

FARMERS & MERCHANTS BANCORP  
Form 10-Q  
May 08, 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 March 31, 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 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

(Do not check if a smaller reporting company)

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

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

Number of shares of common stock of the registrant: Par value \$0.01, authorized 2,000,000 shares; issued and outstanding 782,565 as of April 30, 2009.

---

---

---

## FARMERS &amp; MERCHANTS BANCORP

FORM 10-Q  
TABLE OF CONTENTS

PART I. - FINANCIAL INFORMATION		Page
Item 1 -	Financial Statements	
	<u>Consolidated Balance Sheet as of March 31, 2009 (Unaudited), December 31, 2008 and March 31, 2008 (Unaudited).</u>	3
	<u>Consolidated Statement of Income (Unaudited) for the Three Months Ended March 31, 2009 and 2008.</u>	4
	<u>Consolidated Statement of Comprehensive Income (Unaudited) for the Three Months Ended March 31, 2009 and 2008.</u>	5
	<u>Consolidated Statement of Changes in Shareholders' Equity (Unaudited) for the Three Months Ended March 31, 2009 and 2008.</u>	6
	<u>Consolidated Statement of Cash Flows (Unaudited) for the Three Months Ended March 31, 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>	11
Item 3 -	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
Item 4 -	<u>Controls and Procedures</u>	28
PART II. - OTHER INFORMATION		
Item 1 -	<u>Legal Proceedings</u>	28
Item 1A -	<u>Risk Factors</u>	29
Item 2 -	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
Item 3 -	<u>Defaults Upon Senior Securities</u>	29
Item 4 -	<u>Submission of Matters to a Vote of Security Holders</u>	29
Item 5 -	<u>Other Information</u>	29
Item 6 -	<u>Exhibits</u>	29

<u>Signatures</u>	30
-------------------	----

<u>Index to Exhibits</u>	30
--------------------------	----

2

---

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

FARMERS & MERCHANTS BANCORP  
Consolidated Balance Sheets (Unaudited)

(in thousands)	March 31, 2009	December 31, 2008	March 31, 2008
<b>Assets</b>			
<b>Cash and Cash Equivalents:</b>			
Cash and Due From Banks	\$ 37,289	\$ 46,774	\$ 48,160
Federal Funds Sold and Securities Purchased Under Agreements to Resell	112,023	14,000	-
<b>Total Cash and Cash Equivalents</b>	<b>149,312</b>	<b>60,774</b>	<b>48,160</b>
<b>Investment Securities:</b>			
Available-for-Sale	262,308	291,839	226,646
Held-to-Maturity	70,953	71,890	104,418
<b>Total Investment Securities</b>	<b>333,261</b>	<b>363,729</b>	<b>331,064</b>
<b>Loans</b>			
Loans	1,168,738	1,177,364	1,111,285
Less: Allowance for Loan Losses	20,500	20,034	19,032
<b>Loans, Net</b>	<b>1,148,238</b>	<b>1,157,330</b>	<b>1,092,253</b>
Premises and Equipment, Net	22,406	21,653	20,353
Bank Owned Life Insurance	42,418	41,965	40,619
Interest Receivable and Other Assets	36,175	38,986	35,911
<b>Total Assets</b>	<b>\$ 1,731,810</b>	<b>\$ 1,684,437</b>	<b>\$ 1,568,360</b>
<b>Liabilities</b>			
<b>Deposits:</b>			
Demand	\$ 267,936	\$ 319,318	\$ 273,190
Interest Bearing Transaction	143,688	146,879	131,180
Savings	370,470	353,055	319,007
Time	694,287	613,450	570,681
<b>Total Deposits</b>	<b>1,476,381</b>	<b>1,432,702</b>	<b>1,294,058</b>
Securities Sold Under Agreements to Repurchase	60,000	60,000	40,000
Federal Home Loan Bank Advances	690	703	49,441
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	22,946	24,177	25,306
<b>Total Liabilities</b>	<b>1,570,327</b>	<b>1,527,892</b>	<b>1,419,115</b>
<b>Shareholders' Equity</b>			
Common Stock	8	8	8
Additional Paid-In Capital	76,839	78,527	82,863
Retained Earnings	78,284	72,350	63,754
Accumulated Other Comprehensive Income	6,352	5,660	2,620

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

Total Shareholders' Equity	161,483	156,545	149,245
Total Liabilities and Shareholders' Equity	\$ 1,731,810	\$ 1,684,437	\$ 1,568,360

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

3

---

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

(in thousands except per share data)	Three Months Ended March 31,	
	2009	2008
<b>Interest Income</b>		
Interest and Fees on Loans	\$ 18,661	\$ 20,557
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	33	6
<b>Interest on Investment Securities:</b>		
Taxable	3,491	2,420
Exempt from Federal Tax	743	774
<b>Total Interest Income</b>	<b>22,928</b>	<b>23,757</b>
<b>Interest Expense</b>		
Deposits	4,231	6,742
Borrowed Funds	539	231
Subordinated Debentures	119	195
<b>Total Interest Expense</b>	<b>4,889</b>	<b>7,168</b>
<b>Net Interest Income</b>	<b>18,039</b>	<b>16,589</b>
Provision for Loan Losses	870	570
<b>Net Interest Income After Provision for Loan Losses</b>	<b>17,169</b>	<b>16,019</b>
<b>Non-Interest Income</b>		
Service Charges on Deposit Accounts	1,612	1,718
Net Gain (Loss) on Investment Securities	1,020	(139)
Credit Card Merchant Fees	-	534
Increase in Cash Surrender Value of Life Insurance	453	439
ATM Fees	367	361
Net Loss on Deferred Compensation Investments	(51)	(632)
Other	757	696
<b>Total Non-Interest Income</b>	<b>4,158</b>	<b>2,977</b>
<b>Non-Interest Expense</b>		
Salaries and Employee Benefits	7,304	7,118
Net Loss on Deferred Compensation Investments	(51)	(632)
Occupancy	709	658
Equipment	699	496
Credit Card Merchant Expense	-	407
ORE Holding Costs	505	-
Other	2,809	1,719
<b>Total Non-Interest Expense</b>	<b>11,975</b>	<b>9,766</b>
<b>Income Before Income Taxes</b>	<b>9,352</b>	<b>9,230</b>
Provision for Income Taxes	3,418	3,466
<b>Net Income</b>	<b>\$ 5,934</b>	<b>\$ 5,764</b>
<b>Earnings Per Share</b>	<b>\$ 7.55</b>	<b>\$ 7.21</b>

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





Table of Contents

FARMERS & MERCHANTS BANCORP  
 Consolidated Statements of Comprehensive Income (Unaudited)

(in thousands)	Three Months Ended March 31,	
	2009	2008
Net Income	\$ 5,934	\$ 5,764
Other Comprehensive Income -		
Unrealized Gains on Securities:		
Unrealized holding gains arising during the period, net of income tax benefits of \$931 and \$1,130 for the quarters ended March 31, 2009 and 2008, respectively.	1,283	1,556
Less: Reclassification adjustment for realized (gains) losses included in net income, net of related income tax effects of \$(429) and \$58 for the quarters ended March 31, 2009 and 2008, respectively.	(591)	81
Total Other Comprehensive Income	692	1,637
Comprehensive Income	\$ 6,626	\$ 7,401

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

Table of Contents

## FARMERS &amp; 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	Total Shareholders' Equity
Balance, December 31, 2007	800,112	\$ 8	\$ 84,437	\$ 57,990	\$ 983	\$ 143,418
Net Income		-	-	5,764	-	5,764
Repurchase of Stock	(3,422)	-	(1,574)	-	-	(1,574)
Change in Net Unrealized Gains on Securities Available-for-Sale		-	-	-	1,637	1,637
Balance, March 31, 2008	796,690	\$ 8	\$ 82,863	\$ 63,754	\$ 2,620	\$ 149,245
Balance, December 31, 2008	786,960	\$ 8	\$ 78,527	\$ 72,350	\$ 5,660	\$ 156,545
Net Income		-	-	5,934	-	5,934
Repurchase of Stock	(4,395)	-	(1,688)	-	-	(1,688)
Change in Net Unrealized Gains on Securities Available-for-Sale		-	-	-	692	692
Balance, March 31, 2009	782,565	\$ 8	\$ 76,839	\$ 78,284	\$ 6,352	\$ 161,483

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

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

(in thousands)	Three Months Ended	
	March 31, 2009	March 31, 2008
<b>Operating Activities:</b>		
Net Income	\$ 5,934	\$ 5,764
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	870	570
Depreciation and Amortization	467	417
Net (Accretion) Amortization of Investment Security Premiums & Discounts	(900)	470
Net (Gain) Loss on Investment Securities	(1,020)	139
Net Gain on Sale of Property & Equipment	(13)	-
Net Change in Operating Assets & Liabilities:		
Net Decrease (Increase) in Interest Receivable and Other Assets	1,856	(248)
Net Decrease in Interest Payable and Other Liabilities	(1,232)	(394)
Net Cash Provided by Operating Activities	5,962	6,718
<b>Investing Activities:</b>		
Securities Available-for-Sale:		
Purchased	-	(89,664)
Sold, Matured or Called	32,651	7,306
Securities Held-to-Maturity:		
Purchased	(20)	-
Matured or Called	952	1,148
Net Loans Originated or Acquired	8,138	29,571
Principal Collected on Loans Previously Charged Off	84	92
Net Additions to Premises and Equipment	(1,220)	(582)
Proceeds from Disposition of Property & Equipment	13	-
Net Cash Provided (Used) by Investing Activities	40,598	(52,129)
<b>Financing Activities:</b>		
Net Decrease in Demand, Interest-Bearing Transaction, and Savings Accounts	(37,158)	(24,265)
Net Increase in Time Deposits	80,837	7,533
Net Increase in Securities Sold Under Agreement to Repurchase	-	40,000
Net (Decrease) Increase in Federal Home Loan Bank Advances	(13)	20,487
Stock Repurchases	(1,688)	(1,574)
Net Cash Provided by Financing Activities	41,978	42,181
Increase (Decrease) in Cash and Cash Equivalents	88,538	(3,230)
Cash and Cash Equivalents at Beginning of Year	60,774	51,390
Cash and Cash Equivalents as of March 31, 2009 and March 31, 2008	\$ 149,312	\$ 48,160

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.

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.

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.

2. Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157 (SFAS 157), "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 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, SFAS 157 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.

8

---

Table of Contents

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. See Note 3 to these Consolidated Financial Statements. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, "Accounting by Creditors for Impairment of a Loan." 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 December 31, 2008, substantially all impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, 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.

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 March 31, 2009, Using			
	Fair Value March 31, 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	\$ 262,308	\$ -	\$ 262,308	\$ -
Total Assets Measured at Fair Value On a Recurring Basis	\$ 262,308	\$ -	\$ 262,308	\$ -





Table of Contents

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 March 31, 2009, Using			
	Fair Value March 31, 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	\$ 2,020	\$ -	\$ 2,020	\$ -
Other Real Estate	4,990	-	4,990	-
Total Assets Measured at Fair Value On a Non-Recurring Basis	\$ 7,010	\$ -	\$ 7,010	\$ -

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 \$2.98 million with an allowance for loan losses of \$961,000 and ORE was \$7.5 million with a valuation allowance of \$2.5 million.

In April 2009, the FASB issued the following three FSP's intended to provide additional guidance and enhance disclosures regarding fair value measurements and impairment of securities:

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," provides additional guidance for estimating fair value in accordance with SFAS No. 157 when the volume and level of activity for the asset or liability have decreased significantly. FSP FAS 157-4 also provides guidance on identifying circumstances that indicate a transaction is not orderly. The provisions of FSP FAS 157-4 are effective for the Company's interim period ending on June 30, 2009. Management is currently evaluating the effect that the provisions of FSP FAS 157-4 may have on the Company's consolidated financial statements.

FSP FAS 107-1 and APB 28-1, "Interim Disclosures about Fair Value of Financial Instruments," requires disclosures about fair value of financial instruments in interim reporting periods of publicly traded companies that were previously only required to be disclosed in annual financial statements. The provisions of FSP FAS 107-1 and APB 28-1 are effective for the Company's interim period ending on June 30, 2009. As FSP FAS 107-1 and APB 28-1 amends only the disclosure requirements about fair value of financial instruments in interim periods, the adoption of FSP FAS 107-1 and APB 28-1 is not expected to affect the Company's consolidated financial statements.

FSP FAS 115-2 and FAS 124-2, "Recognition and Presentation of Other-Than-Temporary Impairments," amends current other-than-temporary impairment guidance in GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The provisions of FSP FAS 115-2 and FAS 124-2 are effective for the Company's interim period ending on June 30, 2009. Management is currently evaluating the effect that the provisions of FSP FAS 115-2 and FAS 124-2 may have on the Company's consolidated financial statements.

3. 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. No cash dividends were declared during the first quarter of 2009 or 2008.

10

---

Table of Contents

Earnings per share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. The table below calculates the earnings per share for the three months ended March 31, 2009 and 2008.

(net income in thousands)	2009	2008
Net Income	\$ 5,934	\$ 5,764
Average Number of Common Shares Outstanding	785,655	798,982
Per Share Amount	\$ 7.55	\$ 7.21

## 4. Recent Accounting Developments

In December 2007, the FASB issued Statement No. 141R, “Business Combinations” (SFAS No. 141R). SFAS No. 141R broadens the guidance of SFAS No. 141, extending 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. SFAS No. 141R expands on required disclosures to improve the statement users’ abilities to evaluate the nature and financial effects of business combinations. SFAS No. 141R is effective for the first annual reporting period beginning on or after December 15, 2008. The adoption of this Statement did not have a material impact on its financial position, results of operations, or cash flows.

In March 2008, the FASB issued Statement No. 161, “Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (SFAS No. 161). SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. The adoption of this Statement did not have a material impact on its financial position, results of operations, or cash flows.

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

The following is management’s discussion and analysis of the major factors that influenced our financial performance for the three months ended March 31, 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 needs of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations is influenced by the seasonal banking needs of its agricultural customers (e.g., during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in fall and winter as crops are harvested and sold).

For the three months ended March 31, 2009, Farmers & Merchants Bancorp reported net income of \$5,934,000, earnings per share of \$7.55 and return on average assets of 1.42%. Return on average shareholders' equity was 15.03% for the three months ended March 31, 2009.

For the three months ended March 31, 2008, Farmers & Merchants Bancorp reported net income of \$5,764,000, earnings per share of \$7.21 and return on average assets of 1.54%. Return on average shareholders' equity was 15.88% for the three months ended March 31, 2008.

Factors resulting in the Company's improved earnings performance in the first quarter of 2009 as compared to the same period last year were: (1) a \$1.45 million increase in net interest income due to a 12.4% increase in average earning assets; and (2) a \$1.16 million increase in gain on sale of investment securities. These two positive factors were partially offset by: (3) an \$805,000 increase in loan loss provisions and ORE holding costs; and (4) a \$1.09 million increase in other non-interest expense primarily due to increased FDIC deposit insurance costs.

The following is a summary of the financial results for the three-month period ended March 31, 2009 compared to March 31, 2008.

- Net income increased 2.9% to \$5.9 million from \$5.7 million.
- Earnings per share increased 4.7% to \$7.55 from \$7.21.

- Total assets increased 10.4% to \$1.7 billion.
- Total loans increased 5.2% to \$1.2 billion.
- Total deposits increased 14.1% to \$1.5 billion.

Table of Contents

Results of Operations

Net Interest Income / Net Interest Margin

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

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

Net interest income increased 8.7% to \$18.0 million during the first quarter of 2009 compared to \$16.6 million for the first quarter of 2008. On a fully tax equivalent basis, net interest income increased 8.5% and totaled \$18.4 million at March 31, 2009, compared to \$16.9 million at March 31, 2008. As more fully discussed below, the increase in net interest income was due to a 12.4% increase in average earning assets partially offset by a drop in the net interest margin.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. At March 31, 2009, the Company's net interest margin was 4.82% compared to 4.94% at March 31, 2008. Recent trends in: (1) market interest rates; and (2) competitive pricing of both loans and deposits will continue, in management's opinion, to place pressure on the Company's net interest margin in future quarters.

Loans, generally the Company's highest earning assets, increased \$57.4 million as of March 31, 2009, compared to March 31, 2008. See "Financial Condition – Loans" for further discussion of this increase. On an average balance basis, loans increased by \$49.4 million for the quarter ended March 31, 2009. Loans decreased from 80.7% of average earning assets at March 31, 2008 to 77.5% at March 31, 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 6.51% for the quarter ended March 31, 2009, compared to 7.41% for the quarter ended March 31, 2008. Even with the increase in loan balances, the decrease in yield resulted in interest revenue from loans decreasing 9.2% to \$18.7 million for quarter ended March 31, 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, in conjunction with recent decreases in market interest rates by the FRB, could place even greater negative pressure on future loan yields and net interest margin.





Table of Contents

The investment portfolio is the other main component of the Company's earning assets. The Company invests primarily in mortgage-backed securities issued by government-sponsored entities, U.S. Government Agencies, and high-grade municipals. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC," securities that caused many banks to incur losses in 2008. In late 2008, the FRB began paying interest on the deposits that banks maintained in their FRB accounts, whereas historically banks had to "sell" these balances (called "Federal Funds Sold") to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during the first quarter of 2009. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in the first quarter of 2009.

Average Federal Funds Sold (including interest earning balances at the FRB) for the quarter ended March 31, 2009, was \$52.3 million an increase of \$51.5 million compared to the average balance for the quarter ended March 31, 2008. Interest income on Federal Funds Sold increased \$27,000 to \$33,000 for the quarter ended March 31, 2009, compared to \$6,000 for the quarter ended March 31, 2008. The average yield on Federal Funds Sold was 0.26% for the quarter ended March 31, 2009 compared to 2.93% for the quarter ended March 31, 2008.

Table of Contents

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

Assets	Balance	Three Months Ended March 31, 2009 Interest	Rate	Balance	Three Months Ended March 31, 2008 Interest	Rate
Federal Funds Sold and Securities Purchased Under Agreements to Resell	\$ 52,288	\$ 33	0.26%	\$ 822	\$ 6	2.93%
Investment Securities Available-for-Sale						
Municipals - Non-Taxable	10,210	190	7.45%	9,458	176	7.45%
Mortgage Backed Securities	249,499	3,427	5.49%	146,766	1,952	5.32%
Other	3,557	4	0.45%	3,756	73	7.77%
Total Investment Securities Available-for-Sale	263,266	3,621	5.50%	159,980	2,201	5.50%
Investment Securities Held-to-Maturity						
U.S. Agencies	-	-	0.00%	30,425	318	4.18%
Municipals - Non-Taxable	64,588	921	5.71%	66,101	969	5.87%
Mortgage Backed Securities	4,963	48	3.87%	6,545	63	3.85%
Other	1,991	13	2.61%	2,012	13	2.58%
Total Investment Securities Held-to-Maturity	71,542	982	5.49%	105,083	1,363	5.19%
Loans						
Real Estate	676,045	11,242	6.74%	649,343	11,855	7.32%
Home Equity Line and Loans	66,473	1,006	6.14%	65,070	1,153	7.11%
Agricultural	201,587	3,108	6.25%	184,112	3,578	7.79%
Commercial	205,603	3,104	6.12%	194,950	3,569	7.34%
Consumer	11,193	197	7.14%	12,646	261	8.28%
Credit Card	-	-	0.00%	5,353	137	10.27%
Municipal	1,050	4	1.54%	1,037	4	1.55%
Total Loans	1,161,951	18,661	6.51%	1,112,511	20,557	7.41%
Total Earning Assets	1,549,047	\$ 23,298	6.10%	1,378,396	\$ 24,128	7.02%
Unrealized Gain (Loss) on Securities Available-for-Sale	9,464			2,281		
Allowance for Loan Losses	(20,661)			(18,639)		
Cash and Due From Banks	33,376			37,543		
All Other Assets	105,148			94,858		
Total Assets	\$ 1,676,374			\$ 1,494,439		

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

Liabilities & Shareholders'

Equity

Interest Bearing Deposits						
Interest Bearing DDA	\$ 140,585	\$ 49	0.14%	\$ 130,230	\$ 26	0.08%
Savings	365,794	756	0.84%	313,601	1,076	1.38%
Time Deposits	647,980	3,425	2.14%	569,719	5,640	3.97%
Total Interest Bearing Deposits	1,154,359	4,230	1.49%	1,013,550	6,742	2.67%
Securities Sold Under						
Agreement to Repurchase	60,000	530	3.58%	8,352	68	3.27%
Other Borrowed Funds	699	10	5.80%	21,534	163	3.04%
Subordinated Debentures	10,310	119	4.68%	10,310	195	7.59%
Total Interest Bearing Liabilities	1,225,368	\$ 4,889	1.62%	1,053,746	\$ 7,168	2.73%
Interest Rate Spread			4.48%			4.29%
Demand Deposits (Non-Interest Bearing)						
	270,343			273,095		
All Other Liabilities	22,693			22,413		
Total Liabilities	1,518,404			1,349,254		
Shareholders' Equity	157,970			145,185		
Total Liabilities & Shareholders' Equity	\$ 1,676,374			\$ 1,494,439		
Impact of Non-Interest Bearing Deposits and Other Liabilities						
			0.34%			0.64%
Net Interest Income and Margin on Total Earning Assets						
		18,409	4.82%		16,960	4.94%
Tax Equivalent Adjustment		(370)			(371)	
Net Interest Income		\$ 18,039	4.72%		\$ 16,589	4.83%

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 \$415,000 and \$825,000 for the quarters ended March 31, 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		
	Mar. 31, 2009 compared to Mar. 31, 2008		
	Volume	Rate	Net Chg.
Interest Earning Assets			
Federal Funds Sold	\$ 37	\$ (10)	\$ 27
Investment Securities Available-for-Sale			
Municipals - Non-Taxable	14	-	14
Mortgage Backed Securities	1,409	66	1,475
Other	(3)	(66)	(69)
Total Investment Securities Available-for-Sale	1,420	-	1,420
Investment Securities Held-to-Maturity			
U.S. Agencies	(318)	-	(318)
Municipals - Non-Taxable	(22)	(26)	(48)
Mortgage Backed Securities	(15)	-	(15)
Total Investment Securities Held-to-Maturity	(355)	(26)	(381)
Loans			
Real Estate	434	(1,047)	(613)
Home Equity	23	(170)	(147)
Agricultural	308	(778)	(470)
Commercial	180	(645)	(465)
Consumer	(29)	(35)	(64)
Credit Card	(137)	-	(137)
Total Loans	779	(2,675)	(1,896)
Total Earning Assets	1,881	(2,711)	(830)
Interest Bearing Liabilities			
Interest Bearing Deposits			
Transaction	2	21	23
Savings	157	(477)	(320)
Time Deposits	687	(2,902)	(2,215)
Total Interest Bearing Deposits	846	(3,358)	(2,512)
Securities Sold Under Agreement to Repurchase	454	8	462
Other Borrowed Funds	(232)	79	(153)
Subordinated Debentures	-	(76)	(76)
Total Interest Bearing Liabilities	1,068	(3,347)	(2,279)
Total Change	\$ 813	\$ 636	\$ 1,449

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

Average investment securities totaled \$334.8 million for the quarter ended March 31, 2009, an increase of \$69.7 million compared to the average balance for the quarter ended March 31, 2008. See “Financial Condition – Investment Securities” for a discussion of the Company’s investment strategy in 2009. Interest income on securities increased \$1.0 million to \$4.6 million for the quarter ended March 31, 2009, compared to \$3.6 million for the quarter ended March 31, 2008. The average yield, on a tax equivalent basis, in the investment portfolio was 5.5% for the quarter ended March 31, 2009, compared to 5.4% for the quarter ended March 31, 2008. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statement of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Average interest-bearing sources of funds increased \$171.6 million or 16.3% during the first quarter of 2009. Of that increase, securities sold under agreement to repurchase, a new borrowing added during the first quarter of 2008 to manage the Company’s interest rate risk, increased \$51.6 million, and interest-bearing deposits increased \$140.8 million. Other borrowed funds, primarily borrowings from the Federal Home Loan Bank (“FHLB”), decreased \$20.8 million from the first quarter of 2008. See “Financial Condition – Federal Home Loan Bank Advances.”

During the first quarter of 2009 the Company was able to grow average interest bearing deposits by \$140.8 million. The increase was primarily in time and savings deposits, which grew \$130.4 million, as lower cost interest bearing DDA increased by \$10.4 million. See “Financial Condition – Deposits” for a discussion of trends in the Company’s deposit base. Total interest expense on deposits was \$4.2 million for the first quarter of 2009 as compared to \$6.7 million at March 31, 2008. From September 2007 through December 2008, the FRB lowered market rates by 5.00%. The Company has begun to feel this beneficial impact as the average rate paid on interest-bearing deposits declined to 1.49% for the first quarter of 2009 from 2.67% for the first quarter of 2008. The Company anticipates that this decline in deposit rates will continue in to the second quarter of 2009.

### 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.

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 quarter 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 provision for loan losses during the first quarter of 2009 was \$870,000 and \$570,000 for the first quarter of 2008. Net charge-offs during the first quarter of 2009 were \$404,000 and \$21,000 during the first quarter of 2008. Net charge-offs represented 0.03% of average loans, a level that is low compared to the banking industry as a whole at the present time. See "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" and "Part II Item 1A. Risk Factors" of this report.

Table of Contents

The allowance for loan losses was \$20.5 million or 1.75% of total loan balances at March 31, 2009 and \$19.0 million or 1.71% of total loan balances at March 31, 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 March 31, 2009 was adequate. See the following table for allowance for loan loss activity for the periods indicated.

Allowance for Loan Losses (in thousands)	Three Months Ended	
	March 31,	
	2009	2008
Balance at Beginning of Period	\$ 20,034	\$ 18,483
Provision Charged to Expense	870	570
Recoveries of Loans Previously Charged Off	83	92
Loans Charged Off	(487)	(113)
Balance at End of Period	\$ 20,500	\$ 19,032

## 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.

Overall, non-interest income increased \$1.2 million or 39.7% for the three months ended March 31, 2009, compared to the same period of 2008. This increase was primarily comprised of: (1) \$1.0 million gain on investment securities for the first quarter of 2009 compared to a loss of \$139,000 for the first quarter of 2008; (2) no credit card merchant fees due to the sale of the merchant portfolio in June 2008; and (3) losses of \$51,000 on deferred compensation investments during the first quarter of 2009 as compared to losses of \$632,000 during the first quarter 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) deposit insurance; (10) merchant bankcard operations; and (11) other miscellaneous expenses.

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. Losses on deferred compensation investments were \$51,000 in the first quarter of 2009 compared to losses of \$632,000 for the same period of 2008. 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.

Credit Card Merchant Expense decreased \$407,000 or 100% from March 31, 2008. This was due to the sale of the merchant portfolio during the second quarter of 2008.





## Table of Contents

ORE holding costs totaled \$505,000 in 2009 compared to \$0 in 2008. Due to the current economic climate the Company has acquired \$5.0 million of other real estate, most of which is raw land. Included in the \$5.0 million is \$2.5 million related to the establishment of a reserve for ORE valuation adjustments.

Other non-interest expense increased \$1.1 million, or 63.4%, to \$2.8 million in the first quarter of 2009 compared to \$1.7 million in the first quarter of 2008. This increase was due to: (1) increased FDIC insurance premiums for the first quarter of 2009 compared to 2008; (2) accruals for estimated 2009 increases in FDIC premiums based upon recent proposals by the FDIC to levy a 10 basis point special assessment on all banks; and (3) premiums associated with the Bank's participation in the FDIC's newly created Temporary Liquidity Guarantee Program (TLGP). For a discussion of trends in FDIC insurance premiums see "Supervision and Regulation – Deposit Insurance" and "Item 1A. Risk Factors" in the Company's 2008 Annual Report on Form 10-K.

### Income Taxes

The provision for income taxes decreased 1.4% to \$3.4 million for the first quarter of 2009 compared to the first quarter of 2008. The effective tax rate for the first quarter of 2009 was 36.5% compared to 37.6% for the first quarter of 2008. The Company's effective tax rate fluctuates from quarter to quarter due primarily to changes in the mix of taxable and tax-exempt earning sources. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance; California enterprise zone interest income exclusion; and tax-exempt interest income on municipal securities and loans.

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

### Financial Condition

This section discusses material changes in the Company's balance sheet for the three-month period ending March 31, 2009 as compared to the year ended December 31, 2008 and to the three-month period ending March 31, 2008. As previously discussed (see "Overview") the Company's financial condition can be influenced by the seasonal banking needs of its agricultural customers.

### Investment Securities

The investment portfolio provides the Company with an income alternative to loans. The debt securities in the Company's investment portfolio have historically been comprised primarily of Mortgage-backed securities issued by Federal government-sponsored entities, U.S. Government Agencies and high grade bank-qualified municipals. Importantly, 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. At the current time, the Company holds no U.S. Government Agency securities. See "Financial Condition – Investment Securities" in the Company's 2008 Annual Report on Form 10-K.

The Company's investment portfolio at March 31, 2009 was \$333.3 million compared to \$363.7 million at the end of 2008, a decrease of \$30.5 million or 8.4%. At March 31, 2008, the investment portfolio totaled \$331.1 million. During 2008, the Company increased the available-for-sale mortgage-backed securities portfolio as part of a leveraging strategy implemented to manage the Company's interest rate risk. However, in the first quarter of 2009, the Company sold \$19.3 million of those securities that were purchased at fairly high premiums, due to a concern about increasing prepayment speeds as the Federal government implemented policies designed to drive mortgage rates lower.

The Company's total investment portfolio currently represents 19.2% of the Company's total assets as compared to 21.6% at December 31, 2008 and 21.1% at March 31, 2008.

Table of Contents

Not included in the investment portfolio are overnight investments in Federal Funds Sold. In late 2008, the FRB began paying interest on the deposits that banks maintained in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during the first quarter of 2009. Average Federal Funds Sold (including interest earning balances at the FRB) for the quarter ended March 31, 2009, was \$52.3 million compared to \$822,000 thousand for the quarter ended March 31, 2008. This large increase in Federal Funds Sold was due to the significant deposit growth the Company experienced year-over-year and management's decision at the current time not to invest these funds longer-term in the investment portfolio given the historically low level of current long-term interest rates.

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 March 31, 2009, December 31, 2008 and March 31, 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.

The debt securities in the Company's investment portfolio are comprised primarily of Mortgage-backed securities, U.S. Government Agencies and high grade municipals. All of the Mortgage-backed securities are issued by federal government-sponsored entities.

## Loans

The Company's loan portfolio at March 31, 2009 decreased \$8.6 million or 0.7% from December 31, 2008, primarily as a result of the normal seasonal paydowns of loans made to the Company's dairy customers in the fourth quarter of 2008. Compared to March 31, 2008, loans have increased \$57.4 million or 5.2%. Most of the current year's growth occurred in Commercial, 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 loan segments.

On an average balance basis, loans have increased \$49.4 million or 4.4% since the first quarter of 2008. The following table sets forth the distribution of the loan portfolio by type and percent as of the periods indicated.

Loan Portfolio (in thousands)	March 31, 2009		December 31, 2008		March 31, 2008	
	\$	%	\$	%	\$	%
Commercial Real Estate	\$ 272,749	23.3%	\$ 271,856	23.0%	\$ 288,666	25.9%
Agricultural Real Estate	228,512	19.5%	227,166	19.3%	180,352	16.2%
Real Estate Construction	80,697	6.9%	75,472	6.4%	84,779	7.6%
Residential 1st Mortgages	104,412	8.9%	105,980	9.0%	108,635	9.8%
Home Equity Lines and Loans	64,776	5.5%	66,159	5.6%	63,957	5.7%
Agricultural	205,564	17.6%	216,610	18.4%	177,066	15.9%
Commercial	201,946	17.2%	202,636	17.2%	191,841	17.2%
Consumer	12,087	1.0%	13,612	1.2%	18,191	1.6%
Total Loans	1,170,743	100.0%	1,179,491	100.0%	1,113,487	100.0%
Less:						
Unearned Income	2,005		2,127		2,202	
Allowance for Loan Losses	20,500		20,034		19,032	
Net Loans	\$ 1,148,238		\$ 1,157,330		\$ 1,092,253	

#### Non-Performing Assets

Loans on which the accrual of interest has been discontinued are designated as non-accrual loans. 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.

Table of Contents

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 \$133,000, respectively. ORE balances are net of reserve for ORE valuation adjustments in the amounts of \$2.5 million, \$2.1 million, and \$0, respectively.

## Non-Performing Assets

(in thousands)	March 31, 2009	Dec. 31, 2008	March 31, 2008
Non-Performing Loans	\$ 2,981	\$ 5,267	\$ 994
Other Real Estate	4,990	4,817	251
Total	\$ 7,971	\$ 10,084	\$ 1,245
Non-Performing Loans as a % of Total Loans	0.25%	0.45%	0.09%
Allowance for Loan Losses as a % of Non-Performing Loans	687.7%	380.4%	1,914.7%

In addition to the preceding non-performing loans, the Company had outstanding as of March 31, 2009, \$7.8 million in loans past due 15 days which at some future date could become impaired if the borrower's ability to service the loans in accordance with the contract terms becomes uncertain and current collateral values decline due to the weak economy.

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 \$286,000 at March 31, 2009, \$261,000 at December 31, 2008, and \$61,000 at March 31, 2008.

Except for those loans discussed above, the Company's management is not aware of any loans as of March 31, 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, a combination of the following economic conditions in the Company's markets has the potential to create a situation where any borrower's status can quickly change: (1) real estate values declined significantly throughout 2008 and the situation remains volatile; and (2) more recently, general economic conditions have deteriorated and unemployment and business failures are increasing. As a result, 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 "Part II, Item 1A. Risk Factors."

## 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 March 31, 2009 increased \$43.7 million or 3.1% from December 31, 2008, and have increased \$182.3 million or 14.1% compared to March 31, 2008. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted this strong year-over-year deposit growth: (1) the Federal government's decision to increase FDIC deposit insurance limits to \$250,000 (unlimited for non-interest bearing transaction accounts); and (2) 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.



Table of Contents

Core deposits (exclusive of Public Time Deposits) increased \$40.6 million or 3.2% from December 31, 2008 and have increased \$176.4 million or 15.5% since March 31, 2008. Public Time Deposits have increased \$5.9 million since March 31, 2008.

Demand and Interest-Bearing transaction accounts decreased \$54.6 million or 11.7% since December 31, 2008 but increased \$7.2 million or 1.8% since March 31, 2008, while savings and time deposit accounts have increased \$98.2 million or 10.2% since December 31, 2008, and \$175.1 million or 19.7% since March 31, 2008. Demand and Interest bearing transaction accounts have declined as customers have transferred their funds to higher yielding savings and time deposit accounts with the Bank.

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.

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 March 31, 2009 were \$690,000 compared to \$703,000 at December 31, 2008 and \$49.4 million at March 31, 2008. This decrease of \$48.7 million in borrowings since March 31, 2008, was partially due to the Company's management of its liquidity needs using State of California Time deposits (a strategy which it first implemented in 2006 since this source of funds generally has rates lower than FHLB advances) and repurchase agreements. The average rate on FHLB advances during the first quarter of 2009 was 5.8% compared to 3.0% during the first quarter of 2008. This rate increase occurred because the Company paid off all of its short-term, lower cost FHLB advances that were outstanding at March 31, 2008. The small advance of \$690,000 remaining at March 31, 2009, was a long-term advance taken out several years ago when interest rates were higher.

The Company has never had any borrowings outstanding from the FRB since its line was established in August 2008.

As of March 31, 2009 the Company has additional borrowing capacity of \$177.9 million with the Federal Home Loan Bank and \$333.9 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 totaled \$60 million at March 31, 2009, \$60 million at December 31, 2008, and \$40 million at March 31, 2008.

On March 13, 2008, the Bank entered into a \$40 million medium term repurchase agreement with Citigroup as part of a leveraging strategy (see "Investment Securities") in response to the FRB's continued interest rate cuts. 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 investments in Agency pass through securities.

On May 30, 2008, the Company entered into a \$20 million medium term repurchase agreement with Citigroup as part of a leveraging strategy (see "Investment Securities"). 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 investments in Agency pass through securities.





Table of Contents

## 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 4.16% as of March 31, 2009, 4.72% at December 31, 2008 and 5.65% at March 31, 2008. The average rate paid for these securities for the first quarter of 2009 was 4.68% compared to 7.59% for the first quarter 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.

## 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 \$161.5 million at March 31, 2009, \$156.5 million at December 31, 2008, and \$149.2 million at March 31, 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 March 31, 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 following table. There are no conditions or events since that notification that management believes have changed the institution's categories.

(in thousands)	Actual		Regulatory Capital Requirements		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
The Company: As of March 31, 2009						
Total Capital to Risk Weighted Assets	\$ 182,558	13.13%	\$ 111,273	8.0%	N/A	N/A
Tier 1 Capital to Risk Weighted Assets	165,131	11.87%	55,636	4.0%	N/A	N/A
Tier 1 Capital to Average Assets	165,131	9.83%	67,189	4.0%	N/A	N/A



Table of Contents

(in thousands)	Actual		Regulatory Capital Requirements		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
The Bank: As of March 31, 2009						
Total Capital to Risk Weighted Assets	\$ 181,911	13.08%	\$ 111,263	8.0%	\$ 139,079	10.0%
Tier 1 Capital to Risk Weighted Assets	164,485	11.83%	55,631	4.0%	83,447	6.0%
Tier 1 Capital to Average Assets	164,485	9.80%	67,148	4.0%	83,935	5.0%

As previously discussed (see “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, 2009. 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.

In accordance with the provisions of Financial Accounting Standard Board Interpretation No. 46, “Consolidation of Variable Interest Entities” (“FIN 46”), 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 first quarter of 2009 the Company repurchased 4,395 shares at an average share price of \$384 per share. During the first quarter of 2008 the Company repurchased 3,422 shares at an average share price of \$460. Since the second share repurchase program was expanded in 2006 the Company has repurchased over 37,000 shares for total consideration of \$17.3 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.

## Table of Contents

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" of 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 Annual Report to Shareholders on Form 10-K for the year ended December 31, 2008.

### 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 March 31, 2009, the Company had entered into commitments with certain customers amounting to \$354.6 million compared to \$355.2 million at December 31, 2008 and \$453.0 million at March 31, 2008. Letters of credit at March 31, 2009, December 31, 2008 and March 31, 2008, were \$7.9 million, \$7.9 million and \$8.6 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 a Risk Management Plan, which aims to ensure the proper control and management of all risk factors inherent in the operation of the Company. Specifically, credit risk, interest rate risk, liquidity risk, compliance risk, strategic risk, reputation risk, and price risk can all affect the market risk of the Company. These specific 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.



Table of Contents

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 SFAS No. 114, "Accounting by Creditors for the Impairment of a Loan" as amended by SFAS No. 118, "Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures." 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.

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 SFAS No. 5, "Accounting for Contingencies." 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.

26

---



## Table of Contents

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 March 31, 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.

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 March 31, 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 1.64% if rates increase by 200 basis points and an increase in net interest income of 1.55% 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.

## Table of Contents

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 \$71 million and repurchase lines of \$50 million with major banks. In addition, as of March 31, 2009 the Company has available borrowing capacity of \$177.9 million at the Federal Home Loan Bank and \$333.9 million at the Federal Reserve Bank.

## 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.

28

---

Table of Contents

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 to Shareholders 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 first quarter of 2009.

First Quarter 2007	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 Program
01/01/2009 - 01/31/2009	-	\$ -	-	\$ 18,953,150
02/01/2009 - 02/28/2009	723	420.00	723	18,649,490
03/01/2009 - 03/31/2009	3,672	377.00	3,672	17,264,910
Total	4,395	\$ 384.00	4,395	\$ 17,264,910

All of the above shares were repurchased in private transactions.

The common stock of Farmers & Merchants Bancorp is not widely held nor 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 shown on page 30.



Table of Contents

SIGNATURES

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

FARMERS & MERCHANTS BANCORP

Date: May 5, 2009

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

Date: May 5, 2009

/s/ Stephen W. Haley  
Stephen W. Haley  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial & 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.