

FARMERS & MERCHANTS BANCORP
Form 10-Q
November 06, 2009

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, 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: 000-26099

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

Delaware
(State or other jurisdiction of incorporation or
organization)

94-3327828
(I.R.S. Employer Identification No.)

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

95240
(Zip Code)

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

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

Yes No

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

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

(Do not check if a 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
o No x

Number of shares of common stock of the registrant: Par value \$0.01, authorized 20,000,000 shares; issued and
outstanding 781,405 as of October 31, 2009.

FARMERS & MERCHANTS BANCORP

FORM 10-Q
TABLE OF CONTENTS

| PART I. - FINANCIAL INFORMATION | | Page |
|---------------------------------|--|------|
| Item 1 - | <u>Financial Statements</u> | |
| | <u>Consolidated Balance Sheets as of September 30, 2009 (Unaudited), December 31, 2008 and September 30, 2008 (Unaudited).</u> | 3 |
| | <u>Consolidated Statements of Income (Unaudited) for the Three Months and Nine Months Ended September 30, 2009 and 2008.</u> | 4 |
| | <u>Consolidated Statements of Comprehensive Income (Unaudited) for the Three Months and Nine Months Ended September 30, 2009 and 2008.</u> | 5 |
| | <u>Consolidated Statements of Changes in Shareholders' Equity (Unaudited) for the Nine Months Ended September 30, 2009 and 2008.</u> | 6 |
| | <u>Consolidated Statements of Cash Flows (Unaudited) for the Nine Months Ended September 30, 2009 and 2008.</u> | 7 |
| | <u>Notes to the Consolidated Financial Statements (Unaudited)</u> | 8 |
| Item 2 - | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 15 |
| Item 3 - | <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 32 |
| Item 4 - | <u>Controls and Procedures</u> | 35 |
| PART II. - OTHER INFORMATION | | |
| Item 1 - | <u>Legal Proceedings</u> | 35 |
| Item 1A - | <u>Risk Factors</u> | 35 |
| Item 2 - | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 35 |
| Item 3 - | <u>Defaults Upon Senior Securities</u> | 36 |
| Item 4 - | <u>Submission of Matters to a Vote of Security Holders</u> | 36 |

| | | |
|--------------------------|--------------------------|----|
| Item 5 - | <u>Other Information</u> | 36 |
| Item 6 - | <u>Exhibits</u> | 36 |
| <u>Signatures</u> | | 37 |
| <u>Index to Exhibits</u> | | 37 |

Table of ContentsFARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets (Unaudited)

| (in thousands) | Sept. 30, 2009 | December 31, 2008 | Sept. 30, 2008 |
|---|--------------------|-------------------------|--------------------|
| Assets | | | |
| Cash and Cash Equivalents: | | | |
| Cash and Due From Banks | \$27,954 | \$46,774 | \$51,900 |
| Federal Funds Sold | 1,982 | 14,000 | 28,300 |
| Total Cash and Cash Equivalents | 29,936 | 60,774 | 80,200 |
| Investment Securities: | | | |
| Available-for-Sale | 362,350 | 291,839 | 211,222 |
| Held-to-Maturity | 69,016 | 71,890 | 105,413 |
| Total Investment Securities | 431,366 | 363,729 | 316,635 |
| Loans | | | |
| Loans | 1,215,173 | 1,177,364 | 1,161,506 |
| Less: Allowance for Loan Losses | 25,818 | 20,034 | 18,486 |
| Loans, Net | 1,189,355 | 1,157,330 | 1,143,020 |
| Premises and Equipment, Net | 24,469 | 21,653 | 22,039 |
| Bank Owned Life Insurance | 43,317 | 41,965 | 41,537 |
| Interest Receivable and Other Assets | 46,468 | 38,986 | 49,811 |
| Total Assets | \$1,764,911 | \$1,684,437 | \$1,653,242 |
| Liabilities | | | |
| Deposits: | | | |
| Demand | \$283,169 | \$319,318 | \$281,873 |
| Interest Bearing Transaction | 162,454 | 146,879 | 135,529 |
| Savings | 433,613 | 353,055 | 356,206 |
| Time | 617,793 | 613,450 | 627,095 |
| Total Deposits | 1,497,029 | 1,432,702 | 1,400,703 |
| Securities Sold Under Agreement to Repurchase | 60,000 | 60,000 | 60,000 |
| Federal Home Loan Bank Advances | 663 | 703 | 716 |
| Subordinated Debentures | 10,310 | 10,310 | 10,310 |
| Interest Payable and Other Liabilities | 31,175 | 24,177 | 28,394 |
| Total Liabilities | 1,599,177 | 1,527,892 | 1,500,123 |
| Shareholders' Equity | | | |
| Preferred Stock | - | - | - |
| Common Stock | 8 | 8 | 8 |
| Additional Paid-In Capital | 76,386 | 78,527 | 80,508 |
| Retained Earnings | 83,549 | 72,350 | 71,921 |
| Accumulated Other Comprehensive Gain | 5,791 | 5,660 | 682 |
| Total Shareholders' Equity | 165,734 | 156,545 | 153,119 |
| Total Liabilities & Shareholders' Equity | \$1,764,911 | 1,684,437 | \$1,653,242 |

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

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Income (Unaudited)

(in thousands except per share data)

| | Three Months | | Nine Months | |
|---|---------------------|----------|---------------------|----------|
| | Ended September 30, | | Ended September 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Interest Income | | | | |
| Interest and Fees on Loans | \$18,931 | \$19,294 | \$56,238 | \$58,837 |
| Interest on Federal Funds Sold and Securities Purchased | | | | |
| Under Agreements to Resell | 10 | 137 | 78 | 181 |
| Interest on Investment Securities: | | | | |
| Taxable | 3,412 | 3,122 | 10,373 | 8,434 |
| Tax-Exempt | 722 | 757 | 2,201 | 2,293 |
| Total Interest Income | 23,075 | 23,310 | 68,890 | 69,745 |
| Interest Expense | | | | |
| Deposits | 3,164 | 5,349 | 11,436 | 17,541 |
| Borrowed Funds | 552 | 552 | 1,637 | 1,219 |
| Subordinated Debentures | 90 | 149 | 315 | 491 |
| Total Interest Expense | 3,806 | 6,050 | 13,388 | 19,251 |
| Net Interest Income | | | | |
| Net Interest Income | 19,269 | 17,260 | 55,502 | 50,494 |
| Provision for Loan Losses | 2,215 | 765 | 10,345 | 5,370 |
| Net Interest Income After Provision for Loan Losses | 17,054 | 16,495 | 45,157 | 45,124 |
| Non-Interest Income | | | | |
| Service Charges on Deposit Accounts | 1,840 | 1,866 | 5,183 | 5,381 |
| Net Gain on Investment Securities | 510 | 1 | 2,982 | 536 |
| Credit Card Merchant Fees | 0 | 20 | 0 | 1,109 |
| Increase in Cash Surrender Value of Life Insurance | 444 | 464 | 1,352 | 1,356 |
| ATM Fees | 423 | 321 | 1,209 | 1,072 |
| Net Gain (Loss) on Deferred Compensation Investments | 790 | (1,113) | 1,197 | (1,316) |
| Other | 522 | 904 | 1,853 | 5,152 |
| Total Non-Interest Income | 4,529 | 2,463 | 13,776 | 13,290 |
| Non-Interest Expense | | | | |
| Salaries & Employee Benefits | 7,237 | 6,405 | 21,637 | 20,211 |
| Net Gain (Loss) on Deferred Compensation Investments | 790 | (1,113) | 1,197 | (1,316) |
| Occupancy | 719 | 665 | 2,098 | 2,009 |
| Equipment | 567 | 862 | 1,917 | 1,985 |
| Credit Card Merchant Expense | - | 0 | 0 | 828 |
| ORE Holding Costs | 603 | 564 | 1,269 | 583 |
| FDIC Insurance | 195 | 139 | 1,996 | 396 |
| Other | 1,566 | 1,773 | 5,056 | 5,239 |
| Total Non-Interest Expense | 11,677 | 9,295 | 35,170 | 29,935 |
| Income Before Income Taxes | | | | |
| Income Before Income Taxes | 9,906 | 9,663 | 23,763 | 28,479 |
| Provision for Income Taxes | 3,728 | 3,606 | 8,575 | 10,696 |
| Net Income | \$6,178 | \$6,057 | \$15,188 | \$17,783 |
| Earnings Per Share | \$7.90 | \$7.63 | \$19.39 | \$22.34 |

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 Sept 30, | | Ended Sept 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Net Income | \$6,178 | \$6,057 | \$15,188 | \$17,783 |
| Other Comprehensive Loss - | | | | |
| Unrealized Gains on Securities: | | | | |
| Unrealized holding gains arising during the period, net of income tax provision of \$1,436 and \$894 for the quarters ended September 30, 2009 and 2008, respectively, and of \$1,349 and \$7 for the nine months ended September 30, 2009 and 2008, respectively. | 1,979 | 1,232 | 1,859 | 10 |
| Reclassification adjustment for realized (gains) included in net income, net of related income tax effects of \$(215) and \$0 for the quarters ended September 30, 2009 and 2008, respectively, and of \$(1,254) and \$(225) for the nine months ended September 30, 2009 and 2008, respectively. | (295) | (1) | (1,728) | (311) |
| Total Other Comprehensive Gain (Loss) | 1,684 | 1,231 | 131 | (301) |
| Comprehensive Income | \$7,862 | \$7,288 | \$15,319 | \$17,482 |

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 Income (Loss) | Total Shareholders' Equity |
|--|---------------------------------|-----------------|----------------------------------|----------------------|--|----------------------------------|
| Balance, December 31, 2007 | 800,112 | \$8 | \$84,437 | \$57,990 | \$ 983 | \$ 143,418 |
| Net Income | | - | - | 17,783 | - | 17,783 |
| Cash Dividends Declared on Common Stock | | - | - | (3,852) | - | (3,852) |
| Repurchase of Stock | (8,590) | - | (3,929) | - | - | (3,929) |
| Change in Net Unrealized Gain on Securities Available for Sale | | - | - | - | (301) | (301) |
| Balance, September 30, 2008 | 791,522 | \$8 | \$80,508 | \$71,921 | \$ 682 | \$ 153,119 |
| Balance, December 31, 2008 | 786,960 | \$8 | \$78,527 | \$72,350 | \$ 5,660 | \$ 156,545 |
| Net Income | | - | - | 15,188 | - | 15,188 |
| Cash Dividends Declared on Common Stock | | - | - | (3,989) | - | (3,989) |
| Repurchase of Stock | (5,555) | - | (2,141) | - | - | (2,141) |
| Change in Net Unrealized Gain on Securities Available for Sale | | - | - | - | 131 | 131 |
| Balance, September 30, 2009 | 781,405 | \$8 | \$76,386 | \$83,549 | \$ 5,791 | \$ 165,734 |

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

Table of Contents

FARMERS & MERCHANTS BANCORP

Consolidated Statements of Cash Flows (Unaudited)
(in thousands)Nine Months Ended
Sept 30, Sept 30,
2009 2008

Operating Activities:

| | | |
|---|----------|-----------|
| Net Income | \$15,188 | \$17,783 |
| Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities: | | |
| Provision for Loan Losses | 10,345 | 5,370 |
| Depreciation and Amortization | 1,418 | 838 |
| Net Amortization of Investment Security Discounts & Premium | (2,691) | 88 |
| Net Gain on Investment Securities | (2,982) | (536) |
| Net Gain on Sale of Property & Equipment | (10) | (8) |
| Net Change in Operating Assets & Liabilities: | | |
| Net Increase in Interest Receivable and Other Assets | (8,929) | (13,659) |
| Net Increase in Interest Payable and Other Liabilities | 6,998 | 2,694 |
| Net Cash Provided by Operating Activities | 19,337 | 12,570 |

Investing Activities:

Securities Available-for-Sale:

| | | |
|---|------------|------------|
| Purchased | (217,825) | (131,979) |
| Sold, Matured or Called | 153,224 | 62,808 |
| Securities Held-to-Maturity: | | |
| Purchased | (50) | (4,500) |
| Matured or Called | 2,913 | 4,602 |
| Net Loans Originated or Acquired | (42,545) | (26,183) |
| Principal Collected on Loans Previously Charged Off | 175 | 279 |
| Net Additions to Premises and Equipment | (4,237) | (2,689) |
| Proceeds from Sale of Property and Equipment | 13 | 8 |
| Net Cash Used by Investing Activities | (108,332) | (97,654) |

Financing Activities:

| | | |
|--|-----------|-----------|
| Net Increase in Demand, Interest-Bearing Transaction, and Savings Accounts | 59,984 | 25,966 |
| Increase in Time Deposits | 4,343 | 63,947 |
| Net Increase in Securities Sold Under Agreement to Repurchase | - | 60,000 |
| Net Decrease in Federal Home Loan Bank Advances | (40) | (28,238) |
| Cash Dividends | (3,989) | (3,852) |
| Stock Repurchases | (2,141) | (3,929) |
| Net Cash Provided by Financing Activities | 58,157 | 113,894 |
| (Decrease) Increase in Cash and Cash Equivalents | (30,838) | 28,810 |
| Cash and Cash Equivalents at Beginning of Year | 60,774 | 51,390 |
| Cash and Cash Equivalents as of Sept. 30, 2009 and Sept. 30, 2008 | \$29,936 | \$80,200 |

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

Table of Contents

FARMERS & MERCHANTS BANCORP
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

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

The accounting and reporting policies of the Company conform to accounting principles generally accepted in the United States of America 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 unaudited consolidated interim financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. All adjustments that, in the opinion of management, are necessary for a fair presentation for the periods presented have been reflected as required by Regulation S-X, Rule 10-01. All such adjustments are of a normal, recurring nature.

The accompanying unaudited consolidated interim 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 unaudited consolidated interim financial statements in conformity with accounting principles generally accepted in the United States of America 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.

In May 2009, the FASB issued ASC 855 (formerly Statement No. 165), "Subsequent Events". ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC 855 is effective for interim or annual periods ending after June 15, 2009. The Company adopted the provisions of ASC 855 and has evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements were issued or November 9, 2009. The Company does not believe any subsequent events have occurred that would require further disclosure or adjustment to the financial statements.

Certain amounts in the prior periods' unaudited consolidated interim financial statements and related footnote disclosures have been reclassified to conform to the current-year presentation. These reclassifications have no effect on previously reported income.

8

Table of Contents

2. Investment Securities

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

| (in thousands) September 30, 2009 | Amortized Cost | Gross Unrealized | | Fair/Book Value |
|--|-------------------|------------------|--------|--------------------|
| | | Gains | Losses | |
| Securities of U.S. Government Agencies | \$105,346 | \$340 | \$46 | \$105,640 |
| Obligations of States and Political Subdivisions | 8,404 | 3 | - | 8,407 |
| Mortgage-backed Securities | 229,137 | 9,678 | - | 238,815 |
| Other | 9,470 | 19 | 1 | 9,488 |
| Total | \$352,357 | \$10,040 | \$47 | \$362,350 |

| (in thousands) December 31, 2008 | Amortized Cost | Gross Unrealized | | Fair/Book Value |
|--|-------------------|------------------|--------|--------------------|
| | | Gains | Losses | |
| Obligations of States and Political Subdivisions | \$10,224 | \$7 | \$- | \$10,231 |
| Mortgage-backed Securities | 266,416 | 9,761 | 1 | 276,176 |
| Other | 5,432 | - | - | 5,432 |
| Total | \$282,072 | \$9,768 | \$1 | \$291,839 |

Included with the September 30, 2009 available-for-sale "Other Securities Fair/Book Value" total of \$9.5 million was \$5.4 million of FHLB stock. Included with the December 31, 2008 available-for-sale "Other Securities Fair/Book Value" total of \$5.4 million was \$5.1 million of FHLB stock.

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

| (in thousands) September 30, 2009 | Book Value | Gross Unrealized | | Fair Value |
|--|---------------|------------------|--------|---------------|
| | | Gains | Losses | |
| Obligations of States and Political Subdivisions | \$63,069 | \$2,554 | \$5 | \$65,618 |
| Mortgage-backed Securities | 3,957 | 114 | - | 4,071 |
| Other | 1,990 | - | - | 1,990 |
| Total | \$69,016 | \$2,668 | \$5 | \$71,679 |

| (in thousands) December 31, 2008 | Book Value | Gross Unrealized | | Fair Value |
|--|---------------|------------------|--------|---------------|
| | | Gains | Losses | |
| Obligations of States and Political Subdivisions | \$64,765 | \$529 | \$988 | \$64,306 |
| Mortgage-backed Securities | 5,133 | 107 | - | 5,240 |
| Other | 1,992 | - | - | 1,992 |
| Total | \$71,890 | \$636 | \$988 | \$71,538 |

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.

Table of Contents

The remaining principal maturities of debt securities as of September 30, 2009 are shown in the following tables. Mortgage-Backed Securities are presented based on expected maturities. Expected maturities may differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| Securities Available-for-Sale September 30, 2009 (in thousands) | Within 1 Year | After 1 but Within 5 | After 5 but Within 10 | Over 10 years | Total Fair Value |
|--|------------------|----------------------------|-----------------------------|------------------|------------------------|
| Securities of U.S. Government Agencies | \$- | \$100,554 | \$5,086 | \$- | \$105,640 |
| Obligations of States and Political Subdivisions | 1,018 | - | - | 7,389 | 8,407 |
| Mortgage-backed Securities | - | - | 21,776 | 217,039 | 238,815 |
| Other | 7,468 | 2,020 | - | - | 9,488 |
| Total | \$8,486 | \$102,574 | \$26,862 | \$224,428 | \$362,350 |

| Securities Held-to-Maturity September 30, 2009 (in thousands) | Within 1 Year | After 1 but Within 5 | After 5 but Within 10 | Over 10 years | Total Book Value |
|--|------------------|----------------------------|-----------------------------|------------------|------------------------|
| Obligations of States and Political Subdivisions | \$872 | \$4,600 | \$37,889 | \$19,708 | \$63,069 |
| Mortgage-backed Securities | - | 3,957 | - | - | 3,957 |
| Other | - | - | 10 | 1,980 | 1,990 |
| Total | \$872 | \$8,557 | \$37,899 | \$21,688 | \$69,016 |

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.

| September 30, 2009 (in thousands) | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|--------------------|-------------------|--------------------|-----------------|--------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Securities of U.S. Government Agencies | \$24,939 | \$46 | \$- | \$- | \$24,939 | \$46 |
| Obligations of States and Political Subdivisions | 720 | 5 | - | - | 720 | 5 |
| Mortgage-backed Securities | - | - | - | - | - | - |
| Other | 1,250 | 1 | - | - | 1,250 | 1 |
| Total | \$37,146 | \$52 | \$- | \$- | \$37,146 | \$52 |

| December 31, 2008 (in thousands) | Less Than 12 Months | | 12 Months or More | | Total | |
|---|---------------------|--------------------|-------------------|--------------------|-----------------|--------------------|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Obligations of States and Political Subdivisions | \$24,092 | \$988 | \$- | \$- | \$24,092 | \$988 |
| Mortgage-backed Securities | 9,858 | 1 | - | - | 9,858 | 1 |
| Other | - | - | - | - | - | - |
| Total | \$33,950 | \$989 | \$- | \$- | \$33,950 | \$989 |

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 U.S. Government Agencies and Obligations of States and Political Subdivisions

The unrealized losses on the Company's investments in securities of U.S. government agencies and obligations of states and political subdivisions were caused by interest rate increases. 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 its cost basis, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2009.

Table of Contents

Mortgage-backed Securities

The unrealized losses on the Company's investment in mortgage-backed securities were caused by interest rate increases. The contractual cash flows of these investments are guaranteed by an agency 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 its cost basis, the Company does not consider these investments to be other-than-temporarily impaired at September 30, 2009.

3. Fair Value Disclosures

The Company follows the "Fair Value Measurement and Disclosures" topic of the FASB Accounting Standards Codification which establishes a framework for measuring fair value in generally accepted accounting principles 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, The 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.

Securities classified as available-for-sale are reported at fair value on a recurring basis utilizing Level 2 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 loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with the "Receivable" topic of the FASB Accounting Standards Codification. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value, and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2009, substantially all impaired loans were evaluated based on the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. Otherwise, the Company records the impaired loan as nonrecurring Level 3.

Table of Contents

Other Real Estate (“ORE”) is reported at fair value on a non-recurring basis. When the fair value of the ORE is based on an observable market price or a current appraised value which uses observable data, the Company records the ORE as nonrecurring Level 2. Otherwise, the Company records the ORE as nonrecurring Level 3. Other real estate is reported in Interest Receivable and Other Assets on the Company’s Consolidated Balance Sheets.

The following table presents information about the Company’s assets and liabilities measured at fair value on a recurring basis and indicates the fair value hierarchy of the valuation techniques utilized by the Company to determine such fair value.

| | Fair Value Measurements At September 30, 2009, Using | | | |
|--|---|--|--|--|
| | Fair Value September 30, 2009 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (in thousands) | | | | |
| Available-for-Sale Securities | \$362,350 | \$- | \$362,350 | \$ - |
| Total Assets Measured at Fair Value On a Recurring Basis | \$362,350 | \$- | \$362,350 | \$ - |

The following table presents information about the Company’s assets and liabilities measured 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.

| | Fair Value Measurements At September 30, 2009, Using | | | |
|--|---|--|--|--|
| | Fair Value September 30, 2009 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (in thousands) | | | | |
| Impaired Loans | \$11,614 | \$- | \$11,614 | \$ - |
| Other Real Estate | 3,784 | - | 3,784 | - |
| Total Assets Measured at Fair Value On a Non-Recurring Basis | \$15,398 | \$- | \$15,398 | \$ - |

Impaired loans and ORE are measured for impairment using the fair value of the collateral because the loans/ORE are considered to be collateral dependent. Impaired loans were \$12.6 million with an allowance for loan losses of \$1.0 million and ORE was \$6.9 million with a valuation allowance of \$3.1 million. See “Financial Condition – Classified Loans and Non-Performing Assets” for additional details regarding the mix and trend of impaired loans.

Fair Value of Financial Instruments

Generally accepted accounting principles require 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.

Table of Contents

A summary of the carrying amounts and estimated fair value of financial instruments is as follows:

| (in thousands) | September 30, 2009 | | December 31, 2008 | |
|---|--------------------|----------------------|-------------------|----------------------|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| ASSETS: | | | | |
| Cash and Cash Equivalents | \$29,936 | \$29,936 | \$60,774 | \$60,774 |
| Investment Securities Held-to-Maturity | 69,016 | 71,679 | 71,890 | 71,454 |
| Investment Securities Available-for-Sale | 362,350 | 362,350 | 291,839 | 291,839 |
| Loans, Net of Deferred Loan Origination Fees | 1,215,173 | 1,237,134 | 1,177,364 | 1,192,946 |
| Cash Surrender Value of Life Insurance Policies | 43,317 | 43,317 | 41,965 | 41,965 |
| Accrued Interest Receivable | 8,655 | 8,655 | 7,250 | 7,250 |
| LIABILITIES: | | | | |
| Deposits: | | | | |
| Non-Interest Bearing | 283,169 | 283,169 | 319,318 | 319,318 |
| Interest-Bearing | 1,213,860 | 1,215,678 | 1,113,384 | 1,116,389 |
| FHLB Advances & Securities Sold Under Agreement to Repurchase | 60,663 | 63,656 | 60,703 | 62,434 |
| Subordinated Debentures | 10,310 | 4,372 | 10,310 | 7,441 |
| Accrued Interest Payable | 1,979 | 1,979 | 3,067 | 3,067 |

The methods and assumptions used to estimate the fair value of each class of financial instrument listed in the table above are explained below.

Cash and Cash Equivalents: The carrying amounts reported in the balance sheet for cash and due from banks, federal funds sold, and securities purchased under agreements to resell are a reasonable estimate of fair value.

Investment Securities: Fair values for investment securities are based on quoted market prices or dealer quotes, where available. If quoted market prices or dealer quotes are not available, fair values are based on quoted market prices of comparable instruments.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for fixed-rate loans are estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The carrying amount of accrued interest receivable approximates its fair value.

Cash Surrender Value of Life Insurance Policies: The fair value of life insurance policies are based on cash surrender values at each reporting date as provided by the insurers.

Deposit Liabilities: The fair value of demand deposits, interest bearing transaction accounts, and savings accounts is the amount payable on demand. The fair value of fixed-maturity certificates of deposit is estimated by discounting expected future cash flows utilizing interest rates currently being offered for deposits of similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Borrowings: The fair value for Federal Home Loan Bank borrowings and securities sold under agreement to repurchase are determined using discounted future cash flows.

Subordinated Debentures: Fair values of subordinated debentures were determined based on the current market value of like-kind instruments of a similar maturity and structure.

Limitations: Fair value estimates presented herein are based on pertinent information available to management as of September 30, 2009. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date, and; therefore, current estimates of fair value may differ significantly from the amounts presented above.

Table of Contents

4. Dividends and Earnings Per 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 5, 2009, the Board of Directors of Farmers & Merchants Bancorp declared a mid-year cash dividend of \$5.10 per share, a 5.2% increase over the \$4.85 per share paid on July 1, 2008. The cash dividend was paid on July 1, 2009, to shareholders of record on June 5, 2009.

Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The following table calculates the earnings per share for the three and nine months ended September 30, 2009 and 2008.

| (net income in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|---------|------------------------------------|----------|
| | 2009 | 2008 | 2009 | 2008 |
| Net Income | \$6,178 | \$6,057 | \$15,188 | \$17,783 |
| Average Number of Common Shares Outstanding | 781,878 | 793,407 | 783,298 | 795,855 |
| Per Share Amount | \$7.90 | \$7.63 | \$19.39 | \$22.34 |

5. Recent Accounting Pronouncements

FASB Accounting Standards Codification™ (ASC or Codification): In June 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-01 (formerly Statement No. 168), “Topic 105 - Generally Accepted Accounting Principles - FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles.” The Codification is the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents are superseded and all other accounting literature not included in the Codification is considered nonauthoritative. The Codification is effective for interim or annual reporting periods ending after September 15, 2009. The Company has made the appropriate changes to GAAP references in the financial statements.

Measuring Liabilities at Fair Value: In August 2009, the FASB issued ASU No. 2009-05, “Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value”. This ASU provides amendments for fair value measurements of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more techniques. ASU 2009-05 also clarifies that when estimating a fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance or fourth quarter 2009. The Company is assessing the impact of ASU 2009-05 on our financial condition, results of operations, and disclosures.

FASB Amends Disclosures about Fair Value of Financial Instruments: In April 2009, the FASB issued ASC 825 (formerly FASB Staff Position (FSP) 107-1 and APB 28-1), “Interim Disclosures about Fair Value of Financial Instruments.” ASC 825 requires a public entity to provide disclosures about fair value of financial instruments in interim financial information. ASC 825 is effective for interim and annual financial periods ending after June 15, 2009. The Company adopted the provisions of ASC 825 on April 1, 2009 and the disclosure is more fully presented in Note 3. Fair Value Disclosures.

FASB Clarifies Other-Than-Temporary Impairment: In April 2009, the FASB issued ASC 320 (formerly FSP FAS 115-2, FAS124-2 and EITF 99-20-2), "Recognition and Presentation of Other-Than-Temporary-Impairment." ASC 320 (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. ASC 320 is effective for interim and annual periods ending after June 15, 2009. The Company adopted the provisions of ASC 825 on April 1, 2009 and the disclosure is more fully presented in Note 2. Investment Securities. The provisions of ASC 320 did not have an impact on the Company's financial condition and results of operations.

Table of Contents

FASB Clarifies Application of Fair Value Accounting: In April 2009, the FASB issued ASC 820 (formerly FSP FAS 157-4), “Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.” ASC 820 affirms the objective of fair value when a market is not active, clarifies and includes additional factors for determining whether there has been a significant decrease in market activity, eliminates the presumption that all transactions are distressed unless proven otherwise, and requires an entity to disclose a change in valuation technique. ASC 820 is effective for interim and annual periods ending after June 15, 2009. The Company adopted the provisions of ASC 820 on April 1, 2009. The provisions of ASC 820 did not have a material impact on the Company’s financial condition and results of operations.

Business Combinations: In December 2007, the FASB issued ASC 805 (formerly Statement No. 141R), “Business Combinations”. ASC 805 broadens the guidance and , extends its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations. ASC 805 expands on required disclosures to improve the statement users’ abilities to evaluate the nature and financial effects of business combinations. ASC 805 is effective for the first annual reporting period beginning on or after December 15, 2008. In April 2009, the FASB amended the guidance in ASC 805 and is effective for the first annual reporting period beginning on or after December 15, 2008. The provisions of ASC 805 will only impact the Company if we are party to a business combination closing on or after January 1, 2009.

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, 2009. This analysis should be read in conjunction with our 2008 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 the Company’s operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks and uncertainties. In connection with the “safe-harbor” provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (i) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (ii) the effect of changing regional and national economic conditions including in the housing market in the Central Valley of California; (iii) significant changes in interest rates and prepayment speeds; (iv) credit risks of lending and investment activities; (v) changes in federal and state banking laws or regulations; (vi) competitive pressure in the banking industry; (vii) changes in governmental fiscal or monetary policies; (viii) 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; and (ix) other factors discussed in Item 1A. Risk Factors located in the Company’s 2008 Annual Report on Form 10-K.

Table of Contents

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. The Bank serves the northern Central Valley of California through twenty-two banking offices and two stand-alone ATM's. The service area includes Sacramento, San Joaquin, Stanislaus and Merced Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock, Hilmar, and Merced. Substantially all of the Company's business activities are conducted within its market area.

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 Financial Institutions ("DFI") and the Federal Deposit Insurance Corporation ("FDIC").

Overview

The Company's primary service area encompasses the northern Central Valley of California, a region that can be significantly impacted by the seasonal and cyclical operations of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations can be influenced by the banking needs of its agricultural customers (e.g., generally speaking 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 fall and winter as crops are harvested and sold).

The Central Valley of California has been one of the hardest hit areas in the country during the current recession. Housing prices in many areas are down over 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels are well above 10% in many areas. Although, in management's opinion, the Company's credit quality performance over the past eighteen months has compared favorably to our peers, we believe that it is possible that any significant recovery in our local markets will not occur until 2010 or later and this may result in: (1) additional borrower stress in the coming quarters; and (2) continuing modest levels of loan growth over the near term.

Another factor that has adversely impacted the Company's financial results for the first nine months of 2009 has been significantly higher deposit insurance premiums and special assessments. The FDIC has levied these additional costs on all banks to help replenish a deposit insurance fund that has been depleted by the large number of bank failures across the nation. For the three months ended September 30, 2009, the Company's total FDIC insurance costs exceeded the same period in 2008 by \$56,000, a 40.3% increase. For the nine months ended September 30, 2009, the Company's total FDIC insurance costs exceeded the same period in 2008 by \$1.6 million, a 404.0% increase. On September 29, 2009, the FDIC adopted a Notice of Proposed Rulemaking that would call for all banks to prepay their 2010, 2011, and 2012 insurance premiums. If adopted, the FDIC has initially indicated that this rule would not require member banks to pay additional special assessments in 2009. However, the impact on any special assessments in future years is not known at the current time.

For the three and nine months ended September 30, 2009, Farmers & Merchants Bancorp reported net income of \$6,178,000 and \$15,188,000, earnings per share of \$7.90 and \$19.39 and return on average assets of 1.39% and 1.17%, respectively. Return on average shareholders' equity was 15.40% and 12.62% for the three and nine months

ended September 30, 2009.

For the three and nine months ended September 30, 2008, Farmers & Merchants Bancorp reported net income of \$6,057,000 and \$17,783,000, earnings per share of \$7.63 and \$22.34 and return on average assets of 1.50% and 1.53%, respectively. Return on average shareholders' equity was 16.34% and 16.05% for the three and nine months ended September 30, 2008.

16

Table of Contents

Factors impacting the Company's earnings performance in the first nine months of 2009 as compared to the same period last year were: (1) a \$5.7 million increase in loan loss provisions and ORE holding costs as a result of the continuing economic problems in the Company's local markets; (2) a \$1.6 million increase in FDIC deposit insurance costs as a result of the FDIC's need to increase premiums and levy special assessments on all banks in order to replenish the deposit insurance fund that has been depleted from bank failures nationwide; (3) \$1.4 million increase in salaries and employee benefits as a result of increases in staff levels and officer salary increases that became effective in April 2009; and (4) a \$4.4 million decrease in merchant fee income and other non-interest income that primarily related to the sale of the credit card and merchant portfolio in June 2008. These factors were partially offset by: (1) a \$5.0 million increase in net interest income due to a 12.1% increase in average earning assets; (2) a \$2.4 million increase in gain on sale of investment securities; (3) an \$800,000 decrease in merchant expense related to the sale of the merchant portfolio in June 2008; and (4) a \$2.1 million decrease in the provision for income taxes.

The following is a summary of the financial results for the nine month period ended September 30, 2009 compared to September 30, 2008.

- Net income decreased 14.6% to \$15.2 million from \$17.8 million.
- Earnings per share decreased 13.2% to \$19.39 from \$22.34.
- Total assets increased 6.7% to \$1.8 billion.
- Total loans increased 4.6% to \$1.2 billion.
- Allowance for loan losses increased 39.7% to \$25.8 million.
- Total deposits increased 6.9% to \$1.5 billion.
- Net interest income increased 9.9% to \$55.5 million from \$50.5 million.

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, 2009 and 2008.

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 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" and is noted wherever applicable.

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 (allocated in proportion to the respective volume and

rate components).

17

Table of Contents

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

| Assets | Three Months Ended Sept 30, 2009 | | | Three Months Ended Sept 30, 2008 | | |
|-------------------------------|--|-----------|--------|--|-----------|--------|
| | Balance | Interest | Rate | Balance | Interest | Rate |
| Federal Funds Sold | \$ 15,380 | \$ 10 | 0.26 % | \$ 28,786 | \$ 137 | 1.89 % |
| Investment Securities | | | | | | |
| Available-for-Sale: | | | | | | |
| U.S. Agencies | 102,562 | 461 | 1.80 % | - | - | 0.00 % |
| Municipals - | | | | | | |
| Non-Taxable | 8,538 | 163 | 7.63 % | 8,954 | 166 | 7.40 % |
| Mortgage Backed | | | | | | |
| Securities | 242,640 | 2,872 | 4.73 % | 197,255 | 2,648 | 5.37 % |
| Other | 15,159 | 29 | 2.17 % | 3,384 | 88 | 6.59 % |
| Total Investment Securities | | | | | | |
| Available-for-Sale | 368,899 | 3,525 | 3.82 % | 209,593 | 2,902 | 5.54 % |
| Investment Securities | | | | | | |
| Held-to-Maturity: | | | | | | |
| U.S. Agencies | 0 | 0 | 0.00 % | 30,373 | 319 | 4.20 % |
| Municipals - | | | | | | |
| Non-Taxable | 63,821 | 918 | 5.75 % | 67,176 | 955 | 5.68 % |
| Mortgage Backed | | | | | | |
| Securities | 4,163 | 40 | 3.84 % | 5,708 | 55 | 3.85 % |
| Other | 1,990 | 10 | 2.01 % | 1,992 | 13 | 2.61 % |
| Total Investment Securities | | | | | | |
| Held-to-Maturity | 69,974 | 968 | 5.53 % | 105,249 | 1,342 | 5.10 % |
| Loans: | | | | | | |
| Real Estate | 704,804 | 12,138 | 6.83 % | 667,068 | 11,446 | 6.81 % |
| Home Equity | 65,562 | 395 | 2.39 % | 65,162 | 1,070 | 6.51 % |
| Agricultural | 215,094 | 3,246 | 5.99 % | 188,981 | 3,208 | 6.73 % |
| Commercial | 198,207 | 2,947 | 5.90 % | 205,995 | 3,327 | 6.41 % |
| Consumer | 10,586 | 201 | 7.53 % | 12,156 | 239 | 7.80 % |
| Credit Card | 0 | 0 | 0.00 % | 0 | 0 | 0.00 % |
| Municipal | 1,154 | 4 | 1.38 % | 1,357 | 4 | 1.17 % |
| Total Loans | 1,195,407 | 18,931 | 6.28 % | 1,140,719 | 19,294 | 6.71 % |
| Total Earning Assets | 1,649,660 | \$ 23,434 | 5.64 % | 1,484,347 | \$ 23,674 | 6.33 % |
| Unrealized Loss on Securities | | | | | | |
| Available-for-Sale | 7,720 | | | (1,772) | | |
| Allowance for Loan Losses | (25,543) | | | (18,513) | | |

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

| | | | | | | | |
|---|--------------|-----------|--------|--|--------------|-----------|--------|
| Cash and Due From | | | | | | | |
| Banks | 30,656 | | | | 35,264 | | |
| All Other Assets | 111,768 | | | | 112,935 | | |
| Total Assets | \$ 1,774,261 | | | | \$ 1,612,261 | | |
| Liabilities & Shareholders' Equity | | | | | | | |
| Interest Bearing | | | | | | | |
| Deposits: | | | | | | | |
| Interest Bearing DDA | \$ 159,035 | \$ 88 | 0.22 % | | \$ 129,686 | \$ 33 | 0.10 % |
| Savings | 413,536 | 605 | 0.58 % | | 331,377 | 879 | 1.05 % |
| Time Deposits | 667,891 | 2,471 | 1.47 % | | 636,785 | 4,437 | 2.76 % |
| Total Interest Bearing Deposits | 1,240,462 | 3,164 | 1.01 % | | 1,097,848 | 5,349 | 1.93 % |
| Securities Sold Under Agreement to Repurchase | | | | | | | |
| Other Borrowed Funds | 60,000 | 541 | 3.58 % | | 60,000 | 541 | 3.58 % |
| Subordinated Debentures | 3,566 | 11 | 1.22 % | | 724 | 11 | 6.03 % |
| Total Interest Bearing Liabilities | 10,310 | 90 | 3.46 % | | 10,310 | 149 | 5.73 % |
| Interest Rate Spread | 1,314,338 | \$ 3,806 | 1.15 % | | 1,168,882 | \$ 6,050 | 2.05 % |
| Demand Deposits (Non-Interest Bearing) | | | 4.49 % | | | | 4.27 % |
| All Other Liabilities | 272,875 | | | | 266,939 | | |
| Total Liabilities | 26,566 | | | | 28,169 | | |
| Shareholders' Equity | 1,613,779 | | | | 1,463,990 | | |
| Total Liabilities & Shareholders' Equity | 160,482 | | | | 148,271 | | |
| Impact of Non-Interest Bearing Deposits and Other Liabilities | \$ 1,774,261 | | | | \$ 1,612,261 | | |
| Net Interest Income and Margin on Total Earning Assets | | | 0.23 % | | | | 0.44 % |
| Tax Equivalent Adjustment | | | | | | | |
| Net Interest Income | | 19,628 | 4.72 % | | | 17,624 | 4.71 % |
| | | (359) | | | | (364) | |
| | | \$ 19,269 | 4.63 % | | | \$ 17,260 | 4.61 % |

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 \$453,000 and \$385,000 for the quarters ended September 30, 2009 and 2008, 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 | Nine Months Ended Sept. 30, 2009 | | | Nine Months Ended Sept. 30, 2008 | | |
|--|--|-----------|--------|--|-----------|---------|
| | Balance | Interest | Rate | Balance | Interest | Rate |
| Federal Funds Sold | \$ 41,449 | \$ 78 | 0.25 % | \$ 12,362 | \$ 181 | 1.96 % |
| Investment Securities Available-for-Sale: | | | | | | |
| U.S. Agencies | 42,359 | 557 | 1.75 % | - | - | 0.00 % |
| Municipals - Non-Taxable | 9,467 | 536 | 7.55 % | 8,955 | 502 | 7.47 % |
| Mortgage Backed Securities | 252,026 | 9,609 | 5.08 % | 174,771 | 7,025 | 5.36 % |
| Other | 9,860 | 38 | 0.51 % | 3,504 | 240 | 5.88 % |
| Total Investment Securities Available-for-Sale | 313,712 | 10,740 | 4.56 % | 187,230 | 7,767 | 5.53 % |
| Investment Securities Held-to-Maturity: | | | | | | |
| U.S. Agencies | 0 | 0 | 0.00 % | 30,399 | 953 | 4.18 % |
| Municipals - Non-Taxable | 64,218 | 2,761 | 5.73 % | 66,459 | 2,892 | 5.80 % |
| Mortgage Backed Securities | 4,555 | 131 | 3.83 % | 6,124 | 177 | 3.85 % |
| Other | 1,991 | 38 | 2.54 % | 1,998 | 39 | 2.60 % |
| Total Investment Securities Held-to-Maturity | 70,764 | 2,930 | 5.52 % | 104,980 | 4,061 | 5.16 % |
| Loans: | | | | | | |
| Real Estate | 689,515 | 34,537 | 6.70 % | 661,124 | 34,304 | 6.94 % |
| Home Equity | 65,874 | 2,392 | 4.85 % | 65,007 | 3,293 | 6.77 % |
| Agricultural | 209,398 | 9,577 | 6.11 % | 183,499 | 9,964 | 7.26 % |
| Commercial | 201,356 | 9,124 | 6.06 % | 199,921 | 10,228 | 6.84 % |
| Consumer | 10,878 | 597 | 7.34 % | 12,489 | 772 | 8.26 % |
| Credit Card | 0 | 0 | 0.00 % | 3,506 | 265 | 10.11 % |
| Municipal | 1,094 | 11 | 1.34 % | 1,187 | 11 | 1.24 % |
| Total Loans | 1,178,115 | 56,238 | 6.38 % | 1,126,733 | 58,837 | 6.98 % |
| Total Earning Assets | 1,604,040 | \$ 69,986 | 5.83 % | 1,431,305 | \$ 70,846 | 6.62 % |
| Unrealized Gain (Loss) on Securities | | | | | | |
| Available-for-Sale | 9,163 | | | 1,163 | | |
| Allowance for Loan Losses | (22,382) | | | (18,790) | | |

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

| | | | | | | | | |
|--|--------------|-----------|--------|--|--------------|-----------|--------|--|
| Cash and Due From | | | | | | | | |
| Banks | 31,907 | | | | 36,498 | | | |
| All Other Assets | 106,904 | | | | 103,130 | | | |
| Total Assets | \$ 1,729,632 | | | | \$ 1,553,306 | | | |
| Liabilities & Shareholders' Equity | | | | | | | | |
| Interest Bearing | | | | | | | | |
| Deposits: | | | | | | | | |
| Interest Bearing DDA | \$ 149,747 | \$ 224 | 0.20 % | | \$ 129,870 | \$ 90 | 0.09 % | |
| Savings | 382,634 | 2,021 | 0.71 % | | 321,197 | 2,716 | 1.13 % | |
| Time Deposits | 670,271 | 9,191 | 1.83 % | | 601,873 | 14,735 | 3.27 % | |
| Total Interest | | | | | | | | |
| Bearing Deposits | 1,202,652 | 11,436 | 1.27 % | | 1,052,940 | 17,541 | 2.23 % | |
| Securities Sold Under | | | | | | | | |
| Agreement to | | | | | | | | |
| Repurchase | 60,000 | 1,606 | 3.58 % | | 38,102 | 987 | 3.46 % | |
| Other Borrowed Funds | 1,985 | 31 | 2.09 % | | 10,425 | 232 | 2.98 % | |
| Subordinated | | | | | | | | |
| Debentures | 10,310 | 315 | 4.08 % | | 10,310 | 491 | 6.37 % | |
| Total Interest Bearing | | | | | | | | |
| Liabilities | 1,274,947 | \$ 13,388 | 1.40 % | | 1,111,777 | \$ 19,251 | 2.32 % | |
| Interest Rate Spread | | | | | | | | |
| | | | 4.43 % | | | | 4.30 % | |
| Demand Deposits | | | | | | | | |
| (Non-Interest Bearing) | 269,570 | | | | 267,698 | | | |
| All Other Liabilities | 24,615 | | | | 26,095 | | | |
| Total Liabilities | 1,569,132 | | | | 1,405,570 | | | |
| Shareholders' Equity | | | | | | | | |
| | 160,500 | | | | 147,736 | | | |
| Total Liabilities & Shareholders' Equity | | | | | | | | |
| | \$ 1,729,632 | | | | \$ 1,553,306 | | | |
| Impact of Non-Interest | | | | | | | | |
| Bearing Deposits and | | | | | | | | |
| Other Liabilities | | | | | | | | |
| | | | 0.29 % | | | | 0.52 % | |
| Net Interest Income | | | | | | | | |
| and Margin on Total | | | | | | | | |
| Earning Assets | | | | | | | | |
| | | 56,598 | 4.72 % | | | 51,595 | 4.82 % | |
| Tax Equivalent | | | | | | | | |
| Adjustment | | | | | | | | |
| | | (1,096) | | | | (1,101) | | |
| Net Interest Income | | \$ 55,502 | 4.63 % | | | \$ 50,494 | 4.72 % | |

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 \$1.7 million for the nine months ended September 30, 2009 and 2008, respectively. Yields on securities available-for-sale are based on historical cost.

Table of ContentsFarmers & Merchants Bancorp
Volume and Rate Analysis of
Net Interest Revenue(Rates on a Taxable Equivalent
Basis)

(in thousands)

| | Three Months Ended | | | Nine Months Ended | | |
|--|---|----------|----------|---|----------|----------|
| | Sept. 30, 2009 compared to Sept. 30, 2008 | | | Sept. 30, 2009 compared to Sept. 30, 2008 | | |
| | Volume | Rate | Net Chg. | Volume | Rate | Net Chg. |
| Interest Earning Assets | | | | | | |
| Federal Funds Sold | \$(45) | \$(82) | \$(127) | \$156 | \$(259) | \$(103) |
| Investment Securities Available for Sale | | | | | | |
| U.S Agencies | 461 | - | 461 | 557 | - | 557 |
| Municipals - Non-Taxable | (8) | 5 | (3) | 29 | 5 | 34 |
| Mortgage Backed Securities | 561 | (337) | 224 | 2,963 | (379) | 2,584 |
| Other | 13 | (72) | (59) | 53 | (255) | (202) |
| Total Investment Securities Available for Sale | 1,027 | (404) | 623 | 3,602 | (629) | 2,973 |
| Investment Securities Held to Maturity | | | | | | |
| U.S. Agencies | (319) | 0 | (319) | (953) | 0 | (953) |
| Municipals - Non-Taxable | (49) | 12 | (37) | (96) | (35) | (131) |
| Mortgage Backed Securities | (15) | - | (15) | (45) | (1) | (46) |
| Other | 0 | (3) | (3) | 0 | (1) | (1) |
| Total Investment Securities Held to Maturity | (383) | 9 | (374) | (1,094) | (37) | (1,131) |
| Loans: | | | | | | |
| Real Estate | 649 | 44 | 693 | 1,448 | (1,215) | 233 |
| Home Equity | 7 | (682) | (675) | 44 | (945) | (901) |
| Agricultural | 413 | (375) | 38 | 1,306 | (1,693) | (387) |
| Commercial | (123) | (257) | (380) | 73 | (1,177) | (1,104) |
| Consumer | (30) | (8) | (38) | (93) | (82) | (175) |
| Credit Card | 0 | - | 0 | (265) | 0 | (265) |
| Other | (1) | 1 | 0 | - | 0 | 0 |
| Total Loans | 915 | (1,277) | (362) | 2,513 | (5,112) | (2,599) |
| Total Earning Assets | 1,514 | (1,754) | (240) | 5,177 | (6,037) | (860) |
| Interest Bearing Liabilities | | | | | | |
| Interest Bearing Deposits: | | | | | | |
| Transaction | 8 | 46 | 54 | 15 | 119 | 134 |
| Savings | 181 | (455) | (274) | 455 | (1,150) | (695) |
| Time Deposits | 204 | (2,170) | (1,966) | 1,531 | (7,075) | (5,544) |
| Total Interest Bearing Deposits | 393 | (2,579) | (2,186) | 2,001 | (8,106) | (6,105) |
| Securities Sold Under Agreement to Repurchase | 0 | - | 0 | 585 | 34 | 619 |
| Other Borrowed Funds | 15 | (15) | 0 | (147) | (54) | (201) |

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

| | | | | | | |
|-------------------------|---------|----------|----------|---------|----------|----------|
| Subordinated Debentures | - | (59) | (59) | - | (176) | (176) |
| Total Interest Bearing | | | | | | |
| Liabilities | 408 | (2,653) | (2,245) | 2,439 | (8,302) | (5,863) |
| Total Change | \$1,106 | \$899 | \$2,005 | \$2,738 | \$2,265 | \$5,003 |

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

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: Market Risk – Interest Rate Risk").

3rd Quarter 2009 vs. 3rd Quarter 2008

Net interest income for the third quarter of 2009 increased 11.6% or \$2.0 million to \$19.3 million. On a fully taxable equivalent basis, net interest income increased 11.4% and totaled \$19.6 million for the third quarter of 2009. As more fully discussed below, the increase in net interest income was primarily due to an increase in earning assets.

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, 2009, the Company's net interest margin was 4.72% compared to 4.71% for the quarter ended September 30, 2008. Over the past year the Company has increased the size of its investments, both in absolute dollar terms and as a percentage of earning assets, to absorb the liquidity generated from deposit growth. As a result, this increase in lower yielding assets (compared to loans) has placed pressure on the Company's net interest margin. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2009. Additionally, competitive trends in the pricing of both loans and deposits have placed, and may continue to place, pressure on the Company's net interest margin.

Loans, generally the Company's highest earning assets, increased \$53.7 million as of September 30, 2009 compared to September 30, 2008. See "Financial Condition – Loans" for further discussion on this increase. On an average balance basis, loans increased by \$54.7 million for the quarter ended September 30, 2009. Loans decreased from 70.1% of average earning assets at September 30, 2008 to 67.4% at September 30, 2009. As a result of decreases in market interest rates from September 2007 through December 2008 the year-to-date yield on the loan portfolio declined to 6.28% for the quarter ended September 30, 2009, compared to 6.71% for the quarter ended September 30, 2008. Even with the increase in loan balances, the decrease in yield resulted in interest revenue from loans decreasing 1.9% to \$18.9 million for quarter ended September 30, 2009. The Company has been experiencing aggressive competitor pricing for loans to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Since the risk factor for investments is typically lower than that of loans, the yield earned on investments is generally less than that of loans. Average investment securities totaled \$438.8 million for the quarter ended September 30, 2009, an increase of \$124.0 million compared to the average balance for the quarter ended September 30, 2008. Interest income on securities increased \$250,000 to \$4.5 million for the quarter ended September 30, 2009, compared to \$4.2 million for the quarter ended September 30, 2008. The average investment portfolio yield, on a tax equivalent (TE) basis, was 4.09% for the quarter ended September 30, 2009, compared to 5.39% for the quarter ended September 30, 2008. This decrease in yield was due to: (1) an overall drop in market interest rates; (2) the sale of some higher yielding mortgage-backed securities, as well as; (3) the Company's decision to shorten the maturities of new investment purchases. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2009. 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.

Overnight investments in Federal Funds Sold are an additional earning asset available to the Company. Historically, in order to earn interest on excess cash balances banks had to "sell" these balances (called "Federal Funds Sold") on an overnight basis to other banks. However, in late 2008 the FRB began paying interest on the deposits that banks maintained in their FRB accounts (which are also classified as Federal Funds Sold on the Company's balances sheet)

providing an essentially risk-free alternative for earning interest on overnight cash balances. These balances earn interest at the Fed Funds rate which has been 0.25% since December, 2008. Average Federal Funds Sold (which includes interest earning balances at the FRB) for the quarter ended September 30, 2009, was \$15.4 million, a decrease of \$13.4 million compared to the average balance for the quarter ended September 30, 2008. Interest income on Federal Funds Sold for the quarter ended September 30, 2009, decreased \$127,000 to \$10,000 compared to the quarter ended September 30, 2008 since the average yield on Federal Funds Sold dropped to 0.26% for the quarter ended September 30, 2009 from 1.89% for the quarter ended September 30, 2008. See “Financial Condition – Investment Securities” for a discussion of the Company’s investment strategy in 2009.

Table of Contents

Average interest-bearing sources of funds increased \$145.4 million or 12.4% during the third quarter of 2009. Of that increase: (1) interest-bearing deposits increased \$142.6 million; (2) securities sold under agreement to repurchase remained unchanged (see “Financial Condition - Securities Sold Under Agreement to Repurchase”); (3) Federal Home Loan Bank (“FHLB”) Advances increased \$2.8 million (see “Financial Condition – Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings”); and (4) subordinated debt remained unchanged.

The \$142.6 million increase in average interest-bearing deposits occurred across all deposit types with the largest growth in savings deposits which increased 24.5%. See “Financial Condition – Deposits” for a discussion of trends in the Company’s deposit base. Total interest expense on deposits was \$3.2 million for the third quarter of 2009 as compared to \$5.3 million for the third quarter of 2008. From September 2007 through December 2008, the FRB lowered market rates by 500 basis points, and as a result the average rate paid on interest-bearing deposits declined to 1.01% for the third quarter of 2009 from 1.93% for the third quarter of 2008. The Company anticipates that this decline in deposit rates should continue, albeit at a slower pace, for the remainder of 2009.

Nine Months Ending September 30, 2009 vs. Nine Months Ending September 30, 2008

During the first nine months of 2009, net interest income increased 9.9% to \$55.5 million, compared to \$50.5 million at September 30, 2008. On a fully taxable equivalent basis, net interest income increased 9.7% and totaled \$56.6 million at September 30, 2009, compared to \$51.6 million at September 30, 2008. The increase in net interest income was primarily due to an increase in earning assets.

For the nine months ended September 30, 2009, the Company’s net interest margin was 4.72% compared to 4.82% for the same period in 2008.

Loans, on an average balance basis, increased by \$51.4 million for the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008. The yield on the loan portfolio decreased 60 basis points to 6.38% for the nine months ended September 30, 2009 compared to 6.98% for the nine months ended September 30, 2008. This decrease in yield, partially offset by an increase in average balances, resulted in interest income from loans decreasing 4.4% or \$2.6 million for the first nine months of 2009.

Average investment securities were \$384.5 million for the nine months ended September 30, 2009 compared to \$292.2 million for the same period in 2008. The average yield (TE) for the nine months ended September 30, 2009 was 4.74% compared to 5.40% for the nine months ended September 30, 2008. The decrease in the yield on investment securities was offset by an increase in volume, resulting in an increase in interest income of \$1.8 million or 15.6%, for the nine months ended September 30, 2009.

Average interest-bearing sources of funds increased \$163.2 million or 14.7% during the nine months ended September 30, 2009. Of that increase: (1) interest-bearing deposits increased \$149.7 million; (2) FHLB Advances decreased \$8.4 million; (3) securities sold under agreement to repurchase increased \$21.9 million; and (4) subordinated debt remained unchanged.

The \$149.7 million increase in average interest-bearing deposits occurred across all deposit types with the largest growth in savings deposits which increased 19.1%. Total interest expense on deposits was \$11.4 million for the first nine months of 2009 as compared to \$17.5 million for the first nine months of 2008. The average rate paid on interest-bearing deposits was 1.27% in the first nine months of 2009 and 2.23% in the first nine months of 2008.

Provision and Allowance for Loan 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 allowance for loan losses is established to absorb losses inherent in the loan portfolio. The allowance for loan losses is maintained at a level considered by management to be

adequate to provide for risks inherent in the loan portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. In determining the adequacy of the allowance for loan losses, management takes into consideration examinations by the Company's supervisory authorities, results of internal credit reviews, financial condition of borrowers, loan concentrations, prior loan loss experience, and general economic conditions. The allowance is based on estimates and ultimate losses may vary from the current estimates. Management reviews these estimates periodically and, when adjustments are necessary, they are reported in the period in which they become known.

Table of Contents

The Company has established credit management policies and procedures that govern both the approval of new loans and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans to one borrower and by restricting loans made primarily to its principal market area where management believes it is better 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 portfolio and regularly conducts credit reviews of individual loans. Loans that are performing but have shown some signs of weakness are subjected to more stringent reporting and oversight.

Changes in the provision between the first nine months of 2009 and 2008 were the result of management's evaluation of the adequacy of the allowance for loan losses relative to factors such as the credit quality of the loan portfolio, loan growth, current loan losses and the prevailing economic climate and its effect on borrowers' ability to repay loans in accordance with the terms of the notes. The Central Valley of California has been one of the hardest hit areas in the country during this recession. Housing prices in many areas are down over 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels are well above 10% in many areas. Although, in management's opinion, the Company's levels of net charge-offs over the past eighteen months and non-performing assets as of September 30, 2009 compare favorably to our peers, we believe that it is prudent to be prepared for the possibility that any significant recovery in our local markets will not occur until 2010 or later and this may result in additional borrower stress in the coming quarters. Accordingly, during the second quarter of 2009, management and the Board of Directors increased the Company's level of loan loss reserves and as of September 30, 2009, the balance was \$25.8 million or 2.12% of total loans. This represents a \$7.3 million or 39.7% increase over September 30, 2008.

The provision for loan losses during the first nine months of 2009 was \$10.3 million compared to \$5.4 million for the first nine months of 2008. Net charge-offs during the first nine months of 2009 were \$4.5 million as compared to \$5.4 million during the first nine months of 2008. Net charge-offs for the nine months ended September 30, 2009, represented 0.38% of average loans, a level that, in management's opinion, compares favorably to the Company's peers at the present time. See "Item 1A. Risk Factors" and "Note 1. Significant Accounting Policies – Allowance for Loan Losses" in the Company's 2008 Annual Report on Form 10-K and "Item 3. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk" of this report.

The allowance for loan losses was \$25.8 million or 2.12% of total loan balances at September 30, 2009 compared to \$18.5 million or 1.59% of total loan balances at September 30, 2008. As of December 31, 2008, the allowance for loan losses was \$20.0 million, which represented 1.70% of the total loan balance. After reviewing all factors above, management concluded that the allowance for loan losses as of September 30, 2009 was adequate. See the following table for allowance for loan loss activity for the periods indicated.

| (in thousands) | Three Months Ended | | Nine Months Ended | |
|--|--------------------|----------|-------------------|----------|
| | September 30, | | September 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Balance at Beginning of Period | \$25,454 | \$18,682 | \$20,034 | \$18,483 |
| Provision Charged to Expense | 2,215 | 765 | 10,345 | 5,370 |
| Recoveries of Loans Previously Charged Off | 56 | 61 | 175 | 295 |
| Loans Charged Off | (1,907) | (1,022) | (4,736) | (5,662) |
| Balance at End of Period | \$25,818 | \$18,486 | \$25,818 | \$18,486 |

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) credit card merchant fees; (4) ATM fees; (5) investment gains and losses on non-qualified deferred compensation plans; (6) increases in the cash surrender value of bank owned life insurance; (7) gains and losses on the sale of loans and/or other business assets; and (8) fees from other miscellaneous business services.

3rd Quarter 2009 vs. 3rd Quarter 2008

Non-interest income increased \$2.1 million or 83.9% for the three months ended September 30, 2009, compared to the same period of 2008. This increase was primarily comprised of: (1) a \$509,000 increase in the net gain on investment securities for the third quarter of 2009 compared to the third quarter of 2008, and (2) a \$1.9 million increase in net gains on deferred compensation investments for the third quarter of 2009 compared to net losses for the third quarter of 2008. These increases were partially offset by a \$382,000 decrease in other non-interest income which was primarily a result of the conversion of the Company's ATM/EFT system that generated a one-time increase in other non-interest income during the third quarter of 2008.

Nine Months Ending September 30, 2009 vs. Nine Months Ending September 30, 2008

Non-interest income increased \$486,000 or 3.7% for the nine months ended September 30, 2009 compared to the same period of 2008. This increase was primarily comprised of: (1) Credit card merchant fees decreased \$1.1 million; and (2) other non-interest income decreased \$3.3 million, both primarily due to the sale of the Company's credit card portfolio and merchant portfolio in June 2008. These decreases were offset by: (3) an increase of \$2.4 million in investment gains for the first nine months of 2009 compared to the first nine months of 2008; and (4) net gains of \$1.2 million on deferred compensation investments during the first nine months of 2009 compared to net losses of \$1.3 million during the first nine months of 2008.

The Company allows executives who participate in non-qualified deferred compensation plans to self direct the investment of their vested balances. See "Note 12 of the Notes to Consolidated Financial Statements" in the Company's 2008 Annual Report on Form 10-K. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in Non-Interest Income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

Non-Interest Expense

Non-interest expense for the Company includes expenses for: (1) salaries and employee benefits; (2) occupancy; (3) equipment; (4) supplies; (5) legal fees; (6) professional services; (7) data processing; (8) marketing; (9) FDIC deposit insurance premiums and assessments; (10) merchant bankcard operations; and (11) other miscellaneous expenses.

3rd Quarter 2009 vs. 3rd Quarter 2008

Non-interest expense increased \$2.4 million or 25.6% for the three months ended September 30, 2009, compared to the same period of 2008. This increase was primarily comprised of: (1) an \$832,000 increase in salary and employee benefits as a result of increases in staff levels and officer salary increases that became effective in April 2009; (2) a \$1.9 million increase in net gains on deferred compensation investments for the third quarter of 2009 compared to net losses for the third quarter of 2008; and (3) a \$56,000 or 40.3% increase in FDIC insurance from the third quarter of 2008. These increases were partially offset by decreases in expenses associated with furniture & equipment and computer hardware & software.

Nine Months Ending September 30, 2009 vs. Nine Months Ending September 30, 2008

Non-interest expense increased \$5.2 million or 17.5% for the nine months ended September 30, 2009 compared to the same period of 2008. This increase was primarily comprised of: (1) a \$1.4 million increase in salary & employee benefits; (2) a \$2.5 million increase in gains on deferred compensation investments; (3) a \$1.6 million increase in

FDIC insurance premiums and special assessments (see “Overview”); and (4) a \$686,000 increase in ORE holding costs. These increases were partially offset by an \$828,000 decrease in credit card merchant expense as a result of the sale of the Company’s merchant portfolio in June 2008.

Table of Contents

The Company allows executives who participate in non-qualified deferred compensation plans to self-direct the investment of their vested balances. See “Note 12 of the Notes to Consolidated Financial Statements” in the Company’s 2008 Annual Report on Form 10-K. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company’s net income.

Income Taxes

The provision for income taxes increased 3.4% to \$3.7 million for the third quarter of 2009. The Company’s effective tax rate increased for the third quarter of 2009 and was 37.6% compared to 37.3% for the same period in 2008.

The provision for income taxes decreased 19.8% to \$8.6 million for the first nine months of 2009. The Company’s effective tax rate decreased for the first nine months of 2009 and was 36.1% compared to 37.6% for the same period in 2008.

The Company’s effective tax rate can change from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt sources of income and expense. The substantial increase in the third quarter 2009 loan loss provision, which is a tax deductible item, had a significant impact on the effective tax rate for the third quarter of 2009, and to a lesser extent, the first nine months of 2009. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance, California enterprise zone interest income exclusion and tax-exempt interest income on municipal securities and loans.

Financial Condition

This section discusses material changes in the Company’s balance sheet for the nine month period ending September 30, 2009 as compared to the year ended December 31, 2008 and to the nine month period ending September 30, 2008. As previously discussed (see “Overview”) the Company’s financial condition is influenced by the seasonal banking needs of its agricultural customers.

Investment Securities and Federal Funds Sold

The investment portfolio is an important component of the Company’s earning asset mix, providing an income alternative to loans that exhibits a high level of safety of principal and liquidity.

Since the beginning of 2009 the Company has generated a significant amount of excess liquidity because interest rates have been low and perceived market risks high, causing customers to move funds from the stock market and other investment vehicles to FDIC insured bank deposits. Additionally, given the drop in mortgage rates during the first nine months of 2009, many of our higher coupon mortgage-backed securities were prepaying quickly, and their market value gains disappearing. As a result, during the first nine months of 2009 the Company sold, for a gain of \$2.9 million, approximately \$62.2 million of mortgage-backed securities. This further increased our excess cash position.

The Company’s reinvestment strategy for the cash generated from security sales and deposit inflows was: (1) during the first quarter forego higher yields in order to reduce current credit risk exposure by maintaining excess liquidity at the FRB; and (2) beginning during the second quarter increase yields by moving out of cash, but: (i) limit future interest rate risk exposure, and (ii) provide cash for future loan growth when economic conditions in the Company’s market improve by investing primarily in adjustable rate short-to-medium term agency mortgage-backed securities and callable agency debt securities.

The Company's investment portfolio at September 30, 2009 was \$431.3 million compared to \$363.7 million at the end of 2008, an increase of \$67.6 million or 18.6%. At September 30, 2008, the investment portfolio totaled \$316.6 million. The Company's investment portfolio currently represents 24.4% of the Company's total assets as compared to 21.6% at December 31, 2008 and 19.2% at September 30, 2008. The investment portfolio is comprised primarily of mortgage-backed securities (all of which were issued by U.S. government agencies), agency debt securities, bank-qualified municipals and investment grade corporate securities. The Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC", classes of securities that resulted in losses for many banks during 2008. See "Financial Condition – Investment Securities" in the Company's 2008 Annual Report on Form 10-K.

Table of Contents

Overnight investments in Federal Funds Sold are an additional earning asset available to the Company. Historically, in order to earn interest on excess cash balances banks had to “sell” these balances (called “Federal Funds Sold”) on an overnight basis to other banks. However, in late 2008 the FRB began paying interest on the deposits that banks maintained in their FRB accounts (which are also classified as Federal Funds Sold on the Company’s balances sheet) providing an essentially risk-free alternative for earning interest on overnight cash balances. These balances earn interest at the Fed Funds rate which has been 0.25% since December, 2008. Since significant uncertainty/risk existed in the credit markets in early 2009, the Company elected to maintain much of its excess cash at the FRB during the first nine months of 2009, despite the fact that it was earning a very low rate of interest. As a result of this credit risk reduction strategy, average Federal Funds Sold (which includes interest earning balances at the FRB) for the nine months ended September 30, 2009, was \$41.4 million compared to \$12.4 million for the nine months ended September 30, 2008. The Company’s peak Federal Funds Sold position occurred on April 3, 2009 when \$134.0 million was maintained overnight at the FRB. By late April, 2009 the Company determined that the overall risk in the credit markets had returned to acceptable levels, and by June 30, 2009 the Company had moved most of its Federal Funds Sold balances into higher-yielding short- and medium-term investment securities.

The Company classifies its investments as held-to-maturity, trading or available-for-sale. Securities are classified as held-to-maturity 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, 2009, December 31, 2008 and September 30, 2008 there were no securities in the trading portfolio. Securities classified as available-for-sale 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.

As of September 30, 2009, securities carried at \$292.1 million were pledged to secure public deposits, FHLB borrowings, and other government agency deposits as required by law. This amount at December 31, 2008, was \$295.9 million.

Loans

The Company's loan portfolio at September 30, 2009 increased \$37.8 million or 3.2% from December 31, 2008. Compared to September 30, 2008, loans have increased \$53.7 million or 4.6%. Loan growth has been relatively modest over the last six-to-twelve months, a reflection of the difficult economic environment in the Central Valley of California. Much of the current year’s loan growth occurred in Agricultural and Agricultural Real Estate Loans, market segments where the Company believes that current market rates and/or credit risks are more reasonable than in other segments.

On an average balance basis, loans have increased \$51.4 million or 4.6% since the third quarter of 2008. The following table sets forth the distribution of the loan portfolio by type and percent as of the periods indicated.

Table of Contents

| Loan Portfolio (in thousands) | September 30, 2009 | | | December 31, 2008 | | | September 30, 2008 | | |
|----------------------------------|--------------------|-------|---|-------------------|-------|---|--------------------|-------|---|
| | \$ | % | | \$ | % | | \$ | % | |
| Commercial Real Estate | \$292,096 | 24.0 | % | \$271,856 | 23.0 | % | \$267,760 | 23.0 | % |
| Real Estate Secured by | | | | | | | | | |
| Farmland | 252,593 | 20.8 | % | 227,166 | 19.3 | % | 228,153 | 19.6 | % |
| Real Estate Construction | 72,170 | 5.9 | % | 75,472 | 6.4 | % | 77,335 | 6.6 | % |
| Residential 1st Mortgages | 106,005 | 8.7 | % | 105,980 | 9.0 | % | 107,355 | 9.2 | % |
| Home Equity Lines and Loans | 66,250 | 5.4 | % | 66,159 | 5.6 | % | 66,093 | 5.7 | % |
| Agricultural | 212,868 | 17.5 | % | 216,610 | 18.4 | % | 192,220 | 16.5 | % |
| Commercial | 204,228 | 16.8 | % | 202,636 | 17.2 | % | 212,073 | 18.2 | % |
| Consumer | 10,990 | 0.9 | % | 13,612 | 1.2 | % | 12,766 | 1.1 | % |
| Total Loans | 1,217,200 | 100.0 | % | 1,179,491 | 100.0 | % | 1,163,755 | 100.0 | % |
| Less: | | | | | | | | | |
| Unearned Income | 2,027 | | | 2,127 | | | 2,249 | | |
| Allowance for Loan Losses | 25,818 | | | 20,034 | | | 18,486 | | |
| Net Loans | \$1,189,355 | | | \$1,157,330 | | | \$1,143,020 | | |

The Central Valley of California has been one of the hardest hit areas in the country during the current recession. Housing prices in many areas are down over 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels are well above 10% in many areas. In management's opinion it is possible that any significant recovery in our local markets will not occur until 2010 or later and this may result in continuing modest levels of loan growth over the near term.

Classified Loans and Non-Performing Assets

All loans are assigned a credit risk grade using grading standards developed by the bank regulatory agencies. The Company utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans and review the credit risk grades the Company places on loans. Loans that are judged to exhibit a higher risk profile are referred to as "classified loans", and these loans receive increased management attention. As of September 30, 2009 classified loans totaled \$71.7 million. As of September 30, 2009, classified loans included multiple loans to one borrower totaling \$32.5 million all of which were current in their payments.

Classified loans with higher levels of credit risk can be further designated as "non-accrual" loans, and the accrual of interest discontinued. Accrual of interest on loans is generally discontinued either when: (1) a loan becomes contractually past due by 90 days or more with respect to interest or principal; or (2) the loan is considered by management to be impaired because it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When loans 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 is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. Loans where the collateral has been repossessed are classified as other real estate ("ORE") or, if the collateral is personal property, the loan is classified as other assets on the Company's financial statements.

The following table sets forth the amount of the Company's non-performing assets as of the dates indicated. Non-performing loan balances (defined as non-accrual loans plus accruing loans past due 90 days or more) are reported net of guarantees of the U.S. Government, including its agencies and its government-sponsored agencies, in the amounts of \$0, \$473,000, and \$860,000, respectively. ORE balances are net of reserve for ORE valuation adjustments in the amounts of \$3.1 million, \$2.1 million, and \$500,000, respectively.

Table of Contents

Non-Performing Assets

| (in thousands) | September 30, 2009 | Dec. 31, 2008 | September 30, 2008 |
|----------------------|-----------------------|------------------|-----------------------|
| Non-Performing Loans | \$12,644 | \$5,267 | \$6,687 |
| Other Real Estate | 3,784 | 4,817 | 6,392 |
| Total | \$16,428 | \$10,084 | \$13,079 |

| | | | | | | |
|--|-------|---|-------|---|-------|---|
| Non-Performing Loans as a % of Total Loans | 1.04 | % | 0.45 | % | 0.57 | % |
| Allowance for Loan Losses as a % of Non-Performing Loans | 204.2 | % | 380.4 | % | 276.4 | % |

Non-performing loans consist of \$7.5 million of commercial real estate loans, \$2.5 million of agricultural real estate loans, \$2.0 million of agricultural loans, \$484,000 of real estate construction loans, and \$180,000 of home equity lines and loans. Specific reserves of \$1.0 million have been established for these loans. Other Real Estate consists primarily of raw land and residential finished lots.

Interest income on non-accrual loans which would have been recognized during the period, if all such loans had been current in accordance with their original terms, totaled \$719,000 at September 30, 2009, \$261,000 at December 31, 2008, and \$387,000 at September 30, 2008.

Except for those non-performing loans discussed above, the Company's management is not aware of any loans as of September 30, 2009, 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 repayment terms, or any known events that would result in the loan being designated as non-performing at some future date. However, the Central Valley of California has been one of the hardest hit areas in the country during this recession. Housing prices in many areas are down over 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels are well above 10% in many areas. As a result of this combination of: (1) real estate values having declined significantly over the past 18 months; and (2) recent deterioration in general economic conditions leading to increased unemployment and business failures; borrowers who are current in their payments may experience deterioration in the value of their collateral below the amount outstanding on the loan, significantly increasing the potential of default if their income levels decline. See "Item 1A. Risk Factors" in the Company's 2008 Annual Report on Form 10-K.

Deposits

One of the key sources of funds to support earning assets (loans and investments) 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, 2009 increased \$64.3 million or 4.5% from December 31, 2008, and have increased \$96.3 million or 6.9% compared to September 30, 2008. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) interest rates were low and perceived market risks high, causing customers to move funds from the stock market and other investment vehicles to bank deposits; (2) the Federal government's decision to increase FDIC deposit insurance limits from \$100,000 to \$250,000 per depositor (unlimited for non-interest bearing transaction accounts); and (3) 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 territory. The Company expects that the impact of the first two factors may mitigate during the remainder of 2009 and into 2010, particularly if funds move back into the stock market. This could impact future deposit growth.

Table of Contents

Core deposits (exclusive of Public Time Deposits) increased \$65.7 million or 5.2% from December 31, 2008 and have increased \$98.2 million or 7.9% since September 30, 2008. Public Time Deposits have decreased \$1.8 million since September 30, 2008.

Demand and Interest-Bearing transaction accounts decreased \$20.1 million or 4.4% since December 31, 2008, (partially due to the seasonal impact of the agricultural industry - see "Overview") but increased \$28.2 million or 6.8% since September 30, 2008, while savings and time deposit accounts have increased \$84.9 million or 8.8% since December 31, 2008, and \$68.1 million or 6.9% since September 30, 2008.

In December 2008, the Bank elected to participate in the provisions of the FDIC's Temporary Liquidity Guarantee Program that provides full FDIC deposit insurance on all non-interest bearing transaction accounts even if they exceed the deposit insurance limit of \$250,000 on other types of deposit accounts. This program has been extended through June 30, 2010, and the Company will continue to participate.

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 (see "Item 3. Quantitative and Qualitative Disclosures About Market Risk and Liquidity Risk"). 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.

FHLB Advances as of September 30, 2009 were \$663,000 compared to \$703,000 at December 31, 2008 and \$716,000 at September 30, 2008. The average rate on FHLB advances during the first nine months of 2009 was 2.1% compared to 3.0% during the first nine months of 2008.

There were no outstandings on the Company's line with the FRB as of September 30, 2009.

As of September 30, 2009 the Company has additional borrowing capacity of \$174 million with the Federal Home Loan Bank and \$243 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.

Securities Sold Under Agreement to Repurchase

Securities Sold Under Agreement to Repurchase are used as secured borrowing alternatives to FHLB Advances or FRB Borrowings, and totaled \$60 million at September 30, 2009, December 31, 2008, and September 30, 2008.

On March 13, 2008, the Bank entered into a \$40 million medium term repurchase agreement with Citigroup as part of a leveraging strategy in response to the FRB's continued interest rate cuts (see "Financial Condition - Investment Securities" in the Company's 2008 Annual Report on Form 10-K). The repurchase agreement pricing rate is 3.20% with an embedded 3 year cap tied to 3 month Libor with a strike price of 3.3675%. The repurchase agreement matures March 13, 2013, putable only on March 13, 2011, and is secured by investment securities.

On May 30, 2008, the Company entered into a second repurchase agreement with Citigroup for \$20 million. The repurchase agreement pricing rate is 4.19% with an embedded 3 year cap tied to 3 month Libor with a strike price of 3.17%. The repurchase agreement matures June 5, 2013, putable only on June 5, 2011, and is secured by investment securities.

Subordinated Debentures

On December 17, 2003, the Company raised \$10 million through an offering of trust-preferred securities. Although this amount is reflected as subordinated debt on the Company's balance sheet, under applicable regulatory guidelines, trust preferred securities 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 3.14% as of September 30, 2009, 4.72% at December 31, 2008 and 5.66% at September 30, 2008. The average rate paid for these securities for the first nine months of 2009 was 4.08% compared to 6.37% for the first nine months of 2008. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company's common stock.

Table of Contents

Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders' Equity totaled \$165.7 million at September 30, 2009, \$156.5 million at December 31, 2008, and \$153.1 million at September 30, 2008.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain 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's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios set forth in the table below of Total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets (all terms as defined in the regulations). Management believes, as of September 30, 2009, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

In its most recent notification from the FDIC the Bank was categorized 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 table below. There are no conditions or events since that notification that management believes have changed the institution's categories.

| (in thousands) The Company: As of September 30, 2009 | Actual | | Regulatory Capital Requirements | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|------------|---------|---------------------------------|-------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital to Risk Weighted Assets | \$ 188,848 | 12.55 % | \$ 120,428 | 8.0 % | N/A | N/A |
| Tier 1 Capital to Risk Weighted Assets | \$ 169,943 | 11.28 % | \$ 60,214 | 4.0 % | N/A | N/A |
| Tier 1 Capital to Average Assets | \$ 169,943 | 9.56 % | \$ 71,108 | 4.0 % | N/A | N/A |

| (in thousands) The Bank: As of September 30, 2009 | Actual | | Regulatory Capital Requirements | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|------------|---------|---------------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital to Risk Weighted Assets | \$ 188,042 | 12.50 % | \$ 120,395 | 8.0 % | \$ 150,493 | 10.0 % |
| Tier 1 Capital to Risk Weighted Assets | \$ 169,142 | 11.24 % | \$ 60,197 | 4.0 % | \$ 90,296 | 6.0 % |
| Tier 1 Capital to Average Assets | \$ 169,142 | 9.52 % | \$ 71,053 | 4.0 % | \$ 88,816 | 5.0 % |

As previously discussed (see Long-term Subordinated Debentures), in order to supplement its regulatory capital base, during December 2003 the Company issued \$10 million of trust preferred securities. On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities (“TPS”) by bank holding companies (“BHCs”). Under the final rule BHCs may include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. The quantitative limitation concerning goodwill will not be effective until March 31, 2011. 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.

Table of Contents

In accordance with the “Variable Interest Entities” topic of the FASB Accounting Standards Codification, the Company does not consolidate the subsidiary trust which has issued the trust-preferred securities.

In 1998, the Board approved the Company’s first stock repurchase program. This program was extended and expanded in both 2004 and 2006. Most recently, on November 12, 2008, the Board of Directors approved increasing the funds available for the Company’s Common Stock Repurchase Program. The Board’s resolution authorized up to \$20 million in repurchases over the four year period ending October 31, 2012.

During the third quarter of 2009 the Company repurchased 750 shares at an average share price of \$390 per share. During the third quarter of 2008 the Company repurchased 2,514 shares at an average share price of \$451. Since the second share repurchase program was expanded in 2006 the Company has repurchased over 38,000 shares for total consideration of \$17.7 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 Registrar and Transfer Company, as Rights Agent, and the Company declared a dividend of a right to acquire one preferred share purchase right (a “Right”) for each outstanding share of the Company’s Common Stock, \$0.01 par value per share, to stockholders of record at the close of business on August 15, 2008. Generally, the Rights only are triggered and become exercisable if a person or group (the “Acquiring Person”) acquires beneficial ownership of 10 percent or more of the Company’s common stock or announces a tender offer for 10 percent or more of the Company’s common stock.

The Rights Plan is similar to plans adopted by many other publicly-traded companies. The effect of the Rights Plan is to discourage any potential acquirer from triggering the Rights without first convincing Farmers & Merchants Bancorp’s Board of Directors that the proposed acquisition is fair to, and in the best interest of, all of the shareholders of the Company. The provisions of the Plan will substantially dilute the equity and voting interest of any potential acquirer unless the Board of Directors approves of the proposed acquisition. Each Right, if and when exercisable, will entitle the registered holder to purchase from the Company one one-hundredth of a share of Series A Junior Participating Preferred Stock, no par value, at a purchase price of \$1,200 for each one one-hundredth of a share, subject to adjustment. Each holder of a Right (except for the Acquiring Person, whose Rights will be null and void upon such event) shall thereafter have the right to receive, upon exercise, that number of Common Shares of the Company having a market value of two times the exercise price of the Right. At any time before a person becomes an Acquiring Person, the Rights can be redeemed, in whole, but not in part, by Farmers and Merchants Bancorp’s Board of Directors at a price of \$0.001 per Right. The Rights Plan will expire on August 5, 2018.

Based upon the Company’s strong capital position and continued earnings strength, the Company elected not to participate in the Federal Government’s 2008 TARP capital purchase program. See “Part I, Item 1A. Risk Factors” in the Company’s 2008 Annual Report on Form 10-K.

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 loan 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 2008 Annual Report on Form 10-K.

Table of Contents

Off Balance Sheet Arrangements and Aggregate Contractual Obligations and Commitments

Off-balance sheet arrangements are any contractual arrangement to which an unconsolidated entity is a party, under which the Company has: (1) any obligation under a guarantee contract; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets; (3) any obligation under certain derivative instruments; or (4) any obligation under a material variable interest held by the Company in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company, or engages in leasing, hedging or research and development services with the Company.

In the ordinary course of business, the Company enters into commitments to extend credit to its customers. As of September 30, 2009, the Company had entered into commitments with certain customers amounting to \$301.9 million compared to \$355.2 million at December 31, 2008 and \$364.3 million at September 30, 2008. Letters of credit at September 30, 2009, December 31, 2008 and September 30, 2008, were \$10.4 million, \$7.9 million and \$7.4 million, respectively. These commitments are not reflected in the accompanying consolidated financial statements and do not significantly impact operating results.

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.

Credit risk in the loan portfolio is controlled by limits on industry concentration, aggregate customer borrowings, and geographic boundaries. Standards on loan quality also are designed to reduce loan credit risk. Senior Management, Directors' Committees, and the Board of Directors are regularly provided with information intended to identify, measure, control, and monitor the credit risk of the Company.

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans. The systematic methodology consists of two major elements. The first major element includes a detailed analysis of the loan portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB Accounting Standards Codification. Individual loans are reviewed to identify loans for impairment. A loan is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan. Impairment is measured as either the expected future cash flows discounted at each loan's effective interest rate, the fair value of the loan's collateral if the loan is collateral dependent, or an observable market price of the loan, 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 portfolio is the loan risk rating system. The originating credit officer assigns borrowers an initial risk rating, which is based primarily on a thorough analysis of each 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.

Table of Contents

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 the possibility of loss. Management performs a detailed analysis of these loans, 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 portfolio by risk rating and into groups of loans with similar characteristics in accordance with the “Contingency” topic of the FASB Accounting Standards Codification. In this second phase, groups of loans with similar characteristics are reviewed and the appropriate allowance factor is applied based on the five-year average charge-off rate for each particular group of loans.

The second major element of the analysis, which considers qualitative internal and external factors that may affect a loan’s collectibility, 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:

- § then-existing general economic and business conditions affecting the key lending areas of the Company;
- § credit quality trends (including trends in non-performing loans expected to result from existing conditions);
- § collateral values;
- § loan volumes and concentrations;
- § seasoning of the loan portfolio;
- § specific industry conditions within portfolio segments;
- § recent loss experience within portfolio segments;
- § duration of the current business cycle;
- § bank regulatory examination results; and
- § findings of the Company’s internal credit examiners.

Management reviews 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 problem 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 problem 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 major element of the allowance.

Implicit in lending activities is the risk that losses will and do occur and that the amount of such losses will vary over time. Consequently, the Company maintains an allowance for loan losses by charging a provision for loan losses to earnings. Loans determined to be losses are charged against the allowance for loan losses. The Company’s allowance for loan losses is maintained at a level considered by management to be adequate to provide for estimated losses inherent in the existing portfolio.

Management believes that the allowance for loan losses at September 30, 2009, was adequate to provide for both recognized probable losses and estimated inherent losses in the portfolio. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans, or net loan charge-offs that would increase the provision for loan 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.

Table of Contents

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

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

The simulation model estimates the impact of changing interest rates on interest income from all interest earning assets and the interest expense paid on all interest bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 100 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At September 30, 2009, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was a decrease in net interest income of 2.77% if rates increase by 200 basis points and an increase in net interest income of 1.23% if rates decline 100 basis points. Comparatively, at December 31, 2008, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was a decrease in net interest income of 2.17% if rates increase by 200 basis points and an increase in net interest income of 1.38% if rates decline 100 basis points. All results are within the Company's policy limits.

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 and securities; pricing strategies on loans 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.

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 1. Financial Statements – Consolidated Statements of Cash Flows") cash and cash equivalents, cash provided by operating activities, principal payments on loans, 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 \$66 million and repurchase lines of \$50 million with major banks. In addition, as of September 30, 2009 the Company has available borrowing capacity of \$174 million at the Federal Home Loan Bank and \$243 million at the Federal Reserve Bank.

Table of Contents

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 2008 Annual Report on Form 10-K. In management's opinion, there have been no material changes in risk factors since the filing of the 2008 Form 10-K.

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

The following table indicates the number of shares repurchased by Farmers & Merchants Bancorp during the third quarter of 2009.

| Third Quarter 2009 | Number of Shares | Average Price per Share | Number of Shares Purchased as Part of a Publicly Announced Plan or Program | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan or |
|--------------------|------------------|-------------------------|--|--|
| | | | | |

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

| | | | | Program |
|-------------------------|-----|-------|-----|---------------|
| 07/01/2009 - 07/31/2009 | - | \$- | - | \$ 17,105,010 |
| 08/01/2009 - 08/31/2009 | 750 | 390 | 750 | 16,812,510 |
| 09/01/2009 - 09/30/2009 | - | - | - | 16,812,510 |
| Total | 750 | \$390 | 750 | \$ 16,812,510 |

35

Table of Contents

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol "FMCB.OB." Additionally, management is aware that there are private transactions in the Company's common stock.

ITEM 3. Defaults Upon Senior Securities

Not applicable

ITEM 4. Submission of Matters to a Vote of Security Holders

None

ITEM 5. Other Information

None

ITEM 6. Exhibits

See Exhibit Index on Page 37.

36

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 6, 2009

/s/ Kent A. Steinwert

Kent A. Steinwert
President and
Chief Executive Officer
(Principal Executive Officer)

Date: November 6, 2009

/s/ Stephen W. Haley

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

Index to 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. |