	5,976,000	4,637,000
Furniture and equipment rent, depreciation and maintenance	2,119,000	2,332,000	1,738,000
Data processing	7,939,000	7,696,000	5,869,000

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Advertising	1,586,000	1,363,000	1,315,000
FDIC insurance costs	1,236,000	1,717,000	1,182,000
Problem asset costs	338,000	1,212,000	585,000
Efficiency program-related costs	172,000	765,000	0
Merger-related costs	0	0	5,447,000
Other expense	14,141,000	15,726,000	11,134,000
Total noninterest expenses	77,118,000	79,381,000	65,610,000
Income before federal income tax expense	46,887,000	38,831,000	25,196,000
Federal income tax expense	14,974,000	11,811,000	7,865,000
Net income	\$31,913,000	\$27,020,000	\$17,331,000
Earnings per common share:			
Basic	\$1.96	\$1.63	\$1.28
Diluted	\$1.96	\$1.62	\$1.28

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years ended December 31, 2016, 2015 and 2014

	2016	2015	2014
Net income	\$31,913,000	\$27,020,000	\$17,331,000
Other comprehensive income (loss):			
Unrealized holding gains (losses) on securities available for sale	(10,697,000)	1,874,000	8,596,000
Fair value of interest rate swap	169,000	0	11,000
Total other comprehensive income (loss)	(10,528,000)	1,874,000	8,607,000
Tax effect of unrealized holding gains (losses) on securities available for sale	3,743,000	(627,000)	(3,014,000)
Tax effect of fair value of interest rate swap	(59,000)	0	(4,000)
Total tax effect of other comprehensive income (loss)	3,684,000	(627,000)	(3,018,000)
Other comprehensive income (loss), net of tax effect	(6,844,000)	1,247,000	5,589,000
Comprehensive income	\$25,069,000	\$28,267,000	\$22,920,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

Years ended December 31, 2016, 2015 and 2014

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

Balances, December 31, 2014	\$ 0	\$317,904	\$10,218	\$ 16	\$ 328,138
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See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)

Years ended December 31, 2016, 2015 and 2014

(\$ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
Balances, January 1, 2015	\$ 0	\$317,904	\$10,218	\$ 16	\$ 328,138
Employee stock purchase plan (2,058 shares)		44			44
Dividend reinvestment plan (30,467 shares)		655			655
Stock option exercises (59,117 shares)		891			891
Stock grants to directors for retainer fees (20,094 shares)		403			403
Stock-based compensation expense		684			684
Share repurchase program (788,541 shares)		(15,762)			(15,762)
Cash dividends (\$0.58 per common share)			(9,516)		(9,516)
Net income for 2015			27,020		27,020
Change in net unrealized gain on securities available for sale, net of tax effect				1,247	1,247
Change in fair value of interest rate swap, net of tax effect				0	0
Balances, December 31, 2015	\$ 0	\$304,819	\$27,722	\$ 1,263	\$ 333,804

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)

Years ended December 31, 2016, 2015 and 2014

(\$ in thousands except per share amounts)	Preferred Stock	Common Stock	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income/(Loss)	Total Shareholders' Equity
Balances, January 1, 2016	\$ 0	\$304,819	\$27,722	\$ 1,263	\$ 333,804
Employee stock purchase plan (1,362 shares)		36			36
Dividend reinvestment plan (58,325 shares)		1,601			1,601
Stock option exercises (72,711 shares)		978			978
Stock grants to directors for retainer fees (13,000 shares)		327			327
Stock-based compensation expense		1,459			1,459
Share repurchase program (167,878 shares)		(3,732)			(3,732)
Cash dividends (\$1.16 per common share)			(18,731)		(18,731)
Net income for 2016			31,913		31,913
Change in net unrealized gain on securities available for sale, net of tax effect				(6,954)	(6,954)
Change in fair value of interest rate swap, net of tax effect				110	110
Balances, December 31, 2016	\$ 0	\$305,488	\$40,904	\$ (5,581)	\$ 340,811

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31, 2016, 2015 and 2014

	2016	2015	2014
Cash flows from operating activities			
Net income	\$31,913,000	\$27,020,000	\$17,331,000
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	9,576,000	11,654,000	7,613,000
Accretion of acquired loans	(4,925,000)	(5,338,000)	(3,194,000)
Provision for loan losses	2,900,000	(1,000,000)	(3,000,000)
Deferred income tax expense	(812,000)	4,412,000	4,506,000
Stock-based compensation expense	1,459,000	684,000	714,000
Stock grants to directors for retainer fee	327,000	403,000	155,000
Proceeds from sales of mortgage loans held for sale	114,757,000	120,880,000	67,422,000
Origination of mortgage loans held for sale	(110,778,000)	(116,997,000)	(65,392,000)
Net gain on sales of mortgage loans held for sale	(3,699,000)	(3,626,000)	(1,625,000)
Gain on trust preferred securities repurchase	(2,970,000)	0	0
Net gain from sales and valuation write-downs of foreclosed assets	(520,000)	(62,000)	(894,000)
Net loss from sales and valuation write-downs of former bank premises	35,000	0	0
Net loss from sales of premises and equipment	174,000	55,000	25,000
Net (gain) loss from sales of available for sale securities	1,000	(17,000)	0
Earnings on bank owned life insurance	(1,264,000)	(1,113,000)	(1,184,000)
Net change in:			
Accrued interest receivable	122,000	(321,000)	(11,000)
Other assets	(648,000)	(4,815,000)	1,795,000
Accrued interest and other liabilities	(1,046,000)	4,185,000	(9,822,000)
Net cash from operating activities	34,602,000	36,004,000	14,439,000
Cash flows from investing activities			
Cash received in merger	0	0	91,806,000
Purchases of securities available for sale	(164,336,000)	(10,645,000)	(19,874,000)
Proceeds from maturities, calls and repayments of securities available for sale	172,173,000	93,873,000	75,880,000
Proceeds from sales of securities available for sale	264,000	1,483,000	0
Purchases of Federal Home Loan Bank stock	(459,000)	0	0
Proceeds from Federal Home Loan Bank stock redemption	0	6,132,000	5,527,000
Loan originations and payments, net	(97,282,000)	(188,932,000)	(90,853,000)
Purchases of bank owned life insurance	(7,000,000)	0	0

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Purchases of premises and equipment, net	(2,025,000)	(1,081,000)	(2,175,000)
Proceeds from sales of former bank premises	45,000	0	0
Proceeds from sales of foreclosed assets	2,059,000	2,967,000	4,427,000
Net cash from (for) investing activities	(96,561,000)	(96,203,000)	64,738,000
Cash flows from financing activities			
Net decrease in time deposits	(20,854,000)	(147,106,000)	(58,927,000)
Net increase (decrease) in all other deposits	120,457,000	146,944,000	(11,307,000)
Net increase (decrease) in securities sold under agreements to repurchase	(23,061,000)	(12,798,000)	43,780,000
Proceeds from Federal Home Loan Bank advances	110,000,000	20,000,000	0
Maturities of Federal Home Loan Bank advances	(3,000,000)	(6,000,000)	(3,000,000)
Proceeds from stock option exercises, net of cashless exercises	978,000	891,000	282,000
Employee stock purchase plan	36,000	44,000	23,000
Dividend reinvestment plan	1,601,000	655,000	209,000
Repurchase of common stock	(3,732,000)	(15,762,000)	0
Repurchase of trust preferred securities	(8,030,000)	0	0
Payment of cash dividends to common shareholders	(18,731,000)	(9,516,000)	(24,464,000)
Net cash from (for) financing activities	155,664,000	(22,648,000)	(53,404,000)
Net change in cash and cash equivalents	93,705,000	(82,847,000)	25,773,000
Cash and cash equivalents at beginning of period	89,891,000	172,738,000	146,965,000
Cash and cash equivalents at end of period	\$ 183,596,000	\$ 89,891,000	\$ 172,738,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

Years ended December 31, 2016, 2015 and 2014

	2016	2015	2014
Supplemental disclosures of cash flows information			
Cash paid during the year for:			
Interest	\$ 12,477,000	\$ 11,618,000	\$ 11,439,000
Federal income taxes	15,125,000	8,000,000	2,625,000
Noncash financing and investing activities:			
Transfers from loans to foreclosed assets	414,000	2,203,000	1,490,000
Transfers from bank premises to other real estate owned	381,000	0	0
Common stock issued in connection with the Firstbank merger	0	0	173,310,000

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2016

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

Loans: Loans that we have the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Net unamortized deferred loan fees amounted to \$1.4 million at December 31, 2016 and 2015.

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Year-end mortgage loans held for sale, included in total loans in the balance sheet, were as follows:

	2016	2015
Mortgage loans held for sale	\$1,035,000	\$1,316,000
Less: Allowance to adjust to lower of cost or market	0	0
Mortgage loans held for sale, net	\$1,035,000	\$1,316,000

Mortgage Loan Derivatives: We enter into forward contracts and interest rate lock commitments in the ordinary course of business, which are accounted for as derivatives. The derivatives are not designated as hedges and are carried at fair value. The net gain or loss on derivatives is included in mortgage banking activities in the income statement. The balance of derivatives was immaterial at December 31, 2016 and 2015.

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 statements of income.

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.

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

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

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

Transfers of Financial Assets: Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Bank and put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that

right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets. Our transfers of financial assets are generally limited to commercial loan participations sold and residential mortgage loans sold in the secondary market.

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

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

Foreclosed Assets: Assets acquired through or in lieu of foreclosure are initially recorded at their estimated fair value net of estimated selling costs, establishing a new cost basis. If fair value subsequently declines, a valuation allowance is recorded through noninterest expense, as are collection and operating costs after acquisition. Foreclosed assets, included in other assets in the balance sheet, totaled \$0.5 million and \$1.3 million as of December 31, 2016 and 2015, respectively.

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MERCANTILE BANK CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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