



We Believe.

We believe in our customers.

We believe in our communities.

We believe in Michigan.

We believe in the future.

It's no secret that America is in the midst of its worst economy in decades. You can't turn on the TV, open a newspaper or log on to the Internet without experiencing a barrage of financial doom and gloom. You probably know someone who has lost a job or taken a cut in salary. You may be feeling the financial pinch yourself.

Mercantile Bank has not been immune to the effects of this downturn. As a bank heavily invested in the business community, we feel the pain when our customers' sales decrease and their growth is curtailed. In the extreme, businesses can find their ability to repay loans compromised, which directly affects our bottom line.

While we want to acknowledge these challenges in this Report, we also want to express something that seems to be in short supply these days: Optimism.

The economy will recover. The stock market will bounce back. Our home state of Michigan will regain its financial footing. With the support of Mercantile Bank, our customers will help lead the way.



## We Believe in Technology.

In 2009, Mercantile will utilize new technologies to make banking even more convenient. We are introducing MercMobile™, which lets customers use their cell phones to access balance information, pay bills, transfer funds and more. We are also extending our Electronic Check Deposit service to retail customers: Merc@Home™. Deposit allows account holders to scan checks and deposit them online.



## We Believe in Growth.

In 2008, we provided financing to Design 1 Salon and Day Spa, enabling the company to construct a new salon with adjacent retail space. This was Design 1's fourth location in the Grand Rapids market. This project created quality jobs in both the construction and retail sectors.



## We Believe in Home-ownership.

We donated funds to Home Repair Services in 2008. This agency works with lower income homeowners and their families to strengthen and sustain homeownership, and prevent foreclosures.

## 2008 in Review

Like many financial institutions, Mercantile Bank has been greatly impacted by the collapse of the sub-prime lending market.

Mercantile Bank never participated in that business. However, we have certainly felt the fallout – the flood of foreclosures leading from this collapse has eroded both real estate values and family wealth.

Couple this with a state economy that is severely challenged by America's highest unemployment rate and the continuing troubles of Detroit's automakers, and you can see why 2008 was such a challenging year for a Michigan bank. The confluence of financial stresses created a maelstrom of economic woes and the most challenging business conditions in many years.

Still, the second half of 2008 produced some positive signs for us.

While each of the first two quarters of 2008 showed net losses – due to significant additions to our reserve for loan losses – Mercantile Bank returned to profitability in quarters three and four. Our net interest margin expanded during the most recent two quarters from its second-quarter low point. Since the end of the second quarter, we increased quarterly net interest income by \$1.9 million through a combination of margin expansion and earning asset growth.

The provision for loan and lease losses declined from that recorded during the first six months, as the rate of loan downgrades improved slightly during the second half of the year. Loans outstanding rose modestly year over year, another positive development. Also, our loan yields began to stabilize in the fourth quarter, despite falling interest rates, as the result of several pricing initiatives we implemented throughout the year.

Still, there's no denying that 2008 proved to be a deviation from our historical levels of profitability. Our 2008 performance was impacted primarily by declining interest rates that lowered our average net interest margin relative to 2007, and deteriorating asset quality that gave rise to a higher provision for loan and lease losses.

Asset quality remains our major concern and we continue to be relentlessly vigilant in the identification and management of problem assets. We began

# We Believe



Winding through the fall colors of a Michigan forest.



## We Believe in Outreach.

We were the title sponsor for the 2008 Bowling Party held by the United Church Outreach Ministry (UCOM). Many employees also participated in the event, which raised \$6,000. UCOM provided basic material and educational assistance to more than 40,000 Grand Rapids residents last year, 16,000 of them children.



## We Believe in Financial Literacy.

We teach financial basics to people around the state in many different venues.

For instance, our Lansing team has conducted a banking program with Lansing Public Schools for the past three years.

We were awarded the 2008 Michigan Bankers Association Financial Literacy Award for our efforts.

# We Believe



The Lake Michigan shoreline, just minutes from our Holland office.

actively working with our borrowers as soon as our local economy began to show weakness – more than six quarters ago, earlier than many of our banking peers – and we've made significant upgrades to an already strong risk management process. We have worked hard to identify our distressed borrowers and we are now working with them to achieve the best possible result for all stakeholders. Our performance in the second half of 2008 reflects these efforts.

It should be noted that, contrary to media reports that credit has dried up, Mercantile Bank continues to actively seek new loan customers who are positioned to succeed in this challenging environment.

## Enhancing the Customer Experience

We also continue to develop new ways to serve customers, boost customer satisfaction and improve our competitive position. We made a number of moves in the past year that have significantly enhanced the customer experience:

**Free ATM.** All Mercantile deposit customers can now withdraw cash from any ATM, anywhere, absolutely free. Not only do we waive our fee, we reimburse our customers for any fee assessed by another bank. This is a distinct advantage over our competitors, and we intend to fully highlight it in our marketing efforts.

**Executive Banking.** In 2008, we relaunched our popular Executive Banking package with expanded VIP-quality services and tools for managing personal banking needs. Response has been very favorable.

**Merc@Work.** We created a Merc@Work checking account expressly for the employees of our business customers. Employees who direct deposit their payroll checks to this account receive a host of exclusive perks. Direct deposit also benefits employers, so businesses welcome this outreach to their employees.

**Saturday Hours.** Three of our Grand Rapids locations added Saturday hours (9:00 a.m. – noon) in September to better serve our customers and build retail sales opportunities. While many of our business customers bank with us via Internet or courier service, the Saturday hours have been very well received by our ever-growing base of personal customers.



## We Believe in Fun.

Our financial contributions ensured that a number of middle school students could attend Mystic Lake YMCA Camp in Lansing for four fun-filled days in June.



## We Believe in Family.

In May, our Washtenaw team bought food and cooked a meal at the Ann Arbor Ronald McDonald House, which allows families of hospitalized kids to stay close by. There was nearly 100% employee participation, and the team is on the schedule to repeat in 2009.



## We Believe in Healthy Bodies.

The second Wednesday of every month, Grand Rapids employees volunteer to make sandwiches and pack evening meal bags for Kids Food Basket, a hunger relief organization that provides needy children with an evening meal each weekday. In 2008, employees also donated over 1,700 juice boxes and decorated more than 3,000 supper bags.

## Serving the Community

Make no mistake, most of our customers are doing well for themselves even in the midst of this recession. But many in the communities we serve are not. More people are hurting and in need of assistance. More charitable organizations face funding challenges. In response, we intensified our efforts to lend a helping hand in 2008.

On a corporate level, we continued to focus our philanthropy on children and underserved segments of our local communities. They are among the first to feel the effects of economic stress, and they are often ill equipped to deal with it. We consider it both a responsibility and a privilege to make their lives better.

On an individual level, our employees devoted nearly 23,000 hours to community service in 2008 – and almost 66,000 volunteer hours over the past three years. Whether it's organizing fundraising events or mentoring school kids, serving on non-profit Boards or collecting and distributing food for those in need, our employees are always ready to roll up their sleeves and get involved.

You'll read about a few of our 2008 community activities throughout this Report. Keep in mind that this is just a small fraction of the total, and that we'll deliver more of the same in 2009.

## 2009 and Beyond

Unfortunately, there's likely to be more of the same economic distress in 2009, as well. Many difficult months lie ahead, especially for the citizens and businesses of Michigan.

However, while the national media and many economists seem to have given up on Michigan, Mercantile Bank has not. Most of us were born and raised here, and we've been through difficult times before. We see every day the great strength and strong work ethic of Michigan residents. We work every day with some of the country's most innovative entrepreneurs, visionaries who will help transition Michigan to a new, more robust economy.

# We Believe



A portion of the ever-expanding skyline of Grand Rapids, Michigan.



We Believe  
in Healthy  
Minds.

In 2007, we made a five-year financial commitment to network180, Kent County's public mental health system. Our \$30,000 donation in 2008 helped network180 provide care to children, teens, adults, families and seniors who experience mental health or substance abuse problems, or who are living with a developmental disability.



## We Believe in Beauty.

We donated funds to help the West Grand Neighborhood Association repair a series of murals underneath a Grand Rapids highway overpass. The murals accent rain gardens that were planted as part of a neighborhood beautification project.



## We Believe in Hope.

For the fifth straight year, our Holland office sponsored the annual Steak and Burger fundraising dinner held by the Boys and Girls Club of Greater Holland. The Holland team continued to volunteer many hours at the Club, which provides young people with support, guidance and hope for the future.



L-R: Mike Price, Bob Kaminski, Chuck Christmas

Yes, we believe in Michigan. And we believe Mercantile Bank is ideally positioned to help our customers lead the way to an economic recovery. After all, we've always been more than bankers. We serve as trusted business advisors. Our advice and expertise is valued now more than ever, and we look forward to playing an important role in Michigan's recovery.

As a sign of our faith, and a validation of our shareholders' faith in us, a quarterly cash dividend of \$0.04 per share was declared by our Board of Directors on January 8, 2009, and paid on March 10, 2009. This is the company's 25th consecutive quarterly cash dividend payment to shareholders.

We want to thank all of our dedicated and talented employees, and the hard-working members of our Board of Directors, for their efforts in 2008. We also thank the shareholders who continue to stand by us through these challenging times.

**We believe in all of you.**

Michael H. Price  
Chairman  
President  
Chief Executive Officer

Robert B. Kaminski, Jr.  
Executive Vice President  
Chief Operating Officer

Charles E. Christmas  
Senior Vice President  
Chief Financial Officer  
Treasurer

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

FORM 10-K

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

For the fiscal year ended December 31, 2008

or

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

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

Commission file number 000-26719

**MERCANTILE BANK CORPORATION**

(Exact name of registrant as specified in its charter)

**Michigan**

(State or other jurisdiction of incorporation or organization)

**38-3360865**

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

**310 Leonard Street NW, Grand Rapids, Michigan**

(Address of principal executive offices)

**49504**

(Zip Code)

**(616) 406-3000**

(Registrant's telephone number, including area code)

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

Title of each class  
Common Stock

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

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

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

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

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

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

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

Large accelerated filer     
Non-accelerated filer   

Accelerated filer X  
Smaller reporting company   

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

The aggregate value of the common equity held by non-affiliates (persons other than directors and executive officers) of the registrant, computed by reference to the closing price of the common stock as of the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$56.2 million.

As of February 2, 2009, there were issued and outstanding 8,592,730 shares of the registrant's common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the proxy statement for the 2009 annual meeting of shareholders (Portions of Part III).

## PART I

### Item 1. Business.

#### The Company

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

Mercantile Bank Mortgage Company initiated business in October 2000 as a subsidiary of our bank, and was reorganized as Mercantile Bank Mortgage Company, LLC (“our mortgage company”), on January 1, 2004. Mercantile Insurance Center, Inc. (“our insurance company”), a subsidiary of our bank, commenced operations during 2002 to offer insurance products. Mercantile Bank Real Estate Co., L.L.C., (“our real estate company”), a subsidiary of our bank, was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids which serves as our bank’s main office and Mercantile Bank Corporation’s headquarters. Mercantile Bank Capital Trust I (the “Mercantile trust”), a business trust subsidiary, was formed in September 2004 to issue trust preferred securities.

To date we have raised capital from our initial public offering of common stock in October 1997, a public offering of common stock in July 1998, three private placements of common stock during 2001, a public offering of common stock in August 2001 and a public offering of common stock in September 2003. In addition, we raised capital through a public offering of \$16.0 million of trust preferred securities in 1999, which was refinanced as part of a \$32.0 million private placement of trust preferred securities in 2004. Our expenses have generally been paid using the proceeds of the capital sales and dividends from our bank. Our principal source of future operating funds is expected to be dividends from our bank.

We filed an election to become a financial holding company, pursuant to the Bank Holding Company Act, as amended by Title I of the Gramm-Leach-Bliley Act and implementing Federal Reserve Board regulations, which election became effective March 23, 2000.

#### Our Bank

Our bank is a state banking company that operates under the laws of the State of Michigan, pursuant to a charter issued by the Michigan Office of Financial and Insurance Regulation. Our bank’s deposits are insured to the maximum extent permitted by law by the Federal Deposit Insurance Corporation (“FDIC”). Our bank’s primary service area is the Kent and Ottawa County areas of West Michigan, which includes the City of Grand Rapids, the second largest city in the State of Michigan. In addition, our bank opened new offices in the cities of East Lansing and Ann Arbor, Michigan, during 2005, and in Novi, Michigan, during 2007.

Our bank, through its nine offices, provides commercial and retail banking services primarily to small-to medium-sized businesses based in and around the Grand Rapids, Holland, Lansing, Ann Arbor and Oakland County areas. These offices consist of a main office located at 310 Leonard Street NW, Grand Rapids, Michigan, a combination branch and retail loan center located at 4613 Alpine Avenue NW, Comstock Park, Michigan, a combination branch and operations center located at 5610 Byron Center Avenue SW, Wyoming, Michigan, and branches located at 4860 Broadmoor Avenue SE, Kentwood, Michigan, 3156 Knapp Street NE, Grand Rapids, Michigan, 880 East 16<sup>th</sup> Street, Holland, Michigan, 3737 Coolidge Road, East Lansing, Michigan, 325 Eisenhower Parkway, Ann Arbor, Michigan, and 28350 Cabot Drive, Novi, Michigan.

Our bank makes secured and unsecured commercial, construction, mortgage and consumer loans, and accepts checking, savings and time deposits. Our bank owns seven automated teller machines ("ATM"), located at our branch locations in Grand Rapids, Holland and East Lansing, that participate in the MAC, NYCE and PLUS regional network systems, as well as other ATM networks throughout the country. Our bank also enables customers to conduct certain loan and deposit transactions by telephone and personal computer. Courier service is provided to certain commercial customers, and safe deposit facilities are available at our branch locations in Grand Rapids, Holland and East Lansing. Our bank does not have trust powers. In December 2001, our bank entered into a joint brokerage services and marketing agreement with Raymond James Financial Services, Inc. to make available to its customers financial planning, retail brokerage, equity research, insurance and annuities, retirement planning, trust services and estate planning. The joint brokerage services and marketing agreement was terminated during the first quarter 2009.

### **Our Mortgage Company**

Our mortgage company's predecessor, Mercantile Bank Mortgage Company, commenced operations on October 24, 2000, when our bank contributed most of its residential mortgage loan portfolio and participation interests in certain commercial mortgage loans to Mercantile Bank Mortgage Company. On the same date, our bank also transferred its residential mortgage origination function to Mercantile Bank Mortgage Company. On January 1, 2004, Mercantile Bank Mortgage Company was reorganized as Mercantile Bank Mortgage Company, LLC, a limited liability company, which is 99% owned by our bank and 1% owned by our insurance company. The reorganization had no impact on the company's financial position or results of operations. Mortgage loans originated and held by our mortgage company are serviced by our bank pursuant to a servicing agreement.

### **Our Insurance Company**

Our insurance company acquired an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent.

### **Our Real Estate Company**

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

### **The Mercantile Trust**

In 2004, we formed the Mercantile trust, a Delaware business trust. Mercantile trust's business and affairs are conducted by its property trustee, a Delaware trust company, and three individual administrative trustees who are employees and officers of the company. Mercantile trust was established for the purpose of issuing and selling its Series A and Series B trust preferred securities and common securities, and used the proceeds from the sales of those securities to acquire Series A and Series B Floating Rate Notes issued by the company. Substantially all of the net proceeds received by the company from the Series A transaction were used to redeem the trust preferred securities that had been issued by MBWM Capital Trust I in September 1999. We established MBWM Capital Trust I in 1999 to issue the trust preferred securities that were redeemed. Substantially all of the net proceeds received by the company from the Series B transaction were contributed to our bank as capital. The Series A and Series B Floating Rate Notes are categorized on our consolidated financial statements as subordinated debentures. Additional information regarding Mercantile trust is incorporated by reference to "Note 17 – Subordinated Debentures" and "Note 18 – Regulatory Matters" of the Notes to Consolidated Financial Statements included in this Annual Report.

## **Effect of Government Monetary Policies**

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

## **Regulation and Supervision**

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

The Bank Holding Company Act limits the activities of bank holding companies that have not qualified as financial holding companies to banking and the management of banking organizations, and to certain non-banking activities. These non-banking activities include those activities that the Federal Reserve Board found, by order or regulation as of the day prior to enactment of the Gramm-Leach-Bliley Act, to be so closely related to banking as to be a proper incident to banking. These non-banking activities include, among other things: operating a mortgage company, finance company, or factoring company; performing certain data processing operations; providing certain investment and financial advice; acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, nonoperating basis; and providing discount securities brokerage services for customers. With the exception of the activities of our mortgage company discussed above, neither we nor any of our subsidiaries engages in any of the non-banking activities listed above.

In March 2000, our election to become a financial holding company, as permitted by the Bank Holding Company Act, as amended by Title I of the Gramm-Leach-Bliley Act, was accepted by the Federal Reserve Board. In order to continue as a financial holding company, we and our bank must satisfy statutory requirements regarding capitalization, management, and compliance with the Community Reinvestment Act. As a financial holding company, we are permitted to engage in a broader range of activities than are permitted to bank holding companies.

Those expanded activities include any activity which the Federal Reserve Board (in certain instances in consultation with the Department of the Treasury) determines, by order or regulation, to be financial in nature or incidental to such financial activity, or to be complementary to a financial activity and not to pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. Such expanded activities include, among others: insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, or issuing annuities, and acting as principal, agent, or broker for such purposes; providing financial, investment, or economic advisory services, including advising a mutual fund; and underwriting, dealing in, or making a market in securities. Other than the insurance agency activities of our insurance company, neither we nor our subsidiaries presently engage in any of the expanded activities.

Our bank is subject to restrictions imposed by federal law and regulation. Among other things, these restrictions apply to any extension of credit to us or to our other subsidiaries, to investments in stock or other securities that we issue, to the taking of such stock or securities as collateral for loans to any borrower, and to acquisitions of assets or services from, and sales of certain types of assets to, us or our other subsidiaries. Federal law restricts our ability to borrow from our bank by limiting the aggregate amount we may borrow and by requiring that all loans to us be secured in designated amounts by specified forms of collateral.

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

## **Employees**

As of December 31, 2008, we and our bank employed 269 full-time and 71 part-time persons. Management believes that relations with employees are good.

## **Lending Policy**

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

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

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

The Board of Directors has delegated significant lending authority to officers of our bank. The Board of Directors believes this empowerment, supported by our strong credit culture and the significant experience of our commercial lending staff, makes us responsive to our customers. The loan policy currently specifies lending authority for certain officers up to \$5.0 million, and \$10.0 million for our bank's Chairman of the Board and Chief Executive Officer; however, the \$10.0 million lending authority is generally used only in rare circumstances where timing is of the essence. Generally, loan requests exceeding \$2.5 million require approval by the Officers Loan Committee, and loan requests exceeding \$4.0 million, up to the legal lending limit of approximately \$33.6 million, require approval by the Board of Directors. In most circumstances, we apply an in-house lending limit that is significantly less than our bank's legal lending limit.

## **Lending Activity**

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

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Working capital loans are often structured as a line of credit and are reviewed periodically in connection with the borrower's year-end financial reporting. These loans are generally secured by substantially all of the assets of the borrower, and have an interest rate tied to the Mercantile Prime Rate. Loans and leases for machinery and equipment purposes typically have a maturity of three to five years and are fully amortizing, while commercial real estate loans are usually written with a five-year maturity and amortize over a 15 to 20 year period. Commercial loans and leases typically have an interest rate that is fixed to maturity or is tied to the Mercantile Prime Rate.

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

Commercial real estate lending involves more risk than residential lending because loan balances are greater and repayment is dependent upon the borrower's business operations. We attempt to minimize the risks associated with these transactions by generally limiting our commercial real estate lending to owner-operated properties of well-known customers or new customers whose businesses have an established profitable history. In many cases, risk is further reduced by limiting the amount of credit to any one borrower to an amount considerably less than our legal lending limit and avoiding certain types of commercial real estate financings.

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

*Single-Family Residential Real Estate Loans.* Our mortgage company originates single-family residential real estate loans in our market area, usually according to secondary market underwriting standards. Loans not conforming to those standards are made in limited circumstances. Single-family residential real estate loans provide borrowers with a fixed or adjustable interest rate with terms up to 30 years.

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

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

We believe our consumer loans are underwritten carefully, with a strong emphasis on the amount of the down payment, credit quality, employment stability and monthly income of the borrower. These loans are generally repaid on a monthly repayment schedule with the source of repayment tied to the borrower's periodic income. In addition, consumer lending collections are dependent on the borrower's continuing financial stability, and are thus likely to be adversely affected by job loss, illness and personal bankruptcy. In many cases, repossessed collateral for a defaulted consumer loan will not provide an adequate source of repayment of the outstanding loan balance because of depreciation of the underlying collateral.

We believe that the generally higher yields earned on consumer loans compensate for the increased credit risk associated with such loans, and that consumer loans are important to our efforts to serve the credit needs of the communities and customers that we serve.

## **Loan and Lease Portfolio Quality**

We utilize a comprehensive grading system for our commercial loans and leases as well as residential mortgage and consumer loans. All commercial loans and leases are graded on a ten grade rating system. The rating system utilizes standardized grade paradigms that analyze several critical factors such as cash flow, management and collateral coverage. All commercial loans and leases are graded at inception and reviewed at various intervals thereafter. Residential mortgage and consumer loans are graded on a random sampling basis after the loan has been made using a separate standardized grade paradigm that analyzes several critical factors such as debt-to-income and credit and employment histories.

Our independent loan and lease review program is primarily responsible for the administration of the grading system and ensuring adherence to established lending policies and procedures. The loan and lease review program is an integral part of maintaining our strong asset quality culture. The loan and lease review function works closely with senior management, although it functionally reports to the Board of Directors. All commercial loan and lease relationships equal to or exceeding \$1.8 million are formally reviewed every twelve months, with a random sampling performed on credits under \$1.8 million. Our watch list credits are reviewed monthly by our Watch List Committee, which is comprised of personnel from the administration, lending and loan and lease review functions.

Loans and leases are placed in a nonaccrual status when, in our opinion, uncertainty exists as to the ultimate collection of principal and interest. As of December 31, 2008, loans and leases placed in nonaccrual status totaled \$47.9 million, or 2.58% of total loans and leases. As of the same date, loans and leases past due 90 days or more and still accruing interest totaled \$1.4 million, or 0.07% of total loans and leases.

Additional detail and information relative to the loan and lease portfolio is incorporated by reference to Management's Discussion and Analysis of Financial Condition and Results of Operation ("Management's Discussion and Analysis") and Note 3 of the Consolidated Financial Statements in this Annual Report.

## **Allowance for Loan and Lease Losses**

In each accounting period, we adjust the allowance for loan and lease losses ("allowance") to the amount we believe is necessary to maintain the allowance at adequate levels. Through the loan and lease 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, but not limited to, consideration of the internally prepared Reserve Analysis, composition of the loan and lease portfolio, third party analysis of the loan and lease administration processes and portfolio and general economic conditions. In addition, the historical strong commercial loan and lease growth and expansions into new markets are taken into account.

The Reserve Analysis, used since our inception 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 the vast majority of our total loans and leases, reserve allocation factors are based upon the loan ratings as determined by our standardized grade paradigms. For retail loans, reserve allocation factors are based upon the type of credit. Adjustments for specific lending relationships, including impaired loans and leases, are made on a case-by-case basis. The reserve allocation factors are primarily based on the recent levels and historical trends of net loan charge-offs and non-performing assets, the comparison of the recent levels and historical trends of net loan charge-offs and non-performing assets with a customized peer group consisting of ten similarly-sized publicly traded banking organizations conducting business in the states of Michigan, Illinois, Indiana or Ohio, the review and consideration of our loan and lease migration analysis and the experience of senior management making similar loans and leases for an extensive period of time. We regularly review the Reserve Analysis and make adjustments periodically based upon identifiable trends and experience.

We believe that the present allowance is adequate, based on the broad range of considerations listed above.

The primary risks associated with commercial loans and leases are the financial condition of the borrower, the sufficiency of collateral, and lack of timely payment. We have a policy of requesting and reviewing periodic financial statements from our commercial loan and lease customers, and periodically reviewing existence of collateral and its value. The primary risk element that we consider for consumer and residential real estate loans is lack of timely payment. We have a reporting system that monitors past due loans and have adopted policies to pursue our creditor's rights in order to preserve our bank's collateral position.

Additional detail regarding the allowance is incorporated by reference to Management's Discussion and Analysis and Note 3 of the Notes to Consolidated Financial Statements of the Company included in this Annual Report.

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

## **Investments**

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

As a bank holding company, we are also permitted to make portfolio investments in equity securities and to make equity investments in subsidiaries engaged in a variety of non-banking activities, which include real estate-related activities such as community development, real estate appraisals, arranging equity financing for commercial real estate, and owning and operating real estate used substantially by our bank or acquired for its future use. In addition, our bank holding company's qualification as a financial holding company enables us to make equity investments in companies engaged in a broader range of financial activities than we could do without that qualification. Such expanded activities include insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, or issuing annuities, and acting as principal, agent, or broker for such purposes; providing financial, investment, or economic advisory services, including advising a mutual fund; and underwriting, dealing in, or making a market in securities. Our bank holding company has no plans at this time to make directly any of these equity investments at the bank holding company level. Our Board of Directors may, however, alter the investment policy at any time without shareholder approval.

In addition, so long as our bank holding company is qualified as a financial holding company, it would be permitted, as part of the business of underwriting or merchant banking activity and under certain circumstances and procedures, to invest in shares or other ownership interests in, or assets of, companies engaged in non-financial activities. In order to make those investments, our bank holding company would be required (i) to become, or to have an affiliate that is, a registered securities broker or dealer or a registered municipal securities dealer, or (ii) to control both an insurance company predominantly engaged in underwriting life, accident and health, or property and casualty insurance (other than credit insurance) or issuing annuities, and a registered investment adviser that furnishes investment advice to an insurance company. We do not currently have any securities, insurance, or investment advisory affiliates of the required types, nor does our bank holding company have any current plans to make any of the equity investments described in this paragraph.

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

Additional detail and information relative to the securities portfolio is incorporated by reference to Management's Discussion and Analysis and Note 2 of the Notes to Consolidated Financial Statements included in this Annual Report.

### **Competition**

Our primary markets for loans and core deposits are the Grand Rapids, Holland, Lansing, Ann Arbor and Oakland County metropolitan areas. We face substantial competition in all phases of our operations from a variety of different competitors. We compete for deposits, loans and other financial services with numerous Michigan-based and out-of-state banks, savings banks, thrifts, credit unions and other financial institutions as well as from other entities that provide financial services. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Many of our primary competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do, and offer larger branch networks and other services which we do not. Most of these same entities have greater capital resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. Under the Gramm-Leach-Bliley Act, effective March 11, 2000, securities firms and insurance companies that elect to become financial holding companies may acquire banks and other financial institutions. The Gramm-Leach-Bliley Act affects the competitive environment in which we conduct our business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services.

### **Selected Statistical Information**

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

### **Return on Equity and Assets**

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

### **Available Information**

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

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**Item 1A. Risk Factors.**

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

**Difficult market conditions have adversely affected our industry.**

Dramatic declines in the housing market over the past two years, with falling home prices and increasing foreclosures, unemployment and under-employment, have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs, initially of asset-backed securities but spreading to other securities and loans, have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets has adversely affected our business, financial condition and results of operations. Market developments may affect consumer confidence levels and may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for credit losses. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry.

**Current levels of market volatility are unprecedented.**

The capital and credit markets have been experiencing volatility and disruption for more than 12 months. In more recent months, the volatility and disruption have reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without apparent regard to those issuers' underlying financial strength. The current levels of market disruption and volatility have an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

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

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

**The soundness of other financial institutions could adversely affect us.**

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

**There can be no assurance that recently enacted legislation will stabilize the U.S. financial system.**

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the “EESA”). The legislation was the result of a proposal by Treasury Secretary Henry Paulson to the U.S. Congress in response to the financial crisis affecting the banking system, financial markets, and other financial institutions. Among other things, the EESA established the Troubled Asset Relief Program, or TARP. Under TARP, the U.S. Treasury was given the authority, among other things, to purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions and others for the purpose of stabilizing and providing liquidity to the U.S. financial markets. On October 14, 2008, the U.S. Treasury announced a program under the EESA pursuant to which it would make senior preferred stock investments in qualifying financial institutions (the “TARP Capital Purchase Program”). Also on October 14, 2008, the Federal Deposit Insurance Corporation announced the development of a guarantee program under the systemic risk exception to the Federal Deposit Insurance Act pursuant to which the FDIC would, among other things, offer a guarantee of certain financial institution indebtedness in exchange for an insurance premium to be paid to the FDIC by issuing financial institutions (the “FDIC Temporary Liquidity Guarantee Program”). On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the “ARRA”), a further package of economic stimulus measures. In addition, Treasury Secretary Geithner has announced further measures to address the crisis in the financial services sector. There can be no assurance, however, as to the actual impact that the EESA, the ARRA, their respective implementing regulations, the programs of the FDIC or any other governmental agency, or any further legislation, will have on the financial markets. The failure to stabilize the financial markets, and a continuation or worsening of current financial market conditions, could materially and adversely affect our business, financial condition, results of operations, access to credit or the trading price of our common stock.

**The impact on us of recently enacted legislation, in particular the Emergency Economic Stabilization Act of 2008 and its implementing regulations, and actions by the FDIC, cannot be predicted at this time.**

The programs established or to be established under the EESA and TARP or other legislation may have adverse effects upon us. We may face increased regulation of our industry. Compliance with such regulation may increase our costs and limit our ability to pursue business opportunities. Also, participation in specific programs may subject us to additional restrictions. For example, participation in the TARP Capital Purchase Program would limit (without the consent of the U.S. Treasury) our ability to increase our dividend or to repurchase our common stock for so long as any securities issued by us under such program remained outstanding. It would also subject us to additional executive compensation restrictions. The effects of participating or not participating in any such programs, and the extent of our participation in such programs, cannot reliably be determined at this time.

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

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

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

We are and will continue to be dependent upon the services of our management team, including Michael H. Price, Chairman of the Board, President and Chief Executive Officer, and our other senior managers. The loss of Mr. Price, or any of our other senior managers, could have an adverse effect on our growth and performance. We have entered into employment contracts with Mr. Price and two other executive officers. The contracts provide for a three year employment period that is extended for an additional year each year unless a notice is given indicating that the contract will not be extended.

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

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

**Decline in the availability of out-of-area deposits could cause liquidity or interest rate margin concerns, or limit our growth.**

We have utilized and expect to continue to utilize out-of-area or wholesale deposits to support our asset growth. These deposits are generally a lower cost source of funds when compared to the interest rates that we would have to offer in our local markets to generate a commensurate level of funds. In addition, the overhead costs associated with wholesale deposits are considerably less than the overhead costs we would incur to obtain and administer a similar level of local deposits. A decline in the availability of these wholesale deposits would require us to fund our growth with more costly funding sources, which could reduce our net interest margin, limit our growth, reduce our asset size, or increase our overhead costs. Wholesale deposits include deposits obtained through brokers. If a bank is not well capitalized, regulatory approval is required to accept brokered deposits.

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

In many situations, our Board of Directors has the authority, without any vote of our shareholders, to issue shares of our authorized but unissued preferred or common stock, including shares authorized and unissued under our Stock Incentive Plan of 2006. In the future, we may issue additional securities, through public or private offerings, in order to raise additional capital. Any such issuance would dilute the percentage of ownership interest of existing shareholders and may dilute the per share book value of the common stock. In addition, option holders under our stock-based incentive plans may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

**Our growth and expansion may be limited by many factors.**

Our primary growth strategy has been to grow internally by increasing our business in the western Michigan area, and more recently in the Lansing, Ann Arbor and Oakland County areas of Michigan. We are also considering other areas in which we may expand our business. This internal growth strategy depends in large part on generating an increasing level of loans and deposits at acceptable risk and interest rate levels without commensurate increases in non-interest expenses. There can be no assurance that we will be successful in continuing our growth strategy due to delays and other impediments resulting from regulatory oversight, limited availability of qualified personnel and favorable and cost effective branch sites, and management time, capital, and expenses required to develop new branch sites and markets. In addition, the success of our growth strategy will depend on maintaining sufficient regulatory capital levels and on adequate economic conditions in our market areas.

In addition, although we have no current plans to do so, we may acquire banks, related businesses or branches of other financial institutions that we believe provide a strategic fit with our business. To the extent that we grow through acquisitions, we cannot assure you that we will be able to adequately or profitably manage this growth. Acquiring other banks, businesses, or branches involves risks commonly associated with acquisitions, including exposure to unknown or contingent liabilities and asset quality issues, difficulty and expense of integrating the operations and personnel, potential disruption to our business including the diversion of management's time and attention, and the possible loss of key employees and customers.

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

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. We compete for deposits, loans and other financial services with numerous Michigan-based and out-of-state banks, thrifts, credit unions and other financial institutions as well as other entities that provide financial services, including securities firms and mutual funds. Some of the financial institutions and financial service organizations with which we compete are not subject to the same degree of regulation as we are. Most of our competitors have been in business for many years, have established customer bases, are larger, have substantially higher lending limits than we do and offer branch networks and other services which we do not, including trust and international banking services. Most of these entities have greater capital and other resources than we do, which, among other things, may allow them to price their services at levels more favorable to the customer and to provide larger credit facilities than we do. This competition may limit our growth or earnings. Under the Gramm-Leach-Bliley Act of 1999, effective March 11, 2000, securities firms and insurance companies that elect to become financial holding companies may acquire banks and other financial institutions. The Gramm-Leach-Bliley Act affects the competitive environment in which we conduct business. The financial services industry is also likely to become more competitive as further technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.

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

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

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

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

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

Our Articles of Incorporation and By-laws, and the corporate laws of the State of Michigan, include provisions which are designed to provide our Board of Directors with time to consider whether a hostile takeover offer is in our and our shareholders' best interest. These provisions, however, could discourage potential acquisition proposals and could delay or prevent a change in control. The provisions also could diminish the opportunities for a holder of our common stock to participate in tender offers, including tender offers at a price above the then-current market price for our common stock. These provisions could also prevent transactions in which our shareholders might otherwise receive a premium for their shares over then-current market prices, and may limit the ability of our shareholders to approve transactions that they may deem to be in their best interests.

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

**There is a limited trading market for our common stock.**

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

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

We have paid a quarterly cash dividend each quarter beginning with the first quarter of 2003. While we expect to continue paying cash dividends, there is no assurance that we will continue to do so.

### **Our business is subject to operational risks.**

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

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

### **Item 1B. Unresolved Staff Comments**

We have received no written comments regarding our periodic or current reports from the staff of the Securities and Exchange Commission that were issued 180 days or more before the end of our 2008 fiscal year and that remain unresolved.

### **Item 2. Properties.**

During 2005, our bank placed into service a new four-story facility located approximately two miles north from the center of downtown Grand Rapids. This facility serves as our headquarters and our bank's main office, and houses the administration function, our bank's commercial lending and review function, our bank's loan operations function, a full service branch, and portions of our bank's retail lending and business development function. The facility consists of approximately 55,000 square feet of usable space and contains multiple drive-through lanes with ample parking. The land and building are owned by our real estate company. The address of this facility is 310 Leonard Street NW, Grand Rapids, Michigan.

Our bank designed and constructed a full service branch and retail loan facility which opened in July of 1999 in Alpine Township, a northwest suburb of Grand Rapids. The facility is one story and has approximately 8,000 square feet of usable space. The land and building are owned by our bank. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 4613 Alpine Avenue NW, Comstock Park, Michigan.

During 2001, our bank designed and constructed two facilities on a 4-acre parcel of land located in the City of Wyoming, a southwest suburb of Grand Rapids. The land had been purchased by our bank in 2000. The larger of the two buildings is a full service branch and deposit operations facility which opened in September of 2001. The facility is two-stories and has approximately 25,000 square feet of usable space. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 5610 Byron Center Avenue SW, Wyoming, Michigan. The other building is a single-story facility with approximately 11,000 square feet of usable space. Our bank's accounting, audit, loss prevention and wire transfer functions are housed in this building, which underwent a renovation in 2005 that almost doubled its size. The address of this facility is 5650 Byron Center Avenue SW, Wyoming, Michigan.

During 2002, our bank designed and constructed a full service branch which opened in December of 2002 in the City of Kentwood, a southeast suburb of Grand Rapids. The land had been purchased by our bank in 2001. The facility is one story and has approximately 10,000 square feet of usable space. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 4860 Broadmoor Avenue SW, Kentwood, Michigan.

During 2003, our bank designed and constructed a full service branch in the northeast quadrant of the City of Grand Rapids. The land had been purchased by our bank in 2002. The facility is one story and has approximately 3,500 square feet of usable space. The facility has multiple drive-through lanes and ample parking space. The address of this facility is 3156 Knapp Street NE, Grand Rapids, Michigan.

During 2003, our bank designed and started construction of a new two-story facility located in Holland, Michigan. This facility, which was completed during the fourth quarter of 2004, serves as a full service banking center for the Holland area, including commercial lending, retail lending and a full service branch. The facility, which is owned by our bank, consists of approximately 30,000 square feet of usable space and contains multiple drive-through lanes with ample parking. The address of this facility is 880 East 16<sup>th</sup> Street, Holland, Michigan.

During 2005, our bank opened a branch facility in the City of Ann Arbor, Michigan. The facility is one story and has approximately 10,000 square feet of usable space. The facility is operated under a lease agreement between our bank and a third party, and serves as a full service banking center for the Ann Arbor area, including commercial lending, retail lending and a full service branch. There is ample parking space, but no drive-through lanes. The address of this facility is 325 Eisenhower Parkway, Ann Arbor, Michigan.

During 2006, our bank purchased approximately 3 acres of vacant land and designed and initiated construction of a new three-story facility in East Lansing, Michigan. This facility was completed during the second quarter of 2007, and serves as a full service banking center for the greater Lansing area, including commercial lending, retail lending, and a full service branch. The facility consists of approximately 27,000 square feet of usable space and contains multiple drive-through lanes with ample parking. The address of this facility is 3737 Coolidge Road, East Lansing, Michigan.

During 2007, our bank opened a branch facility in the City of Novi, Michigan. The facility is one story and has approximately 8,600 square feet of usable space. The facility is operated under a lease agreement between our bank and a third party, and serves as a full service banking center for the Oakland County area, including commercial lending, retail lending and a full service branch. There is ample parking space, but no drive-through lanes. The address of this facility is 28350 Cabot Road, Novi, Michigan.

### **Item 3. Legal Proceedings.**

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

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**Item 4. Submission of Matters to a Vote of Security Holders.**

None

**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock is traded on the Nasdaq Global Select Market under the symbol "MBWM". At February 10, 2009, there were 393 record holders of our common stock. In addition, we estimate that there were approximately 4,000 beneficial owners of our common stock who own their shares through brokers or banks.

The following table shows the high and low sales prices for our common stock as reported by the Nasdaq Global Select Market for the periods indicated and the quarterly cash dividends paid by us during those periods. Applicable prices have been adjusted for the 5% stock dividend paid on May 4, 2007.

	<u>High</u>	<u>Low</u>	<u>Dividend</u>
<b>2008</b>			
First Quarter.....	\$ 16.19	\$ 10.19	\$ 0.15
Second Quarter .....	11.40	7.10	0.08
Third Quarter .....	10.09	4.82	0.04
Fourth Quarter .....	9.69	4.00	0.04
<b>2007</b>			
First Quarter.....	\$ 36.62	\$ 29.30	\$ 0.13
Second Quarter .....	31.43	26.59	0.14
Third Quarter .....	27.40	19.86	0.14
Fourth Quarter .....	22.70	14.49	0.14

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

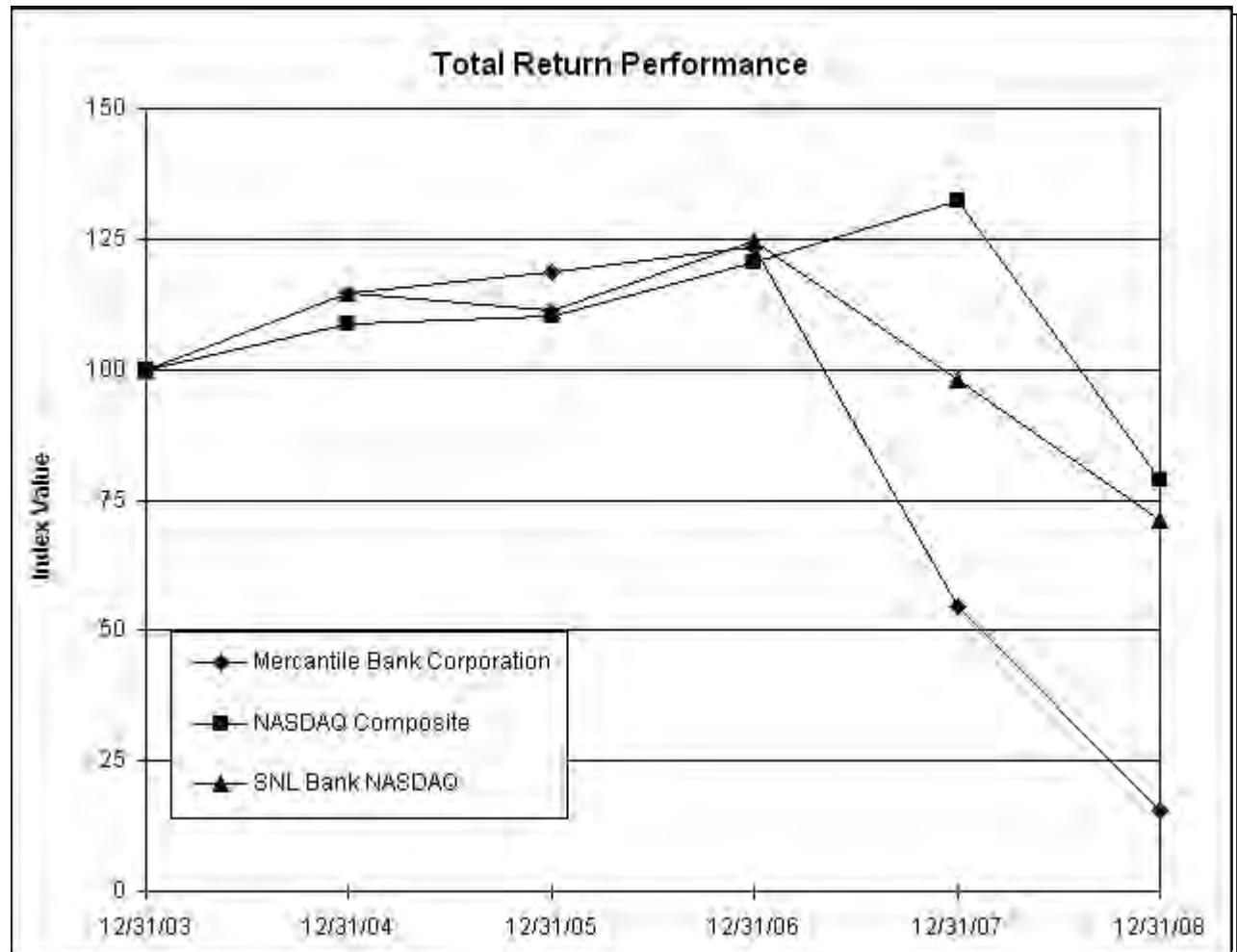
On January 8, 2009, we declared a \$0.04 per share cash dividend on our common stock, payable on March 10, 2009 to record holders as of February 10, 2009. We currently expect to continue to pay a quarterly cash dividend, although there can be no assurance that we will continue to do so.

**Issuer Purchases of Equity Securities**

We did not purchase any shares of our common stock during the fourth quarter of 2008.

## Shareholder Return Performance Graph

Set forth below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on our common stock (based on the last reported sales price of the respective year) with the cumulative total return of the Nasdaq Composite Index and the SNL Nasdaq Bank Index from December 31, 2003 through December 31, 2008. The following is based on an investment of \$100 on December 31, 2003 in our common stock, the Nasdaq Composite Index and the SNL Nasdaq Bank Index, with dividends reinvested where applicable.



Index	Period Ending					
	12/31/03	12/31/04	12/31/05	12/31/06	12/31/07	12/31/08
Mercantile Bank Corporation	100.00	114.78	118.66	123.62	54.67	15.60
NASDAQ Composite	100.00	108.59	110.08	120.56	132.39	78.72
SNL Bank NASDAQ	100.00	114.61	111.12	124.75	97.94	71.13

## Item 6. Selected Financial Data.

The Selected Financial Data on page F-3 in this Annual Report is incorporated here by reference.

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

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

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

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

**Item 8. Financial Statements and Supplementary Data.**

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

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

None

**Item 9A. Controls and Procedures.**

As of December 31, 2008, an evaluation was performed under the supervision of and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of December 31, 2008.

There have been no significant changes in our internal controls over financial reporting during the quarter ended December 31, 2008, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2008. This evaluation was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework in *Internal Control – Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2008. Refer to page F-32 for management's report.

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

**Item 9B. Other Information.**

None

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### **PART III**

#### **Item 10. Directors, Executive Officers and Corporate Governance.**

The information presented under the captions “Election of Directors,” “Executive Officers,” “Section 16(a) Beneficial Ownership Reporting Compliance” and “Corporate Governance – Code of Ethics” in the definitive Proxy Statement of Mercantile for our April 23, 2009 Annual Meeting of Shareholders (the “Proxy Statement”), a copy of which will be filed with the Securities and Exchange Commission before the meeting date, is incorporated here by reference.

We have a separately-designated standing audit committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934. The members of the Audit Committee consist of Betty S. Burton, David M. Cassard, David M. Hecht, Calvin D. Murdock, Merle J. Prins and Timothy O. Schad. The Board of Directors has determined that Messrs. Cassard, Murdock and Schad, members of the Audit Committee, are qualified as audit committee financial experts, as that term is defined in the rules of the Securities and Exchange Commission. Messrs. Cassard, Murdock and Schad are independent, as independence for audit committee members is defined in the Nasdaq listing standards and the rules of the Securities and Exchange Commission.

#### **Item 11. Executive Compensation.**

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

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

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

## Equity Compensation Plan Information

The following table summarizes information, as of December 31, 2008, relating to compensation plans under which equity securities are authorized for issuance.

<u>Plan Category</u>	Number of securities to be issued upon exercise of outstanding options, <u>warrants and rights</u> (a)	Weighted average exercise price of outstanding options, <u>warrants and rights</u> (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders (1)	325,434	\$ 20.49	396,000 (2)
Equity compensation plans not approved by security holders	0	0	0
Total	325,434	\$ 20.49	396,000

(1) These plans are Mercantile's 1997 Employee Stock Option Plan, 2000 Employee Stock Option Plan, 2004 Employee Stock Option Plan, Independent Director Stock Option Plan and the Stock Incentive Plan of 2006.

(2) These securities are available under the Stock Incentive Plan of 2006. Incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards.

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

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

### **Item 14. Principal Accountant Fees and Services.**

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

## PART IV

### Item 15. Exhibits and Financial Statement Schedules

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

Report of Independent Registered Public Accounting Firm dated March 11, 2009 – BDO Seidman, LLP

Report of Independent Registered Public Accounting Firm dated February 20, 2007 – Crowe Horwath LLP

Consolidated Balance Sheets --- December 31, 2008 and 2007

Consolidated Statements of Income for each of the three years in the period ended December 31, 2008

Consolidated Statements of Changes in Shareholders' Equity for each of the three years in the period ended December 31, 2008

Consolidated Statements of Cash Flows for each of the three years in the period ended December 31, 2008

Notes to Consolidated Financial Statements

The consolidated financial statements, the notes to the consolidated financial statements, and the reports of independent registered public accounting firm listed above are incorporated by reference in Item 8 of this report.

#### (2) Financial Statement Schedules

Not applicable

#### (b) Exhibits:

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
3.1	Our Articles of Incorporation are incorporated by reference to exhibit 3.1 of our Form 10-Q for the quarter ended June 30, 2008
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
10.1	Our 1997 Employee Stock Option Plan is incorporated by reference to exhibit 10.1 of our Registration Statement on Form SB-2 (Commission File No. 333-33081) that became effective on October 23, 1997 *
10.2	Our 2000 Employee Stock Option Plan is incorporated by reference to exhibit 10.14 of our Form 10-K for the year ended December 31, 2000 *
10.3	Our 2004 Employee Stock Option Plan is incorporated by reference to exhibit 10.1 of our Form 10-Q for the quarter ended September 30, 2004 *

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
10.4	Form of Stock Option Agreement for options under the 2004 Employee Stock Option Plan is incorporated by reference to exhibit 10.2 of our Form 10-Q for the quarter ended September 30, 2004 *
10.5	Our Independent Director Stock Option Plan is incorporated by reference to exhibit 10.26 of our Form 10-K for the year ended December 31, 2002 *
10.6	Form of Stock Option Agreement for options under the Independent Director Stock Option Plan is incorporated by reference to exhibit 10.1 of our Form 8-K filed October 22, 2004 *
10.7	Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan for Members of the Board of Directors dated June 29, 2006 is incorporated by reference to exhibit 10.9 of our Form 10-K for the year ended December 31, 2007
10.8	First Amendment dated October 25, 2007 to the Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan for Members of the Board of Directors dated June 29, 2006 is incorporated by reference to exhibit 10.10 of our Form 10-K for the year ended December 31, 2007
10.9	Second Amendment dated October 23, 2008 to the Mercantile Bank of Michigan Amended and Restated Deferred Compensation Plan for Members of the Board of Directors dated June 29, 2007
10.10	Agreement between Fiserv Solutions, Inc. and our bank dated September 10, 1997, is incorporated by reference to exhibit 10.3 of our Registration Statement on Form SB-2 (Commission File No. 333-33081) that became effective on October 23, 1997
10.11	Extension Agreement of Data Processing Contract between Fiserv Solutions, Inc. and our bank dated May 12, 2000 extending the agreement between Fiserv Solutions, Inc. and our bank dated September 10, 1997, is incorporated by reference to exhibit 10.15 of our Form 10-K for the year ended December 31, 2000
10.12	Extension Agreement of Data Processing Contract between Fiserv Solutions, Inc. and our bank dated November 21, 2002 extending the agreement between Fiserv Solutions, Inc. and our bank dated September 10, 1997, is incorporated by reference to exhibit 10.5 of our Form 10-K for the year ended December 31, 2002
10.13	Extension Agreement of Data Processing Contract between Fiserv Solutions, Inc. and our bank dated December 20, 2006 extending the agreements between Fiserv Solutions, Inc. and our bank dated September 10, 1997 and November 21, 2002 is incorporated by reference to exhibit 10.14 of our Form 10-K for the year ended December 31, 2007
10.14	Amended and Restated Employment Agreement dated as of October 18, 2001, among the company, our bank and Gerald R. Johnson, Jr., is incorporated by reference to exhibit 10.21 of our Form 10-K for the year ended December 31, 2001 *

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
10.15	Amended and Restated Employment Agreement dated as of October 18, 2001, among the company, our bank and Michael H. Price, is incorporated by reference to exhibit 10.22 of our Form 10-K for the year ended December 31, 2001 *
10.16	Employment Agreement dated as of October 18, 2001, among the company, our bank and Robert B. Kaminski, Jr., is incorporated by reference to exhibit 10.23 of our Form 10-K for the year ended December 31, 2001 *
10.17	Employment Agreement dated as of October 18, 2001, among the company, our bank and Charles E. Christmas, is incorporated by reference to exhibit 10.23 of our Form 10-K for the year ended December 31, 2001 *
10.18	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Gerald R. Johnson, Jr., is incorporated by reference to exhibit 10.21 of our Form 10-K for the year ended December 31, 2002 *
10.19	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Michael H. Price, is incorporated by reference to exhibit 10.22 of our Form 10-K for the year ended December 31, 2002 *
10.20	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Robert B. Kaminski, Jr., is incorporated by reference to exhibit 10.23 of our Form 10-K for the year ended December 31, 2002 *
10.21	Amendment to Employment Agreement dated as of October 17, 2002, among the company, our bank and Charles E. Christmas, is incorporated by reference to exhibit 10.24 of our Form 10-K for the year ended December 31, 2002 *
10.22	Amendment to Employment Agreement dated as of October 28, 2004, among the company, our bank and Robert B. Kaminski, Jr., is incorporated by reference to exhibit 10.21 of our Form 10-K for the year ended December 31, 2004 *
10.23	Junior Subordinated Indenture between us and Wilmington Trust Company dated September 16, 2004 providing for the issuance of the Series A and Series B Floating Rate Junior Subordinated Notes due 2034 is incorporated by reference to exhibit 10.1 of our Form 8-K filed December 15, 2004
10.24	Amended and Restated Trust Agreement dated September 16, 2004 for Mercantile Bank Capital Trust I is incorporated by reference to exhibit 10.2 of our Form 8-K filed December 15, 2004
10.25	Placement Agreement between us, Mercantile Bank Capital Trust I, and SunTrust Capital Markets, Inc. dated September 16, 2004 is incorporated by reference to exhibit 10.3 of our Form 8-K filed December 15, 2004
10.26	Guarantee Agreement dated September 16, 2004 between Mercantile as Guarantor and Wilmington Trust Company as Guarantee Trustee is incorporated by reference to exhibit 10.4 of our Form 8-K filed December 15, 2004
10.27	Form of Agreement Amending Stock Option Agreement, dated November 17, 2005 issued under our 2004 Employee Stock Option Plan, is incorporated by reference to exhibit 10.1 of our Form 8-K filed December 14, 2005 *

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
10.28	Second Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Gerald R. Johnson, Jr. is incorporated by reference to exhibit 10.28 of our Form 10-K for the year ended December 31, 2005 *
10.29	Second Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Michael H. Price is incorporated by reference to exhibit 10.29 of our Form 10-K for the year ended December 31, 2005 *
10.30	Third Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Robert B. Kaminski, Jr. is incorporated by reference to exhibit 10.30 of our Form 10-K for the year ended December 31, 2005 *
10.31	Second Amendment to Employment Agreement dated as of November 17, 2005, among the company, our bank and Charles E. Christmas is incorporated by reference to exhibit 10.31 of our Form 10-K for the year ended December 31, 2005 *
10.32	Form of Mercantile Bank of Michigan Amended and Restated Executive Deferred Compensation Agreement dated November 18, 2006, that has been entered into between our bank and each of Gerald R. Johnson, Jr., Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank is incorporated by reference to exhibit 10.34 of our Form 10-K for the year ended December 31, 2007 *
10.33	Form of First Amendment to the Mercantile Bank of Michigan Executive Deferred Compensation Agreement dated November 18, 2006, that has been entered into between our bank and each of Gerald R. Johnson, Jr., Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank, dated October 25, 2007 is incorporated by reference to exhibit 10.35 of our Form 10-K for the year ended December 31, 2007 *
10.34	Form of Second Amendment to the Mercantile Bank of Michigan Executive Deferred Compensation Agreement date November 18, 2006, that has been entered into between our bank and each of Michael H. Price, Robert B. Kaminski, Charles E. Christmas, and certain other officers of our bank, dated October 23, 2008 *
10.35	Form of Mercantile Bank of Michigan Split Dollar Agreement that has been entered into between our bank and each of Gerald R. Johnson, Jr., Michael H. Price, Robert B. Kaminski, Jr., Charles E. Christmas, and certain other officers of our bank is incorporated by reference to exhibit 10.33 of our Form 10-K for the year ended December 31, 2005 *
10.36	Director Fee Summary *
10.37	Lease Agreement between our bank and The Conlin Company dated July 12, 2005 for our Ann Arbor, Michigan office is incorporated by reference to exhibit 10.36 of our Form 10-K for the year ended December 31, 2005
10.38	Stock Incentive Plan of 2006 is incorporated by reference to Appendix A of our proxy statement for our April 27, 2006 annual meeting of shareholders that was filed with the Securities and Exchange Commission *

<u>EXHIBIT NO.</u>	<u>EXHIBIT DESCRIPTION</u>
10.39	Amendment and Restatement of Stock Incentive Plan of 2006 dated November 18, 2008 *
10.40	Form of Notice of Grant of Incentive Stock Option and Stock Option Agreement for incentive stock options granted in 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.1 of our Form 8-K filed November 22, 2006 *
10.41	Form of Notice of Grant of Incentive Stock Option and Stock Option Agreement for incentive stock options granted after 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.41 of our Form 10-K for the year ended December 31, 2007 *
10.42	Form of Restricted Stock Award Agreement Notification of Award and Terms and Conditions of Award for restricted stock granted in 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.2 of our Form 8-K filed November 22, 2006 *
10.43	Form of Restricted Stock Award Agreement Notification of Award and Terms and Conditions of Award for restricted stock granted after 2006 under our Stock Incentive Plan of 2006 is incorporated by reference to exhibit 10.43 of our Form 10-K for the year ended December 31, 2007 *
10.44	Executive Officer Bonus Plan for 2007 is incorporated by reference to exhibit 10.1 of our Form 8-K filed January 29, 2007 *
10.45	Retirement Agreement by and among Mercantile Bank Corporation, Mercantile Bank of Michigan and Gerald R. Johnson, Jr. is incorporated by reference to exhibit 10.1 of our Form 8-K filed May 25, 2007 *
10.46	Additional Release of Claims Pursuant to Retirement Agreement Dated May 24, 2007 by and among Mercantile Bank Corporation, Mercantile Bank of Michigan and Gerald R. Johnson, Jr. is incorporated by reference to exhibit 10.1 of our Form 10-Q for the quarter ended September 30, 2007 *
10.47	Mercantile Bank Corporation Employee Stock Purchase Plan of 2002
10.48	Lease Agreement between our bank and CD Partners LLC dated October 2, 2007 for our Oakland County, Michigan office is incorporated by reference to exhibit 10.47 of our Form 10-K for the year ended December 31, 2007
21	Subsidiaries of the company
23.1	Consent of BDO Seidman, LLP
23.2	Consent of Crowe Horwath LLP
31	Rule 13a-14(a) Certifications
32.1	Section 1350 Chief Executive Officer Certification
32.2	Section 1350 Chief Financial Officer Certification

\* Management contract or compensatory plan

(c) Financial Statements Not Included In Annual Report  
Not applicable

**MERCANTILE BANK CORPORATION**

**FINANCIAL INFORMATION**

December 31, 2008 and 2007

MERCANTILE BANK CORPORATION

FINANCIAL INFORMATION  
December 31, 2008 and 2007

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### SELECTED FINANCIAL DATA

(Dollars in thousands except per share data)

#### **Consolidated Results of Operations:**

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Interest income	\$ 121,072	\$ 144,181	\$ 137,260	\$ 102,130	\$ 69,022
Interest expense	<u>74,863</u>	<u>88,624</u>	<u>75,673</u>	<u>46,838</u>	<u>26,595</u>
Net interest income	46,209	55,557	61,587	55,292	42,427
Provision for loan and lease losses	21,200	11,070	5,775	3,790	4,674
Noninterest income	7,282	5,870	5,261	5,661	4,302
Noninterest expense	<u>42,126</u>	<u>38,356</u>	<u>32,262</u>	<u>31,117</u>	<u>23,198</u>
Income (loss) before income tax expense (benefit)	(9,835)	12,001	28,811	26,046	18,857
Income tax expense (benefit)	<u>(4,876)</u>	<u>3,035</u>	<u>8,964</u>	<u>8,145</u>	<u>5,136</u>
Net income (loss)	<u>\$ (4,959)</u>	<u>\$ 8,966</u>	<u>\$ 19,847</u>	<u>\$ 17,901</u>	<u>\$ 13,721</u>

#### **Consolidated Balance Sheet Data:**

Total assets	\$2,208,010	\$2,121,403	\$2,067,268	\$1,838,210	\$1,536,119
Cash and cash equivalents	25,804	29,430	51,380	36,753	20,811
Securities	242,787	211,736	202,419	181,614	152,965
Loans and leases, net of deferred fees	1,856,915	1,799,880	1,745,478	1,561,812	1,317,124
Allowance for loan and lease losses	27,108	25,814	21,411	20,527	17,819
Bank owned life insurance policies	42,462	39,118	30,858	28,071	23,750
Deposits	1,599,575	1,591,181	1,646,903	1,419,352	1,159,181
Securities sold under agreements to repurchase	94,413	97,465	85,472	72,201	56,317
Federal Home Loan Bank advances	270,000	180,000	95,000	130,000	120,000
Subordinated debentures	32,990	32,990	32,990	32,990	32,990
Shareholders' equity	174,372	178,155	171,915	155,125	141,617

#### **Consolidated Financial Ratios:**

Return on average assets	(0.23)%	0.43%	1.01%	1.05%	0.99%
Return on average shareholders' equity	(2.87)%	5.10%	12.19%	12.05%	10.16%
Average shareholders' equity to average assets	8.01%	8.44%	8.31%	8.73%	9.79%
Nonperforming loans and leases to total loans and leases	2.66%	1.66%	0.49%	0.26%	0.22%
Allowance for loan and lease losses to total loans and leases	1.46%	1.43%	1.23%	1.31%	1.35%
Tier 1 leverage capital	9.17%	9.97%	10.04%	10.45%	11.53%
Tier 1 leverage risk-based capital	9.68%	10.14%	10.37%	10.82%	11.82%
Total risk-based capital	10.93%	11.39%	11.45%	12.00%	13.03%

#### **Per Share Data:**

Net income (loss):					
Basic	\$ (0.59)	\$ 1.06	\$ 2.36	\$ 2.14	\$ 1.65
Diluted	(0.59)	1.06	2.33	2.10	1.61
Book value at end of period	20.29	20.89	21.43	19.46	17.78
Dividends declared	0.31	0.55	0.48	0.39	0.30
Dividend payout ratio	NA	52.16%	20.34%	17.79%	18.60%

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

### **FORWARD-LOOKING STATEMENTS**

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

Future Factors include 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; changes in local real estate values; changes in the national and local economies; and other risk factors described in Item 1A of this Annual Report. These are representative of the Future Factors that could cause a difference between an ultimate actual outcome and a preceding forward-looking statement.

### **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

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

**Allowance For Loan and Lease Losses:** The allowance for loan and lease losses ("allowance") is maintained at a level we believe is adequate to absorb probable incurred losses identified and inherent in the loan and lease portfolio. Our evaluation of the adequacy of the allowance is an estimate based on past loan loss experience, the nature and volume of the loan and lease portfolio, information about specific borrower situations and estimated collateral values and assessments of the impact of current and anticipated economic conditions on the loan and lease portfolio. Allocations of the allowance may be made for specific loans or 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 is likely. The balance of the allowance represents management's best estimate, but significant downturns in circumstances relating to loan and lease quality or economic conditions could result in a requirement for an increased allowance in the future. Likewise, an upturn in loan and lease quality or improved economic conditions may result in a decline in the required allowance in the future. In either instance, unanticipated changes could have a significant impact on operating earnings.

The allowance is increased through a provision charged to operating expense. Uncollectible loans and leases are charged-off through the allowance. Recoveries of loans and leases previously charged-off are added to the allowance. A loan or lease is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan or lease agreement. Impairment is evaluated in aggregate for smaller-balance loans of similar nature such as residential mortgage, consumer and credit card loans, and on an individual loan or lease 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 fair value of estimated future cash flows using the loan's or lease's existing interest 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. Our policy for recognizing income on impaired loans is to accrue interest unless a loan is placed on nonaccrual status. We put loans into nonaccrual status when the full collection of principal and interest is not expected.

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

## **INTRODUCTION**

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

We were incorporated on July 15, 1997 as a bank holding company to establish and own our bank. Our bank, after receiving all necessary regulatory approvals, began operations on December 15, 1997. Our bank has a strong commitment to community banking and offers a wide range of financial products and services, primarily to small- to medium-sized businesses, as well as individuals. Our bank's lending strategy focuses on commercial lending, and, to a lesser extent, residential mortgage and consumer lending. Our bank also offers a broad array of deposit products, including checking, savings, money market, and certificates of deposit, as well as security repurchase agreements. Our primary markets are the Grand Rapids, Holland, Lansing, Ann Arbor and Oakland County areas. Our bank utilizes certificates of deposit from customers located outside of the primary market area to assist in funding the historically strong asset growth our bank has experienced since inception.

We formed a business trust, Mercantile Bank Capital Trust I ("the trust"), in 2004 to issue trust preferred securities. We 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 we report the subordinated debentures issued to the trust as a liability.

Our mortgage company's predecessor, Mercantile Bank Mortgage Company, was formed to increase the profitability and efficiency of our mortgage loan operations. Mercantile Bank Mortgage Company initiated business on October 24, 2000 from our bank's contribution of most of its residential mortgage loan portfolio and participation interests in certain commercial mortgage loans. On the same date, our bank had also transferred its residential mortgage origination function to Mercantile Bank Mortgage Company. On January 1, 2004, Mercantile Bank Mortgage Company was reorganized as Mercantile Bank Mortgage Company, LLC, a limited liability company. Mortgage loans originated and held by our mortgage company are serviced by our bank pursuant to a servicing agreement.

Our insurance company acquired, at nominal cost, an existing shelf insurance agency effective April 15, 2002. An Agency and Institution Agreement was entered into among our insurance company, our bank and Hub International for the purpose of providing programs of mass marketed personal lines of insurance. Insurance product offerings include private passenger automobile, homeowners, personal inland marine, boat owners, recreational vehicle, dwelling fire, umbrella policies, small business and life insurance products, all of which are provided by and written through companies that have appointed Hub International as their agent.

Our real estate company was organized on July 21, 2003, principally to develop, construct and own our facility in downtown Grand Rapids which serves as our bank's main office and Mercantile Bank Corporation's headquarters. Construction was completed during the second quarter of 2005.

## **FINANCIAL CONDITION**

Primarily reflecting weakening and relatively poor economic conditions within our markets during 2008, our asset growth during 2008 was lower than historical levels. Assets increased from \$2,121.4 million on December 31, 2007 to \$2,208.0 million on December 31, 2008. This represents an increase in total assets of \$86.6 million, or 4.1%. Our asset growth during 2007 was also lower than historical levels due to competitive commercial loan pricing and underwriting environments, combined with weakening economic conditions. Asset growth averaged \$288.0 million per year during the period of 2004 through 2006. The increase in total assets during 2008 was primarily comprised of a \$55.7 million increase in net loans and leases and a \$31.1 million increase in securities. The increase in assets was primarily funded by a \$90.0 million increase in Federal Home Loan Bank ("FHLB") advances.

### ***Earning Assets***

Average earning assets equaled 95.4% of average total assets during 2008, compared to 95.0% during 2007, with our asset composition remaining relatively unchanged. The loan and lease portfolio continued to comprise a majority of earning assets, followed by securities and federal funds sold.

Our loan and lease portfolio, which equaled 88.9% of average earnings assets during 2008, is primarily comprised of commercial loans and leases. Commercial loans and leases increased by \$51.1 million during 2008, and at December 31, 2008, totaled \$1,710.3 million, or 92.1% of the total loan and lease portfolio. As was the case during 2007, the growth in our commercial loan and lease portfolio slowed during 2008. The lower level of growth during 2008 primarily reflected the weakening and relatively poor economic conditions within our markets, compared to 2007 when our loan growth was slowed by competitive pricing and underwriting environments and weakening economic conditions within our markets. The competitive pressures, from financial institutions and other entities such as private equity funds, negatively impacted the volume of loans we booked and accelerated the level of loan payoffs. We believe that adhering to prudent underwriting practices, rather than focusing on loan growth, outweighs the resulting lower level of interest income and net income due to the smaller balance of our commercial loan and lease portfolio.

The commercial loan and lease portfolio represents loans to businesses generally located within our market areas. Approximately 70% of the commercial loan and lease portfolio is primarily secured by real estate properties, with the remaining generally secured by other business assets such as accounts receivable, inventory, and equipment. The continued significant concentration of the loan and lease portfolio in commercial loans and leases and the historical strong growth of this portion of our lending business are consistent with our stated strategy of focusing a substantial amount of our efforts on “wholesale” banking. Corporate and business lending continues to be an area of expertise for our senior management team, and our commercial lenders have extensive commercial lending experience, with most having at least ten 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 employees. Our commercial lending business generates the largest portion of local deposits, and is our primary source of demand deposits.

During the latter part of 2007, our loan review function completed a real estate loan project that expanded our traditional loan coding paradigm to provide increased specificity in the categorization of loans secured by real estate. The following table summarizes our loans secured by real estate, excluding residential mortgage loans representing permanent financing to owner occupied dwellings and home equity lines of credit, as of December 31, 2008:

Residential – Vacant Land	\$ 21,374,000
Residential – Land Development	54,055,000
Residential – Construction	16,839,000
Commercial – Vacant Land	29,269,000
Commercial – Land Development	24,629,000
Commercial – Construction NonOwner Occupied	102,464,000
Commercial – Construction Owner Occupied	9,344,000
Commercial – NonOwner Occupied	558,360,000
Commercial – Owner Occupied	<u>370,099,000</u>
Total	<u>\$ 1,186,433,000</u>

Residential mortgage and consumer loans increased in aggregate \$5.9 million during 2008, and at December 31, 2008, totaled \$146.6 million, or 7.9% of the total loan and lease portfolio. Although residential mortgage loan and consumer loan portfolios may increase in future periods, we expect the commercial sector of the lending efforts and resultant assets to remain the dominant loan portfolio category given our wholesale banking strategy.

The following table presents total loans outstanding as of December 31, 2008, according to scheduled repayments of principal on fixed rate loans and repricing frequency on variable rate loans. Floating rate loans that are currently at interest rate ceilings or interest rate floors are treated as fixed rate loans and are reflected using maturity date and not repricing frequency.

	0-1 Year	1-5 Years	After 5 Years	Total
Construction and land development	\$ 183,749,000	\$ 79,285,000	\$ 358,000	\$ 263,392,000
Real estate – secured by 1-4 family properties	69,079,000	57,214,000	14,483,000	140,776,000
Real estate – secured by multi-family properties	31,107,000	13,784,000	2,474,000	47,365,000
Real estate – secured by nonresidential properties	360,096,000	477,023,000	44,231,000	881,350,000
Commercial	368,926,000	132,709,000	14,566,000	516,201,000
Leases	143,000	1,842,000	0	1,985,000
Consumer	<u>2,447,000</u>	<u>2,808,000</u>	<u>591,000</u>	<u>5,846,000</u>
	<u>\$ 1,015,547,000</u>	<u>\$ 764,665,000</u>	<u>\$ 76,703,000</u>	<u>\$ 1,856,915,000</u>
Fixed rate loans	\$ 318,977,000	\$ 764,422,000	\$ 63,223,000	\$ 1,146,622,000
Floating rate loans	<u>696,570,000</u>	<u>243,000</u>	<u>13,480,000</u>	<u>710,293,000</u>
	<u>\$ 1,015,547,000</u>	<u>\$ 764,665,000</u>	<u>\$ 76,703,000</u>	<u>\$ 1,856,915,000</u>

Our credit policies establish guidelines to manage credit risk and asset quality. These guidelines include loan review and early identification of problem loans and leases to provide effective loan and lease portfolio administration. The credit policies and procedures are meant to minimize the risk and uncertainties inherent in lending. In following these policies and procedures, we must rely on estimates, appraisals and evaluations of loans and leases and the possibility that changes in these could occur quickly because of changing economic conditions. Identified problem loans and leases, which exhibit characteristics (financial or otherwise) that could cause the loans and leases to become nonperforming or require restructuring in the future, are included on the internal "watch list." Senior management and the Board of Directors review this list regularly.

The level of net loan and lease charge-offs and nonperforming assets has increased during the past two years. Although we were never directly involved in the underwriting of or the investing in subprime residential real estate loans, the apparent substantial and rapid collapse of this line of business during 2007 and 2008 throughout the United States had a significant negative impact on the residential real estate development lending portion of our business. The resulting decline in real estate prices and slowdown in sales stretched the cash flow of our local developers and eroded the value of our underlying collateral, causing elevated levels of nonperforming assets and net loan and lease charge-offs.

As of December 31, 2007, nonperforming assets totaled \$35.7 million, or 1.68% of total assets, an increase from the \$9.6 million, or 0.46% of total assets, as of December 31, 2006. Nonperforming loans and leases totaled \$29.8 million and foreclosed properties/repossessed assets equaled \$5.9 million at year-end 2007, compared to \$8.6 million and \$1.0 million, respectively, at year-end 2006. As of December 31, 2007, nonperforming loans secured by real estate, combined with all foreclosed properties, totaled \$28.6 million, or 80% of total nonperforming assets. Nonperforming loans and foreclosed properties associated with the development of residential real estate totaled \$11.1 million, with another \$3.2 million in nonperforming loans secured by, and foreclosed properties consisting of, residential properties. Net loan and lease charge-offs during 2007 totaled \$6.7 million, or 0.38% of average total loans and leases. During 2006, net loan and lease charge-offs totaled \$4.9 million, or 0.29% of average total loans and leases.

During the first quarter of 2008, we experienced a sudden and rapid deterioration in a number of commercial loan relationships which previously had been performing fairly well. An analysis of certain commercial borrowers revealed a reduced capability on the part of these borrowers to make required payments as indicated by factors such as delinquent loan payments, diminished cash flow, deteriorating financial performance, or past due property taxes, and in the case of commercial and residential development projects slow absorption or sales trends. In addition, commercial real estate is the primary source of collateral for many of these borrowing relationships and updated evaluations and appraisals in many cases reflected significant declines from the original estimated values.

During the second quarter of 2008, we found that the financial performance of some of our borrowers and guarantors had become increasingly strained, as real estate remained unsold or insufficiently leased and liquid sources of repayment were exhausted or significantly depleted. Completed evaluations and appraisals during this period reflected substantial declines from the originally estimated values, and in some cases even in comparison to property value estimates made within the past several quarters.

While we continued to face a distressed operating environment during the third quarter of 2008, we experienced a marked slowdown in borrowing relationships that deteriorated to nonperforming status. In addition, we saw notable improvement in a number of larger commercial loan relationships. Although we experienced a small net increase in the level of nonperforming assets during the third quarter, the rate of increase was considerably lower than over the past few quarters.

During the fourth quarter of 2008, we saw a continuation of the stresses caused by the weakening and poor economic conditions, especially in the commercial real estate markets. High vacancy rates or slow absorption has resulted in inadequate cash flow generated from some real estate projects we have financed, and has required guarantors to provide personal funds to make full contractual loan payments and pay other operating costs. In some cases, the guarantors' cash reserves have become seriously diminished, not only from recent cash outlays but from depressed stock portfolios as well. In addition, auto industry uncertainties are placing stress on the commercial and industrial segment of our loan portfolio.

As of December 31, 2008, nonperforming assets totaled \$57.4 million, or 2.60% of total assets, an increase from the \$35.7 million, or 1.68% of total assets, as of December 31, 2007. Nonperforming loans and leases totaled \$49.3 million and foreclosed properties/repossessed assets equaled \$8.1 million at year-end 2008, compared to \$29.8 million and \$5.9 million, respectively, at year-end 2007. As of December 31, 2008, nonperforming loans secured by real estate, combined with all foreclosed properties, totaled \$52.3 million, or about 91% of total nonperforming assets. Nonperforming loans and foreclosed properties associated with the development of residential real estate totaled \$25.3 million, with another \$4.2 million in nonperforming loans secured by, and foreclosed properties consisting of, residential properties. Net loan and lease charge-offs during 2008 totaled \$19.9 million, or 1.09% of average total loans and leases. During 2007, net loan and lease charge-offs totaled \$6.7 million, or 0.38% of average total loans and leases. The increase in net loan and lease charge-offs during 2008 primarily reflects a combination of a higher level of nonperforming assets and the significant decline in property values.

The following table provides a breakdown of nonperforming assets as of December 31, 2008 and net loan charge-offs during 2008 by property type:

	<u>Nonperforming Assets</u>	<u>Net Loan Charge-Offs</u>
Residential – Land Development	\$ 14,273,000	\$ 2,624,000
Residential – Construction	11,040,000	604,000
Residential – Owner Occupied / Rental	4,160,000	2,850,000
Commercial – Land Development	2,234,000	1,599,000
Commercial – Owner Occupied	6,495,000	789,000
Commercial – NonOwner Occupied	14,055,000	5,710,000
Commercial – NonReal Estate	5,134,000	5,688,000
Consumer – NonReal Estate	<u>30,000</u>	<u>42,000</u>
Total	<u>\$ 57,421,000</u>	<u>\$19,906,000</u>

The following table summarizes nonperforming loans and leases and troubled debt restructurings:

	<u>December 31, 2008</u>	<u>December 31, 2007</u>	<u>December 31, 2006</u>	<u>December 31, 2005</u>	<u>December 31, 2004</u>
Loans and leases on nonaccrual status	\$ 47,945,000	\$ 28,832,000	\$ 7,752,000	\$ 3,601,000	\$ 2,842,000
Loans and leases 90 days or more past due and accruing interest	1,358,000	977,000	819,000	394,000	0
Troubled debt restructurings	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total	<u>\$49,303,000</u>	<u>\$ 29,809,000</u>	<u>\$ 8,571,000</u>	<u>\$ 3,995,000</u>	<u>\$ 2,842,000</u>

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

	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
Loan and leases outstanding at year-end	<u>\$ 1,856,915,000</u>	<u>\$ 1,799,880,000</u>	<u>\$1,745,478,000</u>	<u>\$1,561,812,000</u>	<u>\$1,317,124,000</u>
Daily average balance of loans and leases outstanding	<u>\$ 1,829,686,000</u>	<u>\$ 1,765,465,000</u>	<u>\$1,660,284,000</u>	<u>\$1,432,609,000</u>	<u>\$1,177,568,000</u>
Balance of allowance at beginning of year	\$ 25,814,000	\$ 21,411,000	\$ 20,527,000	\$ 17,819,000	\$ 14,379,000
Loans and leases charged-off:					
Commercial, financial and agricultural	(12,566,000)	(4,232,000)	(5,208,000)	(718,000)	(1,328,000)
Construction and land development	(4,835,000)	(1,353,000)	0	(521,000)	0
Leases	(174,000)	(18,000)	0	0	0
Residential real estate	(2,900,000)	(1,618,000)	(50,000)	(131,000)	(16,000)
Instalment loans to individuals	(119,000)	(53,000)	(131,000)	(22,000)	(61,000)
Total loans and leases charged-off	<u>(20,594,000)</u>	<u>(7,274,000)</u>	<u>(5,389,000)</u>	<u>(1,392,000)</u>	<u>(1,405,000)</u>
Recoveries of previously charged-off loans and leases:					
Commercial, financial and agricultural	597,000	586,000	487,000	298,000	150,000
Construction and land development	8,000	11,000	0	2,000	0
Leases	6,000	0	0	0	0
Residential real estate	51,000	3,000	2,000	6,000	0
Instalment loans to individuals	26,000	7,000	9,000	4,000	21,000
Total recoveries	<u>688,000</u>	<u>607,000</u>	<u>498,000</u>	<u>310,000</u>	<u>171,000</u>
Net charge-offs	(19,906,000)	(6,667,000)	(4,891,000)	(1,082,000)	(1,234,000)
Provision for loan and leases losses	<u>21,200,000</u>	<u>11,070,000</u>	<u>5,775,000</u>	<u>3,790,000</u>	<u>4,674,000</u>
Balance of allowance at year-end	<u>\$ 27,108,000</u>	<u>\$ 25,814,000</u>	<u>\$ 21,411,000</u>	<u>\$ 20,527,000</u>	<u>\$ 17,819,000</u>
Ratio of net charge-offs during the period to average loans and leases outstanding during the period	<u>(1.09%)</u>	<u>(0.38%)</u>	<u>(0.29%)</u>	<u>(0.08%)</u>	<u>(0.10%)</u>
Ratio of allowance to loans and leases outstanding at end of the period	<u>1.46%</u>	<u>1.43%</u>	<u>1.23%</u>	<u>1.31%</u>	<u>1.35%</u>

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at adequate levels. Through the loan and lease review and credit departments, we attempt to establish specific portions of the allowance based on specifically identifiable problem loans and leases. The evaluation of the allowance is further based on, but not limited to, consideration of the internally prepared Reserve Analysis, composition of the loan and lease portfolio, third party analysis of the loan and lease administration processes and portfolio and general economic conditions. In addition, the historically strong commercial loan and lease growth and expansions into new markets are taken into account.

The Reserve Analysis, used since our inception 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 total loans and leases, reserve allocation factors are based upon the loan ratings as determined by our standardized grade paradigms. For retail loans, reserve allocation factors are based upon the type of credit. Adjustments for specific lending relationships, including impaired loans and leases, are made on a case-by-case basis. The reserve allocation factors are primarily based on the recent levels and historical trends of net loan charge-offs and non-performing assets, the comparison of the recent levels and historical trends of net loan charge-offs and non-performing assets with a customized peer group consisting of ten similarly-sized publicly traded banking organizations conducting business in the states of Michigan, Illinois, Indiana or Ohio, the review and consideration of our loan and lease migration analysis and the experience of senior management making similar loans and leases for an extensive period of time. We regularly review the Reserve Analysis and make adjustments periodically based upon identifiable trends and experience.

The following table illustrates the breakdown of the allowance balance to loan type (dollars in thousands) and of the total loan and lease portfolio (in percentages).

	December 31, 2008		December 31, 2007		December 31, 2006		December 31, 2005		December 31, 2004	
	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio	Amount	Loan Portfolio
Commercial, financial and agricultural	\$ 20,170	77.9%	\$ 18,947	77.4%	\$15,706	74.7%	\$16,507	76.9%	\$15,457	79.8%
Construction and land development	5,137	14.1	4,907	14.7	3,975	17.1	2,868	14.5	1,581	10.3
Leases	41	0.1	29	0.1	15	0.1	30	0.1	39	0.2
Residential real estate	1,656	7.6	1,829	7.5	1,591	7.6	1,020	8.2	557	9.3
Instalment loans to individuals	104	0.3	102	0.3	124	0.5	102	0.3	185	0.4
Unallocated	<u>0</u>	<u>0.0</u>	<u>0</u>	<u>0.0</u>	<u>0</u>	<u>0.0</u>	<u>0</u>	<u>0.0</u>	<u>0</u>	<u>0.0</u>
Total	<u><b>\$ 27,108</b></u>	<u><b>100.0%</b></u>	<u><b>\$ 25,814</b></u>	<u><b>100.0%</b></u>	<u><b>\$21,411</b></u>	<u><b>100.0%</b></u>	<u><b>\$20,527</b></u>	<u><b>100.0%</b></u>	<u><b>\$17,819</b></u>	<u><b>100.0%</b></u>

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

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

Securities increased \$31.1 million during 2008, from \$211.7 million on December 31, 2007 to \$242.8 million at December 31, 2008. During 2008, the securities portfolio equaled 10.6% of average earning assets. Proceeds from called U.S. Government Agency bonds totaled \$60.0 million during 2008, with another \$8.1 million received from principal paydowns on mortgage-backed securities and \$1.8 million from matured and called tax-exempt municipal securities. The proceeds were invested back into the securities portfolio, with \$40.9 million invested in U.S. Government Agency bonds and \$27.7 million invested in mortgage-backed securities. We also purchased \$27.6 million in bonds issued through the Michigan Strategic Fund during 2008, although we sold \$5.5 million shortly after purchase. These bonds are purchased and sold at par value, and are sellable back to the re-marketing brokerage firm weekly. In addition, FHLB of Indianapolis stock increased \$5.9 million to support the increased level of FHLB advances. We maintain the securities portfolio at levels to provide adequate pledging for the repurchase agreement program and secondary liquidity for our daily operations. In addition, the portfolio serves a primary interest rate risk management function. At December 31, 2008, the portfolio was comprised of high credit quality U.S. Government Agency issued bonds (26%), U.S. Government Agency issued and guaranteed mortgage-backed securities (32%), tax-exempt municipal general obligation and revenue bonds (27%), Michigan Strategic Fund bonds (9%), Federal Home Loan Bank stock (6%) and a mutual fund (less than 1%).

The following table reflects the composition of the securities portfolio, excluding Federal Home Loan Bank stock:

	<u>December 31, 2008</u>		<u>December 31, 2007</u>		<u>December 31, 2006</u>	
	Carrying Value	Percentage	Carrying Value	Percentage	Carrying Value	Percentage
U.S. Government agency debt obligations	\$ 62,382,000	27.5%	\$ 80,945,000	40.1%	\$ 76,836,000	39.4%
Mortgage-backed securities	77,026,000	33.9	54,619,000	27.0	53,083,000	27.2
Municipal general obligations	56,893,000	25.1	57,668,000	28.5	56,870,000	29.2
Municipal revenue bonds	7,544,000	3.3	7,662,000	3.8	7,073,000	3.6
Michigan Strategic Fund bonds	22,105,000	9.7	0	0.0	0	0.0
Mutual fund	<u>1,156,000</u>	<u>0.5</u>	<u>1,109,000</u>	<u>0.6</u>	<u>1,048,000</u>	<u>0.6</u>
Total	<u><u>\$ 227,106,000</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 202,003,000</u></u>	<u><u>100.0%</u></u>	<u><u>\$ 194,910,000</u></u>	<u><u>100.0%</u></u>

All securities, with the exception of tax-exempt municipal bonds, have been designated as "available for sale" as defined in Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Securities designated as available for sale are stated at fair value, with the unrealized gains and losses, net of income tax, reported as a separate component of shareholders' equity in accumulated other comprehensive income. The fair value of securities designated as available for sale at December 31, 2008 and 2007 was \$162.7 million and \$136.7 million, respectively. The net unrealized gain recorded at year-end 2008 was \$3.2 million, compared to a net unrealized gain of \$0.4 million at year-end 2007. All tax-exempt municipal bonds have been designated as "held to maturity" as defined in SFAS No. 115, and are stated at amortized cost. As of December 31, 2008 and 2007, held to maturity securities had an amortized cost of \$64.4 million and \$65.3 million and a fair value of \$65.4 million and \$66.4 million, respectively.

Market values on our U.S. Government Agency bonds, mortgage-backed securities issued or guaranteed by U.S. Government Agencies and tax-exempt municipal securities are determined on a monthly basis with the assistance of a third party vendor. Evaluated pricing models that vary by type of security and incorporate available market data are utilized. Standard inputs include issuer and type of security, benchmark yields, reported trades, broker/dealer quotes and issuer spreads. The market value of other securities is estimated at carrying value as those financial instruments are generally bought and sold at par value. We believe our valuation methodology provides for a reasonable estimation of market value, and that it is consistent with the requirements of SFAS No. 157. Reference is made to Note 15 for additional information.

The following table shows by class of maturities as of December 31, 2008, the amounts and weighted average yields of investment securities <sup>(1)</sup>:

	Carrying Value	Average Yield
U.S. Treasury securities and obligations of U.S.		
Government agencies and corporations		
One year or less	\$ 0	NA
Over one through five years	12,235,000	4.70%
Over five through ten years	17,065,000	5.29
Over ten years	<u>33,082,000</u>	<u>5.33</u>
	62,382,000	5.20
Obligations of states and political subdivisions		
One year or less	1,884,000	6.64
Over one through five years	10,457,000	6.73
Over five through ten years	13,496,000	6.57
Over ten years	<u>38,600,000</u>	<u>6.35</u>
	64,437,000	6.47
Mortgage-backed securities	77,026,000	5.16
Michigan Strategic Fund bonds	22,105,000	2.99
Mutual fund	<u>1,156,000</u>	<u>4.00</u>
	<u>\$ 227,106,000</u>	<u>5.32%</u>

<sup>(1)</sup> Yields on tax-exempt securities are computed on a fully taxable-equivalent basis.

Federal funds sold, consisting of excess funds sold overnight to correspondent banks, are used to manage daily liquidity needs and interest rate sensitivity. During 2008, the average balance of these funds equaled 0.6% of average earning assets, up slightly from 0.4% during 2007. The levels maintained during 2008 and 2007 are well within our internal policy guidelines. Given the volatile market conditions, during the fourth quarter of 2008 we made the decision to operate with a higher than normal balance of federal funds sold. It is expected that we will maintain the higher balance of federal funds sold, likely to average 1.0% to 1.5% of average earning assets, until market conditions return to more normalized levels.

#### ***Non-Earning Assets***

Cash and due from bank balances decreased from \$29.1 million at December 31, 2007, to \$16.8 million on December 31, 2008, a decrease of \$12.3 million. While we experienced only nominal change in our cash balances, our due from bank balances declined significantly primarily due to two programs that were instituted in mid 2007: 1) an image exchange program with our primary correspondent bank for our outgoing cash letter that resulted in faster collection of items in the outgoing cash letter, and 2) the virtual elimination of required reserves on deposit with the Federal Reserve Bank of Chicago due to the institution of a deposit reclassification program. Cash and due from bank balances averaged \$21.0 million, or 1.0% of average assets during 2008, compared to \$33.1 million, or 1.6% of average assets, during 2007.

Net premises and equipment decreased from \$34.3 million at December 31, 2007, to \$32.3 million on December 31, 2008, a decrease of \$2.0 million. Net purchases of premises and equipment during 2008 totaled \$0.7, while depreciation and amortization expense equaled \$2.7 million.

### **Source of Funds**

Our major sources of funds are from deposits, repurchase agreements and FHLB advances. Total deposits increased from \$1,591.2 million at December 31, 2007, to \$1,599.6 million on December 31, 2008, an increase of \$8.4 million. Local deposits decreased from \$666.1 million at year-end 2007, to \$470.4 million at year-end 2008, a decrease of \$195.7 million. Out-of-area deposits increased from \$925.0 million at December 31, 2007, to \$1,129.2 million on December 31, 2008, an increase of \$204.2 million. FHLB advances increased from \$180.0 million at year-end 2007 to \$270.0 million at year-end 2008, while repurchase agreements decreased from \$97.5 million to \$94.4 million, or \$3.1 million, during the same time period. At December 31, 2008, local deposits and repurchase agreements equaled 28.0% of total funding liabilities, compared to 39.8% on December 31, 2007.

We experienced declines in our local deposits throughout 2008, but especially during the latter half of 2008, for a variety of reasons. First, we witnessed local depositors purposely reducing their deposit balances with us, in large part reflecting their concerns over our financial health and that of the entire banking industry, with some larger depositors transferring portions of their deposit balances to one or more other financial institutions. This practice was very pronounced with our municipality and larger business and individual deposit customers. Next, we lost deposit balances due to relatively high certificate of deposit rates offered by some financial institutions located in our markets. While we believe our certificate of deposit rates, which in most cases exceed the rates offered in the brokered deposit markets, are competitive, some financial institutions in our markets were offering certificate of deposit rates that far exceeded our rates, sometimes by as much as 100 basis points. Finally, it appears that the distressed economy is resulting in some of our business customers having lower checking and savings account balances and municipal customers having lower savings and certificate of deposit balances than typical.

Noninterest-bearing checking deposit accounts declined \$22.4 million during 2008, primarily resulting from lower deposit balances from our title company depositors due in large part to lower volumes of real estate transactions. Interest-bearing checking accounts increased \$5.8 million and money market deposit accounts increased \$13.0 million during 2008, the latter primarily reflecting a \$10.0 million deposit from a local municipality. Savings account balances recorded a decrease of \$30.8 million during 2008, while certificates of deposit purchased by customers located within our market areas decreased \$161.4 million. These declines are due to a combination of risk diversification practices on the part of the depositors, higher deposit rates offered by competitors and lower funds available stemming from the distressed economy. One municipal depositor withdrew about \$32.0 million in December of 2008 upon the maturity of a single certificate of deposit, but soon thereafter opened a \$10.0 million money market deposit account and then in January 2009 opened a new \$20.0 million certificate of deposit.

The local deposit environment was very challenging during 2008, and it appears that it will remain that way for at least the next few quarters. Until our operating results and overall financial health improve, as well as that of the entire banking industry, it is very likely that some customers will continue to engage in risk diversification practices. Combined with a distressed economy and a competitive banking environment, our ability to raise local deposits efficiently and economically will be difficult. However, we continue to enjoy deposit relationships with virtually all of our customers who have withdrawn some of their deposits, and we have developed various strategic plans and initiatives to hopefully regain a majority of the lost deposits in future periods. Maintaining and growing our local deposit base is one of our key initiatives.

Certificates of deposit obtained from customers located outside of our market areas increased by \$204.2 million during 2008, and as of December 31, 2008 totaled \$1,129.2 million. The increase primarily reflects the decline in our local deposit base, net of the growth in FHLB advances. Out-of-area deposits consist primarily of certificates of deposit placed by deposit brokers for a fee, but also include certificates of deposit obtained from the deposit owners directly. The owners of the out-of-area deposits include individuals, businesses and governmental units located throughout the United States.

Repurchase agreements decreased \$3.1 million during 2008, and as of December 31, 2008 totaled \$94.4 million. As part of our sweep account program, collected funds from certain business noninterest-bearing checking accounts are invested in overnight interest-bearing repurchase agreements. Such repurchase agreements are not deposit accounts and are not afforded federal deposit insurance.

FHLB advances increased \$90.0 million during 2008, and as of December 31, 2008 totaled \$270.0 million. FHLB 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 at December 31, 2008 totaled \$316.5 million, with availability approximating \$37.0 million.

Shareholders' equity decreased \$3.8 million during 2008. The decrease was primarily attributable to net loss from operations, which totaled \$5.0 million during 2008. Also negatively impacting shareholders' equity during 2008 was the payment of cash dividends, which totaled \$2.6 million. Positively impacting shareholders' equity was unrealized gains for a \$1.8 million, net of tax, adjustment for available for sale securities as defined in SFAS No. 115, and a \$1.2 million, net of tax, change in the fair value of interest rate swaps.

## **RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2008 and 2007**

### ***Summary***

A net loss of \$5.0 million, or \$0.59 per basic and diluted share, was recorded in 2008, compared to net income of \$9.0 million, or \$1.06 per basic and diluted share, generated in 2007. The decline in earnings performance during 2008 from that of 2007 is primarily the result of lower net interest income and a higher provision for loan and lease losses. Net income during 2007 includes a one-time \$1.2 million (\$0.8 million after-tax) expense associated with the financial retirement package for former Chairman and Chief Executive Officer, Gerald R. Johnson Jr., which was recorded in conjunction with Mr. Johnson's retirement effective June 30, 2007. Excluding this one-time expense, net income for 2007 was \$9.8 million, or \$1.16 per basic share and \$1.15 per diluted share.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Return on average assets	(0.23)%	0.43%
Return on average shareholders' equity	(2.87)	5.10
Dividend payout ratio	NA	52.16
Average shareholders' equity to average assets	8.01	8.44

### ***Net Interest Income***

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled \$122.3 million and \$74.9 million during 2008, respectively, providing for net interest income of \$47.4 million. During 2007, interest income and interest expense were \$145.4 million and \$88.6 million, respectively, providing for net interest income of \$56.8 million. In comparing 2008 with 2007, interest income decreased 15.9%, interest expense was down 15.5%, and net interest income decreased 16.4%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The net interest margin declined from 2.87% in 2007 to 2.30% in 2008, a decrease of 19.9%. With approximately 60% of our total loans and leases tied to Prime or LIBOR rates, our earning asset yield in 2008 has been substantially impacted by the steep reduction in market interest rates that began late in the third quarter of 2007. Between mid-September 2007 and late April 2008, the Federal Open Market Committee (“FOMC”) lowered the targeted federal funds rate by a total of 325 basis points. The resulting similar decline in the Prime and LIBOR rates, combined with an increased level of nonperforming assets, a very competitive loan and deposit environment, and a flat to inverted yield curve over an extended period of time, have significantly negatively impacted our yield on earning assets and level of interest income. Our cost of funds also decreased in 2008 compared to 2007 as we paid lower interest rates on our deposits and borrowings; however, due to a significant portion of our interest-bearing liabilities being comprised of fixed rate certificates of deposit and borrowings, our cost of funds declined at a much slower rate than our earning asset yield, resulting in the compressed net interest margin.

The decision by the FOMC to lower the targeted federal funds rate by 50 basis points in early October 2008 placed additional pressure on our yield on earning assets and level of interest income in light of our Prime-based loans repricing downward. Although the FOMC lowered the targeted federal funds rate by another 50 basis points in late October 2008 and an additional 75 basis points in mid-December 2008, we decided to keep the Mercantile Bank Prime Rate unchanged at 4.50%. Virtually all of our prime-based commercial floating rate loans are tied to the Mercantile Bank Prime Rate. Despite the 100 basis point reduction in the targeted federal funds rate in October 2008, deposit rates remained substantially unchanged. The steady deposit rates, combined with an already very low Prime Rate, placed significant pressure on our net interest income and net interest margin, and we believed it was prudent to not lower the Mercantile Bank Prime Rate in association with the FOMC’s 50 basis point reduction in the targeted federal funds rate in late October and the 75 basis point reduction in mid-December.

Our net interest margin, which equaled 2.15% in the second quarter of 2008, has improved over the last six months of 2008, equaling 2.30% and 2.40% in the third and fourth quarters of 2008, respectively. Our implementation of several loan pricing initiatives, including the decision to not lower the Mercantile Prime Rate in association with the two most recent FOMC rate reductions, stabilized our yield on loans and leases in the latter part of 2008. The stabilization of our earning asset yield, which is most influenced by our yield on loans and leases, combined with a reduction in our cost of funds resulting from maturing fixed rate certificates of deposit and borrowings repricing downward in light of decreased market interest rates, resulted in the improved net interest margin. If the interest rate environment stabilizes in 2009, we anticipate that the quarterly net interest margin improvement experienced during the last two quarters of 2008 will continue as we continue to reprice maturing fixed rate liabilities downward.

During the first six months of 2008, we entered into interest rate swaps to convert the variable rate cash flows on certain of our Prime-based commercial loans to a fixed rate of interest. On October 30, 2008, we terminated all of our interest rate swaps. The termination coincides with our decision to not lower the Mercantile Bank Prime Rate in association with the FOMC’s reduction of the targeted federal funds rate by 50 basis points announced on October 29, 2008. During 2008, the net cash flow received from the interest rate swap arrangements contributed \$1.0 million to interest income.

The following table depicts the average balance, interest earned and paid, and weighted average rate of our assets, liabilities and shareholders’ equity during 2008, 2007 and 2006. The subsequent table also depicts the dollar amount of change in interest income and interest expense of interest-earning assets and interest-bearing liabilities, segregated between change due to volume and change due to rate. For tax-exempt investment securities, interest income and yield have been computed on a tax equivalent basis using a marginal tax rate of 35%. As a result, securities interest income was increased by \$1.2 million in each of 2008, 2007 and 2006.

(Dollars in thousands)

	Years ended December 31,									
	2 0 0 8			2 0 0 7			2 0 0 6			
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	
Taxable securities	\$ 147,668	\$ 7,888	5.34%	\$ 141,289	\$ 7,243	5.13%	\$ 128,382	\$ 6,557	5.11%	
Tax-exempt securities	69,857	4,180	5.98	64,122	4,013	6.26	61,949	3,930	6.34	
Total securities	217,525	12,068	5.55	205,411	11,256	5.48	190,331	10,487	5.51	
Loans and leases	1,829,686	110,013	6.01	1,765,465	133,685	7.57	1,660,284	127,470	7.68	
Short-term investments	392	7	1.79	510	20	3.92	320	12	3.75	
Federal funds sold	11,353	204	1.80	8,239	420	5.10	9,745	482	4.95	
Total earning assets	2,058,956	122,292	5.94	1,979,625	145,381	7.34	1,860,680	138,451	7.44	
Allowance for loan and lease losses	(30,184)			(23,157)			(21,464)			
Cash and due from banks	21,004			33,099			38,298			
Other non-earning assets	107,546			94,279			82,419			
Total assets	<u>\$ 2,157,322</u>			<u>\$ 2,083,846</u>			<u>\$ 1,959,933</u>			
Interest-bearing demand deposits	\$ 42,734	\$ 492	1.15%	\$ 37,143	\$ 1,047	2.82%	\$ 36,530	\$ 1,069	2.93%	
Savings deposits	65,091	922	1.42	86,009	2,977	3.46	93,046	3,328	3.58	
Money market accounts	13,948	192	1.38	11,706	359	3.07	10,326	325	3.15	
Time deposits	1,332,071	58,206	4.37	1,385,260	71,838	5.19	1,289,777	60,033	4.65	
Total interest-bearing deposits	1,453,844	59,812	4.11	1,520,118	76,221	5.01	1,429,679	64,755	4.53	
Short-term borrowings	97,313	2,021	2.08	93,307	3,493	3.74	75,885	2,867	3.78	
Federal Home Loan Bank advances	258,939	10,554	4.08	118,904	6,100	5.13	121,932	5,393	4.42	
Long-term borrowings	46,579	2,476	5.32	36,610	2,810	7.68	35,895	2,658	7.40	
Total interest-bearing liabilities	1,856,675	74,863	4.03	1,768,939	88,624	5.01	1,663,391	75,673	4.55	
Demand deposits	108,584			115,172			115,390			
Other liabilities	19,286			23,838			18,371			
Total liabilities	1,984,545			1,907,949			1,797,152			
Average equity	172,777			175,897			162,781			
Total liabilities and equity	<u>\$ 2,157,322</u>			<u>\$ 2,083,846</u>			<u>\$ 1,959,933</u>			
Net interest income	<u>\$ 47,429</u>			<u>\$ 56,757</u>			<u>\$ 62,778</u>			
Rate spread		1.91%								2.89%
Net interest margin		2.30%								3.37%

	Years ended December 31,					
	2008 over 2007			2007 over 2006		
	Total	Volume	Rate	Total	Volume	Rate
<b>Increase (decrease) in interest income</b>						
Taxable securities	\$ 645,000	\$ 334,000	\$ 311,000	\$ 686,000	\$ 662,000	\$ 24,000
Tax exempt securities	167,000	348,000	(181,000)	83,000	136,000	(53,000)
Loans	(23,672,000)	4,713,000	(28,385,000)	6,215,000	7,984,000	(1,769,000)
Short term investments	(13,000)	(4,000)	(9,000)	8,000	7,000	1,000
Federal funds sold	(216,000)	121,000	(337,000)	(62,000)	(76,000)	14,000
Net change in tax-equivalent income	(23,089,000)	5,512,000	(28,601,000)	6,930,000	8,713,000	(1,783,000)
<b>Increase (decrease) in interest expense</b>						
Interest-bearing demand deposits	(555,000)	139,000	(694,000)	(22,000)	18,000	(40,000)
Savings deposits	(2,055,000)	(599,000)	(1,456,000)	(351,000)	(246,000)	(105,000)
Money market accounts	(167,000)	59,000	(226,000)	34,000	43,000	(9,000)
Time deposits	(13,632,000)	(2,673,000)	(10,959,000)	11,805,000	4,644,000	7,161,000
Short term borrowings	(1,472,000)	144,000	(1,616,000)	626,000	652,000	(26,000)
Federal Home Loan Bank advances	4,454,000	5,927,000	(1,473,000)	707,000	(137,000)	844,000
Long term borrowings	(334,000)	655,000	(989,000)	152,000	53,000	99,000
Net change in interest expense	(13,761,000)	3,651,000	(17,412,000)	12,951,000	5,027,000	7,924,000
Net change in tax-equivalent net interest income	<u>\$ 9,328,000</u>	<u>\$ 1,861,000</u>	<u>\$ (11,189,000)</u>	<u>\$ (6,021,000)</u>	<u>\$ 3,686,000</u>	<u>\$ (9,707,000)</u>

Interest income is primarily generated from the loan and lease portfolio, and to a lesser degree, from securities, federal funds sold, and short term investments. Interest income decreased \$23.1 million during 2008 from that earned in 2007, totaling \$122.3 million in 2008 compared to \$145.4 million in the previous year. The decrease is primarily due to the lower interest rate environment and increased level of nonperforming assets during 2008 when compared to 2007, which more than offset the growth in average earning assets year over year. The yield on average earning assets declined from 7.34% in 2007 to 5.94% in 2008.

During 2008, average earning assets increased \$79.4 million, from \$1,979.6 million in 2007 to \$2,059.0 million during 2008. Growth in average total loans and leases, totaling \$64.2 million, comprised 80.9% of the increase in average earning assets during 2008. Interest income generated from the loan and lease portfolio decreased \$23.7 million in 2008 compared to the level earned in 2007; a decline in loan yield from 7.57% in 2007 to 6.01% in 2008 resulted in a \$28.4 million reduction in interest income while growth in the loan and lease portfolio during 2008 resulted in a \$4.7 million increase in interest income. The decrease in the loan and lease portfolio yield is primarily due to a lower interest rate environment during 2008 than in 2007 and an increase in nonperforming loans.

Interest income generated from the securities portfolio increased in 2008 compared to the level earned in 2007 as a result of growth in the portfolio and an increased yield. Average securities increased by \$12.1 million in 2008, increasing from \$205.4 million in 2007 to \$217.5 million in 2008. The growth equated to an increase in interest income of \$0.7 million. The improved yield, which equaled 5.55% in 2008 compared to 5.48% in 2007, resulted in a \$0.1 million increase in interest income. Interest income earned on federal funds sold decreased by \$0.2 million due to a decline in the average rate, which more than offset an increase in the average balance.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree, from repurchase agreements, FHLB advances, and subordinated debentures. Interest expense decreased \$13.7 million during 2008 from that expensed in 2007, totaling \$74.9 million in 2008 compared to \$88.6 million in the previous year. The decline in interest expense is primarily attributable to a decreased cost of funds, which mainly resulted from maturing fixed rate certificates of deposit and borrowings being renewed or replaced at lower interest rates, reflecting the decreased interest rate environment in 2008. Interest-bearing liabilities averaged \$1,856.7 million during 2008, or \$87.8 million higher than the average interest-bearing liabilities of \$1,768.9 million during 2007. This growth resulted in increased interest expense of \$3.7 million. A decline in interest expense of \$17.4 million was recorded during 2008 due to a decreased cost of funds primarily attributable to lower average rates paid on fixed rate certificates of deposit and borrowings. The cost of average interest-bearing liabilities decreased from the 5.01% recorded in 2007 to 4.03% in 2008.

Average certificates of deposit declined \$53.2 million during 2008, which equated to a decrease in interest expense of \$2.7 million. An additional \$10.9 million reduction in interest expense resulted from a decrease in the average rate paid as higher-rate certificates of deposit matured and were either renewed or replaced with lower-costing certificates of deposit throughout 2008. A decline in other average interest-bearing deposit accounts, totaling \$13.1 million, equated to a decrease in interest expense of \$0.4 million, with an additional interest expense reduction of \$2.4 million recorded due to a decrease in the average rate paid during 2008.

Average short-term borrowings, primarily comprised of repurchase agreements and federal funds purchased, increased \$4.0 million during 2008, resulting in increased interest expense of \$0.1 million, while a decrease in the average rate paid during 2008 resulted in a reduction in interest expense of \$1.6 million. Average FHLB advances increased \$140.0 million, equating to an increase in interest expense of \$5.9 million, while a decreased average rate paid on the advances resulted in a \$1.5 million reduction in interest expense. Growth in average long-term borrowings, which is comprised of subordinated debentures, structured repurchase agreements, and deferred director and officer compensation programs, equated to an increase in interest expense of \$0.7 million during 2008, with a decreased average rate reducing interest expense by \$1.0 million.

#### ***Provision for Loan and Lease Losses***

The provision for loan and lease losses totaled \$21.2 million in 2008, compared to the \$11.1 million expensed in 2007. The increase primarily reflects a higher volume of nonperforming loans and leases, increased net loan charge-offs, and other downgrades within our commercial loan and lease portfolio, necessitating a higher allowance balance. Nonperforming loans and leases totaled \$49.3 million, or 2.66% of total loans and leases, as of December 31, 2008, compared to \$29.8 million, or 1.66% of total loans and leases, as of December 31, 2007. Net loan and lease charge-offs during 2008 totaled \$19.9 million, or 1.09% of average total loans and leases. Net loan and lease charge-offs during 2007 totaled \$6.7 million, or 0.38% of average total loans and leases. Loan and lease growth during 2008 equaled \$57.0 million, compared to loan and lease growth of \$54.4 million during 2007. The allowance as a percentage of total loans outstanding as of December 31, 2008 was 1.46%, compared to 1.43% at year-end 2007. Although we believe the allowance is adequate to cover losses as they arise, there can be no assurance that we will not sustain losses in any given period that could be substantial in relation to, or greater than, the size of the allowance.

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at adequate levels. Through the loan and lease 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, but not limited to, consideration of the internally prepared Reserve Analysis, composition of the loan and lease portfolio, third party analysis of the loan and lease administration processes and portfolio and general economic conditions. In addition, the historically strong commercial loan and lease growth and expansions into new markets are taken into account.

The Reserve Analysis, used since our inception 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 total loans and leases, reserve allocation factors are based upon the loan ratings as determined by our standardized grade paradigms. For retail loans, reserve allocation factors are based upon the type of credit. Adjustments for specific lending relationships, including impaired loans and leases, are made on a case-by-case basis. The reserve allocation factors are primarily based on the recent levels and historical trends of net loan charge-offs and non-performing assets, the comparison of the recent levels and historical trends of net loan charge-offs and non-performing assets with a customized peer group consisting of ten similarly-sized publicly traded banking organizations conducting business in the states of Michigan, Illinois, Indiana or Ohio, the review and consideration of our loan and lease migration analysis and the experience of senior management making similar loans and leases for an extensive period of time. We regularly review the Reserve Analysis and make adjustments periodically based upon identifiable trends and experience.

### ***Noninterest Income***

Noninterest income totaled \$7.3 million in 2008, an increase of \$1.4 million from the \$5.9 million earned in 2007. Service charge income on deposits and repurchase agreements increased \$0.4 million during 2008 when compared to 2007, primarily reflecting a decrease in the earnings credit rate and improved collection of overdraft service charges. Earnings from the increased cash surrender value of bank owned life insurance policies, primarily reflecting additional investments during the year and improved yields, increased \$0.5 million in 2008. Residential mortgage banking fees increased \$0.2 million in 2008 due to a higher volume of activity. We recorded increases in virtually all other fee income-producing activities in 2008 when compared to 2007 primarily due to increased volumes.

### ***Noninterest Expense***

Noninterest expense during 2008 totaled \$42.1 million, an increase of \$3.7 million over the \$38.4 million expensed in 2007. Salary expense and benefit costs decreased \$0.4 million in 2008 when compared to 2007. Included in 2007 salary and benefit costs is a one-time \$1.2 million expense associated with the financial retirement package for former Chairman and Chief Executive Officer, Gerald R. Johnson, Jr., in conjunction with Mr. Johnson's retirement effective June 30, 2007. Salary expense and benefit costs increased \$0.8 million in 2008 if this one-time expense is excluded from 2007 salary and benefit costs; the resulting increase primarily reflects annual pay increases and the hiring of additional staff related to our expansion into Oakland County in late 2007. Occupancy, furniture and equipment costs increased \$0.4 million in 2008. Costs associated with the administration and resolution of problem assets, including legal costs, property tax payments, appraisal fees and write-downs on foreclosed properties, totaled \$3.3 million in 2008 compared to \$1.1 million in 2007. FDIC deposit insurance assessments totaled \$1.9 million in 2008 compared to \$0.7 million in 2007. The FDIC issued a final rule in December 2008 that uniformly raised deposit insurance assessment rates for the first quarter of 2009 and indicated that another final rule will be issued in early 2009 that will modify the current deposit insurance assessment methodology. Our 2009 FDIC deposit insurance assessments may increase as a result of these changes in methodology. Other non-interest expenses, in aggregate, increased \$0.3 million in 2008 when compared to 2007, reflecting additional expenditures required to administer an increased asset base.

### ***Federal Income Tax Expense***

During 2008, we recorded a loss before federal income tax of \$9.8 million and a federal income tax benefit of \$5.0 million, compared to net income before federal income tax of \$12.0 million and federal income tax expense of \$3.0 million during 2007. Our effective tax rate for 2008 was (49.6%), compared to 25.3% for 2007. The difference in the effective tax rate primarily reflects the significant difference in income before federal income tax expense (benefit), and the relationship of tax-exempt income to income (loss) before federal income tax expense (benefit).

SFAS No. 109, *Accounting for Income Taxes*, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In accordance with SFAS No. 109, we reviewed our deferred tax assets and determined that no valuation allowance was necessary at year end 2008 or 2007. Despite the loss in 2008 and the challenging economic environment, we are in a cumulative income position, have a history of strong earnings, are well-capitalized, and have cautiously optimistic expectations regarding future taxable income. In making such judgments, significant weight is given to evidence that can be objectively verified. In making decisions regarding any valuation allowance, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors which may impact future operating results. The deferred tax assets will be analyzed quarterly for changes affecting realizability, and there can be no guarantee that a valuation allowance will not be necessary in future periods.

## **RESULTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2007 AND 2006**

### ***Summary***

Net income during 2007 was \$9.0 million, or \$1.06 per basic and diluted share, compared to net income of \$19.8 million, or \$2.36 per basic share and \$2.33 per diluted share, recorded in 2006. The \$10.8 million decline in net income represents a decrease of 54.8%, while diluted earnings per share were down 54.5%. The decline in net income during 2007 from that of 2006 is primarily the result of lower net interest income and a higher provision for loan and lease losses. In addition, net income during 2007 includes a one-time \$1.2 million (\$0.8 million after-tax) expense associated with the financial retirement package for former Chairman and Chief Executive Officer, Gerald R. Johnson Jr., which was recorded in conjunction with Mr. Johnson's retirement effective June 30, 2007. Excluding this one-time expense, net income for 2007 was \$9.8 million, or \$1.16 per basic share and \$1.15 per diluted share.

The following table shows some of the key performance and equity ratios for the years ended December 31, 2007 and 2006:

	<u>2007</u>	<u>2006</u>
Return on average assets	0.43%	1.01%
Return on average shareholders' equity	5.10	12.19
Dividend payout ratio	52.16	20.34
Average shareholders' equity to average assets	8.44	8.31

### ***Net Interest Income***

Net interest income, the difference between revenue generated from earning assets and the interest cost of funding those assets, is our primary source of earnings. Interest income (adjusted for tax-exempt income) and interest expense totaled \$145.4 million and \$88.6 million during 2007, respectively, providing for net interest income of \$56.8 million. During 2006, interest income and interest expense were \$138.5 million and \$75.7 million, respectively, providing for net interest income of \$62.8 million. In comparing 2007 with 2006, interest income increased 5.0%, interest expense was up 17.1% and net interest income decreased 9.6%. The level of net interest income is primarily a function of asset size, as the weighted average interest rate received on earning assets is greater than the weighted average interest cost of funding sources; however, factors such as types and levels of assets and liabilities, interest rate environment, interest rate risk, asset quality, liquidity, and customer behavior also impact net interest income as well as the net interest margin.

The net interest margin declined from 3.37% in 2006 to 2.87% in 2007, a decrease of 14.8%. Our net interest margin during 2005 was 3.50%. Throughout 2005 and during the first half of 2006, our net interest margin was generally on an increasing trend. From June 2004 through June 2006, the FOMC increased the federal funds rate by 25 basis points at 17 consecutive meetings, causing the prime rate to increase from 4.00% in June 2004 to 8.25% in June 2006. Our yield on assets increased significantly during this time period, as the interest rates on over 70% of our total loans and leases were tied to the prime rate. Our cost of funds also increased during this time period, as interest rates paid on our deposits and borrowings increased as well. However, our cost of funds increased at a slower rate than the increase in our yield on assets, with a significant portion of our interest-bearing liabilities comprised of fixed rate certificates of deposit and borrowings, resulting in a lagged increased cost of funds.

From the period of June 2006 through September 2007, the FOMC left the federal funds rate unchanged, resulting in a relatively steady yield on assets. However, our cost of funds continued to increase as maturing fixed rate certificates of deposit and borrowings, which were obtained during lower interest rate environments, were replaced or renewed at higher interest rates, resulting in a declining net interest margin. In September 2007, the FOMC started to aggressively lower the federal funds rate with three interest rate reductions totaling 100 basis points through the end of 2007, causing the prime rate to decline from 8.25% to 7.25%. With about 60% of our total loans and leases tied to the prime rate and a significant portion of our interest-bearing liabilities comprised of fixed rate certificates of deposit and borrowings, our asset yield declined at a much faster rate than our cost of funds, resulting in further compression of our net interest margin.

Also negatively impacting our net interest margin during 2007 was an increase in nonperforming assets, with a higher level of loans on nonaccrual status and a higher balance of foreclosed properties than in previous periods. A very competitive loan and deposit pricing environment, combined with a continuation of a flat to inverted yield curve, also negatively impacted our net interest margin.

Interest income is primarily generated from the loan and lease portfolio, and to a lesser degree from securities, federal funds sold and short term investments. Interest income increased \$6.9 million during 2007 from that earned in 2006, totaling \$145.4 million in 2007 compared to \$138.5 million in the previous year. The increase is primarily due to the growth in earning assets, which more than offset the lower interest rate environment and increased level of nonperforming assets during 2007 when compared to 2006. The yield on average earning assets declined from 7.44% recorded in 2006 to 7.34% in 2007.

During 2007, average earning assets increased \$118.9 million, from \$1,860.7 million in 2006 to \$1,979.6 million during 2007. Growth in average total loans and leases, totaling \$105.2 million, comprised 88.5% of the increase in average earning assets during 2007. Interest income generated from the loan and lease portfolio increased \$6.2 million during 2007 over the level earned in 2006, comprised of an increase of \$8.0 million from the growth in the loan and lease portfolio and a decrease of \$1.8 million due to a decline in the yield earned on the loan portfolio to 7.57% from 7.68%. The decrease in the loan and lease portfolio yield is primarily due to a lower interest rate environment during 2007 than in 2006 and an increase in nonperforming loans.

Growth in the securities portfolio also added to the increase in interest income during 2007 over that of 2006. Average securities increased by \$15.1 million in 2007, increasing from \$190.3 million in 2006 to \$205.4 million in 2007. The growth equated to an increase in interest income of \$0.8 million. The yield earned on the securities portfolio decreased slightly during 2007, from 5.51% to 5.48%. Interest income earned on federal funds sold decreased by \$0.1 million due to a small decline in the average balance during 2007.

Interest expense is primarily generated from interest-bearing deposits, and to a lesser degree from repurchase agreements, FHLB advances and subordinated debentures. Interest expense increased \$12.9 million during 2007 from that expensed in 2006, totaling \$88.6 million in 2007 compared to \$75.7 million in the previous year. The increase in interest expense is primarily attributable to the impact of an increase in interest-bearing liabilities and an increased cost of funds associated with the renewal and replacement of maturing fixed rate certificates of deposit and borrowings in 2007 that were obtained during periods of lower interest rates when compared to the interest rate environment during 2007. Interest-bearing liabilities averaged \$1,768.9 million during 2007, or \$105.5 million higher than the average interest-bearing liabilities of \$1,663.4 million during 2006. This growth resulted in increased interest expense of \$5.0 million. An increase in interest expense of \$7.9 million was recorded during 2007 primarily due to an increased cost of funds primarily attributable to fixed rate certificates of deposit and borrowings. The cost of average interest-bearing liabilities increased from the 4.55% recorded in 2006 to 5.01% in 2007.

Average certificate of deposit growth during 2007 of \$95.5 million equated to an increase in interest expense of \$4.6 million, with an additional \$7.2 million expensed due to the increase in the average rate paid as lower-rate certificates of deposit matured and were either renewed or replaced with higher-costing certificates of deposit throughout 2007. A decline in other average interest-bearing deposit accounts, totaling \$5.0 million, equated to a decrease in interest expense of \$0.2 million, with an additional interest expense reduction of \$0.2 million recorded due to a decrease in the average rate paid during 2007.

Average short term borrowings, comprised of repurchase agreements and federal funds purchased, increased \$17.4 million during 2007, resulting in increased interest expense of \$0.7 million, with a slight reduction in interest expense due to a decrease in the average rate paid during 2007. Average FHLB advances decreased \$3.0 million, equating to a decrease in interest expense of \$0.1 million; however, an increased average rate added \$0.8 million to interest expense. Growth in average long-term borrowings, comprised of subordinated debentures and deferred director and officer compensation programs, equated to an increase in interest expense of less than \$0.1 million during 2007, with an increased average rate adding \$0.1 million to interest expense.

### ***Provision for Loan and Lease Losses***

The provision for loan and lease losses totaled \$11.1 million during 2007, compared to the \$5.8 million expensed during 2006. The increase primarily reflects a higher volume of nonperforming loans and leases and other downgrades within our commercial loan and lease portfolio, necessitating a higher allowance balance. Nonperforming loans and leases totaled \$29.8 million, or 1.66% of total loans and leases, as of December 31, 2007, compared to \$8.6 million, or 0.49% of total loans and leases, as of December 31, 2006. Net loan and lease charge-offs during 2007 totaled \$6.7 million, or 0.38% of average total loans and leases. Net loan and lease charge-offs during 2006 totaled \$4.9 million, or 0.29% of average total loans and leases. Loan and lease growth during 2007 equaled \$54.4 million, compared to loan and lease growth of \$183.7 million during 2006. The allowance as a percentage of total loans outstanding as of December 31, 2007 was 1.43%, compared to 1.23% at year-end 2006.

In each accounting period, we adjust the allowance to the amount we believe is necessary to maintain the allowance at adequate levels. Through the loan and lease 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, but not limited to, consideration of the internally prepared Reserve Analysis, composition of the loan and lease portfolio, third party analysis of the loan and lease administration processes and portfolio and general economic conditions. In addition, the historically strong commercial loan and lease growth and expansions into new markets are taken into account.

### ***Noninterest Income***

Noninterest income totaled \$5.9 million in 2007, an increase of \$0.6 million from the \$5.3 million earned in 2006. Service charge income on deposits and repurchase agreements increased \$0.2 million during 2007 when compared to 2006, reflecting an increase in the number of deposit accounts and modest increases in our fee structure. Earnings from increased cash surrender value of bank owned life insurance policies increased \$0.1 million in 2007, primarily reflecting a higher balance from the purchase of additional policies during the year. We recorded increases in virtually all other fee income-producing activities in 2007 when compared to 2006, with the exception of residential mortgage banking fees, which decreased \$0.1 million due to a lower volume of activity.

### ***Noninterest Expense***

Noninterest expense during 2007 totaled \$38.4 million, an increase of \$6.1 million over the \$32.3 million expensed in 2006. Salary expense and benefit costs increased \$3.9 million in 2007 when compared to 2006. Included in 2007 salary and benefit costs is a one-time \$1.2 million expense associated with the financial retirement package for former Chairman and Chief Executive Officer, Gerald R. Johnson, Jr., in conjunction with Mr. Johnson's retirement effective June 30, 2007. The remainder of the increase in salary and benefit costs during 2007 primarily reflects the increase in full-time equivalent employees from 291 at year-end 2006 to 306 at year-end 2007 and annual pay increases. Occupancy, furniture and equipment costs increased \$0.2 million in 2007. Other non-interest expenses, in aggregate, increased \$2.0 million in 2007 when compared to 2006, reflecting increased costs associated with a higher level of nonperforming assets, higher FDIC insurance premiums and additional expenditures required to administer an increased asset base.

### ***Federal Income Tax Expense***

Federal income tax expense was \$3.0 million in 2007, a decrease of \$6.0 million from the \$9.0 million expensed during 2006. The decrease during 2007 is primarily due to the decline in our pre-federal income tax profitability. Our effective tax rate for 2007 was 25.3%, compared to 31.1% in 2006, reflecting a decrease in taxable income and the related increase in tax-exempt income as a percent of taxable income.

## **CAPITAL RESOURCES**

Shareholders' equity is a noninterest-bearing source of funds that generally provides support for our asset growth. Shareholders' equity was \$174.4 million and \$178.2 million at December 31, 2008 and 2007, respectively. The \$3.8 million decline during 2008 is primarily attributable to net loss from operations, which totaled \$5.0 million. Also negatively impacting shareholders' equity during 2008 was the payment of cash dividends, which totaled \$2.6 million. Positively impacting shareholders' equity was unrealized gains for a \$1.8 million, net of tax, adjustment for available for sale securities as defined in SFAS No. 115, and a \$1.2 million, net of tax, change in the fair value of interest rate swaps.

We and our bank are subject to regulatory capital requirements administered by state and federal banking agencies. Failure to meet the various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements. Our and our bank's capital ratios as of December 31, 2008 and 2007 are disclosed in Note 18 of the Notes to Consolidated Financial Statements.

Our ability to pay cash and stock dividends is subject to limitations under various laws and regulations and to prudent and sound banking practices. During 2008, we paid a cash dividend on our common stock each calendar quarter. However, reflecting our financial results and the poor and weakening economy, we lowered the dollar amount of the cash dividends paid during 2008. During the first quarter of 2008, our cash dividend was \$0.15 per share, but that was lowered to \$0.08 per share during the second quarter and \$0.04 per share during the third and fourth quarters. The reduction of the cash dividends during 2008 had a positive impact on our capital ratios. On January 8, 2009, we declared a \$0.04 per common share cash dividend that will be paid on March 10, 2009 to shareholders of record on February 10, 2009.

## **LIQUIDITY**

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

Our liquidity strategy is to fund loan growth with deposits, repurchase agreements and FHLB 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 historically generally increased, this growth has not been sufficient to meet our historical 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, comprised of certificates of deposit from customers outside of our market areas and advances from the FHLB, totaled \$1,414.2 million, or 71.5% of combined deposits and borrowed funds as of December 31, 2008, compared to \$1,105.0 million, or 58.7% of combined deposits and borrowed funds as of December 31, 2007.

Although local deposits have historically generally increased as new business, municipal governmental unit and individual deposit relationships are established and as existing customers increase the balances in their accounts, the relatively high reliance on wholesale funds will likely remain. As part of our interest rate risk management strategy, a majority of our wholesale funds have a fixed rate and mature within one year, reflecting the fact that a majority of our loans and leases have a floating interest rate tied to either the Prime or LIBOR rates. While this strategy increases inherent liquidity risk, we believe the increased liquidity risk is sufficiently mitigated by the benefits derived from an interest rate risk management standpoint. In addition, we have developed a comprehensive contingency funding plan which we believe further mitigates the increased liquidity risk.

Wholesale funds are generally a lower all-in cost source of funds when compared to the interest rates that would have to be offered in the local markets to generate a commensurate level of funds. Interest rates paid on new out-of-area deposits and FHLB advances have historically been similar to interest rates paid on new certificates of deposit issued to local customers. In addition, the overhead costs associated with wholesale funds are considerably less than the overhead costs that would be incurred to attract and administer a similar level of local deposits, especially if the estimated costs of a needed expanded branching network were taken into account. We believe the relatively low overhead costs reflecting our limited branch network mitigate our high reliance on wholesale funds and resulting relatively low net interest margin.

As a member of the Federal Home Loan Bank of Indianapolis, our bank has access to the FHLB advance borrowing programs. Advances totaled \$270.0 million as of December 31, 2008, compared to \$180.0 million outstanding as of December 31, 2007. Based on available collateral as of December 31, 2008, we could borrow an additional \$37.0 million. Our bank also has the ability to borrow up to \$30.0 million on a daily basis through a correspondent bank using an established unsecured federal funds purchased line. During 2008, our federal funds purchased position averaged \$4.2 million, compared to an average federal funds sold position of \$11.4 million. Given the volatile market conditions, during the fourth quarter of 2008 we made the decision to operate with a higher than normal balance of federal funds sold. It is expected that we will maintain the higher balance of federal funds sold, likely to average 1.0% to 1.5% of average earning assets, until market conditions return to more normalized levels. As a result, we expect the use of our federal funds purchased line of credit, in at least the near future, will be rare, if at all.

During 2008 our bank established a line of credit through the Discount Window of the Federal Reserve Bank of Chicago. Using a substantial majority of our tax-exempt municipal securities as collateral, at year-end 2008 we could have borrowed up to about \$60.0 million for terms of 1 to 28 days, or up to about \$45.0 million for terms of 29 to 90 days. We do not plan to regularly access this line of credit.

The following table reflects, as of December 31, 2008, significant fixed and determinable contractual obligations to third parties by payment date, excluding accrued interest:

	<u>One Year or Less</u>	<u>One to Three Years</u>	<u>Three to Five Years</u>	<u>Over Five Years</u>	<u>Total</u>
Deposits without a stated maturity	\$ 235,789,000	\$ 0	\$ 0	\$ 0	\$ 235,789,000
Certificates of deposits	1,179,405,000	167,415,000	16,966,000	0	1,363,786,000
Short term borrowings	94,413,000	0	0	0	94,413,000
Federal Home Loan Bank advances	70,000,000	150,000,000	50,000,000	0	270,000,000
Subordinated debentures	0	0	0	32,990,000	32,990,000
Other borrowed money	0	15,000,000	0	4,528,000	19,528,000
Operating leases	329,000	432,000	168,000	0	929,000

In addition to normal loan funding and deposit flow, we must maintain liquidity to meet the demands of certain unfunded loan commitments and standby letters of credit. At December 31, 2008, we had a total of \$379.7 million in unfunded loan commitments and \$51.4 million in unfunded standby letters of credit. Of the total unfunded loan commitments, \$368.7 million were commitments available as lines of credit to be drawn at any time as customers' cash needs vary, and \$11.0 million were for loan commitments scheduled to close and become funded within the next twelve months. The level of commitments to make loans has declined significantly when compared to historical level, primarily reflecting relatively poor economic conditions. We monitor fluctuations in loan balances and commitment levels, and include such data in our overall liquidity management.

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

	<u>December 31, 2008</u>	<u>December 31, 2007</u>	<u>December 31, 2006</u>
Commercial unused lines of credit	\$ 323,785,000	\$ 377,493,000	\$ 345,195,000
Unused lines of credit secured by 1-4 family residential properties	30,658,000	33,083,000	29,314,000
Credit card unused lines of credit	9,413,000	9,035,000	8,510,000
Other consumer unused lines of credit	4,881,000	6,910,000	7,197,000
Commitments to make loans	10,959,000	66,196,000	60,850,000
Standby letters of credit	<u>51,439,000</u>	<u>81,292,000</u>	<u>73,241,000</u>
Total	\$ 431,135,000	\$ 574,009,000	\$ 524,307,000

We monitor our liquidity position and funding strategies on an ongoing basis, but recognize that unexpected events, economic or market conditions, reduction in earnings performance, declining capital levels or situations beyond our control could either cause short term or long term liquidity challenges. While we believe it is unlikely that a funding crisis of any significant degree is likely to materialize, we have developed a comprehensive contingency funding plan that provides a framework for meeting both temporary and longer-term liquidity disruptions. Depending on the particular circumstances of a liquidity situation, possible strategies may include obtaining funds via one or a combination of the following sources of funds: established lines of credit at correspondent banks, the FHLB and the Federal Reserve Bank of Chicago, brokered certificate of deposit market, wholesale securities repurchase markets, issuance of term debt, common or preferred stock, or sale of securities or other assets.

## **MARKET RISK ANALYSIS**

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

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

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

The following table depicts our GAP position as of December 31, 2008 (dollars in thousands):

	<u>Within Three Months</u>	<u>Three to Twelve Months</u>	<u>One to Five Years</u>	<u>After Five Years</u>	<u>Total</u>
<b>Assets:</b>					
Commercial loans <sup>(1)</sup>	\$ 731,445	\$ 212,433	\$ 702,801	\$ 61,629	\$ 1,708,308
Leases	23	120	1,842	0	1,985
Residential real estate loans	52,208	16,871	57,214	14,483	140,776
Consumer loans	2,350	97	2,808	591	5,846
Securities <sup>(2)</sup>	38,942	1,884	43,153	158,808	242,787
Federal funds sold	8,950	0	0	0	8,950
Short term investments	100	0	0	0	100
Allowance for loan and lease losses	0	0	0	0	(27,108)
Other assets	0	0	0	0	126,366
<b>Total assets</b>	<b>834,018</b>	<b>231,405</b>	<b>807,818</b>	<b>235,511</b>	<b>2,208,010</b>
<b>Liabilities:</b>					
Interest-bearing checking	50,248	0	0	0	50,248
Savings	49,943	0	0	0	49,943
Money market accounts	24,886	0	0	0	24,886
Time deposits under \$100,000	59,325	82,272	37,342	0	178,939
Time deposits \$100,000 and over	377,341	660,467	147,039	0	1,184,847
Short term borrowings	94,413	0	0	0	94,413
Federal Home Loan Bank advances	15,000	55,000	200,000	0	270,000
Long term borrowings	37,518	0	15,000	0	52,518
Noninterest-bearing checking	0	0	0	0	110,712
Other liabilities	0	0	0	0	17,132
<b>Total liabilities</b>	<b>708,674</b>	<b>797,739</b>	<b>399,381</b>	<b>0</b>	<b>2,033,638</b>
Shareholders' equity	0	0	0	0	174,372
<b>Total sources of funds</b>	<b>708,674</b>	<b>797,739</b>	<b>399,381</b>	<b>0</b>	<b>2,208,010</b>
<b>Net asset (liability) GAP</b>	<b>\$ 125,344</b>	<b>\$ (566,334)</b>	<b>\$ 408,437</b>	<b>\$ 235,511</b>	
<b>Cumulative GAP</b>	<b>\$ 125,344</b>	<b>\$ (440,990)</b>	<b>\$ (32,553)</b>	<b>\$ 202,958</b>	
<b>Percent of cumulative GAP to total assets</b>	<b>5.7%</b>	<b>(20.0)%</b>	<b>(1.5)%</b>	<b>9.2%</b>	

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

<sup>(2)</sup> Mortgage-backed securities are categorized by expected maturities based upon prepayment trends as of December 31, 2008.

The second interest rate risk measurement used is commonly referred to as net interest income simulation analysis. We believe that this methodology provides a more accurate measurement of interest rate risk than the GAP analysis, and therefore, it serves as our primary interest rate risk measurement technique. The simulation model assesses the direction and magnitude of variations in net interest income resulting from potential changes in market interest rates. Key assumptions in the model include prepayment speeds on various loan and investment assets; cash flows and maturities of interest-sensitive assets and liabilities; and changes in market conditions impacting loan and deposit volume and pricing. These assumptions are inherently uncertain, subject to fluctuation and revision in a dynamic environment; therefore, the model cannot precisely estimate net interest income or exactly predict the impact of higher or lower interest rates on net interest income. Actual results will differ from simulated results due to timing, magnitude, and frequency of interest rate changes and changes in market conditions and our strategies, among other factors.

We conducted multiple simulations as of December 31, 2008, in which 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 net interest income over the next twelve months in comparison to estimated net interest income based on our balance sheet structure, including the balances and interest rates associated with our specific loans, securities, deposits and borrowed funds, as of December 31, 2008. The resulting estimates are well within our policy parameters established to manage and monitor interest rate risk.

<u>Interest Rate Scenario</u>	<u>Dollar Change In Net Interest Income</u>	<u>Percent Change In Net Interest Income</u>
Interest rates down 200 basis points	\$ 8,298,000	17.2%
Interest rates down 100 basis points	7,935,000	16.5
No change in interest rates	7,352,000	15.3
Interest rates up 100 basis points	6,260,000	13.0
Interest rates up 200 basis points	6,963,000	14.4

The resulting estimates have been significantly impacted by the current interest rate and economic environment, as adjustments have been made to critical model inputs with regards to traditional interest rate relationships. This is especially important as it relates to floating rate commercial loans and brokered certificates of deposit, which comprise a substantial portion of our balance sheet. As of December 31, 2008, the Mercantile Prime Rate is 4.50% as compared to the Wall Street Journal Prime Rate of 3.25%. Historically, the two indices have been equal; however, we elected not to reduce the Mercantile Prime Rate in late October and mid-December of 2008 when the Wall Street Journal Prime Rate declined by 50 and 75 basis points, respectively. In conducting our simulations at year-end 2008, we have made the assumption that the Mercantile Prime Rate will remain unchanged until the Wall Street Journal Prime Rate exceeds the Mercantile Prime Rate, at which time the two indices will remain equal in the increasing interest rate scenarios. We have also made similar assumptions in regards to our local deposit rates, which in general have not been reduced since the separation of the Mercantile and Wall Street Journal Prime Rate indices. Also, brokered certificate of deposit rates have substantially decreased since December of 2008, with part of the decline attributable to a significant imbalance whereby the supply of available funds far outweighs the demand from banks looking to raise funds. As a result, we have substantially limited further reductions in brokered certificate of deposit rates in the declining interest rate scenarios.

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Mercantile Bank Corporation  
Grand Rapids, Michigan

We have audited the accompanying consolidated balance sheets of Mercantile Bank Corporation as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years ended December 31, 2008 and 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Mercantile Bank Corporation as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years ended December 31, 2008 and 2007 in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Mercantile Bank Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 11, 2009 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP  
BDO Seidman, LLP

Grand Rapids, Michigan  
March 11, 2009

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Mercantile Bank Corporation  
Grand Rapids, Michigan

We have audited the accompanying consolidated statements of income, changes in shareholders' equity and cash flows for the year ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of its operations and its cash flows for the year ended December 31, 2006 in conformity with U.S. generally accepted accounting principles.

/s/ Crowe Horwath LLP  
Crowe Horwath LLP

Grand Rapids, Michigan  
February 20, 2007

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders  
Mercantile Bank Corporation  
Grand Rapids, Michigan

We have audited Mercantile Bank Corporation's internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Mercantile Bank Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report by Mercantile Bank Corporation's Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

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

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

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Mercantile Bank Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Mercantile Bank Corporation as of December 31, 2008 and 2007, and the related consolidated statements of income, changes in shareholders' equity and cash flows for the years ended December 31, 2008 and 2007, and our report dated March 11, 2009 expressed an unqualified opinion thereon.

/s/ BDO Seidman, LLP  
BDO Seidman, LLP

Grand Rapids, Michigan  
March 11, 2009

March 11, 2009

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

Management is responsible for establishing and maintaining an effective system of internal control over financial reporting presented in conformity with generally accepted accounting principles. There are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective system of internal control can provide only reasonable assurance with respect to financial statement preparation.

Management assessed the Company's system of internal control over financial reporting that is designed to produce reliable financial statements in conformity with generally accepted accounting principles as of December 31, 2008. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2008, Mercantile Bank Corporation maintained effective control over financial reporting presented in conformity with generally accepted accounting principles based on those criteria.

The Company's independent auditors have issued an audit report on the effectiveness of the Company's internal control over financial reporting.

Mercantile Bank Corporation

/s/ Michael H. Price  
Michael H. Price  
Chairman of the Board, President and Chief Executive Officer

/s/ Charles E. Christmas  
Charles E. Christmas  
Senior Vice President – Chief Financial Officer and Treasurer

**MERCANTILE BANK CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**  
December 31, 2008 and 2007

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	<u>2008</u>	<u>2007</u>
<b>ASSETS</b>		
Cash and due from banks	\$ 16,754,000	\$ 29,138,000
Short-term investments	100,000	292,000
Federal funds sold	<u>8,950,000</u>	0
Total cash and cash equivalents	25,804,000	29,430,000
Securities available for sale	162,669,000	136,673,000
Securities held to maturity (fair value of \$65,381,000 at December 31, 2008 and \$66,440,000 at December 31, 2007)	64,437,000	65,330,000
Federal Home Loan Bank stock	15,681,000	9,733,000
Loans and leases	1,856,915,000	1,799,880,000
Allowance for loan and lease losses	<u>(27,108,000)</u>	<u>(25,814,000)</u>
Loans and leases, net	1,829,807,000	1,774,066,000
Premises and equipment, net	32,334,000	34,351,000
Bank owned life insurance policies	42,462,000	39,118,000
Accrued interest receivable	8,513,000	9,957,000
Other assets	<u>26,303,000</u>	<u>22,745,000</u>
Total assets	<u>\$2,208,010,000</u>	<u>\$2,121,403,000</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits		
Noninterest-bearing	\$ 110,712,000	\$ 133,056,000
Interest-bearing	<u>1,488,863,000</u>	<u>1,458,125,000</u>
Total	1,599,575,000	1,591,181,000
Securities sold under agreements to repurchase	94,413,000	97,465,000
Federal funds purchased	0	13,800,000
Federal Home Loan Bank advances	270,000,000	180,000,000
Subordinated debentures	32,990,000	32,990,000
Other borrowed money	19,528,000	4,013,000
Accrued interest and other liabilities	<u>17,132,000</u>	<u>23,799,000</u>
Total liabilities	2,033,638,000	1,943,248,000
Shareholders' equity		
Preferred stock, no par value; 1,000,000 shares authorized, none issued	0	0
Common stock, no par value; 20,000,000 shares authorized; 8,593,304 and 8,527,197 shares issued and outstanding at December 31, 2008 and 2007	172,353,000	172,938,000
Retained earnings (deficit)	<u>(1,281,000)</u>	4,948,000
Accumulated other comprehensive income	<u>3,300,000</u>	<u>269,000</u>
Total shareholders' equity	<u>174,372,000</u>	<u>178,155,000</u>
Total liabilities and shareholders' equity	<u>\$2,208,010,000</u>	<u>\$2,121,403,000</u>

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See accompanying notes to consolidated financial statements.

**MERCANTILE BANK CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**  
Years ended December 31, 2008, 2007 and 2006

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	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Interest income</b>			
Loans and leases, including fees	\$ 110,013,000	\$ 133,685,000	\$ 127,470,000
Securities, taxable	7,888,000	7,243,000	6,557,000
Securities, tax-exempt	2,960,000	2,813,000	2,739,000
Federal funds sold	204,000	420,000	482,000
Short-term investments	7,000	20,000	12,000
Total interest income	121,072,000	144,181,000	137,260,000
<b>Interest expense</b>			
Deposits	59,812,000	76,221,000	64,755,000
Short-term borrowings	2,021,000	3,493,000	2,867,000
Federal Home Loan Bank advances	10,554,000	6,100,000	5,393,000
Long-term borrowings	2,476,000	2,810,000	2,658,000
Total interest expense	74,863,000	88,624,000	75,673,000
<b>Net interest income</b>	46,209,000	55,557,000	61,587,000
Provision for loan and lease losses	<u>21,200,000</u>	<u>11,070,000</u>	<u>5,775,000</u>
<b>Net interest income after provision for loan and lease losses</b>	25,009,000	44,487,000	55,812,000
<b>Noninterest income</b>			
Service charges on accounts	1,994,000	1,610,000	1,386,000
Earnings on bank owned life insurance policies	1,727,000	1,252,000	1,165,000
Credit and debit card fees	745,000	668,000	557,000
Letter of credit fees	687,000	613,000	443,000
Mortgage banking activities	662,000	464,000	553,000
Net gain on sales of commercial loans	0	0	29,000
Other income	1,467,000	1,263,000	1,128,000
Total noninterest income	7,282,000	5,870,000	5,261,000
<b>Noninterest expense</b>			
Salaries and benefits	22,493,000	22,876,000	18,983,000
Occupancy	3,826,000	3,300,000	3,136,000
Furniture and equipment rent, depreciation and maintenance	1,980,000	2,063,000	2,050,000
Nonperforming asset costs	3,266,000	1,099,000	430,000
Data processing	2,394,000	2,017,000	1,657,000
FDIC insurance	1,890,000	654,000	184,000
Advertising	559,000	585,000	600,000
Other expense	5,718,000	5,762,000	5,222,000
Total noninterest expenses	42,126,000	38,356,000	32,262,000
<b>Income (loss) before federal income tax expense (benefit)</b>	(9,835,000)	12,001,000	28,811,000
Federal income tax expense (benefit)	<u>(4,876,000)</u>	<u>3,035,000</u>	<u>8,964,000</u>
<b>Net income (loss)</b>	<u>\$ (4,959,000)</u>	<u>\$ 8,966,000</u>	<u>\$ 19,847,000</u>
Earnings (loss) per share:			
Basic	\$ (0.59)	\$ 1.06	\$ 2.36
Diluted	<u>\$ (0.59)</u>	<u>\$ 1.06</u>	<u>\$ 2.33</u>

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See accompanying notes to consolidated financial statements.

**MERCANTILE BANK CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
Years ended December 31, 2008, 2007 and 2006

	<u>Common Stock</u>	<u>Retained Earnings (Deficit)</u>	<u>Accumulated Comprehensive Income (Loss)</u>	<u>Other</u>	Total Shareholders' Equity
<b>Balances, January 1, 2006</b>	\$ 148,533,000	\$ 8,000,000	\$ (1,408,000)	\$ 155,125,000	
Payment of 5% stock dividend	12,014,000	(12,018,000)			(4,000)
Employee stock purchase plan, 2,912 shares	107,000				107,000
Dividend reinvestment plan, 2,657 shares	98,000				98,000
Stock option exercises, 64,971 shares	814,000				814,000
Stock tendered for stock option exercises, 15,685 shares	(585,000)				(585,000)
Cash dividends (\$0.48 per share)		(4,035,000)			(4,035,000)
Stock-based compensation expense	242,000				242,000
Comprehensive income:					
Net income		19,847,000			19,847,000
Change in net unrealized loss on securities available for sale, net of reclassifications and tax effect			306,000		306,000
Total comprehensive income					20,153,000
<b>Balances, December 31, 2006</b>	161,223,000	11,794,000	(1,102,000)	\$ 171,915,000	
Payment of 5% stock dividend	11,131,000	(11,135,000)			(4,000)
Employee stock purchase plan, 3,966 shares	91,000				91,000
Dividend reinvestment plan, 3,137 shares	76,000				76,000
Stock option exercises, 52,117 shares	643,000				643,000
Stock tendered for stock option exercises, 18,291 shares	(587,000)				(587,000)
Cash dividends (\$0.55 per share)		(4,677,000)			(4,677,000)
Stock-based compensation expense	361,000				361,000
Comprehensive income:					
Net income		8,966,000			8,966,000
Change in net unrealized gain (loss) on securities available for sale, net of reclassifications and tax effect			1,371,000		1,371,000
Total comprehensive income					10,337,000
<b>Balances, December 31, 2007</b>	172,938,000	4,948,000	269,000	\$ 178,155,000	

See accompanying notes to consolidated financial statements.

**MERCANTILE BANK CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Continued)**  
Years ended December 31, 2008, 2007 and 2006

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	Common Stock	Retained Earnings (Deficit)	Accumulated Comprehensive Income (Loss)	Total Shareholders' Equity
<b>Balances, December 31, 2007</b>	<b>\$ 172,938,000</b>	<b>\$ 4,948,000</b>	<b>\$ 269,000</b>	<b>\$ 178,155,000</b>
Employee stock purchase plan, 10,904 shares	76,000			76,000
Dividend reinvestment plan, 4,340 shares	40,000			40,000
Stock option exercises, 2,000 shares	16,000			16,000
Stock tendered for stock option exercises, 1,123 shares	(16,000)			(16,000)
Stock-based compensation expense	654,000			654,000
Cash dividends (\$0.31 per share)	(1,355,000)	(1,270,000)		(2,625,000)
Comprehensive income (loss):				
Net loss	(4,959,000)			(4,959,000)
Change in net unrealized gain on securities available for sale, net of reclassifications and tax effect			1,795,000	1,795,000
Change in net fair value of interest rate swaps, net of reclassifications and tax effect		1,236,000		<u>1,236,000</u>
Total comprehensive loss	<u>_____</u>	<u>_____</u>	<u>_____</u>	<u>(1,928,000)</u>
<b>Balances, December 31, 2008</b>	<b><u>\$ 172,353,000</u></b>	<b><u>\$ (1,281,000)</u></b>	<b><u>\$ 3,300,000</u></b>	<b><u>\$ 174,372,000</u></b>

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See accompanying notes to consolidated financial statements.

**MERCANTILE BANK CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
Years ended December 31, 2008, 2007 and 2006

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	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Cash flows from operating activities</b>			
Net income (loss)	\$ (4,959,000)	\$ 8,966,000	\$ 19,847,000
Adjustments to reconcile net income (loss) to net cash from operating activities:			
Depreciation and amortization	2,762,000	3,080,000	2,887,000
Provision for loan and lease losses	21,200,000	11,070,000	5,775,000
Deferred income tax benefit	(1,558,000)	(2,103,000)	(474,000)
Stock-based compensation expense	654,000	361,000	242,000
Net gain on sales of commercial loans	0	0	(29,000)
Proceeds from sales of mortgage loans held for sale	44,095,000	32,911,000	18,133,000
Origination of mortgage loans held for sale	(42,810,000)	(33,408,000)	(18,766,000)
Net gain on sales of mortgage loans	(506,000)	(432,000)	(231,000)
Loss on sale of foreclosed assets	1,768,000	157,000	8,000
Earnings on bank owned life insurance	(1,727,000)	(1,252,000)	(1,165,000)
Net change in:			
Accrued interest receivable	1,444,000	330,000	(2,013,000)
Other assets	(61,000)	(2,243,000)	(1,658,000)
Accrued interest and other liabilities	<u>(6,667,000)</u>	<u>1,927,000</u>	<u>5,277,000</u>
Net cash from operating activities	<u>13,635,000</u>	<u>19,364,000</u>	<u>27,833,000</u>
<b>Cash flows from investing activities</b>			
Purchases of:			
Securities available for sale	(96,292,000)	(15,406,000)	(24,886,000)
Securities held to maturity	(978,000)	(4,658,000)	(4,567,000)
Federal Home Loan Bank stock	(5,948,000)	(2,224,000)	0
Proceeds from:			
Maturities, calls and repayments of securities available for sale	73,571,000	11,969,000	7,423,000
Maturities, calls and repayments of securities held to maturity	1,840,000	3,221,000	1,330,000
Redemption of Federal Home Loan Bank stock	0	0	378,000
Loan and lease originations and payments, net	(86,489,000)	(66,681,000)	(189,793,000)
Purchases of premises and equipment, net	(673,000)	(3,513,000)	(5,911,000)
Proceeds from sale of foreclosed assets	4,777,000	1,476,000	1,055,000
Purchases of bank owned life insurance policies	<u>(1,617,000)</u>	<u>(7,008,000)</u>	<u>(1,621,000)</u>
Net cash for investing activities	<u>(111,809,000)</u>	<u>(82,824,000)</u>	<u>(216,592,000)</u>
<b>Cash flows from financing activities</b>			
Net increase (decrease) in time deposits	42,774,000	(50,972,000)	229,843,000
Net increase (decrease) in all other deposits	(34,380,000)	(4,750,000)	(2,292,000)
Net increase (decrease) in securities sold under agreements to repurchase	(3,052,000)	11,993,000	13,271,000
Net increase (decrease) in federal funds purchased	(13,800,000)	4,000,000	200,000
Proceeds from Federal Home Loan Bank advances	266,500,000	175,000,000	80,000,000
Pay-off of Federal Home Loan Bank advances	<u>(176,500,000)</u>	<u>(90,000,000)</u>	<u>(115,000,000)</u>
Increase in structured repurchase agreements	15,000,000	0	0
Increase in other borrowed money	515,000	697,000	969,000
Cash paid in lieu of fractional shares on stock dividend	0	(4,000)	(4,000)
Employee stock purchase plan	76,000	91,000	107,000
Dividend reinvestment plan	40,000	76,000	98,000
Stock option exercises, net	0	56,000	229,000
Cash dividends	<u>(2,625,000)</u>	<u>(4,677,000)</u>	<u>(4,035,000)</u>
Net cash from financing activities	<u>94,548,000</u>	<u>41,510,000</u>	<u>203,386,000</u>

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See accompanying notes to consolidated financial statements.

**MERCANTILE BANK CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**  
Years ended December 31, 2008, 2007 and 2006

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	<u>2008</u>	<u>2007</u>	<u>2006</u>
Net change in cash and cash equivalents	(3,626,000)	(21,950,000)	14,627,000
Cash and cash equivalents at beginning of period	<u>29,430,000</u>	<u>51,380,000</u>	<u>36,753,000</u>
<b>Cash and cash equivalents at end of period</b>	<b><u>\$ 25,804,000</u></b>	<b><u>\$ 29,430,000</u></b>	<b><u>\$ 51,380,000</u></b>
 Supplemental disclosures of cash flow information			
Cash paid during the year for:			
Interest	\$ 80,748,000	\$ 87,707,000	\$ 67,925,000
Federal income taxes	0	5,730,000	10,875,000
Transfers from loans and leases to foreclosed assets	9,062,000	6,898,000	2,129,000

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See accompanying notes to consolidated financial statements.

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008 and 2007

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

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

We formed a business trust, Mercantile Bank Capital Trust I (“the trust”), in 2004 to issue trust preferred securities. We 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(R), *Consolidation of Variable Interest Entities*, the trust is not consolidated, but instead we report the subordinated debentures issued to the trust as a liability.

Nature of Operations: Mercantile was incorporated on July 15, 1997 to establish and own the Bank based in Grand Rapids, Michigan. The Bank is a community-based financial institution. The Bank began operations on December 15, 1997. The Bank’s primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are commercial loans, commercial leases, residential mortgage loans, and instalment loans. Substantially all loans and leases are secured by specific items of collateral including business assets, real estate or consumer assets. Commercial loans and leases are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by commercial or residential real estate. The Bank’s loan accounts are primarily with customers located in the Grand Rapids, Holland, Lansing, Ann Arbor and Oakland County areas. The Bank’s retail deposits are also from customers located within those areas. As an alternative source of funds, the Bank has also issued certificates to depositors outside of the Bank’s primary market areas. Substantially all revenues are derived from banking products and services and investment securities.

Mercantile Bank Mortgage Company was formed during 2000. A subsidiary of the Bank, Mercantile Bank Mortgage Company was established to increase the profitability and efficiency of the mortgage loan operations. Mercantile Bank Mortgage Company initiated business on October 24, 2000 via the Bank’s contribution of most of its residential mortgage loan portfolio and participation interests in certain commercial mortgage loans. On the same date, the Bank also transferred its residential mortgage origination function to Mercantile Bank Mortgage Company. On January 1, 2004, Mercantile Bank Mortgage Company was reorganized as Mercantile Bank Mortgage Company, LLC, a limited liability company, which is 99% owned by the Bank and 1% owned by Mercantile Insurance. Mortgage loans originated and held by Mercantile Bank Mortgage Company are serviced by the Bank pursuant to a servicing agreement.

Mercantile Insurance was formed during 2002 through the acquisition of an existing shelf insurance agency. Insurance products are offered through an Agency and Institutions Agreement among Mercantile Insurance, the Bank and Hub International. The insurance products are marketed through a central facility operated by the Michigan Bankers Insurance Association, members of which include the insurance subsidiaries of various Michigan-based financial institutions and Hub International. Mercantile Insurance receives commissions based upon written premiums produced under the Agency and Institutions Agreement.

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

Mercantile filed an election to become a financial holding company pursuant to Title I of the Gramm-Leach-Bliley Act and Federal Reserve Board regulations effective March 23, 2000.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008 and 2007

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

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

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

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

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

Declines in the fair value of securities below their amortized cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) our ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

**Loans and Leases:** Loans and leases that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs and an allowance for loan and lease losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Net unamortized deferred loan fees amounted to \$0.8 million and \$0.3 million at December 31, 2008 and 2007, respectively.

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008 and 2007

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Loans Held for Sale:** Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or market, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Such loans are sold service released. The balance of loans held for sale equaled \$1.1 million and \$1.9 million as of December 31, 2008 and 2007, respectively. Mortgage banking activities include fees on direct brokered mortgage loans and the net gain on sale of mortgage loans originated for sale.

**Allowance for Loan and Lease Losses:** The allowance for loan and lease losses is a valuation allowance for probable incurred credit losses. Loan and lease losses are charged against the allowance when management believes the uncollectibility of a loan or lease balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loan and lease loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions and other factors. Allocations of the allowance may be made for specific loans and leases, but the entire allowance is available for any loan or lease that, in management's judgment, should be charged-off.

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

**Transfers of Financial Assets:** Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity. Our transfers of financial assets are limited to commercial loan participations sold, which were insignificant for 2008, 2007 and 2006, and the sale of residential mortgage loans in the secondary market, the extent of which is disclosed in the consolidated statements of cash flows.

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

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

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008 and 2007

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Foreclosed Assets:** Assets acquired through or in lieu of foreclosure are initially recorded at the estimated fair value net of estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed. Foreclosed assets are included in other assets in the accompanying consolidated balance sheets and totaled \$8.1 million and \$5.9 million at December 31, 2008 and 2007, respectively.

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

**Repurchase Agreements:** Substantially all repurchase agreement liabilities represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

**Financial Instruments and Loan Commitments:** Financial instruments include off-balance-sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. Instruments, such as standby letters of credit that are considered financial guarantees in accordance with Financial Accounting Standards Board (“FASB”) Interpretation No. 45, are recorded at fair value.

**Stock-Based Compensation:** Pursuant to Statement of Financial Accounting Standards (“SFAS”) No. 123(R), *Share-Based Payment*, compensation cost for equity-based awards is measured on the grant date based on the fair value of the award at that date, and is recognized over the requisite service period, net of estimated forfeitures. Fair value of stock option awards is estimated using a closed option valuation (Black-Scholes) model. Fair value of restricted stock awards is based upon the quoted market price of the common stock on the date of grant.

**Income Taxes:** Income tax expense is the total of the current year income tax due or refundable, the change in deferred income tax assets and liabilities, and any adjustments related to unrecognized tax benefits. Deferred income tax assets and liabilities are recognized for the tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates applicable to future years. A valuation allowance, if needed, reduces deferred income tax assets to the amount expected to be realized.

**Fair Values of Financial Instruments:** Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on- and off-balance sheet financial instruments do not include the value of anticipated future business or the values of assets and liabilities not considered financial instruments.

**Earnings Per Share:** Basic earnings per share is based on weighted average common shares outstanding during the period exclusive of unvested restricted shares outstanding. Diluted earnings per share include the dilutive effect of additional potential common shares issuable under stock options and restricted stock awards and are determined using the treasury stock method.

**Stock Dividend:** Earnings per share are restated for all stock dividends, including the 5% stock dividends paid on May 4, 2007 and May 16, 2006. The fair value of shares issued in stock dividends is transferred from retained earnings to common stock to the extent of available retained earnings.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2008 and 2007

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Comprehensive Income:** Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale which are also recognized as separate components of equity. For 2008, other comprehensive income also includes the change in fair value of interest rate swaps as discussed in more detail in Note 13.

**Derivatives:** Derivative financial instruments are recognized as assets or liabilities at fair value. The accounting for changes in the fair value of derivatives depends on the use of the derivatives and whether the derivatives qualify for hedge accounting. During 2008, our derivatives consisted of interest rate swap agreements, which were used as part of our asset liability management to help manage interest rate risk. We do not use derivatives for trading purposes.

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

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

**Contingencies:** Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. We do not believe there are any such matters that would have a material effect on the financial statements.

**Reclassifications:** Some items in the prior year financial statements were reclassified to conform to the current presentation.

**Operating Segment:** While we monitor the revenue streams of the various products and services offered, the Company manages its business on the basis of one operating segment, banking, in accordance with the qualitative and quantitative criteria established by SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

**Adoption of New Accounting Standards:** In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*, to further enhance the accounting and financial reporting related to business combinations. SFAS No. 141(R) establishes principles and requirements for how the acquirer in a business combination (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Therefore, the effects of the adoption of SFAS No. 141(R) will depend upon the extent and magnitude of acquisitions after December 31, 2008.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 applies to other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. SFAS No. 157 does not require any new fair value measurements and was originally effective beginning January 1, 2008. In February 2008, the FASB issued FASB Staff Position (“FSP”) FAS 157-2. FSP FAS 157-2 allows entities to electively defer the effective date of SFAS No. 157 until January 1, 2009 for nonfinancial assets and nonfinancial liabilities except those items recognized or disclosed at fair value on an annual or more frequently recurring basis. We will apply the fair value measurement and disclosure provisions of SFAS No. 157 to nonfinancial assets and nonfinancial liabilities effective January 1, 2009. The application of such is not expected to be material to our results of operations or financial position. On October 10, 2008, the FASB issued FSP FAS 157-3 to clarify the application of fair value measurements of a financial asset when the market for that asset is not active. This clarifying guidance became effective upon issuance. This new guidance had no effect on our consolidated results of operations or financial position. See Note 15 for a discussion regarding the January 1, 2008 implementation of SFAS No. 157 relating to our financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement permits entities to choose to measure eligible items at fair value at specified election dates. For items for which the fair value option has been elected, unrealized gains and losses are to be reported in earnings at each subsequent reporting date. The fair value option is irrevocable unless a new election date occurs, may be applied instrument by instrument, with a few exceptions, and applies only to entire instruments and not to portions of instruments. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting. SFAS No. 159 was effective beginning January 1, 2008. Through December 31, 2008, we have not elected the fair value option for any of our financial assets or liabilities.

In March 2008, the FASB issued SFAS No. 161, *Disclosures About Derivative Instruments and Hedging Activities – an Amendment of FASB Statement No. 133*. SFAS No. 161 expands disclosure requirements regarding an entity’s derivative instruments and hedging activities. Expanded qualitative disclosures that will be required under SFAS No. 161 include: (1) how and why an entity uses derivative instruments; (2) how derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and related interpretations; and (3) how derivative instruments and related hedged items affect an entity’s financial statements. SFAS No. 161 is effective beginning January 1, 2009. We do not expect SFAS No. 161 to have a material effect on our derivative disclosures upon adoption.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. SFAS No. 162 is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with U.S. generally accepted accounting principles (“GAAP”). SFAS No. 162 directs the GAAP hierarchy to the entity, not the independent auditors, as the entity is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. SFAS No. 162 became effective 60 days following the Securities and Exchange Commission’s September 2008 approval of the Public Accounting Oversight Board amendments to remove the GAAP hierarchy from the audit standards. The adoption of SFAS No. 162 did not have an impact on our consolidated results of operations or financial position.

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
December 31, 2008 and 2007

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**NOTE 2 – SECURITIES**

The amortized cost, fair value of available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<b><u>2008</u></b>				
U.S. Government agency debt obligations	\$ 61,511,000	\$ 1,264,000	\$ (393,000)	\$ 62,382,000
Mortgage-backed securities	74,702,000	2,324,000	0	77,026,000
Michigan Strategic Fund bonds	22,105,000	0	0	22,105,000
Mutual fund	<u>1,175,000</u>	0	(19,000)	<u>1,156,000</u>
	<u><u>\$ 159,493,000</u></u>	<u><u>\$ 3,588,000</u></u>	<u><u>\$ (412,000)</u></u>	<u><u>\$ 162,669,000</u></u>
<b><u>2007</u></b>				
U.S. Government agency debt obligations	\$ 80,129,000	\$ 860,000	\$ (44,000)	\$ 80,945,000
Mortgage-backed securities	55,003,000	193,000	(577,000)	54,619,000
Mutual fund	<u>1,127,000</u>	0	(18,000)	<u>1,109,000</u>
	<u><u>\$ 136,259,000</u></u>	<u><u>\$ 1,053,000</u></u>	<u><u>\$ (639,000)</u></u>	<u><u>\$ 136,673,000</u></u>

The carrying amount, unrecognized gains and losses, and fair value of securities held to maturity were as follows:

	<u>Carrying Amount</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<b><u>2008</u></b>				
Municipal general obligation bonds	\$ 56,893,000	\$ 1,133,000	\$ (351,000)	\$ 57,675,000
Municipal revenue bonds	<u>7,544,000</u>	<u>175,000</u>	<u>(13,000)</u>	<u>7,706,000</u>
	<u><u>\$ 64,437,000</u></u>	<u><u>\$ 1,308,000</u></u>	<u><u>\$ (364,000)</u></u>	<u><u>\$ 65,381,000</u></u>
<b><u>2007</u></b>				
Municipal general obligation bonds	\$ 57,668,000	\$ 1,084,000	\$ (164,000)	\$ 58,588,000
Municipal revenue bonds	<u>7,662,000</u>	<u>198,000</u>	<u>(8,000)</u>	<u>7,852,000</u>
	<u><u>\$ 65,330,000</u></u>	<u><u>\$ 1,282,000</u></u>	<u><u>\$ (172,000)</u></u>	<u><u>\$ 66,440,000</u></u>

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
December 31, 2008 and 2007

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**NOTE 2 – SECURITIES (Continued)**

Securities with unrealized losses at year-end 2008 and 2007, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:

<u>Description of Securities</u>	<u>Less than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<b><u>2008</u></b>						
U.S. Government agency debt obligations	\$20,588,000	\$ (387,000)	\$ 1,994,000	\$ (6,000)	\$22,582,000	\$ (393,000)
Mortgage-backed securities	0	0	0	0	0	0
Michigan Strategic Fund bonds	0	0	0	0	0	0
Mutual fund	0	0	1,156,000	(19,000)	1,156,000	(19,000)
Municipal general obligation bonds	3,547,000	(76,000)	10,852,000	(275,000)	14,399,000	(351,000)
Municipal revenue bonds	<u>307,000</u>	<u>(1,000)</u>	<u>794,000</u>	<u>(12,000)</u>	<u>1,101,000</u>	<u>(13,000)</u>
	<b><u>\$24,442,000</u></b>	<b><u>\$ (464,000)</u></b>	<b><u>\$ 14,796,000</u></b>	<b><u>\$ (312,000)</u></b>	<b><u>\$ 39,238,000</u></b>	<b><u>\$ (776,000)</u></b>
<b><u>2007</u></b>						
U.S. Government agency debt obligations	\$ 0	\$ 0	\$ 7,953,000	\$ (44,000)	\$ 7,953,000	\$ (44,000)
Mortgage-backed securities	1,241,000	(3,000)	35,277,000	(574,000)	36,518,000	(577,000)
Mutual fund	0	0	1,109,000	(18,000)	1,109,000	(18,000)
Municipal general obligation bonds	2,899,000	(29,000)	11,001,000	(135,000)	13,900,000	(164,000)
Municipal revenue bonds	<u>255,000</u>	<u>(1,000)</u>	<u>1,029,000</u>	<u>(7,000)</u>	<u>1,284,000</u>	<u>(8,000)</u>
	<b><u>\$ 4,395,000</u></b>	<b><u>\$ (33,000)</u></b>	<b><u>\$56,369,000</u></b>	<b><u>\$ (778,000)</u></b>	<b><u>\$ 60,764,000</u></b>	<b><u>\$ (811,000)</u></b>

We evaluate securities for other-than-temporary impairment at least on a quarterly basis. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability we have to retain our investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, we may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred and the results of reviews of the issuer's financial condition.

There were one U.S. Government agency debt obligation, 36 municipal general obligation bonds and three municipal revenue bonds in a continuous loss position for 12 months or more at December 31, 2008. At December 31, 2008, 67 debt securities and a mutual fund with a fair value totaling \$39.2 million have unrealized losses with aggregate depreciation of \$0.8 million, or 0.3% from the amortized cost basis of total securities. At December 31, 2008, 289 debt securities with a fair value totaling \$161.3 million have unrealized gains with aggregate appreciation of \$4.9 million, or 2.2% from the amortized cost basis of total securities. After we considered whether the securities were issued by the federal government or its agencies and whether downgrades by bond rating agencies had occurred, we determined that unrealized losses were due to changing interest rate environments. As we have the intent and ability to hold debt securities until maturity, or for the foreseeable future if classified as available for sale, no declines are deemed to be other-than-temporary.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 2 – SECURITIES (Continued)**

The amortized cost and fair values of debt securities at year-end 2008, by contractual maturity, are shown below. The contractual maturity is utilized below for U.S. Government agency debt obligations and municipal bonds. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date, primarily mortgage backed securities, are shown separately.

The maturities of securities and their weighted average yields at December 31, 2008 are also shown in the following table. The yields for municipal securities are shown at their tax equivalent yield.

	Held-to-Maturity			Available-for-Sale		
	Weighted Average <u>Yield</u>	Carrying <u>Amount</u>	Fair <u>Value</u>	Weighted Average <u>Yield</u>	Amortized <u>Cost</u>	Fair <u>Value</u>
Due in one year or less	6.64%	\$ 1,884,000	\$ 1,914,000	NA	\$ 0	\$ 0
Due from one to five years	6.73	10,457,000	10,891,000	4.70%	11,934,000	12,235,000
Due from five to ten years	6.57	13,496,000	13,948,000	5.29	16,637,000	17,065,000
Due after ten years	6.35	38,600,000	38,628,000	5.33	32,940,000	33,082,000
Mortgage-backed securities	NA	0	0	5.16	74,702,000	77,026,000
Michigan Strategic Fund bonds	NA	0	0	2.99	22,105,000	22,105,000
Mutual fund	NA	0	0	4.00	1,175,000	1,156,000
	6.47%	<u>\$ 64,437,000</u>	<u>\$ 65,381,000</u>	4.87%	<u>\$159,493,000</u>	<u>\$162,669,000</u>

During 2008, 2007 and 2006, there were no securities sold.

At year-end 2008 and 2007, the amortized cost of securities issued by the state of Michigan and all its political subdivisions totaled \$64.4 million and \$65.3 million, with an estimated market value of \$65.4 million and \$66.4 million, respectively. Total securities of any other specific issuer, other than the U.S. Government and its agencies, did not exceed 10% of shareholders' equity.

The carrying value of securities that are pledged to secure repurchase agreements and other deposits was \$124.2 million and \$109.2 million at December 31, 2008 and 2007, respectively. In addition, substantially all of our municipal bonds have been pledged to the Discount Window of the Federal Reserve Bank of Chicago. Investments in Federal Home Loan Bank stock are restricted and may only be resold, or redeemed by, the issuer.

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 3 – LOANS AND LEASES AND ALLOWANCE FOR LOAN AND LEASE LOSSES**

Year-end loans and leases are as follows:

	December 31, 2008 Balance	%	December 31, 2007 Balance	%	Percent Increase (Decrease)
<b>Real Estate:</b>					
Construction and land development	\$ 263,392,000	14.1%	\$ 263,868,000	14.7%	(0.2)%
Secured by 1 – 4 family properties	140,776,000	7.6	135,517,000	7.5	3.9
Secured by multi-family properties	47,365,000	2.6	51,951,000	2.9	(8.8)
Secured by nonresidential properties	881,350,000	47.5	855,872,000	47.6	3.0
Commercial	516,201,000	27.8	484,645,000	26.9	6.5
Leases	1,985,000	0.1	2,865,000	0.1	(30.7)
Consumer	<u>5,846,000</u>	<u>0.3</u>	<u>5,162,000</u>	<u>0.3</u>	<u>13.3</u>
	<u><b>\$1,856,915,000</b></u>	<u><b>100.0%</b></u>	<u><b>\$1,799,880,000</b></u>	<u><b>100.0%</b></u>	<u><b>3.2%</b></u>

Activity in the allowance for loan and lease losses is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Beginning balance	\$ 25,814,000	\$ 21,411,000	\$ 20,527,000
Provision for loan and lease losses	21,200,000	11,070,000	5,775,000
Charge-offs	(20,594,000)	(7,274,000)	(5,389,000)
Recoveries	<u>688,000</u>	<u>607,000</u>	<u>498,000</u>
Ending balance	<u><b>\$ 27,108,000</b></u>	<u><b>\$ 25,814,000</b></u>	<u><b>\$ 21,411,000</b></u>

	<u>2008</u>	<u>2007</u>
Impaired loans and leases were as follows:		
Year-end loans with no allocated allowance for loan and lease losses	\$ 22,557,000	\$ 10,842,000
Year-end loans with allocated allowance for loan and lease losses	<u>22,222,000</u>	<u>14,052,000</u>
	<u><b>\$ 44,779,000</b></u>	<u><b>\$ 24,894,000</b></u>
Amount of the allowance for loan and lease losses allocated	\$ 3,980,000	\$ 3,237,000

Impaired loans and leases for which no allocation to the allowance for loan and leases losses has been made generally reflect situations whereby the loans and leases have been charged-down to estimated collateral value. The Bank recognized no interest income on impaired loans during 2008, 2007 or 2006. Average impaired loans were \$35.9 million, \$14.0 million and \$6.1 million during 2008, 2007 and 2006, respectively. Lost interest income on nonaccrual loans totaled \$2.1 million, \$0.9 million and \$0.3 million in 2008, 2007 and 2006, respectively. Nonperforming loans includes both smaller balance homogenous loans that are collectively evaluated for impairment and the above individually classified impaired loans.

(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 3 – LOANS AND LEASES AND ALLOWANCE FOR LOAN AND LEASE LOSSES (Continued)**

	<u>2008</u>	<u>2007</u>
Nonperforming loans and leases were as follows:		
Loans and leases past due 90 days or more still accruing interest	\$ 1,358,000	\$ 977,000
Nonaccrual loans and leases	<u>47,945,000</u>	<u>28,832,000</u>
	<u>\$ 49,303,000</u>	<u>\$ 29,809,000</u>

Concentrations within the loan portfolio were as follows at year-end:

	<u>2008</u>	<u>2007</u>		
	Balance	Percentage of Loan Portfolio	Balance	Percentage of Loan Portfolio
Commercial real estate loans to lessors of non-residential buildings	\$ 489,580,000	26.4%	\$ 483,210,000	26.8%

**NOTE 4 - PREMISES AND EQUIPMENT, NET**

Year-end premises and equipment are as follows:

	<u>2008</u>	<u>2007</u>
Land and improvements	\$ 8,538,000	\$ 8,534,000
Buildings and leasehold improvements	24,888,000	24,559,000
Furniture and equipment	<u>12,484,000</u>	<u>12,164,000</u>
	45,910,000	45,257,000
Less: accumulated depreciation	<u>13,576,000</u>	<u>10,906,000</u>
	<u>\$ 32,334,000</u>	<u>\$ 34,351,000</u>

Depreciation expense in 2008, 2007 and 2006 totaled \$2.7 million, \$2.7 million and \$2.6 million, respectively.

We entered into a lease arrangement for our banking facility in Ann Arbor, Michigan during 2005, and for our banking facility in Oakland County during 2007. Rent expense for these facilities totaled \$319,000 and \$169,000 during 2008 and 2007, respectively. Minimum rent commitments under the operating leases were as follows, before considering renewal options that generally are present:

2009	\$ 329,000
2010	254,000
2011	178,000
2012	168,000
2013	0
Total	<u>\$ 929,000</u>

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 5 – DEPOSITS**

Deposits at year-end are summarized as follows:

	<u>December 31, 2008</u>	<u>December 31, 2007</u>		Percent Increase (Decrease)
	<u>Balance</u>	<u>%</u>	<u>Balance</u>	<u>%</u>
Noninterest-bearing demand	\$ 110,712,000	6.9%	\$ 133,056,000	8.4%
Interest-bearing checking	50,248,000	3.1	44,491,000	2.8
Money market	24,886,000	1.6	11,872,000	0.7
Savings	49,943,000	3.1	80,750,000	5.1
Time, under \$100,000	49,991,000	3.1	52,675,000	3.3
Time, \$100,000 and over	184,573,000	11.6	343,296,000	21.6
	470,353,000	29.4	666,140,000	41.9
Out-of-area time, under \$100,000	128,948,000	8.1	100,703,000	6.3
Out-of-area time, \$100,000 and over	<u>1,000,274,000</u>	<u>62.5</u>	<u>824,338,000</u>	<u>51.8</u>
	<u>1,129,222,000</u>	<u>70.6</u>	<u>925,041,000</u>	<u>58.1</u>
	<u>\$1,599,575,000</u>	<u>100.0%</u>	<u>\$1,591,181,000</u>	<u>100.0%</u>
				0.5%

Out-of-area certificates of deposit consist of certificates obtained from depositors outside of the primary market areas. As of December 31, 2008, out-of-area certificates of deposit totaling \$1,101.2 million were obtained through deposit brokers, with the remaining \$28.0 million obtained directly from the depositors.

The following table depicts the maturity distribution for certificates of deposit at year-end:

	2008	2007
In one year or less	\$1,179,405,000	\$1,030,178,000
In one to two years	140,299,000	227,492,000
In two to three years	27,116,000	32,231,000
In three to four years	10,232,000	21,777,000
In four to five years	6,734,000	9,334,000
	<u>\$1,363,786,000</u>	<u>\$1,321,012,000</u>

The following table depicts the maturity distribution for certificates of deposit with balances of \$100,000 or more at year-end:

	2008	2007
Up to three months	\$ 377,341,000	\$ 356,661,000
Three months to six months	281,568,000	247,322,000
Six months to twelve months	378,899,000	320,297,000
Over twelve months	147,039,000	243,354,000
	<u>\$1,184,847,000</u>	<u>\$1,167,634,000</u>

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 6 – SHORT-TERM BORROWINGS**

Information regarding securities sold under agreements to repurchase at year-end is summarized below:

	<u>2008</u>	<u>2007</u>
Outstanding balance at year-end	\$ 94,413,000	\$ 97,465,000
Weighted average interest rate at year-end	1.96%	2.94%
Average daily balance during the year	93,149,000	88,685,000
Weighted average interest rate during the year	2.04%	3.67%
Maximum month-end balance during the year	105,986,000	102,881,000

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 repurchase agreements are recorded as assets of the Bank and are held in safekeeping by a correspondent bank. Repurchase agreements are offered principally to certain large deposit customers. Repurchase agreements were secured by securities with a market value of \$106.5 million and \$108.1 million at year-end 2008 and 2007, respectively.

**NOTE 7 - FEDERAL HOME LOAN BANK ADVANCES**

At year-end, advances from the Federal Home Loan Bank were as follows:

	<u>2008</u>	<u>2007</u>
Maturities January 2009 through December 2013, fixed rates from 2.95% to 5.30%, averaging 3.79%	\$ 270,000,000	\$ 0
Maturities January 2008 through January 2012, fixed rates from 4.01% to 5.34%, averaging 4.71%	0	<u>180,000,000</u>
	<u>\$ 270,000,000</u>	<u>\$ 180,000,000</u>

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 the Bank, under a blanket lien arrangement. Our borrowing line of credit as of December 31, 2008 totaled \$316.5 million.

Maturities over the next five years are:

2009	\$ 70,000,000
2010	65,000,000
2011	85,000,000
2012	40,000,000
2013	10,000,000

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**MERCANTILE BANK CORPORATION**  
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**NOTE 8 - FEDERAL INCOME TAXES**

The consolidated income tax (benefit) provision is as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Current expense (benefit)	\$ (3,318,000)	\$ 5,138,000	\$ 9,438,000
Deferred benefit	<u>(1,558,000)</u>	<u>(2,103,000)</u>	<u>(474,000)</u>
Tax expense (benefit)	<u>\$ (4,876,000)</u>	<u>\$ 3,035,000</u>	<u>\$ 8,964,000</u>

Income tax benefit for 2008 was more than, and income tax expense for 2007 and 2006 was less than, the amount computed by applying the statutory federal income tax rate to income before income taxes. The reasons for the difference are as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Statutory rates	\$ (3,442,000)	\$ 4,200,000	\$ 10,084,000
Increase (decrease) from			
Tax-exempt interest	(818,000)	(794,000)	(795,000)
Bank owned life insurance	(605,000)	(438,000)	(408,000)
Other	<u>(11,000)</u>	<u>67,000</u>	<u>83,000</u>
Tax (benefit) expense	<u>\$ (4,876,000)</u>	<u>\$ 3,035,000</u>	<u>\$ 8,964,000</u>

The net deferred income tax asset recorded includes the following amounts of deferred income tax assets and liabilities:

	<u>2008</u>	<u>2007</u>
Deferred income tax assets		
Allowance for loan and lease losses	\$ 9,488,000	\$ 9,035,000
Deferred loan fees	263,000	111,000
Deferred compensation	1,584,000	1,404,000
Nonaccrual loan interest income	440,000	175,000
Fair value write-downs on foreclosed properties	303,000	27,000
Other	<u>727,000</u>	<u>633,000</u>
	12,805,000	11,385,000
Deferred income tax liabilities		
Depreciation	907,000	1,006,000
Unrealized gain on securities	1,112,000	145,000
Net fair value of interest rate swaps	666,000	0
Other	<u>674,000</u>	<u>713,000</u>
	3,359,000	1,864,000
Net deferred income tax asset	<u>\$ 9,446,000</u>	<u>\$ 9,521,000</u>

SFAS No. 109, *Accounting for Income Taxes*, requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. In accordance with SFAS No. 109, we reviewed our deferred tax assets and determined that no valuation allowance was necessary at year end 2008 or 2007. Despite the loss in 2008 and the challenging economic environment, we are in a cumulative income position, have a history of strong earnings, are well-capitalized, and have cautiously optimistic expectations regarding future taxable income. In making such judgments, significant weight is given to evidence that can be objectively verified. In making decisions regarding any valuation allowance, we consider both positive and negative evidence and analyze changes in near-term market conditions as well as other factors which may impact future operating results. The deferred tax assets will be analyzed quarterly for changes affecting realizability, and there can be no guarantee that a valuation allowance will not be necessary in future periods.

(Continued)

MERCANTILE BANK CORPORATION  
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**NOTE 8 – FEDERAL INCOME TAXES (Continued)**

We adopted the provisions of FASB Interpretation No. 48 (“FIN 48”), *Accounting for Uncertainty in Income Taxes*, on January 1, 2007. The adoption of FIN 48 had no affect on the financial statements. We had no recognized tax benefits at any time during 2008 or 2007 and do not anticipate any significant increase in unrecognized tax benefits during 2009. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is our policy to record such accruals in our income tax accounts; no such accruals existed at any time during 2008 or 2007. We file U.S. federal income tax returns which are subject to examination for all years after 2004.

**NOTE 9 – STOCK-BASED COMPENSATION**

Stock-based compensation plans are used to provide directors and employees with an increased incentive to contribute to the long-term performance and growth of Mercantile, to align the interests of directors and employees with the interests of Mercantile’s shareholders through the opportunity for increased stock ownership and to attract and retain directors and employees. From 1997 through 2005, stock option grants were provided to directors and certain employees through several stock option plans, including the 1997 Employee Stock Option Plan, 2000 Employee Stock Option Plan, 2004 Employee Stock Option Plan and Independent Director Stock Option Plan. During the past three years, stock option and restricted stock grants were provided to certain employees through the Stock Incentive Plan of 2006.

Under our 1997 Employee Stock Option Plan, 2000 Employee Stock Option Plan and 2004 Employee Stock Option Plan, stock options granted to employees were 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 officers during 2005 vested about three weeks after being granted. Under our Independent Director Stock Option Plan, 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. The Stock Incentive Plan of 2006 replaced all of our outstanding stock option plans for stock options not previously granted. Under the Stock Incentive Plan of 2006, incentive awards may include, but are not limited to, stock options, restricted stock, stock appreciation rights and stock awards. Incentive awards that are stock options or stock appreciation rights are granted with an exercise price not less than the closing price of Mercantile stock on the date of grant, or for stock options granted in 2006 or 2007, the day before the date of grant, if the closing price was higher on the day before the date of grant. Price, vesting and expiration date parameters are determined by Mercantile’s Compensation Committee on a grant-by-grant basis. Generally, the stock options granted to employees during the past three years fully vest after two years and expire after seven years. The restricted stock awards granted to certain employees during the past three years fully vest after four years. No payments were required from employees for the restricted stock awards. At year-end 2008, there were approximately 396,000 shares authorized for future incentive awards.

As of December 31, 2008, there was \$0.2 million of total unrecognized compensation cost related to unvested stock options granted under our various stock-based compensation plans. This unrecognized compensation cost is expected to be recognized over a weighted-average period of 1.5 years. As of December 31, 2008, there was \$1.1 million of total unrecognized compensation cost related to unvested restricted stock granted under our Stock Incentive Plan of 2006. The compensation cost is expected to be recognized over a period of 3.0 years.

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**MERCANTILE BANK CORPORATION**  
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**NOTE 9 – STOCK-BASED COMPENSATION** (Continued)

A summary of restricted stock activity is as follows:

	<u>2008</u>		<u>2007</u>		<u>2006</u>	
	<u>Shares</u>	<u>Weighted Average Fair Value</u>	<u>Shares</u>	<u>Weighted Average Fair Value</u>	<u>Shares</u>	<u>Weighted Average Fair Value</u>
Nonvested at beginning of year	63,024	\$ 23.69	21,159	\$ 37.94	0	\$ NA
Granted	56,710	6.21	44,450	17.74	21,159	37.94
Vested	0	NA	0	NA	0	NA
Forfeited	(6,724)	24.83	(2,585)	37.94	0	NA
Nonvested at end of year	<u>113,010</u>	<u>\$ 14.85</u>	<u>63,024</u>	<u>\$ 23.69</u>	<u>21,159</u>	<u>\$ 37.94</u>

A summary of stock option activity is as follows:

	<u>2008</u>		<u>2007</u>		<u>2006</u>	
	<u>Shares</u>	<u>Weighted Average Price</u>	<u>Shares</u>	<u>Weighted Average Price</u>	<u>Shares</u>	<u>Weighted Average Price</u>
Outstanding at beginning of year	271,755	\$ 24.34	288,962	\$ 24.07	330,378	\$ 20.77
Granted	67,460	6.21	54,099	17.74	25,867	37.94
Exercised	(2,000)	8.22	(52,117)	12.33	(64,971)	12.52
Forfeited or expired	(11,781)	29.48	(19,189)	34.38	(2,312)	31.95
Outstanding at end of year	<u>325,434</u>	<u>\$ 20.49</u>	<u>271,755</u>	<u>\$ 24.34</u>	<u>288,962</u>	<u>\$ 24.07</u>
Options exercisable at year-end	<u>198,694</u>	<u>\$ 25.23</u>	<u>181,544</u>	<u>\$ 23.68</u>	<u>234,534</u>	<u>\$ 21.55</u>

The fair value of each stock option award is estimated on the date of grant using a closed option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities on our common stock. Historical data is used to estimate stock option expense and post-vesting termination behavior. The expected term of stock options granted is based on historical data and represents the period of time that stock options granted are expected to be outstanding, which takes into account that the stock options are not transferable. The risk-free interest rate for the expected term of the stock option is based on the U.S. Treasury yield curve in effect at the time of the stock option grant.

The fair value of stock options granted was determined using the following weighted-average assumptions as of grant date:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Risk-free interest rate	2.00%	3.40%	4.60%
Expected option life	5 Years	5 Years	5 Years
Expected stock price volatility	44%	26%	26%
Dividend yield	1%	1%	1%

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(Continued)

**MERCANTILE BANK CORPORATION**  
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**NOTE 9 – STOCK-BASED COMPENSATION** (Continued)

Options outstanding at year-end 2008 were as follows:

Range of Exercise Prices	Outstanding			Exercisable	
	<u>Number</u>	<u>Weighted Average Remaining Contractual Life</u>	<u>Weighted Average Exercise Price</u>	<u>Number</u>	<u>Weighted Average Exercise Price</u>
\$ 4.00 - \$ 8.00	67,460	6.9 Years	\$ 6.21	0	\$ NA
\$ 8.01 - \$12.00	21,157	1.6 Years	8.44	21,157	8.44
\$12.01 - \$16.00	27,736	2.8 Years	12.89	27,736	12.89
\$16.01 - \$20.00	76,242	5.2 Years	17.21	25,263	16.14
\$20.01 - \$24.00	7,632	3.8 Years	20.18	7,632	20.18
\$24.01 - \$28.00	25,428	4.8 Years	26.61	25,428	26.61
\$32.01 - \$36.00	72,987	6.3 Years	34.77	72,987	34.77
\$36.01 - \$40.00	19,856	4.9 Years	37.94	18,491	37.94
\$40.01 - \$44.00	<u>6,936</u>	5.8 Years	40.28	<u>0</u>	NA
Outstanding at year end	<u>325,434</u>	5.3 Years	\$ 20.49	<u>198,694</u>	\$ 25.23

The weighted-average remaining contractual life of the 198,694 stock options exercisable as of December 31, 2008 was 4.6 years.

Information related to options outstanding at year-end 2008, 2007 and 2006 were as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Minimum exercise price	\$ 6.21	\$ 8.22	\$ 7.09
Maximum exercise price	40.28	40.28	40.28
Average remaining option term	5.3 Years	5.9 Years	6.1 Years

Information related to stock option grants and exercises during 2008, 2007 and 2006 follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Aggregate intrinsic value of stock options exercised	\$ 13,000	\$1,019,000	\$1,616,000
Cash received from stock option exercises	0	56,000	229,000
Tax benefit realized from stock option exercises	0	0	0
Weighted average per share fair value of stock options granted	2.32	4.60	11.44

The closing price of our stock on December 31, 2008 was below the exercise price of all of our stock option grants. Therefore, the aggregate intrinsic value of all stock options outstanding and exercisable at December 31, 2008 was \$0.

Shares issued as a result of the exercise of stock option grants have been authorized and unissued shares.

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MERCANTILE BANK CORPORATION  
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**NOTE 10 – RELATED PARTIES**

Certain directors and executive officers of the Bank, including their immediate families and companies in which they are principal owners, were loan customers of the Bank. At year-end 2008 and 2007, the Bank had \$17.7 million and \$19.1 million in loan commitments to directors and executive officers, of which \$14.1 million and \$14.7 million were outstanding at year-end 2008 and 2007, respectively, as reflected in the following table:

	<u>2008</u>	<u>2007</u>
Beginning balance	\$ 14,719,000	\$ 8,797,000
New loans	1,777,000	9,551,000
Repayments	<u>(2,406,000)</u>	<u>(3,629,000)</u>
Ending balance	<u>\$ 14,090,000</u>	<u>\$ 14,719,000</u>

Related party deposits and repurchase agreements totaled \$12.7 million and \$14.2 million at year-end 2008 and 2007, respectively.

**NOTE 11 – COMMITMENTS AND OFF-BALANCE-SHEET RISK**

We are 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 the 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 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. We use the same credit policies in making commitments and conditional obligations as we do for on-balance sheet instruments. Collateral, such as accounts receivable, securities, inventory, and 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 related to loan commitments was \$0.5 million at year-end 2008 and 2007.

At year-end 2008 and 2007, the rates on existing off-balance sheet instruments were substantially equivalent to current market rates, considering the underlying credit standing of the counterparties.

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**MERCANTILE BANK CORPORATION**  
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**NOTE 11 – COMMITMENTS AND OFF-BALANCE-SHEET RISK** (Continued)

Our maximum exposure to credit losses for loan commitments and standby letters of credit outstanding at year-end was as follows:

	<u>2008</u>	<u>2007</u>
Commercial unused lines of credit	\$ 323,785,000	\$ 377,493,000
Unused lines of credit secured by 1 – 4 family residential properties	30,658,000	33,083,000
Credit card unused lines of credit	9,413,000	9,035,000
Other consumer unused lines of credit	4,881,000	6,910,000
Commitments to make loans	10,959,000	66,196,000
Standby letters of credit	<u>51,439,000</u>	<u>81,292,000</u>
	<u>\$ 431,135,000</u>	<u>\$ 574,009,000</u>

Commitments to make loans generally reflect our binding obligations to existing and prospective customers to extend credit, including line of credit facilities secured by accounts receivable and inventory, and term debt secured by either real estate or equipment. In most instances, line of credit facilities are for a one year term and are at a floating rate tied to the prime rate. For term debt secured by real estate, customers are generally offered a floating rate tied to the prime rate and a fixed rate currently ranging from 5.00% to 6.50%. These credit facilities generally balloon within five years, with payments based on amortizations ranging from 10 to 25 years. For term debt secured by non-real estate collateral, customers are generally offered a floating rate tied to the prime rate and a fixed rate currently ranging from 5.00% to 7.00%. These credit facilities generally mature and fully amortize within five years.

Certain of our commercial loan customers have entered into interest rate swap agreements directly with our correspondent banks. To assist our commercial loan customers in these transactions, and to encourage our correspondent banks to enter into the interest rate swap transactions with minimal credit underwriting analyses on their part, we have entered into risk participation agreements with the correspondent banks whereby we agree to make payments to the correspondent banks owed by our commercial loan customers under the interest rate swap agreement in the event that our commercial loan customers do not make the payments. We are not a party to the interest rate swap agreements under these arrangements. As of December 31, 2008, the total notional amount of the underlying interest rate swap agreements was \$61.8 million, with a net fair value from our commercial loan customers' perspective of negative \$8.0 million. Payments made during 2008 in regards to the risk participation agreements totaled \$16,000; however, we believe the affected customer will reimburse us for such payments and therefore we have accrued no liability for these payments or such potential future payments. These risk participation agreements are considered financial guarantees in accordance with FASB Interpretation No. 45 and are therefore recorded as liabilities at fair value, generally equal to the fees collected at the time of their execution. These liabilities are accreted into income during the term of the interest rate swap agreements, generally ranging from four to fifteen years. This liability totaled \$0.3 million and \$0.1 million at December 31, 2008 and 2007, respectively.

The following instruments are considered financial guarantees under FASB Interpretation No. 45. These instruments are carried at fair value.

	<u>2008</u>		<u>2007</u>	
	<u>Contract Amount</u>	<u>Carrying Value</u>	<u>Contract Amount</u>	<u>Carrying Value</u>
Standby letters of credit	\$ 51,439,000	\$ 282,000	\$ 81,292,000	\$ 357,000

We were required to have \$0.3 million of cash on hand or on deposit with the Federal Reserve Bank of Chicago to meet regulatory reserve and clearing requirements at year-end 2008 and 2007. These balances do not earn interest.

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**NOTE 12 – BENEFIT PLANS**

We have a 401(k) benefit plan that covers substantially all of our employees. Our 2008, 2007 and 2006 matching 401(k) contributions charged to expense were \$781,000, \$747,000 and \$674,000, respectively. The percent of our matching contributions to the 401(k) is determined annually by the Board of Directors. The 401(k) benefit plan allows employee contributions up to 15% of their compensation, which are matched at 100% of the first 5% of the compensation contributed up to a maximum matching contribution for the 2008 plan year of \$11,500. Matching contributions are immediately vested.

We have a deferred compensation plan in which all persons serving on the Board of Directors may defer all or portions of their annual retainer and meeting fees, with distributions to be paid upon termination of service as a director or specific dates selected by the director. The deferred amounts are categorized on our financial statements as other borrowed money. The deferred balances are paid interest at a rate equal to the Wall Street Journal Prime Rate, adjusted at the beginning of each calendar quarter. Interest expense for the plan during 2008, 2007 and 2006 was \$89,000, \$109,000 and \$81,000, respectively.

We have a non-qualified deferred compensation program in which selected officers may defer all or portions of salary and bonus payments. The deferred amounts are categorized on our financial statements as other borrowed money. The deferred balances are paid interest at a rate equal to the Wall Street Journal Prime Rate, adjusted at the beginning of each calendar quarter. Interest expense for the plan during 2008, 2007 and 2006 was \$140,000, \$190,000 and 148,000, respectively.

The Mercantile Bank Corporation Employee Stock Purchase Plan of 2002 (“Stock Purchase Plan”) is a non-compensatory plan intended to encourage full- and part-time employees of Mercantile and its subsidiaries to promote our best interests and to align employees’ interests with the interests of our shareholders by permitting employees to purchase shares of our common stock through regular payroll deductions. Shares are purchased on the last business day of each calendar quarter at a price equal to the average, rounded to the nearest whole cent, of the highest and lowest sales prices of our common stock reported on The Nasdaq Stock Market. Originally, 25,000 shares of common stock may be issued under the Stock Purchase Plan; however, the number of shares has been and may continue to be adjusted in the future to reflect stock dividends and other changes in our capitalization. The numbers of shares issued under the Stock Purchase Plan totaled 10,904 and 3,966 in 2008 and 2007, respectively. As of December 31, 2008, there were 5,989 shares available under the Stock Purchase Plan. Effective February 26, 2009, the Stock Purchase Plan was amended to increase the number of shares that can be issued under the plan to 55,000 shares, subject to adjustments.

**NOTE 13 – HEDGING ACTIVITIES**

Our interest rate risk policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using net interest income simulation. Our policy provides for the use of certain derivative instruments and hedging activities to aid in managing interest rate risk to within policy parameters.

A majority of our assets are comprised of commercial loans on which the interest rates are variable, while a majority of our liabilities are comprised of fixed rate certificates of deposit and FHLB advances. Due to this repricing mismatch, we may periodically enter into derivative financial instruments to mitigate the exposure in cash flows resulting from changes in interest rates.

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**MERCANTILE BANK CORPORATION**  
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**NOTE 13 – HEDGING ACTIVITIES** (Continued)

During 2008, we entered into several interest rate swaps with an aggregate notional amount of \$275.0 million. The interest rate swaps qualified as cash flow hedges that converted the variable rate cash inflows on certain of our prime-based commercial loans to a fixed rate of interest. The interest rate swaps paid interest to us at stated fixed rates and required that we make interest payments based on the average of the Wall Street Journal Prime Rate.

On October 30, 2008, we terminated all of our interest rate swaps. The termination coincided with our decision to not lower our prime rate in association with the Federal Open Market Committee's reduction of the targeted federal funds rate by 50 basis points announced on October 29, 2008. Virtually all of our prime-based commercial floating rate loans are tied to the Mercantile Bank Prime Rate, while our interest rate swaps utilized the Wall Street Journal Prime Rate. The resulting difference negatively impacted the effectiveness of our interest rate swaps, so we believed it was prudent to terminate them. The aggregate fair value of the interest rate swaps on October 30, 2008 was \$2.4 million, which will be accreted into interest income on loans and leases during the upcoming periods based on the original term of the interest rate swaps as follows: \$765,000 during the first quarter of 2009; \$525,000 during the second quarter 2009; \$250,000 during the third and fourth quarters 2009; and \$100,000 during the first quarter 2010.

**NOTE 14 – FAIR VALUES OF FINANCIAL INSTRUMENTS**

Carrying amount and estimated fair values of financial instruments were as follows at year-end:

	<u>2008</u>		<u>2007</u>	
	<u>Carrying Values</u>	<u>Fair Values</u>	<u>Carrying Values</u>	<u>Fair Values</u>
<b>Financial assets</b>				
Cash and cash equivalents	\$ 25,804,000	\$ 25,804,000	\$ 29,430,000	\$ 29,430,000
Securities available for sale	162,669,000	162,669,000	136,673,000	136,673,000
Securities held to maturity	64,437,000	65,381,000	65,330,000	66,440,000
Federal Home Loan Bank stock	15,681,000	15,681,000	9,733,000	9,733,000
Loans, net	1,829,807,000	1,872,141,000	1,774,066,000	1,777,883,000
Bank owned life insurance policies	42,462,000	42,462,000	39,118,000	39,118,000
Accrued interest receivable	8,513,000	8,513,000	9,957,000	9,957,000
<b>Financial liabilities</b>				
Deposits	1,599,575,000	1,610,953,000	1,591,181,000	1,585,921,000
Securities sold under agreements to repurchase	94,413,000	94,413,000	97,465,000	97,465,000
Federal funds purchased	0	0	13,800,000	13,800,000
Federal Home Loan Bank advances	270,000,000	274,847,000	180,000,000	180,303,000
Subordinated debentures	32,990,000	31,100,000	32,990,000	32,678,000
Accrued interest payable	15,245,000	15,245,000	21,130,000	21,130,000

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 14 – FAIR VALUES OF FINANCIAL INSTRUMENTS (Continued)**

Carrying amount is the estimated fair value for cash and cash equivalents, Federal Home Loan Bank stock, accrued interest receivable and payable, bank owned life insurance policies, demand deposits, securities sold under agreements to repurchase, and variable rate loans and deposits that reprice frequently and fully. Security fair values are based on market prices or dealer quotes, and if no such information is available, on the rate and term of the security and information about the issuer. For fixed rate loans and deposits and for variable rate loans and deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Fair value of subordinated debentures and Federal Home Loan Bank advances is based on current rates for similar financing. Fair value of off balance sheet items is estimated to be nominal.

Current accounting pronouncements require disclosure of the estimated fair value of financial instruments. Effective January 1, 2008, fair value is defined in accordance with SFAS No. 157 as disclosed in Note 15. Given the current market conditions, a portion of our loan portfolio is not readily marketable and market prices do not exist. We have not attempted to market our loans to potential buyers, if any exist, to determine the fair value of those instruments in accordance with the definition of SFAS No. 157. Since negotiated prices in illiquid markets depends upon the then present motivations of the buyer and seller, it is reasonable to assume that actual sales prices could vary widely from any estimate of fair value made without the benefit of negotiations. Additionally, changes in market interest rates can dramatically impact the value of financial instruments in a short period of time. Accordingly, the fair value measurements for loans included in the table above are unlikely to represent the instruments' liquidation values.

**NOTE 15 – FAIR VALUE MEASUREMENTS**

Effective January 1, 2008, we implemented SFAS No. 157 relating to our financial assets and liabilities. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability, or in the absence of a principal market, the most advantageous market for the asset or liability. The price of the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

SFAS No. 157 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, SFAS No. 157 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

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(Continued)

MERCANTILE BANK CORPORATION  
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**NOTE 15 – FAIR VALUE MEASUREMENTS (Continued)**

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

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

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

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

*Securities available for sale.* Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models. Level 2 securities include U.S. Government Agency bonds and mortgage-backed securities issued or guaranteed by U.S. Government Agencies. We have no Level 1 or 3 securities.

*Securities held to maturity.* Securities held to maturity are carried at amortized cost when we have the positive intent and ability to hold them to maturity. The fair value of held to maturity securities, as disclosed in the accompanying consolidated financial statements, is based on quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models.

*Mortgage loans held for sale.* Mortgage loans held for sale are carried at the lower of cost or fair value and are measured on a nonrecurring basis. Fair value is based on independent quoted market prices, where applicable, or the prices for other mortgage whole loans with similar characteristics. As of December 31, 2008, we determined that the fair value of our mortgage loans held for sale was similar to the cost; therefore, we carried the \$1.1 million of such loans at cost so they are not included in the nonrecurring table below.

*Loans and leases.* We do not record loans and leases at fair value on a recurring basis. However, from time to time, we record nonrecurring fair value adjustments to collateral dependent loans and leases to reflect partial write-downs or specific reserves that are based on the observable market price or current estimated value of the collateral. These loans and leases are reported in the nonrecurring table below at initial recognition of impairment and on an ongoing basis until recovery or charge-off. At time of foreclosure or repossession, foreclosed and repossessed assets are adjusted to fair value less costs to sell upon transfer of the loans and leases to foreclosed and repossessed assets, establishing a new cost basis. At that time, they are reported in our fair value disclosures related to nonfinancial assets.

*Derivatives.* For interest rate swaps, we measure fair value utilizing models that use primarily market observable inputs, such as yield curves and option volatilities, and accordingly, are classified as Level 2. We had no interest rate swap contracts outstanding as of December 31, 2008.

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(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 15 – FAIR VALUE MEASUREMENTS (Continued)**

*Assets and Liabilities Measured at Fair Value on a Recurring Basis*

The balances of assets and liabilities measured at fair value on a recurring basis as of December 31, 2008 are as follows:

	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	<u>Total</u>	<u>(Level 1)</u>	<u>(Level 2)</u>	<u>(Level 3)</u>
Securities available for sale	\$ 162,669,000	\$ 0	\$ 162,669,000	\$ 0
<b>Total</b>	<b><u>\$ 162,669,000</u></b>	<b><u>\$ 0</u></b>	<b><u>\$ 162,669,000</u></b>	<b><u>\$ 0</u></b>

We had no assets or liabilities measured at Level 3 during 2008; however, in previous Form 10-Q filings we indicated that our securities available for sale were measured at Level 1. We recently re-reviewed documentation provided to us by our third party securities pricing vendor and determined that the measurement tools utilized to determine the fair value of our securities more closely reflects a Level 2 categorization than Level 1 as previously reported. There have been no significant measurement methodology changes employed by our securities pricing vendor.

*Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis*

The balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2008 and related gains (losses) during 2008 are as follows:

	Quoted Price in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Total Gains (Losses)
	<u>Total</u>	<u>(Level 1)</u>	<u>(Level 2)</u>	<u>(Level 3)</u>
Impaired loans <sup>(1)</sup>	\$ 37,197,000	\$ 0	\$ 37,197,000	\$ 0
<b>Total</b>	<b><u>\$ 37,197,000</u></b>	<b><u>\$ 0</u></b>	<b><u>\$ 37,197,000</u></b>	<b><u>\$ 0</u></b>
				<b><u>\$ (16,710,000)</u></b>
				<b><u>\$ (16,710,000)</u></b>

<sup>(1)</sup> Represents carrying value and related write-downs and specific reserves for which adjustments are based on the estimated value of the property.

*Nonfinancial Assets and Liabilities Subject to FSP FAS 157-2 Deferral Provisions*

We will apply the fair value measurement and disclosure provisions of SFAS No. 157 effective on January 1, 2009 to nonfinancial assets and liabilities measured on a nonrecurring basis. We measure the fair value of the following on a nonrecurring basis: (1) long-lived assets and (2) foreclosed and repossessed assets.

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 16 – EARNINGS (LOSS) PER SHARE**

The factors used in the earnings (loss) per share computation follow:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Basic</b>			
Net income (loss)	<u><u>\$ (4,959,000)</u></u>	<u><u>\$ 8,966,000</u></u>	<u><u>\$ 19,847,000</u></u>
Weighted average common shares outstanding	<u><u>8,470.721</u></u>	<u><u>8,453,483</u></u>	<u><u>8,403,163</u></u>
Basic earnings (loss) per common share	<u><u>\$ (0.59)</u></u>	<u><u>\$ 1.06</u></u>	<u><u>\$ 2.36</u></u>
<b>Diluted</b>			
Net income (loss)	<u><u>\$ (4,959,000)</u></u>	<u><u>\$ 8,966,000</u></u>	<u><u>\$ 19,847,000</u></u>
Weighted average common shares outstanding for basic earnings (loss) per common share	8,470,721	8,453,483	8,403,163
Add: Dilutive effects of share-based awards	0	44,255	114,809
Average shares and dilutive potential common shares	<u><u>8,470.721</u></u>	<u><u>8,497,738</u></u>	<u><u>8,517,972</u></u>
Diluted earnings (loss) per common share	<u><u>\$ (0.59)</u></u>	<u><u>\$ 1.06</u></u>	<u><u>\$ 2.33</u></u>

Share-based awards for 438,444, 196,256 and 31,940 shares of common stock were not considered in computing diluted earnings per common share for 2008, 2007 and 2006, respectively, because they were antidilutive.

**NOTE 17 – SUBORDINATED DEBENTURES**

The trust, a business trust formed by the company, was incorporated in 2004 for the purpose of issuing Series A and Series B Preferred Securities. On September 16, 2004, the trust sold the Series A Preferred Securities in a private sale for \$16.0 million, and also sold \$495,000 of Series A Common Securities to Mercantile. The proceeds of the Series A Preferred Securities and the Series A Common Securities were used by the trust to purchase \$16,495,000 of Series A Floating Rate Notes that were issued by Mercantile on September 16, 2004. Mercantile used the proceeds of the Series A Floating Rate Notes to finance the redemption on September 17, 2004 of the \$16.0 million of 9.60% Cumulative Preferred Securities issued in 1999 by MBWM Capital Trust I. On December 10, 2004, the trust sold the Series B Preferred Securities in a private sale for \$16.0 million, and also sold \$495,000 of Series B Common Securities to Mercantile. The proceeds of the Series B Preferred Securities and the Series B Common Securities were used by the trust to purchase \$16,495,000 of Series B Floating Rate Notes that were issued by Mercantile on December 10, 2004. Substantially all of the net proceeds of the Series B Floating Rate Notes were contributed to our bank as capital to provide support for asset growth, fund investments in loans and securities and for general corporate purposes.

The only significant assets of the trust are the Series A and Series B Floating Rate Notes, and the only significant liabilities of the trust are the Series A and Series B Preferred Securities. The Series A and Series B Floating Rate Notes are categorized on our consolidated balance sheets as subordinated debentures and the interest expense is recorded on our consolidated statements of income under interest expense on long-term borrowings.

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(Continued)

**MERCANTILE BANK CORPORATION**  
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**NOTE 18 - REGULATORY MATTERS**

Mercantile and the Bank 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 the financial statements.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If an institution is not well capitalized, regulatory approval is required to accept brokered deposits. Subject to limited exceptions, no institution may make a capital distribution if, after making the distribution, it would be undercapitalized. If an institution is undercapitalized, it is subject to being closely monitored by its principal federal regulator, its asset growth and expansion are restricted, and plans for capital restoration are required. In addition, further specific types of restrictions may be imposed on the institution at the discretion of the federal regulator. At year-end 2008 and 2007, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that we believe has changed the Bank's category.

At year end, actual capital levels (in thousands) and minimum required levels for Mercantile and the Bank were:

	<u>Actual</u>		Minimum Required for Capital <u>Adequacy Purposes</u>		Minimum Required to be Well Capitalized Under Prompt Corrective <u>Action Regulations</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>2008</b>						
Total capital (to risk weighted assets)						
Consolidated	\$ 229,307	10.9%	\$ 167,836	8.0%	\$ NA	NA
Bank	226,034	10.8	167,480	8.0	209,350	10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated	203,072	9.7	83,918	4.0	NA	NA
Bank	199,853	9.6	83,740	4.0	125,610	6.0
Tier 1 capital (to average assets)						
Consolidated	203,072	9.2	88,577	4.0	NA	NA
Bank	199,853	9.0	88,413	4.0	110,516	5.0

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 18 - REGULATORY MATTERS (Continued)**

	<u>Actual</u>		Minimum Required for Capital <u>Adequacy</u> Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Regulations	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b><u>2007</u></b>						
Total capital (to risk weighted assets)						
Consolidated Bank	\$ 235,700 232,435	11.4% 11.3	\$ 165,562 165,292	8.0% 8.0	\$ NA 206,615	NA 10.0%
Tier 1 capital (to risk weighted assets)						
Consolidated Bank	209,886 206,621	10.1 10.0	82,781 82,646	4.0 4.0	NA 123,969	NA 6.0
Tier 1 capital (to average assets)						
Consolidated Bank	209,886 206,621	10.0 9.8	84,169 84,061	4.0 4.0	NA 105,076	NA 5.0

Federal and state banking laws and regulations place certain restrictions on the amount of dividends the Bank can transfer to Mercantile and on the capital levels that must be maintained. At year-end 2008, under the most restrictive of these regulations (to remain well capitalized), the Bank could distribute approximately \$12.0 million to Mercantile as dividends without prior regulatory approval.

The capital levels as of year-end 2008 and 2007 include \$32.0 million of trust preferred securities issued by the trust in September 2004 and December 2004 subject to certain limitations. Under applicable Federal Reserve guidelines, the trust preferred securities constitute a restricted core capital element. The guidelines provide that the aggregate amount of restricted core elements that may be included in Tier 1 capital must not exceed 25% of the sum of all core capital elements, including restricted core capital elements, net of goodwill less any associated deferred tax liability. At year-end 2008 and 2007, all \$32.0 million of the trust preferred securities were included as Tier 1 capital of Mercantile.

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 19 - OTHER COMPREHENSIVE INCOME**

Other comprehensive income components, other than net income (loss), and related taxes were as follows:

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Unrealized holding gains on available-for-sale securities	\$ 2,761,000	\$ 2,110,000	\$ 470,000
Change in net fair value of interest rate swaps	2,876,000	0	0
Reclassification adjustments for gains later recognized in income	<u>(974,000)</u>	<u>0</u>	<u>0</u>
Net unrealized gains	4,663,000	2,110,000	470,000
Tax effect of unrealized holding gains on available-for-sale securities and unrealized gain on interest rate swaps	(1,973,000)	(739,000)	(164,000)
Tax effect of reclassification adjustments for gains later recognized in income	<u>341,000</u>	<u>0</u>	<u>0</u>
Other comprehensive income	<u>\$ 3,031,000</u>	<u>\$ 1,371,000</u>	<u>\$ 306,000</u>

Accumulated other comprehensive income, net of tax, consists of a net unrealized gain on available-for-sale securities of \$2,064,000 and a fair value of interest rate swaps of \$1,236,000 at December 31, 2008. At December 31, 2007, accumulated other comprehensive income, net of tax, consists of a net unrealized gain on available-for-sale securities totaling \$269,000.

**NOTE 20 - QUARTERLY FINANCIAL DATA (UNAUDITED)**

	<u>Interest Income</u>	<u>Net Interest Income</u>	<u>Net Income (Loss)</u>	<u>Earnings (Loss) per Share</u>	
				<u>Basic</u>	<u>Diluted</u>
<b><u>2008</u></b>					
First quarter	\$ 31,955,000	\$ 11,383,000	\$(3,738,000)	\$ (0.44)	\$ (0.44)
Second quarter	29,139,000	10,592,000	(2,612,000)	(0.31)	(0.31)
Third quarter	29,843,000	11,728,000	1,079,000	0.13	0.13
Fourth quarter	30,134,000	12,505,000	313,000	0.04	0.04
<b><u>2007</u></b>					
First quarter	\$ 36,025,000	\$ 14,484,000	\$ 4,283,000	\$ 0.51	\$ 0.51
Second quarter	36,084,000	13,948,000	2,221,000	0.26	0.26
Third quarter	36,779,000	14,051,000	2,367,000	0.28	0.28
Fourth quarter	35,293,000	13,074,000	95,000	0.01	0.01
<b><u>2006</u></b>					
First quarter	\$ 31,099,000	\$ 15,099,000	\$ 4,929,000	\$ 0.59	\$ 0.58
Second quarter	33,746,000	15,646,000	5,111,000	0.61	0.60
Third quarter	35,675,000	15,547,000	5,202,000	0.62	0.61
Fourth quarter	36,740,000	15,295,000	4,605,000	0.54	0.54

(Continued)

MERCANTILE BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
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**NOTE 21 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)  
CONDENSED FINANCIAL STATEMENTS**

Following are condensed parent company only financial statements:

CONDENSED BALANCE SHEETS

	<u>2008</u>	<u>2007</u>
<b>ASSETS</b>		
Cash and cash equivalents	\$ 407,000	\$ 2,137,000
Investment in bank subsidiary	203,153,000	206,890,000
Other assets	<u>4,396,000</u>	<u>3,373,000</u>
Total assets	<u>\$ 207,956,000</u>	<u>\$ 212,400,000</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities	\$ 594,000	\$ 1,255,000
Subordinated debentures	32,990,000	32,990,000
Shareholders' equity	<u>174,372,000</u>	<u>178,155,000</u>
Total liabilities and shareholders' equity	<u>\$ 207,956,000</u>	<u>\$ 212,400,000</u>

CONDENSED STATEMENTS OF INCOME

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Income			
Dividends from subsidiaries	\$ 4,739,000	\$ 7,291,000	\$ 6,440,000
Other	<u>0</u>	<u>19,000</u>	<u>73,000</u>
Total income	<u>4,739,000</u>	<u>7,310,000</u>	<u>6,513,000</u>
Expenses			
Interest expense	1,914,000	2,512,000	2,429,000
Other operating expenses	<u>2,431,000</u>	<u>2,835,000</u>	<u>1,917,000</u>
Total expenses	<u>4,345,000</u>	<u>5,347,000</u>	<u>4,346,000</u>
<b>Income before income tax benefit and equity in undistributed net income (loss) of subsidiary</b>	394,000	1,963,000	2,167,000
Federal income tax benefit	(1,417,000)	(1,783,000)	(1,392,000)
Equity in undistributed net income (loss) of subsidiary	<u>(6,770,000)</u>	<u>5,220,000</u>	<u>16,288,000</u>
<b>Net income (loss)</b>	<u>\$ (4,959,000)</u>	<u>\$ 8,966,000</u>	<u>\$ 19,847,000</u>

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(Continued)

**MERCANTILE BANK CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 21 – MERCANTILE BANK CORPORATION (PARENT COMPANY ONLY)**  
**CONDENSED FINANCIAL STATEMENTS** (Continued)

**CONDENSED STATEMENTS OF CASH FLOWS**

	<u>2008</u>	<u>2007</u>	<u>2006</u>
<b>Cash flows from operating activities</b>			
Net income (loss)	\$ (4,959,000)	\$ 8,966,000	\$ 19,847,000
Adjustments to reconcile net income (loss) to net cash from operating activities:			
Equity in undistributed (income) loss of subsidiary	6,770,000	(5,220,000)	(16,288,000)
Stock-based compensation expense	654,000	361,000	242,000
Change in other assets	(1,023,000)	(483,000)	9,000
Change in other liabilities	(661,000)	648,000	73,000
Net cash from operating activities	<u>779,000</u>	<u>4,272,000</u>	<u>3,883,000</u>
<b>Cash flows from investing activities</b>			
Net capital investment into subsidiaries	0	0	0
Net cash from investing activities	<u>0</u>	<u>0</u>	<u>0</u>
<b>Cash flows from financing activities</b>			
Stock option exercises, net	0	56,000	229,000
Employee stock purchase plan	76,000	91,000	107,000
Dividend reinvestment plan	40,000	76,000	98,000
Cash dividends	(2,625,000)	(4,677,000)	(4,035,000)
Fractional shares paid	0	(4,000)	(4,000)
Net cash for financing activities	<u>(2,509,000)</u>	<u>(4,458,000)</u>	<u>(3,605,000)</u>
Net change in cash and cash equivalents	(1,730,000)	(186,000)	278,000
Cash and cash equivalents at beginning of period	<u>2,137,000</u>	<u>2,323,000</u>	<u>2,045,000</u>
<b>Cash and cash equivalents at end of period</b>	<b><u>\$ 407,000</u></b>	<b><u>\$ 2,137,000</u></b>	<b><u>\$ 2,323,000</u></b>

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 March 12, 2009.

MERCANTILE BANK CORPORATION

/s/ Michael H. Price

Michael H. Price  
Chairman of the Board, President and Chief  
Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on March 12, 2009.

/s/ Betty S. Burton

Betty S. Burton, Director

/s/ Calvin D. Murdock

Calvin D. Murdock, Director

/s/ David M. Cassard

David M. Cassard, Director

/s/ Michael H. Price

Michael H. Price, Chairman of the Board, President and  
Chief Executive Officer (principal executive officer)

/s/ Edward J. Clark

Edward J. Clark, Director

/s/ Merle J. Prins

Merle J. Prins, Director

/s/ Peter A. Cordes

Peter A. Cordes, Director

/s/ Timothy O. Schad

Timothy O. Schad, Director

/s/ Doyle A. Hayes

Doyle A. Hayes, Director

/s/ Dale J. Visser

Dale J. Visser, Director

/s/ David M. Hecht

David M. Hecht, Director

/s/ Donald Williams, Sr.

Donald Williams, Sr., Director

/s/ Susan K. Jones

Susan K. Jones, Director

/s/ Charles E. Christmas

Charles E. Christmas, Senior Vice President, Chief  
Financial Officer and Treasurer (principal financial and  
accounting officer)

/s/ Lawrence W. Larsen

Lawrence W. Larsen, Director

# Corporate Information

2009 DIRECTORS AND EXECUTIVE OFFICERS	2009 STRATEGIC PLANNING TEAM MERCANTILE BANK OF MICHIGAN	SHAREHOLDER INFORMATION
<b>Betty S. Burton</b> Retired Educator and Business Owner	<b>Mark S. Augustyn</b> Senior Vice President, Commercial Loan Manager	<b>Annual Meeting</b> The Corporation's Annual Meeting of Shareholders will be held on Thursday, April 23, 2009, at Kent Country Club, 1600 College Ave. NE, Grand Rapids, MI 49505 at 9:00 a.m. local time.
<b>David M. Cassard</b> President, Waters Corporation (real estate investment)	<b>Sherri A. Calcut</b> Senior Vice President, President Mercantile Bank Mortgage Company	<b>Administrative Headquarters</b> 310 Leonard Street NW, 4th Floor Grand Rapids, MI 49504 616-406-3000
<b>Charles E. Christmas</b> Senior Vice President Chief Financial Officer & Treasurer Mercantile Bank Corporation	<b>Charles E. Christmas</b> Senior Vice President, Chief Financial Officer	<b>Legal Counsel</b> Dickinson Wright PLLC 500 Woodward Avenue, Suite 4000 Detroit, MI 48226-3425 <a href="http://www.dickinsonwright.com">www.dickinsonwright.com</a>
<b>Edward J. Clark</b> Chairman & Chief Executive Officer American Seating Company	<b>Alfred A. DeFlavis</b> Senior Vice President, East Region President	<b>Independent Certified Public Accountants</b> BDO Seidman, LLP 99 Monroe Avenue N.W., Suite 800 Grand Rapids, MI 49503-2654 <a href="http://www.bdo.com">www.bdo.com</a>
<b>Peter A. Cordes</b> President & Chief Executive Officer GWI Engineering, Inc. (industrial automation systems)	<b>C. Howard Haas</b> Senior Vice President, City President – Lansing	<b>Investor Relations</b> Margolin & Associates, Inc. 2575 Bolton Road Cleveland Heights, OH 44118
<b>Doyle A. Hayes</b> President & Chief Executive Officer Pyper Products Corporation (plastic injection molding and assembly); Majority Member, Talent Trax, LLC (staffing organization)	<b>Mark R. Hoffhines</b> Senior Vice President, Commercial Lender	<b>Common Stock Listing</b> Nasdaq Global Select Market Symbol: MBWM
<b>David M. Hecht</b> Attorney	<b>Sandy K. Jager</b> Senior Vice President, Internal Auditor	<b>Stock Registrar and Transfer Agent</b> Computershare Trust Company, N.A. P.O. Box 43102 Providence, RI 02940-3010 Shareholder Inquires 1-800-730-4001 <a href="http://www.computershare.com">www.computershare.com</a>
<b>Susan K. Jones</b> Owner Susan K. Jones & Associates (marketing consulting firm); Professor Ferris State University	<b>Amy W.M. Kam</b> Officer, Senior Executive Assistant	<b>SEC Form 10-K</b> Copies of the Corporation's Annual Report on Form 10-K, as filed with the Securities and Exchange Commission, are available to shareholders without charge upon written request. Please mail your request to: <b>Charles E. Christmas</b> Mercantile Bank Corporation 310 Leonard Street NW, 4th Floor Grand Rapids, MI 49504.
<b>Robert B. Kaminski, Jr.</b> Executive Vice President Chief Operating Officer & Secretary Mercantile Bank Corporation	<b>Robert B. Kaminski</b> President, Chief Operating Officer	<i>Mercantile Bank Corporation does not discriminate on the basis of race, color, national origin, sex, religion, age or disability in employment or the provision of services.</i>
<b>Lawrence W. Larsen</b> President & Chief Executive Officer Central Industrial Corporation (material handling and components supplier)	<b>Gordon L. Oosting</b> Senior Vice President, Commercial Lender	
<b>Calvin D. Murdock</b> President SF Supply, Inc. (electrical and automation supplies)	<b>Michael H. Price</b> Chairman, President & Chief Executive Officer	
<b>Michael H. Price</b> Chairman, President & Chief Executive Officer Mercantile Bank Corporation	<b>Raymond E. Reitsma</b> Senior Vice President, Senior Lending Officer	
<b>Merle J. Prins</b> Retired Bank Executive	<b>John R. Schulte</b> Senior Vice President, Chief Information Officer	
<b>Timothy O. Schad</b> Chairman & Chief Executive Officer Nucraft Furniture Company	<b>Michelle L. Shangraw</b> Senior Vice President, Retail Banking Director	
<b>Dale J. Visser</b> Chairman Visser Brothers, Inc. (construction general contractor)	<b>Jonathan P. Steiner</b> Senior Vice President, City President – Holland	
<b>Donald Williams, Sr.</b> Dean Emeritus Grand Valley State University	<b>Joseph M. Valicevic</b> Senior Vice President, Commercial Loan Manager	
	<b>Lonna L. Wiersma</b> Senior Vice President, Human Resource Director	
	<b>Robert T. Worthington</b> Senior Vice President, Risk Management Director	

# Mission Statement

The mission of Mercantile Bank Corporation is to provide financial products and services in a highly professional and personalized manner. We recognize that our most important partners are our customers. We will satisfy our customers by delivering top quality service that distinguishes us from our competitors.

Our employees are our most valuable asset. We strive to hire exceptional team members and are committed to maintaining an environment of growth and development.

We recognize the importance of being strong supporters of the diverse communities we serve, and pledge our commitment to making them stronger.

We believe that fulfilling our mission to our customers, employees and community will allow us to reward our shareholders with an excellent return on their investment in Mercantile Bank Corporation.



## We Believe in Kids.

Since the opening of our Leonard Street headquarters, employees have volunteered their time to mentor students at the nearby Harrison Park Elementary School. In 2008, 34 employees volunteered at least once a week to tutor a child – a 50% increase over 2007.



## We Believe in Holiday Spirit.

When we were told that ACCESS of West Michigan was facing a huge increase in need this past holiday, we donated the funds to feed 105 families a delicious, nutritious, much-appreciated Christmas dinner.



## We Believe in Green.

We provided the construction loan for Celadon New Town Development, an innovative residential, commercial and retail project in Grand Rapids. All the buildings are built to the Michigan *Green* Built Standard or will be *LEED* certified. The project includes insulation made with recycled newspapers, Energy Star appliances, reclaimed brick, solar heating, rain gardens and more. The project has been warmly received by the community, and units are selling before the project is even complete!



## We Believe in Inner Cities.

Bear Manor Properties has been renovating and developing residential and commercial projects in inner city Grand Rapids since 2004. The projects include homes, offices, retail spaces and more, all financed by Mercantile Bank. In 2008, Bear Manor won a Historic Preservation Award for its work.



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