

FARMERS & MERCHANTS BANCORP
Form 10-Q
November 09, 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 September 30, 2018

or

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

For the transition period from _____ to _____

Commission File Number: 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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller Reporting Company

Emerging growth company

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

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 783,721 outstanding as of October 31, 2018.

FARMERS & MERCHANTS BANCORP

FORM 10-Q

TABLE OF CONTENTS

<u>PART I. - FINANCIAL INFORMATION</u>	Page
<u>Item 1 - Financial Statements</u>	
<u>Consolidated Balance Sheets (Unaudited) as of September 30, 2018, December 31, 2017 and September 30, 2017.</u>	3
<u>Consolidated Statements of Income (Unaudited) for the Three and Nine Months Ended September 30, 2018 and 2017.</u>	4
<u>Consolidated Statements of Comprehensive Income (Unaudited) for the Three and Nine Months Ended September 30, 2018 and 2017.</u>	5
<u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Nine Months Ended September 30, 2018 and 2017.</u>	6
<u>Consolidated Statements of Cash Flows (Unaudited) for the Nine Months Ended September 30, 2018 and 2017.</u>	7
<u>Notes to the Consolidated Financial Statements (Unaudited)</u>	8
<u>Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	33
<u>Item 3 - Quantitative and Qualitative Disclosures About Market Risk</u>	55
<u>Item 4 - Controls and Procedures</u>	58
<u>PART II. - OTHER INFORMATION</u>	
<u>Item 1 - Legal Proceedings</u>	58
<u>Item 1A – Risk Factors</u>	58
<u>Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds</u>	59
<u>Item 3 - Defaults Upon Senior Securities</u>	59
<u>Item 4 – Mine Safety Disclosures</u>	59
<u>Item 5 - Other Information</u>	59
<u>Item 6 - Exhibits</u>	59
<u>Signatures</u>	60

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

FARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets

(in thousands except share data)

	Sept. 30, 2018 (Unaudited)	December 31, 2017	Sept. 30, 2017 (Unaudited)
Assets			
Cash and Cash Equivalents:			
Cash and Due from Banks	\$ 52,709	\$ 65,956	\$ 44,166
Interest Bearing Deposits with Banks	58,072	121,193	149,104
Total Cash and Cash Equivalents	110,781	187,149	193,270
Investment Securities:			
Available-for-Sale	458,311	481,596	456,323
Held-to-Maturity	51,459	54,460	55,542
Total Investment Securities	509,770	536,056	511,865
Loans & Leases:			
Loans & Leases	2,416,602	2,215,295	2,216,779
Less: Allowance for Credit Losses	53,067	50,342	50,744
Loans & Leases, Net	2,363,535	2,164,953	2,166,035
Premises and Equipment, Net			
Premises and Equipment, Net	29,614	28,679	28,734
Bank Owned Life Insurance	60,968	59,583	59,128
Interest Receivable and Other Assets	108,794	99,032	112,743
Total Assets	\$ 3,183,462	\$ 3,075,452	\$ 3,071,775
Liabilities			
Deposits:			
Demand	\$ 867,552	\$ 832,652	\$ 767,162
Interest Bearing Transaction	602,494	601,476	564,904
Savings and Money Market	844,553	813,703	827,588
Time	462,324	475,397	549,773
Total Deposits	2,776,923	2,723,228	2,709,427
Subordinated Debentures			
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	96,138	42,254	49,409
Total Liabilities	2,883,371	2,775,792	2,769,146
Shareholders' Equity			
Preferred Stock: No Par Value, 1,000,000 Shares Authorized, None Issued or Outstanding			
Preferred Stock	-	-	-
Common Stock: Par Value \$0.01, 7,500,000 Shares Authorized, 783,721, 812,304 and 812,304			
Common Stock	8	8	8
Shares Issued and Outstanding at September 30, 2018, December 31, 2017 and September 30, 2017, Respectively			
Additional Paid-In Capital	72,974	93,624	93,624

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

Retained Earnings	233,671	206,845	208,443
Accumulated Other Comprehensive (Loss) Income, Net Of Taxes	(6,562)	(817)	554
Total Shareholders' Equity	300,091	299,660	302,629
Total Liabilities and Shareholders' Equity	\$3,183,462	\$3,075,452	\$3,071,775

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

3

Table of ContentsFARMERS & MERCHANTS BANCORP
Consolidated Statements of Income (Unaudited)

(in thousands except per share data)	Three Months		Nine Months	
	Ended September 30, 2018	2017	Ended September 30, 2018	2017
Interest Income				
Interest and Fees on Loans & Leases	\$ 30,959	\$ 26,491	\$ 86,930	\$ 76,270
Interest on Deposits with Banks	638	648	1,737	1,155
Interest on Investment Securities:				
Taxable	2,074	2,038	6,770	6,174
Exempt from Federal Tax	394	432	1,217	1,321
Total Interest Income	34,065	29,609	96,654	84,920
Interest Expense				
Deposits	2,020	1,644	4,954	4,353
Subordinated Debentures	137	115	385	320
Total Interest Expense	2,157	1,759	5,339	4,673
Net Interest Income	31,908	27,850	91,315	80,247
Provision for Credit Losses	2,500	1,600	3,333	2,850
Net Interest Income After Provision for Credit Losses	29,408	26,250	87,982	77,397
Non-Interest Income				
Service Charges on Deposit Accounts	915	897	2,574	2,591
Net (Loss) Gain on Sale of Investment Securities	-	-	(1,330)	131
Increase in Cash Surrender Value of Life Insurance	473	458	1,385	1,367
Debit Card and ATM Fees	1,101	990	3,213	2,877
Net Gain on Deferred Compensation Investments	715	510	1,904	1,703
Other	1,004	783	3,410	3,914
Total Non-Interest Income	4,208	3,638	11,156	12,583
Non-Interest Expense				
Salaries and Employee Benefits	12,329	10,809	37,509	34,751
Net Gain on Deferred Compensation Investments	715	510	1,904	1,703
Occupancy	984	864	2,833	2,580
Equipment	1,078	957	3,119	2,970
Marketing	257	329	976	867
Legal	261	51	1,553	309
FDIC Insurance	227	233	693	694
Gain on Sale of ORE	-	-	-	(414)
Other	2,770	2,554	8,115	7,794
Total Non-Interest Expense	18,621	16,307	56,702	51,254
Income Before Income Taxes	14,995	13,581	42,436	38,726
Provision for Income Taxes	2,995	5,000	9,945	14,137
Net Income	\$ 12,000	\$ 8,581	\$ 32,491	\$ 24,589
Basic Earnings Per Common Share	\$ 15.12	\$ 10.59	\$ 40.26	\$ 30.39

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		Nine Months	
	Ended September 30,		Ended September 30,	
	2018	2017	2018	2017
Net Income	\$ 12,000	\$ 8,581	\$ 32,491	\$ 24,589
Other Comprehensive Income				
Increase in Net Unrealized (Loss) Gain on Available-for-Sale Securities	(1,679)	322	(9,486)	1,106
Deferred Tax Benefit (Expense) Related to Unrealized Gains	496	(135)	2,816	(465)
Reclassification Adjustment for Realized Losses (Gains) on Available-for-Sale Securities Included in Net Income	-	-	1,330	(131)
Deferred Tax Benefit (Expense) Related to Reclassification Adjustment	-	-	(405)	55
Change in Net Unrealized (Losses) Gains on Available-for-Sale Securities, Net of Tax	(1,183)	187	(5,745)	565
Total Other Comprehensive (Loss) Income	(1,183)	187	(5,745)	565
Comprehensive Income	\$ 10,817	\$ 8,768	\$ 26,746	\$ 25,154

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) Income, net \$	Total Shareholders' Equity \$
Balance, January 1, 2017	807,329	8	\$90,671	\$189,313	\$ (11)	\$ 279,981
Net Income			-	24,589	-	24,589
Cash Dividends Declared on Common Stock (\$6.75 per share)			-	(5,459)	-	(5,459)
Issuance of Common Stock	4,975	-	2,953	-	-	2,953
Change in Net Unrealized Gains on Securities Available-for-Sale, Net of Tax			-	-	565	565
Balance, September 30, 2017	812,304	8	\$93,624	\$208,443	\$ 554	\$ 302,629
Balance, January 1, 2018	812,304	8	\$93,624	\$206,845	\$ (817)	\$ 299,660
Net Income			-	32,491	-	32,491
Cash Dividends Declared on Common Stock (\$6.90 per share)			-	(5,665)	-	(5,665)
Repurchase of Common Stock	(44,503)	-	(31,152)	-	-	(31,152)
Issuance of Common Stock	15,920	-	10,502	-	-	10,502
Change in Net Unrealized Loss on Securities Available-for-Sale, Net of Tax			-	-	(5,745)	(5,745)
Balance, September 30, 2018	783,721	8	\$72,974	\$233,671	\$ (6,562)	\$ 300,091

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

Table of ContentsFARMERS & MERCHANTS BANCORP
Consolidated Statements of Cash Flows (Unaudited)

(in thousands)	Nine Months	
	Ended September 30, 2018	2017
Operating Activities:		
Net Income	\$32,491	\$24,589
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Credit Losses	3,333	2,850
Depreciation and Amortization	1,751	1,595
Net Amortization of Investment Security Premiums & Discounts	768	1,097
Amortization of Core Deposit Intangible	81	82
Accretion of Discount on Acquired Loans	(115)	(163)
Net Loss (Gain) on Sale of Investment Securities	1,330	(131)
Net Gain on Sale of Property & Equipment	(295)	(1,189)
Net Gain on Sale of ORE	-	(414)
Earnings from Equity Investment	(381)	-
Dividends from Equity Investment	63	-
Net Change in Operating Assets & Liabilities:		
Net Decrease (Increase) in Interest Receivable and Other Assets	2,083	(2,315)
Net Increase in Interest Payable and Other Liabilities	3,441	107
Net Cash Provided by Operating Activities	44,550	26,108
Investing Activities:		
Purchase of Investment Securities Available-for-Sale	(274,440)	(208,985)
Proceeds from Sold, Matured or Called Securities Available-for-Sale	342,208	201,001
Purchase of Investment Securities Held-to-Maturity	(3,042)	(1,070)
Proceeds from Matured or Called Securities Held-to-Maturity	5,998	3,592
Net Loans & Leases Paid, Originated or Acquired	(201,914)	(39,245)
Principal Collected on Loans & Leases Previously Charged Off	115	205
Additions to Premises and Equipment	(3,654)	(3,215)
Purchase of Other Investments	(4,053)	(12,728)
Proceeds from Sale of Property & Equipment	986	3,304
Proceeds from Sale of Other Real Estate	-	3,186
Net Cash Used in Investing Activities	(137,796)	(53,955)
Financing Activities:		
Net Increase in Deposits	53,695	127,716
Common Stock Repurchases	(31,152)	-
Cash Dividends	(5,665)	(5,459)
Net Cash Provided by Financing Activities	16,878	122,257
(Decrease) Increase in Cash and Cash Equivalents	(76,368)	94,410
Cash and Cash Equivalents at Beginning of Period	187,149	98,860
Cash and Cash Equivalents at End of Period	\$110,781	\$193,270
Supplementary Data		
Cash Payments Made for Income Taxes	\$5,421	\$13,142
Issuance of Common Stock	\$10,502	\$2,953
Interest Paid	\$5,248	\$4,586
Supplementary Noncash Disclosure		
Security (purchases) sales settled in subsequent period	\$(55,000)	\$-

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

7

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.

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 and nine-month period ended September 30, 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.

Out of Period Adjustment

During the quarter ended September 30, 2018, while preparing 2017 tax returns, the Company identified certain items related to IRS Code Section 162(m) that were not appropriately reflected in the 2014 through 2017 Provision for Income Taxes. To reflect this change, the cumulative impact of \$990,000 was recognized by reducing the Company's Provision for Income Taxes in the third quarter of 2018. After evaluating the quantitative and qualitative aspects of the adjustment, the Company concluded that its prior period financial statements were not materially misstated and, therefore, no restatement was required.

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

Investments 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.

Table of Contents

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.

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.

Table of Contents

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.

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 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.

Table of Contents

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.

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.

Table of Contents

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.

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.

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.

13

Table of Contents

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.

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 Unrealized		Fair/Book Value
		Gains	Losses	
September 30, 2018				
Government Agency & Government-Sponsored Entities	\$ 3,045	\$ 7	\$ -	\$ 3,052
US Treasury Notes	164,671	-	463	164,208
US Govt SBA	17,144	6	177	16,973
Mortgage Backed Securities ⁽¹⁾	279,757	265	8,955	271,067
Other	3,011	-	-	3,011
Total	\$ 467,628	\$ 278	\$ 9,595	\$ 458,311
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

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

Total	\$ 482,757	\$ 1,016	\$ 2,177	\$ 481,596
-------	------------	----------	----------	------------

14

Table of Contents

	Amortized Cost	Gross Unrealized		Fair/Book Value
		Gains	Losses	
September 30, 2017				
Government Agency & Government-Sponsored Entities	\$ 3,091	\$ 78	\$ -	\$ 3,169
US Treasury Notes	144,657	2	249	144,410
US Govt SBA	31,732	45	86	31,691
Mortgage Backed Securities (1)	274,877	1,985	819	276,043
Other	1,010	-	-	1,010
Total	\$ 455,367	\$ 2,110	\$ 1,154	\$ 456,323

(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 Unrealized		Fair Value
		Gains	Losses	
September 30, 2018				
Obligations of States and Political Subdivisions	\$51,459	\$ 97	\$ 174	\$51,382
Total	\$51,459	\$ 97	\$ 174	\$51,382

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

	Book Value	Gross Unrealized		Fair Value
		Gains	Losses	
September 30, 2017				
Obligations of States and Political Subdivisions	\$55,542	\$ 749	\$ -	\$56,291
Total	\$55,542	\$ 749	\$ -	\$56,291

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 September 30, 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
September 30, 2018				
Within one year	\$ 156,111	\$ 155,934	\$ 2,085	\$ 2,086
After one year through five years	15,601	15,319	6,730	6,733
After five years through ten years	1,566	1,563	20,230	20,210
After ten years	14,593	14,428	22,414	22,353
	187,871	187,244	51,459	51,382
Investment securities not due at a single maturity date:				
Mortgage-backed securities	279,757	271,067	-	-

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

Total	\$467,628	\$458,311	\$51,459	\$51,382
-------	-----------	-----------	----------	----------

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.

15

Table of Contents

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
September 30, 2018						
<u>Securities Available-for-Sale</u>						
US Treasury Notes	\$ 84,315	\$ 290	\$ 24,902	\$ 173	\$ 109,217	\$ 463
US Govt SBA	4,965	62	8,467	115	13,432	177
Mortgage Backed Securities	182,243	5,772	78,272	3,183	260,515	8,955
Total	\$ 271,523	\$ 6,124	\$ 111,641	\$ 3,471	\$ 383,164	\$ 9,595

Securities Held-to-Maturity

Obligations of States and Political

Subdivisions	\$ 15,309	\$ 174	\$ -	\$ -	\$ 15,309	\$ 174
Total	\$ 15,309	\$ 174	\$ -	\$ -	\$ 15,309	\$ 174

	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
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

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
September 30, 2017						

Securities Available-for-Sale

US Treasury Notes	\$ 74,414	\$ 249	\$ -	\$ -	\$ 74,414	\$ 249
US Govt SBA	18,669	86	-	-	18,669	86
Mortgage Backed Securities	122,887	819	-	-	122,887	819
Total	\$ 215,970	\$ 1,154	\$ -	\$ -	\$ 215,970	\$ 1,154

There were no HTM investments with gross unrealized losses at September 30, 2017

As of September 30, 2018, the Company held 431 investment securities of which 132 were in an unrealized loss position for less than twelve months. 88 securities were in a loss 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 September 30, 2018, December 31, 2017 and September 30, 2017, no securities of government agency and government sponsored entities were in an unrealized loss position for less than 12 months or for 12 months or more.

Table of Contents

U.S. Treasury Notes – At September 30, 2018, ten U.S. Treasury Note security investments were in an unrealized loss position for less than 12 months and one was in a loss position for 12 months or more. The unrealized losses on the Company's investment in U.S. Treasury Notes were \$463,000, \$442,000, and \$249,000 at September 30, 2018, December 31, 2017, and September 30, 2017, respectively. 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 September 30, 2018, December 31, 2017, and September 30, 2017.

U.S. Government SBA – At September 30, 2018, 27 U.S. Government SBA security investments were in an unrealized loss position for less than 12 months and 45 were in a loss position for 12 months or more. The unrealized losses on the Company's investment in U.S. Government SBA securities were \$177,000, \$208,000, and \$86,000 at September 30, 2018, December 31, 2017, and September 30, 2017, respectively. 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 September 30, 2018, December 31, 2017, and September 30, 2017.

Mortgage Backed Securities – At September 30, 2018, 56 mortgage backed security investments were in an unrealized loss position for less than 12 months and 42 were in a loss position for 12 months or more. The unrealized losses on the Company's investment in mortgage backed securities were \$8.9 million, \$1.5 million, and \$819,000 at September 30, 2018, December 31, 2017, and September 30, 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 September 30, 2018, December 31, 2017 and September 30, 2017.

Obligations of States and Political Subdivisions - At September 30, 2018, 39 obligations of states and political subdivisions were in an unrealized loss position for less than 12 months. None were in a loss position for 12 months or more. As of September 30, 2018, over ninety-nine 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 one 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 \$174,000, \$0 and \$0 at September 30, 2018, December 31, 2017 and September 30, 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 September 30, 2018.

Proceeds from sales and calls of securities were as follows:

Three Months	Nine Months
Ended September 30,	Ended September 30,

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

(in thousands)	2018	2017	2018	2017
Proceeds	\$ -	\$ -	\$ 31,370	\$ 7,831
Gains	-	-	8	143
Losses	-	-	1,338	12

17

Table of Contents

Pledged Securities

As of September 30, 2018, securities carried at \$241.8 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 \$201.8 million at September 30, 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):

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
September 30, 2018											
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	\$50,000
Charge-Offs	-	-	-	(12)	(14)	-	(613)	(84)	-	-	(728)
Recoveries	-	-	-	12	4	40	19	40	-	-	116
Provision	(31)	1,422	(372)	59	284	4	1,029	142	430	366	3,300
Ending Balance- September 30, 2018	\$10,891	\$13,507	\$1,474	\$874	\$2,598	\$8,203	\$9,632	\$307	\$3,793	\$1,788	\$53,000
Third Quarter Allowance for Credit Losses:											
Beginning Balance- July 1, 2018											
	\$10,783	\$13,314	\$1,616	\$864	\$2,548	\$7,658	\$9,436	\$270	\$3,400	\$1,248	\$51,000
Charge-Offs	-	-	-	-	(10)	-	(599)	(25)	-	-	(634)
Recoveries	-	-	-	6	2	27	16	13	-	-	64
Provision	108	193	(142)	4	58	518	779	49	393	540	2,535
Ending Balance- September 30, 2018	\$10,891	\$13,507	\$1,474	\$874	\$2,598	\$8,203	\$9,632	\$307	\$3,793	\$1,788	\$53,000
Ending Balance Individually Evaluated for Impairment											
	314	-	-	121	15	-	192	7	-	-	649
Ending Balance Collectively	10,577	13,507	1,474	753	2,583	8,203	9,440	300	3,793	1,788	52,000

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

Evaluated
for
Impairment
Loans &
Leases:

Ending Balance	\$767,410	\$553,608	\$92,521	\$263,549	\$38,490	\$287,821	\$304,333	\$7,723	\$101,147	\$-	\$2,4
Ending Balance											
Individually Evaluated for Impairment	4,713	7,238	-	2,426	305	-	1,670	7	-	-	16
Ending Balance											
Collectively Evaluated for Impairment	\$762,697	\$546,370	\$92,521	\$261,123	\$38,185	\$287,821	\$302,663	\$7,716	\$101,147	\$-	\$2,4

18

Table of Contents

	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
December 31, 2017	\$11,110	\$9,450	\$3,223	\$865	\$2,140	\$7,381	\$8,515	\$200	\$3,586	\$1,449	\$47,000
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2017	(109)	-	-	(53)	(3)	(374)	-	(146)	-	-	(6)
Charge-Offs	109	-	-	40	8	17	8	76	-	-	25
Recoveries	(188)	2,635	(1,377)	(37)	179	1,135	674	79	(223)	(27)	2,500
Provision											
Ending Balance- December 31, 2017	\$10,922	\$12,085	\$1,846	\$815	\$2,324	\$8,159	\$9,197	\$209	\$3,363	\$1,422	\$50,000
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	49,000
Loans & Leases:											
Ending Balance	\$684,961	\$499,231	\$100,206	\$260,751	\$34,525	\$273,582	\$265,703	\$6,656	\$89,680	\$-	\$2,000,000
Ending Balance Individually Evaluated for Impairment	4,822	-	-	2,373	340	-	1,734	10	-	-	9,000
Ending Balance Collectively Evaluated for Impairment	\$680,139	\$499,231	\$100,206	\$258,378	\$34,185	\$273,582	\$263,969	\$6,646	\$89,680	\$-	\$2,000,000
September 30, 2017	Commercial Real	Agricultural	Real Estate	Residential 1st	Home Equity	Agricultural	Commercial	Consumer &	Leases	Unallocated	Total

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	\$47,000
Charge-Offs	(109)	-	-	-	-	(7)	-	(114)	-	-	(2,000)
Recoveries	110	-	-	37	6	-	6	46	-	-	20,000
Provision	(14)	1,946	(473)	95	115	(14)	539	77	(392)	971	2,800
Ending Balance- September 30, 2017											
	\$11,097	\$11,396	\$2,750	\$997	\$2,261	\$7,360	\$9,060	\$209	\$3,194	\$2,420	\$50,000
Third Quarter Allowance for Credit Losses:											
Beginning Balance- July 1, 2017											
	\$11,242	\$10,265	\$2,687	\$872	\$2,170	\$7,236	\$9,544	\$205	\$2,952	\$1,891	\$49,000
Charge-Offs	-	-	-	-	-	-	-	(54)	-	-	(5,000)
Recoveries	99	-	-	18	1	-	2	14	-	-	13,000
Provision	(244)	1,131	63	107	90	124	(486)	44	242	529	1,600
Ending Balance- September 30, 2017											
	\$11,097	\$11,396	\$2,750	\$997	\$2,261	\$7,360	\$9,060	\$209	\$3,194	\$2,420	\$50,000
Ending Balance Individually Evaluated for Impairment											
	385	-	-	61	17	69	231	5	-	-	76,000
Ending Balance Collectively Evaluated for Impairment											
	10,712	11,396	2,750	936	2,244	7,291	8,829	204	3,194	2,420	49,000
Leases:											
Ending Balance											
	\$683,037	\$470,738	\$162,167	\$257,920	\$33,350	\$259,127	\$257,951	\$7,312	\$85,177	\$-	\$2,200,000
Ending Balance Individually Evaluated for Impairment											
	4,855	-	-	1,887	369	368	1,752	7	-	-	9,200

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

Ending
Balance
Collectively
Evaluated
for

Impairment	\$678,182	\$470,738	\$162,167	\$256,033	\$32,981	\$258,759	\$256,199	\$7,305	\$85,177	\$-	\$2,2
------------	-----------	-----------	-----------	-----------	----------	-----------	-----------	---------	----------	-----	-------

19

Table of Contents

The ending balance of loans individually evaluated for impairment includes restructured loans in the amount of \$2.8 million at September 30, 2018, \$3.0 million at December 31, 2017 and \$3.0 million at September 30, 2017, which are no longer classified as TDRs.

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.

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

September 30, 2018	Pass	Special Mention	Substandard	Total Loans & Leases
Loans & Leases:				
Commercial Real Estate	\$764,839	\$2,571	\$ -	\$ 767,410
Agricultural Real Estate	537,027	3,271	13,310	553,608
Real Estate Construction	92,521	-	-	92,521
Residential 1st Mortgages	262,946	-	603	263,549
Home Equity Lines & Loans	38,443	-	47	38,490
Agricultural	281,698	4,635	1,488	287,821

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

Commercial	303,507	171	655	304,333
Consumer & Other	7,552	-	171	7,723
Leases	101,147	-	-	101,147
Total	\$2,389,680	\$10,648	\$ 16,274	\$ 2,416,602

20

Table of Contents

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

September 30, 2017	Pass	Special Mention	Substandard	Total Loans &Leases
Loans & Leases:				
Commercial Real Estate	\$678,083	\$4,458	\$ 496	\$683,037
Agricultural Real Estate	465,427	1,281	4,030	470,738
Real Estate Construction	152,989	9,178	-	162,167
Residential 1st Mortgages	256,906	43	971	257,920
Home Equity Lines & Loans	33,297	-	53	33,350
Agricultural	250,372	5,331	3,424	259,127
Commercial	253,144	4,184	623	257,951
Consumer & Other	7,142	-	170	7,312
Leases	82,889	2,288	-	85,177
Total	\$2,180,249	\$26,763	\$ 9,767	\$2,216,779

There were no loans or leases outstanding at September 30, 2018, December 31, 2017, and September 30, 2017, rated doubtful or loss.

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
September 30, 2018							
Loans & Leases:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$ -	\$767,410	\$ 767,410
Agricultural Real Estate	-	-	-	-	-	553,608	553,608
Real Estate Construction	-	-	-	-	-	92,521	92,521
Residential 1st Mortgages	167	-	-	-	167	263,382	263,549
Home Equity Lines & Loans	-	-	-	-	-	38,490	38,490
Agricultural	150	-	-	-	150	287,671	287,821
Commercial	21	-	-	-	21	304,312	304,333
Consumer & Other	17	-	-	-	17	7,706	7,723
Leases	-	-	-	-	-	101,147	101,147
Total	\$ 355	\$ -	\$ -	\$ -	\$ 355	\$2,416,247	\$ 2,416,602

Table of Contents

	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
September 30, 2017							
Loans & Leases:							
Commercial Real Estate	\$ -	\$ -	\$ -	\$ -	\$ -	\$683,037	\$ 683,037
Agricultural Real Estate	-	-	-	-	-	470,738	470,738
Real Estate Construction	-	-	-	-	-	162,167	162,167
Residential 1st Mortgages	-	-	-	-	-	257,920	257,920
Home Equity Lines & Loans	-	-	-	-	-	33,350	33,350
Agricultural	-	-	-	-	-	259,127	259,127
Commercial	-	3	-	-	3	257,948	257,951
Consumer & Other	16	-	-	4	20	7,292	7,312
Leases	-	-	-	-	-	85,177	85,177
Total	\$ 16	\$ 3	\$ -	\$ 4	\$ 23	\$2,216,756	\$ 2,216,779

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

	Unpaid			Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	Recorded	Principal	Related	Average	Interest	Average	Interest
	Investment	Balance	Allowance	Recorded	Income	Recorded	Income
September 30, 2018				Investment	Recognized	Investment	Recognized
With no related allowance recorded:							
Commercial Real Estate	\$ 98	\$ 98	\$ -	\$ 99	\$ 2	\$ 101	\$ 6
Agricultural Real Estate	7,239	7,238	-	3,620	6	804	6
Residential 1st Mortgages	-	-	-	-	-	553	8
	\$ 7,337	\$ 7,336	\$ -	\$ 3,719	\$ 8	\$ 1,458	\$ 20
With an allowance recorded:							

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

Commercial Real Estate	\$ 2,920	\$ 2,910	\$ 314	\$ 2,929	\$ 24	\$ 2,950	\$ 72
Residential 1st Mortgages	1,562	1,739	77	1,630	12	989	32
Home Equity Lines & Loans	75	85	4	76	1	76	3
Commercial	1,675	1,670	192	1,986	14	1,879	44
Consumer & Other	7	7	7	7	-	8	-
	\$ 6,239	\$ 6,411	\$ 594	\$ 6,628	\$ 51	5,902	\$ 151
Total	\$ 13,576	\$ 13,747	\$ 594	\$ 10,347	\$ 59	\$ 7,360	\$ 171

22

Table of Contents

	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

	Three Months Ended September 30, 2017				Nine Months Ended September 30, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
September 30, 2017							
With no related allowance recorded:							
Commercial Real Estate	\$ 106	\$ 107	\$ -	\$ 107	\$ 2	\$ 121	\$ 9
Agricultural Real Estate	-	-	-	488	-	868	-
Residential 1st Mortgages	399	456	-	403	3	415	6
Home Equity Lines & Loans	-	-	-	-	-	21	-
Agricultural	-	-	-	30	-	40	-
Commercial	-	-	-	-	-	504	-
	\$ 505	\$ 563	\$ -	\$ 1,028	\$ 5	\$ 1,969	\$ 15
With an allowance recorded:							
Commercial Real Estate	\$ 2,991	\$ 2,977	\$ 384	\$ 3,000	\$ 25	2,509	\$ 80
Residential 1st Mortgages	519	574	26	472	3	442	12
Home Equity Lines & Loans	83	90	4	67	-	76	2
Agricultural	367	367	69	499	7	588	21
Commercial	1,760	1,752	234	1,696	14	1,624	44
Consumer & Other	4	11	4	14	-	12	-
	\$ 5,724	\$ 5,771	\$ 721	\$ 5,748	\$ 49	5,251	\$ 159
Total	\$ 6,229	\$ 6,334	\$ 721	\$ 6,776	\$ 54	\$ 7,220	\$ 174

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.

At September 30, 2018, there were no formal foreclosure proceedings in process for consumer mortgage loans secured by residential real estate properties.

At September 30, 2018, the Company allocated \$594,000 of specific reserves to \$13.6 million of troubled debt restructured loans & leases, all of which were performing. The Company had no commitments at September 30, 2018 to lend additional amounts to customers with outstanding loans or leases that are classified as TDRs.

During the nine-month periods ending September 30, 2018, there were two loans & leases modified as a troubled debt restructuring. When a loan is restructured, the modification of the terms can include one or a combination of the following: a reduction of the stated interest rate; 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 were for 5 years. Modifications involving an extension of the maturity date was 10 years.

Table of Contents

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three and nine-month periods ended September 30, 2018 (in thousands):

	Three Months Ended September 30, 2018			Nine Months Ended September 30, 2018		
	Pre-Modification Number of Loans	Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Pre-Modification Number of Loans	Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Agricultural Real Estate	1	\$ 7,239	\$ 7,239	1	\$ 7,239	\$ 7,239
Residential 1st Mortgages	-	-	-	1	175	163
Total	1	\$ 7,239	\$ 7,239	2	\$ 7,414	\$ 7,402

The TDRs described above had minimal impact on the allowance for credit losses for the three and nine-month periods ending September 30, 2018.

During the three and nine-months ended September 30, 2018, the twelve months ended December 31, 2017, and the three and nine-month periods ending September 30, 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.

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 Loans	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings		
Residential 1st Mortgages	2	673
Home Equity Lines and Loans	1	32
Commercial	2	138
Consumer & Other	1	9
Total	6	\$ 852

The troubled debt restructurings described above had minimal impact on the allowance for credit losses and resulted in charge-offs of \$44,000 for the twelve months ended December 31, 2017.

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.

Table of Contents

The following table presents loans or leases by class modified as troubled debt restructured loans or leases during the three and nine-month periods ended September 30, 2017 (in thousands):

	Three Months Ended September 30, 2017			Nine Months Ended September 30, 2017		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Residential 1st Mortgages	1	\$ 112	\$ 112	1	\$ 112	\$ 112
Home Equity Lines & Loans	1	32	32	1	32	32
Commercial	2	138	138	2	138	138
Total	4	\$ 282	\$ 282	4	\$ 282	\$ 282

The TDRs described above had minimal impact on the allowance for credit losses for the three and nine-month periods ending September 30, 2017.

At September 30, 2017, the Company allocated \$721,000 of specific reserves to \$6.2 million of troubled debt restructured loans & leases, all of which were performing. The Company had no commitments at September 30, 2017 to lend additional amounts to customers with outstanding loans or leases that are classified as TDRs.

During the three and nine-month periods ending September 30, 2017, there were four loans & leases modified as a troubled debt restructuring. When a loan is restructured, the modification of the terms can include one or a combination of the following: a reduction of the stated interest rate; 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 were for 5 years. Modifications involving an extension of the maturity date ranged from 7 to 10 years.

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:

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.

25

Table of Contents

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%.

The following tables present information about the Company's assets and liabilities 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 September 30, 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	\$ 3,052	\$-	\$ 3,052	\$ -
US Treasury Notes	164,208	164,208	-	-
US Govt SBA	16,973	-	16,973	-
Mortgage Backed Securities	271,067	-	271,067	-

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

Other	3,011	201	310	2,500
Total Assets Measured at Fair Value On a Recurring Basis	\$ 458,311	\$ 164,409	\$ 291,402	\$ 2,500

26

Table of Contents

(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)
		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 September 30, 2017, Using Quoted Prices in Active Markets for Identical Assets (Level 1)			Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
		Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Available-for-Sale Securities:						
Government Agency & Government-Sponsored Entities	\$ 3,169	\$ -	\$ 3,169	\$ -		
US Treasury Notes	144,410	144,410	-	-		
US Govt SBA	31,691	-	31,691	-		
Mortgage Backed Securities	276,043	-	276,043	-		
Other	1,010	200	310	500		
Total Assets Measured at Fair Value On a Recurring Basis	\$ 456,323	\$ 144,610	\$ 311,213	\$ 500		

Fair values for Level 2 available-for-sale investment securities are based on quoted market prices for similar securities. During the three and nine-months ended September 30, 2018 and 2017, there were no transfers in or out of Level 1, 2, or 3.

The available for sale investment security categorized as a Level 3 asset consisted of one investment in a limited liability company that purchases SBA loans. The balances in the investment were \$2.5M, \$2.5M and \$500,000 at September 30, 2018, December 31, 2017 and September 30, 2017, respectively. 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 September 30, 2018, December 31, 2017, and September 30, 2017.

Table of Contents

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 September 30, 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	\$ 2,596	\$ -	\$ -	\$ 2,596
Residential 1st Mortgage	1,476	-	-	1,476
Home Equity Lines and Loans	71	-	-	71
Commercial	1,478	-	-	1,478
Total Impaired Loans	5,621	-	-	5,621
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	\$ 6,494	\$ -	\$ -	\$ 6,494

(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:				
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

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

Total Other Real Estate	873	-	-	873
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 6,054	\$ -	\$ -	\$ 6,054

28

Table of Contents

(in thousands)	Fair Value Total	Fair Value Measurements At September 30, 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	\$ 2,594	\$ -	\$ -	\$ 2,594
Residential 1st Mortgage	491	-	-	491
Home Equity Lines and Loans	78	-	-	78
Agricultural	298	-	-	298
Commercial	1,519	-	-	1,519
Total Impaired Loans	4,980	-	-	4,980
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	\$ 5,853	\$ -	\$ -	\$ 5,853

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 September 30, 2018:

(in thousands)	Fair Value	Valuation Technique	Unobservable Inputs	Range, Weighted Avg.	
Impaired Loans					
Commercial Real Estate	\$ 2,596	Income Approach	Capitalization Rate	3.25%, 3.25	%
Residential 1st Mortgage	\$ 1,476	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% -4%, 3	%
Home Equity Lines and Loans	\$ 71	Sales Comparison Approach	Adjustment for Difference Between Comparable Sales	1% - 2%, 1 2.95% - 8.70%,	%
Commercial	\$ 1,478	Income Approach	Capitalization Rate	3.40	%

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

29

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:

September 30, 2018 (in thousands)	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets for Identical Assets (Level 1)				Total Estimated Fair Value
		Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)			
Assets:						
Cash and Cash Equivalents	\$ 110,781	\$ 110,781	\$ -	\$ -		\$ 110,781
Investment Securities Available-for-Sale	458,311	164,409	291,402	2,500		458,311
Investment Securities Held-to-Maturity	51,459	-	35,716	15,663		51,379
FHLB Stock	10,877	N/A	N/A	N/A		N/A
Loans & Leases, Net of Deferred Fees & Allowance	2,363,535	-	-	2,317,185		2,317,185
Accrued Interest Receivable	14,612	-	14,612	-		14,612
Liabilities:						
Deposits	2,776,923	2,314,600	457,526	-		2,772,126
Subordinated Debentures	10,310	-	7,579	-		7,579
Accrued Interest Payable	1,227	-	1,227	-		1,227

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

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	144,364	334,732	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

30

Table of Contents

September 30, 2017 (in thousands)	Carrying Amount	Fair Value of Financial Instruments Using Quoted Prices in Active Markets for Identical Assets (Level 1)				Total Estimated Fair Value
		Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)			
Assets:						
Cash and Cash Equivalents	\$193,270	\$ 193,270	\$ -	\$ -		\$ 193,270
Total Investment Securities Available-for-Sale	456,323	144,610	311,213	500		456,323
Total Investment Securities Held-to-Maturity	55,542	-	39,254	17,037		56,291
FHLB Stock	10,342	N/A	N/A	N/A		N/A
Total Loans & Leases, Net of Deferred Fees & Allowance	2,166,035	-	-	2,148,524		2,148,524
Accrued Interest Receivable	11,498	-	11,498	-		11,498
Liabilities:						
Total Deposits	2,709,427	2,159,654	547,796	-		2,707,450
Subordinated Debentures	10,310	-	6,589	-		6,589
Accrued Interest Payable	939	-	939	-		939

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. On May 8, 2018, the Board of Directors declared a mid-year cash dividend of \$6.90 per share, a 2.2% increase over the \$6.75 per share paid on July 1, 2017. The cash dividend was paid on July 2, 2018, to shareholders of record on June 8, 2018.

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 and nine months ended September 30, 2018 and 2017.

(net income in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net Income	\$ 12,000	\$ 8,581	\$ 32,491	\$ 24,589
Weighted Average Number of Common Shares Outstanding	793,418	810,291	807,129	809,002
Basic Earnings Per Common Share Amount	\$ 15.12	\$ 10.59	\$ 40.26	\$ 30.39

7.Shareholders' Equity

During the nine months ended September 30, 2018, the Company issued a combined total 13,520 shares of common stock to the Bank's non-qualified defined contribution retirement plans. There were also 2,400 shares issued to individuals during the third quarter of 2018. All of the shares were issued at prices ranging from \$635.00 to \$690.00

per share based upon valuations completed during the quarter of issuance 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.

On July 31, 2018, Farmers & Merchants Bancorp purchased 44,503 shares of the Company's Common Stock from the estate of a former Director. The purchase price was \$700.00 per share for a total consideration of Thirty One Million One Hundred Fifty-Two Thousand One Hundred Dollars (\$31,152,100). After the transaction, the Company remained "well capitalized" under the regulatory framework for prompt corrective action.

Table of Contents

During the first and third quarters of 2017, the Company issued a combined total 4,975 shares of common stock to the Bank's non-qualified defined contribution retirement plans. These shares were issued at prices ranging from \$590.00 to \$595.00 per share based upon valuations completed during the quarter of issuance 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.

8. Investment In Bank of Rio Vista

Over the past year, Farmers & Merchants Bancorp acquired 1,586, or 39.65%, of the outstanding common shares of Bank of Rio Vista for \$12.0 million.

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 the remaining 40.35% of the outstanding common shares of Bank of Rio Vista. The transaction closed on October 10, 2018. See Note 10 – Subsequent Events for further information.

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 nine months ended September 30, 2018, the Company's recorded investment in Bank of Rio Vista increased by \$381,000, based upon the earnings of Bank of Rio Vista that are attributed to the Company's ownership.

9. 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.

Table of Contents

Accounting Guidance Pending Adoption at September 30, 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.

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.

10. Subsequent Events

On October 10, 2018, Farmers & Merchants Bancorp completed the acquisition of the Bank of Rio Vista. In the transaction, the shareholders of Bank of Rio Vista owning 2,414 shares, or 60.35% of the outstanding common shares, received \$28.7 million in cash. Over the past year, Farmers & Merchants Bancorp 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.

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 and nine months ended September 30, 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.

Table of Contents

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; and (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.

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-eight 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 which was converted to a full service branch 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 ("BORV"). This transaction closed on October 10, 2018 (see Note 10 for additional information).

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 exceeded 80% of seasonal averages, but snow levels were modest. Fortunately, reservoir levels are high and the availability of water this 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 and nine months ended September 30, 2018, Farmers & Merchants Bancorp reported net income of \$12,000,000 and \$32,491,000, earnings per share of \$15.12 and \$40.26 and return on average assets of 1.55% and

1.41%, respectively. Return on average shareholders' equity was 15.97% and 14.24% for the three and nine months ended September 30, 2018.

Table of Contents

For the three and nine months ended September 30, 2017, Farmers & Merchants Bancorp reported net income of \$8,581,000 and \$24,589,000, earnings per share of \$10.59 and \$30.39 and return on average assets of 1.13% and 1.10%, respectively. Return on average shareholders' equity was 11.54% and 11.28% for the three and nine months ended September 30, 2017.

The following is a summary of the financial results for the nine-month period ended September 30, 2018 compared to September 30, 2017.

- Net income increased 32.1% to \$32.5 million from \$24.6 million.
- Earnings per share increased 32.5% to \$40.26 from \$30.39.
- Total assets increased 3.6% to \$3.2 billion from \$3.1 billion.
- Total loans & leases increased 9.0% to \$2.4 billion from \$2.2 billion.
- Total deposits increased 2.5% to \$2.8 billion from \$2.7 billion.

The primary reasons for the Company's \$3.7 million or 9.6% increase in pre-tax income in the first nine months of 2018 as compared to the same period of 2017 were:

· A \$11.4 million increase in net interest income related to the growth in earning assets and the improvement in the net interest margin.

This positive impact was partially offset by:

- A \$1.5 million increase in the net loss on the sale of investment securities.
- A \$2.8 million increase in salaries and employee benefits.
- A \$1.6 million increase in legal and other expenses primarily related to the acquisition of the Bank of Rio Vista.
- A \$900,000 decrease in the gain on sale of fixed assets due to the sale of one of our properties in the first half of the prior year (2017).
- A \$414,000 increase in non-interest expense related to a non-recurring gain on sale of ORE in the prior year (2017) and was recorded as a reduction to non-interest expense.
- A \$483,000 increase in the provision for credit losses.

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 and nine-month periods ended September 30, 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 "taxable 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.

Table of Contents

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.”

36

Table of Contents

Farmers & Merchants Bancorp
 Quarterly Average Balances and Interest Rates
 (Interest and Rates on a Taxable Equivalent Basis)
 (in thousands)

Assets	Balance	Three Months Ended Sept 30, 2018			Three Months Ended Sept 30, 2017		
		Interest	Rate	Balance	Interest	Rate	
Interest Bearing Deposits with Banks	\$ 127,570	\$ 638	1.98 %	\$ 189,647	\$ 648	1.36 %	
Investment Securities:							
U.S. Treasuries	49,530	181	1.46 %	80,985	224	1.11 %	
U.S. Govt SBA	18,136	97	2.14 %	32,458	162	2.00 %	
Government Agency & Government-Sponsored Entities	3,052	22	2.88 %	3,098	22	2.84 %	
Obligations of States and Political Subdivisions - Non-Taxable	51,667	497	3.85 %	56,036	663	4.73 %	
Mortgage Backed Securities	287,599	1,754	2.44 %	282,477	1,623	2.30 %	
Other	3,011	21	2.79 %	1,010	6	2.38 %	
Total Investment Securities	412,995	2,572	2.49 %	456,064	2,700	2.37 %	
Loans & Leases:							
Real Estate	1,666,801	21,416	5.10 %	1,565,218	18,889	4.79 %	
Home Equity Lines & Loans	38,193	533	5.54 %	32,705	430	5.22 %	
Agricultural	283,078	3,760	5.27 %	260,398	3,083	4.70 %	
Commercial	290,588	3,867	5.28 %	258,574	3,041	4.67 %	
Consumer	6,298	98	6.17 %	5,872	73	4.93 %	
Other	1,382	8	2.30 %	1,678	9	2.13 %	
Leases	98,316	1,277	5.15 %	80,629	966	4.75 %	
Total Loans & Leases	2,384,656	30,959	5.15 %	2,205,074	26,491	4.77 %	
Total Earning Assets	2,925,221	\$ 34,169	4.63 %	2,850,785	\$ 29,839	4.15 %	
Unrealized (Loss) Gain on Securities Available-for-Sale	(7,668)			1,334			
Allowance for Credit Losses	(51,831)			(49,889)			
Cash and Due From Banks	47,381			45,084			
All Other Assets	191,562			198,054			
Total Assets	\$ 3,104,665			\$ 3,045,368			
Liabilities & Shareholders' Equity							
Interest Bearing Deposits:							
Interest Bearing DDA	\$ 619,697	\$ 509	0.33 %	\$ 553,394	\$ 321	0.23 %	
Savings and Money Market	830,680	467	0.22 %	812,749	340	0.17 %	
Time Deposits	467,443	1,044	0.89 %	579,527	982	0.67 %	
Total Interest Bearing Deposits	1,917,820	2,020	0.42 %	1,945,670	1,643	0.34 %	
Federal Home Loan Bank Advances	46	-	0.00 %	0	0	0.00 %	
Subordinated Debentures	10,310	137	5.27 %	10,310	115	4.43 %	
Total Interest Bearing Liabilities	1,928,176	\$ 2,157	0.44 %	1,955,980	\$ 1,758	0.36 %	

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

Interest Rate Spread		4.19%		3.80%
Demand Deposits (Non-Interest Bearing)	832,752		741,839	
All Other Liabilities	43,239		50,210	
Total Liabilities	2,804,167		2,748,029	
Shareholders' Equity	300,498		297,339	
Total Liabilities & Shareholders' Equity	\$3,104,665		\$3,045,368	
Impact of Non-Interest Bearing Deposits and Other Liabilities		0.15%		0.11%
Net Interest Income and Margin on Total Earning Assets	32,012	4.34%	28,081	3.91%
Tax Equivalent Adjustment	(104)		(231)	
Net Interest Income	\$ 31,908	4.33%	\$ 27,850	3.88%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$1.3 million and \$1.4 million for the quarters ended September 30, 2018 and 2017, respectively. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp

Year-to-Date Average Balances and Interest Rates

(Interest and Rates on a Taxable Equivalent Basis)

(in thousands)

Assets	Balance	Nine Months Ended Sept. 30, 2018			Nine Months Ended Sept. 30, 2017		
		Interest	Rate	Balance	Interest	Rate	
Interest Bearing Deposits with Banks	\$ 131,509	\$ 1,737	1.77%	\$ 142,717	\$ 1,155	1.08%	
Investment Securities:							
U.S. Treasuries	69,374	728	1.40%	82,441	665	1.08%	
U.S. Govt SBA	24,559	339	1.84%	34,125	412	1.61%	
Government Agency & Government-Sponsored Entities	3,063	66	2.87%	3,109	66	2.83%	
Obligations of States and Political Subdivisions - Non-Taxable	53,120	1,536	3.86%	56,945	2,026	4.74%	
Mortgage Backed Securities	308,835	5,578	2.41%	291,179	5,013	2.30%	
Other	3,010	60	2.66%	1,010	17	2.24%	
Total Investment Securities	461,961	8,307	2.40%	468,809	8,199	2.33%	
Loans & Leases:							
Real Estate	1,607,127	60,612	5.04%	1,561,675	55,021	4.71%	
Home Equity Lines & Loans	36,221	1,464	5.40%	32,109	1,217	5.07%	
Agricultural	265,812	10,127	5.09%	266,205	9,015	4.53%	
Commercial	281,664	10,933	5.19%	233,853	8,064	4.61%	
Consumer	5,795	240	5.54%	5,592	221	5.28%	
Other	1,382	23	2.23%	1,679	28	2.23%	
Leases	93,484	3,531	5.05%	77,508	2,704	4.66%	
Total Loans & Leases	2,291,485	86,930	5.07%	2,178,621	76,270	4.68%	
Total Earning Assets	2,884,955	\$ 96,974	4.49%	2,790,147	\$ 85,624	4.10%	
Unrealized Gain on Securities							
Available-for-Sale	(7,064)			746			
Allowance for Credit Losses	(51,113)			(48,887)			
Cash and Due From Banks	46,448			44,896			
All Other Assets	190,733			190,732			
Total Assets	\$ 3,063,959			\$ 2,977,634			
Liabilities & Shareholders' Equity							
Interest Bearing Deposits:							
Interest Bearing DDA	\$ 596,872	\$ 1,086	0.24%	\$ 516,867	\$ 723	0.19%	
Savings and Money Market	823,595	1,130	0.18%	802,778	954	0.16%	
Time Deposits	472,460	2,738	0.77%	584,773	2,675	0.61%	
Total Interest Bearing Deposits	1,892,927	4,954	0.35%	1,904,418	4,352	0.31%	
Federal Home Loan Bank							
Advances	16	-	0.00%	1	-	0.00%	
Subordinated Debentures	10,310	385	4.99%	10,310	320	4.15%	
Total Interest Bearing Liabilities	1,903,253	\$ 5,339	0.38%	1,914,729	\$ 4,672	0.33%	

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

Interest Rate Spread		4.12%		3.78%
Demand Deposits (Non-Interest Bearing)	813,129		721,808	
All Other Liabilities	43,352		50,394	
Total Liabilities	2,759,734		2,686,931	
Shareholders' Equity	304,225		290,703	
Total Liabilities & Shareholders' Equity	\$3,063,959		\$2,977,634	
Impact of Non-Interest Bearing Deposits and Other Liabilities		0.13%		0.10%
Net Interest Income and Margin on Total Earning Assets	91,635	4.25%	80,952	3.88%
Tax Equivalent Adjustment	(320)		(705)	
Net Interest Income	\$ 91,315	4.23%	\$ 80,247	3.85%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of \$4.2 million and \$3.6 million for the nine months ended September 30, 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

(in thousands)	Three Months Ended			Nine Months Ended		
	Sept. 30, 2018 compared to Sept. 30, 2017			Sept. 30, 2018 compared to Sept. 30, 2017		
	Volume	Rate	Net Chg.	Volume	Rate	Net Chg.
Interest Earning Assets						
Interest Bearing Deposits with Banks	\$ (250)	\$ 239	\$ (11)	(97)	679	\$ 582
Investment Securities:						
U.S. Treasuries	(102)	59	(43)	(116)	179	63
U.S. Govt SBA	(76)	11	(65)	(126)	53	(73)
Government Agency & Government-Sponsored Entities	-	-	-	(1)	1	-
Obligations of States and Political Subdivisions - Non-Taxable	(49)	(116)	(165)	(130)	(359)	(489)
Mortgage Backed Securities	29	102	131	312	253	565
Other	14	2	16	39	4	43
Total Investment Securities	(184)	58	(126)	(22)	131	109
Loans & Leases:						
Real Estate	1,265	1,262	2,527	1,635	3,956	5,591
Home Equity Lines & Loans	76	27	103	163	85	247
Agricultural	282	395	677	(13)	1,125	1,112
Commercial	400	426	826	1,777	1,092	2,869
Consumer	5	20	25	8	11	19
Other	(2)	1	(1)	(5)	-	(5)
Leases	225	85	310	591	235	826
Total Loans & Leases	2,251	2,216	4,467	4,156	6,504	10,659
Total Earning Assets	1,817	2,513	4,330	4,037	7,314	11,350
Interest Bearing Liabilities						
Interest Bearing Deposits:						
Interest Bearing DDA	42	146	188	123	240	363
Savings and Money Market	8	119	127	25	151	176
Time	(211)	273	62	(573)	636	63
Total Interest Bearing Deposits	(161)	538	377	(425)	1,027	602
Subordinated Debentures	-	22	22	-	65	65
Total Interest Bearing Liabilities	(161)	560	399	(425)	1,092	667
Total Change on a Tax Equivalent Basis	\$ 1,978	\$ 1,953	\$ 3,931	\$ 4,462	\$ 6,222	\$ 10,683

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

Third Quarter 2018 vs. Third Quarter 2017

Net interest income for the third quarter of 2018 increased 14.6% or \$4.1 million to \$31.9 million. On a fully taxable equivalent basis, net interest income increased 14.0% and totaled \$32 million for the third quarter of 2018. As more fully discussed below, the increase in net interest income was due primarily to a \$74.4 million increase in average earning assets, and a 43 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 September 30, 2018, the Company's net interest margin was 4.34% compared to 3.91% for the quarter ended September 30, 2017. This increase in net interest margin was due primarily to an increase in the yield received on earning assets, offset somewhat by an increase in the rates paid on interest bearing liabilities.

Average loans & leases totaled \$2.4 billion for the quarter ended September 30, 2018; an increase of \$179.6 million compared to the average balance for the quarter ended September 30, 2017. Loans & leases increased from 77.4% of average earning assets at September 30, 2017 to 81.5% at September 30, 2018. The annualized yield on the Company's loan & lease portfolio increased to 5.15% for the quarter ended September 30, 2018, compared to 4.77% for the quarter ended September 30, 2017. Overall, the positive impact on interest revenue from the increase in loan & lease balances and rising yields resulted in interest revenue from loans & leases increasing 16.9% to \$31 million for quarter ended September 30, 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 \$413.0 million for the quarter ended September 30, 2018; a decrease of \$43.1 million compared to the average balance for the quarter ended September 30, 2017. Tax equivalent interest income on securities decreased \$126,000 to \$2.6 million for the quarter ended September 30, 2018, compared to \$2.7 million for the quarter ended September 30, 2017. The average investment portfolio yield, on a tax equivalent basis, was 2.49% for the quarter ended September 30, 2018, compared to 2.37% for the quarter ended September 30, 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 Statement 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 currently earn interest at 2.20%. Average interest bearing deposits with banks for the quarter ended September 30, 2018, were \$127.6 million, a decrease of \$62.1 million compared to the average balance for the quarter ended September 30, 2017. Interest income on interest bearing deposits with banks for the quarter ended September 30, 2018, decreased \$11,000 to \$637,000 compared to the quarter ended September 30, 2017.

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

Average interest-bearing liabilities decreased \$27.8 million or 1.4% during the third quarter of 2018. Of that decrease: (1) interest-bearing transaction deposits increased \$66.3 million; (2) savings and money market deposits increased \$17.9 million; (3) time deposits decreased \$112.1 million (see “Financial Condition – Deposits”); (4) Federal Home Loan Bank (“FHLB”) Advances increased \$46,000 (see “Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings”); and (5) subordinated debt remained unchanged (see “Financial Condition – Subordinated Debentures”).

40

Table of Contents

Total interest expense on interest bearing deposits was \$2.0 million for the third quarter of 2018 as compared to \$1.6 million for the third quarter of 2017. The average rate paid on interest-bearing deposits was 0.42% for the third quarter of 2018 compared to 0.34% for the third quarter of 2017. As a result of the increase in market interest rates over the past 27 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 rates and net interest margin.

Nine Months Ending September 30, 2018 vs. Nine Months Ending September 30, 2017

During the first nine months of 2018, net interest income increased 13.8% to \$91.3 million, compared to \$80.2 million at September 30, 2017. On a fully taxable equivalent basis, net interest income increased 13.2% and totaled \$91.6 million at September 30, 2018, compared to \$81.0 million at September 30, 2017. The increase in net interest income was due primarily to a \$94.8 million increase in average earning assets, and a 37 basis point increase in the net interest margin.

For the nine months ended September 30, 2018, the Company's net interest margin was 4.25% compared to 3.88% for the same period in 2017. This increase in net interest margin was due primarily to an increase in the yield received on earning assets, offset somewhat by an increase in the rates paid on interest bearing liabilities.

The average balance of loans & leases increased by \$112.9 million for the nine months ended September 30, 2018 compared to the nine months ended September 30, 2017. The yield on the loan & lease portfolio increased 39 basis points to 5.07% for the nine months ended September 30, 2018 compared to 4.68% for the nine months ended September 30, 2017. This increase in yield was enhanced by the increase in the average balance of loans resulting in interest income from loans & leases increasing 14.0% or \$10.7 million for the first nine months of 2018.

Average investment securities were \$462 million for the nine months ended September 30, 2018 compared to \$468.8 million for the same period in 2017. The average tax equivalent yield for the nine months ended September 30, 2018 was 2.40% compared to 2.33% for the nine months ended September 30, 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 Statement of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Average interest bearing deposits with banks consisted primarily of FRB deposits. Balances with the FRB currently earn interest at 2.20%. Average interest bearing deposits with banks for the nine-months ended September 30, 2018, was \$131.5 million, a decrease of \$11.2 million compared to the average balance for the nine-months ended September 30, 2017. Interest income on interest bearing deposits with banks for the nine-months ended September 30, 2018, increased \$582,000 to \$1.7 million compared to the nine-months ended September 30, 2017.

Average interest-bearing liabilities decreased \$11.5 million or 0.60% during the nine months ended September 30, 2018 as compared to the nine months ended September 30, 2017. Of that decrease: (1) interest-bearing transaction deposits increased \$80.0 million; (2) savings and money market deposits increased \$20.8 million; (3) time deposits decreased \$112.3 million (see "Financial Condition – Deposits"); and (4) subordinated debt remained unchanged (see "Financial Condition – Subordinated Debentures").

Total interest expense on interest bearing deposits was \$5.0 million for the first nine months of 2018 as compared to \$4.4 million for the first nine months of 2017. The average rate paid on interest-bearing deposits was 0.35% in the first nine months of 2018 and 0.31% in the first nine months of 2017.

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.

Table of Contents

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.

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:

42

Table of Contents

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.

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.

Table of Contents

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 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 September 30, 2018, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

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 exceeded 80% of seasonal averages, but snow levels were modest. Fortunately, reservoir levels are high and the availability of water this 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 \$3.3 million provision for credit losses during the first nine months of 2018 compared to \$2.9 million for the same period in 2017. Net charge-offs during the first nine months of 2018 were \$608,000 compared to net charge-offs of \$25,000 in the first nine months 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.

Table of Contents

After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of September 30, 2018, was adequate.

(in thousands)	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Balance at Beginning of Period	\$ 51,137	\$ 49,064	\$ 50,342	\$ 47,919
Charge-Offs	(634)	(54)	(723)	(230)
Recoveries	64	134	115	205
Provision	2,500	1,600	3,333	2,850
Balance at End of Period	\$ 53,067	\$ 50,744	\$ 53,067	\$ 50,744

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

September 30, 2018	Commercial	Agricultural	Real Estate	Residential	Home Equity	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
	Real Estate	Real Estate	Estate Construction	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	-	-	-	(12)	(14)	-	(613)	(84)	-	-	(723)
Recoveries	-	-	-	12	4	40	19	40	-	-	115
Provision	(31)	1,422	(372)	59	284	4	1,029	142	430	366	3,333
Ending Balance-											
September 30, 2018	\$ 10,891	\$ 13,507	\$ 1,474	\$ 874	\$ 2,598	\$ 8,203	\$ 9,632	\$ 307	\$ 3,793	\$ 1,788	\$ 53,067
Third Quarter Allowance for Credit Losses:											
Beginning Balance-											
July 1, 2018	\$ 10,783	\$ 13,314	\$ 1,616	\$ 864	\$ 2,548	\$ 7,658	\$ 9,436	\$ 270	\$ 3,400	\$ 1,248	\$ 51,137
Charge-Offs	-	-	-	-	(10)	-	(599)	(25)	-	-	(634)
Recoveries	-	-	-	6	2	27	16	13	-	-	64
Provision	108	193	(142)	4	58	518	779	49	393	540	2,500
Ending Balance-											
September 30, 2018	\$ 10,891	\$ 13,507	\$ 1,474	\$ 874	\$ 2,598	\$ 8,203	\$ 9,632	\$ 307	\$ 3,793	\$ 1,788	\$ 53,067

The Allowance for Credit Losses at September 30, 2018 increased \$2.7 million from December 31, 2017. The allowance allocated to the following portfolio segments changed materially during the first nine months of 2018:

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

The allowance for agricultural real estate loans increased \$1.4 million due to balance increases in this portfolio segment, along with a \$9.3 million increase in substandard loans related primarily to one borrower.

The allowance for commercial loans increased \$1.0 million primarily due to balance increases in this portfolio segment.

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.

45

Table of Contents

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.

Third Quarter 2018 vs. Third Quarter 2017

Non-interest income increased \$570,000 or 15.7% for the three months ended September 30, 2018, compared to the same period of 2017. This increase was due to a \$205,000 increase in the net gain on deferred compensation investments, and \$217,000 related to the Company's portion of the income of BORV, which is accounted for on the equity method. See Note 8 for additional information.

Nine Months Ending September 30, 2018 vs. Nine Months Ending September 30, 2017

Non interest income decreased \$1.4 million or 11.3% for the nine months ended September 30, 2018 compared to the same period of 2017. This decrease was primarily due to a \$1.5 million decrease resulting from a loss on the sale of investment securities. This decrease was partially offset by a \$201,000 increase in the net gain on deferred compensation investments and increased debit card and ATM fees.

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.

Third Quarter 2018 vs. Third Quarter 2017

Overall, non-interest expense increased \$2.3 million or 14.2% for the three months ended September 30, 2018, compared to the same period in 2017. This increase was primarily comprised of: (1) a \$1.5 million increase in salaries and employee benefits; (2) a \$241,000 increase in occupancy and equipment; (3) a \$210,000 increase in legal expense primarily related to the acquisition of BORV; and (4) a \$190,000 write-off of capitalized development costs for a branch construction project that has been postponed.

Nine Months Ending September 30, 2018 vs. Nine Months Ending September 30, 2017

Non-interest expense increased \$5.4 million or 10.6% for the nine months ended September 30, 2018, compared to the same period of 2017. This increase was primarily comprised of: (1) a \$2.8 million increase in salaries and employee benefits; (2) a \$1.6 million increase in legal and other expenses primarily related to the acquisition of BORV; and (3) a \$414,000 increase in non-interest expense related to a non-recurring gain on sale of ORE in the prior year (2017) that was recorded as a reduction to non-interest expense.

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 40.1% to \$3.0 million for the third quarter of 2018 compared to the third quarter of 2017 primarily as a result of: (1) the Federal corporate tax rate change and (2) as a result of tax planning, the Company has amended and plans to amend tax returns in open tax years resulting in a reduction of \$990,000 in the company's tax provision this quarter. See "Note 1. Significant Accounting Policies - Out of Period Adjustment." The effective tax rate for the third quarter of 2018 was 20.0% compared to 36.8% for the third quarter of 2017.

The provision for income taxes decreased 29.7% to \$9.9 million for the first nine months of 2018. The Company's effective tax rate for the first nine months of 2018 was 23.4% compared to 36.5% for the same period in 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 statutory rate of 42% 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.

Table of Contents

Financial Condition

This section discusses material changes in the Company's balance sheet at September 30, 2018, as compared to December 31, 2017 and to September 30, 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 September 30, 2018 was \$509.8 million compared to \$536.1 million at the end of 2017, a decrease of \$26.3 million or 4.9%. At September 30, 2017, the investment portfolio totaled \$511.9 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.

The Company's total investment portfolio currently represents 16.0% of the Company's total assets as compared to 17.4% at December 31, 2017, and 16.7% at September 30, 2017.

As of September 30, 2018, the Company held \$51.5 million of municipal investments, of which \$35.8 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 September 30, 2018, ninety-nine 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 one percent (\$295,000) 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 primarily of FRB deposits. The FRB pays interest on the deposits that banks maintain in their FRB accounts (currently 2.20%), 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 \$58.1 million at September 30, 2018, \$121.2 million at December 31, 2017 and \$149.1 million at September 30, 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 September 30, 2018, December 31, 2017 and September 30, 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.

Table of Contents

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.

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.

Table of Contents

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).

Overall, the Company's loan & lease portfolio at September 30, 2018 totaled \$2.4 billion, an increase of \$199.8 million or 9.0% over September 30, 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 September 30, 2018 increased \$201.3 million from \$2.2 billion at December 31, 2017.

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)	September 30, 2018		December 31, 2017		September 30, 2017	
	\$	%	\$	%	\$	%
Commercial Real Estate	\$ 774,837	31.9 %	\$ 691,639	31.1 %	\$ 689,732	31.0 %
Agricultural Real Estate	553,608	22.8 %	499,231	22.5 %	470,738	21.2 %
Real Estate Construction	92,521	3.8 %	100,206	4.5 %	162,167	7.3 %
Residential 1st Mortgages	263,549	10.9 %	260,751	11.7 %	257,920	11.6 %
Home Equity Lines and Loans	38,490	1.6 %	34,525	1.6 %	33,350	1.5 %
Agricultural	287,821	11.9 %	273,582	12.3 %	259,127	11.7 %
Commercial	304,333	12.6 %	265,703	12.0 %	257,951	11.6 %
Consumer & Other	7,723	0.3 %	6,656	0.3 %	7,312	0.3 %
Leases	101,081	4.2 %	88,957	4.0 %	84,485	3.8 %
Total Gross Loans & Leases	2,423,963	100.0 %	2,221,250	100.0 %	2,222,782	100.0 %
Less: Unearned Income	7,361		5,955		6,003	
Subtotal	2,416,602		2,215,295		2,216,779	

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

Less: Allowance for Credit Losses	53,067	50,342	50,744
Net Loans & Leases	\$2,363,535	\$2,164,953	\$2,166,035

49

Table of Contents

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 September 30, 2018, classified loans totaled \$16.3 million compared to \$8.9 million at December 31, 2017 and \$9.8 million at September 30, 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. At September 30, 2018 and December 31, 2017, non-accrual loans & leases totaled \$0. At September 30, 2017, non-accrual loans & leases totaled \$4,000.

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.

As of September 30, 2018, restructured loans & leases on accrual totaled \$13.6 million as compared to \$6.3 million at December 31, 2017. Restructured loans on accrual at September 30, 2017 were \$6.2 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.

Table of Contents

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)	September 30, 2018	Dec. 31, 2017	September 30, 2017
Non-Performing Loans & Leases	\$ 0	\$ 0	\$ 4
Other Real Estate	873	873	873
Total Non-Performing Assets	\$ 873	\$ 873	\$ 877
Non-Performing Loans & Leases as a % of Total Loans & Leases			
	0.00	% 0.00	% 0.00
Restructured Loans & Leases (Performing)	\$ 13,551	\$ 6,301	\$ 6,202

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 \$0, \$0, and \$4,000 have been established for non-performing loans & leases at September 30, 2018, December 31, 2017 and September 30, 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 nine months ended September 30, 2018, \$0 for the year ended December 31, 2017, and \$483 for the nine months ended September 30, 2017.

The Company reported \$873,000 of ORE at September 30, 2018, December 31, 2017, September 30, 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 September 30, 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 strengthened throughout most of the Central Valley, for the most part 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 exceeded 80% of seasonal averages, but snow levels were modest. Fortunately, reservoir levels are high and the availability of water this 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 agricultural industry is facing challenges associated with: (1) weakness in export markets due to a stronger dollar and 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.

In addition to the other information set forth in this report, readers should carefully consider the factors discussed in “Part I, Item 1A. Risk Factors” in the Company’s 2017 Annual Report on Form 10-K.

Table of Contents

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 September 30, 2018 have increased \$67.5 million or 2.5% compared to September 30, 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; (2) the Company's expansion of its service area into Walnut Creek and Concord. Market interest rates have been increasing over the past 24 months, resulting in significant competitive pressures on deposit rates. The Company remains selective in how they respond to competitor rates, which may impact future deposit growth

Although total deposits have increased 2.5% since September 30, 2017, importantly, low cost transaction accounts have grown at a strong pace:

- Demand and interest-bearing transaction accounts increased \$138.0 million or 10.36% since September 30, 2017.
- Savings and money market accounts have increased \$17.0 million or 2.0% since September 30, 2017.

Time deposit accounts have decreased \$87.4 million or 15.9% since September 30, 2017, primarily due to the Company's decision not to renew \$55.0 million in high rate public funds time deposit accounts from the State of California.

The Company's deposit balances at September 30, 2018 have increased \$53.7 million or 2.0% compared to December 31, 2017. Savings and money market deposits increased 3.8% or \$30.9 million while demand and interest-bearing transaction accounts increased by \$35.9 million or 2.5% and time deposit accounts decreased by \$13.1 million or 2.7%. Deposit trends in the first nine months 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 September 30, 2018, December 31, 2017, or September 30, 2017. There were no Federal Funds purchased or advances from the FRB at September 30, 2018, December 31, 2017 or September 30, 2017.

As of September 30, 2018, the Company has additional borrowing capacity of \$537.6 million with the Federal Home Loan Bank and \$433.5 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 5.18% as of September 30, 2018, 4.45% at December 31, 2017 and 4.17% at September 30, 2017. The average rate paid for these securities for the first nine months of 2018 was 4.99% and 4.15% for the first nine months 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.

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 \$300.1 million at September 30, 2018, \$299.7 million at December 31, 2017, and \$302.6 million at September 30, 2017.

Table of Contents

The Company and the Bank are subject to various federal regulatory capital requirements under the Basel III Capital Rules. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's 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 and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company 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. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. 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 September 30, 2018						
Total Capital Ratio	\$351,093	12.37%	\$227,048	8.0 %	N/A	N/A
Common Equity Tier 1 Capital Ratio	\$305,397	10.76%	\$127,714	4.5 %	N/A	N/A
Tier 1 Capital Ratio	\$315,397	11.11%	\$170,286	6.0 %	N/A	N/A
Tier 1 Leverage Ratio	\$315,397	10.12%	\$124,718	3.0 %	N/A	N/A

(in thousands)	Actual		Current Regulatory Capital Requirements		Well Capitalized Under Prompt Corrective Action	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
The Bank:						
As of September 30, 2018						
Total Capital Ratio	\$338,695	11.99%	\$226,049	8.0 %	\$282,562	10.0 %
Common Equity Tier 1 Capital Ratio	\$303,153	10.73%	\$127,153	4.5 %	\$183,665	6.5 %
Tier 1 Capital Ratio	\$303,153	10.73%	\$169,537	6.0 %	\$226,049	8.0 %

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

Tier 1 Leverage Ratio	\$303,153	9.78 %	\$123,985	3.0 %	\$154,982	5.0 %
-----------------------	-----------	--------	-----------	-------	-----------	-------

53

Table of Contents

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 November 6, 2018, the Board of Directors approved an extension of the \$20 million stock repurchase program over the three-year period ending December 31, 2021. 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 in 2017 and in the third quarter of 2018 the Company repurchased \$31.2 million of shares. 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.

During the second and third quarters of 2018, the Company issued a combined total 13,520 shares of common stock to the Bank’s non-qualified defined contribution retirement plans. There were also 2,400 shares issued to individuals during the third quarter of 2018. All of the shares were issued at prices ranging from \$635.00 to \$690.00 per share based upon valuations completed during the quarter of issuance 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.

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.

Table of Contents

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)	September 30, 2018	December 31, 2017	September 30, 2017
Commitments to Extend Credit	\$ 789,169	\$ 735,678	\$ 700,747
Letters of Credit	20,176	20,061	19,225
Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties	-	759	1,479

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 September 30, 2018, December 31, 2017, and September 30, 2017. We do not anticipate any material losses as a result of these transactions.

Other Matter

During the 3rd quarter of 2018, Moss Adams, the Company's independent registered public accounting firm, identified that the concurring review partner who performed the initial engagement quality review on the March and June 2018 Interim Financial Statements had completed five consecutive years of service, and therefore, was not eligible to serve in this role.

Upon identification of the matter, the lead audit partner advised the Company's Executive Vice President & Chief Financial Officer and Audit Committee Chairman of the independence violation and Moss Adams' plans for reperforming the engagement quality review.

On October 1, 2018, another Moss Adams audit partner commenced the reperformance of the engagement quality reviews of the March and June 2018 Interim Financial Statements in accordance with AS 1220. The results of the review reaffirmed the original conclusions reached.

On October 9, 2018, the Company's Audit Committee held a meeting and discussed the independence violation. The Committee's conclusions were that: (i) notwithstanding the circumstances, they believed Moss Adams maintained appropriate objectivity and impartiality in performance of the reviews; (ii) a reasonable investor would conclude that the independence violation did not impair Moss Adams' ability to be objective and exercise impartial judgment in connection with its reviews of the 2018 Interim Financial Statements; and (iii) a reasonable investor would conclude that Moss Adams continuing to serve as auditor of the Company is appropriate.

Accordingly, the Company will continue to engage Moss Adams to perform its 2018 independent audit.

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.

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.

Table of Contents

Management believes, that based upon the preceding methodology, and using information currently available, the allowance for credit losses at September 30, 2017 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 200 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 September 30, 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 2.72% if rates increase by 200 basis points and a decrease in net interest income of 6.52% if rates decline 200 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.

57

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 September 30, 2018, the Company has additional borrowing capacity of \$537.6 million with the FHLB and \$433.5 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 September 30, 2018, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities AFS of approximately \$247 million, which represents 7.75% 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.

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.

58

Table of Contents

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

There were 44,503 shares repurchased by Farmers & Merchants Bancorp during the first nine months of 2018.

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.

During the nine months ended September 30, 2018, the Company issued a combined total 13,520 shares of common stock to the Bank's non-qualified defined contribution retirement plans. There were also 2,400 shares issued to individuals during the third quarter of 2018. All of the shares were issued at prices ranging from \$635.00 to \$690.00 per share based upon valuations completed during the quarter of issuance 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.

During the first and third quarters of 2017, the Company issued a combined total 4,975 shares of common stock to the Bank's non-qualified defined contribution retirement plans. These shares were issued at prices ranging from \$590.00 to \$595.00 per share based upon valuations completed during the quarter of issuance 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.

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.

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

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

101.LAB XBRL Label Linkbase Document
101.PRE
XBRL Presentation Linkbase Document
101.DEF
XBRL Definition Linkbase Document

59

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: November 8, 2018 /s/ Kent A. Steinwert

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

Date: November 8, 2018 /s/ Stephen W. Haley

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