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MERCANTILE BANK CORP  
Form 10-Q  
November 08, 2006

U.S. SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2006

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File No. 000-26719

MERCANTILE BANK CORPORATION  
(Exact name of registrant as specified in its charter)

Michigan  
(State or other jurisdiction of  
incorporation or organization)

38-3360865  
(IRS Employer Identification No.)

310 LEONARD STREET, NW, GRAND RAPIDS, MI 49504  
(Address of principal executive offices) (Zip Code)

(616) 406-3000  
(Registrant's telephone number, including area code)

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

Yes X No  
--- ---

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated filer --- Accelerated filer X Non-Accelerated filer ---

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

Yes --- No X  
--- ---

At November 8, 2006, there were 8,019,315 shares of Common Stock outstanding.

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MERCANTILE BANK CORPORATION

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## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

MERCANTILE BANK CORPORATION  
CONSOLIDATED BALANCE SHEETS

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
|  | -----<br>(Unaudited)  | -----                |
| <b>ASSETS</b>  |                       |                      |
| Cash and due from banks  | \$ 39,100,000         | \$ 36,208,000        |
| Short-term investments   | 176,000               | 545,000              |
| Federal funds sold   | 16,000,000            | 0                    |
|  | -----                 | -----                |
| Total cash and cash equivalents  | 55,276,000            | 36,753,000           |
| Securities available for sale  | 125,746,000           | 112,961,000          |
| Securities held to maturity (fair value of \$63,332,000 at<br>September 30, 2006 and \$62,850,000 at December 31, 2005)  | 62,097,000            | 60,766,000           |
| Federal Home Loan Bank stock   | 7,764,000             | 7,887,000            |
| Total loans and leases   | 1,710,268,000         | 1,561,812,000        |
| Allowance for loan and lease losses  | (21,938,000)          | (20,527,000)         |
|  | -----                 | -----                |
| Total loans and leases, net  | 1,688,330,000         | 1,541,285,000        |
| Premises and equipment, net  | 32,309,000            | 30,206,000           |
| Bank owned life insurance policies   | 30,150,000            | 28,071,000           |
| Accrued interest receivable  | 10,438,000            | 8,274,000            |
| Other assets   | 14,724,000            | 12,007,000           |
|  | -----                 | -----                |
| Total assets   | \$2,026,834,000       | \$1,838,210,000      |
|  | =====                 | =====                |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                       |                      |
| Deposits   |                       |                      |
| Noninterest-bearing  | \$ 115,269,000        | \$ 120,828,000       |
| Interest-bearing   | 1,499,434,000         | 1,298,524,000        |
|  | -----                 | -----                |
| Total deposits   | 1,614,703,000         | 1,419,352,000        |
| Securities sold under agreements to repurchase   | 74,111,000            | 72,201,000           |
| Federal funds purchased  | 0                     | 9,600,000            |
| Federal Home Loan Bank advances  | 115,000,000           | 130,000,000          |
| Subordinated debentures  | 32,990,000            | 32,990,000           |
| Other borrowed money   | 3,147,000             | 2,347,000            |
| Accrued expenses and other liabilities   | 19,335,000            | 16,595,000           |
|  | -----                 | -----                |
| Total liabilities  | 1,859,286,000         | 1,683,085,000        |
| Shareholders' equity   |                       |                      |
| Preferred stock, no par value; 1,000,000 shares<br>authorized, none issued   | 0                     | 0                    |
| Common stock, no par value: 20,000,000 shares authorized;<br>8,018,680 shares outstanding at September 30, 2006 and<br>7,590,526 shares outstanding at December 31, 2005 | 161,045,000           | 148,533,000          |
| Retained earnings  | 8,230,000             | 8,000,000            |

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|   |                 |                 |
|---|-----------------|-----------------|
| Accumulated other comprehensive income (loss) | (1,727,000)     | (1,408,000)     |
| Total shareholders' equity                    | 167,548,000     | 155,125,000     |
| Total liabilities and shareholders' equity    | \$2,026,834,000 | \$1,838,210,000 |

See accompanying notes to consolidated financial statements.

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MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
AND COMPREHENSIVE INCOME

|  | Three Months<br>Ended<br>September 30,<br>2006<br><br>(Unaudited) | Three Months<br>Ended<br>September 30,<br>2005<br><br>(Unaudited) | Nine Months<br>Ended<br>September 30,<br>2006<br><br>(Unaudited) | Nine<br>En<br>Septem<br>2<br><br>(Unau |
|--|---|---|--|--|
| Interest income  |   |   |  |  |
| Loans and leases, including fees                                 | \$33,261,000  | \$24,570,000  | \$ 93,292,000  | \$66,59                                |
| Investment securities  | 2,335,000   | 2,113,000   | 6,871,000  | 6,03                                   |
| Federal funds sold   | 76,000  | 76,000  | 347,000  | 17                                     |
| Short-term investments   | 3,000   | 5,000   | 10,000   | 1                                      |
| Total interest income  | 35,675,000  | 26,764,000  | 100,520,000  | 72,81                                  |
| Interest expense   |   |   |  |  |
| Deposits   | 17,268,000  | 10,554,000  | 46,111,000   | 26,88                                  |
| Short-term borrowings  | 707,000   | 475,000   | 2,028,000  | 1,18                                   |
| Federal Home Loan Bank advances                                  | 1,452,000   | 1,148,000   | 4,136,000  | 3,01                                   |
| Long-term borrowings   | 701,000   | 515,000   | 1,953,000  | 1,39                                   |
| Total interest expense   | 20,128,000  | 12,692,000  | 54,228,000   | 32,48                                  |
| NET INTEREST INCOME  | 15,547,000  | 14,072,000  | 46,292,000   | 40,33                                  |
| Provision for loan and lease losses                              | 1,350,000   | 895,000   | 4,075,000  | 2,52                                   |
| NET INTEREST INCOME AFTER PROVISION<br>FOR LOAN AND LEASE LOSSES | 14,197,000  | 13,177,000  | 42,217,000   | 37,81                                  |
| Noninterest income   |   |   |  |  |
| Services charges on accounts                                     | 361,000   | 369,000   | 1,006,000  | 1,04                                   |
| Net gain on sales of commercial loans                            | 0   | 56,000  | 29,000   | 8                                      |
| Other income   | 1,001,000   | 905,000   | 2,845,000  | 2,62                                   |
| Total noninterest income   | 1,362,000   | 1,330,000   | 3,880,000  | 3,75                                   |
| Noninterest expense  |   |   |  |  |
| Salaries and benefits  | 4,731,000   | 4,983,000   | 14,179,000   | 13,54                                  |
| Occupancy  | 802,000   | 805,000   | 2,404,000  | 1,88                                   |
| Furniture and equipment  | 513,000   | 459,000   | 1,550,000  | 1,10                                   |
| Other expense  | 1,982,000   | 2,073,000   | 5,932,000  | 5,77                                   |
| Total noninterest expenses                                       | 8,028,000   | 8,320,000   | 24,065,000   | 22,31                                  |

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|                                    |              |              |               |              |
|------------------------------------|--------------|--------------|---------------|--------------|
| INCOME BEFORE FEDERAL INCOME       |              |              |               |              |
| TAX EXPENSE                        | 7,531,000    | 6,187,000    | 22,032,000    | 19,250,000   |
| Federal income tax expense         | 2,329,000    | 1,887,000    | 6,790,000     | 5,900,000    |
| NET INCOME                         | \$ 5,202,000 | \$ 4,300,000 | \$ 15,242,000 | \$13,350,000 |
| COMPREHENSIVE INCOME               | \$ 6,757,000 | \$ 3,855,000 | \$ 14,923,000 | \$12,780,000 |
| Basic earnings per share           | \$ 0.65      | \$ 0.54      | \$ 1.91       | \$ 1.58      |
| Diluted earnings per share         | \$ 0.64      | \$ 0.53      | \$ 1.88       | \$ 1.56      |
| Cash dividends per share           | \$ 0.13      | \$ 0.11      | \$ 0.38       | \$ 0.38      |
| Average basic shares outstanding   | 8,016,016    | 7,965,172    | 7,997,187     | 7,950,000    |
| Average diluted shares outstanding | 8,118,206    | 8,115,575    | 8,117,709     | 8,130,000    |

See accompanying notes to consolidated financial statements.

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

|  | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/(loss) | Share<br>holders' Equity |
|--|-----------------|----------------------|--|--------------------------|
| BALANCE, JANUARY 1, 2005   | \$131,010,000   | \$ 10,475,000        | \$ 132,000   | \$141,617,000            |
| Payment of 5% stock dividend, 377,527 shares   | 17,187,000      | (17,191,000)         |  |                          |
| Employee stock purchase plan, 1,762 shares   | 69,000          |                      |  |                          |
| Dividend reinvestment plan, 3,477 shares   | 136,000         |                      |  |                          |
| Stock option exercises, 39,446 shares  | 368,000         |                      |  |                          |
| Stock tendered for stock option exercises,<br>7,565 shares   | (298,000)       |                      |  |                          |
| Cash dividends, \$0.32 per share   |                 | (2,349,000)          |  | (2,349,000)              |
| Comprehensive income:  |                 |                      |  |                          |
| Net income for the period from January 1,<br>2005 through September 30, 2005   |                 | 13,352,000           |  | 13,352,000               |
| Change in net unrealized gain/(loss)<br>on securities available for sale, net<br>of reclassifications and tax effect |                 |                      | (571,000)  | (571,000)                |
| Total comprehensive income   |                 |                      |  | 12,781,000               |
| BALANCE, SEPTEMBER 30, 2005  | \$148,472,000   | \$ 4,287,000         | \$ (439,000)   | \$152,320,000            |

See accompanying notes to consolidated financial statements.

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

|  | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income/ (loss) | Share |
|--|-----------------|----------------------|---|-------|
|  | -----           | -----                | -----   | ----- |
| BALANCE, JANUARY 1, 2006   | \$148,533,000   | \$ 8,000,000         | \$ (1,408,000)  | \$155 |
| Payment of 5% stock dividend, 379,432 shares   | 12,014,000      | (12,018,000)         |   |       |
| Employee stock purchase plan, 2,144 shares   | 83,000          |                      |   |       |
| Dividend reinvestment plan, 1,970 shares   | 76,000          |                      |   |       |
| Stock option exercises, 59,126 shares  | 755,000         |                      |   |       |
| Stock tendered for stock option exercises,<br>14,518 shares  | (569,000)       |                      |   |       |
| Stock option expense   | 153,000         |                      |   |       |
| Cash dividends, \$0.38 per share   |                 | (2,994,000)          |   | (2)   |
| Comprehensive income:  |                 |                      |   |       |
| Net income for the period from January 1,<br>2006 through September 30, 2006   |                 | 15,242,000           |   | 15    |
| Change in net unrealized gain/(loss)<br>on securities available for sale, net<br>of reclassifications and tax effect |                 |                      | (319,000)   |       |
| Total comprehensive income   |                 |                      |   | 14    |
| BALANCE, SEPTEMBER 30, 2006  | \$161,045,000   | \$ 8,230,000         | \$ (1,727,000)  | \$167 |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS

|                                      | Three Months<br>Ended<br>September 30,<br>2006 | Three Months<br>Ended<br>September 30,<br>2005 | Nine Months<br>Ended<br>September 30,<br>2006 | Nine<br>En<br>Septem<br>2 |
|--------------------------------------|--|--|---|---------------------------|
|                                      | -----  | -----  | -----   | -----                     |
|                                      | (Unaudited)                                    | (Unaudited)                                    | (Unaudited)                                   | (Unau                     |
| CASH FLOWS FROM OPERATING ACTIVITIES |  |  |   |                           |
| Net income                           | \$ 5,202,000                                   | \$ 4,300,000                                   | \$ 15,242,000                                 | \$ 13,                    |
| Adjustments to reconcile net income  |  |  |   |                           |

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|   |              |              |               |       |
|---|--------------|--------------|---------------|-------|
| to net cash from operating activities                             |              |              |               |       |
| Depreciation and amortization                                     | 781,000      | 728,000      | 2,360,000     | 1,    |
| Provision for loan and lease losses                               | 1,350,000    | 895,000      | 4,075,000     | 2,    |
| Net gain on sales of commercial loans                             | 0            | (56,000)     | (29,000)      |       |
| Stock option expense  | 51,000       | 0            | 153,000       |       |
| Net change in:  |              |              |               |       |
| Accrued interest receivable                                       | (1,391,000)  | (1,489,000)  | (2,164,000)   | (2,   |
| Bank owned life insurance policies                                | (298,000)    | (258,000)    | (872,000)     | (     |
| Other assets  | (1,050,000)  | 429,000      | (2,957,000)   | (2,   |
| Accrued expenses and other liabilities                            | 1,256,000    | 1,959,000    | 2,740,000     | 4,    |
|   | -----        | -----        | -----         | ----- |
| Net cash used in operating activities                             | 5,901,000    | 6,508,000    | 18,548,000    | 16,   |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                       |              |              |               |       |
| Loan and lease originations and payments, net                     | (40,716,000) | (64,620,000) | (151,091,000) | (172, |
| Purchases of:   |              |              |               |       |
| Securities available for sale                                     | (6,025,000)  | (6,061,000)  | (19,038,000)  | (29,  |
| Securities held to maturity                                       | (352,000)    | (1,429,000)  | (2,107,000)   | (8,   |
| Federal Home Loan Bank stock                                      | 0            | (462,000)    | 0             | (1,   |
| Proceeds from:  |              |              |               |       |
| Maturities, calls and repayments of available for sale securities | 1,720,000    | 3,299,000    | 5,807,000     | 12,   |
| Maturities, calls and repayments of held to maturity securities   | 0            | 0            | 730,000       |       |
| Redemption of FHLB stock  | 123,000      | 0            | 123,000       |       |
| Purchases of premises and equipment, net                          | (2,129,000)  | (2,263,000)  | (4,050,000)   | (7,   |
| Purchases of bank owned life insurance policies                   | 0            | (1,148,000)  | (1,207,000)   | (1,   |
|   | -----        | -----        | -----         | ----- |
| Net cash from investing activities                                | (47,379,000) | (72,684,000) | (170,833,000) | (207, |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                       |              |              |               |       |
| Net increase in deposits  | 66,791,000   | 75,436,000   | 195,351,000   | 238,  |
| Net increase in securities sold under agreements to repurchase    | 9,680,000    | 6,960,000    | 1,910,000     | 6,    |
| Net decrease in federal funds purchased                           | (11,400,000) | 0            | (9,600,000)   | (15,  |
| Proceeds from new FHLB advances                                   | 15,000,000   | 25,000,000   | 65,000,000    | 65,   |
| Maturities of FHLB advances                                       | (30,000,000) | (25,000,000) | (80,000,000)  | (50,  |
| Net increase in other borrowed money                              | 190,000      | 142,000      | 800,000       |       |
| Employee stock purchase plan                                      | 28,000       | 30,000       | 83,000        |       |
| Dividend reinvestment plan  | 31,000       | 52,000       | 76,000        |       |
| Stock option exercises, net                                       | 63,000       | 17,000       | 186,000       |       |
| Payment of cash dividends   | (1,042,000)  | (834,000)    | (2,994,000)   | (2,   |
| Cash paid in lieu of fractional shares on stock dividend          | 0            | 0            | (4,000)       |       |
|   | -----        | -----        | -----         | ----- |
| Net cash from financing activities                                | 49,341,000   | 81,803,000   | 170,808,000   | 243,  |
|   | -----        | -----        | -----         | ----- |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

|  | Three Months<br>Ended<br>September 30,<br>2006 | Three Months<br>Ended<br>September 30,<br>2005 | Nine Months<br>Ended<br>September 30,<br>2006 | Nine<br>En<br>Septem<br>2 |
|--|--|--|---|---------------------------|
|  | -----<br>(Unaudited)                           | -----<br>(Unaudited)                           | -----<br>(Unaudited)                          | -----<br>(Unau            |
| Net change in cash and cash equivalents              | 7,863,000                                      | 15,627,000                                     | 18,523,000                                    | 52,2                      |
| Cash and cash equivalents at beginning<br>of period  | 47,413,000                                     | 57,459,000                                     | 36,753,000                                    | 20,8                      |
|  | -----  | -----  | -----   | -----                     |
| CASH AND CASH EQUIVALENTS AT END OF<br>PERIOD        | \$55,276,000                                   | \$73,086,000                                   | \$55,276,000                                  | \$73,0                    |
|  | =====  | =====  | =====   | =====                     |
| Supplemental disclosures of cash flow<br>information |  |  |   |                           |
| Cash paid during the period for:                     |  |  |   |                           |
| Interest   | \$18,306,000                                   | \$10,934,000                                   | \$48,483,000                                  | \$27,7                    |
| Federal income tax                                   | 2,880,000                                      | 1,882,000                                      | 8,755,000                                     | 6,3                       |

See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The unaudited financial statements for the three and nine months ended September 30, 2006 include the consolidated results of operations of Mercantile Bank Corporation and its consolidated subsidiaries. These subsidiaries include Mercantile Bank of Michigan ("our bank"), our bank's three subsidiaries, Mercantile Bank Mortgage Company, LLC ("our mortgage company"), Mercantile Bank Real Estate Co., LLC ("our real estate company"), and Mercantile Insurance Center, Inc. ("our insurance center"). These consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and Item 303(b) of Regulation S-K and do not include all disclosures required by accounting principles generally accepted in the United States of America for a complete presentation of our financial condition and results of operations. In the opinion of management, the information reflects all adjustments (consisting only of normal recurring adjustments) which are necessary in order to make the financial statements not misleading and for a fair presentation of the results of operations for such periods. The results for the periods ended September 30, 2006 should not be considered as indicative of results for a full year. For further information, refer to the



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consolidated financial statements and footnotes included in our annual report on Form 10-K for the year ended December 31, 2005.

The Company formed a business trust, Mercantile Bank Capital Trust I ("the trust"), in 2004 to issue trust preferred securities. The Company issued subordinated debentures to the trust in return for the proceeds raised from the issuance of the trust preferred securities. In accordance with FASB Interpretation No. 46, the trust is not consolidated, but instead the Company reports the subordinated debentures issued to the trust as a liability.

**Earnings Per Share:** Basic earnings per share is based on weighted average common shares outstanding during the period. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under stock options. Options for 7,163 shares were antidilutive and were not included in determining diluted earnings per share for the three and nine month periods ended September 30, 2006.

**Stock Dividend:** All per share amounts and average shares outstanding have been adjusted for all periods presented to reflect the 5% stock dividend distributed on May 16, 2006. The Statement of Changes in Shareholders' Equity reflects a transfer from retained earnings to common stock for the value of the shares distributed to the extent of available retained earnings.

**Allowance for Loan and Lease Losses:** The allowance for loan and lease losses ("allowance") is a valuation allowance for probable incurred credit losses, increased by the provision for loan and lease losses and recoveries, and decreased by charge-offs. Management estimates the allowance balance required based on past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, and economic conditions. Allocations of the allowance may be made for specific loans and leases, but the entire allowance is available for any loan or lease that, in management's judgment, should be charged-off. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is confirmed.

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

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

A loan or lease is impaired when full payment under the loan or lease terms is not expected. 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 or lease is impaired, a portion of the allowance is allocated so that the loan or lease is reported, net, at the present value of estimated future cash flows using the loan's or lease's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans and leases are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship.

**Stock Options:** Stock option plans are used to reward directors and

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employees and provide them with additional equity interest. Stock options granted to non-employee directors are at 125% of the market price on the date of grant, fully vest after five years and expire ten years from the date of grant. Stock options granted to employees are granted at the market price on the date of grant, generally fully vest after one year and expire ten years from the date of grant. Stock options granted to non-executive employees during 2005 vested about three weeks after being granted.

The Stock Incentive Plan of 2006 ("Incentive Plan") was approved by shareholders at the annual meeting held on April 27, 2006. The Incentive Plan provides for the grant of equity-based incentives to eligible participants. The forms of long-term incentive compensation include stock options, stock appreciation rights, restricted stock units, restricted stock, stock awards and other awards based on or related to shares of Mercantile Bank Corporation common stock. The Incentive Plan provides for 350,000 shares of Mercantile Bank Corporation common stock to be available for incentive awards under the Incentive Plan, combined with the 245,769 shares available for issuance under previously authorized stock option plans, for a total of 595,769 shares.

Prior to January 1, 2006, the Company accounted for stock-based compensation expense using the intrinsic value method as required by APB Opinion No. 25 "Accounting for Stock Issued to Employees" and as permitted by SFAS No. 123 "Accounting for Stock-Based Compensation." No compensation cost for stock options was reflected in net income for 2005, as all options granted had an exercise price equal to the market price of the underlying common stock at date of grant.

On January 1, 2006, the Company adopted SFAS No. 123(R), which requires measurement of compensation cost for all stock-based awards be based on the grant-date fair value and recognition of compensation cost over the service period of stock-based awards, which is usually the same as the vesting period. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the Company's valuation methodology previously utilized for options in the footnote disclosures required under SFAS No. 123. The Company has adopted SFAS No. 123(R) using the modified prospective method, which provides for no retroactive application to prior periods and no cumulative adjustment to equity accounts. As amended, this applies to awards granted or modified beginning with the first quarter of 2006. Compensation cost is also recorded for prior option grants that vest after the date of adoption. SFAS No. 123(R) also amends SFAS No. 95 "Statement of Cash Flows," and requires tax benefits relating to excess stock-based compensation deductions be presented in the consolidated statements of cash flows as financing cash inflows.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

On March 29, 2005, the Securities and Exchange Commission ("SEC") published Staff Accounting Bulletin ("SAB") No. 107, which expressed the views of the Staff regarding interaction between SFAS No. 123(R) and certain SEC rules and regulations and provided the Staff's views regarding the valuation of stock-based payment arrangements for public companies. SAB No. 107 requires

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that stock-based compensation be classified in the same expense category as cash compensation. Accordingly, the Company has included stock-based compensation expense in salaries and employee benefits in the consolidated statements of income and comprehensive income.

The adoption of SFAS No. 123(R) had the following impact on reported amounts compared with amounts that would have been reported using the intrinsic value method under previous accounting.

|                            | Three Months Ended September 30, 2006 |                               |                |
|----------------------------|---------------------------------------|-------------------------------|----------------|
|                            | Using<br>Previous<br>Accounting       | SFAS<br>123(R)<br>Adjustments | As<br>Reported |
| Income before taxes        | \$7,582,000                           | \$(51,000)                    | \$7,531,000    |
| Income taxes               | 2,329,000                             | 0                             | 2,329,000      |
| Net income                 | \$5,253,000                           | \$(51,000)                    | \$5,202,000    |
| Basic earnings per share   | \$ 0.66                               | \$ (0.01)                     | \$ 0.65        |
| Diluted earnings per share | \$ 0.65                               | \$ (0.01)                     | \$ 0.64        |

|                            | Nine Months Ended September 30, 2006 |                               |                |
|----------------------------|--------------------------------------|-------------------------------|----------------|
|                            | Using<br>Previous<br>Accounting      | SFAS<br>123(R)<br>Adjustments | As<br>Reported |
| Income before taxes        | \$22,185,000                         | \$(153,000)                   | \$22,032,000   |
| Income taxes               | 6,790,000                            | 0                             | 6,790,000      |
| Net income                 | \$15,395,000                         | \$(153,000)                   | \$15,242,000   |
| Basic earnings per share   | \$ 1.93                              | \$ (0.02)                     | \$ 1.91        |
| Diluted earnings per share | \$ 1.90                              | \$ (0.02)                     | \$ 1.88        |

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

The following tables illustrate the effect on net income and earnings per share if expense had been measured using the fair value recognition provisions of SFAS No. 123.

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Three Months Ended September 30, 2005

|                            | As<br>Reported | Pro Forma<br>Adjustments | Pro Forma<br>As If Under<br>SFAS 123 |
|----------------------------|----------------|--------------------------|--------------------------------------|
| Income before taxes        | \$6,187,000    | \$(94,000)               | \$6,093,000                          |
| Income taxes               | 1,887,000      | 0                        | 1,887,000                            |
| Net income                 | \$4,300,000    | \$(94,000)               | \$4,206,000                          |
| Basic earnings per share   | \$ 0.54        | \$ (0.01)                | \$ 0.53                              |
| Diluted earnings per share | \$ 0.53        | \$ (0.01)                | \$ 0.52                              |

Nine Months Ended September 30, 2005

|                            | As<br>Reported | Pro Forma<br>Adjustments | Pro Forma<br>As If Under<br>SFAS 123 |
|----------------------------|----------------|--------------------------|--------------------------------------|
| Income before taxes        | \$19,258,000   | \$(281,000)              | \$18,977,000                         |
| Income taxes               | 5,906,000      | 0                        | 5,906,000                            |
| Net income                 | \$13,352,000   | \$(281,000)              | \$13,071,000                         |
| Basic earnings per share   | \$ 1.68        | \$ (0.04)                | \$ 1.64                              |
| Diluted earnings per share | \$ 1.64        | \$ (0.03)                | \$ 1.61                              |

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

The following is activity under the stock option plans:

|                                    | Nine Months Ended<br>September 30, 2006 |  |
|------------------------------------|---|--|
|                                    | Shares                                  | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding at beginning of period | 315,302                                 | \$21.83                                  |
| Granted                            | 0                                       | NA                                       |
| Exercised                          | 59,126                                  | 12.76                                    |
| Forfeited                          | 2,204                                   | 33.55                                    |

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|                              |                           |                           |
|------------------------------|---------------------------|---------------------------|
| Outstanding at end of period | -----<br>253,972<br>===== | -----<br>\$23.84<br>===== |
| Exercisable at end of period | -----<br>211,320<br>===== | -----<br>\$22.32<br>===== |

The aggregate intrinsic value of all options outstanding at September 30, 2006 was \$4.0 million.

The aggregate intrinsic value of all options that were exercisable at September 30, 2006 was \$3.6 million.

The aggregate intrinsic value of stock options exercised during the first nine months of 2006 was \$1.6 million.

The weighted average fair value of the stock options for 2,479 shares that vested during the first nine months of 2006 was \$10.90 per share.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES (Continued)

Stock options outstanding as of September 30, 2006:

|                              | Outstanding |   |  | Exercisable |  |
|------------------------------|-------------|---|--|-------------|--|
|                              | Shares      | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Weighted<br>Average<br>Exercise<br>Price | Shares      | Weighted<br>Average<br>Exercise<br>Price |
|                              | -----       | -----   | -----                                    | -----       | -----                                    |
| \$4.00 - \$8.00              | 8,952       | 0.8 Years   | \$ 7.46                                  | 8,952       | \$ 7.46                                  |
| \$8.01 - \$12.00             | 42,208      | 3.3 Years   | 9.20                                     | 42,208      | 9.20                                     |
| \$12.01 - \$16.00            | 29,306      | 5.0 Years   | 13.07                                    | 29,306      | 13.07                                    |
| \$16.01 - \$20.00            | 39,785      | 5.9 Years   | 16.83                                    | 32,153      | 16.94                                    |
| \$20.01 - \$24.00            | 7,272       | 6.0 Years   | 21.19                                    | 0           | NA                                       |
| \$24.01 - \$28.00            | 31,170      | 7.1 Years   | 27.94                                    | 31,170      | 27.94                                    |
| \$32.01 - \$36.00            | 41,783      | 7.9 Years   | 35.29                                    | 34,847      | 35.36                                    |
| \$36.01 - \$40.00            | 46,333      | 9.1 Years   | 37.68                                    | 32,684      | 37.68                                    |
| \$40.01 - \$44.00            | 7,163       | 8.0 Years   | 42.29                                    | 0           | NA                                       |
|                              | -----       |   |  | -----       |  |
| Outstanding at end of period | 253,972     | 6.3 Years   | \$23.84                                  | 211,320     | \$22.32                                  |
|                              | =====       |   |  | =====       |  |

The compensation cost yet to be recognized for stock option grants that have been awarded but not vested is \$51,000 for the remainder of 2006, and \$27,000, \$17,000 and \$8,000 for 2007, 2008, and 2009, respectively.

Newly Issued but Not Yet Effective Accounting Standards: In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income

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Taxes - an interpretation of FASB Statement No. 109 ("FIN 48"), which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS 109, Accounting for Income Taxes. FIN 48 prescribes a recognition and measurement threshold for a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company has not completed its evaluation of the impact of the adoption of FIN 48.

In September 2006, the Securities and Exchange Commission released Staff Accounting Bulletin ("SAB") 108. This SAB provides guidance to registrants in the determination of what is material to their financial statements. This SAB is required to be applied to financial statements issued after November 15, 2006. Upon adoption, the cumulative effect of applying the new guidance is to be reflected as an adjustment to opening retained earnings as of the beginning of the current fiscal year. The Company has not completed its evaluation of the impact of SAB 108.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

### 2. LOANS AND LEASES

Our total loans and leases at September 30, 2006 were \$1,710.3 million compared to \$1,561.8 million at December 31, 2005, an increase of \$148.5 million, or 9.5%. The components of our outstanding balances at September 30, 2006 and December 31, 2005, and the percentage changes in loans and leases from the end of 2005 to the end of the third quarter 2006 are as follows:

|                                      | September 30, 2006 |        | December 31, 2005 |        | Percent<br>Increase/<br>(Decrease) |
|--------------------------------------|--------------------|--------|-------------------|--------|------------------------------------|
|                                      | Balance            | %      | Balance           | %      |                                    |
| Real Estate:                         |                    |        |                   |        |                                    |
| Construction and land development    | \$ 259,409,000     | 15.2%  | \$ 226,544,000    | 14.5%  | 14.5%                              |
| Secured by 1-4 family properties     | 128,932,000        | 7.5    | 128,111,000       | 8.2    | 0.6                                |
| Secured by multi-family properties   | 38,438,000         | 2.2    | 30,114,000        | 2.0    | 27.6                               |
| Secured by nonresidential properties | 821,389,000        | 48.0   | 714,963,000       | 45.8   | 14.9                               |
| Commercial                           | 453,982,000        | 26.6   | 454,911,000       | 29.1   | (0.2)                              |
| Leases                               | 1,046,000          | 0.1    | 1,786,000         | 0.1    | (41.4)                             |
| Consumer                             | 7,072,000          | 0.4    | 5,383,000         | 0.3    | 31.4                               |
|                                      | -----              | -----  | -----             | -----  | -----                              |
| Total loans and leases               | \$1,710,268,000    | 100.0% | \$1,561,812,000   | 100.0% | 9.5%                               |
|                                      | =====              | =====  | =====             | =====  | =====                              |

### 3. ALLOWANCE FOR LOAN AND LEASE LOSSES

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The following is a summary of the change in our allowance for loan and lease losses account for the three and nine months ended September 30:

|                                     | Three months ended    |                       | Nine months ended     |                       |
|-------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                     | September 30,<br>2006 | September 30,<br>2005 | September 30,<br>2006 | September 30,<br>2005 |
| Balance at beginning of period      | \$21,507,000          | \$18,856,000          | \$20,527,000          | \$17,819,000          |
| Charge-offs                         | (1,250,000)           | (338,000)             | (3,113,000)           | (1,042,000)           |
| Recoveries                          | 331,000               | 158,000               | 449,000               | 274,000               |
| Provision for loan and lease losses | 1,350,000             | 895,000               | 4,075,000             | 2,520,000             |
| Balance at September 30             | \$21,938,000          | \$19,571,000          | \$21,938,000          | \$19,571,000          |

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

4. PREMISES AND EQUIPMENT - NET

Premises and equipment are comprised of the following:

|                                      | September 30,<br>2006 | December 31,<br>2005 |
|--------------------------------------|-----------------------|----------------------|
| Land and improvements                | \$ 9,565,000          | \$ 7,135,000         |
| Buildings and leasehold improvements | 19,810,000            | 18,450,000           |
| Furniture and equipment              | 10,609,000            | 10,351,000           |
|                                      | 39,984,000            | 35,936,000           |
| Less: accumulated depreciation       | 7,675,000             | 5,730,000            |
| Premises and equipment, net          | \$32,309,000          | \$30,206,000         |

Depreciation expense amounted to \$644,000 during the third quarter of 2006, compared to \$590,000 in the third quarter of 2005. Depreciation expense amounted to \$1,947,000 during the first nine months of 2006, compared to \$1,422,000 during the first nine months of 2005.

5. DEPOSITS

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Our total deposits at September 30, 2006 were \$1,614.7 million compared to \$1,419.4 million at December 31, 2005, an increase of \$195.3 million, or 13.8%. The components of our outstanding balances at September 30, 2006 and December 31, 2005, and percentage change in deposits from the end of 2005 to the end of the third quarter 2006 are as follows:

|                                      | September 30, 2006     |               | December 31, 2005      |               | Percent Increase/<br>(Decrease) |
|--------------------------------------|------------------------|---------------|------------------------|---------------|---------------------------------|
|                                      | Balance                | %             | Balance                | %             |                                 |
| Noninterest-bearing demand           | \$ 115,269,000         | 7.1%          | \$ 120,828,000         | 8.5%          | (4.6)%                          |
| Interest-bearing checking            | 41,224,000             | 2.5           | 39,792,000             | 2.8           | 3.6                             |
| Money market                         | 9,565,000              | 0.6           | 10,344,000             | 0.7           | (7.5)                           |
| Savings                              | 78,239,000             | 4.8           | 106,247,000            | 7.5           | (26.4)                          |
| Time, under \$100,000                | 42,892,000             | 2.7           | 23,906,000             | 1.7           | 79.4                            |
| Time, \$100,000 and over             | 283,455,000            | 17.6          | 155,401,000            | 11.0          | 82.4                            |
|                                      | 570,644,000            | 35.3          | 456,518,000            | 32.2          | 25.0                            |
| Out-of-area time, under \$100,000    | 76,600,000             | 4.8           | 80,048,000             | 5.6           | (4.3)                           |
| Out-of-area time, \$100,000 and over | 967,459,000            | 59.9          | 882,786,000            | 62.2          | 9.6                             |
|                                      | 1,044,059,000          | 64.7          | 962,834,000            | 67.8          | 8.4                             |
| <b>Total deposits</b>                | <b>\$1,614,703,000</b> | <b>100.0%</b> | <b>\$1,419,352,000</b> | <b>100.0%</b> | <b>13.8%</b>                    |

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

6. SHORT-TERM BORROWINGS

Information relating to our securities sold under agreements to repurchase follows:

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
| Outstanding balance at end of period    | \$74,111,000          | \$72,201,000         |
| Average interest rate at end of period  | 3.88%                 | 3.31%                |
| Average balance during the period       | \$69,217,000          | \$60,743,000         |
| Average interest rate during the period | 3.63%                 | 2.63%                |



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Maximum month end balance  
during the period                      \$79,443,000              \$74,639,000

Securities sold under agreements to repurchase ("repurchase agreements") generally have original maturities of less than one year. Repurchase agreements are treated as financings and the obligations to repurchase securities sold are reflected as liabilities. Securities involved with the agreements are recorded as assets of our bank and are primarily held in safekeeping by correspondent banks. Repurchase agreements are offered principally to certain large deposit customers as deposit equivalent investments.

7. FEDERAL HOME LOAN BANK ADVANCES

Our outstanding balances at September 30, 2006 and December 31, 2005 were as follows:

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
|  | -----                 | -----                |
| Maturities October 2006 through May 2008, fixed rates from 3.42% to 5.69%, averaging 4.72% | \$115,000,000         | \$ 0                 |
| Maturities January 2006 through May 2008, fixed rates from 2.13% to 4.92%, averaging 3.68% |                       | 120,000,000          |
| Maturities in May 2006, floating rates tied to Libor indices, averaging 4.42%              |                       | 10,000,000           |
|  | -----                 | -----                |
| Total Federal Home Loan Bank advances  | \$115,000,000         | \$130,000,000        |
|  | =====                 | =====                |

Each advance is payable at its maturity date, and is subject to a prepayment fee if paid prior to the maturity date. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans, first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of September 30, 2006 totaled \$321.9 million, with availability of \$195.8 million.

7. FEDERAL HOME LOAN BANK ADVANCES (Continued)

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Maturities of FHLB advances currently outstanding during the next five years are:

|      |              |
|------|--------------|
| 2006 | \$35,000,000 |
| 2007 | 65,000,000   |
| 2008 | 15,000,000   |
| 2009 | 0            |
| 2010 | 0            |

### 8. COMMITMENTS AND OFF-BALANCE-SHEET RISK

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

These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. Our bank's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. Our bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, property and equipment, is generally obtained based on management's credit assessment of the borrower. If required, estimated loss exposure resulting from these instruments is expensed and recorded as a liability. The balance of the liability account was \$0.5 million as of September 30, 2006 and December 31, 2005.

A summary of the contractual amounts of our financial instruments with off-balance-sheet risk at September 30, 2006 and December 31, 2005 follows:

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
|   | -----                 | -----                |
| Commercial unused lines of credit                                   | \$333,437,000         | \$303,115,000        |
| Unused lines of credit secured by 1-4 family residential properties | 28,751,000            | 27,830,000           |
| Credit card unused lines of credit                                  | 8,332,000             | 7,971,000            |
| Other consumer unused lines of credit                               | 7,500,000             | 10,791,000           |
| Commitments to make loans   | 91,883,000            | 83,280,000           |
| Standby letters of credit   | 65,044,000            | 59,058,000           |
|   | -----                 | -----                |

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|                                  |               |               |
|----------------------------------|---------------|---------------|
| Total loan and lease commitments | \$534,947,000 | \$492,045,000 |
|                                  | =====         | =====         |

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MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

9. REGULATORY MATTERS

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

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If not well capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

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

|  | Actual    |       | Minimum Required for Capital Adequacy Purposes |       | Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations |       |
|--|-----------|-------|--|-------|--|-------|
|  | Amount    | Ratio | Amount   | Ratio | Amount   | Ratio |
| September 30, 2006                       |           |       |  |       |  |       |
| Total capital (to risk weighted assets)  |           |       |  |       |  |       |
| Consolidated                             | \$223,213 | 11.6% | \$153,858                                      | 8.0%  | \$ NA  | NA    |
| Bank                                     | 219,573   | 11.4  | 153,674  | 8.0   | 192,092  | 10.0% |
| Tier 1 capital (to risk weighted assets) |           |       |  |       |  |       |
| Consolidated                             | 201,275   | 10.5  | 76,929   | 4.0   | NA   | NA    |
| Bank                                     | 197,635   | 10.3  | 76,837   | 4.0   | 115,256  | 6.0   |
| Tier 1 capital (to average assets)       |           |       |  |       |  |       |
| Consolidated                             | 201,275   | 10.1  | 79,369   | 4.0   | NA   | NA    |

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|      |         |      |        |     |        |     |
|------|---------|------|--------|-----|--------|-----|
| Bank | 197,635 | 10.0 | 79,321 | 4.0 | 99,151 | 5.0 |
|------|---------|------|--------|-----|--------|-----|

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MERCANTILE BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

9. REGULATORY MATTERS (Continued)

|   | Actual    |       | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Regulations |       |
|---|-----------|-------|--|-------|--|-------|
|   | Amount    | Ratio | Amount   | Ratio | Amount   | Ratio |
|   | -----     | ----- | -----  | ----- | -----  | ----- |
| December 31, 2005                           |           |       |  |       |  |       |
| Total capital (to risk<br>weighted assets)  |           |       |  |       |  |       |
| Consolidated                                | \$209,060 | 12.0% | \$139,337  | 8.0%  | \$ NA  | NA    |
| Bank  | 205,642   | 11.8  | 139,158  | 8.0   | 173,947  | 10.0% |
| Tier 1 capital (to risk<br>weighted assets) |           |       |  |       |  |       |
| Consolidated                                | 188,533   | 10.8  | 69,669   | 4.0   | NA   | NA    |
| Bank  | 185,115   | 10.6  | 69,579   | 4.0   | 104,368  | 6.0   |
| Tier 1 capital (to<br>average assets)       |           |       |  |       |  |       |
| Consolidated                                | 188,533   | 10.5  | 72,163   | 4.0   | NA   | NA    |
| Bank  | 185,115   | 10.3  | 72,100   | 4.0   | 90,124   | 5.0   |

Our consolidated capital levels as of September 30, 2006 and December 31, 2005 include the \$32.0 million in trust preferred securities issued by the trust subject to certain limitations. Federal Reserve guidelines limit the amount of trust preferred securities which can be included in our Tier 1 capital to 25% of total Tier 1 capital. As of September 30, 2006 and December 31, 2005, all \$32.0 million of the trust preferred securities were included as Tier 1 capital.

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. We declared a 5% stock dividend on April 11, 2006, that was distributed on May 16, 2006 to record holders as of April 24, 2006. All earnings per share and dividend per share information have been adjusted for the 5% stock dividend. We have also paid three cash dividends on our common stock during 2006. On January 10, 2006, we declared a \$0.12 per share cash dividend on our common stock, which was paid on March 10, 2006 to record holders as of February 10, 2006. On April 11, 2006, we declared a \$0.13 per share cash dividend on our common stock, which was paid on June 9, 2006 to record holders as of May 17, 2006. On July 11, 2006, we declared a \$0.13 per share cash dividend on our common stock, which was paid on September 8, 2006 to record holders as of August 10, 2006. On October 10, 2006, we declared a \$0.13 per share cash dividend on our common stock, which is payable on December 8, 2006 to record holders as of November 10,

2006.

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MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

10. BENEFIT PLANS

We sponsor an employee stock purchase plan which allows employees to use after-tax payroll dollars to purchase our common stock on a quarterly basis. We have registered 30,387 shares of common stock to be issued and purchased under the plan; however, the plan allows for shares to be purchased directly from us or on the open market. During the nine months ended September 30, 2006, we issued 2,144 shares under the plan.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

FORWARD LOOKING STATEMENTS

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

Future Factors include, among others, changes in interest rates and interest rate relationships; demand for products and services; the degree of competition by traditional and non-traditional competitors; changes in banking regulation; changes in tax laws; changes in prices, levies, and assessments; the impact of technological advances; governmental and regulatory policy changes; the outcomes of contingencies; trends in customer behavior as well as their ability to repay loans; and changes in the national and local economy. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a forward-looking statement.

INTRODUCTION

The following discussion compares the financial condition of Mercantile Bank Corporation and its consolidated subsidiaries, Mercantile Bank of Michigan ("our bank"), our bank's three subsidiaries Mercantile Bank Mortgage Company, LLC ("our mortgage company"), Mercantile Bank Real Estate Co., LLC ("our real estate

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company") and Mercantile Insurance Center, Inc. ("our insurance center"), at September 30, 2006 to December 31, 2005 and the results of operations for the three and nine months ended September 30, 2006 and September 30, 2005. This discussion should be read in conjunction with the interim consolidated financial statements and footnotes included in this report. Unless the text clearly suggests otherwise, references in this report to "us," "we," "our," or "the company" include Mercantile Bank Corporation and its consolidated subsidiaries referred to above.

### CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require management to apply significant judgment to various accounting, reporting and disclosure matters. Management must use assumptions and estimates to apply these principles where actual measurements are not possible or practical. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our unaudited financial statements included in this report. For a complete discussion of our significant accounting policies, see footnotes to our Consolidated Financial Statements included on pages F-35 through F-40 in our Form 10-K for the fiscal year ended December 31, 2005 (Commission file number 000-26719). Below is a discussion of our Allowance for Loan and Lease Losses policy. This policy is critical because it is highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements, and actual results may differ from those estimates. Management has reviewed the application of this policy with the Audit Committee of the company's Board of Directors.

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**Allowance for Loan and Lease Losses:** The allowance for loan and lease losses ("allowance") is a valuation allowance for probable incurred credit losses, increased by the provision for loan and lease losses and recoveries, and decreased by charge-offs. Management estimates the allowance balance required based on past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, and economic conditions. Allocations of the allowance may be made for specific loans and leases, but the entire allowance is available for any loan or lease that, in management's judgment, should be charged-off. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is confirmed.

A loan or lease is impaired when full payment under the loan or lease terms is not expected. 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 or lease is impaired, a portion of the allowance is allocated so that the loan or lease is reported, net, at the present value of estimated future cash flows using the loan's or lease's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Loans and leases are evaluated for impairment when payments are delayed, typically 30 days or more, or when serious deficiencies are identified within the credit relationship.

### FINANCIAL CONDITION

During the first nine months of 2006, our assets increased from \$1,838.2 million on December 31, 2005, to \$2,026.8 million on September 30, 2006. This represents an increase in total assets of \$188.6 million, or 10.3%. The asset growth was

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comprised primarily of a \$147.0 million increase in net loans, an \$18.5 million increase in cash and cash equivalents and a \$14.0 million increase in securities. The growth in total assets was primarily funded by a \$195.3 million increase in deposits, partially offset by a \$15.0 million decrease in Federal Home Loan Bank advances and a \$9.6 million decrease in federal funds purchased.

Commercial loans and leases increased by \$145.9 million during the first nine months of 2006, and at September 30, 2006, totaled \$1,574.3 million, or 92.0% of the total loan and lease portfolio. The continued significant concentration of the loan and lease portfolio in commercial loans and leases and the rapid growth of this portion of our lending business is consistent with our stated strategy of focusing a substantial amount of efforts on "wholesale" banking. Corporate and business lending continues to be an area of expertise of our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least 10 years' experience. Of each of the loan categories that we originate, commercial loans and leases are most efficiently originated and managed; thus limiting overhead costs by necessitating the attention of fewer full-time employees. Our commercial lending business generates the greatest amount of local deposits, and is our primary source of demand deposits.

Residential mortgage loans and consumer loans increased by \$0.8 million and \$1.7 million, respectively, during the first nine months of 2006. As of September 30, 2006, residential mortgage and consumer loans totaled a combined \$136.0 million, or 8.0% of the total loan and lease portfolio. Although we plan to increase our non-commercial loan portfolios in future periods, given our wholesale banking strategy, we expect the commercial sector of our lending efforts and resultant assets to remain the dominant loan portfolio category.

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Management believes the quality of our loan and lease portfolio remains strong. Net loan and lease charge-offs during the first nine months of 2006 totaled \$2.7 million, or 0.22% of average total loans and leases on an annualized basis. During the first nine months of 2005, net loan and lease charge-offs totaled \$0.8 million, or 0.07% of average total loans and leases on an annualized basis. Nonperforming assets at September 30, 2006 totaled \$9.4 million, or 0.47% of period-ending total assets. Nonperforming assets at December 31, 2005 totaled \$4.0 million, or 0.22% of period-ending total assets, while nonperforming assets at September 30, 2005 totaled \$2.1 million, or 0.12% of period-ending total assets.

We believe we have instilled a strong credit culture within our lending departments as it pertains to the underwriting and administration processes, which in part is reflected in our low loan and lease net charge-off and delinquency ratios. Over 98% of the loan portfolio consists of loans extended directly to companies and individuals doing business and residing within our market areas. The remaining portion is comprised of commercial loans participated with certain commercial banks outside the immediate areas, which we underwrite using the same loan underwriting criteria as though our bank was the originating bank.

Securities increased \$14.0 million during the first nine months of 2006. Purchases during the first nine months of 2006 totaled \$21.1 million, while proceeds from the maturities, calls and repayments of securities and the redemption of Federal Home Loan Bank of Indianapolis ("FHLBI") stock totaled \$6.7 million. Our securities portfolio primarily consists of U.S. Government

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Agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government Agencies, investment-grade tax-exempt municipal securities and FHLBI stock.

Cash and cash equivalents increased \$18.5 million during the first nine months of 2006, totaling \$55.3 million on September 30, 2006. Cash and due from bank balances were up \$2.9 million and federal funds sold increased \$16.0 million. Our commercial lending and wholesale funding focus results in relatively large day-to-day fluctuations of our cash and cash equivalent balances. Average cash and cash equivalents during the first nine months of 2006 equaled \$48.0 million.

Premises and equipment at September 30, 2006 equaled \$32.3 million, an increase of \$2.1 million over the past nine months. Purchases of premises and equipment during the first nine months of 2006 totaled \$4.0 million, primarily reflecting the initial construction costs of our new banking facility located in East Lansing, Michigan. Depreciation expense during the first nine months of 2006 equaled \$1.9 million.

Deposits increased \$195.3 million during the first nine months of 2006, totaling \$1,614.7 million at September 30, 2006. Local deposits increased \$114.1 million, while out-of-area deposits increased \$81.2 million. As a percent of total deposits, local deposits increased from 32.2% on December 31, 2005, to 35.3% on September 30, 2006. Noninterest-bearing demand deposits, comprising 7.1% of total deposits, decreased \$5.6 million during the first nine months of 2006. Savings deposits (4.8% of total deposits) decreased \$28.0 million, interest-bearing checking deposits (2.5% of total deposits) increased \$1.4 million and money market deposit accounts (0.6% of total deposits) decreased \$0.8 million during the first nine months of 2006. Local certificates of deposit, comprising 20.3% of total deposits, increased by \$147.0 million during the first nine months of 2006. The increase in local certificates of deposit is primarily attributable to increases in balances from municipalities and transfers of monies by consumer and commercial customers from savings accounts to certificates of deposit products, the latter of which reflecting that rates offered on certificates of deposit have risen at a faster pace than the rates offered on savings accounts.

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Out-of-area deposits increased \$81.2 million during the first nine months of 2006, totaling \$1,044.1 million as of September 30, 2006. Out-of-area deposits consist primarily of certificates of deposit obtained from depositors located outside our market areas and placed by deposit brokers for a fee, but also include certificates of deposit obtained from the deposit owners directly. Out-of-area deposits are utilized to support our asset growth, and are generally a lower cost source of funds when compared to the deposit interest rates that would have to be offered in the local markets to generate a sufficient level of funds. During the first nine months of 2006, rates paid on new out-of-area certificates of deposit were generally similar to the rates paid on new certificates of deposit issued to local customers. Overhead costs associated with the out-of-area deposits are considerably less than the overhead costs that would be incurred to administer a similar level of local deposits. Although local deposits have and are expected to increase as new business, governmental and consumer deposit relationships are established, our relatively high reliance on out-of-area deposits is expected to continue.

Securities sold under agreements to repurchase ("repurchase agreements") increased \$1.9 million during the first nine months of 2006, totaling \$74.1 million as of September 30, 2006. As part of our sweep account program,



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collected funds from certain business noninterest-bearing checking accounts are invested into over-night interest-bearing repurchase agreements. Although not considered a deposit account and therefore not afforded federal deposit insurance, the repurchase agreements have characteristics very similar to that of our business checking deposit accounts.

Federal funds purchased declined by \$9.6 million during the first nine months of 2006, with a zero balance as of September 30, 2006. Advances obtained from the FHLBI totaled \$115.0 million as of September 30, 2006, a decrease of \$15.0 million from the \$130.0 million outstanding on December 31, 2005. The advances are collateralized by residential mortgage loans, first mortgage liens on multi-family residential property loans and first mortgage liens on commercial real estate property loans, and substantially all other assets of our bank, under a blanket lien arrangement. Our borrowing line of credit as of September 30, 2006 totaled \$321.9 million, with availability of \$195.8 million. FHLBI advances, along with out-of-area deposits, are the primary components of our wholesale funding program.

### 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 meet deposit withdrawals, maintain reserve requirements, fund loans and support our operations. Liquidity is primarily achieved through the growth of deposits (both local and out-of-area), advances from the FHLBI and federal funds purchased, as well as liquid assets such as securities available for sale, matured securities, and federal funds sold. Asset and liability management is the process of managing our balance sheet to achieve a mix of earning assets and liabilities that maximizes profitability, while providing adequate liquidity.

Our liquidity strategy is to fund loan growth with deposits, repurchase agreements and FHLBI advances, and to maintain an adequate level of short- and medium-term investments to meet typical daily loan and deposit activity. Although deposit and repurchase agreement growth from customers located in our market areas has generally consistently increased, this growth has not been sufficient to meet our substantial loan growth and provide monies for additional investing activities. To assist in providing the additional needed funds, we have regularly obtained monies from wholesale funding sources. Wholesale funds, primarily comprised of certificates of deposit from customers outside of our market areas and advances from the FHLBI, totaled \$1,159.1 million, or 64.3% of combined deposits and borrowed funds as of September 30, 2006. As of December 31, 2005, wholesale funds totaled \$1,092.8 million, or 67.0% of combined deposits and borrowed funds. Reliance on wholesale funds is expected to continue due to our anticipated future asset growth.

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As a member of the FHLBI, our bank has access to the FHLBI's borrowing programs. At September 30, 2006, advances from the FHLBI totaled \$115.0 million, down from the \$130.0 million outstanding at December 31, 2005. Based on available collateral at September 30, 2006, our bank could borrow an additional \$195.8 million from the FHLBI.

Our bank has the ability to borrow money on a daily basis through correspondent banks via established unsecured federal funds purchased lines, totaling \$72.0 million as of September 30, 2006. The average balance of federal funds purchased

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during the first nine months of 2006 equaled \$3.8 million, compared to a \$9.6 million average federal funds sold position during the same time period.

In addition to typical loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. As of September 30, 2006, our bank had a total of \$469.9 million in unfunded loan commitments and \$65.0 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$378.0 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$91.9 million were for loan commitments expected to close and become funded within the next twelve months. We monitor fluctuations in loan balances and commitment levels, and include such data in managing our overall liquidity.

### CAPITAL RESOURCES

Shareholders' equity is a noninterest-bearing source of funds that provides support for asset growth. Shareholders' equity increased by \$12.4 million during the first nine months of 2006, from \$155.1 million on December 31, 2005, to \$167.5 million at September 30, 2006. The increase is primarily attributable to net income of \$15.2 million recorded during the first nine months of 2006. Shareholders' equity also increased \$0.3 million from the issuance of new shares of common stock resulting from our dividend reinvestment plan, employee stock purchase plan and stock option exercises. Shareholders' equity was negatively impacted during the first nine months of 2006 by the payment of cash dividends totaling \$3.0 million and a \$0.3 million mark-to-market adjustment for available for sale securities as defined in SFAS No. 115.

We are subject to regulatory capital requirements primarily administered by federal bank regulatory agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. The capital ratios of the company and our bank as of September 30, 2006 and December 31, 2005 are disclosed under Note 9 of the Notes to Consolidated Financial Statements.

Our and our bank's ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. We declared a 5% stock dividend on April 11, 2006, that was distributed on May 16, 2006 to record holders as of April 24, 2006. All earnings per share and cash dividend per share information have been adjusted for the 5% stock dividend. We paid a \$0.12 per share cash dividend on March 10, 2006 and a \$0.13 per share cash dividend on June 9, 2006 and September 8, 2006. On October 10, 2006, we declared a \$0.13 per share cash dividend payable on December 8, 2006 to record holders as of November 10, 2006.

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### MERCANTILE BANK CORPORATION

### RESULTS OF OPERATIONS

Net income for the third quarter of 2006 was \$5.2 million (\$0.65 per basic share and \$0.64 per diluted share), which represents a 21.0% increase over net income of \$4.3 million (\$0.54 per basic share and \$0.53 per diluted share) recorded during the third quarter of 2005. Net income for the first nine months of 2006 was \$15.2 million (\$1.91 per basic share and \$1.88 per diluted share), which represents a 14.2% increase over net income of \$13.4 million (\$1.68 per basic share and \$1.64 per diluted share) recorded during the first nine months of 2005. The improvement in net income during both time periods is primarily the result of higher net interest income and improved operating efficiency, which

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more than offset a higher provision expense.

Interest income during the third quarter of 2006 was \$35.7 million, an increase of 33.3% over the \$26.8 million earned during the third quarter of 2005. Interest income during the first nine months of 2006 was \$100.5 million, an increase of 38.0% over the \$72.8 million earned during the first nine months of 2005. The growth in interest income during both time periods is primarily attributable to growth in earning assets and an increased interest rate environment. During the third quarter of 2006, earning assets averaged \$1,881.9 million, \$234.6 million higher than average earning assets of \$1,647.3 million during the third quarter of 2005. Average loans were up \$223.9 million and securities increased \$13.6 million. During the first nine months of 2006, earning assets averaged \$1,834.5 million, \$253.4 million higher than average earning assets of \$1,581.0 million during the same time period in 2005. Average loans were up \$233.5 million and securities increased \$18.3 million. Also positively impacting the growth in interest income was the increased yield on earning assets. During the third quarter of 2006 and 2005, earning assets had a weighted average yield (tax equivalent-adjusted basis) of 7.58% and 6.51%, respectively. During the first nine months of 2006 and 2005, earning assets had a weighted average yield of 7.39% and 6.23%, respectively. With approximately 65% of our total loans and leases tied to the prime rate, our asset yield has benefited from recent increases in the prime rate. Between June 30, 2004 and September 30, 2006, the Federal Open Market Committee has raised the target federal funds rate by a total of 425 basis points, with the prime rate increasing by the same magnitude.

Interest expense during the third quarter of 2006 was \$20.1 million, an increase of 58.6% over the \$12.7 million expensed during the third quarter of 2005. Interest expense during the first nine months of 2006 was \$54.2 million, an increase of 67.0% over the \$32.5 million expensed during the first nine months of 2005. The increase in interest expense is primarily attributable to the increase in interest-bearing liabilities necessitated by the growth in assets and a higher interest rate environment. During the third quarter of 2006, interest-bearing liabilities averaged \$1,683.9 million, \$222.2 million higher than average interest-bearing liabilities of \$1,461.7 million during the third quarter of 2005. Interest-bearing deposits were up \$228.5 million, while FHLBI advances decreased \$13.9 million. During the first nine months of 2006, interest-bearing liabilities averaged \$1,639.3 million, \$240.2 million higher than average interest-bearing liabilities of \$1,399.1 million during the same time period in 2005. Interest-bearing deposits were up \$233.5 million, while FHLBI advances decreased \$2.8 million. During the third quarter of 2006 and 2005, interest-bearing liabilities had a weighted average rate of 4.74% and 3.44%, respectively. During the first nine months of 2006 and 2005, interest-bearing liabilities had a weighted average rate of 4.42% and 3.10%, respectively. The higher weighted average cost of interest-bearing liabilities is primarily due to the increase in market interest rates.

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Net interest income during the third quarter of 2006 was \$15.5 million, an increase of 10.5% over the \$14.1 million earned during the third quarter of 2005. Net interest income during the first nine months of 2006 was \$46.3 million, an increase of 14.8% over the \$40.3 million earned during the same time period in 2005. The increase in net interest income is primarily due to the growth in earning assets, which more than offset a decline in the net interest margin. The net interest margin during the third quarter of 2006 was 3.34%, compared to the 3.46% during the third quarter of 2005. During the first nine

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months of 2006, the net interest margin was 3.44%, compared to 3.48% during the same time period in 2005.

The following table sets forth certain information relating to our consolidated average interest-earning assets and interest-bearing liabilities and reflects the average yield on assets and average cost of liabilities for the third quarter of 2006 and 2005. Such yields and costs are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the period presented. Tax-exempt securities interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 35%. Securities interest income was increased by \$296,000 and \$282,000 in the third quarter of 2006 and 2005, respectively, for this adjustment.

|   | Quarters ended September 30, |          |                 |                    |          |                 |
|---|------------------------------|----------|-----------------|--------------------|----------|-----------------|
|   | 2006                         |          |                 | 2005               |          |                 |
|   | Average<br>Balance           | Interest | Average<br>Rate | Average<br>Balance | Interest | Average<br>Rate |
|   | (dollars in thousands)       |          |                 |                    |          |                 |
| <b>ASSETS</b>                                   |                              |          |                 |                    |          |                 |
| Loans and leases                                | \$1,684,700                  | \$33,261 | 7.83%           | \$1,460,792        | \$24,570 | 6.67%           |
| Securities                                      | 191,160                      | 2,631    | 5.51            | 177,539            | 2,395    | 5.40            |
| Federal funds sold                              | 5,750                        | 76       | 5.17            | 8,274              | 76       | 3.58            |
| Short-term investments                          | 262                          | 3        | 5.15            | 689                | 5        | 2.68            |
|   | -----                        | -----    |                 | -----              | -----    |                 |
| Total interest-earning<br>assets                | 1,881,872                    | 35,971   | 7.58            | 1,647,294          | 27,046   | 6.51            |
| Allowance for loan and<br>lease losses          | (21,697)                     |          |                 | (19,343)           |          |                 |
| Other assets                                    | 124,024                      |          |                 | 112,252            |          |                 |
|   | -----                        |          |                 | -----              |          |                 |
| Total assets                                    | \$1,984,199                  |          |                 | \$1,740,203        |          |                 |
|   | =====                        |          |                 | =====              |          |                 |
| <b>LIABILITIES AND<br/>SHAREHOLDERS' EQUITY</b> |                              |          |                 |                    |          |                 |
| Interest-bearing deposits                       | \$1,453,005                  | \$17,268 | 4.72%           | \$1,224,483        | \$10,554 | 3.42%           |
| Short-term borrowings                           | 71,652                       | 707      | 3.91            | 64,970             | 475      | 2.90            |
| FHLB advances                                   | 123,206                      | 1,452    | 4.61            | 137,120            | 1,148    | 3.28            |
| Long-term borrowings                            | 36,004                       | 701      | 7.72            | 35,110             | 515      | 5.82            |
|   | -----                        | -----    |                 | -----              | -----    |                 |
| Total interest-bearing<br>liabilities           | 1,683,867                    | 20,128   | 4.74            | 1,461,683          | 12,692   | 3.44            |
| Noninterest-bearing<br>deposits                 | 116,609                      |          |                 | 115,003            |          |                 |
| Other liabilities                               | 19,163                       |          |                 | 12,977             |          |                 |
| Shareholders' equity                            | 164,560                      |          |                 | 150,540            |          |                 |
|   | -----                        |          |                 | -----              |          |                 |
| Total liabilities and<br>shareholders' equity   | \$1,984,199                  |          |                 | \$1,740,203        |          |                 |
|   | =====                        |          |                 | =====              |          |                 |
| Net interest income                             |                              | \$15,843 |                 |                    | \$14,354 |                 |
|   |                              | =====    |                 |                    | =====    |                 |
| Net interest rate spread                        |                              |          | 2.84%           |                    |          | 3.07%           |
|   |                              |          | =====           |                    |          | =====           |

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|   |               |               |
|---|---------------|---------------|
| Net interest rate spread<br>on average assets | 3.17%<br>==== | 3.27%<br>==== |
| Net interest margin on<br>earning assets      | 3.34%<br>==== | 3.46%<br>==== |

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MERCANTILE BANK CORPORATION

Provisions to the allowance during the third quarter of 2006 were \$1.4 million, an increase of 50.8% over the \$0.9 million that was expensed during the third quarter of 2005. Provisions to the allowance during the first nine months of 2006 were \$4.1 million, an increase of 61.7% over the \$2.5 million that was expensed during the same time period in 2005. The increase during both time periods primarily reflects the higher volume of net loan and lease charge-offs. Net loan and lease charge-offs of \$0.9 million were recorded during the third quarter of 2006, compared to net loan and lease charge-offs of \$0.2 million during the third quarter of 2005. During the first nine months of 2006, net loan and lease charge-offs totaled \$2.7 million, compared to net loan and lease charge-offs of \$0.8 million during the same time period in 2005. The allowance, as a percentage of total loans outstanding, was 1.28% as of September 30, 2006, compared to 1.31% at September 30, 2005.

In each accounting period, the allowance is adjusted to the amount believed necessary to maintain the allowance at adequate levels. Through the loan review and credit departments, we attempt to allocate specific portions of the allowance based on specifically identifiable problem loans and leases. The evaluation of the allowance is further based on, although not limited to, consideration of the internally prepared Allowance Analysis, composition of the loan and lease portfolio, third party analysis of the loan administration processes and loan portfolio and general economic conditions. In addition, the rapid growth of the loan and lease portfolio is taken into account.

The Allowance Analysis, used since the inception of our bank and completed monthly, applies reserve allocation factors to outstanding loan and lease balances to calculate an overall allowance dollar amount. For commercial loans and leases, which continue to comprise a vast majority of our loan and lease portfolio, reserve allocation factors are based upon the loan ratings as determined by our loan rating paradigm that is administered by our loan review function. For retail loans, reserve allocation factors are based upon the type of credit. Adjustments for specific loan relationships, including impaired loans, are made on a case-by-case basis. The reserve allocation factors are based on the experience of senior management making similar loans in the same community over almost 20 years. The Allowance Analysis is reviewed regularly by senior management and the Board of Directors and is adjusted periodically based upon identifiable trends and experience.

Noninterest income during the third quarter of 2006 was \$1.36 million, an increase of 2.4% over the \$1.33 million earned during the third quarter of 2005. Noninterest income during the first nine months of 2006 was \$3.88 million, an increase of 3.2% over the \$3.76 million earned during the same time period in 2005. Service charge income on deposits and repurchase agreements decreased \$8,000 (2.2%) during the third quarter of 2006 when compared to the third quarter of 2005, and declined \$42,000 (4.0%) during the first nine months of 2006 when compared to the same time period during 2005, primarily reflecting an

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increase in the earnings credit rate on noninterest-bearing checking accounts which was only partially offset by an increase in new accounts opened during the last twelve months. During both time periods, we recorded increased fee income in virtually all other major fee income categories.

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Noninterest expense during the third quarter of 2006 was \$8.0 million, a decrease of 3.5% from the \$8.3 million expensed during the third quarter of 2005. Noninterest expense during the first nine months of 2006 was \$24.1 million, an increase of 7.8% over the \$22.3 million expensed during the same time period in 2005. Employee salary and benefit expenses were \$0.3 million lower during the third quarter of 2006 than the level expensed during the third quarter of 2005, but were \$0.6 million higher during the first nine months of 2006 than the level expensed during the first nine months of 2005. The decline in the quarter-over-quarter comparison and the increase in the year-to-date-over-year-to-date comparison primarily reflect increased costs from the hiring of additional staff and merit annual pay increases but lower non-lender bonus program expenses. The level of full-time equivalent employees increased from 263 at September 30, 2005 to 284 as of September 30, 2006. During the third quarter of 2005 and the first nine months of 2005, we expensed \$0.7 million and \$1.9 million, respectively, for the non-lender bonus program. During the third quarter of 2006 and the first nine months of 2006, no expense was recorded for the non-lender bonus program, primarily reflecting management's assessment of the likelihood of achieving a 15% growth in net income for all of 2006.

Occupancy, furniture and equipment costs increased \$0.1 million during the third quarter of 2006 over the level expensed during the third quarter of 2005, and increased \$1.0 million during the first nine months of 2006 over the level expensed during the first nine months of 2005, primarily reflecting the opening of our new main office during the second quarter of 2005 and the opening of our new leased facilities in Lansing and Ann Arbor during the third quarter of 2005. Other overhead costs decreased \$0.1 million during the third quarter of 2006 over the level expensed during the third quarter of 2005, but increased \$0.2 million during the first nine months of 2006 over the level expensed during the first nine months of 2005. While virtually all major general and administrative costs were up during each of the time periods, the lack of initial start-up costs for the Lansing and Ann Arbor banking offices during the third quarter of 2006 which were present during the third quarter of 2005 more than offset the increase in the other costs during that specific time period. Monitoring and controlling noninterest costs, while at the same time providing high quality service to customers, is a key component to our business strategy. While the dollar volume of noninterest costs has generally consistently increased, the rate of growth has been lower than the rate of increase in net interest income and noninterest income.

Federal income tax expense was \$2.3 million during the third quarter of 2006, an increase of 23.4% over the \$1.9 million expensed during the third quarter of 2005. Federal income tax expense was \$6.8 million during the first nine months of 2006, an increase of 15.0% over the \$5.9 million expensed during the first nine months of 2005. The increases during both time periods primarily results from the increase in net income before federal income tax. Our effective tax rate was approximately 30.9% during the third quarter of 2006 and the first nine months of 2006, compared to approximately 30.6% during the third quarter of 2005 and the first nine months of 2005.

## MERCANTILE BANK CORPORATION

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Evaluating the exposure to changes in interest rates includes assessing both the adequacy of the process used to control interest rate risk and the quantitative level of exposure. Our interest rate risk management process seeks to ensure that appropriate policies, procedures, management information systems and internal 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 our net interest margin during periods of changing market interest rates. The following table depicts our GAP position as of September 30, 2006 (dollars in thousands):

## MERCANTILE BANK CORPORATION

|                                 | Within<br>Three<br>Months<br>----- | Three to<br>Twelve<br>Months<br>----- | One to<br>Five<br>Years<br>----- | After<br>Five<br>Years<br>----- | Total<br>----- |
|---------------------------------|------------------------------------|---------------------------------------|----------------------------------|---------------------------------|----------------|
| Assets:                         |                                    |                                       |                                  |                                 |                |
| Commercial loans and leases (1) | \$871,667                          | \$ 67,884                             | \$589,530                        | \$ 45,183                       | \$1,574,2      |
| Residential real estate loans   | 54,127                             | 3,234                                 | 57,908                           | 13,663                          | 128,9          |
| Consumer loans                  | 1,278                              | 650                                   | 4,557                            | 587                             | 7,0            |

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|  |           |             |            |           |         |
|--|-----------|-------------|------------|-----------|---------|
| Investment securities (2)                    | 8,977     | 2,215       | 34,737     | 149,678   | 195,6   |
| Federal funds sold                           | 16,000    | 0           | 0          | 0         | 16,0    |
| Short-term investments                       | 176       | 0           | 0          | 0         | 1       |
| Allowance for loan and lease losses          | 0         | 0           | 0          | 0         | (21,9   |
| Other assets                                 | 0         | 0           | 0          | 0         | 126,7   |
|  | -----     | -----       | -----      | -----     | -----   |
| Total assets                                 | 952,225   | 73,983      | 686,732    | 209,111   | 2,026,8 |
| Liabilities:                                 |           |             |            |           |         |
| Interest-bearing checking                    | 41,224    | 0           | 0          | 0         | 41,2    |
| Savings                                      | 78,239    | 0           | 0          | 0         | 78,2    |
| Money market accounts                        | 9,565     | 0           | 0          | 0         | 9,5     |
| Time deposits <\$100,000                     | 32,171    | 51,483      | 35,838     | 0         | 119,49  |
| Time deposits \$100,000 and over             | 299,726   | 640,620     | 310,568    | 0         | 1,250,9 |
| Short-term borrowings                        | 74,111    | 0           | 0          | 0         | 74,1    |
| FHLB advances                                | 35,000    | 65,000      | 15,000     | 0         | 115,0   |
| Long-term borrowings                         | 36,137    | 0           | 0          | 0         | 36,1    |
| Noninterest-bearing checking                 | 0         | 0           | 0          | 0         | 115,2   |
| Other liabilities                            | 0         | 0           | 0          | 0         | 19,3    |
|  | -----     | -----       | -----      | -----     | -----   |
| Total liabilities                            | 606,173   | 757,103     | 361,406    | 0         | 1,859,2 |
| Shareholders' equity                         | 0         | 0           | 0          | 0         | 167,5   |
|  | -----     | -----       | -----      | -----     | -----   |
| Total sources of funds                       | 606,173   | 757,103     | 361,406    | 0         | 2,026,8 |
|  | -----     | -----       | -----      | -----     | -----   |
| Net asset (liability) GAP                    | \$346,052 | \$(683,120) | \$325,326  | \$209,111 |         |
|  | =====     | =====       | =====      | =====     |         |
| Cumulative GAP                               | \$346,052 | \$(337,068) | \$(11,742) | \$197,369 |         |
|  | =====     | =====       | =====      | =====     |         |
| Percent of cumulative GAP to<br>total assets | 17.1%     | (16.6)%     | (0.6)%     | 9.7%      |         |
|  | =====     | =====       | =====      | =====     |         |

(1) Floating rate loans that are currently at interest rate floors or ceilings are treated as fixed rate loans and are reflected using maturity date and not next repricing date.

(2) Mortgage-backed securities are categorized by expected final maturities based upon prepayment trends as of September 30, 2006.

The second interest rate risk measurement we use is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, 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 the company's strategies, among other factors.



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We conducted multiple simulations as of September 30, 2006, whereby it was assumed that changes in market interest rates occurred ranging from up 200 basis points to down 200 basis points in equal quarterly instalments over the next twelve months. The following table reflects the suggested impact on our net interest income over the next twelve months, which is well within our policy parameters established to manage and monitor interest rate risk.

| Interest Rate Scenario<br>-----      | Dollar Change In<br>Net Interest Income<br>----- | Percent Change In<br>Net Interest Income<br>----- |
|--------------------------------------|--|---|
| Interest rates down 200 basis points | \$ (3,924,000)                                   | (5.3)%  |
| Interest rates down 100 basis points | (2,966,000)                                      | (4.0)   |
| No change in interest rates          | (2,183,000)                                      | (2.9)   |
| Interest rates up 100 basis points   | 133,000  | 0.2   |
| Interest rates up 200 basis points   | 2,428,000  | 3.3   |

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; economic and competitive conditions; potential changes in lending, investing and deposit gathering strategies; client preferences; and other factors.

#### ITEM 4. CONTROLS AND PROCEDURES

As of September 30, 2006, 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 September 30, 2006. There have been no significant changes in our internal controls over financial reporting during the quarter ended September 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

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## PART II - OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

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

#### ITEM 1A. RISK FACTORS

There have been no material changes in our risk factors from those previously disclosed in our annual report on Form 10-K for the year ended December 31, 2005.

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### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

#### Issuer Purchases of Equity Securities

| Period           | (a) Total Number<br>of Shares<br>Purchased | (b) Average Price<br>Paid Per Share | (c) Total Number of Shares<br>Purchased as Part of<br>Publicly Announced Plans or<br>Programs | (d) Max<br>that May<br>the |
|------------------|--|-------------------------------------|---|----------------------------|
| -----            | -----                                      | -----                               | -----   | -----                      |
| July 1 - 31      | 0  | N/A                                 | 0   |                            |
| August 1 - 31    | 218  | \$39.48                             | 0   |                            |
| September 1 - 30 | 0  | N/A                                 | 0   |                            |
|                  | ---  | -----                               | ---   |                            |
| Total            | 218  | \$39.48                             | 0   |                            |
|                  | ===  | =====                               | ===   |                            |

The shares shown in column (a) above as having been purchased were acquired from one of our employees when they used shares of common stock that they already owned to pay part of the exercise price when exercising stock options issued under our employee stock option plans.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

### ITEM 5. OTHER INFORMATION

Not applicable.

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### ITEM 6. EXHIBITS

| EXHIBIT NO. | EXHIBIT DESCRIPTION   |
|-------------|---|
| -----       | -----   |
| 3.1         | Our Articles of Incorporation are incorporated by reference to Exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2004   |
| 3.2         | Our Amended and Restated Bylaws dated as of January 16, 2003 are incorporated by reference to Exhibit 3.2 of our Registration Statement on Form S-3 (Commission File No. 333-103376) that became effective on February 21, 2003 |
| 31          | Rule 13a-14(a) Certifications   |
| 32.1        | Section 1350 Chief Executive Officer Certification  |

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32.2 Section 1350 Chief Financial Officer Certification

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on November 8, 2006.

MERCANTILE BANK CORPORATION

By: /s/ Gerald R. Johnson, Jr.

-----  
Gerald R. Johnson, Jr.  
Chairman of the Board and Chief  
Executive Officer  
(Principal Executive Officer)

By: /s/ Charles E. Christmas

-----  
Charles E. Christmas  
Senior Vice President, Chief  
Financial Officer and Treasurer  
(Principal Financial and  
Accounting Officer)

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EXHIBIT INDEX

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