

FARMERS & MERCHANTS BANCORP
Form 10-Q
May 10, 2018

UNITED STATES
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 ended March 31, 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: 000-26099

FARMERS & MERCHANTS BANCORP
(Exact name of registrant as specified in its charter)

Delaware 94-3327828
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

111 W. Pine Street, Lodi, California 95240
(Address of principal Executive offices) (Zip Code)

Registrant's telephone number, including area code (209) 367-2300

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer
Smaller Reporting Company Emerging growth company

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

(Do not check if a smaller reporting 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

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

Yes No

Number of shares of common stock of the registrant 821,073 outstanding as of May 4, 2018.

FARMERS & MERCHANTS BANCORP

FORM 10-Q
TABLE OF CONTENTS

<u>PART I. - FINANCIAL INFORMATION</u>	<u>Page</u>
Item 1 - Financial Statements	
<u>Consolidated Balance Sheets (Unaudited) as of March 31, 2018, December 31, 2017 and March 31, 2017.</u>	3
<u>Consolidated Statements of Income (Unaudited) for the Three Months Ended March 31, 2018 and 2017.</u>	4
<u>Consolidated Statements of Comprehensive Income (Unaudited) for the Three Months Ended March 31, 2018 and 2017.</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Three Months Ended March 31, 2018 and 2017.</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited) for the Three Months Ended March 31, 2018 and 2017.</u>	7
<u>Notes to the Consolidated Financial Statements (Unaudited)</u>	8
Item 2 - <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	31
Item 3 - <u>Quantitative and Qualitative Disclosures About Market Risk</u>	49
Item 4 - <u>Controls and Procedures</u>	52
<u>PART II. - OTHER INFORMATION</u>	
Item 1 - <u>Legal Proceedings</u>	52
Item 1A - <u>Risk Factors</u>	53
Item 2 - <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
Item 3 - <u>Defaults Upon Senior Securities</u>	53
Item 4 - <u>Mine Safety Disclosures</u>	53
Item 5 - <u>Other Information</u>	53
Item 6 - <u>Exhibits</u>	53
<u>Signatures</u>	54

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARMERS & MERCHANTS BANCORP

Consolidated Balance Sheets

(in thousands except share data)

	March 31, 2018 (Unaudited)	December 31, 2017	March 31, 2017 (Unaudited)
Assets			
Cash and Cash Equivalents:			
Cash and Due from Banks	\$ 37,974	\$ 65,956	\$ 42,164
Interest Bearing Deposits with Banks	97,010	121,193	122,348
Total Cash and Cash Equivalents	134,984	187,149	164,512
Investment Securities:			
Available-for-Sale	495,814	481,596	452,842
Held-to-Maturity	53,527	54,460	57,281
Total Investment Securities	549,341	536,056	510,123
Loans & Leases:			
Loans & Leases	2,235,083	2,215,295	2,146,032
Less: Allowance for Credit Losses	50,677	50,342	48,400
Loans & Leases, Net	2,184,406	2,164,953	2,097,632
Premises and Equipment, Net	28,491	28,679	28,781
Bank Owned Life Insurance	60,035	59,583	58,216
Interest Receivable and Other Assets	102,726	99,032	93,745
Total Assets	\$ 3,059,983	\$ 3,075,452	\$ 2,953,009
Liabilities			
Deposits:			
Demand	\$ 797,435	\$ 832,652	\$ 709,908
Interest Bearing Transaction	589,883	601,476	503,678
Savings and Money Market	831,324	813,703	804,383
Time	482,763	475,397	589,644
Total Deposits	2,701,405	2,723,228	2,607,613
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	42,392	42,254	46,539
Total Liabilities	2,754,107	2,775,792	2,664,462
Shareholders' Equity			
Preferred Stock: No Par Value, 1,000,000 Shares Authorized, None Issued or Outstanding	-	-	-
Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 812,304, 812,304 and 818,704 Shares Issued and Outstanding at March 31, 2018, December 31, 2017 and March 31, 2017, Respectively	8	8	8
Additional Paid-In Capital	93,624	93,624	91,482
Retained Earnings	216,786	206,845	197,134

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Accumulated Other Comprehensive Loss	(4,542)	(817)	(77)
Total Shareholders' Equity	305,876		299,660		288,547	
Total Liabilities and Shareholders' Equity	\$ 3,059,983		\$ 3,075,452		\$ 2,953,009	

The accompanying notes are an integral part of these unaudited consolidated financial statements

3

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Income (Unaudited)

(in thousands except per share data)	Three Months	
	Ended March 31,	
	2018	2017
Interest Income		
Interest and Fees on Loans & Leases	\$27,044	\$24,531
Interest on Deposits with Banks	585	249
Interest on Investment Securities:		
Taxable	2,381	2,012
Exempt from Federal Tax	418	450
Total Interest Income	30,428	27,242
Interest Expense		
Deposits	1,405	1,276
Subordinated Debentures	117	100
Total Interest Expense	1,522	1,376
Net Interest Income	28,906	25,866
Provision for Credit Losses	333	600
Net Interest Income After Provision for Credit Losses	28,573	25,266
Non-Interest Income		
Service Charges on Deposit Accounts	817	846
Increase in Cash Surrender Value of Life Insurance	452	455
Debit Card and ATM Fees	1,016	910
Net Gain on Deferred Compensation Investments	782	794
Other	1,598	2,401
Total Non-Interest Income	4,665	5,406
Non-Interest Expense		
Salaries and Employee Benefits	13,527	12,492
Net Gain on Deferred Compensation Investments	782	794
Occupancy	942	848
Equipment	1,023	987
Marketing	329	175
Legal	440	183
FDIC Insurance	239	228
Gain on Sale of ORE	-	(114)
Other	2,654	2,829
Total Non-Interest Expense	19,936	18,422
Income Before Income Taxes	13,302	12,250
Provision for Income Taxes	3,361	4,429
Net Income	\$9,941	\$7,821
Basic Earnings Per Common Share	\$12.24	\$9.68

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)	Three Months Ended March 31,		2017	
	2018			
Net Income	\$	9,941	\$	7,821
Other Comprehensive Income				
Increase in Net Unrealized Loss on Available-for-Sale Securities		(5,288)		(114)
Deferred Tax Benefit Related to Unrealized Losses		1,563		48
Change in Net Unrealized Loss on Available-for-Sale Securities, Net of Tax		(3,725)		(66)
Total Other Comprehensive Loss		(3,725)		(66)
Comprehensive Income	\$	6,216	\$	7,755

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)

	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss, net	Total Shareholders' Equity
Balance, January 1, 2017	807,329	\$ 8	\$ 90,671	\$ 189,313	\$ (11)	\$ 279,981
Net Income			-	7,821	-	7,821
Issuance of Common Stock	1,375	-	811	-	-	811
Change in Net Unrealized Loss on Securities Available-for-Sale, net of tax		-	-	-	(66)	(66)
Balance, March 31, 2017	808,704	\$ 8	\$ 91,482	\$ 197,134	\$ (77)	\$ 288,547
Balance, January 1, 2018	812,304	\$ 8	\$ 93,624	\$ 206,845	\$ (817)	\$ 299,660
Net Income			-	9,941	-	9,941
Change in Net Unrealized Loss on Securities Available-for-Sale, net of tax		-	-	-	(3,725)	(3,725)
Balance, March 31, 2018	812,304	\$ 8	\$ 93,624	\$ 216,786	\$ (4,542)	\$ 305,876

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Cash Flows (Unaudited)

(in thousands)	Three Months Ended March 31, 2018	March 31, 2017
Operating Activities:		
Net Income	\$ 9,941	\$ 7,821
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	333	600
Depreciation and Amortization	582	494
Net Amortization of Investment Security Premiums & Discounts	277	402
Amortization of Core Deposit Intangible	27	27
Accretion of Discount on Acquired Loans	(18)	(66)
Net (Gain) on Sale of Property & Equipment	(292)	(1,108)
Net Gain on Sale of ORE	-	(114)
Net Change in Operating Assets & Liabilities:		
Net Decrease in Interest Receivable and Other Assets	(2,525)	5,378
Net Increase in Interest Payable and Other Liabilities	682	(3,452)
Net Cash Provided by Operating Activities	9,007	9,982
Investing Activities:		
Purchase of Investment Securities		
Available-for-Sale	(109,482)	(79,007)
Proceeds from Sold, Matured or Called Securities		
Available-for-Sale	89,724	73,905
Purchase of Investment Securities		
Held-to-Maturity	(1,952)	(210)
Proceeds from Matured or Called Securities		
Held-to-Maturity	2,870	1,023
	(19,791)	31,484

Net Loans & Leases Paid, Originated or Acquired Principal Collected on Loans & Leases				
Previously Charged Off	23		32	
Additions to Premises and Equipment	(1,085)	(1,157)
Purchase of Other Investments	(639)	(128)
Proceeds from Sale of Property & Equipment	983		2,219	
Proceeds from Sale of Other Real Estate	-		1,607	
Net Cash (Used in) Provided by Investing Activities	(39,349)	29,768	
Financing Activities: Net (Decrease) Increase in Deposits	(21,823)	25,902	
Net Cash (Used in) Provided by Financing Activities	(21,823)	25,902	
(Decrease) Increase in Cash and Cash Equivalents	(52,165)	65,652	
Cash and Cash Equivalents at Beginning of Period	187,149		98,860	
Cash and Cash Equivalents at End of Period	\$ 134,984		\$ 164,512	
Supplementary Data Issuance of Common Stock to the Bank's Non-Qualified Retirement Plans	\$ -		\$ 811	
Interest Paid	\$ 1,750		\$ 1,346	

The accompanying notes are an integral part of these unaudited consolidated financial statements

Table of Contents

FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

Farmers & Merchants Bancorp (the “Company”) was organized March 10, 1999. Primary operations are related to traditional banking activities through its subsidiary Farmers & Merchants Bank of Central California (the “Bank”) which was established in 1916. The Bank’s wholly owned subsidiaries include Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation has been dormant since 1991. Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

The Company’s other subsidiaries include F & M Bancorp, Inc. and FMCB Statutory Trust I. F & M Bancorp, Inc. was created in March 2002 to protect the name F & M Bank. During 2002, the Company completed a fictitious name filing in California to begin using the streamlined name “F & M Bank” as part of a larger effort to enhance the Company’s image and build brand name recognition. In December 2003, the Company formed a wholly owned subsidiary, FMCB Statutory Trust I, for the sole purpose of issuing Trust Preferred Securities and related subordinated debentures, in accordance with generally accepted accounting principles in the United States (“U.S. GAAP”). FMCB Statutory Trust I is a non-consolidated subsidiary.

On November 18, 2016, Farmers & Merchants Bancorp completed the acquisition of Delta National Bancorp, headquartered in Manteca, California, and the parent holding company for Delta Bank N.A., a locally owned and operated community bank established in 1973. As of the acquisition date, Delta National Bancorp had approximately \$112 million in assets and four branch locations in the communities of Manteca, Riverbank, Modesto and Turlock. At the effective time of the acquisition, Delta National Bancorp was merged into Farmers & Merchants Bancorp and Delta Bank, N.A. was merged into Farmers & Merchants Bank of Central California.

The accounting and reporting policies of the Company conform to U.S. GAAP and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

Basis of Presentation

The accompanying consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information.

These statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) for interim reporting on Form 10-Q. These statements reflect all adjustments (consisting only of normal recurring adjustments), which are necessary for a fair presentation of financial results for the interim periods presented. The results of operations for the three-month period ended March 31, 2018 may not necessarily be indicative of future operating results. Certain disclosures normally presented in the notes to the annual consolidated financial statements prepared in accordance with U.S. GAAP have been omitted. These interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

The accompanying consolidated financial statements include the accounts of the Company and the Company’s wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank’s wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the

date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Certain amounts in the prior years' financial statements and related footnote disclosures have been reclassified to conform to the current-year presentation. These reclassifications had no effect on previously reported net income or total shareholders' equity.

8

Table of Contents

Revenue from Contracts with Customers

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, “Revenue from Contracts with Customers” (“Topic 606”). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

The Company’s primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is limited judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Cash and Cash Equivalents

For purposes of the Consolidated Statements of Cash Flows, the Company has defined cash and cash equivalents as those amounts included in the balance sheet captions Cash and Due from Banks, Interest Bearing Deposits with Banks, Federal Funds Sold and Securities Purchased Under Agreements to Resell. For these instruments, the carrying amount is a reasonable estimate of fair value.

Equity Method Investment

Investment over which the Company exercises significant influence over the activities of the entity but which do not meet the requirements for consolidation is accounted for using the equity method of accounting pursuant to ASC 323, whereby the Company records its share of the underlying income or loss of the entity. Equity in losses of the equity method investment is not recognized after the carrying value of the investment, including advances and loans, has been reduced to zero, unless guarantees or other funding obligations exist.

Investment Securities

Investment securities are classified at the time of purchase as held-to-maturity (“HTM”) if it is management’s intent and the Company has the ability to hold the securities until maturity. These securities are carried at cost, adjusted for amortization of premium and accretion of discount using a level yield of interest over the estimated remaining period until maturity. Losses, reflecting a decline in value judged by the Company to be other than temporary, are recognized in the period in which they occur.

Securities are classified as available-for-sale (“AFS”) if it is management’s intent, at the time of purchase, to hold the securities for an indefinite period of time and/or to use the securities as part of the Company’s asset/liability management strategy. These securities are reported at fair value with aggregate unrealized gains or losses excluded from income and included as a separate component of shareholders’ equity, net of related income taxes. Fair values are based on quoted market prices or broker/dealer price quotations on a specific identification basis. Gains or losses on the sale of these securities are computed using the specific identification method.

Trading securities, if any, are acquired for short-term appreciation and are recorded in a trading portfolio and are carried at fair value, with unrealized gains and losses recorded in non-interest income.

Management evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: (1) OTTI related to credit loss, which must be recognized in the income statement; and (2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

Table of Contents

Loans & Leases

Loans & leases are reported at the principal amount outstanding net of unearned discounts and deferred loan & lease fees and costs. Interest income on loans & leases is accrued daily on the outstanding balances using the simple interest method. Loan & lease origination fees are deferred and recognized over the contractual life of the loan or lease as an adjustment to the yield. Loans & leases are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose, a loan or lease is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or lease or is guaranteed by a financially capable party. When a loan or lease is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged against current income; thereafter, interest income is recognized only as it is collected in cash. Additionally, cash would be applied to principal if all principal was not expected to be collected. Loans & leases placed on non-accrual status are returned to accrual status when the loans or leases are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan or lease.

A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Impaired loans & leases are either: (1) non-accrual loans & leases; or (2) restructured loans & leases that are still accruing interest. Loans or leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

A restructuring of a loan or lease constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the borrower's (the term "borrower" is used herein to describe a customer who has entered into either a loan or lease transaction) financial difficulties grants a concession to the borrower that it would not otherwise consider. Restructured loans & leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment as described above.

Generally, the Company will not restructure loans or leases for borrowers unless: (1) the existing loan or lease is brought current as to principal and interest payments; and (2) the restructured loan or lease can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan or lease amounts. After restructure, a determination is made whether the loan or lease will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance sheet date. The allowance is established through a provision for credit losses, which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components: specific reserves related to impaired loans & leases; general reserves

for inherent losses related to loans & leases that are not impaired; and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

Table of Contents

The determination of the general reserve for loans & leases that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, qualitative factors that include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan & lease portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1st mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer and other; and (9) equipment leases. The allowance for credit losses attributable to each portfolio segment, which includes both individually evaluated impaired loans & leases and loans & leases that are collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan or lease is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan or lease has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or lease or in the Company's credit position at some future date. Special mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan or lease is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans or leases classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans or leases classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans or leases classified as loss are considered uncollectible. Once a loan or lease becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Company will estimate its probable loss and immediately charge-off some or all of the balance.

Table of Contents

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Real Estate Construction – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agricultural Real Estate and Agricultural – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Leases – Equipment leases are generally considered to possess a moderate inherent risk of loss. As lessor, the Company is subject to both the credit risk of the borrower and the residual value risk of the equipment. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the correction in residential real estate values that occurred between 2007 and 2012. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Consumer & Other – A consumer installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's and Bank's regulators, including the Federal Reserve Board ("FRB"), the California Department of Business Oversight ("DBO") and the Federal Deposit Insurance Corporation ("FDIC"), as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Table of Contents

Acquired Loans

Loans acquired through purchase or through a business combination are recorded at their fair value at the acquisition date. Credit discounts, which reflect estimates of credit losses, expected to be incurred over the life of the loan, are included in the determination of fair value; therefore, an allowance for loan losses is not recorded at the acquisition date.

Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures

The Company also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in Interest Payable and Other Liabilities on the Company's Consolidated Balance Sheet.

Premises and Equipment

Premises, equipment, and leasehold improvements are stated at cost, less accumulated depreciation and amortization. Depreciation is computed principally by the straight-line method over the estimated useful lives of the assets. Estimated useful lives of buildings range from 30 to 40 years, and for furniture and equipment from 3 to 7 years. Leasehold improvements are amortized over the lesser of the terms of the respective leases, or their useful lives, which are generally 5 to 10 years. Remodeling and capital improvements are capitalized while maintenance and repairs are charged directly to occupancy expense.

Other Real Estate

Other real estate, which is included in other assets, is expected to be sold and is comprised of properties no longer utilized for business operations and property acquired through foreclosure in satisfaction of indebtedness. These properties are recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Initial losses on properties acquired through full or partial satisfaction of debt are treated as credit losses and charged to the allowance for credit losses at the time of acquisition. Subsequent declines in value from the recorded amounts, routine holding costs, and gains or losses upon disposition, if any, are included in non-interest expense as incurred.

Income Taxes

The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount combined with the current taxes payable or refundable results in the income tax expense for the current year.

The Company follows the standards set forth in the "Income Taxes" topic of the Financial Accounting Standards Board ("FASB") Accounting Standard Codification ("ASC"), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. This standard prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The Company accounts for leases with Investment Tax Credits (ITC) under the deferred method as established in ASC 740-10. ITC are viewed and accounted for as a reduction of the cost of the related assets and presented as deferred income on the Company's financial statement.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Table of Contents

Interest expense and penalties associated with unrecognized tax benefits, if any, are included in the provision for income taxes in the Consolidated Statements of Income.

Basic Earnings Per Common Share

The Company's common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. There are no common stock equivalent shares.

Therefore, there is no presentation of diluted basic earnings per common share. See Note 6 for additional information.

Segment Reporting

The "Segment Reporting" topic of the FASB ASC requires that public companies report certain information about operating segments. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. The Company is a holding company for a community bank, which offers a wide array of products and services to its customers. Pursuant to its banking strategy, emphasis is placed on building relationships with its customers, as opposed to building specific lines of business. As a result, the Company is not organized around discernible lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change. Therefore, the Company only reports one segment.

Low Income Housing Tax Credit Investments (LIHTC)

The Company accounts for its interest in LIHTC using the cost method as established in ASC 323-740. As an investor, the Company obtains income tax credits and deductions from the operating losses of these tax credit entities. The income tax credits and deductions are allocated to the investors based on their ownership percentages and are recorded as a reduction of income tax expense (or an increase to income tax benefit) and a reduction of federal income taxes payable.

Comprehensive Income

The "Comprehensive Income" topic of the FASB ASC establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Other comprehensive income (loss) refers to revenues, expenses, gains, and losses that U.S. GAAP recognize as changes in value to an enterprise but are excluded from net income. For the Company, comprehensive income includes net income and changes in fair value of its available-for-sale investment securities.

Loss Contingencies

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

Business Combinations And Related Matters

Business combinations are accounted for under the acquisition method of accounting in accordance with ASC 805, Business Combinations. Under the acquisition method, the acquiring entity in a business combination recognizes 100 percent of the acquired assets and assumed liabilities, regardless of the percentage owned, at their estimated fair values as of the date of acquisition. Any excess of the fair value over the purchase price of net assets and other identifiable intangible assets acquired is recorded as bargain purchase gain. Assets acquired and liabilities assumed from contingencies must also be recognized at fair value, if the fair value can be determined during the measurement period. Results of operations of an acquired business are included in the statement of operations from the date of acquisition. Acquisition-related costs, including conversion charges, are expensed as incurred. The Company applied this guidance to the acquisition of Delta National Bancorp that was consummated on November 18, 2016.

Table of Contents

Intangible Assets

Intangible assets are comprised of core deposit intangibles acquired in the Delta National Bancorp acquisition. Intangible assets with definite useful lives are amortized over their respective estimated useful lives. If an event occurs that indicates the carrying amount of an intangible asset may not be recoverable, management reviews the asset for impairment.

2. Investment Securities

The amortized cost, fair values, and unrealized gains and losses of the securities available-for-sale are as follows (in thousands):

	Amortized Cost	Gross Gains	Unrealized Losses	Fair/Book Value
March 31, 2018				
Government Agency & Government-Sponsored Entities	\$ 3,068	\$ 27	\$ -	\$ 3,095
US Treasury Notes	144,147	3	741	143,409
US Govt SBA	27,786	12	261	27,537
Mortgage Backed Securities ⁽¹⁾	324,251	393	5,881	318,763
Other	3,010	-	-	3,010
Total	\$ 502,262	\$ 435	\$ 6,883	\$ 495,814

	Amortized Cost	Gross Gains	Unrealized Losses	Fair/Book Value
December 31, 2017				
Government Agency & Government-Sponsored Entities	\$ 3,080	\$ 48	\$ -	\$ 3,128
US Treasury Notes	144,606	-	442	144,164
US Govt SBA	29,559	29	208	29,380
Mortgage Backed Securities ⁽¹⁾	302,502	939	1,527	301,914
Other	3,010	-	-	3,010
Total	\$ 482,757	\$ 1,016	\$ 2,177	\$ 481,596

	Amortized Cost	Gross Gains	Unrealized Losses	Fair/Book Value
March 31, 2017				
Government Agency & Government-Sponsored Entities	\$ 3,115	\$ 102	\$ -	\$ 3,217
US Treasury Notes	104,717	2	300	104,419
US Govt SBA	34,947	34	247	34,734
Mortgage Backed Securities ⁽¹⁾	309,187	1,820	1,545	309,462
Other	1,010	-	-	1,010
Total	\$ 452,976	\$ 1,958	\$ 2,092	\$ 452,842

⁽¹⁾ All Mortgage Backed Securities consist of securities collateralized by residential real estate and were issued by an agency or government sponsored entity of the U.S. government.

The book values, estimated fair values and unrealized gains and losses of investments classified as held-to-maturity are as follows (in thousands):

	Book Value	Gross Gains	Unrealized Losses	Fair Value
March 31, 2018				
Obligations of States and Political Subdivisions	\$ 53,527	\$ 274	\$ 56	\$ 53,745
Total	\$ 53,527	\$ 274	\$ 56	\$ 53,745

Book	Gross Unrealized	Fair
------	------------------	------

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

December 31, 2017	Value	Gains	Losses	Value
Obligations of States and Political Subdivisions	\$54,460	\$ 776	\$ -	\$55,236
Total	\$54,460	\$ 776	\$ -	\$55,236

March 31, 2017	Book Value	Gross Unrealized Gains	Unrealized Losses	Fair Value
Obligations of States and Political Subdivisions	\$57,281	\$ 414	\$ 22	\$57,673
Total	\$57,281	\$ 414	\$ 22	\$57,673

15

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

Fair values are based on quoted market prices or dealer quotes. If a quoted market price or dealer quote is not available, fair value is estimated using quoted market prices for similar securities.

The amortized cost and estimated fair values of investment securities at March 31, 2018 by contractual maturity are shown in the following table (in thousands):

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair/Book Value	Book Value	Fair Value
March 31, 2018				
Within one year	\$ 123,199	\$ 122,897	\$ 2,907	\$ 2,915
After one year through five years	14,798	14,762	6,711	6,714
After five years through ten years	17,877	17,482	17,707	17,795
After ten years	22,137	21,910	26,202	26,321
	178,011	177,051	53,527	53,745
Investment securities not due at a single maturity date:				
Mortgage-backed securities	324,251	318,763	-	-
Total	\$ 502,262	\$ 495,814	\$ 53,527	\$ 53,745

Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following tables show those investments with gross unrealized losses and their market value aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at the dates indicated (in thousands):

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
March 31, 2018						

Securities Available-for-Sale

US Treasury Notes	\$ 23,551	\$ 436	\$ 59,866	\$ 305	\$ 83,417	\$ 741
US Govt SBA	10,848	82	11,737	179	22,585	261
Mortgage Backed Securities	259,314	4,606	41,230	1,275	300,544	5,881
Total	\$ 293,713	\$ 5,124	\$ 112,833	\$ 1,759	\$ 406,546	\$ 6,883

Securities Held-to-Maturity

Obligations of States and Political Subdivisions	\$ 7,654	\$ 56	\$ -	\$ -	\$ 7,654	\$ 56
Total	\$ 7,654	\$ 56	\$ -	\$ -	\$ 7,654	\$ 56

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
December 31, 2017						

Securities Available-for-Sale

US Treasury Notes	\$ 94,281	\$ 144	\$ 49,883	\$ 298	\$ 144,164	\$ 442
US Govt SBA	8,379	51	12,900	157	21,279	208
Mortgage Backed Securities	126,863	932	43,208	595	170,071	1,527

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Total \$ 229,523 \$ 1,127 \$ 105,991 \$ 1,050 \$ 335,514 \$ 2,177

There were no HTM investments with gross unrealized losses at December 31, 2017

March 31, 2017	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
<u>Securities Available-for-Sale</u>						
US Treasury Notes	\$ 69,433	\$ 300	\$ -	\$ -	\$ 69,433	\$ 300
US Govt SBA	26,412	247	-	-	26,412	247
Mortgage Backed Securities	168,546	1,545	-	-	168,546	1,545
Total	\$ 264,391	\$ 2,092	\$ -	\$ -	\$ 264,391	\$ 2,092
<u>Securities Held-to-Maturity</u>						
Obligations of States and Political Subdivisions	\$ 4,278	\$ 22	\$ -	\$ -	\$ 4,278	\$ 22
Total	\$ 4,278	\$ 22	\$ -	\$ -	\$ 4,278	\$ 22

Table of Contents

As of March 31, 2018, the Company held 491 investment securities of which 164 were in an unrealized loss position for less than twelve months. 95 securities were in an unrealized position for twelve months or more. Management periodically evaluates each investment security for other-than-temporary impairment relying primarily on industry analyst reports and observations of market conditions and interest rate fluctuations. Management believes it will be able to collect all amounts due according to the contractual terms of the underlying investment securities.

Securities of Government Agency and Government Sponsored Entities – At March 31, 2018, no securities of government agency and government sponsored entities were in an unrealized loss position for less than 12 months. No securities were in an unrealized loss position for 12 months or more. The unrealized losses on the Company's investments in securities of government agency and government sponsored entities were \$0 at March 31, 2018, December 31, 2017 and at March 31, 2017.

U.S. Treasury Notes – At March 31, 2018, four U.S. Treasury Note security investments were in an unrealized loss position for less than 12 months and four were in an unrealized loss position for 12 months or more. The unrealized losses on the Company's investment in U.S. Treasury Notes were \$741,000 at March 31, 2018 and \$442,000 at December 31, 2017, and \$300,000 at March 31, 2017. The unrealized losses were caused by interest rate fluctuations. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company did not consider these investments to be other-than-temporarily impaired at March 31, 2018, December 31, 2017, and March 31, 2017.

U.S. Government SBA – At March 31, 2018, 66 U.S. Government SBA security investments were in an unrealized loss position for less than 12 months and 66 were in an unrealized loss position for 12 months or more. The unrealized losses on the Company's investment in U.S. Government SBA securities were \$261,000 at March 31, 2018 and \$208,000 at December 31, 2017, and \$247,000 at March 31, 2017. The unrealized losses were caused by interest rate fluctuations. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company did not consider these investments to be other-than-temporarily impaired at March 31, 2018, December 31, 2017, and March 31, 2017.

Mortgage Backed Securities – At March 31, 2018, 75 mortgage backed security investments were in an unrealized loss position for less than 12 months and 25 were in an unrealized loss position for 12 months or more. The unrealized losses on the Company's investment in mortgage backed securities were \$5.9 million, \$1.5 million, and \$1.5 million at March 31, 2018, December 31, 2017, and March 31, 2017, respectively. The unrealized losses on the Company's investment in mortgage backed securities were caused by interest rate fluctuations. The contractual cash flows of these investments are guaranteed by an agency or government sponsored entity of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2018, December 31, 2017, and March 31, 2017.

Obligations of States and Political Subdivisions - At March 31, 2018, 19 obligations of states and political subdivisions were in an unrealized loss position for less than 12 months. None were in an unrealized loss position for 12 months or more. As of March 31, 2018, over ninety-eight percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of the two percent of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

The unrealized losses on the Company's investment in obligations of states and political subdivisions were \$56,000, \$0 and \$22,000 at March 31, 2018, December 31, 2017 and March 31, 2017, respectively. Management believes that any unrealized losses on the Company's investments in obligations of states and political subdivisions were primarily caused by interest rate fluctuations. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company does not intend to sell the securities and it is more likely than not that the Company will not have to sell the securities before recovery of their cost basis, the Company does not consider these investments to be other-than-temporarily impaired at March 31, 2018, December 31, 2017, and March 31, 2017.

Table of Contents

There were no proceeds from sales and calls of securities for the period ending March 31, 2018 and March 31, 2017.

Pledged Securities

As of March 31, 2018, securities carried at \$245.4 million were pledged to secure public deposits, Federal Home Loan Bank ("FHLB") borrowings, and other government agency deposits as required by law. This amount was \$214.5 million at December 31, 2017, and \$203.8 million at March 31, 2017.

3. Loans & Leases and Allowance for Credit Losses

The following tables show the allocation of the allowance for credit losses by portfolio segment and by impairment methodology at the dates indicated (in thousands):

March 31, 2018	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2018	\$10,922	\$12,085	\$1,846	\$815	\$2,324	\$8,159	\$9,197	\$209	\$3,363	\$1,422	\$50,3
Charge-Offs	-	-	-	-	(4)	-	-	(17)	-	-	(21
Recoveries	-	-	-	3	1	6	2	11	-	-	23
Provision	156	157	27	9	22	(297)	175	36	27	21	333
Ending Balance- March 31, 2018	\$11,078	\$12,242	\$1,873	\$827	\$2,343	\$7,868	\$9,374	\$239	\$3,390	\$1,443	\$50,6
Ending Balance Individually Evaluated for Impairment	335	-	-	76	17	-	205	8	-	-	641
Ending Balance Collectively Evaluated for Impairment	10,743	12,242	1,873	751	2,326	7,868	9,169	231	3,390	1,443	50,0
Loans: Ending Balance	\$698,349	\$508,400	\$96,315	\$264,137	\$34,691	\$261,427	\$274,682	\$6,685	\$90,397	\$-	\$2,23
Ending Balance Individually Evaluated	4,784	-	-	2,427	332	-	1,713	9	-	-	9,26

for
Impairment
Ending
Balance
Collectively
Evaluated
for
Impairment

\$693,565	\$508,400	\$96,315	\$261,710	\$34,359	\$261,427	\$272,969	\$6,676	\$90,397	\$-	\$2,22
-----------	-----------	----------	-----------	----------	-----------	-----------	---------	----------	-----	--------

18

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

December 31, 2017	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Edt
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2017	\$11,110	\$9,450	\$3,223	\$865	\$2,140	\$7,381	\$8,515	\$200	\$3,586	\$1,449	\$47
Charge-Offs	(109)	-	-	(53)	(3)	(374)	-	(146)	-	-	(6
Recoveries	109	-	-	40	8	17	8	76	-	-	25
Provision	(188)	2,635	(1,377)	(37)	179	1,135	674	79	(223)	(27)	2,
Ending Balance- December 31, 2017	\$10,922	\$12,085	\$1,846	\$815	\$2,324	\$8,159	\$9,197	\$209	\$3,363	\$1,422	\$50
Ending Balance Individually Evaluated for Impairment	366	-	-	73	17	-	220	8	-	-	68
Ending Balance Collectively Evaluated for Impairment	10,556	12,085	1,846	742	2,307	8,159	8,977	201	3,363	1,422	49
Loans & Leases: Ending Balance	\$684,961	\$499,231	\$100,206	\$260,751	\$34,525	\$273,582	\$265,703	\$6,656	\$89,680	\$-	\$2,
Ending Balance Individually Evaluated for Impairment	4,822	-	-	2,373	340	-	1,734	10	-	-	9,
Ending Balance Collectively Evaluated for Impairment	680,139	499,231	100,206	258,378	34,185	273,582	263,969	6,646	89,680	-	2,
March 31, 2017	Commercial Real	Agricultural	Real Estate	Residential 1st	Home Equity	Agricultural	Commercial	Consumer &	Leases	Unallocated	Edt

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

	Estate	Real Estate	Construction	Mortgages	Lines & Loans				Other			
Year-To-Date Allowance for Credit Losses:												
Beginning Balance- January 1, 2017	\$11,110	\$9,450	\$3,223	\$865	\$2,140	\$7,381	\$8,515	\$200	\$3,586	\$1,449	\$47	
Charge-Offs	(109)	-	-	-	-	(7)	-	(35)	-	-	(1)	
Recoveries	7	-	-	3	2	-	4	16	-	-	32	
Provision	657	(57)	(277)	12	(17)	(863)	(40)	17	280	888	60	
Ending Balance- March 31, 2017	\$11,665	\$9,393	\$2,946	\$880	\$2,125	\$6,511	\$8,479	\$198	\$3,866	\$2,337	\$48	
Ending Balance Individually Evaluated for Impairment	471	-	-	69	17	331	268	6	-	-	1,	
Ending Balance Collectively Evaluated for Impairment	11,194	9,393	2,946	811	2,108	6,180	8,211	192	3,866	2,337	47	
Loans: Ending Balance	\$676,527	\$463,645	\$164,791	\$249,628	\$31,817	\$266,010	\$209,184	\$7,119	\$77,311	\$-	\$2,	
Ending Balance Individually Evaluated for Impairment	4,924	975	-	2,069	451	698	1,633	9	-	-	10	
Ending Balance Collectively Evaluated for Impairment	\$671,603	\$462,670	\$164,791	\$247,559	\$31,366	\$265,312	\$207,551	\$7,110	\$77,311	\$-	\$2,	

Table of Contents

The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$2.9 million at March 31, 2018, \$3.0 million at December 31, 2017 and \$3.4 million at March 31, 2017, which are no longer classified as TDRs.

The following tables show the loan & lease portfolio allocated by management's internal risk ratings at the dates indicated (in thousands):

March 31, 2018	Pass	Special Mention	Substandard	Total Loans & Leases
Loans & Leases:				
Commercial Real Estate	\$691,537	\$6,812	\$ -	\$698,349
Agricultural Real Estate	495,936	8,537	3,927	508,400
Real Estate Construction	86,779	9,536	-	96,315
Residential 1st Mortgages	263,101	-	1,036	264,137
Home Equity Lines & Loans	34,643	-	48	34,691
Agricultural	252,553	6,286	2,588	261,427
Commercial	268,745	5,460	477	274,682
Consumer & Other	6,565	-	120	6,685
Leases	88,320	2,077	-	90,397
Total	\$2,188,179	\$38,708	\$ 8,196	\$2,235,083

December 31, 2017	Pass	Special Mention	Substandard	Total Loans
Loans & Leases:				
Commercial Real Estate	\$677,636	\$6,843	\$ 482	\$684,961
Agricultural Real Estate	488,672	6,529	4,030	499,231
Real Estate Construction	90,728	9,478	-	100,206
Residential 1st Mortgages	259,795	41	915	260,751
Home Equity Lines and Loans	34,476	-	49	34,525
Agricultural	264,425	6,439	2,718	273,582
Commercial	260,565	4,610	528	265,703
Consumer & Other	6,498	-	158	6,656
Leases	87,497	2,183	-	89,680
Total	\$2,170,292	\$36,123	\$ 8,880	\$2,215,295

March 31, 2017	Pass	Special Mention	Substandard	Total Loans & Leases
Loans & Leases:				
Commercial Real Estate	\$668,243	\$6,768	\$ 1,516	\$676,527
Agricultural Real Estate	461,318	1,351	976	463,645
Real Estate Construction	156,426	8,365	-	164,791
Residential 1st Mortgages	249,238	45	345	249,628
Home Equity Lines & Loans	31,752	-	65	31,817
Agricultural	255,390	9,857	763	266,010
Commercial	204,792	3,638	754	209,184
Consumer & Other	6,965	-	154	7,119
Leases	74,817	2,494	-	77,311
Total	\$2,108,941	\$32,518	\$ 4,573	\$2,146,032

See “Note 1. Significant Accounting Policies - Allowance for Credit Losses” for a description of the internal risk ratings used by the Company. There were no loans or leases outstanding at March 31, 2018, December 31, 2017, and March 31, 2017, rated doubtful or loss.

20

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

The following tables show an aging analysis of the loan & lease portfolio by the time past due at the dates indicated (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans & Leases
March 31, 2018							
Loans & Leases:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$ -	\$698,349	\$ 698,349
Agricultural Real Estate	-	-	-	-	-	508,400	508,400
Real Estate Construction	-	-	-	-	-	96,315	96,315
Residential 1st Mortgages	14	49	-	81	144	263,993	264,137
Home Equity Lines & Loans	20	-	-	-	20	34,671	34,691
Agricultural	-	-	-	-	-	261,427	261,427
Commercial	-	14	-	-	14	274,668	274,682
Consumer & Other	8	-	-	-	8	6,677	6,685
Leases	-	-	-	-	-	90,397	90,397
Total	\$ 42	\$ 63	\$ -	\$ 81	\$ 186	\$2,234,897	\$ 2,235,083

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans & Leases
December 31, 2017							
Loans & Leases:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$ -	\$684,961	\$ 684,961
Agricultural Real Estate	-	-	-	-	-	499,231	499,231
Real Estate Construction	-	-	-	-	-	100,206	100,206
Residential 1st Mortgages	448	-	-	-	448	260,303	260,751
Home Equity Lines and Loans	10	-	-	-	10	34,515	34,525
Agricultural	-	-	-	-	-	273,582	273,582
Commercial	180	-	-	-	180	265,523	265,703
Consumer & Other	7	-	-	-	7	6,649	6,656
Leases	-	-	-	-	-	89,680	89,680
Total	\$ 645	\$ -	\$ -	\$ -	\$ 645	\$2,214,650	\$ 2,215,295

	30-59 Days Past Due	60-89 Days Past Due	90 Days and Still Accruing	Nonaccrual	Total Past Due	Current	Total Loans & Leases
March 31, 2017							
Loans & Leases:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$ -	\$676,527	\$ 676,527
Agricultural Real Estate	-	-	-	976	976	462,669	463,645
Real Estate Construction	-	-	-	-	-	164,791	164,791
Residential 1st Mortgages	110	-	-	60	170	249,458	249,628
Home Equity Lines & Loans	-	-	-	64	64	31,753	31,817
Agricultural	-	-	-	315	315	265,695	266,010

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Commercial	-	-	-	-	-	209,184	209,184
Consumer & Other	16	-	-	6	22	7,097	7,119
Leases	-	-	-	-	-	77,311	77,311
Total	\$ 126	\$ -	\$ -	\$ 1,421	\$ 1,547	\$2,144,485	\$ 2,146,032

21

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Table of Contents

The following tables show information related to impaired loans & leases for the periods indicated (in thousands):

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
March 31, 2018					
With no related allowance recorded:					
Commercial Real Estate	\$ 102	\$ 102	\$ -	\$ 103	\$ 2
Residential 1st Mortgages	903	1,005	-	907	8
	\$ 1,005	\$ 1,107	\$ -	\$ 1,010	\$ 10
With an allowance recorded:					
Commercial Real Estate	\$ 2,955	\$ 2,943	\$ 335	\$ 2,964	\$ 24
Residential 1st Mortgages	583	649	29	546	7
Home Equity Lines & Loans	78	88	4	76	1
Commercial	1,720	1,713	205	1,731	15
Consumer & Other	8	8	8	8	-
	\$ 5,344	\$ 5,401	\$ 581	\$ 5,325	\$ 47
Total	\$ 6,349	\$ 6,508	\$ 581	\$ 6,335	\$ 57

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2017					
With no related allowance recorded:					
Commercial Real Estate	\$ 104	\$ 104	\$ -	\$ 107	\$ 11
Agricultural Real Estate	-	-	-	488	-
Residential 1st Mortgages	911	1,012	-	532	11
Home Equity Lines and Loans	-	-	-	16	-
Agricultural	-	-	-	30	-
	\$ 1,015	\$ 1,116	\$ -	\$ 1,173	\$ 22
With an allowance recorded:					
Commercial Real Estate	\$ 2,973	\$ 2,961	\$ 366	\$ 2,999	\$ 104
Residential 1st Mortgages	508	571	25	469	16
Home Equity Lines and Loans	73	89	4	74	3
Agricultural	-	-	-	409	21
Commercial	1,741	1,734	220	1,693	59
Consumer & Other	8	9	8	11	-
	\$ 5,303	\$ 5,364	\$ 623	\$ 5,655	\$ 203
Total	\$ 6,318	\$ 6,480	\$ 623	\$ 6,828	\$ 225

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
March 31, 2017					
With no related allowance recorded:					
Commercial Real Estate	\$ 110	\$ 110	\$ -	\$ 147	\$ 4
Agricultural Real Estate	976	983	-	1,141	-
Residential 1st Mortgages	413	467	-	432	-
Home Equity Lines & Loans	64	65	-	32	-
Agricultural	60	66	-	30	-
Commercial	-	-	-	1,512	-
	\$ 1,623	\$ 1,691	\$ -	\$ 3,294	\$ 4
With an allowance recorded:					

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Commercial Real Estate	\$ 3,024	\$ 3,010	\$ 471	\$ 1,512	\$ 30
Residential 1st Mortgages	426	466	20	428	5
Home Equity Lines & Loans	89	95	4	90	1
Agricultural	638	639	331	632	8
Commercial	1,641	1,633	268	1,541	16
Consumer & Other	6	12	6	6	-
	\$ 5,824	\$ 5,855	\$ 1,100	\$ 4,209	\$ 60
Total	\$ 7,447	\$ 7,546	\$ 1,100	\$ 7,503	\$ 64

Total recorded investment shown in the prior table will not equal the total ending balance of loans & leases individually evaluated for impairment on the allocation of allowance table. This is because this table does not include impaired loans that were previously modified in a troubled debt restructuring, are currently performing and are no longer disclosed or classified as TDR's.

Table of Contents

At March 31, 2018, the Company allocated \$577,000 of specific reserves to \$6.2 million of troubled debt restructured loans & leases, all of which were performing. The Company had no commitments at March 31, 2018 to lend additional amounts to customers with outstanding loans or leases that are classified as TDRs.

During the three-month period ending March 31, 2018, there were no loans & leases modified as a troubled debt restructuring.

During the three months ended March 31, 2018, the twelve months ended December 31, 2017, and the three months ended March 31, 2017, there were no payment defaults on loans or leases modified as troubled debt restructurings within twelve months following the modification. The Company considers a loan or lease to be in payment default once it is greater than 90 days contractually past due under the modified terms.

At December 31, 2017, the Company allocated \$623,000 of specific reserves to \$6.3 million of troubled debt restructured loans, all of which were performing. The Company had no commitments at December 31, 2017 to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

During the period ending December 31, 2017, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan.

Modifications involving a reduction of the stated interest rate of the loan ranged from 3 to 5 years. Modifications involving an extension of the maturity date ranged from 3 to 10 years.

The following table presents loans by class modified as troubled debt restructured loans for the period ended December 31, 2017 (in thousands):

	December 31, 2017	
	Pre-Modification Number of Outstanding Loans Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings		
Residential 1st Mortgages	2 \$ 673	\$ 630
Home Equity Lines and Loans	1 32	32
Commercial	2 138	138
Consumer & Other	1 9	8
Total	6 \$ 852	\$ 808

The troubled debt restructurings described above had no impact on the allowance for credit losses and resulted in charge-offs of \$44,000 for the twelve months ended December 31, 2017.

At March 31, 2017, the Company allocated \$844,000 of specific reserves to \$6.0 million of troubled debt restructured loans & leases, all of which were performing. The Company had no commitments at March 31, 2017 to lend additional amounts to customers with outstanding loans or leases that are classified as TDRs.

During the three-month period ending March 31, 2017, there were no loans & leases modified as a troubled debt restructuring.

4. Fair Value Measurements

The Company follows the “Fair Value Measurement and Disclosures” topic of the FASB ASC, which establishes a framework for measuring fair value in U.S. GAAP and expands disclosures about fair value measurements. This standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, this standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

Table of Contents

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

Securities classified as available-for-sale are reported at fair value on a recurring basis utilizing Level 1, 2 and 3 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

The Company does not record all loans & leases at fair value on a recurring basis. However, from time to time, a loan or lease is considered impaired and an allowance for credit losses is established. Once a loan or lease is identified as individually impaired, management measures impairment in accordance with the "Receivable" topic of the FASB ASC. The fair value of impaired loans or leases is estimated using one of several methods, including collateral value when the loan is collateral dependent, market value of similar debt, enterprise value, and discounted cash flows. Impaired loans & leases not requiring an allowance represent loans & leases for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans & leases. Impaired loans & leases where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. The fair value of collateral dependent impaired loans is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including sales comparison, cost and the income approach. Adjustments are often made in the appraisal process by the appraisers to take into account differences between the comparable sales and income and other available data. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for Level 3 nonrecurring impaired loans is primarily the sales comparison approach less selling costs of 10%.

Other Real Estate ("ORE") is reported at fair value on a non-recurring basis. Fair values are based on recent real estate appraisals. These appraisals may use a single valuation approach or a combination of approaches including sales comparison, cost and the income approach. Adjustments are often made in the appraisal process by the appraisers to take into account differences between the comparable sales and income and other available data. Such adjustments can be significant and typically result in a Level 3 classification of the inputs for determining fair value. The valuation technique used for Level 3 nonrecurring ORE is primarily the sales comparison approach less selling costs of 10%.

At March 31, 2018, there were no formal foreclosure proceedings in process for consumer mortgage loans secured by residential real estate properties.

Table of Contents

The following tables present information about the Company's assets measured at fair value on a recurring basis and indicate the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated.

(in thousands)	Fair Value Total	Fair Value Measurements At March 31, 2018, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$ 3,095	\$-	\$ 3,095	\$ -
US Treasury Notes	143,409	143,409	-	-
US Govt SBA	27,537	-	27,537	-
Mortgage Backed Securities	318,763	-	318,763	-
Other	3,010	200	310	2,500
Total Assets Measured at Fair Value On a Recurring Basis	\$ 495,814	\$ 143,609	\$ 349,705	\$ 2,500

(in thousands)	Fair Value Total	Fair Value Measurements At December 31, 2017, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$ 3,128	\$-	\$ 3,128	\$ -
US Treasury Notes	144,164	144,164	-	-
US Govt SBA	29,380	-	29,380	-
Mortgage Backed Securities	301,914	-	301,914	-
Other	3,010	200	310	2,500
Total Assets Measured at Fair Value On a Recurring Basis	\$ 481,596	\$ 144,364	\$ 334,732	\$ 2,500

(in thousands)	Fair Value Total	Fair Value Measurements At March 31, 2017, Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities:				
Government Agency & Government-Sponsored Entities	\$ 3,128	\$-	\$ 3,128	\$ -
US Treasury Notes	144,164	144,164	-	-
US Govt SBA	29,380	-	29,380	-
Mortgage Backed Securities	301,914	-	301,914	-
Other	3,010	200	310	2,500
Total Assets Measured at Fair Value On a Recurring Basis	\$ 481,596	\$ 144,364	\$ 334,732	\$ 2,500

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Available-for-Sale Securities:

Government Agency & Government-Sponsored Entities	\$ 3,217	\$-	\$ 3,217	\$ -
US Treasury Notes	104,419	104,419	-	-
US Govt SBA	34,734	-	34,734	-
Mortgage Backed Securities	309,462	-	309,462	-
Other	1,010	200	310	500
Total Assets Measured at Fair Value On a Recurring Basis	\$ 452,842	\$ 104,619	\$ 347,723	\$ 500

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the period ended March 31, 2018, there were no transfers in or out of level 1, 2, or 3.

Table of Contents

The available for sale investment security categorized as a Level 3 asset for period ended March 31, 2018 consisted of one \$2.5 million investment in a limited liability company that purchases SBA loans. The Company increased this investment by \$2.0 million during 2017. This security is not actively traded and is owned by a few investors for CRA purposes. The significant unobservable data reflected in the fair value measurement include dealer quotes, projected prepayment speeds/average lives and credit information, among other things. There were no gains or losses or transfers in or out of level 3 during the period ended March 31, 2018.

The following tables present information about the Company's other real estate and impaired loans or leases, classes of assets or liabilities that the Company carries at fair value on a non-recurring basis, and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value for the periods indicated. Not all impaired loans or leases are carried at fair value. Impaired loans or leases are only included in the following tables when their fair value is based upon a current appraisal of the collateral, and if that appraisal results in a partial charge-off or the establishment of a specific reserve.

(in thousands)	Fair Value Total	Fair Value Measurements At March 31, 2018, Using Quoted Prices in Active Markets for		
		Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Commercial Real Estate	\$ 2,608	\$ -	\$ -	\$ 2,608
Residential 1st Mortgage	475	-	-	475
Home Equity Lines and Loans	74	-	-	74
Commercial	1,508	-	-	1,508
Total Impaired Loans	4,665	-	-	4,665
Other Real Estate				
Real Estate Construction	873	-	-	873
Total Other Real Estate	873	-	-	873
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 5,538	\$ -	\$ -	\$ 5,538

(in thousands)	Fair Value Total	Fair Value Measurements At December 31, 2017, Using Quoted Prices in Active Markets for		
		Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans:				

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Commercial Real Estate	\$ 2,595	\$ -	\$ -	\$ 2,595
Residential 1st Mortgage	997	-	-	997
Home Equity Lines and Loans	75	-	-	75
Commercial	1,514	-	-	1,514
Total Impaired Loans	5,181	-	-	5,181
Other Real Estate:				
Real Estate Construction	873	-	-	873
Total Other Real Estate	873	-	-	873
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 6,054	\$ -	\$ -	\$ 6,054

26

Table of Contents

(in thousands)	Fair Value Total	Fair Value Measurements At March 31, 2017, Using Quoted Prices in Active Markets for		
		Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans				
Commercial Real Estate	\$ 2,539	\$ -	\$ -	\$ 2,539
Residential 1st Mortgage	389	-	-	389
Home Equity Lines and Loans	82	-	-	82
Agricultural	367	-	-	367
Commercial	1,365	-	-	1,365
Total Impaired Loans	4,742	-	-	4,742
Other Real Estate				
Home Equity Lines and Loans	685	-	-	685
Real Estate Construction	1,467	-	-	1,467
Total Other Real Estate	2,152	-	-	2,152
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 6,894	\$ -	\$ -	\$ 6,894

The Company's property appraisals are primarily based on the sales comparison approach and the income approach methodologies, which consider recent sales of comparable properties, including their income generating characteristics, and then make adjustments to reflect the general assumptions that a market participant would make when analyzing the property for purchase. These adjustments may increase or decrease an appraised value and can vary significantly depending on the location, physical characteristics and income producing potential of each property. Additionally, the quality and volume of market information available at the time of the appraisal can vary from period to period and cause significant changes to the nature and magnitude of comparable sale adjustments. Given these variations, comparable sale adjustments are generally not a reliable indicator for how fair value will increase or decrease from period to period. Under certain circumstances, management discounts are applied based on specific characteristics of an individual property.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a nonrecurring basis at March 31, 2018:

(in thousands)	Fair Value	Valuation Technique	Unobservable Inputs	Range, Weighted Avg.
Impaired Loans				
Commercial Real Estate	\$ 2,608	Income Approach	Capitalization Rate	3.25%, 3.25%
Residential 1st Mortgage	\$ 475	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% -4%, 3%
Home Equity Lines and Loans	\$ 74	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% - 2%, 1% 2.95% - 8.70%, 3.40%
Commercial	\$ 1,508	Income Approach	Capitalization Rate	

Other Real Estate				
Real Estate		Sales Comparison	Adjustment for Difference Between	
Construction	\$ 873	Approach	Comparable Sales	10%, 10%

Table of Contents

5. Fair Value of Financial Instruments

U.S. GAAP requires disclosure of fair value information about financial instruments, whether or not recognized on the balance sheet, for which it is practical to estimate that value. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization. The valuation of loans held for investment was impacted by the adoption of ASU 2016-01. In accordance with ASU 2016-01, the fair value of loans held for investment, excluding previously presented impaired loans measured at fair value on a non-recurring basis, is estimated using discounted cash flow analyses. The discount rates used to determine fair value use interest rate spreads that reflect factors such as liquidity, credit, and nonperformance risk of the loans. Loans are considered a Level 3 classification.

The following tables summarize the book value and estimated fair value of financial instruments for the periods indicated:

	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets			Total Estimated Fair Value
		for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
March 31, 2018 (in thousands)					
Assets:					
Cash and Cash Equivalents	\$ 134,984	\$ 134,984	\$ -	\$ -	\$ 134,984
Investment Securities Available-for-Sale	495,814	143,609	349,705	2,500	495,814
Investment Securities Held-to-Maturity	53,527	-	37,028	16,717	53,745
FHLB Stock	10,342	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance	2,184,406	-	-	2,152,504	2,152,504
Accrued Interest Receivable	9,237	-	9,237	-	9,237
Liabilities:					
Deposits	2,701,405	2,218,642	478,846	-	2,697,488
Subordinated Debentures	10,310	-	7,751	-	7,751
Accrued Interest Payable	909	-	909	-	909

	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets			Total Estimated Fair Value
		for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
December 31, 2017 (in thousands)					

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Assets:

Cash and Cash Equivalents	\$ 187,149	\$ 187,149	\$ -	\$ -	\$ 187,149
Investment Securities Available-for-Sale	481,596	29,580	449,516	2,500	481,596
Investment Securities Held-to-Maturity	54,460	-	38,492	16,744	55,236
FHLB Stock	10,342	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance	2,164,953	-	-	2,137,987	2,137,987
Accrued Interest Receivable	10,999	-	10,999	-	10,999

Liabilities:

Deposits	2,723,228	2,247,831	472,671	-	2,720,502
Subordinated Debentures	10,310	-	7,428	-	7,428
Accrued Interest Payable	1,137	-	1,137	-	1,137

28

Table of Contents

March 31, 2017 (in thousands)	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets			Total Estimated Fair Value
		for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:					
Cash and Cash Equivalents	\$ 164,512	\$ 164,512	\$ -	\$ -	\$ 164,512
Investment Securities Available-for-Sale	452,842	104,619	347,723	500	452,842
Investment Securities Held-to-Maturity	57,281	-	39,991	17,682	57,673
FHLB Stock	8,872	N/A	N/A	N/A	N/A
Loans & Leases, Net of Deferred Fees & Allowance	2,097,632	-	-	2,076,248	2,076,248
Accrued Interest Receivable	7,962	-	7,962	-	7,962
Liabilities:					
Deposits	2,607,613	2,017,969	587,811	-	2,605,780
Subordinated Debentures	10,310	-	6,581	-	6,581
Accrued Interest Payable	882	-	882	-	882

6. Dividends and Basic Earnings Per Common Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. No cash dividends were declared during the first quarter of 2018 or 2017.

Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The Company has no securities or other contracts, such as stock options, that could require the issuance of common stock. Accordingly, diluted earnings per share are not presented. The following table calculates the basic earnings per common share for the three months ended March 31, 2018 and 2017.

(net income in thousands)	2018	2017
Net Income	\$9,941	\$7821
Weighted Average Number of Common Shares Outstanding	812,304	807,986
Basic Earnings Per Common Share Amount	\$12.24	\$9.68

7. Pending Acquisition of Bank of Rio Vista

On March 26, 2018, Farmers & Merchants Bancorp and Bank of Rio Vista announced that a definitive agreement had been signed by both parties for the acquisition of Bank of Rio Vista by Farmers & Merchants Bancorp. The transaction is subject to customary closing conditions, including regulatory approvals and Bank of Rio Vista's shareholder approval. The Boards of Directors of both Farmers & Merchants Bancorp and Bank of Rio Vista have unanimously approved the transaction, which is expected to close in the third quarter of 2018.

In this transaction, the shareholders of Bank of Rio Vista owning 2,414 shares, or 60.35% of the outstanding common shares, will receive \$28.7 million in cash subject to certain adjustments defined in the definitive agreement. Over the past year, Farmers & Merchants Bancorp previously acquired 1,586, or 39.65%, of the outstanding common shares of Bank of Rio Vista for \$12.0 million. As a result, the total price paid for all common shares of Bank of Rio Vista is \$40.7 million or 1.42 times the minimum book value that must be delivered at close.

As a result of signing a definitive agreement with Bank of Rio Vista, Farmers & Merchants Bancorp is accounting for the 39.65% of the outstanding common shares of Bank of Rio Vista that it currently owns under the equity method of accounting, in accordance with ASC 323-10 effective first quarter 2018. During the three months ended March 31, 2018, the Company's recorded investment in Bank of Rio Vista increased by \$124,000, based upon the earnings of Bank of Rio Vista that are attributed to the Company's ownership.

Table of Contents

8. Recent Accounting Pronouncements

Recently Adopted Accounting Guidance

The following paragraphs provide descriptions of recently adopted accounting standards that may have had a material effect on the Company's financial position or results of operations.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company's revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and debit card and ATM fees, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The ASU addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most notably, the ASU changes the income statement impact of equity investments held by the Company and the requirement for the Company to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The Company adopted the ASU provisions on January 1, 2018. The adoption of the ASU resulted in the use of an exit price rather than an entrance price to determine the fair value of loans not measured at fair value on a non-recurring basis in the consolidated balance sheets. See Note 5 – Fair Value of Financial Instruments for further information regarding the valuation of these loans.

In February 2018, the FASB issued ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The amendments in ASU 2018-02 allow a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings for stranded tax effects resulting from the newly enacted Tax Cuts and Jobs Act ("Tax Act"). The amount of the reclassification consists of the difference between the historical corporate income tax rates and the newly enacted 21 percent corporate income tax rate. The amendments are effective for all entities for the interim and annual reporting periods beginning after December 15, 2018 and early adoption is permitted, including interim periods in those years. The Company adopted the amendments as of December 31, 2017, which resulted in a net reclassification of \$144,000 between AOCI and retained earnings.

Accounting Guidance Pending Adoption at March 31, 2018

The following paragraphs provide descriptions of newly issued but not yet effective accounting standards that could have a material effect on the Company's financial position or results of operations.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU will require the earlier recognition of credit losses on loans and other financial instruments based on an expected loss model, replacing the incurred loss model that is currently in use. Under the new guidance, an entity will measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. The

expected loss model will apply to loans and leases, unfunded lending commitments, held-to-maturity debt securities and other debt instruments measured at amortized cost. The impairment model for available-for-sale debt securities will require the recognition of credit losses through a valuation allowance when fair value is less than amortized cost, regardless of whether the impairment is considered to be other-than-temporary. The new guidance is effective on January 1, 2020, with early adoption permitted on January 1, 2019. The Company has selected a vendor to analyze our loan data and has chosen an implementation team. The Company is currently working with the vendor and our IT department to establish the data transmission interface. While the Company has not quantified the impact of this ASU, it is evaluating historical loan level data requirements necessary for the implementation of the model, as well as various methodologies for determining expected credit losses.

Table of Contents

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The new standard is being issued to increase the transparency and comparability around lease obligations. Previously unrecorded off-balance sheet obligations will now be brought more prominently to light by presenting lease liabilities on the face of the balance sheet, accompanied by enhanced qualitative and quantitative disclosures in the notes to the financial statements. This ASU applies to leasing arrangements exceeding a twelve-month term. ASU 2016-02 is effective for annual periods, including interim periods within those annual periods beginning after December 15, 2018 and requires a modified retrospective method upon adoption. Early application of the amendments is permitted. The Company is currently evaluating the provisions of this ASU to determine the potential impact the new standard will have on the Company's consolidated financial statements. While the Company has not quantified the impact to its balance sheet, it does expect the adoption of this ASU will result in a gross-up in its balance sheet as a result of recording a right-of-use asset and a lease liability for these leases.

9. Subsequent Events

On May 01, 2018, the Company issued 8,769 shares of common stock to the Bank's non-qualified defined contribution retirement plans. These shares were issued at a price of \$635 per share based upon a valuation completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds were contributed to the Bank as equity capital.

Item 2. Management's Discussion And Analysis Of Financial Condition And Results Of Operations

The following is management's discussion and analysis of the major factors that influenced our financial performance for the three months ended March 31, 2018. This analysis should be read in conjunction with our 2017 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

Forward-Looking Statements

This Form 10-Q contains various forward-looking statements, usually containing the words "estimate," "project," "expect," "objective," "goal," or similar expressions and includes assumptions concerning Farmers & Merchants Bancorp's (together with its subsidiaries, the "Company" or "we") operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks and uncertainties. In connection with the "safe-harbor" provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (1) economic conditions in the Central Valley of California; (2) significant changes in interest rates and loan prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; (8) water management issues in California and the resulting impact on the Company's agricultural customers; (9) expansion into new geographic markets and new lines of business; (10) other factors discussed in Item 1A. Risk Factors located in the Company's 2017 Annual Report on Form 10-K.

Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

Table of Contents

Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. Banking services are provided in twenty-four locations in the Company's service area. The service area includes Sacramento, San Joaquin, Stanislaus, Merced and Contra Costa Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock, Hilmar, Merced, Manteca, Riverbank, Walnut Creek and Concord. In January 2018, the Company opened a loan production office ("LPO") in Napa, California and is currently building out a full service branch location that should be ready for occupancy in the third quarter of 2018. In March 2018 the Company announced that it had entered into a definitive agreement to purchase Bank of Rio Vista (see Note 7 for additional information).

For additional information about the proposed acquisition of Bank of Rio Vista, see the Company's Current Report on Form 8-K filed with the SEC on March 27, 2018.

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System ("FRB"). As a California, state-chartered, non-fed member bank, the Bank is subject to regulation and examination by the California Department of Business Oversight ("DBO") and the Federal Deposit Insurance Corporation ("FDIC").

Overview

Although the Company has initiated efforts to expand its geographic footprint into the East Bay area of San Francisco and Napa, California, the Company's primary service area remains the mid Central Valley of California, a region that can be significantly impacted by the seasonal needs of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations is influenced by the seasonal banking needs of its agricultural customers (e.g., during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in late fall and winter as crops are harvested and sold).

The State of California experienced drought conditions from 2013 through most of 2016. Then, in late 2016 and early 2017 significant levels of rain and snow alleviated drought conditions in many areas of California, including those in the Company's primary service area. In late 2017 and early 2018 rain levels have exceeded 80% of seasonal averages, but snow levels have been modest. Fortunately, reservoir levels are high and the availability of water this summer and fall in our primary service area should not be an issue. However, the weather patterns over the past 5 years further reinforce the fact that the long-term risks associated with the availability of water are significant.

For the three months ended March 31, 2018, Farmers & Merchants Bancorp reported net income of \$9,941,000, earnings per share of \$12.24 and return on average assets of 1.31%. Return on average shareholders' equity was 13.14% for the three months ended March 31, 2018.

For the three months ended March 31, 2017, Farmers & Merchants Bancorp reported net income of \$7,821,000, earnings per share of \$9.68 and return on average assets of 1.07%. Return on average shareholders' equity was 11.00% for the three months ended March 31, 2017.

The following is a summary of the financial results for the three-month period ended March 31, 2018 compared to March 31, 2017.

- Net income increased 27.1% to \$9,941,000 from \$7,821,000.
- Earnings per share increased 26.5% to \$12.24 from \$9.68.

- Total assets increased 3.6% to \$3.1 billion from \$3.0 billion.
- Total loans & leases increased 4.2% to \$2.2 billion from \$2.1 billion.
- Total deposits increased 3.6% to \$2.7 billion from \$2.6 billion.

Table of Contents

The primary reasons for the Company's \$2.1 million or 27.1% increase in net income in the first quarter of 2018 as compared to the same period of 2017 were:

- A \$3.04 million increase in net interest income primarily related to the growth in earning assets.
- A \$267,000 decrease in the provision for credit losses
- A \$1.1 million decrease in the provision for income taxes due to the effective tax rate decreasing to 25.3% from 36.2% in the first quarter of 2017. This decrease is the result of the recently enacted Tax Cuts and Jobs Act.

These positive impacts were partially offset by:

- A \$741,000 decrease in non-interest income primarily related to a decrease in the gain on sale of fixed assets related to the disposition of one of the Company's properties that took place in the first quarter of 2017.
- A \$1.5 million increase in non-interest expense primarily related to contributions to non-qualified retirement plans.

Results of Operations

Net Interest Income / Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three month periods ended March 31, 2018 and 2017.

The average yields on earning assets and average rates paid on interest-bearing liabilities have been computed on an annualized basis for purposes of comparability with full year data. Average balance amounts for assets and liabilities are the computed average of daily balances.

Net interest income is the amount by which the interest and fees on loans & leases and other interest-earning assets exceed the interest paid on interest-bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as "tax equivalent" adjustment and is noted wherever applicable. The presentation of net interest income and net interest margin on a tax equivalent basis is a common practice within the banking industry.

The Volume and Rate Analysis of Net Interest Income summarizes the changes in interest income and interest expense based on changes in average asset and liability balances (volume) and changes in average rates (rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to: (1) changes in volume (change in volume multiplied by initial rate); (2) changes in rate (change in rate multiplied by initial volume); and (3) changes in rate/volume, also called "changes in mix" (allocated in proportion to the respective volume and rate components).

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. See "Item 3. Quantitative and Qualitative Disclosures about Market Risk – Interest Rate Risk."

Table of Contents

Farmers & Merchants Bancorp
Year-to-Date Average Balances and Interest Rates
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Three Months Ended March 31, 2018				Three Months Ended March 31, 2017			
	Balance	Interest	Annualized Yield/Rate		Balance	Interest	Annualized Yield/Rate	
Assets								
Interest Bearing Deposits With Banks	\$ 152,936	\$ 585	1.54	%	\$ 125,340	\$ 249	0.80	%
Investment Securities								
U.S. Treasuries	92,107	297	1.29	%	83,412	217	1.04	%
U.S. Govt SBA	28,750	123	1.71	%	35,869	125	1.39	%
Government Agency & Government-Sponsored Entities	3,074	22	2.86	%	3,122	22	2.82	%
Obligations of States and Political Subdivisions - Non-Taxable	54,689	529	3.87	%	57,835	690	4.77	%
Mortgage Backed Securities	322,296	1,920	2.38	%	288,545	1,643	2.28	%
Other	3,010	18	2.39	%	1,010	5	1.98	%
Total Investment Securities	503,926	2,909	2.31	%	469,793	2,702	2.30	%
Loans & Leases								
Real Estate	1,548,359	19,044	4.95	%	1,562,054	17,931	4.62	%
Home Equity Line & Loans	34,735	448	5.19	%	31,694	382	4.85	%
Agricultural	251,784	3,028	4.84	%	267,705	2,891	4.34	%
Commercial	268,032	3,311	4.97	%	214,517	2,460	4.61	%
Consumer	5,293	76	5.77	%	5,326	68	5.14	%
Other	1,382	8	2.33	%	1,678	9	2.16	%
Leases	91,222	1,129	4.98	%	71,908	790	4.42	%
Total Loans & Leases	2,200,807	27,044	4.94	%	2,154,882	24,531	4.58	%
Total Earning Assets	2,857,669	\$ 30,538	4.30	%	2,750,015	\$ 27,482	4.02	%
Unrealized (Loss) Gain on Securities								
Available-for-Sale	(4,832)				(359)			
Allowance for Credit Losses	(50,612)				(48,061)			
Cash and Due From Banks	46,527				46,491			
All Other Assets	187,290				184,203			
Total Assets	\$ 3,036,042				\$ 2,932,289			
Liabilities & Shareholders' Equity								
Interest Bearing Deposits								
Interest Bearing DDA	\$ 585,176	\$ 272	0.19	%	\$ 495,564	\$ 181	0.15	%
Savings and Money Market	825,514	330	0.16	%	802,634	308	0.15	%
Time Deposits	478,740	803	0.67	%	579,931	787	0.55	%
Total Interest Bearing Deposits	1,889,430	1,405	0.30	%	1,878,129	1,276	0.27	%
Federal Home Loan Bank Advances	4	-	0.00	%	4	-	0.00	%
Subordinated Debentures	10,310	117	4.56	%	10,310	100	3.90	%
Total Interest Bearing Liabilities	1,899,744	\$ 1,522	0.32	%	1,888,443	\$ 1,376	0.29	%
Interest Rate Spread			3.98	%			3.73	%
	795,261				712,732			

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Demand Deposits (Non-Interest Bearing)							
All Other Liabilities	38,464			46,613			
Total Liabilities	2,733,469			2,647,788			
Shareholders' Equity	302,573			284,501			
Total Liabilities & Shareholders' Equity	\$3,036,042			\$2,932,289			
Impact of Non-Interest Bearing Deposits and Other Liabilities		0.14	%		0.09	%	
Net Interest Income and Margin on Total Earning Assets		29,016	4.12	%	26,106	3.82	%
Tax Equivalent Adjustment		(110)			(240)		
Net Interest Income		\$28,906	4.07	%	\$25,866	3.78	%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan & lease interest income includes fee income and unearned discount in the amount of \$1.5 million and \$1.3 million for the quarters ended March 31, 2018 and 2017, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Three Months Ended		
	Mar. 31, 2018 compared to Mar. 31, 2017		
	Volume	Rate	Net Chg.
Interest Earning Assets			
Interest Bearing Deposits With Banks	\$ 64	272	\$ 336
Investment Securities			
U.S. Treasuries	24	56	80
U.S. Govt SBA	(28)	25	(3)
Government Agency & Government-Sponsored Entities	-	-	-
Obligations of States and Political Subdivisions - Non-Taxable	(36)	(125)	(161)
Mortgage Backed Securities	198	79	277
Other	12	1	13
Total Investment Securities	170	36	206
Loans & Leases			
Real Estate	(159)	1,202	1,043
Home Equity Line & Loans	38	28	66
Agricultural	(180)	347	167
Commercial	650	203	853
Consumer	-	46	46
Other	(2)	1	(1)
Leases	230	109	339
Total Loans & Leases	577	1,936	2,513
Total Earning Assets	811	2,244	3,055
Interest Bearing Liabilities			
Interest Bearing Deposits			
Transaction	36	55	91
Savings and Money Market	9	13	22
Time Deposits	(152)	168	16
Total Interest Bearing Deposits	(107)	236	129
Other Borrowed Funds	-	-	-
Subordinated Debentures	-	17	17
Total Interest Bearing Liabilities	(107)	253	146
Total Change	\$ 918	\$ 1,991	\$ 2,909

Notes: Rate/volume variance is allocated based on the percentage relationship of changes in volume and changes in rate to the total "net change." The above figures have been rounded to the nearest whole number.

Table of Contents

Net interest income increased \$3.0 million or 11.8% to \$28.9 million during the first quarter of 2018 compared to \$25.9 million for the first quarter of 2017. On a fully tax equivalent basis, net interest income increased 11.1% and totaled \$29.0 million at March 31, 2018, compared to \$26.1 million at March 31, 2017. As more fully discussed below, the increase in net interest income was primarily due to a \$107.7 million increase in average earning assets combined with a 30 basis point increase in the net interest margin.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended March 31, 2018, the Company's net interest margin was 4.12% compared to 3.82% for the quarter ended March 31, 2017. This increase in net interest margin was primarily due to a 28 basis point increase in the yield on earning assets offset by a 3 basis point increase in the cost of interest bearing liabilities.

Average loans & leases totaled \$2.2 billion for the quarter ended March 31, 2018; an increase of \$45.9 million compared to the average balance for the quarter ended March 31, 2017. Loans & leases decreased from 78.4% of average earning assets at March 31, 2017 to 77.01% at March 31, 2018. The annualized yield on the Company's loan portfolio increased to 4.94% for the quarter ended March 31, 2018, compared to 4.58% for the quarter ended March 31, 2017. This increase in yield was primarily due to an increase in market interest rates. Overall, the increase in loan & lease balances and the increase in yields resulted in interest revenue from loans & leases increasing 10.2% to \$27.0 million for quarter ended March 31, 2018. The Company has been experiencing aggressive competitor pricing for loans & leases to which it may need to continue to respond in order to retain key customers. This could place negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Historically, the Company invested primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by the U.S. Treasury, government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, at certain times the Company selectively added investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities. Since the risk factor for these types of investments is generally lower than that of loans & leases, the yield earned on investments is generally less than that of loans & leases.

Average investment securities totaled \$503.9 million for the quarter ended March 31, 2018; an increase of \$34.1 million compared to the average balance for the quarter ended March 31, 2017. Tax equivalent interest income on securities increased \$206,000 to \$2.9 million for the quarter ended March 31, 2018, compared to \$2.7 million for the quarter ended March 31, 2017. The average investment portfolio yield, on a tax equivalent (TE) basis, was 2.31% for the quarter ended March 31, 2018, compared to 2.30% for the quarter ended March 31, 2017. This overall increase in yield was caused primarily by an increase in market interest rates offset by a decline in the TE yield on municipal securities due to a decrease in the federal corporate tax rate. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2018. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Interest bearing deposits with banks consisted primarily of FRB deposits. Balances with the FRB earn interest at the Fed Funds rate, which increased to 1.75% in March 2018. Average interest bearing deposits with banks for the quarter ended March 31, 2018, was \$152.9 million, an increase of \$27.6 million compared to the average balance for the quarter ended March 31, 2017. Interest income on interest bearing deposits with banks for the quarter ended March 31, 2018, increased \$336,000 to \$585,000 compared to the quarter ended March 31, 2017.

Edgar Filing: FARMERS & MERCHANTS BANCORP - Form 10-Q

Average interest-bearing liabilities increased \$11.3 million or 0.60% during the first quarter of 2018. Of that increase: (1) interest-bearing transaction deposits increased \$89.6 million; (2) savings and money market deposits increased \$22.9 million; (3) time deposits decreased \$101.2 million (see “Financial Condition – Deposits”); (4) FHLB advances decreased remained unchanged (see “Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings”); and (5) subordinated debt remained unchanged (see “Financial Condition – Subordinated Debentures”).

Table of Contents

Total interest expense on interest bearing deposits was \$1.4 million for the first quarter of 2018 as compared to \$1.3 million for the first quarter of 2017. The average rate paid on interest-bearing deposits was 0.30% for the first quarter of 2018 compared to 0.27% for the first quarter of 2017. As a result of the increase in market interest rates over the past 24 months, the Company is beginning to experience more aggressive competitor rates on interest bearing deposits which it may need to meet in order to retain key customers. This could place negative pressure on future deposit rate and net interest margin.

Provision and Allowance for Credit Losses

As a financial institution that assumes lending and credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The Company has established credit management policies and procedures that govern both the approval of new loans & leases and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans & leases to one borrower (the term “borrower” is used herein to describe a customer who has entered into either a loan or lease transaction), and by restricting loans & leases made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company’s credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. Management reports regularly to the Board of Directors regarding trends and conditions in the loan & lease portfolio and regularly conducts credit reviews of individual loans & leases. Loans & leases that are performing but have shown some signs of weakness are subject to more stringent reporting and oversight.

Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance sheet date. The allowance is established through a provision for credit losses, which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components: specific reserves related to impaired loans & leases; general reserves for inherent losses related to loans & leases that are not impaired; and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Loans & leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan’s or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan’s or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

A restructuring of a loan or lease constitutes a troubled debt restructuring (“TDR”) under ASC 310-40, if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. Restructured loans or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as

impaired and are individually evaluated for impairment.

The determination of the general reserve for loans or leases that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors that include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan & lease portfolio, and probable losses inherent in the portfolio taken as a whole.

37

Table of Contents

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1st mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer & other; and (9) equipment leases. See “Financial Condition – Loans & Leases” for examples of loans & leases made by the Company. The allowance for credit losses attributable to each portfolio segment, which includes both impaired loans & leases and loans & leases that are not impaired, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan or lease is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan or lease has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or lease position at some future date. Special mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan or lease is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans or leases classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans or leases classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans or leases classified as loss are considered uncollectible. Once a loan or lease becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Bank will estimate its probable loss and immediately charge-off some or all of the balance.

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates

of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Table of Contents

Real Estate Construction – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company’s commercial, agricultural and consumer loan types. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agricultural Real Estate and Agricultural – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Leases – Equipment leases are generally considered to possess a moderate inherent risk of loss. As Lessor, the company is subject to both the credit risk of the borrower and the residual value risk of the equipment. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the weakness in residential real estate values over the past five years. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Consumer & Other – A consumer installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

In addition, the Company's and Bank's regulators, including the FRB, DBO and FDIC, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Provision for Credit Losses

Changes in the provision for credit losses between years are the result of management’s evaluation, based upon information currently available, of the adequacy of the allowance for credit losses relative to factors such as the credit quality of the loan & lease portfolio, loan & lease growth, current credit losses, and the prevailing economic climate and its effect on borrowers’ ability to repay loans & leases in accordance with the terms of the notes.

The Central Valley of California was one of the hardest hit areas in the country during the recession. In many areas, housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has

improved throughout most of the Central Valley, in many of the Company's market segments housing prices remain below peak levels and unemployment rates that remain above those in other areas of the state and country. While, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of March 31, 2018, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

Table of Contents

The State of California experienced drought conditions from 2013 through most of 2016. Then, in late 2016 and early 2017 significant levels of rain and snow alleviated drought conditions in many areas of California, including those in the Company’s primary service area. In late 2017 and early 2018 rain levels have exceeded 80% of seasonal averages, but snow levels have been modest. Fortunately, reservoir levels are high and the availability of water this summer and fall in our primary service area should not be an issue. However, the weather patterns over the past 5 years further reinforce the fact that the long-term risks associated with the availability of water are significant.

The Company made a \$333,000 provision for credit losses during the first quarter of 2018 compared to \$600,000 during the first quarter of 2017. Net recoveries during the first quarter of 2018 were \$2,000 compared to net charge-offs of \$119,000 in the first quarter of 2017. See “Overview – Looking Forward: 2018 and Beyond”, “Critical Accounting Policies and Estimates – Allowance for Credit Losses” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk” located in the Company’s 2017 Annual Report on Form 10-K.

After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of March 31, 2018, was adequate.

Allowance for Credit Losses (in thousands)	Three Months Ended	
	March 31,	
	2018	2017
Balance at Beginning of Period	\$ 50,342	\$ 47,919
Loans or Leases Charged Off	(21)	(151)
Recoveries of Loans or Leases Previously Charged Off	23	32
Provision Charged to Expense	333	600
Balance at End of Period	\$ 50,677	\$ 48,400

The table below breaks out current quarter activity by portfolio segment (in thousands):

March 31, 2018	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Home Equity		Agricultural	Commercial	Consumer Leases Other	Unallocated	Total
				1st Mortgages	Lines & Loans					

Year-To-Date Allowance for Credit Losses:

Beginning Balance- January 1, 2018	\$ 10,922	\$ 12,085	\$ 1,846	\$ 815	\$ 2,324	\$ 8,159	\$ 9,197	\$ 209	\$ 3,363	\$ 1,422	\$ 50,342
Charge-Offs	-	-	-	-	(4)	-	-	(17)	-	-	(21)
Recoveries	-	-	-	3	1	6	2	11	-	-	23
Provision	156	157	27	9	22	(297)	175	36	27	21	333
Ending Balance- March 31, 2018	\$ 11,078	\$ 12,242	\$ 1,873	\$ 827	\$ 2,343	\$ 7,868	\$ 9,374	\$ 239	\$ 3,390	\$ 1,443	\$ 50,677

The Allowance for Credit Losses at March 31, 2018 increased \$335,000 from December 31, 2017. Charge-offs, recoveries, and provision were minimal during the first quarter of 2018. This resulted in no material changes in the allocation of the provision across portfolio segments.

See “Management’s Discussion and Analysis - Financial Condition – Classified Loans & Leases and Non-Performing Assets” for further discussion regarding these loan categories.

See “Note 3. Allowance for Credit Losses” for additional details regarding the provision and allowance for credit losses.

Non-Interest Income

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) increases in the cash surrender value of bank owned life insurance; (4) debit card and ATM fees; (5) net gains and losses on non-qualified deferred compensation plans; and (6) fees from other miscellaneous business services.

Table of Contents

Overall, non-interest income decreased \$741,000 or 13.7% for the three months ended March 31, 2018, compared to the same period of 2017. This decrease was primarily due to a \$1.1 million decrease resulting from a Q1 2017 gain on sale of fixed assets related to the disposition of one of the Company's properties, offset by a \$109,000 increase in Debit Card and ATM Fees and \$124,000 related to the Company's portion of the income of BORV, which is accounted for on the equity method. See Note 7 for additional information.

Non-Interest Expense

Non-interest expense for the Company includes expenses for: (1) salaries and employee benefits; (2) net gains and losses on non-qualified deferred compensation plan investments; (3) occupancy; (4) equipment; (5) supplies; (6) legal fees; (7) professional services; (8) data processing; (9) marketing; (10) deposit insurance; (11) ORE carrying costs and gains/losses on sale; and (12) other miscellaneous expenses.

Overall, non-interest expense increased \$1.5 million or 8.2% for the three months ended March 31, 2018, compared to the same period in 2017. This increase was primarily comprised of: (1) a \$1.0 million increase in salaries and employee benefits primarily related to increased contributions to retirement and profit sharing plans; (2) increased legal fees of \$257,000 primarily related to the acquisition of Bank of Rio Vista and (3) increased consulting fees of \$295,000 primarily related to the acquisition of Bank of Rio Vista.

Income Taxes

On December 22, 2017 the Tax Cuts and Jobs act was signed into law changing the Bank's Federal corporate tax rate from 35% to 21%. The Bank's provision for income taxes decreased 24.1% to \$3.4 million for the first quarter of 2018 compared to the first quarter of 2017 primarily as a result of the Federal corporate tax rate change. The effective tax rate for the first quarter of 2018 was 25.3% compared to 36.2% for the first quarter of 2017. The Company's effective tax rate fluctuates from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt earning sources. The effective rates were lower than the combined Federal and State statutory rate of 30% due primarily to benefits regarding the cash surrender value of life insurance; credits associated with low income housing tax credit investments (LIHTC); and tax-exempt interest income on municipal securities and loans.

Current tax law causes the Company's current taxes payable to approximate or exceed the current provision for taxes on the income statement. Three provisions have had a significant effect on the Company's current income tax liability: (1) the restrictions on the deductibility of credit losses; (2) deductibility of retirement and other long-term employee benefits only when paid; and (3) the statutory deferral of deductibility of California franchise taxes on the Company's federal return.

Financial Condition

This section discusses material changes in the Company's balance sheet at March 31, 2018, as compared to December 31, 2017 and to March 31, 2017. As previously discussed (see "Overview") the Company's financial condition can be influenced by the seasonal banking needs of its agricultural customers.

Investment Securities and Federal Funds Sold

The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by US Treasury, government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, at certain times, the Company has selectively added investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities.

The Company's investment portfolio at March 31, 2018 was \$549.3 million compared to \$536.1 million at the end of 2017, an increase of \$13.3 million or 2.5%. At March 31, 2017, the investment portfolio totaled \$510.1 million. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company currently invests most of its available funds in either shorter term U.S. Treasury, government agency & government-sponsored entity securities or shorter term (10, 15, and 20 year) mortgage-backed securities. As part of the acquisition of Delta National Bancorp, the Company now owns \$27.5 million of floating rate U.S. Government SBA securities.

Table of Contents

The Company's total investment portfolio currently represents 17.9% of the Company's total assets as compared to 17.4% at December 31, 2017, and 17.3% at March 31, 2017.

As of March 31, 2018 the Company held \$53.5 million of municipal investments, of which \$36.8 million were bank-qualified municipal bonds, all classified as HTM. In order to comply with Section 939A of the Dodd-Frank Act, the Company performs its own credit analysis on new purchases of municipal bonds. As of March 31, 2018, ninety-eight percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of all municipal investments with particular attention paid to the approximately two percent (\$795,000) of the portfolio that is not rated, and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consisted of FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest bearing deposits with banks totaled \$97.0 million at March 31, 2018, \$121.2 million at December 31, 2017 and \$122.3 million at March 31, 2017.

The Company classifies its investments as HTM, trading, or AFS. Securities are classified as HTM and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of March 31, 2018, December 31, 2017 and March 31, 2017, there were no securities in the trading portfolio. Securities classified as AFS include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

Loans & Leases

Loans & leases can be categorized by borrowing purpose and use of funds. Common examples of loans & leases made by the Company include:

Commercial and Agricultural Real Estate - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties generally within our market area. Commercial mortgage term loans can be made if the property is either income producing or scheduled to become income producing based upon acceptable pre-leasing, and the income will be the Bank's primary source of repayment for the loan. Loans are made both on owner occupied and investor properties; generally do not exceed 10 years (and may have pricing adjustments on a shorter timeframe); have debt service coverage ratios of 1.00 or better with a target of greater than 1.25; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Real Estate Construction - These are loans for development and construction (the Company generally requires the borrower to fund the land acquisition) and are secured by commercial or residential real estate. These loans are generally made only to experienced local developers with whom the Bank has a successful track record; for projects in our service area; with Loan To Value (LTV) below 75%; and where the property can be developed and sold within 2 years. Commercial construction loans are made only when there is a written take-out commitment from the Bank or an acceptable financial institution or government agency. Most acquisition, development and construction loans are tied to the prime rate or LIBOR with an appropriate spread based on the amount of perceived risk in the loan.

Residential 1st Mortgages - These are loans primarily made on owner occupied residences; generally underwritten to income and LTV guidelines similar to those used by FNMA and FHLMC; however, we will make loans on rural residential properties up to 40 acres. Most residential loans have terms from ten to twenty years and carry fixed rates priced off of treasury rates. The Company has always underwritten mortgage loans based upon traditional underwriting criteria and does not make loans that are known in the industry as “subprime,” “no or low doc,” or “stated income.” Home Equity Lines and Loans - These are loans made to individuals for home improvements and other personal needs. Generally, amounts do not exceed \$250,000; Combined Loan To Value (CLTV) does not exceed 80%; FICO scores are at or above 670; Total Debt Ratios do not exceed 43%; and in some situations the Company is in a 1st lien position.

Table of Contents

Agricultural - These are loans and lines of credit made to farmers to finance agricultural production. Lines of credit are extended to finance the seasonal needs of farmers during peak growing periods; are usually established for periods no longer than 12 to 36 months; are often secured by general filing liens on livestock, crops, crop proceeds and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a processing plant, or orchard/vineyard development; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Commercial - These are loans and lines of credit to businesses that are sole proprietorships, partnerships, LLC's and corporations. Lines of credit are extended to finance the seasonal working capital needs of customers during peak business periods; are usually established for periods no longer than 12 to 24 months; are often secured by general filing liens on accounts receivable, inventory and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a plant or purchase of a business; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Consumer - These are loans to individuals for personal use, and primarily include loans to purchase automobiles or recreational vehicles, and unsecured lines of credit. The Company has a very minimal consumer loan portfolio, and loans are primarily made as an accommodation to deposit customers.

Leases - These are leases to businesses or individuals, for the purpose of financing the acquisition of equipment. They can be either "finance leases" where the lessee retains the tax benefits of ownership but obtains 100% financing on their equipment purchases; or "true tax leases" where the Company, as lessor, places reliance on equipment residual value and in doing so obtains the tax benefits of ownership. Leases typically have a maturity of three to ten years, and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

The Company accounts for leases with Investment Tax Credits (ITC) under the deferred method as established in ASC 740-10. ITC are viewed and accounted for as a reduction of the cost of the related assets and presented as deferred income on the Company's financial statement.

See "Item 3. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" for a discussion about the credit risks the Company assumes and its overall credit risk management practices.

Each loan or lease type involves risks specific to the: (1) borrower; (2) collateral; and (3) loan & lease structure. See "Results of Operations - Provision and Allowance for Credit Losses" for a more detailed discussion of risks by loan & lease type. The Company's current underwriting policies and standards are designed to mitigate the risks involved in each loan & lease type. The Company's policies require that loans & leases are approved only to those borrowers exhibiting a clear source of repayment and the ability to service existing and proposed debt. The Company's underwriting procedures for all loan & lease types require careful consideration of the borrower, the borrower's financial condition, the borrower's management capability, the borrower's industry, and the economic environment affecting the loan or lease.

Most loans & leases made by the Company are secured, but collateral is the secondary or tertiary source of repayment; cash flow is our primary source of repayment. The quality and liquidity of collateral are important and must be confirmed before the loan is made.

In order to be responsive to borrower needs, the Company prices loans & leases: (1) on both a fixed rate and adjustable rate basis; (2) over different terms; and (3) based upon different rate indices; as long as these structures are consistent with the Company's interest rate risk management policies and procedures (see Item 3. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk).

Table of Contents

Overall, the Company's loan & lease portfolio at March 31, 2018 totaled \$2.2 billion, an increase of \$89.1 million or 4.1% over March 31, 2017. This increase has occurred as a result of: (1) the Company's intensified business development efforts directed toward credit-qualified borrowers; (2) entry into the equipment leasing business; and (3) expansion of our service area into Walnut Creek, Concord and Napa. No assurances can be made that this growth in the loan & lease portfolio will continue.

Loans & leases at March 31, 2018 increased \$19.8 million from \$2.2 billion at December 31, 2017. This relatively small overall increase was a result of \$12.2 million in normal seasonal pay downs of loans made to the Company's agricultural customers offset by growth in other portfolio segments.

The following table sets forth the distribution of the loan & lease portfolio by type and percent as of the periods indicated.

Loan & Lease Portfolio (in thousands)	March 31, 2018		December 31, 2017		March 31, 2017	
	\$	%	\$	%	\$	%
Commercial Real Estate	\$705,063	31.5 %	\$691,639	31.1 %	\$682,687	31.7 %
Agricultural Real Estate	508,400	22.7 %	499,231	22.5 %	463,645	21.6 %
Real Estate Construction	96,315	4.3 %	100,206	4.5 %	164,791	7.7 %
Residential 1st Mortgages	264,137	11.8 %	260,751	11.7 %	249,628	11.6 %
Home Equity Lines and Loans	34,691	1.5 %	34,525	1.6 %	31,817	1.5 %
Agricultural	261,427	11.7 %	273,582	12.3 %	266,010	12.4 %
Commercial	274,682	12.3 %	265,703	12.0 %	209,184	9.7 %
Consumer & Other	6,685	0.3 %	6,656	0.3 %	7,119	0.3 %
Leases	89,678	3.9 %	88,957	4.0 %	76,591	3.5 %
Total Gross Loans & Leases	2,241,078	100.0 %	2,221,250	100.0 %	2,151,472	100.0 %
Less: Unearned Income	5,995		5,955		5,440	
Subtotal	2,235,083		2,215,295		2,146,032	
Less: Allowance for Credit Losses	50,677		50,342		48,400	
Net Loans & Leases	\$2,184,406		\$2,164,953		\$2,097,632	

Classified Loans & Leases and Non-Performing Assets

All loans & leases are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See "Results of Operations - Provision and Allowance for Credit Losses" for more detail on risk grades. The Company utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans & leases and review the credit risk grades the Company places on loans & leases. Loans & leases that are judged to exhibit a higher risk profile are referred to as "classified loans & leases," and these loans & leases receive increased management attention. As of March 31, 2018, classified loans totaled \$8.2 million compared to \$8.9 million at December 31, 2017 and \$4.6 million at March 31, 2017.

Classified loans & leases with higher levels of credit risk can be further designated as "impaired" loans & leases. A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. See "Results of Operations - Provision and Allowance for Credit Losses" for further details. Impaired loans & leases consist of: (1) non-accrual loans & leases; and/or (2) restructured loans & leases that are still performing (i.e., accruing interest).

Non-Accrual Loans & leases - Accrual of interest on loans & leases is generally discontinued when a loan or lease becomes contractually past due by 90 days or more with respect to interest or principal. When loans & leases are 90 days past due, but in management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan or lease is placed on non-accrual status, all interest previously accrued but not

collected is reversed. Income on such loans & leases is then recognized only to the extent that cash is received and where the future collection of principal is probable. As of March 31, 2018 non-accrual loans & leases totaled \$81,000. At December 31, 2017 and March 31, 2017, non-accrual loans & leases totaled \$0 and \$1.4 million, respectively.

Restructured Loans & Leases - A restructuring of a loan or lease constitutes a TDR under ASC 310-40, if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR loans, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment.

Table of Contents

As of March 31, 2018, restructured loans & leases on accrual totaled \$6.2 million as compared to \$6.3 million at December 31, 2017. Restructured loans on accrual at March 31, 2017 were \$5.9 million.

Other Real Estate - Loans where the collateral has been repossessed are classified as other real estate ("ORE") or, if the collateral is personal property, the loan is classified as other assets on the Company's financial statements.

The following table sets forth the amount of the Company's non-performing loans & leases (defined as non-accrual loans & leases plus accruing loans & leases past due 90 days or more) and ORE as of the dates indicated.

Non-Performing Assets

(in thousands)	March 31, 2018	Dec. 31, 2017	March 31, 2017
Non-Performing Loans & Leases	\$ 81	\$ 0	\$ 1,421
Other Real Estate	873	873	2,152
Total Non-Performing Assets	\$ 954	\$ 873	\$ 3,573
Non-Performing Loans & Leases as a % of Total Loans & Leases	0.00	%	0.00
Restructured Loans & Leases (Performing)	\$ 6,246	\$ 6,301	\$ 5,984

Although management believes that non-performing loans & leases are generally well-secured and that potential losses are provided for in the Company's allowance for credit losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. Specific reserves of \$4,000, \$0, and \$261,000 have been established for non-performing loans & leases at March 31, 2018, December 31, 2017 and March 31, 2017, respectively.

Foregone interest income on non-accrual loans & leases, which would have been recognized during the period, if all such loans & leases had been current in accordance with their original terms, totaled \$0 for the three months ended March 31, 2018 and for the year ended December 31, 2017, and \$24,000 for the three months ended March 31, 2017.

The Company reported \$873,000 of ORE at March 31, 2018, \$873,000 at December 31, 2017, and \$3.6 million at March 31, 2017.

Except for those classified and non-performing loans & leases discussed above, the Company's management is not aware of any loans & leases as of March 31, 2018, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan or lease repayment terms, or any known events that would result in the loan or lease being designated as non-performing at some future date. However:

The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has improved throughout most of the Central Valley, in many of the Company's market segments housing prices remain below peak levels and unemployment levels remain above those in other areas of the state and country.

The State of California experienced drought conditions from 2013 through most of 2016. Then, in late 2016 and early 2017 significant levels of rain and snow alleviated drought conditions in many areas of California, including those in the Company's primary service area. In late 2017 and early 2018 rain levels have exceeded 80% of seasonal averages, but snow levels have been modest. Fortunately, reservoir levels are high and the availability of water this summer and fall in our primary service area should not be an issue. However, the weather patterns over the past 5 years further reinforce the fact that the long-term risks associated with the availability of water are significant.

Table of Contents

The agricultural industry is facing challenges associated with: (1) weakness in export markets due to proposed changes in trade policies; (2) tight labor markets and higher wages due to legislative changes at the state and federal levels; and (3) proposed changes in immigration policy and the resulting impact on the labor pool.

See “Part I, Item 1A. Risk Factors” in the Company’s 2017 Annual Report on Form 10-K.

Deposits

One of the key sources of funds to support earning assets is the generation of deposits from the Company’s customer base. The ability to grow the customer base, and subsequently deposits, is a significant element in the performance of the Company.

The Company's deposit balances at March 31, 2018 have increased \$93.8 million or 3.6% compared to March 31, 2017. In addition to the Company’s ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Company’s strong financial results and position and F&M Bank’s reputation as one of the most safe and sound banks in its market area; and (2) the Company’s expansion of its service area into Walnut Creek and Concord. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 3.6% since March 31, 2017, importantly, low cost transaction accounts continue to grow at a strong pace as well:

· Demand and interest-bearing transaction accounts increased \$173.7 million or 14.3% since March 31, 2017.

· Savings and money market accounts have increased \$26.9 million or 3.3% since March 31, 2017.

Time deposit accounts have decreased \$106.9 million or 18.1% since March 31, 2017, primarily due to the Company’s decision not to renew \$90.0 million in high rate public funds time deposit accounts from the State of California.

The Company's deposit balances at March 31, 2018 have decreased \$21.8 million or 0.80% compared to December 31, 2017. Savings and money market deposits increased 2.2% or \$17.6 million while demand and interest-bearing transaction accounts decreased by \$46.8 million or 3.3% and time deposit accounts increased by \$7.4 million or 1.5%. Deposit trends in the first half of the year can be impacted by the seasonal needs of our agricultural customers.

Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings

Lines of credit with the Federal Reserve Bank and the Federal Home Loan Bank are other key sources of funds to support earning assets. These sources of funds are also used to manage the Company’s interest rate risk exposure, and as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. There were no FHLB Advances at March 31, 2018, December 31, 2017, or March 31, 2017. There were no Federal Funds purchased or advances from the FRB at March 31, 2018, December 31, 2017 or March 31, 2017.

As of March 31, 2018 the Company has additional borrowing capacity of \$472.1 million with the Federal Home Loan Bank and \$368.8 million with the Federal Reserve Bank. Any borrowings under these lines would be collateralized with loans that have been accepted for pledging at the FHLB and FRB.

Long-Term Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities (“TPS”). See Note 14 located in “Item 8. Financial Statements and Supplementary Data” of the Company’s 2017 Annual Report on Form 10-K. Although this amount is reflected as subordinated debt on the Company’s balance sheet, under current

regulatory guidelines, our TPS will continue to qualify as regulatory capital (See “Capital”). These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly and were 5.03% as of March 31, 2018, 4.45% at December 31, 2017 and 4.00% at March 31, 2017. The average rate paid for these securities for the first quarter of 2018 was 4.56% and 3.90% for the first quarter of 2017. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company’s common stock.

Table of Contents

Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders' Equity totaled \$305.9 million at March 31, 2018, \$299.7 million at December 31, 2017, and \$288.5 million at March 31, 2017.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain actions by regulators that, if undertaken, could have a material effect on the Company and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The implementation of Basel III requirements will increase the required capital levels that the Company and the Bank must maintain. The final rules include new minimum risk-based capital and leverage ratios, which would be phased in over time. The new minimum capital level requirements applicable to the Company and the Bank under the final rules will be: (i) a common equity Tier 1 capital ratio of 4.5% of risk-weighted assets ("RWA"); (ii) a Tier 1 capital ratio of 6% of RWA; (iii) a total capital ratio of 8% of RWA; and (iv) a Tier 1 leverage ratio of 4% of total assets. The final rules also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios, which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0% of RWA; (ii) a Tier 1 capital ratio of 8.5% of RWA; and (iii) a total capital ratio of 10.5% of RWA. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. The final rules also permit the Company's subordinated debentures issued in 2003 to continue to be counted as Tier 1 capital.

The final rules became effective as applied to the Company and the Bank on January 1, 2015, with a phase in period through January 1, 2019. The Company believes that it is currently in compliance with all of these new capital requirements (as fully phased-in) and that they will not result in any restrictions on the Company's business activity.

In addition, the most recent notification from the FDIC categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

(in thousands)	Actual		Current Regulatory Capital Requirements		Well Capitalized Under Prompt Corrective Action	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
The Company: As of March 31, 2018						
Total Capital Ratio	\$352,361	13.33 %	\$211,442	8.0 %	N/A	N/A
Common Equity Tier 1 Capital Ratio	\$309,102	11.70 %	\$118,936	4.5 %	N/A	N/A
Tier 1 Capital Ratio	\$319,102	12.07 %	\$158,582	6.0 %	N/A	N/A
Tier 1 Leverage Ratio	\$319,102	10.49 %	\$121,695	3.0 %	N/A	N/A

Table of Contents

(in thousands)	Actual		Current Regulatory Capital Requirements		Well Capitalized Under Prompt Corrective Action	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
The Bank: As of March 31, 2018						
Total Capital Ratio	\$340,551	12.95 %	\$210,435	8.0 %	\$263,044	10.0 %
Common Equity Tier 1 Capital Ratio	\$307,447	11.69 %	\$118,370	4.5 %	\$170,979	6.5 %
Tier 1 Capital Ratio	\$307,447	11.69 %	\$157,826	6.0 %	\$210,435	8.0 %
Tier 1 Leverage Ratio	\$307,447	10.15 %	\$121,184	3.0 %	\$151,480	5.0 %

As previously discussed (see “Long-Term Subordinated Debentures”), in order to supplement its regulatory capital base, during December 2003 the Company issued \$10 million of trust preferred securities. On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities (“TPS”) by bank holding companies (“BHCs”). Under the final rule BHCs may include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. Any portion of trust-preferred securities not qualifying as Tier 1 capital would qualify as Tier 2 capital subject to certain limitations. The Company has received notification from the Federal Reserve Bank of San Francisco that all of the Company’s trust preferred securities currently qualify as Tier 1 capital.

The Company is not considered the primary beneficiary of this Trust (variable interest entity), therefore the trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability.

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on August 11, 2015, the Board of Directors approved an extension of the \$20 million stock repurchase program over the three-year period ending September 30, 2018. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2017 Annual Report on Form 10-K for additional information.

There were no stock repurchases during the first quarter of 2018 or 2017. The remaining dollar value of shares that may yet be purchased under the Company’s Common Stock Repurchase Plan is approximately \$20 million.

On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Computershare as Rights Agent. The Rights Plan was set to expire on August 5, 2018. On November 19, 2015, the Board of Directors approved a seven-year extension of the term of the Rights Plan. Pursuant to an Amendment to the Rights Agreement dated February 18, 2016, the term of the Rights Plan was extended from August 5, 2018 to August 5, 2025. The extension of the term of the Rights Plan was intended as a means to continue to guard against abusive takeover tactics and was not in response to any particular proposal. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2017 Annual Report on Form 10-K for further explanation.

The company did not issue any new shares during the first quarter of 2018. During the first quarter of 2017, the Company issued 1,375 shares of common stock to the Bank’s non-qualified defined contribution retirement plans. These shares were issued at a price of \$590.00 per share based upon a valuation completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(a)(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds were contributed to the Bank as equity capital.

Critical Accounting Policies and Estimates

This “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing the Company’s financial statements management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. These judgments govern areas such as the allowance for credit losses, the fair value of financial instruments and accounting for income taxes.

Table of Contents

For a full discussion of the Company's critical accounting policies and estimates see "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's 2017 Annual Report on Form 10-K.

Off Balance Sheet Commitments

In the normal course of business the Company enters into financial instruments with off balance sheet risks in order to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit, letters of credit and other types of financial guarantees. The Company had the following off balance sheet commitments as of the dates indicated.

(in thousands)	March 31, 2018	December 31, 2017	March 31, 2017
Commitments to Extend Credit	\$ 767,718	\$ 735,678	\$ 602,932
Letters of Credit	19,729	20,061	17,394
Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties	-	759	1,256

The Company's exposure to credit loss in the event of nonperformance by the other party with regard to standby letters of credit, undisbursed loan commitments, and financial guarantees is represented by the contractual notional amount of those instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. The Company uses the same credit policies in making commitments and conditional obligations as it does for recorded balance sheet items. The Company may or may not require collateral or other security to support financial instruments with credit risk. Evaluations of each customer's creditworthiness are performed on a case-by-case basis.

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Most standby letters of credit are issued for 12 months or less. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Additionally, the Company maintains a reserve for off balance sheet commitments which totaled \$267,000 at March 31, 2018, December 31, 2017, and March 31, 2017. We do not anticipate any material losses as a result of these transactions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Risk Management

The Company has adopted risk management policies and procedures, which aim to ensure the proper control and management of all risk factors inherent in the operation of the Company, most importantly credit risk, interest rate risk and liquidity risk. These risk factors are not mutually exclusive. It is recognized that any product or service offered by the Company may expose the Company to one or more of these risk factors.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance.

Credit risk in the investment portfolio and correspondent bank accounts is addressed through defined limits in the Company's policy statements. In addition, certain securities carry insurance to enhance credit quality of the bond.

In order to control credit risk in the loan & lease portfolio the Company has established credit management policies and procedures that govern both the approval of new loans & leases and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits

on loans & leases to one borrower, and by restricting loans & leases made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. However, as a financial institution that assumes credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The allowance for credit losses is maintained at a level considered by management to be adequate to provide for risks inherent in the loan & lease portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs.

Table of Contents

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans & leases. The systematic methodology consists of three parts.

Part 1 - includes a detailed analysis of the loan & lease portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB ASC. Individual loans & leases are reviewed to identify them for impairment. A loan or lease is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan or lease. Impairment is measured as either the expected future cash flows discounted at each loan's or lease's effective interest rate, the fair value of the loan's or lease's collateral if the loan or lease is collateral dependent, or an observable market price of the loan or lease, if one exists. Upon measuring the impairment, the Company will ensure an appropriate level of allowance is present or established.

Central to the first phase of the analysis of the loan & lease portfolio is the risk rating system. The originating credit officer assigns each borrower an initial risk rating, which is based primarily on a thorough analysis of that borrower's financial position in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior credit administration personnel. Credits are monitored by credit administration personnel for deterioration in a borrower's financial condition, which would impact the ability of the borrower to perform under the contract. Risk ratings are adjusted as necessary. Risk ratings are reviewed by both the Company's independent third-party credit examiners and bank examiners from the DBO and FDIC.

Based on the risk rating system, specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicates that the loan or lease is impaired and there is a probability of loss. Management performs a detailed analysis of these loans & leases, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral, and assessment of the guarantors. Management then determines the inherent loss potential and allocates a portion of the allowance for losses as a specific allowance for each of these credits.

The second phase is conducted by segmenting the loan & lease portfolio by risk rating and into groups of loans & leases with similar characteristics in accordance with the "Contingency" topic of the FASB ASC. In this second phase, groups of loans & leases with similar characteristics are reviewed and the appropriate allowance factor is applied based on the historical average charge-off rate for each particular group of loans or leases.

Part 2 - considers qualitative internal and external factors that may affect a loan or lease's collectability, is based upon management's evaluation of various conditions, the effects of which are not directly measured in the determination of the historical and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the second element of the analysis of the allowance include, but are not limited to the following conditions that existed as of the balance sheet date:

- § general economic and business conditions affecting the key service areas of the Company;
- § credit quality trends (including trends in collateral values, delinquencies and non-performing loans & leases);
- § loan & lease volumes, growth rates and concentrations;
- § loan & lease portfolio seasoning;
- § specific industry and crop conditions;
- § recent loss experience; and
- § duration of the current business cycle.

Part 3 - An unallocated allowance often occurs due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the continuing sluggish economic conditions in the Central Valley; and (2) the long term impact of drought conditions currently being experienced in California.

Table of Contents

Management reviews all of these conditions in discussion with the Company's senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the second element of the allowance or in the unallocated allowance.

Management believes, that based upon the preceding methodology, and using information currently available, the allowance for credit losses at March 31, 2018 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans & leases, or net loan & lease charge-offs that would require increases in the provision for credit losses and thereby adversely affect the results of operations.

Interest Rate Risk

The mismatch between maturities of interest sensitive assets and liabilities results in uncertainty in the Company's earnings and economic value and is referred to as interest rate risk. The Company does not attempt to predict interest rates and positions the balance sheet in a manner, which seeks to minimize, to the extent possible, the effects of changing interest rates.

The Company measures interest rate risk in terms of potential impact on both its economic value and earnings. The methods for governing the amount of interest rate risk include: (1) analysis of asset and liability mismatches (Gap analysis); (2) the utilization of a simulation model; and (3) limits on maturities of investment, loan & lease, and deposit products, which reduces the market volatility of those instruments.

The Gap analysis measures, at specific time intervals, the divergence between earning assets and interest bearing liabilities for which repricing opportunities will occur. A positive difference, or Gap, indicates that earning assets will reprice faster than interest-bearing liabilities. This will generally produce a greater net interest margin during periods of rising interest rates and a lower net interest margin during periods of declining interest rates. Conversely, a negative Gap will generally produce a lower net interest margin during periods of rising interest rates and a greater net interest margin during periods of decreasing interest rates.

The interest rates paid on deposit accounts do not always move in unison with the rates charged on loans & leases. In addition, the magnitude of changes in the rates charged on loans & leases is not always proportionate to the magnitude of changes in the rate paid for deposits. Consequently, changes in interest rates do not necessarily result in an increase or decrease in the net interest margin solely as a result of the differences between repricing opportunities of earning assets or interest bearing liabilities.

The Company also utilizes the results of a dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. The sensitivity of the Company's net interest income is measured over a rolling one-year horizon.

The simulation model estimates the impact of changing interest rates on interest income from all interest-earning assets and the interest expense paid on all interest-bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 100 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At March 31, 2018, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an increase in net interest income of 2.27% if rates increase by 200 basis points and a decrease in net interest income of 4.05% if rates decline 100 basis points. Comparatively, at December 31, 2017, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an

increase in net interest income of 2.83% if rates increase by 200 basis points and a decrease in net interest income of 4.42% if rates decline 100 basis points.

The estimated sensitivity does not necessarily represent a Company forecast and the results may not be indicative of actual changes to the Company's net interest income. These estimates are based upon a number of assumptions including: the nature and timing of interest rate levels including yield curve shape; prepayments on loans & leases and securities; pricing strategies on loans & leases and deposits; replacement of asset and liability cash flows; and other assumptions. While the assumptions used are based on current economic and local market conditions, there is no assurance as to the predictive nature of these conditions including how customer preferences or competitor influences might change.

Table of Contents

Liquidity Risk

Liquidity risk is the risk to earnings or capital resulting from the Company's inability to meet its obligations when they come due without incurring unacceptable losses. It includes the ability to manage unplanned decreases or changes in funding sources and to recognize or address changes in market conditions that affect the Company's ability to liquidate assets or acquire funds quickly and with minimum loss of value. The Company endeavors to maintain a cash flow adequate to fund operations, handle fluctuations in deposit levels, respond to the credit needs of borrowers, and to take advantage of investment opportunities as they arise.

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows" of the Company's 2017 Annual Report on Form 10-K) cash and cash equivalents, cash provided by operating activities, principal payments on loans & leases, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of \$78 million and repurchase lines of \$130 million with major banks. As of March 31, 2018, the Company has additional borrowing capacity of \$472 million with the FHLB and \$369 million with the FRB. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

At March 31, 2018, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities AFS of approximately \$381 million, which represents 12.45% of total assets.

ITEM 4. CONTROLS AND PROCEDURES

The Company maintains disclosure controls and procedures designed to ensure that information is recorded and reported in all filings of financial reports. Such information is reported to the Company's management, including its Chief Executive Officer and its Chief Financial Officer to allow timely and accurate disclosure based on the definition of "disclosure controls and procedures" in Rule 13a-15(e). In designing these controls and procedures, management recognizes that they can only provide reasonable assurance of achieving the desired control objectives. Management also evaluated the cost-benefit relationship of possible controls and procedures.

As of the end of the period covered by this report, the Company carried out an evaluation of the effectiveness of Company's disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer, the Chief Financial Officer and other senior management of the Company. The evaluation was based, in part, upon reports and affidavits provided by a number of executives. Based on the foregoing, the Company's Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect the internal controls over financial reporting subsequent to the date the Company completed its evaluation.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings

Certain lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Company or its subsidiaries. Based upon information available to the Company, its review of such lawsuits and claims and consultation with its counsel, the Company believes the liability relating to these actions, if any, would not have a material adverse effect on its consolidated financial statements.

There are no material proceedings adverse to the Company to which any director, officer or affiliate of the Company is a party.

Table of Contents

ITEM 1A. Risk Factors

See “Item 1A. Risk Factors” in the Company’s 2017 Annual Report to Shareholders on Form 10-K. In management’s opinion, there have been no material changes in risk factors since the filing of the 2017 Form 10-K.

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

There were no shares repurchased by Farmers & Merchants Bancorp during the first quarter of 2018. The remaining dollar value of shares that may yet be purchased under the Company’s Stock Repurchase Plan is approximately \$20.0 million.

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades are reported on the OTCQX under the symbol “FMCB.” Additionally, management is aware that there are private transactions in the Company’s common stock.

ITEM 3. Defaults Upon Senior Securities

Not applicable

ITEM 4. Mine Safety Disclosures

Not applicable

ITEM 5. Other Information

None

ITEM 6. Exhibits

Exhibit No. Description

<u>31(a)</u>	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>31(b)</u>	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
<u>32</u>	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	Presentation Linkbase Document
XBRL	
101.DEF	XBRL Definition Linkbase Document

Table of Contents

SIGNATURES

Pursuant to the requirement 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

Date: May 9, 2018 /s/ Kent A.
Steinwert

Kent A. Steinwert
Chairman,
President
& Chief Executive
Officer
(Principal
Executive Officer)

Date: May 9, 2018 /s/ Stephen W.
Haley

Stephen W. Haley
Executive Vice
President and
Chief Financial
Officer
(Principal
Financial &
Accounting
Officer)