

FARMERS & MERCHANTS BANCORP INC  
Form 10-Q  
July 25, 2018

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10 Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period June 30, 2018

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 001-38084

FARMERS & MERCHANTS BANCORP, INC.

(Exact name of registrant as specified in its charter)

OHIO 34-1469491  
(State or other jurisdiction of (IRS Employer  
incorporation or organization) Identification No.)

307 North Defiance Street, Archbold, Ohio 43502  
(Address of principal executive offices) (Zip Code)

(419) 446-2501

Registrant's telephone number, including area code

(Former name, former address and former fiscal year, if changed since last report.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes      No

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

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
Emerging growth company		

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

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

Yes      No

Indicate the number of shares of each of the issuers' classes of common stock, as of the latest practicable date:

Common Stock, No Par Value	9,263,910
Class	Outstanding as of July 20, 2018

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

FARMERS & MERCHANTS BANCORP, INC.

INDEX

Form 10-Q Items	Page
PART I. <u>FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets- June 30, 2018 and December 31, 2017</u>	3
<u>Condensed Consolidated Statements of Income &amp; Comprehensive Income - Three and Six Months Ended June 30, 2018 and June 30, 2017</u>	4-5
<u>Condensed Consolidated Statements of Cash Flows- Six Months Ended June 30, 2018 and June 30, 2017</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7-36
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	37-52
Item 3. <u>Qualitative and Quantitative Disclosures About Market Risk</u>	53
Item 4. <u>Controls and Procedures</u>	54
PART II. <u>OTHER INFORMATION</u>	54
Item 1. <u>Legal Proceedings</u>	54
Item 1A. <u>Risk Factors</u>	54
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	54
Item 3. <u>Defaults Upon Senior Securities</u>	54
Item 4. <u>Mine Safety Disclosures</u>	54

Item 5.	<u>Other Information</u>	54
Item 6.	<u>Exhibits</u>	55
	<u>Signatures</u>	56
101.INS	XBRL Instance Document (1)	
101.SCH	XBRL Taxonomy Extension Scheme Document (1)	
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (1)	
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (1)	
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (1)	
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (1)	

(1) Pursuant to Rule 406T of Regulation S-T, the interactive Data Files in Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

## ITEM 1 FINANCIAL STATEMENTS

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED BALANCE SHEETS

	(in thousands of dollars)	
	June 30, 2018	December 31, 2017
	(Unaudited)	
<b>Assets</b>		
Cash and due from banks	\$31,838	\$ 33,480
Federal funds sold	726	987
Total cash and cash equivalents	32,564	34,467
Interest-bearing time deposits	4,019	4,018
Securities - available-for-sale	187,036	196,398
Other securities, at cost	3,717	3,717
Loans held for sale	913	1,221
Loans, net	824,226	816,156
Premises and equipment	21,957	21,726
Goodwill	4,074	4,074
Mortgage servicing rights	2,356	2,299
Other real estate owned	649	674
Bank owned life insurance	14,692	14,523
Other assets	9,129	7,736
Total Assets	\$1,105,332	\$ 1,107,009
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing	\$200,067	\$ 199,114
<b>Interest-bearing</b>		
NOW accounts	311,185	298,711
Savings	238,167	233,949
Time	181,347	187,566
Total deposits	930,766	919,340
Federal funds purchased and securities sold under agreements to repurchase	23,898	39,495
Federal Home Loan Bank (FHLB) advances	5,000	5,000
Dividend payable	1,284	1,193
Accrued expenses and other liabilities	6,808	7,844
Total liabilities	967,756	972,872
<b>Commitments and Contingencies</b>		
<b>Stockholders' Equity</b>		
Common stock - No par value 20,000,000 shares authorized; issued and outstanding 10,400,000 shares 6/30/18 and 12/31/17 <sup>(1)</sup>	11,842	11,546

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Treasury stock - 1,134,620 shares 6/30/18, 1,134,120 shares 12/31/17 <sup>(1)</sup>	(12,186 )	(12,160 )
Retained earnings	142,330	136,577
Accumulated other comprehensive loss	(4,410 )	(1,826 )
Total stockholders' equity	137,576	134,137
Total Liabilities and Stockholders' Equity	\$1,105,332	\$ 1,107,009

(1) Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2017, Condensed Consolidated Balance Sheet has been derived from the audited Consolidated Balance Sheet as of that date.

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	(in thousands of dollars, except per share data) Three Months Ended		(in thousands of dollars, except per share data) Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
<b>Interest Income</b>				
Loans, including fees	\$10,521	\$9,120	\$20,623	\$17,820
Debt securities:				
U.S. Treasury and government agencies	612	623	1,235	1,265
Municipalities	289	300	570	615
Dividends	53	44	108	86
Federal funds sold and other	62	37	137	59
Total interest income	11,537	10,124	22,673	19,845
<b>Interest Expense</b>				
Deposits	1,389	1,098	2,708	2,128
Federal funds purchased and securities sold under agreements to repurchase	118	118	242	231
Borrowed funds	20	37	40	73
Total interest expense	1,527	1,253	2,990	2,432
Net Interest Income - Before Provision for Loan Losses	10,010	8,871	19,683	17,413
Provision for Loan Losses	132	25	172	98
Net Interest Income After Provision				
For Loan Losses	9,878	8,846	19,511	17,315
<b>Noninterest Income</b>				
Customer service fees	1,465	1,330	2,931	2,811
Other service charges and fees	1,040	1,209	2,052	2,080
Net gain on sale of loans	301	218	433	419
Net gain on sale of available-for-sale securities	-	16	-	47
Total noninterest income	2,806	2,773	5,416	5,357
<b>Noninterest Expense</b>				
Salaries and wages	3,225	3,137	6,535	6,138
Employee benefits	848	783	1,984	1,705
Net occupancy expense	441	374	828	787
Furniture and equipment	565	491	1,072	963
Data processing	305	308	636	619
Franchise taxes	228	225	467	450
ATM expense	333	292	645	597
Advertising	247	192	433	367
Net (gain) loss on sale of other assets owned	(1 )	14	16	14
FDIC assessment	81	82	168	165

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Mortgage servicing rights amortization	95	97	180	181
Other general and administrative	1,271	1,103	2,314	2,183
Total noninterest expense	7,638	7,098	15,278	14,169
Income Before Income Taxes	5,046	4,521	9,649	8,503
Income Taxes	932	1,298	1,768	2,441
Net Income	\$4,114	\$3,223	\$7,881	\$6,062
Net Income Per Share <sup>(1)</sup>	\$0.44	\$0.35	\$0.85	\$0.66
Dividends Declared <sup>(1)</sup>	\$0.14	\$0.12	\$0.27	\$0.24

(1) Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017  
 See Notes to Condensed Consolidated Unaudited Financial Statements



## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	(in thousands of dollars) Three Months Ended June 30, June 30, 2018 2017		(in thousands of dollars) Six Months Ended June 30, June 30, 2018 2017	
Net Income	\$4,114	\$ 3,223	\$7,881	\$ 6,062
Other Comprehensive Income (Loss) (Net of Tax):				
Net unrealized gain (loss) on available-for-sale				
securities	(344 )	2,044	(2,815)	2,456
Reclassification adjustment for gain on sale of				
available-for-sale securities	-	(16 )	-	(47 )
Net unrealized gain (loss) on available-for-sale				
securities	(344 )	2,028	(2,815)	2,409
Tax expense (benefit)	(72 )	690	(591 )	819
Other comprehensive income (loss)	(272 )	1,338	(2,224)	1,590
Comprehensive Income	\$3,842	\$ 4,561	\$5,657	\$ 7,652

See Notes to Condensed Consolidated Unaudited Financial Statements

## FARMERS &amp; MERCHANTS BANCORP, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	(in thousands of dollars)	
	Six Months Ended	
	June 30, 2018	June 30, 2017
<b>Cash Flows from Operating Activities</b>		
Net income	\$7,881	\$6,062
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	922	970
Amortization on available-for-sale securities, net	500	578
Amortization of servicing rights	180	181
Amortization of core deposit intangible	84	161
Compensation expense related to stock awards	314	224
Deferred income taxes	(592 )	1,278
Provision for loan loss	172	98
Gain on sale of loans held for sale	(433 )	(419 )
Originations of loans held for sale	(27,216)	(30,242)
Proceeds from sale of loans held for sale	27,618	31,658
Loss on sale of other assets owned	16	14
Gain on sales of securities available-for-sale	-	(47 )
Change in other assets and other liabilities, net	(914 )	(2,189 )
Net cash provided by (used in) operating activities	8,532	8,327
<b>Cash Flows from Investing Activities</b>		
Activity in available-for-sale securities:		
Maturities, prepayments and calls	8,712	14,647
Sales	-	13,562
Purchases	(2,695 )	(3,387 )
Change in interest-bearing time deposits	1	(626 )
Proceeds from sale of other assets owned	9	130
Additions to premises and equipment	(1,262 )	(469 )
Loan originations and principal collections, net	(8,644 )	(34,184)
Net cash used in investing activities	(3,879 )	(10,327)
<b>Cash Flows from Financing Activities</b>		
Net change in deposits	11,426	35,272
Net change in federal funds purchased and securities sold under agreements		
to repurchase	(15,597)	(30,229)
Cash dividends paid on common stock	(2,385 )	(2,106 )
Net cash provided by (used in) financing activities	(6,556 )	2,937
Net Increase (Decrease) in Cash and Cash Equivalents	(1,903 )	937
Cash and cash equivalents - Beginning of year	34,467	28,322

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Cash and cash equivalents - End of period	\$32,564	\$29,259
Supplemental Information		
Cash paid during the year for:		
Interest	\$2,993	\$2,436
Income taxes	\$1,307	\$2,302
Noncash investing activities:		
Transfer of loans to other real estate owned	\$-	\$-

See Notes to Condensed Consolidated Unaudited Financial Statements.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

## NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017. Operating results for the six months ended June 30, 2018 are not necessarily indicative of the results that are expected for the year ended December 31, 2018. The condensed consolidated balance sheet of the Company as of December 31, 2017, has been derived from the audited consolidated balance sheet of the Company as of that date. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

## NOTE 2 ASSET PURCHASES

The Company purchased an office on December 13, 2013 in Custar, Ohio. Core deposit intangible assets of \$1.17 million were recognized and are being amortized over its remaining economic useful life of the deposits of 7 years on a straight line basis.

The amortization expense for the year ended December 31, 2017 was \$245 thousand, which included the remaining \$78 thousand from the purchase of the Hicksville office on July 9, 2010. Of the \$167 thousand to be expensed in 2018, \$84 thousand has been expensed for the six months ended June 30, 2018.

	(In Thousands)
	Custar
2018	\$ 167
2019	167
2020	161
	\$ 495

## NOTE 3 SECURITIES

The amortized cost and fair value of securities, with gross unrealized gains and losses at June 30, 2018 and December 31, 2017, follows:

	(In Thousands)			
	June 30, 2018			
	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
Available-for-Sale:				
U.S. Treasury	\$21,168	\$ -	\$ (377 )	\$20,791
U.S. Government agencies	79,169	-	(2,859 )	76,310
Mortgage-backed securities	36,416	21	(1,601 )	34,836
State and local governments	55,865	313	(1,079 )	55,099
Total available-for-sale securities	\$192,618	\$ 334	\$ (5,916 )	\$187,036

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES (Continued)

	(In Thousands)			
	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
U.S. Treasury	\$21,219	\$ -	\$ (241 )	\$20,978
U.S. Government agencies	82,198	-	(1,732 )	80,466
Mortgage-backed securities	40,236	64	(790 )	39,510
State and local governments	55,512	437	(505 )	55,444
Total available-for-sale securities	\$199,165	\$ 501	\$ (3,268 )	\$196,398

Investment securities will at times depreciate to an unrealized loss position. The Company utilizes the following criteria to assess whether impairment is other than temporary. No one item by itself will necessarily signal that a security should be recognized as an other than temporary impairment.

1. The fair value of the security has significantly declined from book value.
2. A downgrade has occurred that lowered the credit rating to below investment grade (below Baa3 by Moody and BBB – by Standard and Poors.)
3. Dividends have been reduced or eliminated or scheduled interest payments have not been made.
4. The underwater security has longer than 10 years to maturity and the loss position had existed for more than 3 years.
5. Management does not possess both the intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the impairment is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value, thereby establishing a new cost basis. The new cost basis shall not be changed for subsequent recoveries in fair value. The amount of the write down shall be included in current earnings as a realized loss. The recovery in fair value, if any, shall be recognized in earnings when the security is sold. The table below is presented by category of security and length of time in a continuous loss position. The Company currently does not hold any securities with other than temporary impairment.

Information pertaining to securities with gross unrealized losses at June 30, 2018 and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous loss position follows:

(In Thousands)	
June 30, 2018	
Less Than Twelve Months	Twelve Months & Over
Gross Unrealized	Gross Unrealized
Fair	Fair

	Losses	Value	Losses	Value
U.S. Treasury	\$(104 )	\$6,864	\$(273 )	\$13,927
U.S. Government agencies	(469 )	14,664	(2,390)	61,646
Mortgage-backed securities	(94 )	5,640	(1,507)	27,975
State and local governments	(472 )	30,386	(607 )	12,002
Total available-for-sale securities	\$(1,139)	\$57,554	\$(4,777)	\$115,550

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 3 SECURITIES (Continued)

	(In Thousands)			
	December 31, 2017			
	Less Than Twelve Months		Twelve Months & Over	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
U.S. Treasury	\$(36 )	\$6,924	\$(205 )	\$14,054
U.S. Government agencies	(314)	27,328	(1,418)	53,139
Mortgage-backed securities	(70 )	7,149	(720 )	28,080
State and local governments	(205)	24,999	(300 )	11,567
Total available-for-sale securities	\$(625)	\$66,400	\$(2,643)	\$106,840

Unrealized losses on securities have not been recognized into income because the issuers' bonds are of high credit quality, values have only been impacted by rate changes, and the Company has the intent and ability to hold the securities for the foreseeable future. Additionally, the decline in value is primarily due to changes in interest rates since the securities were purchased. The fair value is expected to recover as the bonds approach the maturity date.

Below are the gross realized gains and losses for the three and six months ended June 30, 2018 and June 30, 2017.

	Three Months		Six Months	
	(In Thousands)		(In Thousands)	
	2018	2017	2018	2017
Gross realized gains	\$ -	\$ 27	\$ -	\$ 58
Gross realized losses	-	(11 )	-	(11 )
Net realized gains	\$ -	\$ 16	\$ -	\$ 47
Tax expense related to net realized gains	\$ -	\$ 5	\$ -	\$ 16

The net realized gains on sales and related tax expense is a reclassification out of accumulated other comprehensive income (loss). The net realized gain is included in net gain on sale of available-for-sale securities and the related tax expense is included in income taxes in the condensed consolidated statements of income and comprehensive income.

The amortized cost and fair value of debt securities at June 30, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.



	(In Thousands)	
	Amortized	
	Cost	Fair Value
One year or less	\$22,734	\$22,674
After one year through five years	79,589	78,096
After five years through ten years	50,835	48,566
After ten years	3,044	2,864
Total	\$156,202	\$152,200
Mortgage-backed securities	36,416	34,836
Total	\$192,618	\$187,036

Investments with a carrying value of \$83.2 million and \$82.9 million at June 30, 2018 and December 31, 2017, respectively, were pledged to secure public deposits and securities sold under repurchase agreements.

Other securities include Federal Home Loan Bank of Cincinnati and Farmer Mac stock as of June 30, 2018 and December 31, 2017.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS

Loan balances as of June 30, 2018 and December 31, 2017:

Loans:	(In Thousands)	
	June 30, 2018	December 31, 2017
Consumer Real Estate	\$82,853	\$ 83,620
Agricultural Real Estate	69,701	64,073
Agricultural	104,830	95,111
Commercial Real Estate	411,509	410,520
Commercial and Industrial	116,351	126,275
Consumer	40,513	37,757
Industrial Development Bonds	6,071	6,415
	831,828	823,771
Less: Net deferred loan fees and costs	(813 )	(747 )
	831,015	823,024
Less: Allowance for loan losses	(6,789 )	(6,868 )
Loans - Net	\$824,226	\$ 816,156

The following is a contractual maturity schedule by major category of loans as of June 30, 2018:

	(In Thousands)		
	Within One Year	Within Five Years	After Five Years
Consumer Real Estate	\$4,338	\$14,305	\$64,210
Agricultural Real Estate	867	5,642	63,192
Agricultural	63,873	29,129	11,828
Commercial Real Estate	12,918	140,932	257,659
Commercial and Industrial	60,579	45,926	9,846
Consumer	5,218	26,031	9,264
Industrial Development Bonds	600	65	5,406

The distribution of fixed rate loans and variable rate loans by major loan category is as follows as of June 30, 2018:

	(In Thousands)	
	Fixed	Variable
	Rate	Rate
Consumer Real Estate	\$39,784	\$43,069
Agricultural Real Estate	50,538	19,163
Agricultural	37,971	66,859
Commercial Real Estate	249,029	162,480
Commercial and Industrial	41,256	75,095
Consumer	35,945	4,568
Industrial Development Bonds	6,071	-

As of June 30, 2018 and December 31, 2017 one to four family residential mortgage loans amounting to \$15.8 and \$17.3 million, respectively, have been pledged as security for future loans and existing loans the Bank has received from the Federal Home Loan Bank.

Unless listed separately, Industrial Development Bonds are included in the Commercial and Industrial category for the remainder of the tables in this Note 4.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the contractual aging of the recorded investment (in thousands) in past due loans by portfolio classification of loans as of June 30, 2018 and December 31, 2017, net of deferred loan fees and costs:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
June 30, 2018							
Consumer Real Estate	\$ 325	\$ 143	\$ 250	\$ 718	\$ 81,650	\$ 82,368	\$ -
Agricultural Real Estate	16	-	-	16	69,660	69,676	-
Agricultural	-	-	-	-	104,980	104,980	-
Commercial Real Estate	-	-	-	-	410,886	410,886	-
Commercial and Industrial	44	-	-	44	122,466	122,510	-
Consumer	25	28	-	53	40,542	40,595	-
Total	\$ 410	\$ 171	\$ 250	\$ 831	\$ 830,184	\$ 831,015	\$ -
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
December 31, 2017							
Consumer Real Estate	\$ 565	\$ 212	\$ 113	\$ 890	\$ 82,310	\$ 83,200	\$ -
Agricultural Real Estate	-	-	101	101	63,943	64,044	-
Agricultural	-	-	-	-	95,238	95,238	-
Commercial Real Estate	-	-	38	38	409,915	409,953	-
Commercial and Industrial	-	42	-	42	132,745	132,787	-
Consumer	34	2	7	43	37,759	37,802	-
Total	\$ 599	\$ 256	\$ 259	\$ 1,114	\$ 821,910	\$ 823,024	\$ -

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table presents the recorded investment in nonaccrual loans by class of loans as of June 30, 2018 and December 31, 2017:

	(In Thousands)	
	June 30,	December 31,
	2018	2017
Consumer Real Estate	\$796	\$ 708
Agricultural Real Estate	-	101
Agricultural	-	-
Commercial Real Estate	-	38
Commercial & Industrial	107	149
Consumer	-	7
Total	\$903	\$ 1,003

Following are the characteristics and underwriting criteria for each major type of loan the Bank offers:

**Consumer Real Estate:** Purchase, refinance, or equity financing of one to four family owner occupied dwelling. Success in repayment is subject to borrower's income, debt level, character in fulfilling payment obligations, employment, and others.

**Agricultural Real Estate:** Purchase of farm real estate or for permanent improvements to the farm real estate. Cash flow from the farm operation is the repayment source and is therefore subject to the financial success of the farm operation.

**Agricultural:** Loans for the production and housing of crops, fruits, vegetables, and livestock or to fund the purchase or re-finance of capital assets such as machinery and equipment and livestock. The production of crops and livestock is especially vulnerable to commodity prices and weather. The vulnerability to commodity prices is offset by the farmer's ability to hedge their position by the use of the future contracts. The risk related to weather is often mitigated by requiring crop insurance.

**Commercial Real Estate:** Construction, purchase, and refinance of business purpose real estate. Risks include potential construction delays and overruns, vacancies, collateral value subject to market value fluctuations, interest rate, market demands, borrower's ability to repay in orderly fashion, and others. The Bank does employ stress testing on higher balance loans to mitigate risk by ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

**Commercial and Industrial:** Loans to proprietorships, partnerships, or corporations to provide temporary working capital and seasonal loans as well as long term loans for capital asset acquisition. Risks include adequacy of cash flow, reasonableness of projections, financial leverage, economic trends, management ability and estimated capital expenditures during the fiscal year. The Bank does employ stress testing on higher balance loans to mitigate risk by

ensuring the customer's ability to repay in a changing rate environment before granting loan approval.

Industrial Development Bonds (IDB): Funds for public improvements in the Bank's service area. Repayment ability is based on the continuance of the taxation revenue as the source of repayment.

Consumer: Funding for individual and family purposes. Success in repayment is subject to borrower's income, debt level, character in fulfilling payment obligations, employment, and others.

The Bank uses a nine tier risk rating system to grade its loans. The grade of a loan may change during the life of the loan.

The risk ratings are described as follows.

- 1.Zero (0) Unclassified. Any loan which has not been assigned a classification.
- 2.One (1) Excellent. Credit to premier customers having the highest credit rating based on an extremely strong financial condition, which compares favorably with industry standards (upper quartile of Risk Management Association ratios). Financial statements indicate a sound earnings and financial ratio trend for several years with satisfactory profit margins and excellent liquidity exhibited. Prime credits may also be borrowers with loans fully secured by highly liquid collateral such as traded stocks, bonds, certificates of deposit, savings account, etc. No credit or collateral exceptions exist and the loan adheres to the Bank's loan policy in every respect. Financing alternatives would be readily available and would qualify for unsecured credit. This grade is summarized by high liquidity, minimum risk, strong ratios, and low handling costs.

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 4 LOANS (Continued)

3. Two (2) Good. Desirable loans of somewhat less stature than Grade 1, but with strong financial statements. Loan supported by financial statements containing strong balance sheets, generally with a leverage position less than 1.50, and a history of profitability. Probability of serious financial deterioration is unlikely. Possessing a sound repayment source (and a secondary source), which would allow repayment in a reasonable period of time. Individual loans backed by liquid personal assets, established history and unquestionable character.

4. Three (3) Satisfactory. Satisfactory loans of average or slightly above average risk – having some deficiency or vulnerability to changing economic conditions, but still fully collectible. Projects should normally demonstrate acceptable debt service coverage. Generally, customers should have a leverage position less than 2.00. May be some weakness but with offsetting features of other support readily available. Loans that are meeting the terms of repayment.

Loans may be graded 3 when there is no recent information on which to base a current risk evaluation and the following conditions apply:

At inception, the loan was properly underwritten and did not possess an unwarranted level of credit risk:

- a. At inception, the loan was secured with collateral possessing a loan value adequate to protect the Bank from loss;
  - b. The loan exhibited two or more years of satisfactory repayment with a reasonable reduction of the principal balance;
  - c. During the period that the loan has been outstanding, there has been no evidence of any credit weakness. Some examples of weakness include slow payment, lack of cooperation by the borrower, breach of loan covenants, or the business is in an industry which is known to be experiencing problems. If any of the credit weaknesses is observed, a lower risk grade is warranted.
5. Four (4) Satisfactory / Monitored. A “4” (Satisfactory/Monitored) risk grade may be established for a loan considered satisfactory but which is of average credit risk due to financial weakness or uncertainty. The loans warrant a higher than average level of monitoring to ensure that weaknesses do not advance. The level of risk in Satisfactory/Monitored classification is considered acceptable and within normal underwriting guidelines, so long as the loan is given management supervision.
6. Five (5) Special Mention. Loans that possess some credit deficiency or potential weakness which deserves close attention, but which do not yet warrant substandard classification. Such loans pose unwarranted financial risk that, if not corrected, could weaken the loan and increase risk in the future. The key distinctions of a 5 (Special Mention) classification are that (1) it is indicative of an unwarranted level of risk, and (2) weaknesses are considered “potential”, versus “defined”, impairments to the primary source of loan repayment and collateral.
7. Six (6) Substandard. One or more of the following characteristics may be exhibited in loans classified substandard:
- a. Loans, which possess a defined credit weakness and the likelihood that a loan will be paid from the primary source, are uncertain. Financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss.
  - b. Loans are inadequately protected by the current net worth and paying capacity of the borrower.
    - c. The primary source of repayment is weakened, and the Bank is forced to rely on a secondary source of repayment such as collateral liquidation or guarantees.
  - d. Loans are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected.
  - e. Unusual courses of action are needed to maintain a high probability of repayment.
  - f. The borrower is not generating enough cash flow to repay loan principal; however, continues to make interest payments.
  - g. The lender is forced into a subordinate position or unsecured collateral position due to flaws in documentation.

h. Loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms.

i. The lender is seriously contemplating foreclosure or legal action due to the apparent deterioration in the loan.

j. There is significant deterioration in the market conditions and the borrower is highly vulnerable to these conditions.

13

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 4 LOANS (Continued)

8. Seven (7) Doubtful. One or more of the following characteristics may be exhibited in loans classified Doubtful:

- a. Loans have all of the weaknesses of those classified as Substandard. Additionally, however, these weaknesses make collection or liquidation in full based on existing conditions improbable.
- b. The primary source of repayment is gone, and there is considerable doubt as to the quality of the secondary source of repayment.
- c. The possibility of loss is high, but, because of certain important pending factors which may strengthen the loan, loss classification is deferred until its exact status is known. A Doubtful classification is established deferring the realization of the loss.

9. Eight (8) Loss. Loans are considered uncollectable and of such little value that continuing to carry them as assets on the institution's financial statements is not feasible. Loans will be classified Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following table represents the risk category of loans by portfolio class, net of deferred fees and costs, based on the most recent analysis performed as of June 30, 2018 and December 31, 2017:

(In Thousands)					
	Agricultural Real Estate		Commercial Real Estate	Commercial and Industrial	Industrial Development Bonds
June 30, 2018					
1-2	\$ 3,919	\$ 4,493	\$ 5,604	\$ 2,151	\$ -
3	14,414	34,305	30,774	18,285	3,217
4	50,899	65,061	363,946	93,664	2,854
5	431	1,121	7,601	1,151	-
6	13	-	2,961	1,081	-
7	-	-	-	107	-
8	-	-	-	-	-
Total	\$ 69,676	\$ 104,980	\$ 410,886	\$ 116,439	\$ 6,071
December 31, 2017					
1-2	\$ 4,143	\$ 6,558	\$ 1,244	\$ 9,205	\$ -
3	15,244	37,267	32,498	15,277	3,489
4	43,416	51,312	359,600	99,581	2,926
5	1,125	101	7,758	1,381	-
6	116	-	8,853	817	-
7	-	-	-	111	-
8	-	-	-	-	-
Total	\$ 64,044	\$ 95,238	\$ 409,953	\$ 126,372	\$ 6,415

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

For consumer residential real estate, and other, the Company also evaluates credit quality based on the aging status of the loan, as was previously stated, and by payment activity. The following tables present the recorded investment in those classes based on payment activity and assigned risk grading as of June 30, 2018 and December 31, 2017.

	(In Thousands)	
	Consumer Real Estate June 30, 2018	Consumer Real Estate December 31, 2017
Grade		
Pass	\$81,834	\$ 82,632
Special Mention (5)	-	-
Substandard (6)	454	488
Doubtful (7)	80	80
Total	\$82,368	\$ 83,200

	(In Thousands)			
	Consumer - Credit June 30, 2018, 2017		Consumer - Other June 30, 2018, 2017	
	2018	2017	2018	2017
Performing	\$3,998	\$ 4,108	\$36,579	\$ 33,666
Nonperforming	-	-	18	28
Total	\$3,998	\$ 4,108	\$36,597	\$ 33,694

Information about impaired loans as of June 30, 2018, December 31, 2017 and June 30, 2017 are as follows:

	(In Thousands)		
	June 30, 2018	December 31, 2017	June 30, 2017
Impaired loans without a valuation allowance	804	1,131	1,024
Impaired loans with a valuation allowance	648	614	691
Total impaired loans	\$ 1,452	\$ 1,745	\$ 1,715
Valuation allowance related to impaired loans	\$ 132	\$ 106	\$ 115
Total non-accrual loans	\$ 903	\$ 1,003	\$ 1,365

Total loans past-due ninety days or more and

still accruing	\$ -	\$ -	\$ -
Quarter ended average investment in impaired			
loans	\$ 1,452	\$ 2,160	\$ 1,744
Year to date average investment in impaired			
loans	\$ 1,570	\$ 1,885	\$ 1,789

No additional funds are committed to be advanced in connection with impaired loans.

The Bank had approximately \$107 thousand of its impaired loans classified as troubled debt restructured (TDR) as of June 30, 2018, \$534 thousand as of December 31, 2017 and \$546 thousand as of June 30, 2017. During the year to date 2018 and 2017, there were no new loans considered TDR.

For the three and six month period ended June 30, 2018 and 2017, there were no TDRs that subsequently defaulted after modification.

For the six month period ended June 30, 2018, \$418 thousand of impaired loans classified as TDR involving one relationship was paid off.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

For the majority of the Bank's impaired loans, the Bank will apply the fair value of collateral or use a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine fair value of collateral, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off, whether a partial or full loan balance. A charge-off in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-off may be realized as further unsecured positions are recognized.

The following tables present loans individually evaluated for impairment by class of loans for three months ended June 30, 2018 and June 30, 2017 .

Three Months Ended June 30, 2018	(In Thousands)			QTD	QTD	QTD
	Unpaid Recorded Investment	Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
With no related allowance recorded:						
Consumer Real Estate	\$606	\$ 606	\$ -	\$ 526	\$ 6	\$ 4
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	198	198	-	199	3	-
Commercial and Industrial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
With a specific allowance recorded:						
Consumer Real Estate	254	254	46	152	-	-
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	-	-	-	139	-	-
Commercial and Industrial	394	394	86	436	4	-
Consumer	-	-	-	-	-	-
Totals:						
Consumer Real Estate	\$860	\$ 860	\$ 46	\$ 678	\$ 6	\$ 4
Agricultural Real Estate	\$-	\$ -	\$ -	\$ -	\$ -	\$ -

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Agricultural	\$-	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial Real Estate	\$ 198	\$ 198	\$ -	\$ 338	\$ 3	\$ -
Commercial and Industrial	\$394	\$ 394	\$ 86	\$ 436	\$ 4	\$ -
Consumer	\$-	\$ -	\$ -	\$ -	\$ -	\$ -

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

(In Thousands)

Three Months Ended June 30, 2017	Recorded Investment	Unpaid Principal Balance	Related Allowance	QTD Average Recorded Investment	QTD Interest Income Recognized	QTD Interest Income Recognized Cash Basis
With no related allowance recorded:						
Consumer Real Estate	\$923	\$ 923	\$ -	\$ 948	\$ 8	\$ 6
Agricultural Real Estate	101	101	-	101	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-	-
Commercial and Industrial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
With a specific allowance recorded:						
Consumer Real Estate	85	85	25	87	-	-
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	492	492	57	493	7	-
Commercial and Industrial	114	114	33	115	-	-
Consumer	-	-	-	-	-	-
Totals:						
Consumer Real Estate	\$1,008	\$ 1,008	\$ 25	\$ 1,035	\$ 8	\$ 6
Agricultural Real Estate	\$101	\$ 101	\$ -	\$ 101	\$ -	\$ -
Agricultural	\$-	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial Real Estate	\$492	\$ 492	\$ 57	\$ 493	\$ 7	\$ -
Commercial and Industrial	\$114	\$ 114	\$ 33	\$ 115	\$ -	\$ -
Consumer	\$-	\$ -	\$ -	\$ -	\$ -	\$ -

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

The following tables present loans individually evaluated for impairment by class of loans for six months ended June 30, 2018 and June 30, 2017.

Six Months Ended June 30, 2018	(In Thousands)			YTD Average Recorded Investment	YTD Interest Income Recognized	YTD Interest Income Recognized Cash Basis
	Unpaid Recorded Investment	Principal Balance	Related Allowance			
With no related allowance recorded:						
Consumer Real Estate	\$606	\$ 606	\$ -	\$ 509	\$ 14	\$ 10
Agricultural Real Estate	-	-	-	34	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	198	198	-	200	5	-
Commercial and Industrial	-	-	-	104	-	-
Consumer	-	-	-	-	-	-
With a specific allowance recorded:						
Consumer Real Estate	254	254	46	116	-	-
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	-	-	-	279	-	-
Commercial and Industrial	394	394	86	328	8	-
Consumer	-	-	-	-	-	-
Totals:						
Consumer Real Estate	\$860	\$ 860	\$ 46	\$ 625	\$ 14	\$ 10
Agricultural Real Estate	\$-	\$ -	\$ -	\$ 34	\$ -	\$ -
Agricultural	\$-	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial Real Estate	\$198	\$ 198	\$ -	\$ 479	\$ 5	\$ -
Commercial and Industrial	\$394	\$ 394	\$ 86	\$ 432	\$ 8	\$ -
Consumer	\$-	\$ -	\$ -	\$ -	\$ -	\$ -



## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

Six Months Ended June 30, 2017	(In Thousands)			YTD	YTD	YTD
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Interest Income Recognized Cash Basis
With no related allowance recorded:						
Consumer Real Estate	\$923	\$ 923	\$ -	\$ 976	\$ 16	\$ 12
Agricultural Real Estate	101	101	-	111	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-	-
Commercial and Industrial	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
With a specific allowance recorded:						
Consumer Real Estate	85	85	25	90	-	-
Agricultural Real Estate	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Commercial Real Estate	492	492	57	496	13	-
Commercial and Industrial	114	114	33	116	-	-
Consumer	-	-	-	-	-	-
Totals:						
Consumer Real Estate	\$1,008	\$1,008	\$ 25	\$ 1,066	\$ 16	\$ 12
Agricultural Real Estate	\$101	\$ 101	\$ -	\$ 111	\$ -	\$ -
Agricultural	\$-	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial Real Estate	\$492	\$ 492	\$ 57	\$ 496	\$ 13	\$ -
Commercial and Industrial	\$114	\$ 114	\$ 33	\$ 116	\$ -	\$ -
Consumer	\$-	\$ -	\$ -	\$ -	\$ -	\$ -

As of June 30, 2018, the Company had no foreclosed residential real estate property obtained by physical possession and \$255 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings are in process according to local jurisdictions. As of June 30, 2017, the Company had \$25 thousand of foreclosed residential real estate property obtained by physical possession and \$36 thousand of consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings were in process according to local jurisdictions.

The Allowance for Loan and Lease Losses (ALLL) has a direct impact on the provision expense. An increase in the ALLL is funded through recoveries and provision expense. The following tables summarize the activities in the allowance for credit losses.

	(In Thousands)	
	Six Months Ended	Twelve Months Ended
	June 30, 2018	December 31, 2017
Allowance for Loan & Lease Losses		
Balance at beginning of year	\$6,868	\$ 6,784
Provision for loan loss	172	222
Loans charged off	(327 )	(288 )
Recoveries	76	150
Allowance for Loan & Lease Losses	\$6,789	\$ 6,868
Allowance for Unfunded Loan Commitments &		
Letters of Credit	\$315	\$ 227
Total Allowance for Credit Losses	\$7,104	\$ 7,095

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 4 LOANS (Continued)

The Company segregates its ALLL into two reserves: The ALLL and the Allowance for Unfunded Loan Commitments and Letters of Credit (AULC). When combined, these reserves constitute the total Allowance for Credit Losses (ACL).

The AULC is reported within other liabilities on the balance sheet while the ALLL is netted within the loans, net asset line. The ACL presented above represents the full amount of reserves available to absorb possible credit losses.

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ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 4 LOANS (Continued)

The following table breaks down the activity within ACL for each loan portfolio classification and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs.

Additional analysis, presented in thousands, related to the allowance for credit losses for three months ended June 30, 2018 and June 30, 2017 is as follows:

	Consumer	Agricultural	Commercial	Commercial	Commercial	Consumer Credit	Unallocated	Total
	Real Estate	Real Estate	Agricultural	Real Estate and Industrial	Commercial	Consumer Credit	Unallocated	Total
Three Months Ended June 30, 2018								
ALLOWANCE FOR CREDIT LOSSES:								
Beginning balance	\$ 254	\$ 263	\$ 706	\$ 3,674	\$ 1,443	\$ 431	\$ 265	\$ 7,065
Charge Offs	-	-	-	(1 )	(100 )	(81 )	-	(182 )
Recoveries	-	-	3	2	3	31	-	39
Provision (Credit)	(3 )	(8 )	42	(415 )	74	78	-	132
Other Non-interest expense related to								
unfunded	-	-	-	-	-	-	50	50
Ending Balance	\$ 251	\$ 255	\$ 751	\$ 3,260	\$ 1,420	\$ 459	\$ 315	\$ 7,104
Ending balance: individually evaluated								
for impairment	\$ 46	\$ -	\$ -	\$ -	\$ 86	\$ -	\$ -	\$ 132
	\$ 205	\$ 255	\$ 751	\$ 3,260	\$ 1,334	\$ 459	\$ 315	\$ 6,972

Ending balance:  
collectively  
evaluated

for impairment

Ending balance:  
loans acquired  
with

deteriorated  
credit quality

\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$-
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FINANCING

RECEIVABLES:

Ending balance	\$ 82,368	\$ 69,676	\$ 104,980	\$ 410,886	\$ 122,510	\$ 40,595	\$ -	\$ -	\$ 831,015
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Ending balance:  
individually  
evaluated

for impairment

\$ 860	\$ -	\$ -	\$ 198	\$ 394	\$ -	\$ -	\$ -	\$ -	\$ 1,452
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Ending balance:  
collectively  
evaluated

for impairment

\$ 81,508	\$ 69,676	\$ 104,980	\$ 410,688	\$ 122,116	\$ 40,595	\$ -	\$ -	\$ -	\$ 829,563
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Ending balance:  
loans acquired  
with

deteriorated  
credit quality

\$ 119	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 119
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	Consumer	Agricultural	Commercial	Commercial	Commercial	Consumer	Credit	Unallocated	Total
	Real Estate	Real Estate	Agricultural	Real Estate and Industrial	Real Estate and Industrial	Consumer	Credit	Unallocated	Total
Three Months Ended June 30, 2017									
ALLOWANCE FOR CREDIT LOSSES:									
Beginning balance	\$ 277	\$ 244	\$ 634	\$ 3,008	\$ 1,299	\$ 397	\$ 219	\$ 991	\$ 7,069
Charge Offs	-	-	-	-	-	(53 )	-	-	(53 )
Recoveries	2	-	1	5	3	25	-	-	36
Provision (Credit)	(29 )	9	(39 )	63	50	38	-	(67 )	25
Other Non-interest expense related to unfunded	-	-	-	-	-	-	-	-	-
Ending Balance	\$ 250	\$ 253	\$ 596	\$ 3,076	\$ 1,352	\$ 407	\$ 219	\$ 924	\$ 7,077
Ending balance: individually evaluated									
for impairment	\$ 25	\$ -	\$ -	\$ 57	\$ 33	\$ -	\$ -	\$ -	\$ 115
Ending balance: collectively evaluated									
for impairment	\$ 225	\$ 253	\$ 596	\$ 3,019	\$ 1,319	\$ 407	\$ 219	\$ 924	\$ 6,962
Ending balance: loans acquired with deteriorated credit quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
FINANCING RECEIVABLES:									
Ending balance	\$ 83,903	\$ 64,003	\$ 83,771	\$ 394,051	\$ 129,675	\$ 35,435	\$ -	\$ -	\$ 790,838
	\$ 1,008	\$ 101	\$ -	\$ 492	\$ 114	\$ -	\$ -	\$ -	\$ 1,715

Ending balance:  
individually  
evaluated

for impairment  
Ending balance:  
collectively  
evaluated

for impairment	\$82,895	\$63,902	\$83,771	\$393,559	\$129,561	\$35,435	\$-	\$-	\$789,123
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Ending balance:  
loans acquired with

deteriorated credit quality	\$196	\$-	\$-	\$-	\$-	\$-	\$-	\$-	\$196
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

Additional analysis, presented in thousands, related to the allowance for credit losses for six months ended June 30, 2018 and June 30, 2017 is as follows:

	Consumer	Agricultural	Real Estate	Real Estate	Commercial	Commercial	Consumer Credit	Unallocated	Total
			Real Estate	Real Estate	Real Estate and Industrial	Real Estate and Industrial	Consumer Credit	Unallocated	Total
Six Months Ended									
June 30, 2018									
ALLOWANCE									
FOR CREDIT									
LOSSES:									
Beginning balance	\$ 343	\$ 244	\$ 667	\$ 3,149	\$ 1,546	\$ 441	\$ 227	\$ 478	\$ 7,095
Charge Offs	(34 )	-	-	(16 )	(100 )	(177 )	-	-	(327 )
Recoveries	-	-	6	4	6	60	-	-	76
Provision (Credit)	(58 )	11	78	123	(32 )	135	-	(85 )	172
Other Non-interest expense related to									
unfunded	-	-	-	-	-	-	88	-	88
Ending Balance	\$ 251	\$ 255	\$ 751	\$ 3,260	\$ 1,420	\$ 459	\$ 315	\$ 393	\$ 7,104
Ending balance: individually evaluated									
for impairment	\$ 46	\$ -	\$ -	\$ -	\$ 86	\$ -	\$ -	\$ -	\$ 132
Ending balance: collectively evaluated									
for impairment	\$ 205	\$ 255	\$ 751	\$ 3,260	\$ 1,334	\$ 459	\$ 315	\$ 393	\$ 6,972
Ending balance: loans acquired with	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -



deteriorated credit quality									
FINANCING RECEIVABLES:									
Ending balance	\$ 82,368	\$ 69,676	\$ 104,980	\$ 410,886	\$ 122,510	\$ 40,595	\$ -	\$ -	\$ 831,015
Ending balance: individually evaluated									
for impairment	\$ 860	\$ -	\$ -	\$ 198	\$ 394	\$ -	\$ -	\$ -	\$ 1,452
Ending balance: collectively evaluated									
for impairment	\$ 81,508	\$ 69,676	\$ 104,980	\$ 410,688	\$ 122,116	\$ 40,595	\$ -	\$ -	\$ 829,563
Ending balance: loans acquired with									
deteriorated credit quality	\$ 119	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 119

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 4 LOANS (Continued)

	Consumer		Agricultural		Commercial		Commercial		Unfunded	
									Loan	
									Commitment	
									&	
									Letters	
									of	
	Real Estate	Real Estate	Agricultural	Real Estate and Industrial	Commercial	Commercial	Consumer Credit	Unallocated	Total	
Six Months Ended										
June 30, 2017										
ALLOWANCE										
FOR CREDIT										
LOSSES:										
Beginning balance	\$ 316	\$ 241	\$ 616	\$ 3,250	\$ 1,318	\$ 394	\$ 217	\$ 649	\$ 7,001	
Charge Offs	-	-	-	-	-	(97 )	-	-	(97 )	
Recoveries	13	-	2	7	6	45	-	-	73	
Provision (Credit)	(79 )	12	(22 )	(181 )	28	65	-	275	98	
Other Non-interest										
expense related to										
unfunded	-	-	-	-	-	-	2	-	2	
Ending Balance	\$ 250	\$ 253	\$ 596	\$ 3,076	\$ 1,352	\$ 407	\$ 219	\$ 924	\$ 7,077	
Ending balance:										
individually										
evaluated										
for impairment	\$ 25	\$ -	\$ -	\$ 57	\$ 33	\$ -	\$ -	\$ -	\$ 115	
Ending balance:										
collectively										
evaluated										
for impairment	\$ 225	\$ 253	\$ 596	\$ 3,019	\$ 1,319	\$ 407	\$ 219	\$ 924	\$ 6,962	
Ending balance:										
loans acquired with										
deteriorated credit										
quality	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	
FINANCING										
RECEIVABLES:										
Ending balance	\$ 83,903	\$ 64,003	\$ 83,771	\$ 394,051	\$ 129,675	\$ 35,435	\$ -	\$ -	\$ 790,838	

Ending balance:  
individually  
evaluated

for impairment	\$ 1,008	\$ 101	\$ -	\$ 492	\$ 114	\$ -	\$ -	\$ -	\$ 1,715
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Ending balance:  
collectively  
evaluated

for impairment	\$ 82,895	\$ 63,902	\$ 83,771	\$ 393,559	\$ 129,561	\$ 35,435	\$ -	\$ -	\$ 789,123
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Ending balance:  
loans acquired with

deteriorated credit quality	\$ 196	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 196
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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 5 EARNINGS PER SHARE

Basic earnings per share are calculated using the two-class method. The two-class method is an earnings allocation formula under which earnings per share is calculated from common stock and participating securities according to dividends declared and participation rights in undistributed earnings. Under this method, all earnings distributed and undistributed, are allocated to participating securities and common shares based on their respective rights to receive dividends. Unvested share-based payment awards that contain non-forfeitable rights to dividends are considered participating securities (i.e. unvested restricted stock), not subject to performance based measures. Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding. Application of the two-class method for participating securities results a more dilutive basic earnings per share as the participating securities are allocated the same amount of income as if they are outstanding for purposes of basic earnings per share. There is no additional potential dilution in calculating diluted earnings per share, therefore basic and diluted earnings per share are the same amounts. Other than the restricted stock plan, the Company has no other stock based compensation plans.

	(in thousands of dollars) Three Months Ended		(in thousands of dollars) Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
<b>Earnings per share</b>				
Net income	\$4,114	\$3,223	\$7,881	\$6,062
Less: distributed earnings allocated to participating securities	(13 )	(11 )	(25 )	(21 )
Less: undistributed earnings allocated to participating securities	(28 )	(19 )	(54 )	(36 )
Net earnings available to common shareholders	\$4,073	\$3,193	\$7,802	\$6,005
<b>Weighted average common shares outstanding including participating securities <sup>(1)</sup></b>	9,265,898	9,241,750	9,265,928	9,241,750
Less: average unvested restricted shares <sup>(1)</sup>	(92,368 )	(86,300 )	(92,398 )	(86,300 )
Weighted average common shares outstanding <sup>(1)</sup>	9,173,530	9,155,450	9,173,530	9,155,450
Basic earnings and diluted per share <sup>(1)</sup>	\$0.44	\$0.35	\$0.85	\$0.66

(1) Share data has been adjusted to reflect a 2-for-1 stock split on September 20, 2017



ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair values of financial instruments are management's estimate of the values at which the instruments could be exchanged in a transaction between willing parties. These estimates are subjective and may vary significantly from amounts that would be realized in actual transactions. In addition, other significant assets are not considered financial assets including deferred tax assets, premises, equipment and intangibles. Further, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on the fair value estimates and have not been considered in any of the estimates.

The following assumptions and methods were used in estimating the fair value for financial instruments:

Cash and Cash Equivalents

The carrying amounts reported in the balance sheet for cash, cash equivalents and federal funds sold approximate their fair values. Also included in this line item are the carrying amounts of interest-bearing deposits maturing within ninety days which approximate their fair values. Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Interest Bearing Time Deposits

Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Securities – Available-for-sale

Fair values for securities, excluding Federal Home Loan Bank and Farmer Mac stock, are based on quoted market price, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Other Securities

The carrying value of Federal Home Loan Bank and Farmer Mac stock, listed as "other securities", approximates fair value based on the redemption provisions of the Federal Home Loan Bank.

Loans Held for Sale

The carrying amount approximates fair value due to insignificant amount of time between origination and date of sale.

Loans, net

The fair values of the loans are estimated using a credit mark adjustment along with discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. The

credit mark adjustment was estimated using merger and acquisition analysis of nationwide bank and thrift deals closed in the last six months of 2017.

#### Deposits

The fair values disclosed for deposits with no defined maturities are equal to their carrying amounts, which represent the amount payable on demand. The carrying amounts for variable-rate, fixed term money market accounts and certificates of deposit approximate their fair value at the reporting date. Fair value for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

#### Federal Funds Purchased and Securities Sold Under Agreements to Repurchase

The carrying value of federal funds purchased and securities sold under agreements to repurchase approximates fair values.

#### FHLB Advances

Fair values of FHLB advances are estimated using discounted cash flow analysis based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

## Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

## Off Balance Sheet Financial Instruments

Fair values for off-balance sheet, credit related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counter-parties' credit standing.

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of June 30, 2018 and December 31, 2017 are reflected below.

	(In Thousands)				
	June 30, 2018				
	Carrying	Fair	Level 1	Level 2	Level 3
	Amount	Value			
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$32,564	\$32,564	\$32,564	\$-	\$-
Interest-bearing time deposits	4,019	4,019	-	4,019	-
Securities - available-for-sale	187,036	187,036	20,791	164,835	1,410
Other Securities	3,717	3,717	-	-	3,717
Loans held for sale	913	913	-	-	913
Loans, net	824,226	809,064	-	-	809,064
Interest receivable	4,686	4,686	-	-	4,686
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$549,352	\$550,699	\$-	\$-	\$550,699
Non-interest bearing Deposits	200,067	200,067	-	200,067	-
Time Deposits	181,347	179,959	-	-	179,959
Total Deposits	930,766	930,725	-	200,067	730,658
<b>Federal Funds Purchased and Securities Sold Under</b>					
Agreement to Repurchase	23,898	23,898	-	-	23,898
Federal Home Loan Bank advances	5,000	5,001	-	-	5,001
Interest payable	316	316	-	-	316



## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands)				
	December 31, 2017				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
<b>Financial Assets:</b>					
Cash and Cash Equivalents	\$34,467	\$34,467	\$34,467	\$-	\$-
Interest-bearing time deposits	4,018	4,009	-	4,009	-
Securities - available-for-sale	196,398	196,398	20,978	173,992	1,428
Other Securities	3,717	3,717	-	-	3,717
Loans held for sale	1,221	1,221	-	-	1,221
Loans, net	816,156	819,193	-	-	819,193
Interest receivable	4,276	4,276	-	-	4,276
<b>Financial Liabilities:</b>					
Interest bearing Deposits	\$532,660	\$532,660	\$-	\$-	\$532,660
Non-interest bearing Deposits	199,114	199,114	-	199,114	-
Time Deposits	187,566	188,335	-	-	188,335
Total Deposits	919,340	920,109	-	199,114	720,995
<b>Federal Funds Purchased and Securities Sold Under</b>					
Agreement to Repurchase	39,495	39,495	-	-	39,495
Federal Home Loan Bank advances	5,000	5,021	-	-	5,021
Interest payable	318	318	-	-	318

## Fair Value Measurements

In general, fair values determined by Level 1 inputs use quoted prices in active markets for identical assets or liabilities in active markets that the Company has the ability to access.

Available-for-sale securities, when quoted prices are available in an active market, securities are valued using the quoted price and are classified as Level 1.

Fair values determined by Level 2 inputs use other inputs that are observable, either directly or indirectly. These Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and other inputs such as interest rates and yield curves that are observable at commonly quoted intervals.

Available-for-sale securities classified as Level 2 are valued using the prices obtained from an independent pricing service. The prices are not adjusted. Securities of obligations of state and political subdivisions are valued using a type of matrix, or grid, pricing in which securities are benchmarked against the treasury rate based on credit rating. Substantially all assumptions used by the independent pricing service are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the

marketplace.

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability. The Bank holds some local municipals that the Bank evaluates based on the credit strength of the underlying project. The fair value is determined by valuing similar credit payment streams at similar rates.

In instances where inputs used to measure fair value fall into different levels in the above fair value hierarchy, fair value measurements in their entirety are categorized based on the lowest level input that is significant to the valuation. The Company's assessment of the significance of particular inputs to these fair value measurements requires judgment and considers factors specific to each asset.

29

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## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following summarizes financial assets measured at fair value on a recurring basis as of June 30, 2018 and December 31, 2017, segregated by level or the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured at Fair Value on a Recurring Basis (In Thousands)			
	Quoted Prices in	Significant	Significant
	Active Markets	Observable	Observable
	for Identical	Inputs	Inputs
		(Level 2)	(Level 3)
June 30, 2018	Assets (Level 1)	(Level 2)	(Level 3)
Assets - (Securities Available-for-Sale)			
U.S. Treasury	\$ 20,791	\$ -	\$ -
U.S. Government agencies	-	76,310	-
Mortgage-backed securities	-	34,836	-
State and local governments	-	53,689	1,410
Total Securities Available-for-Sale	\$ 20,791	\$ 164,835	\$ 1,410
	Quoted Prices in	Significant	Significant
	Active Markets	Observable	Observable
	for Identical	Inputs	Inputs
		(Level 2)	(Level 3)
December 31, 2017	Assets (Level 1)	(Level 2)	(Level 3)
Assets - (Securities Available-for-Sale)			
U.S. Treasury	\$ 20,978	\$ -	\$ -
U.S. Government agencies	-	80,466	-
Mortgage-backed securities	-	39,510	-
State and local governments	-	54,016	1,428
Total Securities Available-for-Sale	\$ 20,978	\$ 173,992	\$ 1,428

The following table represents the changes in the Level 3 fair-value category of which unobservable inputs are relied upon as of June 30, 2018 and June 30, 2017.

(In Thousands)  
Fair Value Measurements Using  
Significant

	Unobservable Inputs (Level 3)		Total
	State and Local	State and Local	
	Governments		Governments
	Tax-Exempt		
Balance at January 1, 2018	\$-	\$ 1,428	\$ 1,428
Change in Market Value	-	(18 )	(18 )
Payments & Maturities	-	-	-
Balance at June 30, 2018	\$-	\$ 1,410	\$ 1,410

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands)		
	Fair Value Measurements Using		
	Significant		
	Unobservable Inputs (Level 3)		
	State and Local	State and Local	State and Local
	Governments	Governments	Governments
	Tax-Exempt	Total	Total
Balance at January 1, 2017	\$- \$ 1,418	\$ 1,418	\$ 1,418
Change in Market Value	- 30	30	30
Payments & Maturities	- -	-	-
Balance at June 30, 2017	\$- \$ 1,448	\$ 1,448	\$ 1,448

Most of the Company's available-for-sale securities, including any bonds issued by local municipalities, have CUSIP numbers or have similar characteristics of those in the municipal markets, making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At June 30, 2018 and December 31, 2017, such assets consist primarily of collateral dependent impaired loans. Collateral dependent impaired loans categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals.)

At June 30, 2018 and December 31, 2017, fair value of collateral dependent impaired loans categorized as Level 3 was \$516 and \$508 thousand, respectively. The specific allocation for impaired loans was \$132 and \$106 thousand as of June 30, 2018 and December 31, 2017, respectively, which are accounted for in the allowance for loan losses (see Note 4).

Other real estate is reported at either the lower of the fair value of the real estate minus the estimated costs to sell the asset or the cost of the asset. The determination of fair value of the real estate relies primarily on appraisals from third parties. If the fair value of the real estate, minus the estimated costs to sell the asset, is less than the asset's cost, the deficiency is recognized as a valuation allowance against the asset through a charge to expense. The valuation allowance is therefore increased or decreased, through charges or credits to expense, for changes in the asset's fair value or estimated selling costs.

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The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements:

	(In Thousands) Fair Value at June 30, 2018	Valuation Technique	Unobservable Inputs	Range  (Weighted Average)
State and local government	\$ 1,410	Discounted Cash Flow	Credit strength of underlying project or entity / Discount rate	0-5%  (3.78% )
Collateral dependent impaired loans	516	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50%  (20.37%)
Other real estate owned - residential	-	Appraisals	Discount to reflect current market	0-20%  ( — )
Other real estate owned - commercial	-	Appraisals	Discount to reflect current market	0-20%  ( — )

31

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 6 FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	(In Thousands) Fair Value at December 31, 2017	Valuation Technique	Unobservable Inputs Credit strength of underlying project or entity / Discount rate	Range (Weighted Average)
State and local government	\$ 1,428	Discounted Cash Flow		0-5% (3.68%)
Collateral dependent impaired loans	508	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0-50% (17.28%)
Other real estate owned - residential	22	Appraisals	Discount to reflect current market	0-20% (2.22%)
Other real estate owned - commercial	266	Appraisals	Discount to reflect current market	0-20% (5.15%)

The following table presents impaired loans and other real estate owned as recorded at fair value on June 30, 2018 and December 31, 2017:

Assets Measured at Fair Value on a Nonrecurring Basis at June 30, 2018  
(In Thousands)

	Balance at June 30, 2018	Quoted Prices in Active Markets for		
		Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent impaired loans	\$ 516	\$ -	\$ -	\$ 516
Other real estate	-	-	-	-

owned - residential

Other real estate

owned - commercial      -                              -                              -                              -

Assets Measured at Fair Value on a Nonrecurring Basis at December 31, 2017  
(In Thousands)

	Balance at December 31, 2017	Quoted Prices in Active		
		Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Collateral dependent				
impaired loans	\$ 508	\$ -	\$ -	\$ 508
Other real estate				
owned - residential	22	-	-	22
Other real estate				
owned - commercial	266	-	-	266



## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 7 FEDERAL FUNDS PURCHASED AND SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

The Company did not have any Federal Funds Purchased as of June 30, 2018 and had \$10.4 million as of December 31, 2017. During the same time periods the company also had \$23.9 million and \$29.1 million in securities sold under agreement to repurchase.

June 30, 2018						
Remaining Contractual Maturity of the Agreements (In Thousands)						
	Overnight & Continuous		Up to 30 days	30-90 days	Greater Than 90 days	Total
Federal funds purchased	\$-	\$	-	\$	-	\$-
Repurchase Agreements;						
US Treasury & agency securities	753		-	-	23,145	23,898
	\$753	\$	-	\$	-	\$23,898

December 31, 2017						
Remaining Contractual Maturity of the Agreements (In Thousands)						
	Overnight & Continuous		Up to 30 days	30-90 days	Greater Than 90 days	Total
Federal funds purchased	\$10,425	\$	-	\$	-	\$10,425
Repurchase Agreements;						
US Treasury & agency securities	6,145		-	-	22,925	29,070
	\$16,570	\$	-	\$	-	\$22,925
						\$39,495

## ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

## NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued ASU No. 2014-09 “Revenue from Contracts with Customers (Topic 606)” ASU 2014-09 requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. On July 9, 2015, the FASB approved amendments deferring the effective date by one year. ASU 2014-09 is now effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The amendments can be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early application was permitted but not before the original public entity effective date, i.e., annual periods beginning after December 15, 2016. The Company has adopted ASU 2014-09 on January 1, 2018 and ASU No 2014-09 did not have a significant impact on its financial statements. Several of the Company’s revenue streams were reviewed out as a result of the standard.

In January 2016, the Financial Accounting Standards Board (FASB) issued ASU No. 2016-01 “Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company adopted ASU 2016-01 on January 1, 2018 and it did not have a material impact on the consolidated financial statement. The Bank’s equity securities are membership stocks in the Federal Home Loan Bank and Farmer Mac and thereby excluded from fair value pricing. For exit pricing on loans, the company used recent Merger and Acquisition Transaction Metrics compiled by S&P Global Market Intelligence for the second half of 2017. This provided the credit mark to be used along with the fair value adjustment based on the yield metrics of the portfolio.

In February 2016, the FASB issued ASU No. 2016-02 “Leases (Topic 842).” ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within

those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures and currently has very limited exposure to the rule.

In June 2016, FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances. The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS (Continued)

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently gathering information, reviewing possible vendors and has formed a committee to formulate the methodology to be used. Most importantly, the Company is gathering as much data as possible to enable review scenarios and determine which calculations will produce the most reliable results. At this time, an external advisor has been contracted. The Company is in the early stages of CECL conversion analysis.

In November 2016, the FASB issued ASU No. 2016-18 “Statement of Cash Flows (Topic 230) – Restricted Cash.” ASU-2016-18 provides amendments to cash flow statement classification and presentation to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and should be applied using a retrospective transition method to each period presented. Early adoption is permitted including adoption in an interim period. The Company has adopted ASU 2016-18 on January 1, 2018 and does not currently have restricted cash or restricted cash equivalents. In the future, restricted cash or restricted cash equivalents will be presented in accordance with the guidance.

In January 2017, the FASB issued ASU No. 2017-01 “Business Combinations (Topic 805) – Clarifying the Definition of a Business.” ASU 2017-01 provides amendments to clarify the definition of a business and affect all companies and other reporting organizations that must determine whether they have acquired or sold a business. The amendments are intended to help companies and other organizations evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and adoption is permitted under certain circumstances. The company has adopted ASU 2017-01 on January 1, 2018 and going forward will account for business combinations accordingly.

In January 2017, the FASB issued ASU No. 2017-04 “Intangibles – Goodwill and other (Topic 350) – Simplifying the Test for Goodwill Impairment.” These amendments eliminate Step 2 from the goodwill impairment test. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment test performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. The Company does not expect ASU 2017-04 to have a material impact on its accounting disclosures, as goodwill testing has been completed annually without any impairment concerns.

In March 2017, the FASB issued Accounting Standards Update (ASU) No. 2017-08 “Receivables – Nonrefundable Fees and Other Cost (Subtopic 310-20), Premium Amortization on Purchased Callable Debit Securities.” These amendments shorten the amortization period for certain callable debit securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes the interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to

retained earnings as of the beginning of the period of adoption. The Company adopted this standard as of January 1, 2018. The impact of just over \$30 thousand of accelerated amortization expense was booked and the adjustment ran through retained earnings. This will not alter the Bank or Company's well capitalized status. The Bank's Municipal Tax-Exempt category of securities was the only category affected by the adoption.

ITEM 1 NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS (Continued)

NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS (Continued)

In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-09 “Compensation – Stock Compensation (Topic 718), Scope of Modification Accounting.” These amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The amendments should be applied on a prospective basis to an award modified on or after the adoption date. The Company adopted ASU 2016-09 on January 1, 2017. ASU 2016-09 also requires that companies make an accounting policy election regarding forfeitures, to either estimate the number of awards that are expected to vest or account for them when they occur. The impact of this change and that of the remaining provisions of ASU 2016-09 did not have a significant impact on our financial statements.

In February 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2018-02 “Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” The amendments allow for the reclassification of stranded tax effects in accumulated other comprehensive income (AOCI) an option rather than a requirement; however, disclosure is required if not elected. The reclassification from accumulated other comprehensive income to retained earnings results from the newly enacted federal corporate income tax rate resulting from the Tax Cuts and Job Acts signed by President Trump in December 2017. The amount of the reclassification is the difference between the historical corporate income tax rate and the newly enacted corporate income tax rate of 21%. Entities will have an option to adopt the standard retrospectively or in the period of adoption. The company has adopted this standard on January 1, 2018 and reclassified approximately \$360 thousand into retained earnings.

In March of 2018, the FASB issued ASU 2018-05 “Income Taxes (Topic 740): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin (SAB) No. 118.” These amendments add SEC guidance to the FASB Accounting Standards Codification regarding the Tax Cuts and Jobs Act pursuant to the issuance of SAB 118. The amendments are effective upon addition to the FASB Codification.

In June 2018, the financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2018-07 “Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” These amendments expand the scope of Topic 718, Compensation – Stock Compensation (which currently only includes share-based payments to employees) to include share-based payments issued to nonemployees for goods or services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. The ASU supersedes Subtopic 505-50, Equity – Equity-Based Payments to Non-Employees. The guidance is effective for public companies for fiscal years, and interim fiscal periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, but no earlier than a company’s adoption date of Topic 606, Revenue from Contracts with Customers. At this time, the Company does not recognize the existence of any non-employee relationships involving share-based payments. The Company will continue to assess prior to adoption.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

Overall, the local economies continue to grow. The loan pipeline remains strong though down slightly as compared to a year ago. The business climate is strong though tempered by some concern with tariffs, steel supply and the macro economy. This concern has led to projects being delayed. Profitability remains solid in all loan segments. The passing of the Farm Bill enabled some agricultural real estate sales into the secondary market to occur during the quarter. Tariffs are impacting crop prices, especially soybeans at this time. Farmers recognize this strategy may result in short-term pain for long-term gain though it has created unease. The automotive industry is still strong and the manufacturers in our market area continue to fill orders. More companies are turning to automation as finding employees has become more difficult. The labor shortage is a concern for many industrial sectors. The Company has also experienced difficulty in finding quality employees with the low unemployment rates throughout our markets.

Federal rate increases have resulted in a widening of the net interest margin. The sustainability of a widening of the margin with future rate hikes is questionable. Pressure on the cost of funds continues to mount with each rate increase. The flattening of the yield curve, which is being driven by the increase in the short end of the curve puts the most pressure on the most liquid funds. A slowing in the rate of loan growth has and will put pressure on the margin also.

Lastly, a very bright spot in 2018 has been the change in tax rates. The Company has chosen to invest a portion of those tax savings dollars to increase the base pay of our lowest paid employees. We continue to evaluate how best to utilize those funds to impact our shareholders, customers, communities and employees. Additional investment in capital assets is also occurring.

With long-term sustainable growth as a strategic objective, the Bank opened its 25<sup>th</sup> office in Findlay, Ohio, in the first quarter. Unique to the office is the utilization of newer technology in the form of Interactive Teller Machines (ITMs). The use of ITMs enabled the office to be remodeled and eliminated the traditional teller line and drive-up. The ITMs have remote assistance available upon request or the customer can complete the transactions themselves with debit card activation. Previous teller line space has been converted to work stations at which personal relationship bankers may assist customers with transactions, open a deposit account, add a service or grant a consumer loan. The strategic initiative provides a better customer experience upon entering the office. A personal relationship banker will greet the customer and personally assist them with their banking needs. The physical office transformations will continue with existing offices over multiple years and any additional new offices will be designed accordingly. The Bank converted its first existing office to our new vision in June with an additional office scheduled for third quarter conversion.

All offices had some type of personnel transformation during the quarter as the banking experience of our communities is also more personalized. Bankers will be spending more time out of the office, focused on small business relationships and home loan originations. Along with the new office, the Company plans for growth in 2018 to be more focused within its newer markets – both in loans and deposits.

The dividend declared for the second quarter represented a 12% increase over the declaration of the same period last year and a 12.5% increase over 2017 on a year-to-date declaration basis. Strong earnings for the second quarter exceeded the prior quarter and second quarter last year. The focus remains on loan and deposit growth for 2018 along with a widening of our footprint from the additional offices. As mentioned previously, improved profitability through long term sustainable growth is the overall goal of the organization.

## NATURE OF ACTIVITIES

Farmers & Merchants Bancorp, Inc. (the “Company”) is a financial holding company incorporated under the laws of Ohio in 1985. Our subsidiaries are, The Farmers & Merchants State Bank (the “Bank”), a community bank operating in Northwest Ohio since 1897 and Farmers & Merchants Risk Management, Inc., a captive insurance company formed in December 2014 and is located in Nevada. We report our financial condition and net income on a consolidated basis and we have only one segment.

Our executive offices are located at 307 North Defiance Street, Archbold, Ohio 43502, and our telephone number is (419) 446-2501. The Bank operates twenty-five full service banking offices throughout Northwest Ohio and Northeast Indiana.

The Bank opened an additional office during February of 2018 in Findlay, Ohio and the office is located in Hancock County. The Bank purchased the building in 2017 and was subsequently remodeled. The Bank has continued its expansion strategy and the new office is expected to provide new growth opportunities.



ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The Farmers & Merchants State Bank engages in general commercial banking and savings business including commercial, agricultural and residential mortgage, consumer and credit card lending activities. The largest segment of the lending business relates to commercial, both real estate and non-real estate. The type of commercial business ranges from small business to multi-million dollar companies. The loans are a reflection of business located within the Banks' market area. Because the Bank's offices are located in Northwest Ohio and Northeast Indiana, a substantial amount of the loan portfolio is comprised of loans made to customers in the farming industry for such items as farm land, farm equipment, livestock and operating loans for seed, fertilizer, and feed. Other types of lending activities include loans for home improvements, and loans for the purchase of autos, trucks, recreational vehicles, motorcycles, and other consumer goods.

The Bank also provides checking account services, as well as savings and time deposit services such as certificates of deposits. In addition, Automated Teller Machines (ATMs) are provided at most branch locations along with other independent locations such as major employers and hospitals in the market area. The Bank has custodial services for Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs). The Bank provides on-line banking access for consumer and business customers. For consumers, this includes bill-pay, on-line statement opportunities and mobile banking. For business customers, it provides the option of electronic transaction origination such as wire and Automated Clearing House (ACH) file transmittal. In addition, the Bank offers remote deposit capture or electronic deposit processing and merchant credit card services. Mobile banking was added in 2012 and has been widely accepted and used by consumers. Over the past couple of years, the Bank has updated its consumer offerings with "Secure" and "Pure" checking in 2014 and with KASASA Cash Back in 2015. During the second quarter 2017, new business checking products were announced and existing business accounts were converted to one of three new products, Business Essential, Edge or Elite. The new products provided customers with new options to bundle services and for the Bank to utilize the full relationship to determine pricing. This was the next step of implementation for the Bank's "earn to free" strategic initiative. Upgrades to our digital products and services continue to occur in both retail and business lines. The Bank began utilizing Integrated Teller Machines (ITMs) with the opening of our Findlay office and incorporated the use of them in our Waterville office at the end of second quarter 2018. ITMs operate as an ATM with the addition of remote teller access to assist the user. The Bank plans to utilize ITMs in locations going forward.

The Bank has established underwriting policies and procedures which facilitate operating in a safe and sound manner in accordance with supervisory and regulatory guidance. Within this sphere of safety and soundness, the Bank's practice has been to not promote innovative, unproven credit products which may not be in the best interest of the Bank or its customers. The Bank does offer a hybrid mortgage loan. Hybrid loans are loans that start out as a fixed rate mortgage but after a set number of years automatically adjust to an adjustable rate mortgage. The Bank offers a three year fixed rate mortgage after which the interest rate will adjust annually. The majority of the Bank's adjustable rate mortgages are of this type. In order to offer longer term fixed rate mortgages, the Bank does participate in the Freddie Mac, Farmer Mac and Small Business Lending programs. The Bank also normally retains the servicing rights on these partially or 100% sold loans. In order for the customer to participate in these programs they must meet the requirements established by those agencies. In addition, the Bank does sell some of its longer term fixed rate agricultural mortgages into the secondary market with the aid of a broker.

The Bank does not have a program to fund sub-prime loans. Sub-prime loans are characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers.

All loan requests are reviewed as to credit worthiness and are subject to the Bank's underwriting guidelines as to secured versus unsecured credit. Secured loans are in turn subject to loan to value (LTV) requirements based on collateral types as set forth in the Bank's Loan Policy. In addition, credit scores of those seeking consumer credit are reviewed and if they do not meet the Bank's Loan Policy guidelines and additional officer approval is required.

Consumer Loans:

Maximum loan to value (LTV) for cars, trucks and light trucks vary from 90% to 110% depending on whether direct or indirect.

Loans above 100% are generally due to additional charges for extended warranties and/or insurance coverage periods for wage or death.

Boats, campers, motorcycles, RV's and Motor Coaches range from 80%-90% based on age of vehicle.

1st or 2nd mortgages on 1-4 family homes range from 75%-90% with "in-house" first real estate mortgages requiring private mortgage insurance on those exceeding 80% LTV.

Raw land LTV maximum ranges from 65%-75% depending on whether or not the property has been improved.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Commercial/Agriculture/Real Estate:

- Maximum LTVs range from 70%-80% depending on type.
- Accounts Receivable: Up to 80% LTV less retainages and greater than 90 days.

Inventory:

• Agriculture:

Livestock and grain up to 80% LTV, crops (insured) up to 75% and Warehouse Receipts up to 87%.

• Commercial:

Maximum LTV of 50% on raw and finished goods.

• Floor plan:

- o New/used vehicles to 100% of wholesale.
- o New/Used recreational vehicles and manufactured homes to 80% of wholesale.

Equipment:

- New not to exceed 80% of invoice, used NTE 50% of listed book or 75% of appraised value.

• Restaurant equipment up to 35% of market value.

• Heavy trucks, titled trailers up to NTE 75% LTV and aircraft up to 75% of appraised value.

F&M Investment Services, the brokerage department of the Bank, opened for business in April, 1999. Securities are offered through Raymond James Financial Services, Inc.

In December of 2014, the Company became a financial holding company within the meaning of the Bank Holding Company Act of 1956 as amended (the "Act"), in order to provide the flexibility to take advantage of the expanded powers available to a financial holding company under the Act. Our subsidiary bank is in turn regulated and examined by the Ohio Division of Financial Institutions and the Federal Deposit Insurance Corporation. The activities of our bank subsidiary are also subject to other federal and state laws and regulations. The Company also formed a captive insurance company (the "captive") in December 2014 which is located in Nevada and regulated by the State of Nevada Division of Insurance.

The Bank's primary market includes communities located in the Ohio counties of Defiance, Fulton, Hancock, Henry, Lucas, Williams, Wood and in the Indiana counties of Allen, DeKalb and Steuben. In our banking activities, we compete directly with other commercial banks, credit unions, farm credit services, and savings and loan institutions in each of our operating localities. In a number of our locations, we compete against entities which are much larger than us. The primary factors in competing for loans and deposits are the rates charged as well as location and quality of the services provided.

At June 30, 2018, we had 276 full time equivalent employees. The employees are not represented by a collective bargaining unit. We provide our employees with a comprehensive benefit program, some of which are contributory. We consider our employee relations to be good.

## REGULATORY DEVELOPMENTS

The Bank remains attentive to the current regulatory environment in light of the risk-based approach regulatory agencies use to conduct examinations. The degree of regulatory changes and the complexity of the recent new rules,

which lack clarity or guidance on various provisions, and have resulted in uncertainties regarding liability, pose an increased overall risk of noncompliance. Various significant mortgage rules require ongoing monitoring by means of testing, validation of results, additional training, and further research or consultation to assist with ensuring compliance.

Regulatory Reform legislation successfully passed in both the House and Senate. The Economic Growth Regulatory Reform and Consumer Protection Act (EGRRCPA) became a new law with the signature of President Trump on May 24, 2018. EGRRCPA is considered right-sized financial regulation which will pave the way for banks to lend to creditworthy borrowers and better serve their communities. Regulatory relief will not be immediate. In many instances, guidance or new rulemaking will be required to implement the changes. The Bank along with many community banks will eventually experience the rollback of some of the burdensome requirements resulting from the Dodd-Frank Wall Street Reform and Consumer Protection Act. Sections in the EGRRCPA address access to mortgage credit; consumer access to credit; protections for veterans, consumers, and homeowners; rules for certain bank holding companies, capital access; and protections for student borrowers. In the next 12 to 18 months or longer, the Bank will focus on the implementing rules and guidance for the various provisions in each section of the EGRRCPA that impact its operations and activities.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The Bank is subject to numerous laws, rules, regulations and guidance which include, but are not limited to, the following significant matters: deposit insurance coverage; equal credit opportunity; fair lending; community reinvestment; anti-money laundering; suspicious activity reporting; identity theft identification and prevention; protections for military members and their dependents; flood disaster protection; integrated mortgage disclosures; mortgage servicing rights; legal lending limits; electronic fund transfers; consumer privacy; and unfair and deceptive acts and practices. Extensive training and training resources are necessary to develop and maintain expertise on the various regulatory matters.

The Bank completed implementation of the U.S. Department of the Treasury's final rules on Customer Due Diligence (CDD) and Beneficial Ownership. The mandatory effective date was May 11, 2018. Prior to these new rules, the ability for individuals to hide financial activity through anonymous ownership of business entities was a weakness in the fight against financial crime. The CDD Final Rule is a significant step toward greater financial transparency. By gaining a more complete profile of entity customers, financial institutions can help further reduce the flow of illicit funds through the US banking system. The CDD and Beneficial Ownership final rules added a fifth core element to the original core elements necessary for an effective Bank Secrecy Act and Anti-Money Laundering compliance program.

The Company has implemented Basel III capital rules which began to be phased in for the Company on January 1, 2015. These rules may impact the ability of some financial institutions to pay dividends, though the Company believes itself to be able to maintain its strong capital position and not be limited in that regard.

With regard to all regulatory matters, the Bank remains committed in making good faith efforts to comply with technical requirements of the laws, rules, regulations, and guidance from both federal and state agencies which govern its activities.

#### CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the financial services industry in which it operates. At times the application of these principles requires management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements and accompanying notes.

These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event. These policies, along with the disclosures presented in the notes to the condensed consolidated financial statements and in the management discussion and analysis of the financial condition and results of operations, provide information on how significant assets and liabilities are valued and how those values are determined for the financial statements. Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the recognition of revenue, the determination of the ALLL, the valuation of its Mortgage Servicing Rights and the valuation of real estate acquired through or in lieu of; loan foreclosures ("OREO Property") as the accounting areas that require the most subjective or

complex judgments, and as such could be the most subject to revision as new information becomes available.

The Company recognizes revenues as they are earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The Company's principal source of revenue is interest income from loans and investment securities. The Company also earns noninterest income from various banking and financial services offered primarily through Farmers & Merchants State Bank. Interest income is primarily recognized on an accrual basis according to nondiscretionary formulas written in contracts, such as loan agreements or investment security contracts. The Company also earns noninterest income from various banking and financial services provided to business and consumer clients such as deposit account, debit card, and mortgage banking services. Revenue is recorded for noninterest income based on the contractual terms for the service or transaction performed. In certain circumstances, noninterest income is reported net of associated expenses.

OREO Property held for sale and is initially recorded at fair value at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and a write-down is recorded by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell.

The net income from operations of foreclosed real estate held for sale is reported either in noninterest income or noninterest expense depending upon whether the property is in a gain or loss position overall. At June 30, 2018 OREO property holdings were \$649 thousand. OREO totaled \$674 thousand and \$630 thousand as of December 31, 2017 and June 30, 2017 respectively.

The ALLL and ACL represents management's estimate of probable credit losses inherent in the Bank's loan portfolio, unfunded loan commitments, and letters of credit at the report date. The ALLL methodology is regularly reviewed for its appropriateness and is approved annually by the Board of Directors. This written methodology is consistent with Generally Accepted Accounting Principles which provides for a consistently applied analysis.

The Bank's methodology provides an estimate of the probable credit losses either by calculating a specific loss per credit or by applying a composite of historical factors over a relevant period of time with current internal and external factors which may affect credit collectability. Such factors which may influence estimated losses are the conditions of the local and national economy, local unemployment trends, and abilities of lending staff, valuation trends of fixed assets, and trends in credit delinquency, classified credits, and credit losses.

Inherent in most estimates is imprecision. The Bank's ALLL provides a margin for imprecision with an unallocated portion. Bank regulatory agencies and external auditors periodically review the Bank's methodology and adequacy of the ALLL. Any required changes in the ALLL or loan charge-offs by these agencies or auditors may have a material effect on the ALLL.

The Bank is also required to estimate the value of its mortgage servicing rights. The Bank's mortgage servicing rights relating to fixed rate single-family mortgage loans that it has sold without recourse but services for others for a fee represent an asset on the Bank's balance sheet. The valuation is completed by an independent third party.

The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced.

The Bank's mortgage servicing rights relating to loans serviced for others represent an asset. This asset is initially capitalized and included in other assets on the Company's consolidated balance sheet. The mortgage servicing rights are then amortized against noninterest income in proportion to, and over the period of the estimated future net servicing income of the underlying mortgage servicing rights using the level yield method. The amortization thereof is recorded in non-interest expense. There are a number of factors, however, that can affect the ultimate value of the mortgage servicing rights to the Bank. The expected and actual rates of mortgage loan prepayments are the most significant factors driving the potential for the impairment of the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced, meaning that the present value of the mortgage servicing rights is less than the carrying value of those rights on the Bank's balance sheet. Therefore, in an attempt to reflect an accurate expected value to the Bank of the mortgage servicing rights, the Bank receives a valuation of its mortgage servicing rights from an independent third party. The independent third party's valuation of the mortgage servicing rights is based on relevant characteristics of the Bank's loan servicing portfolio, such as loan terms, interest rates and recent national prepayment experience, as well as

current national market interest rate levels, market forecasts and other economic conditions. For purposes of determining impairment, the mortgage servicing assets are stratified into like groups based on loan type, term, new versus seasoned and interest rate. Management, with the advice from its third party valuation firm, reviewed the assumptions related to prepayment speeds, discount rates, and capitalized mortgage servicing income on a quarterly basis. Changes are reflected in the following quarter's analysis related to the mortgage servicing asset. In addition, based upon the independent third party's valuation of the Bank's mortgage servicing rights, management then establishes a valuation allowance by each strata, if necessary, to quantify the likely impairment of the value of the mortgage servicing rights to the Bank. The estimates of prepayment speeds and discount rates are inherently uncertain, and different estimates could have a material impact on the Bank's net income and results of operations. The valuation allowance is evaluated and adjusted quarterly by management to reflect changes in the fair value of the underlying mortgage servicing rights based on market conditions. The accuracy of these estimates and assumptions by management and its third party valuation specialist can be directly tied back to the fact that management has only been required to record minor valuation allowances through its income statement over time based upon the valuation of each stratum of servicing rights.



## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

For more information regarding the estimates and calculations used to establish the ALLL and the value of Mortgage Servicing Rights, please see Note 4 to the consolidated financial statements provided herewith.

## MATERIAL CHANGES IN FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

The Company plans to continue in its growth mode in 2018 led by loan growth from within our newer markets. The Bank is focused on funding the loan growth with the least expensive source. Growing deposits will also be a focus especially in our newer markets. The Bank decreased the level of pledged securities by offering the Insured Cash Sweep, "ICS" product accessed through the Promontory network of financial institutions as compared to a year ago. This has provided more availability for runoff of securities by the Bank if warranted to fund loan growth. Competition for deposits is intense with most competitors offering "special" rates for specific terms. Relationship ties garner higher rates.

Liquidity in terms of cash and cash equivalents ended \$1.9 million lower as of June 30, 2018 than it was at yearend December 31, 2017. A decrease in securities held along with increased deposits funded the \$8.1 million increase in net loans since yearend 2017. The largest loan growth occurred in agricultural real estate and agricultural portfolios. Consumer real estate and commercial real estate portfolios also experienced increases. The largest decline was in the commercial and industrial portfolios.

In comparing to the same prior year period, the June 30, 2018 (net of deferred fees and cost) loan balances of \$831 million accounted for a \$40.2 million or 5.1% increase when compared to 2017's \$790.8 million. The year over year improvement was made up of a 4.3% increase in commercial real estate loans, a 14.6% increase in consumer loans and lastly a combined increase in agricultural related loans (comprised of a 8.9% increase in agricultural real estate loans and 25.3% increase in non-real estate agricultural loans). Consumer real estate loans slightly decreased by 1.8%, commercial and industrial loans decreased by 5.4% and Industrial Development Bonds ("IDB's") decreased 8.3%. The Company credits the growth to a strong team of lenders focused on providing customers valuable localized services and thereby increasing our market share.

The chart below shows the breakdown of the loan portfolio by category as of June 30, for the last three years, net of deferred fees and costs.

	(In Thousands)		
	June 30, 2018	June 30, 2017	June 30, 2016
	Amount	Amount	Amount
Consumer Real Estate	\$82,368	\$83,903	\$88,165
Agricultural Real Estate	69,676	64,003	60,203
Agricultural	104,980	83,771	83,433
Commercial Real Estate	410,886	394,051	357,243
Commercial and Industrial	116,439	123,058	104,434
Consumer	40,595	35,435	30,485
Industrial Development Bonds	6,071	6,617	5,952
<b>Total Loans, net</b>	<b>\$831,015</b>	<b>\$790,838</b>	<b>\$729,915</b>

While the security portfolio has been utilized to fund loan growth for the last three years, additional sources have been cultivated during 2016, 2017, and 2018. The security portfolio decreased \$9.4 million in the first six months 2018 from yearend 2017. The amount of pledged investment securities increased by \$346 thousand as compared to yearend and decreased \$3.2 million as compared to June 30, 2017. This was accomplished by utilizing Promontory's Insured Cash Sweep, "ICS", product to protect Ohio public fund depositors and commercial sweep customers with FDIC coverage rather than pledge securities. This in turn improves liquidity with the additional option of selling unpledged investment securities if needed to fund loan growth or other initiatives. As of June 30, 2018, pledged investment securities totaled \$83.2 million. The current portfolio is in a net unrealized loss position of \$5.6 million.

For the Bank, an additional \$6.1 million is also available from the Federal Home Loan Bank based on current collateral pledging with up to \$114.0 million available provided adequate collateral is pledged.

With the exception of FHLB stock and Farmer Mac stock, carried at cost, which is shown as other securities, all of the Company's security portfolio is categorized as "available-for-sale" and as such is recorded at fair value.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Management feels confident that liquidity needs for future growth can be met through additional maturities and/or sales from the security portfolio, increased deposits and additional borrowings. For short term needs, the Bank has \$123.1 million of unsecured borrowing capacity through its correspondent banks.

Overall total assets decreased .2% since yearend 2017 and grew 3.7% since June 30, 2017. The largest growth in both periods was in the loan portfolios followed by other assets since yearend and cash and cash equivalents since June 30, 2017.

Deposits accounted for the largest growth within liabilities, up 1.2% or \$11.4 million since yearend and 6.1% or \$53.3 million over June 30, 2017 balances. Core deposits continue to drive the increase which provided the greatest benefit for both lower cost of funds and the opportunity to generate additional noninterest income. Compared to previous year, a movement of funds from securities sold under agreement to repurchase into interest bearing NOW accounts occurred due to utilization of the ICS product previously mentioned. This growth aided the increased liquidity position and funded the loan growth for the periods along with usage of purchased Federal Funds for daily borrowings.

Shareholders' equity increased by \$3.4 million as of the second quarter of 2018 compared to yearend 2017, as earnings exceeded dividend declarations. Accumulated other comprehensive loss increased in loss position by \$2.6 million from December 2017. Dividends paid for the quarter increased from the previous quarter by \$400 thousand and dividends declared increased by 7.7% or one cent from the previous quarter. Compared to June 30, 2017, shareholders' equity increased 4.8% or \$6.3 million. Record profits during 2017 were offset by a change in accumulated other comprehensive loss related to the available-for-sale securities portfolio from a loss position of \$382 thousand to a loss position of \$4.4 million as of June 30, 2017 and 2018, respectively. Profits are higher in June 2018 than June 2017 by \$1.8 million.

Basel III regulatory capital requirements became effective in 2016. The Bank and Company include a capital conservation buffer as a part of the transition provision. For calendar year 2016, the applicable required capital conservation buffer percentage of 0.625% was the base above which institutions avoid limitations on distributions and certain discretionary bonus payments. For the calendar year 2017, the applicable required capital conservation buffer percentage was 1.25%. For 2018, the capital conservation buffer percentage increases to 1.875%. The total buffer requirement will increase to 2.5% for calendar year 2019. As of June 30, 2018, the Company and the Bank are both positioned well above the 2019 requirement.

The Company continues to be well-capitalized in accordance with Federal regulatory capital requirements as the capital ratios below show:

Tier I Leverage Ratio	12.38 %
Risk Based Capital Tier I	15.28 %
Total Risk Based Capital	16.07 %
Stockholders' Equity/Total Assets	12.45 %
Capital Conservation Buffer	8.07 %

## MATERIAL CHANGES IN RESULTS OF OPERATIONS

Comparison of Results of Interest Earnings and Expenses for three month periods ended June 30, 2018 and 2017

When comparing second quarter 2018 to second quarter 2017, average loan balances grew \$56 million. This represented a strong 7.2% increase in a one year time period. Interest income on loan balances also experienced an increase of \$1.4 million as compared to the quarter ended June 30, 2017. Increases in the prime lending rate between the periods also contributed to the improvement in interest income and rate yield.

The higher levels of loan interest income helped to offset the available-for-sale securities portfolio, which decreased in average balances when comparing to the previous year. The decreased balances were expected as available-for-sale securities were used as a source of funds for loan growth. The income associated with the security portfolio decreased \$13 thousand in comparison to the same second quarter 2017. The benefit of the increase in interest income from loans was well above the loss of interest income from the smaller security portfolio.

Overall, interest income for the quarter comparisons was higher for second quarter 2018 by 14% or \$1.4 million as to second quarter 2017.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

In terms of annualized yield, for the quarter ended June 30, 2018, it was 4.41% which compares to a year ago second quarter ended June 30, 2017 of 4.11%. The following chart demonstrates the value of increased loan balances in the balance sheet mix, even if offset by lower balances in the available-for-sale security portfolio. The yields on tax-exempt securities and the portion of the tax-exempt IDB loans included in loans have been tax adjusted based on a 34% tax rate for 2017 and a 21% tax rate for 2018 in the charts to follow.

Interest Earning Assets:	(In Thousands)		Yield/Rate		
	Quarter to Date Ended June 30, 2018		June 30, June 30,		
	Average Balance	Interest/Dividends	2018	2017	
Loans	\$ 833,932	\$ 10,521	5.05%	4.69%	%
Taxable Investment Securities	149,284	707	1.89%	1.82%	%
Tax-exempt Investment Securities	50,663	247	2.47%	3.05%	%
Fed Funds Sold & Other	19,315	62	1.28%	1.03%	%
<b>Total Interest Earning Assets</b>	<b>\$ 1,053,194</b>	<b>\$ 11,537</b>	<b>4.41%</b>	<b>4.11%</b>	<b>%</b>

## Change in Interest Income Quarter to Date June 30, 2018 Compared to June 30, 2017

Interest Earning Assets:	(In Thousands)		
	Change	Due to Volume	Due to Rate
Loans	\$1,401	\$ 710	\$691
Taxable Investment Securities	5	(24 )	29
Tax-exempt Investment Securities	(18 )	(12 )	(6 )
Fed Funds Sold & Other	25	16	9
<b>Total Interest Earning Assets</b>	<b>\$1,413</b>	<b>\$ 690</b>	<b>\$723</b>

Offsetting some of the increase in interest income for the quarter was the increase in cost of funds in 2018. Second quarter 2018 was higher by \$274 thousand than second quarter 2017. Since 2017, average interest-bearing deposit balances have increased \$44 million and resulted in \$291 thousand more in interest expense for the most recent quarter. Additionally, interest expense on FHLB borrowings was down \$17 thousand in the second quarter 2018 over the same time frame in 2017 due to a payoff of \$5 million in December 2017.

Interest Bearing Liabilities:	(In Thousands)		Yield/Rate		
	Quarter to Date Ended June 30, 2018		June 30, June 30,		
	Average Balance	Interest/Dividends	2018	2017	

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Savings Deposits	\$ 558,826	\$ 835	0.60%	0.45%
Other Time Deposits	181,590	554	1.22%	1.13%
Other Borrowed Money	5,000	20	1.60%	1.48%
Fed Funds Purchased & Securities				
Sold under Agreement to Repurchase	26,292	118	1.80%	1.51%
Total Interest Bearing Liabilities	\$ 771,708	\$ 1,527	0.79%	0.68%

Change in Interest Expense Quarter to Date June 30, 2018 Compared to June 30, 2017

	(In Thousands)		
	Change	Due to Volume	Due to Rate
Interest Bearing Liabilities:			
Savings Deposits	\$261	\$ 71	\$190
Other Time Deposits	30	(11 )	41
Other Borrowed Money	(17 )	(20 )	3
Fed Funds Purchased & Securities			
Sold under Agreement to Repurchase	-	(23 )	23
Total Interest Bearing Liabilities	\$274	\$ 17	\$257

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Overall, net interest spread for the second quarter 2018 is higher than last year. As the following chart illustrates, higher yields on interest and dividend income did offset the higher interest expense in the most recent quarter when comparing to the same period a year ago.

	June 30, 2018		June 30, 2017		June 30, 2016	
Interest/Dividend income/yield	4.41	%	4.11	%	3.99	%
Interest Expense / yield	0.79	%	0.68	%	0.58	%
Net Interest Spread	3.62	%	3.43	%	3.41	%
Net Interest Margin	3.83	%	3.61	%	3.56	%

Net interest income was up \$1.1 million for the second quarter 2018 over the same time frame in 2017 due to the increase in loan interest income and partially offset by higher interest expense, as previously mentioned. As the new loans added in 2017 and 2018 generate more income, management expects the benefits of the Company's strategy of repositioning the balance sheet to continue to widen this margin as measured in dollars. In terms of net interest margin rate, the Bank recognizes competition for deposits have and will continue to put pressure on the margin which may lead to a tightening.

## Comparison of Noninterest Results of Operations - Second Quarter 2018 to Second Quarter 2017

## Provision Expense

The ALLL has a direct impact on the provision expense. The increase in the ALLL is funded through recoveries and provision expense. The following tables both deal with the allowance for credit losses. The first table breaks down the activity within ALLL for each loan portfolio class and shows the contribution provided by both the recoveries and the provision along with the reduction of the allowance caused by charge-offs. The second table discloses how much of the ALLL is attributed to each class of the loan portfolio, as well as the percent that each particular class of the loan portfolio represents to the entire loan portfolio in the aggregate. The commercial and industrial along with the consumer loan portfolios accounted for the largest component of charge-offs and recoveries for second quarter of 2018 and 2017. As was mentioned in previous discussion, the commercial real estate portfolio is currently creating a large impact on the ALLL due to the loan growth.

Total provision for loan losses was \$107 thousand higher for the second quarter 2018 as compared to the same quarter 2017. Management continues to monitor asset quality, making adjustments to the provision as necessary. Loan charge-offs were \$129 thousand higher in second quarter 2018 than the same quarter 2017. Recoveries were \$3 thousand higher in second quarter 2018 as compared to second quarter 2017. Combined net charge-offs were \$126 thousand higher in second quarter 2018 than the same time period 2017. Past due loans decreased \$226 thousand from June 30, 2017 as compared to June 30, 2018. The majority of the change is attributed to the decrease of past due balances in the consumer real estate, agricultural real estate and commercial real estate portfolios while the commercial and industrial increased.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The following table breaks down the activity within the ALLL for each loan portfolio class and shows the contribution provided by both recoveries and the provision, along with the reduction of the allowance caused by charge-offs. The time period covered is for three months ended June 30, 2018, 2017, and 2016.

	(In Thousands)		
	Three Months Ended	Three Months Ended	Three Months Ended
	June 30, 2018	June 30, 2017	June 30, 2016
Loans, net	\$831,015	\$790,838	\$729,915
Daily average of outstanding loans	\$833,932	\$777,649	\$720,408
Allowance for Loan Losses - April 1,	\$6,800	\$6,850	\$6,285
Loans Charged off:			
Consumer Real Estate	-	-	63
Agriculture Real Estate	-	-	-
Agricultural	-	-	18
Commercial Real Estate	1	-	-
Commercial and Industrial	100	-	-
Consumer	81	53	93
	182	53	174
Loan Recoveries:			
Consumer Real Estate	-	2	19
Agriculture Real Estate	-	-	-
Agricultural	3	1	1
Commercial Real Estate	2	5	3
Commercial and Industrial	3	3	3
Consumer	31	25	17
	39	36	43
Net Charge Offs	143	17	131
Provision for loan loss	132	25	339
Acquisition provision for loan loss	-	-	-
Allowance for Loan & Lease Losses			
- June 30,	6,789	6,858	6,493
Allowance for Unfunded Loan Commitments			
& Letters of Credit - June 30,	315	219	219
Total Allowance for Credit Losses - June 30,	\$7,104	\$7,077	\$6,712
Ratio of net charge-offs to average			
Loans outstanding	0.02 %	0.00 %	0.02 %



Ratio of the Allowance for Loan Loss to

Nonperforming Loans*	751.49 %	502.23 %	424.86 %
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\*Nonperforming loans are defined as all loans on nonaccrual, plus any loans past 90 days not on nonaccrual. The Bank uses the following guidelines as stated in policy to determine when to realize a charge-off of a loan, whether partial loan balance or full loan balance. A charge down in whole or in part is realized when unsecured consumer loans, credit card credits and overdraft lines of credit reach 90 days delinquency. At 120 days delinquent, secured consumer loans are charged down to the value of the collateral, if repossession of the collateral is assured and/or in the process of repossession. Consumer mortgage loan deficiencies are charged down upon the sale of the collateral or sooner upon the recognition of collateral deficiency. Commercial and agricultural credits are charged down at 120 days delinquency, unless an established and approved work-out plan is in place or litigation of the credit will likely result in recovery of the loan balance. Upon notification of bankruptcy, unsecured debt is charged off. Additional charge-offs may be realized as further unsecured positions are recognized.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Loans classified as nonaccrual were lower as of June 30, 2018 at \$903 thousand as compared to \$1.4 million as of June 30, 2017.

In determining the allocation for impaired loans the Bank applies the appraised market value of the collateral securing the asset, reduced by applying a discount for estimated costs of collateral liquidation. In some instances where the discounted market value is less than the loan amount, a specific impairment allocation is assigned, which may be reduced or eliminated by the write down of the credit's active principal outstanding balance.

For the majority of the Bank's impaired loans, including all collateral dependent loans, the Bank will apply the appraised market value methodology. However, the Bank may also utilize a measurement incorporating the present value of expected future cash flows discounted at the loan's effective rate of interest. To determine appraised market value, collateral asset values securing an impaired loan are periodically evaluated. Maximum time of re-evaluation is every 12 months for chattels and titled vehicles and every two years for real estate. In this process, third party evaluations are obtained and heavily relied upon. Until such time that updated appraisals are received, the Bank may discount the collateral value used.

The following table presents the balances for allowance of loan losses by loan type for six months ended June 30, 2018 and June 30, 2017.

Balance at End of Period Applicable To:	(In Thousands) June 30, 2018		(In Thousands) June 30, 2017	
	Amount	% of Loan Category	Amount	% of Loan Category
Consumer Real Estate	\$ 251	9.91 %	\$ 250	10.61 %
Agricultural Real Estate	255	8.39 %	253	8.09 %
Agricultural	751	12.63 %	596	10.59 %
Commercial Real Estate	3,260	49.44 %	3,076	49.83 %
Commercial and Industrial	1,420	14.74 %	1,352	16.40 %
Consumer	459	4.89 %	407	4.48 %
Unallocated	393	0.00 %	924	0.00 %
Allowance for Loan & Lease Losses	6,789		6,858	
Off Balance Sheet Commitments	315		219	
Total Allowance for Credit Losses	\$ 7,104		\$ 7,077	

## Noninterest Income

Noninterest income was up \$33 thousand for the second quarter 2018 over the same time frame in 2017. The Company has seen an increase in its mortgage production volume and as a result the gain on the sale of these loans was \$83 thousand higher for the second quarter 2018 over the same period in 2017. Loan originations on loans held for sale for the second quarter 2018 were \$15.6 million with proceeds from sale at \$17.6 million for 2018 which was more than 2017's second quarter activity of \$15.8 million in originations and \$15.4 million in sales. The net result of the activity was 2018 had \$83 thousand more revenue on gain of sale on the quarter. The mortgages sold were out of both the 1-4 family and agricultural real estate portfolios.

The Company was able to better take advantage of market fluctuations in its available-for-sale portfolio and sales on securities in second quarter 2017 than second quarter 2018. The gain was \$16 thousand lower in the most recent quarter than the same quarter prior year. The next largest fluctuation in noninterest income was in the combined service fee lines, which was \$34 thousand lower than the same quarter last year.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The impact of mortgage servicing rights, both to income and expense, is shown in the following table which reconciles the value of mortgage servicing rights. The capitalization runs through noninterest income while the amortization thereof is included in non-interest expense. For the second quarter of 2018, mortgage servicing rights caused a net \$43 thousand in income, in comparison to a net \$21 thousand income for the second quarter of 2017. The higher capitalized additions for 2018 are attributed to a lower loan origination level of 1-4 families combined with a higher mortgage servicing rights value being applied to originations of 1-4 families in 2018 as compared to 2017. For loans of 15 years and less, the value was .988% in the second quarter 2018 versus .712% in second quarter 2017. For loans over 15 years, the value was 1.168% versus 1.001% for the same periods respectively. The carrying value is well below the market value of \$3.2 million which indicates any large expense to fund the valuation allowance to be unlikely in 2018.

	(In Thousands)	
	2018	2017
Beginning Balance, January 1,	\$2,299	\$2,192
Capitalized Additions	237	219
Amortization	(180 )	(181 )
Ending Balance, June 30,	2,356	2,230
Valuation Allowance	-	-
Mortgage Servicing Rights net, June 30,	\$2,356	\$2,230

## Noninterest Expense

For the second quarter 2018, noninterest expenses were \$540 thousand higher than for the same quarter in 2017. Salaries, wages, and employee benefits increased \$153 thousand, with the addition of the Findlay office, along with normal merit increases. Furniture and equipment expenses increased \$74 thousand from the prior year due to an increase in depreciation of \$25 thousand and maintenance contracts of \$55 thousand. Data processing charges decreased just \$3 thousand for second quarter 2018 compared to the second quarter 2017. General and administrative expenses were up \$168 thousand compared to second quarter 2017 with the largest increases arising from auditing/accounting fees, provision for unfunded loans, appraisal fees, and consulting fees. These increased expenses were offset by a reduction in core deposit intangible expense, legal fees, and miscellaneous expenses.

Results overall, net income in the second quarter of 2018 was up \$891 thousand as compared to the same quarter last year. The improved results of second quarter 2018 as compared to second quarter 2017 are not solely related to the change in tax rate from 34% to 21%. The Company has done an exceptional job of growing loans while keeping past dues low. The Company remains strong, stable, and well capitalized and has the capacity to continue to cover the increased costs of expansion.

Comparison of Results of Interest Earnings and Expenses for six month periods ended June 30, 2018 and 2017

## Interest Income

Higher loan balances created the improvement in the interest income for the first half 2018 as compared to first half 2017. Interest income rose 14.3% or \$2.8 million while interest income from loans accounted for the majority of the increase. Offsetting the improvement from loans was a decrease in securities income of \$53 thousand. The change in the balance sheet mix along with the loan growth caused the asset yield to improve by 30 basis points to 4.35% for the first half 2018 compared to first half 2017's 4.05%.

With each quarter of 2018, the loan growth and prime rate increases contribute to the continued improvement in asset yield. The growth factor contribution is shown in the charts which follow. Improvement in loan interest income far outweighs the loss for investments decreasing.

The average interest earning asset base was \$54.3 million higher in first half 2018 than for first half 2017, an increase of approximately 5.5%.

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

The yields on tax-exempt securities and the portion of the tax-exempt IDB loans included in loans have been tax adjusted based on a 34% tax rate for 2017 and a 21% tax rate for 2018 in the charts to follow.

Interest Earning Assets:	(In Thousands)		Yield/Rate	
	Average Balance	Interest/Dividends	Year to Date Ended June 30, 2018	June 30, June 30, 2018 2017
Loans	\$ 829,545	\$ 20,623	4.97%	4.63 %
Taxable Investment Securities	150,464	1,426	1.90%	1.78 %
Tax-exempt Investment Securities	50,245	487	2.45%	3.07 %
Fed Funds Sold & Other	19,435	137	1.41%	0.96 %
<b>Total Interest Earning Assets</b>	<b>\$ 1,049,689</b>	<b>\$ 22,673</b>	<b>4.35%</b>	<b>4.05 %</b>

## Change in Interest Income Year to Date June 30, 2018 Compared to June 30, 2017

Interest Earning Assets:	(In Thousands)		
	Change	Due to Volume	Due to Rate
Loans	\$2,803	\$ 1,483	\$ 1,320
Taxable Investment Securities	(1 )	(90 )	89
Tax-exempt Investment Securities	(52 )	(36 )	(16 )
Fed Funds Sold & Other	78	50	28
<b>Total Interest Earning Assets</b>	<b>\$2,828</b>	<b>\$ 1,407</b>	<b>\$ 1,421</b>

## Interest Expense

Interest expense was also higher for first half 2018 compared to first half 2017. At \$3 million, first half 2018 was up \$558 thousand as compared to same time period 2017 or 22.9%.

The average balance of interest-bearing liabilities was higher by \$36.6 million in 2018 than first half 2017. Interest bearing deposits increased \$46.2 million while Fed Funds sold and securities sold under agreement to repurchase decreased by \$4.7 million. The higher balance coupled with the slight variation of the balance sheet mix, resulted in a 12 basis points increase in the cost of funds at 0.78% for first half 2018 as compared to 2017's 0.66%.

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The Federal Funds and prime rate increases of 25 basis points in December 2015, December 2016, March, June, and December of 2017 along with March and June of 2018, has only had a marginal effect on the Bank's pricing methodologies. Loans with variable rates and floors have had the rates begin to increase over the floors with the 175 basis points increase in prime rate over the last 30 months. This should be evident in the second quarter chart relating to the change report due to volume and rate. On the liability side, the slow pace of the rate increases has placed more pressure on the short term funds. Competition for public funds had caused those short term deposits to price higher. This is evidenced in the change chart as the increase cost is driven more by rate than volume.

Interest Bearing Liabilities:	(In Thousands)		Yield/Rate		
	Year to Date Ended June 30, 2018		June 30, June 30,		
	Average Balance	Interest/Dividends	2018	2017	
Savings Deposits	\$ 555,181	\$ 1,576	0.57%	0.42	%
Other Time Deposits	183,729	1,132	1.23%	1.12	%
Other Borrowed Money	5,000	40	1.60%	1.46	%
Fed Funds Purchased & Securities					
Sold under Agreement to Repurchase	26,689	242	1.81%	1.47	%
Total Interest Bearing Liabilities	\$ 770,599	\$ 2,990	0.78%	0.66	%

## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

## Change in Interest Expense Year to Date June 30, 2018 Compared to June 30, 2017

	(In Thousands)		
	Change	Due to Volume	Due to Rate
Interest Bearing Liabilities:			
Savings Deposits	\$511	\$ 148	\$363
Other Time Deposits	69	(36 )	105
Other Borrowed Money	(33 )	(40 )	7
Fed Funds Purchased & Securities			
Sold under Agreement to Repurchase	11	(42 )	53
Total Interest Bearing Liabilities	\$558	\$ 30	\$528

## Net Interest Income

Overall, net interest spread figures for the first half 2018 are up from 2017 by 18 basis points and up 17 basis points from 2016. Net interest margin for the first half of 2018 is higher than the same period 2017 and 2016. As the chart below illustrates, both higher yields on interest and dividend income, were offset by higher interest expense resulting in total net interest margin up 22 basis points since the first half of 2017 and over first half 2016 by 23 basis points.

	June 30, 2018		June 30, 2017		June 30, 2016	
Interest/Dividend income/yield	4.35	%	4.05	%	3.98	%
Interest Expense / yield	0.78	%	0.66	%	0.58	%
Net Interest Spread	3.57	%	3.39	%	3.40	%
Net Interest Margin	3.78	%	3.56	%	3.55	%

Net interest income was up \$2.3 million in the first half 2018 over the same time frame in 2017 due to the increase in loan income even with higher interest expense, as previously mentioned. New loans added in 2017 and 2018 will continue to generate more income, while deposit pressure is expected to increase on the expense side.



## ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Comparison of Results of Noninterest Earnings and Expenses for six month periods ended June 30, 2018 and 2017

## Provision Expense

Total provision for loan losses was \$74 thousand lower for six months 2018 than for the first six months 2017. While loan growth continued in the first half, strong asset quality continued also. The strong asset quality and lower net charge-offs offset any need for additional provision above the \$172 thousand that was expensed.

	(In Thousands)		
	Six Months Ended	Six Months Ended	Six Months Ended
	June 30, 2018	June 30, 2017	June 30, 2016
Loans, net	\$831,015	\$790,838	\$729,915
Daily average of outstanding loans	\$829,545	\$769,931	\$706,523
Allowance for Loan Losses - January 1,	\$6,868	\$6,784	\$6,057
Loans Charged off:			
Consumer Real Estate	34	-	64
Agriculture Real Estate	-	-	-
Agricultural	-	-	18
Commercial Real Estate	16	-	3
Commercial and Industrial	100	-	20
Consumer	177	97	153
	327	97	258
Loan Recoveries:			
Consumer Real Estate	-	13	21
Agriculture Real Estate	-	-	-
Agricultural	6	2	5
Commercial Real Estate	4	7	5
Commercial and Industrial	6	6	5
Consumer	60	45	42
	76	73	78
Net Charge Offs	251	24	180
Provision for loan loss	172	98	616
Acquisition provision for loan loss	-	-	-
Allowance for Loan & Lease Losses - June 30,	6,789	6,858	6,493
Allowance for Unfunded Loan Commitments	315	219	219

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& Letters of Credit - June 30,					
Total Allowance for Credit Losses - June 30,	\$7,104		\$7,077		\$6,712
Ratio of net charge-offs to average Loans outstanding	0.03	%	0.00	%	0.03 %
Ratio of the Allowance for Loan Loss to Nonperforming					
Loans*	751.49	%	502.23	%	424.86 %

Noninterest Income

In comparing past due balances of loans 30+ days, June 30, 2018 balances were \$226 thousand lower than June 30, 2017 balances. Net charge-offs were also higher at \$251 thousand for first half 2018 compared to first half 2017's \$24 thousand.

Noninterest income for the first six months 2018 increased over the first half of 2017 by \$59 thousand. Combined service fees increased by \$92 thousand and gain on sale of loans showed a \$14 thousand improvement over first half 2017. Gain on sale of available-for-sale securities decreased by \$47 thousand over 2017.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)

Noninterest Expense

Through the first half 2018, noninterest expenses were \$1.1 million higher than in first half 2017. The effect of an increase of \$397 thousand in salaries and wages was combined with an increase of \$279 thousand in employee benefits. One new office has been added in 2018, merit increases along with increased costs in medical benefits have impacted the 2018 salaries, wages, and benefits. Higher profit levels are also driving higher incentive accruals for 2018.

Data processing fees were only \$17 thousand higher than last year due to seven year contract extension signed in the third quarter of 2016. It has helped reduce the expense while adding new products and services to better align with our customers' expectations in the coming years. We have already added additional products in 2018, mainly focused on mobile services and business deposit accounts.

The next largest increase for 2018 was in the furniture and equipment. This line item on the income statement was up by \$109 thousand over first half 2017. Increased depreciation for new offices and office transformations, along with maintenance costs have led to this expense to increase over 2017.

Net Income

Overall, net income through the first half of 2018 was up \$1.8 million as compared to the first half of 2017. The Company continues to grow loans while keeping past dues low. The growth in loans has spurred the increase in net interest income that has flowed through to the bottom line. The asset quality has kept loan provision down as the allowance for loan loss remains adequate for the level of credit risk. The opening of the new offices has hampered earnings in the short term; however, the Company remains focused on the long term.

The Company continues to look for new opportunities to generate and protect revenue and provide additional channels through which to serve our customers and maintain our high level of customer satisfaction.

FORWARD LOOKING STATEMENTS

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as "intend," "believe," "expect," "anticipate," "should," "planned," "estimated," and "potential." Such forward-looking statements are based on current expectations, but actual results may differ materially from those

currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

## ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of our interest rate risk arises from the instruments, positions and transactions entered into for purposes other than trading such as loans, available for sale securities, interest bearing deposits, short term borrowings and long term borrowings. Interest rate risk occurs when interest bearing assets and liabilities re-price at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates.

Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. In the event that our asset/liabilities management strategies are unsuccessful, our profitability may be adversely affected. The Company employs a sensitivity analysis utilizing interest rate shocks to help in this analysis.

The shocks presented below assume an immediate change of rate in the percentages and directions shown covering a twelve month period:

Interest Rate Shock on Net Interest Margin				Interest Rate Shock on Net Interest Income		
Net Interest Margin (Ratio)	% Change to Flat Rate	Rate Direction	Rate Changes by	Cumulative Total (\$000)	% Change to Flat Rate	
4.48	% 18.52	% Rising	3.00%	49,434	16.96%	
4.21	% 11.19	% Rising	2.00%	46,670	10.42%	
3.93	% 3.90	% Rising	1.00%	43,930	3.94%	
3.78	% 0.00	% Flat	0.00%	42,265	0.00%	
3.53	% -6.80	% Falling	-1.00%	39,718	-6.03%	
3.27	% -13.57	% Falling	-2.00%	37,365	-11.59%	
3.00	% -20.67	% Falling	-3.00%	34,976	-17.25%	

The net interest margin represents the forecasted twelve month margin. The Company also reviews shocks with a 4.0% fluctuation with a delayed time frame of 10 months and over a 24 month time frame. It also shows the effect rate changes will have on both the margin and net interest income. The goal of the Company is to lengthen the term of some of the Bank's fixed rate liabilities or sources of funds to decrease the exposure to a rising rate environment. Of course, customer desires also impact the Bank's ability to attract longer term deposits. Some movement into the longer term time deposits has occurred. Over the past five year period, the Bank has experienced a decrease in the time balances of our deposit portfolio, and therefore, a loss of term funding. Over the past two years, the Bank has also paid off term borrowings with the last \$5 million maturing this year.

The shock chart currently shows a widening net interest margin over the next twelve months in an increasing rate environment with a tightening in a falling rate environment. Cost of funds are below 0.80% so at even the lowest shock of 100 basis points, the Bank cannot take full advantage and reprice funds to match the level of shock. Since the average duration of the majority of the assets is outside the 12 month shock period, the rising rate environment only shows minor improvement. The majority of the newer loans added to the commercial real estate portfolio begin with an initial fixed rate period of three to five years whose variable adjustment is outside of the current shock time frame. The Bank continues to adjust its assumptions by including decay rates and key rate ties on certain deposit accounts and continues to review and modify those rates as the index rates change. All shocks are within risk exposure guidelines at all levels. The effect of the rate shocks may be mitigated to the extent that not all lines of business are directly tied to an external index and actual balance sheet composition may differ from prediction.

Overall, the Company must concentrate on increasing loan spreads on variable loans and extend the duration on cost of funds where possible.

## ITEM 4 CONTROLS AND PROCEDURES

As of June 30, 2018, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2018. There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2018 that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

## PART II OTHER INFORMATION

## ITEM 1 LEGAL PROCEEDINGS

None

## ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2017.

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

Treasury stock repurchased the quarter ended June 30, 2018.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced or Plan Programs	(d) Maximum Number of Shares that may yet be purchased under the Plans or Programs
4/1/2018 to 4/30/2018	—	—	—	400,000
5/1/2018 to 5/31/2018	—	—	—	400,000
6/1/2018 to 6/30/2018	—	—	—	400,000
Total	—	—	—	400,000

- (1) From time to time, the Company purchases shares in the market pursuant to a stock repurchase program publicly announced on January 19, 2018. On that date, the Board of Directors authorized the repurchase of 400,000 common shares between January 19, 2018 and December 31, 2018.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 MINE SAFETY DISCLOSURES

Not applicable

ITEM 5 OTHER INFORMATION

54

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ITEM 6 EXHIBITS

- 3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 to Registrant's Report on Form 8-K filed with the Commission on August 25, 2017).
- 3.2 Amended and Restated Code of Regulations of the Registrant (incorporated by reference to Exhibit 3.2 to Registrant's Quarterly Report on Form 10-Q filed with the Commission on July 26, 2017).
- 31.1 Rule 13-a-14(a) Certification - CEO
- 31.2 Rule 13-a-14(a) Certification - CFO
- 32.1 Section 1350 Certification - CEO
- 32.2 Section 1350 Certification - CFO
  
- 101.INS XBRL Instance Document (1)
- 101.SCH XBRL Taxonomy Extension Schem Document (1)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document (1)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document (1)
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document (1)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document (1)

SIGNATURES

SIGNATURES

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

Farmers & Merchants Bancorp, Inc.,

Date: July 25, 2018 By: /s/ Paul S. Siebenmorgen  
Paul S. Siebenmorgen  
President and CEO

Date: July 25, 2018 By: /s/ Barbara J. Britenriker  
Barbara J. Britenriker  
Exec. Vice-President and CFO