

FARMERS & MERCHANTS BANCORP INC

Form 10-Q

November 05, 2009

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**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, 2009**

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 0-14492
FARMERS & MERCHANTS BANCORP, INC.
(Exact name of registrant as specified in its charter)**

OHIO

34-1469491

(State or other jurisdiction of
incorporation or organization)

(I.R.S Employer
Identification No.)

307-11 North Defiance Street, Archbold, Ohio

43502

(Address of principal executive offices)

(Zip Code)

(419) 446-2501

Registrant's telephone number, including area code

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 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, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting 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

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

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

Common Stock, No Par Value

4,734,674

Class

Outstanding as of November 3, 2009

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ITEM 1 FINANCIAL STATEMENTS

FARMERS & MERCHANTS BANCORP, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (Unaudited)
 (in thousands of dollars)

| | September 30, 2009 | Dec 31, 2008 |
|---------------------------------------------------------------------------------------|-----------------------|-----------------------|
| ASSETS: | | |
| Cash and due from banks | \$ 10,812 | \$ 19,148 |
| Interest bearing deposits with banks | 13,475 | 0 |
| Federal funds sold | 10,685 | 1,739 |
| Investment Securities: | | |
| U.S. Treasury | 5,362 | 0 |
| U.S. Government | 133,204 | 134,501 |
| State & political obligations | 52,051 | 43,160 |
| All others | 4,498 | 4,498 |
| Loans and leases (Net of reserve for loan losses of \$7,447 and \$5,497 respectively) | 553,314 | 562,336 |
| Bank premises and equipment-net | 16,076 | 16,806 |
| Accrued interest and other assets | 22,178 | 19,467 |
| Goodwill | 4,074 | 4,074 |
| TOTAL ASSETS | \$ 825,729 | \$ 805,729 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| LIABILITIES: | | |
| Deposits: | | |
| Noninterest bearing | \$ 59,430 | \$ 62,582 |
| Interest bearing | 583,372 | 553,150 |
| Federal funds purchased and securities sold under agreement to repurchase | 48,730 | 48,214 |
| Other borrowed money | 34,404 | 45,635 |
| Accrued interest and other liabilities | 6,780 | 5,601 |
| Total Liabilities | 732,716 | 715,182 |
| SHAREHOLDERS EQUITY: | | |
| Common stock, no par value authorized 6,500,000 shares; issued 5,200,000 shares | 12,677 | 12,677 |
| Treasury Stock - 437,551 shares 2009, 376,913 shares 2008 | (9,162) | (8,727) |
| Unearned Stock Awards 27,875 for 2009 and 23,575 for 2008 | (495) | (503) |
| Undivided profits | 86,703 | 84,864 |
| Accumulated other comprehensive income (expense) | 3,290 | 2,236 |
| Total Shareholders Equity | 93,013 | 90,547 |
| LIABILITIES AND SHAREHOLDERS EQUITY | \$ 825,729 | \$ 805,729 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

Note: The December 31, 2008 Balance Sheet has been derived from the audited financial statements of that date.

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FARMERS & MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(in thousands of dollars, except per share data)

| | Three Months Ended | | Nine Months Ended | |
|-------------------------------------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2009 | September 30, 2008 | September 30, 2009 | September 30, 2008 |
| INTEREST INCOME: | | | | |
| Loans and leases | \$ 8,301 | \$ 8,652 | \$ 25,284 | \$ 26,421 |
| Investment Securities: | | | | |
| U.S. Treasury securities | 2 | | 2 | |
| Securities of U.S. Government agencies | 1,269 | 1,673 | 4,171 | 5,032 |
| Obligations of states and political subdivisions | 446 | 430 | 1,273 | 1,275 |
| Other | 54 | 59 | 152 | 171 |
| Federal funds | 4 | 3 | 16 | 262 |
| Deposits in banks | 5 | | 18 | |
| Total Interest Income | 10,081 | 10,817 | 30,916 | 33,161 |
| INTEREST EXPENSE: | | | | |
| Deposits | 2,719 | 3,655 | 8,407 | 12,150 |
| Borrowed funds | 502 | 777 | 1,714 | 2,194 |
| Total Interest Expense | 3,221 | 4,432 | 10,121 | 14,344 |
| NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES | | | | |
| | 6,860 | 6,385 | 20,795 | 18,817 |
| PROVISION FOR LOAN LOSSES | 1,433 | 33 | 3,171 | 482 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | | | | |
| | 5,427 | 6,352 | 17,624 | 18,335 |
| OTHER INCOME: | | | | |
| Service charges | 885 | 908 | 2,382 | 2,587 |
| Other | 798 | 539 | 2,639 | 2,075 |
| Net securities gains (losses) | | | 147 | 15 |
| | 1,683 | 1,447 | 5,168 | 4,677 |
| OTHER EXPENSES: | | | | |
| Salaries and wages | 2,097 | 2,303 | 6,246 | 6,419 |
| Pension and other employee benefits | 825 | 746 | 2,386 | 2,419 |
| Occupancy expense (net) | 314 | 300 | 910 | 761 |
| Other operating expenses | 2,184 | 2,008 | 7,261 | 6,001 |
| | 5,420 | 5,357 | 16,803 | 15,600 |
| INCOME BEFORE FEDERAL INCOME TAX | | | | |
| | 1,690 | 2,442 | 5,989 | 7,412 |

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| | | | | |
|-------------------------------------------------------|-----------|-----------|-----------|-----------|
| FEDERAL INCOME TAXES | 414 | 659 | 1,582 | 2,022 |
| NET INCOME | \$ 1,276 | \$ 1,783 | \$ 4,407 | \$ 5,390 |
| OTHER COMPREHENSIVE INCOME (NET OF TAX): | | | | |
| Unrealized gains (losses) on securities | 1,455 | 692 | 1,054 | (326) |
| COMPREHENSIVE INCOME (EXPENSE) | \$ 2,731 | \$ 2,475 | \$ 5,461 | \$ 5,064 |
| NET INCOME PER SHARE | \$ 0.27 | \$ 0.37 | \$ 0.93 | \$ 1.11 |
| Based upon average weighted shares outstanding of: | 4,731,841 | 4,822,467 | 4,743,656 | 4,868,996 |
| DIVIDENDS DECLARED | \$ 0.18 | \$ 0.18 | \$ 0.54 | \$ 0.50 |

No disclosure of diluted earnings per share is required as shares are antidiluted as of quarter end.
See Notes to Condensed Consolidated Unaudited Financial Statements.

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FARMERS & MERCHANTS BANCORP, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(in thousands of dollars)

| | Nine Months Ended | |
|--------------------------------------------------------------------------------------|-----------------------|-----------------------|
| | September 30, 2009 | September 30, 2008 |
| <i>CASH FLOWS FROM OPERATING ACTIVITIES:</i> | | |
| Net income | \$ 4,407 | \$ 5,390 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Depreciation and amortization | 1,105 | 897 |
| Premium amortization | 617 | 287 |
| Discount amortization | (76) | (78) |
| Amortization of servicing rights | 828 | 301 |
| Amortization of core deposit intangible | 118 | 118 |
| Provision for loan losses | 3,171 | 482 |
| (Gain) Loss on sale of fixed assets | 48 | 108 |
| (Gain) Loss on sale of investment securities | (147) | (15) |
| Changes in Operating Assets and Liabilities: | | |
| Accrued interest receivable and other assets | (3,363) | (1,159) |
| Accrued interest payable and other liabilities | 302 | (520) |
| Net Cash Provided by Operating Activities | 7,010 | 5,811 |
| <i>CASH FLOWS FROM INVESTING ACTIVITIES</i> | | |
| Capital expenditures | (385) | (991) |
| Proceeds from sale of fixed assets | 8 | |
| Proceeds from maturities of investment securities: | 61,679 | 57,609 |
| Proceeds from sale of investment securities: | 4,219 | 25 |
| Purchase of investment securities | (77,661) | (54,420) |
| Net (increase) decrease in loans and leases | 5,851 | (19,543) |
| Net Cash Provided (Used) by Investing Activities | (6,289) | (17,320) |
| <i>CASH FLOWS FROM FINANCING ACTIVITIES</i> | | |
| Net increase (decrease) in deposits | 27,070 | (35,884) |
| Net change in short-term borrowings | 516 | 11,617 |
| Increase in long-term borrowings | | 17,000 |
| Payments on long-term borrowings | (11,231) | (5,384) |
| Purchase of Treasury stock | (555) | (2,847) |
| Payment of Stock Awards | 128 | 98 |
| Payments of dividends | (2,564) | (2,353) |
| Net Cash Provided (Used) by Financing Activities | 13,364 | (17,753) |
| Net change in cash and cash equivalents | 14,085 | (29,262) |
| Cash and cash equivalents Beginning of year | 20,887 | 48,887 |

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| | | | | |
|----------------------------------------------|-------------------|-----------|----|--------|
| CASH AND CASH EQUIVALENTS | END OF THE PERIOD | \$ 34,972 | \$ | 19,625 |
| RECONCILIATION OF CASH AND CASH EQUIVALENTS: | | | | |
| Cash and cash due from banks | | \$ 10,812 | \$ | 19,006 |
| Interest bearing deposits with banks | | 13,475 | | |
| Federal funds sold | | 10,685 | | 619 |
| | | \$ 34,972 | \$ | 19,625 |

See Notes to Condensed Consolidated Unaudited Financial Statements.

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FARMERS & MERCHANTS BANCORP, INC.

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10Q and Rule 10-01 of Regulation S-X; accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2009 are not necessarily indicative of the results that are expected for the year ended December 31, 2009. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2008.

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

INTRODUCTION

Farmers & Merchants Bancorp, Inc. (the Company) was incorporated on February 25, 1985, under the laws of the State of Ohio. Farmers & Merchants Bancorp, Inc., and its subsidiary The Farmers & Merchants State Bank (the Bank) are engaged in commercial banking. The executive offices of the Company are located at 307 North Defiance Street, Archbold 43502.

As the new year began, the banking industry along with the rest of the business world continued to feel the impact of the slow and difficult economy. As lending rates continued downward the Bank found itself very active in making home mortgage real estate and home equity loans. Customers were taking advantage of the low interest rate and were refinancing their existing mortgages. This activity continued through the second quarter. While rates remain attractive, activity has slowed in the third quarter and is likely to continue to slow during the fourth quarter, especially as the tax credit disappears in November. The gain on sale of real estate to the secondary market through September 2009 was two and a half times as compared to the same time period of 2008.

The Bank also chose to sell off a portion of the security portfolio, mainly securities that were outside the state of Ohio. The Bank replaced these securities with Ohio based securities to help support pledging to the Ohio Public accounts that are deposited with the Bank. The sales produced a favorable gain on securities for the Bank of almost \$150 thousand for 2009.

Two major factors to the lower profitability of 2009 for the Bank has been the increased FDIC assessment on deposits and the cost of increasing the loan loss allowance. FDIC increases constitutes a huge burden to community banks across the nation that have not participated in risky or questionable activities, but none-the-less must pay for those who did. With the special assessment of the second quarter, the Bank has expensed over an additional million dollars in 2009 as compared to 2008. With the tough economy, the Bank has expensed over \$2.5 million more in 2009 than in 2008 to fund the loan allowance. Until the economy shows sustained improvement, the Bank will remain conservative in its analysis of the loan allowance. These additional expenses have been offset by favorable actions that have enabled the Bank to remain a profitable, solid and secure financial institution which continues to serve its shareholders and customers.

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

CRITICAL ACCOUNTING POLICY AND ESTIMATES

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, and the Company follows general practices within the industries in which it operates. At times the application of these principles requires Management to make assumptions, estimates and judgments that affect the amounts reported in the financial statements. These assumptions, estimates and judgments are based on information available as of the date of the financial statements. As this information changes, the financial statements could reflect different assumptions, estimates and judgments. Certain policies inherently have a greater reliance on assumptions, estimates and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Examples of critical assumptions, estimates and judgments are when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not required to be recorded at fair value warrants an impairment write-down or valuation reserve to be established, or when an asset or liability must be recorded contingent upon a future event.

Based on the valuation techniques used and the sensitivity of financial statement amounts to assumptions, estimates, and judgments underlying those amounts, management has identified the determination of the Allowance for Loan and Lease Losses (ALLL), the valuation of its Mortgage Servicing Rights and the valuation of its post retirement benefit liability as the accounting areas that requires the most subjective or complex judgments, and as such have the highest possibility of being subject to revision as new information becomes available.

The ALLL represents management's estimate of credit losses inherent in the Bank's loan portfolio at the report date. The estimate is a composite of a variety of factors including past experience, collateral value and the general economy. ALLL includes a specific portion, a formula driven portion, and a general nonspecific portion.

Subsequent events have been evaluated through November 3, 2009, which is the date the financial statements were available to be issued.

FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

Cash and Cash Equivalents

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

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

Securities and Other Securities

Fair values for securities, excluding Federal Home Loan Bank stock and Federal Reserve Bank stock, are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. The carrying value of Federal Home Loan Bank and Federal Reserve Bank stock approximates fair value based on the redemption provisions of the Federal Home Loan Bank and the Federal Reserve Bank.

Loans

Most commercial and real estate mortgage loans are made on a variable rate basis. For those variable-rate loans that re-price frequently, and with no significant change in credit risk, fair values are based on carrying values. The fair values of the fixed rate and all other loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality.

Deposits

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

Borrowings

Short-term borrowings are carried at cost that approximates fair value. Other long-term debt was generally valued using a discounted cash flow analysis with a discounted rate based on current incremental borrowing rates for similar types of arrangements, or if not available, based on an approach similar to that used for loans and deposits.

Accrued Interest Receivable and Payable

The carrying amounts of accrued interest approximate their fair values.

Dividends Payable

The carrying amounts of dividends payable approximate their fair values and are generally paid within forty days of declaration.

Off Balance Sheet Financial Instruments

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

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)****Off Balance Financial Sheet Financial Instruments (Continued)**

The estimated fair values, and related carrying or notional amounts, for on and off-balance sheet financial instruments as of September 30, 2009 and December 31, 2008 are reflected below.

(In Thousands)

| | September 30, 2009 | | December 31, 2008 | |
|------------------------------------------------|--------------------|------------|-------------------|------------|
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial Assets | | | | |
| Cash and Cash Equivalents | \$ 34,972 | \$ 34,972 | \$ 20,887 | \$ 20,887 |
| Securities-available for sale | 190,617 | 190,617 | 177,661 | 177,661 |
| Other Securities | 4,498 | 4,498 | 4,498 | 4,498 |
| Loans, net | 553,314 | 512,647 | 562,336 | 562,049 |
| Interest Receivable | 4,731 | 4,731 | 4,048 | 4,048 |
| Financial Liabilities | | | | |
| Deposits | 642,802 | \$631,212 | \$615,732 | \$614,495 |
| Short-term Debt | | | | |
| Repurchase Agreement Sold | 48,730 | 48,730 | 48,214 | 48,214 |
| Long Term Debt | 34,404 | 31,730 | 45,635 | 44,940 |
| Interest Payable | 1,308 | 1,308 | 907 | 907 |
| Dividends Payable | 852 | 852 | 857 | 857 |
| Off-Balance Sheet Financial Instruments | | | | |
| Commitments to extend credit | \$ | \$ | \$ | \$ |
| Standby Letters of Credit | | | | |

Fair Value Measurements

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring basis at September 30, 2009, and the valuation techniques used by the Company to determine those fair values.

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

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

Level 3 inputs are unobservable inputs, including inputs that are available in situations where there is little, if any, market activity for the related asset or liability.

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

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)****Fair Value Measurements (Continued)**

Disclosures concerning assets and liabilities measured at fair value are as follows:

Assets and Liabilities Measured at Fair Value on a Recurring Basis at September 30, 2009

(\$ in Thousands)

| | | Quoted Prices in Active Markets for Identical | Significant Observable Inputs (Level 2) | Significant Observable Inputs (Level 3) | Balance at September 30, 2009 |
|-------------|-------------------------------|--------------------------------------------------------|--------------------------------------------------|--------------------------------------------------|-------------------------------------|
| Assets | Securities Available for Sale | \$ 138,566 | \$ 52,051 | \$ 0 | \$ 190,617 |
| Liabilities | | \$ 0 | \$ 0 | \$ 0 | \$ 0 |

The Company did not have any assets or liabilities measured at fair value that were categorized as Level 3 during the period. All of the Company's available for sale securities, including any bonds issued by local municipalities, have CUSIP numbers making them marketable and comparable as Level 2.

The Company also has assets that, under certain conditions, are subject to measurement at fair value on a non-recurring basis. At September 30, 2009, such assets consist primarily of impaired loans. The Company has established the fair values of these assets using Level 3 inputs, specifically discounted cash flow projections. During the quarter ended September 30, 2009, the impairment charges recorded to the income statement for impaired loans were not significant.

Impaired loans accounted for under FAS 114 categorized as Level 3 assets consist of non-homogeneous loans that are considered impaired. The Company estimates the fair value of the loans based on the present value of expected future cash flows using management's best estimate of key assumptions. These assumptions include future payment ability, timing of payment streams, and estimated realizable values of available collateral (typically based on outside appraisals).

Other assets, including bank owned life insurance, are also subject to periodic impairment assessments under other accounting principles generally accepted in the United States of America. These assets are not considered financial instruments. Effective February 12, 2008, the FASB issued a staff position, FSP FAS 157-2, which delayed the applicability of FAS 157 to non-financial instruments. Accordingly, these assets have been omitted from the above disclosures.

LIQUIDITY, CAPITAL RESOURCES AND MATERIAL CHANGES IN FINANCIAL CONDITION

In comparing the balance sheet of September 30, 2009 to that of December 31, 2008, the liquidity of the Bank remains strong with a movement of money from cash and due banks to interest bearing deposits with banks. The Bank has taken advantage of the Federal Reserve Bank's payment of interest on excess funds. The Federal Funds rate is extremely low at 0.25% but does at least allow for a measure of interest income on these funds. The Bank monitors the rate paid by the Federal Reserve versus the Federal Fund Sold rate offered through correspondent banks and that accounts for the movement on this area of the balance sheet. Overall, cash and cash equivalents increased over \$14 million and securities increased an additional \$13 million. Of the additional \$13 million in investment securities only \$280 thousand was needed to pledge to offset public deposits. The Company's increased liquidity came from a decrease in Bank's loan portfolio and an

Table of Contents**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS (Continued)****LIQUIDITY, CAPITAL RESOURCES AND MATERIAL CHANGES IN FINANCIAL CONDITION**

(Continued)

increase in the Bank's deposits. Borrowings from the Federal Home Loan Bank were also decreased by \$11 million. Liquidity remains strong and the Bank has money to lend to credit worthy customers.

Net loans show a decrease of \$9 million for the nine months ended September 30, 2009. Approximately \$2 million of the decrease is due to the increase of the loan loss reserve. This is in addition to \$1.1 million of net charge-offs for the nine months of 2009 decreasing the net loan balance. However it is important to note that even with the tough economy, net charge-offs only increased \$158 thousand over 2008's level. Overall, total assets of the Company increased \$20 million from December 31, 2008 to September 30, 2009.

Deposits increased \$27 million led by the success of the Bank's offering of a high interest bearing transaction account along with an increase in health savings accounts. The success of this product is also the reason for the continued movement of deposits out of non-interest bearing to interest bearing.

Capital increased almost \$2.5 million from year-end during the nine months of 2009. The increase occurred even though funds were utilized to purchase additional shares of treasury stock. The unrealized gain on the Bank's market value of securities accounted for \$1 million of the increase. The Company repurchased 171,889 shares during the 2008 fiscal year and continued with an additional 28,907 shares in the first two quarters of 2009. No shares were purchased during the third quarter of 2009. In terms of dollars spent, 2008 purchases cost just under \$3.6 million and 2009 purchases cost just over \$555 thousand. The Company has authorization to purchase up to 225 thousand shares during 2009.

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

| | |
|-----------------------------------|--------|
| Primary Ratio | 11.36% |
| Tier I Leverage Ratio | 10.47% |
| Risk Based Capital Tier I | 13.35% |
| Total Risk Based Capital | 14.57% |
| Stockholders' Equity/Total Assets | 11.26% |

As stated previously, net loans decreased \$9 million during the first three quarters of 2009. Past due loans over 30 days ended September 30, 2009 at 2.87% compared to December 31, 2008 past due percentage of 2.82%. Driving the percentage is the commercial and agricultural portfolios. Those same loans are affecting the non-accrual balances of the Bank. A loan is placed in non-accrual automatically once it has reached 90 days past due. The balance in non-accruals increased \$3.9 million during the nine months of 2009 as compared to the December 31, 2008 level.

Residential mortgage delinquency remains under three percent and consumer loan is less than one third of a percent. A discussion of the additional impact to profitability caused by the non-accruals will follow in the discussion of results of operations.

Unlike many of the industry headlines, the Bank has not experienced losses due to the subprime mortgage market. The Bank did not participate in subprime lending and the local economies have dealt more with decreased working hours and bonuses. Issues in the 1-4 family real estate portfolio have dealt mainly with rental and non-owner occupied properties.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS

Interest Income

Interest income and yield on the loan portfolio is not down as significantly in 2009 as compared to 2008 at this time as is interest expense. 2008 loan interest income was low by having had \$458 thousand deducted for reversal of interest income to the loans whose status went to nonaccrual. While the nonaccrual balance remains high in 2009, previous interest has not had to be reversed by as large an amount as in 2008. Interest income on nonaccruals may be recorded when collected in cash when the borrower does not have a charge-off or a specific allocation amount in the loan loss reserve, but overall, the high nonaccrual balances remain a barrier to higher profitability.

The low rate environment of 2008 and 2009 also impacted the yield of the portfolio. Lines of credit, adjustable rate mortgages subject to repricing, home equities and new loans all priced considerably lower in 2009 versus 2008. This was the other large factor in the lower interest income.

While the security portfolio increased, the yields on the new securities were significantly lower than the average rate on the portfolio. 2009 interest income from the investment portfolio was \$880 thousand lower than the first nine months of 2008. Many mortgage related bonds were called and replaced with lower yielding securities.

The lower interest rate of 2009 also impacted the Federal Funds interest income. However, the main reason for the large decrease was the difference in average balances in the portfolio. The Bank had a large amount of cash in 2008 with the acquisition transaction of December 31, 2007.

Overall, interest income was down \$2.2 million in comparing the first nine months of 2009 to 2008 and down \$736 thousand when comparing the September quarter end results of 2009 to 2008.

Interest Expense

The decrease in interest expense outpacing the decrease in interest income remains a bright spot in the performance of 2009. Interest expense for the nine months ended September 30, 2009 decreased over \$4.2 million in 2009 compared to the same 2008 period. For the third quarter ended 2009, the number was \$1.2 million lower than same quarter last year - nearly one half million lower than the loss of interest income. The Bank continued to have certificates of deposit price lower as they renewed during 2009. Interest on borrowed funds was also lower as loans were paid off and not replaced due to the increased liquidity position of the Bank.

Overall, the decrease in interest expense outpaced the decrease in interest income, and net interest income was almost \$2 million higher for the nine months ended September 2009 as compared to the same 2008 period. Third quarter 2009 was \$475 thousand higher as compared to 2008. Net interest income should continue to increase as the Bank continues to work to reduce the amount of loans in nonaccrual, maintains a smaller cash position, and lastly works to increase the yield on loans with the addition of floors and wider spreads on renewing loans.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Provision Expense

Provision for loan loss was \$2.7 million higher for the nine months ended September 2009 as compared to the same 2008 period. As mentioned earlier, the continuation of a large balance in nonaccrual loans along with challenging economic conditions warranted a higher provision to the loan loss reserve. For the quarter ended September 30th, \$1.4 million more was expensed to increase for the reserve for the additional \$3.8 million added to non-accruals during the third quarter. The net charge-off position was only slightly higher in 2009 by approximately \$158 thousand compared to 2008. The Bank remains conservative in its views of the loan loss reserve.

Non-interest Income

Non-interest income increased by \$491 thousand for the nine months ended September 2009 as compared to the same 2008 period. Just under one third of the increase was due to the gain on sale of securities mentioned earlier. Service charges were down as consumers decreased their use of overdraft privilege and overall overdrafts (in terms of number of items) decreased. Other non-interest income showed significant growth. The largest driver for improvement was the increased revenue from the mortgage refinance activity, specifically gain on sale of real estate loans and mortgage servicing rights. A lower interest rate environment and the tax credit being provided by the Federal Government have helped to generate the mortgage activity. The Bank recognizes income from the sale of those loans in the secondary market and also from establishing the value of retaining the rights to service the mortgage. In general, the Bank earns .25% for servicing the account over its life.

Non-interest Expense

Non-interest expense was \$1.2 million higher for 2009 as compared to 2008 as of September 30th. The third quarter was \$63 thousand higher comparing 2009 to 2008. One more office was opened and operated in 2009 than during the same period 2008. Full time equivalent employees were 251 as of September 30, 2009 compared to 262 as of September 30, 2008. At December 31, 2008, there were 258 and 255 as of June 30, 2009. This decreasing trend correlates to lower salaries and wages. For 2009, the expense was \$173 thousand lower in comparing to the nine months ended period of 2008. It was \$206 thousand lower in comparing just the third quarter due to a lower incentive accrual. Pension and other benefits are also lower due to newer employees and a focus on switching to the use of health savings accounts and a higher deductible plan. The Bank intends to have all employees in one plan for 2010. Occupancy expense is higher with the addition of the office in Angola, Indiana in the second half of 2008. The newest location operates from a leased property. It is expected to be profitable on a monthly basis within 18 months. The challenging economic conditions have also resulted in an increase of over \$1.3 million in other expense for the nine months ended as of September 30, 2009 compared to 2008. This increase is based primarily on a \$1 million increase in FDIC assessments, the doubling of legal fees for collection over last year, and a one half million dollar increase in mortgage servicing rights expense. As a secondary mortgage loan is rewritten, any remaining existing servicing right must be completely expensed when the new loan is processed with a new value assigned to the servicing right. This results in increased income but also the correlating expense.

High volume in the consumer indirect auto portfolio also related to an increased expense in the payment of dealers reserve. The cash for clunkers stimulus and the overall strategies of competitors temporarily leaving the market, created increased volume in the Bank's portfolio. This expense is three times higher than same period last year by \$145.5 thousand.

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

MATERIAL CHANGES IN RESULTS OF OPERATIONS (Continued)

Net Income

Overall, net income was down \$983 thousand in comparing 2009 to 2008 first three quarters performance. \$507 thousand of that difference occurred in the performance of the three months ended September 30th to the same three months last year. The Company expects for the performance to continue to be a challenge as another special FDIC assessment is possible in the second half. The Company remains positioned for continued improvement in the net interest margin as loans continue to reprice with floors and spread added. The Company continues to focus on positioning the balance sheet for a neutral rate position going forward. The Company does remain, however, a reflection of the local economy in which it operates. To the degree that the local economies continue to deal with slow downs, the Company will be hampered to achieve its goals. In comparison to peer, the Company continues to show better strength and performance.

FORWARD LOOKING STATEMENTS

Statements contained in this portion of the Company's report may be forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements may be identified by the use of words such as intend, believe, expect, anticipate, should, planned, estimated, and potential. Such forward-looking statements are based on current expectations, but may differ materially from those currently anticipated due to a number of factors, which include, but are not limited to, factors discussed in documents filed by the Company with the Securities and Exchange Commission from time to time. Other factors which could have a material adverse effect on the operations of the company and its subsidiaries which include, but are not limited to, changes in interest rates, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Bank's market area, changes in relevant accounting principles and guidelines and other factors over which management has no control. The forward-looking statements are made as of the date of this report, and the Company assumes no obligation to update the forward-looking statements or to update the reasons why actual results differ from those projected in the forward-looking statements.

ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates and equity prices. The primary market risk to which the Company is subject is interest rate risk. The majority of the Company's interest rate risk arises from the instruments, positions and transactions entered into for purposes, other than trading, such as lending, investing and securing sources of funds. Interest rate risk occurs when interest bearing assets and liabilities reprice at different times as market interest rates change. For example, if fixed rate assets are funded with variable rate debt, the spread between asset and liability rates will decline or turn negative if rates increase.

Interest rate risk is managed within an overall asset/liability framework for the Company. The principal objectives of asset/liability management are to manage sensitivity of net interest spreads and net income to potential changes in interest rates. Funding positions are kept within predetermined limits designed to ensure that risk-taking is not excessive and that liquidity is properly managed. The Company employs a sensitivity analysis in the form of a net interest rate shock as shown in the table on the following page.

Table of Contents**ITEM 3 QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK**

(Continued)

| Interest Rate Shock on Net Interest Margin | | | Interest Rate Shock on Net Interest Income | | | |
|--------------------------------------------|-----------------------|----------------|--------------------------------------------|--------------------------|-----------------------|--|
| Net Interest Margin (Ratio) | % Change to Flat Rate | Rate Direction | Rate Changes by | Cumulative Total (\$000) | % Change to Flat Rate | |
| 3.02% | -9.161% | Rising | 3.000% | 18,618 | -7.804% | |
| 3.12% | -6.076% | Rising | 2.000% | 19,147 | -5.186% | |
| 3.22% | -3.022% | Rising | 1.000% | 19,672 | -2.584% | |
| 3.33% | 0.000% | Flat | 0.000% | 20,194 | 0.000% | |
| 3.39% | 1.981% | Falling | -1.000% | 20,606 | 2.040% | |
| 3.43% | 3.175% | Falling | -2.000% | 20,757 | 2.791% | |
| 3.44% | 3.578% | Falling | -3.000% | 20,770 | 2.852% | |

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The net interest margin represents the forecasted twelve month margin. It also shows what effect rate changes will have on both the margin and the net interest income. The shock report has consistently shown an improvement in a falling rate environment. The goal of the Company is to lengthen some of the liabilities or sources of funds to decrease the exposure to a raising rate environment. The Bank has offered higher rates on certificates of deposits for longer periods so far during 2009. Of course, customer desires also drive the ability to capture longer term deposits. Currently, the customer looks for terms twelve months and under while the Bank would prefer 24 months and longer. It is often a meeting in the middle that satisfies both.

The Bank continues to remain focused on gaining more relationships per customer as a way to help control the cost of funds also. In the flat and rising rate environment scenario, the model cannot take into account the addition of floors and increased spread on the loan accounts. These are added as the note is renewed and cannot be captured until then. To the extent the Bank is successful in this endeavor, the flat and rising rate scenario will be more profitable than forecasted here.

ITEM 4 CONTROLS AND PROCEDURES

As of September 30, 2009, an evaluation was performed under the supervision and with the participation of the Company's management including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of September 30, 2009. There have been no significant changes in the Company's internal controls that occurred during the quarter ended September 30, 2009.

PART II**ITEM 1 LEGAL PROCEEDINGS**

None

ITEM 1A RISK FACTORS

There have been no material changes in the risk factors disclosed by Registrant in its Report on Form 10-K for the fiscal year ended December 31, 2008.

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ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs | (d) Maximum Number of Shares that may yet be purchased under the Plans or Programs |
|-----------------------|-----------------------------------------------|----------------------------------------------|----------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|
| 7/1/2009 to 7/31/2009 | | | | 196,093 |
| 8/1/2009 to 8/31/2009 | | | | 196,093 |
| 9/1/2009 to 9/30/2009 | | | | 196,093 |
| Total | | | (1) | 196,093 |

(1) The Company could have purchased shares in the market pursuant to a stock repurchase program publicly announced on January 16, 2009. On that date, the Board of Directors authorized the repurchase of 225,000 common shares between January 1, 2009 and December 31, 2009. No shares were repurchased in the third quarter.

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None

ITEM 5 OTHER INFORMATION

ITEM 6 EXHIBITS

- 3.1 Amended Articles of Incorporation of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on August 1, 2006)
- 3.2 Code of Regulations of the Registrant (incorporated by reference to Registrant's Quarterly Report on Form 10-Q filed with the Commission on May 10, 2004)
- 31.1 Rule 13-a-14(a) Certification -CEO
- 31.2 Rule 13-a-14(a) Certification -CFO
- 32.1 Section 1350 Certification - CEO
- 32.2 Section 1350 Certification - CFO

SIGNATURES

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

Farmers & Merchants Bancorp, Inc.,

Date: October 28, 2009

By: /s/ Paul S. Siebenmorgen
Paul S. Siebenmorgen
President and CEO

Date: October 28, 2009

By: /s/ Barbara J. Britenriker
Barbara J. Britenriker
Exec. Vice-President and CFO