

MACATAWA BANK CORP  
Form 10-Q  
August 08, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2007

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-25927

**MACATAWA BANK CORPORATION**  
(Exact name of issuer as specified in its charter)

Michigan  
(State of other jurisdiction of  
incorporation or organization)

38-3391345  
(I.R.S. Employer  
Identification No.)

**10753 Macatawa Drive, Holland, Michigan 49424**  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (616) 820-1444  
\_\_\_\_\_

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.  
Yes  No

Indicate by check 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.  
Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 17,179,154 shares of the Company's Common Stock (no par value) were outstanding as of August 3, 2007.



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**Part I Financial Information****Item 1.**

MACATAWA BANK CORPORATION  
 CONSOLIDATED BALANCE SHEETS  
 As of June 30, 2007 (unaudited) and December 31, 2006

| (dollars in thousands)  | <u>June 30,<br/>2007</u> | <u>December 31,<br/>2006</u> |
|---|--------------------------|------------------------------|
| <b>ASSETS</b>   |                          |                              |
| Cash and cash equivalents   |                          |                              |
| Cash and due from banks   | \$ 33,192                | \$ 39,882                    |
| Federal funds sold  | 30,123                   | --                           |
|   | <hr/>                    | <hr/>                        |
| Total cash and cash equivalents   | 63,315                   | 39,882                       |
| Securities available for sale   | 194,066                  | 198,546                      |
| Securities held to maturity   | 1,921                    | 2,711                        |
| Federal Home Loan Bank stock  | 12,275                   | 12,275                       |
| Loans held for sale   | 1,597                    | 1,547                        |
| Total loans   | 1,724,773                | 1,711,450                    |
| Allowance for loan losses   | (23,943)                 | (23,259)                     |
|   | <hr/>                    | <hr/>                        |
| Net loans   | 1,700,830                | 1,688,191                    |
| Premises and equipment - net  | 64,202                   | 60,731                       |
| Accrued interest receivable   | 11,189                   | 11,233                       |
| Goodwill  | 25,918                   | 23,915                       |
| Acquisition intangibles   | 3,248                    | 1,563                        |
| Bank-owned life insurance   | 22,258                   | 21,843                       |
| Other assets  | 15,476                   | 12,379                       |
|   | <hr/>                    | <hr/>                        |
| Total assets  | <u>\$ 2,116,295</u>      | <u>\$ 2,074,816</u>          |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                          |                              |
| Deposits  |                          |                              |
| Noninterest-bearing   | \$ 170,308               | \$ 180,032                   |
| Interest-bearing  | 1,491,378                | 1,487,525                    |
|   | <hr/>                    | <hr/>                        |
| Total deposits  | 1,661,686                | 1,667,557                    |
| Federal funds purchased   | --                       | 11,990                       |
| Other borrowed funds  | 244,760                  | 192,018                      |
| Long-term debt  | 41,238                   | 41,238                       |
| Accrued expenses and other liabilities  | 5,087                    | 5,164                        |
|   | <hr/>                    | <hr/>                        |
| Total liabilities   | 1,952,771                | 1,917,967                    |
| Shareholders' equity  |                          |                              |
| Preferred stock, no par value, 500,000 shares authorized;<br>no shares issued and outstanding   |                          |                              |
| Common stock, no par value, 40,000,000 shares authorized;<br>17,170,235 shares and 16,254,619 issued and outstanding as of<br>June 30, 2007 and December 31, 2006, respectively | 165,940                  | 153,728                      |

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| (dollars in thousands)                     | June 30,<br>2007 | December 31,<br>2006 |
|--|------------------|----------------------|
| Retained earnings                          | 367              | 4,840                |
| Accumulated other comprehensive loss       | (2,783)          | (1,719)              |
|  | <hr/>            | <hr/>                |
| Total shareholders' equity                 | 163,524          | 156,849              |
|  | <hr/>            | <hr/>                |
| Total liabilities and shareholders' equity | \$ 2,116,295     | \$ 2,074,816         |
|  | <hr/>            | <hr/>                |

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See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME  
Three and Six Month Periods Ended June 30, 2007 and 2006  
(unaudited)

(dollars in thousands, except per share data)

|  | <b>Three Months<br/>Ended<br/>June 30, 2007</b> | <b>Three Months<br/>Ended<br/>June 30, 2006</b> | <b>Six Months<br/>Ended<br/>June 30, 2007</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|--|---|---|---|---|
| Interest income  |   |   |   |   |
| Loans, including fees  | \$ 33,105                                       | \$ 30,889                                       | \$ 65,563                                     | \$ 59,268                                     |
| Securities   | 2,192   | 1,799   | 4,408   | 3,484   |
| FHLB Stock   | 123   | 191   | 280   | 362   |
| Other  | 263   | 17  | 364   | 23  |
| <b>Total interest income</b>                                   | <b>35,683</b>                                   | <b>32,896</b>                                   | <b>70,615</b>                                 | <b>63,137</b>                                 |
| Interest expense   |   |   |   |   |
| Deposits   | 15,296  | 12,833  | 30,534  | 24,313  |
| Other  | 4,052   | 3,088   | 7,686   | 5,535   |
| <b>Total interest expense</b>                                  | <b>19,348</b>                                   | <b>15,921</b>                                   | <b>38,220</b>                                 | <b>29,848</b>                                 |
| <b>Net interest income</b>                                     | <b>16,335</b>                                   | <b>16,975</b>                                   | <b>32,395</b>                                 | <b>33,289</b>                                 |
| Provision for loan losses                                      | 965   | 800   | 1,840   | 1,500   |
| <b>Net interest income after<br/>provision for loan losses</b> | <b>15,370</b>                                   | <b>16,175</b>                                   | <b>30,555</b>                                 | <b>31,789</b>                                 |
| Noninterest income   |   |   |   |   |
| Service charges and fees                                       | 1,306   | 1,300   | 2,448   | 2,386   |
| Gain on sales of loans   | 370   | 511   | 813   | 923   |
| Trust fees   | 1,209   | 796   | 2,406   | 1,622   |
| Other  | 1,135   | 1,022   | 2,088   | 1,892   |
| <b>Total noninterest income</b>                                | <b>4,020</b>                                    | <b>3,629</b>                                    | <b>7,755</b>                                  | <b>6,823</b>                                  |
| Noninterest expense  |   |   |   |   |
| Salaries and benefits  | 6,345   | 6,293   | 12,475  | 12,330  |
| Occupancy of premises  | 1,020   | 835   | 2,075   | 1,720   |
| Furniture and equipment  | 933   | 774   | 1,825   | 1,572   |
| Legal and professional fees                                    | 306   | 259   | 557   | 482   |
| Marketing and promotion  | 346   | 321   | 663   | 677   |
| Data processing fees   | 471   | 433   | 950   | 864   |
| Other  | 3,184   | 2,418   | 5,848   | 4,773   |
| <b>Total noninterest expenses</b>                              | <b>12,605</b>                                   | <b>11,333</b>                                   | <b>24,393</b>                                 | <b>22,418</b>                                 |
| <b>Income before income tax expense</b>                        | <b>6,785</b>                                    | <b>8,471</b>                                    | <b>13,917</b>                                 | <b>16,194</b>                                 |
| Income tax expense   | 2,195   | 2,715   | 4,492   | 5,217   |
| <b>Net income</b>  | <b>\$ 4,590</b>                                 | <b>\$ 5,756</b>                                 | <b>\$ 9,425</b>                               | <b>\$ 10,977</b>                              |

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(dollars in thousands, except per share data)

|                            | <b>Three Months<br/>Ended<br/>June 30, 2007</b> | <b>Three Months<br/>Ended<br/>June 30, 2006</b> | <b>Six Months<br/>Ended<br/>June 30, 2007</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|----------------------------|---|---|---|---|
| Basic earnings per share   | \$ .27  | \$ .34  | \$ .55  | \$ .65  |
| Diluted earnings per share | .26   | .33   | .54   | .63   |
| Cash dividends per share   | .13   | .11   | .25   | .22   |

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See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 Three and Six Month Periods Ended June 30, 2007 and 2006  
 (unaudited)

| (dollars in thousands)   | <b>Three Months<br/>Ended<br/>June 30, 2007</b> | <b>Three Months<br/>Ended<br/>June 30, 2006</b> | <b>Six Months<br/>Ended<br/>June 30, 2007</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|--|---|---|---|---|
| Net income   | \$ 4,590  | \$ 5,756  | \$ 9,425                                      | \$ 10,977                                     |
| Other comprehensive income/(loss), net of tax:                           |   |   |   |   |
| Net change in unrealized gains/(losses) on securities available for sale | (1,370)   | (1,289)   | (1,200)                                       | (1,585)                                       |
| Net change in unrealized gains/(losses) on derivative instruments        | (120)   | (210)   | 136   | (630)   |
| <b>Comprehensive income</b>  | <b>\$ 3,100</b>                                 | <b>\$ 4,257</b>                                 | <b>\$ 8,361</b>                               | <b>\$ 8,762</b>                               |

See accompanying notes to consolidated financial statements



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MACATAWA BANK CORPORATION  
 CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
 Six Month Periods Ended June 30, 2007 and 2006  
 (unaudited)

(dollars in thousands, except per share data)

|   | Common<br>Stock   | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|---|-------------------|----------------------|--|----------------------------------|
| <b>Balance, January 1, 2006</b>   | <b>\$ 136,583</b> | <b>\$ 8,040</b>      | <b>\$ (2,879)</b>                                      | <b>\$ 141,744</b>                |
| Net income for six months ended June 30, 2006   |                   | 10,977               |  | 10,977                           |
| Other comprehensive income/(loss), net of tax:  |                   |                      |  |                                  |
| Net change in unrealized gain/(loss) on securities available for sale   |                   |                      | (1,585)  | (1,585)                          |
| Net change in unrealized gain/(loss) on derivative instruments  |                   |                      | (630)  | (630)                            |
| Comprehensive income  |                   |                      |  | 8,762                            |
| Issued 62,731 shares for stock option exercises (net of 4,816 shares exchanged and including \$79 of tax benefit) | 868               |                      |  | 868                              |
| Issued 513,283 shares in payment of 5% stock dividend   | 15,127            | (15,180)             |  | (53)                             |
| Issued 5,401,190 shares in payment of 3-for-2 stock split   |                   |                      |  |                                  |
| Stock compensation expense  | 373               |                      |  | 373                              |
| Cash dividends at \$.22 per share   |                   | (3,795)              |  | (3,795)                          |
| <b>Balance, June 30, 2006</b>   | <b>\$ 152,951</b> | <b>\$ 42</b>         | <b>\$ (5,094)</b>                                      | <b>\$ 147,899</b>                |
| <b>Balance, January 1, 2007</b>   | <b>\$ 153,728</b> | <b>\$ 4,840</b>      | <b>\$ (1,719)</b>                                      | <b>\$ 156,849</b>                |
| Net income for six months ended June 30, 2007   |                   | 9,425                |  | 9,425                            |
| Other comprehensive income/(loss), net of tax:  |                   |                      |  |                                  |
| Net change in unrealized gain/(loss) on securities available for sale   |                   |                      | (1,200)  | (1,200)                          |
| Net change in unrealized gain/(loss) on derivative instruments  |                   |                      | 136  | 136                              |
| Comprehensive income  |                   |                      |  | 8,361                            |
| Issued 20,537 shares for stock option exercises (net of 3,485 shares exchanged and including \$18 of tax benefit) | 169               |                      |  | 169                              |
| Stock compensation expense  | 299               |                      |  | 299                              |
| Issued 136,936 shares for acquisition of Smith & Associates   | 3,150             |                      |  | 3,150                            |
| Issued 819,223 shares in payment of 5% stock dividend   | 9,518             | (9,536)              |  | (18)                             |
| Repurchased 60,000 shares of stock  | (924)             |                      |  | (924)                            |

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(dollars in thousands, except per share data)

|                                   | Common<br>Stock   | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|-----------------------------------|-------------------|----------------------|--|----------------------------------|
| Cash dividends at \$.25 per share |                   | (4,362)              |  | (4,362)                          |
| <b>Balance, June 30, 2007</b>     | <b>\$ 165,940</b> | <b>\$ 367</b>        | <b>\$ (2,783)</b>                                      | <b>\$ 163,524</b>                |

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See accompanying notes to consolidated financial statements

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MACATAWA BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
Six Month Periods Ended June 30, 2007 and 2006  
(unaudited)

| (dollars in thousands)   | <b>Six Months<br/>Ended<br/>June 30, 2007</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|--|---|---|
| <b>Cash flows from operating activities</b>                                |   |   |
| Net income   | \$ 9,425                                      | \$ 10,977                                     |
| Adjustments to reconcile net income to net cash from operating activities: |   |   |
| Depreciation and amortization  | 1,724   | 1,702   |
| Stock compensation expense   | 299   | 373   |
| Provision for loan losses  | 1,840   | 1,500   |
| Origination of loans for sale  | (53,259)                                      | (53,996)                                      |
| Proceeds from sales of loans originated for sale                           | 54,022  | 54,845  |
| Gain on sales of loans   | (813)   | (923)   |
| Net change in:   |   |   |
| Accrued interest receivable and other assets                               | 318   | (816)   |
| Bank-owned life insurance  | (415)   | (465)   |
| Accrued expenses and other liabilities                                     | (176)   | (1,337)                                       |
| Net cash from operating activities   | <u>12,965</u>                                 | <u>11,860</u>                                 |
| <b>Cash flows from investing activities</b>                                |   |   |
| Loan originations and payments, net  | (17,743)                                      | (106,772)                                     |
| Purchases of securities available for sale                                 | (15,335)                                      | (13,881)                                      |
| Maturities and calls of securities available for sale                      | 17,944  | 1,990   |
| Maturities of securities held to maturity                                  | 715   | 1,127   |
| Principal paydowns on securities   | 158   | 215   |
| Additions to premises and equipment  | (5,017)                                       | (5,017)                                       |
| Net cash used in investing activities                                      | <u>(19,278)</u>                               | <u>(122,338)</u>                              |
| <b>Cash flows from financing activities</b>                                |   |   |
| Net increase (decrease) in deposits  | (5,871)                                       | 65,329  |
| Net increase (decrease) in short term borrowings                           | (11,990)                                      | (108)   |
| Proceeds from other borrowed funds   | 85,000  | 75,000  |
| Repayments of other borrowed funds   | (32,258)                                      | (32,439)                                      |
| Cash dividends paid  | (4,380)                                       | (3,848)                                       |
| Repurchases of stock   | (924)   | --  |
| Proceeds from exercises of stock options, including tax benefit            | 169   | 789   |
| Net cash from financing activities   | <u>29,746</u>                                 | <u>104,723</u>                                |
| Net change in cash and cash equivalents                                    | 23,433  | (5,755)                                       |
| Cash and cash equivalents at beginning of period                           | <u>39,882</u>                                 | <u>49,101</u>                                 |
| <b>Cash and cash equivalents at end of period</b>                          | <b><u>\$ 63,315</u></b>                       | <b><u>\$ 43,346</u></b>                       |

See accompanying notes to consolidated financial statements



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MACATAWA BANK CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
Six Month Periods Ended June 30, 2007 and 2006  
(unaudited)

(dollars in thousands)

|   | <b>Six Months<br/>Ended<br/>June 30, 2007</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|---|---|---|
| Supplemental cash flow information        |   |   |
| Interest paid                             | \$ 37,864                                     | \$ 30,366                                     |
| Income taxes paid                         | 5,350   | 5,800   |
| Supplemental noncash disclosures:         |   |   |
| Transfers from loans to other real estate | 3,264   | 1,328   |
| Acquisition of Smith & Associates:        |   |   |
| Acquisition intangibles recorded          | 3,924   | --  |
| Other liabilities assumed                 | 774   | --  |
| Common stock issued                       | 3,150   | --  |

See accompanying notes to consolidated financial statements

MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

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**NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Principles of Consolidation: The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Macatawa Bank, and its wholly-owned subsidiary, Macatawa Bank Mortgage Company. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company also owns all of the common stock of Macatawa Statutory Trust I and Macatawa Statutory Trust II. These are grantor trusts that issued trust preferred securities and are not consolidated with the Company per FASB Interpretation No. 46.

Basis of Presentation: The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six month periods ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's 2006 Annual Report containing financial statements for the year ended December 31, 2006.

All per share amounts and average shares outstanding have been adjusted for all periods presented to reflect the 5% stock dividend distributed on May 30, 2007, the 5% stock dividend distributed on May 30, 2006 and the 3-for-2 stock split distributed on June 29, 2006.

Stock Compensation: Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-based Payment*, using the modified prospective transition method. Accordingly, the Company has recorded stock-based compensation cost using the fair value method starting in 2006. For the three month period ended June 30, 2007, the Company recorded compensation cost for stock options of \$110,000, or \$99,000 after tax, representing \$0.01 per share. For the six month period ended June 30, 2007, the Company recorded compensation cost for stock options of \$227,000, or \$204,000 after tax, representing \$0.01 per share. For the three month period ended June 30, 2006, the Company recorded compensation cost for stock options of \$185,000, or \$145,000 after tax, representing \$0.01 per share. For the six month period ended June 30, 2006 the Company recorded compensation cost for stock options of \$373,000, or \$293,000 after tax, representing \$0.02 per share.

The Company's stock compensation plan allows for the issuance of restricted stock awards. Compensation expense is based upon the market price of the Company's stock at the date of grant and is recognized over the vesting period of the awards. The Company recorded compensation expense of \$36,000 and \$72,000 for restricted stock awards for the three and six months ended June 30, 2007, respectively. There was no compensation expense recorded for restricted stock awards for the three and six months ended June 30, 2006.

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MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

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**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

New Accounting Pronouncements: The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ), as of January 1, 2007. A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded. The adoption had no effect on the Company's financial statements.

The Company and its subsidiaries are subject to U.S. federal income tax. The Company is no longer subject to examination by taxing authorities for years before 2002. The Company does not expect the total amount of unrecognized tax benefits to significantly increase in the next twelve months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. The Company did not have any amounts accrued for interest and penalties at June 30, 2007.

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 159, *The Fair Value Option for Financial Assets and Liabilities*. Adoption of this statement is required for January 1, 2008. Early adoption was allowed, effective to January 1, 2007, if that election was made by April 30, 2007. This statement allows, but does not require, companies to record certain assets and liabilities at their fair value. The fair value determination is made at the instrument level, so similar assets or liabilities could be partially accounted for using the historical cost method, while other similar assets or liabilities are accounted for using the fair value method. Changes in fair value are recorded through the income statement in subsequent periods. The statement provides for a one time opportunity to transfer existing assets and liabilities to fair value at the point of adoption with a cumulative effect adjustment recorded against equity. After adoption, the election to report assets or liabilities at fair value must be made at the point of their inception. We have not yet determined which, if any, assets or liabilities we may determine to report using the fair value accounting method. As such, we have not determined the impact that the adoption of this statement may have on our financial statement.

**NOTE 2 ACQUISITION**

On January 1, 2007, the Company completed the acquisition of Benj. A. Smith & Associates, Ltd. ("Smith & Associates").

Under the terms of the transaction, Smith & Associates was merged into the Company in exchange for 143,783 shares of common stock. The Company in turn contributed the business to Macatawa Bank. The value of the common stock was based on the average closing price during the month of September 2006 (\$21.91 per share). Share and per share amounts have been adjusted for the 5% stock dividend distributed on May 30, 2007.

The acquisition was accounted for under the purchase method of accounting. Accordingly, customer relationship intangibles valued at \$1,920,000 are being amortized using the straight line method over its estimated useful life. The resulting goodwill was \$2,004,000 which will be assessed annually for impairment, with any subsequent impairment recognized in the income statement.

Under the terms of the transaction, one \$300,000 contingent payment will also be made if revenue from transferred account balances, principal additions to transferred account balances generated by Mr. Smith and new accounts generated by Mr. Smith exceeds \$1,600,000 in 2007 and an additional \$300,000 contingent payment will be paid if such revenue exceeds \$1,700,000 in 2008. The contingent payments will be paid in the form of common stock of Macatawa Bank Corporation.

MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

**NOTE 3 SECURITIES**

The amortized cost and fair values of securities were as follows (in thousands):

|  | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> | <b>Fair<br/>Values</b> |
|--|---------------------------|---------------------------------------|--|------------------------|
| <u>June 30, 2007</u>                           |                           |                                       |  |                        |
| Available for Sale:                            |                           |                                       |  |                        |
| U.S. Treasury and federal<br>agency securities | \$ 146,126                | \$ 41                                 | \$ (2,389)                             | \$ 143,778             |
| State and municipal bonds                      | 49,669                    | 272                                   | (619)                                  | 49,322                 |
| Other equity securities                        | 1,000                     | --                                    | (34)                                   | 966                    |
|  | <u>\$ 196,795</u>         | <u>\$ 313</u>                         | <u>\$ (3,042)</u>                      | <u>\$ 194,066</u>      |
| Held to Maturity:                              |                           |                                       |  |                        |
| State and municipal bonds                      | \$ 1,921                  | \$ 37                                 | \$ (6)                                 | \$ 1,952               |
|  | <u>\$ 1,921</u>           | <u>\$ 37</u>                          | <u>\$ (6)</u>                          | <u>\$ 1,952</u>        |
| <u>December 31, 2006</u>                       |                           |                                       |  |                        |
| Available for Sale:                            |                           |                                       |  |                        |
| U.S. Treasury and federal<br>agency securities | \$ 148,753                | \$ 182                                | \$ (2,025)                             | \$ 146,910             |
| State and municipal bonds                      | 49,676                    | 1,042                                 | (63)                                   | 50,655                 |
| Other equity securities                        | 1,000                     | --                                    | (19)                                   | 981                    |
|  | <u>\$ 199,429</u>         | <u>\$ 1,224</u>                       | <u>\$ (2,107)</u>                      | <u>\$ 198,546</u>      |
| Held to Maturity:                              |                           |                                       |  |                        |
| State and municipal bonds                      | \$ 2,711                  | \$ 56                                 | \$ (5)                                 | \$ 2,762               |
|  | <u>\$ 2,711</u>           | <u>\$ 56</u>                          | <u>\$ (5)</u>                          | <u>\$ 2,762</u>        |



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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 3 SECURITIES (Continued)**

Securities with unrealized losses at June 30, 2007 and December 31, 2006, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (in thousands):

| Description of Securities                   | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| June 30, 2007                               |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency securities | \$ 37,218           | \$ (189)        | \$ 99,534         | \$ (2,200)      | \$ 136,752 | \$ (2,389)      |
| State and municipal bonds                   | 28,380              | (425)           | 4,966             | (200)           | 33,346     | (625)           |
| Other equity securities                     | --                  | --              | 966               | (34)            | 966        | (34)            |
| Total temporarily impaired                  | \$ 65,598           | \$ (614)        | \$ 105,466        | \$ (2,434)      | \$ 171,064 | \$ (3,048)      |

| Description of Securities                   | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|---|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|   | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| December 31, 2006                           |                     |                 |                   |                 |            |                 |
| U.S. Treasury and federal agency securities | \$ 5,079            | \$ (15)         | \$ 104,727        | \$ (2,010)      | \$ 109,806 | \$ (2,025)      |
| State and municipal bonds                   | 864                 | --              | 5,561             | (68)            | 6,425      | (68)            |
| Other equity securities                     | --                  | --              | 981               | (19)            | 981        | (19)            |
| Total temporarily impaired                  | \$ 5,943            | \$ (15)         | \$ 111,269        | \$ (2,097)      | \$ 117,212 | \$ (2,112)      |

For unrealized losses on securities, no loss has been recognized into income because management has the intent and ability to hold these securities for the foreseeable future and the declines are largely due to differences in market interest rates as compared to those of the underlying securities. The declines in fair value are considered temporary and are expected to recover as the bonds approach their maturity date.

Contractual maturities of debt securities at June 30, 2007 were as follows (dollars in thousands):

|                            | Held-to-Maturity Securities |            | Available-for-Sale Securities |            |
|----------------------------|-----------------------------|------------|-------------------------------|------------|
|                            | Amortized Cost              | Fair Value | Amortized Cost                | Fair Value |
| Due in one year or less    | \$ --                       | \$ --      | \$ 9,750                      | \$ 9,644   |
| Due from one to five years | 312                         | 306        | 140,340                       | 138,154    |
| Due from five to ten years | 238                         | 251        | 23,860                        | 23,847     |
| Due after ten years        | 1,371                       | 1,395      | 21,845                        | 21,455     |
|                            | \$ 1,921                    | \$ 1,952   | \$ 195,795                    | \$ 193,100 |



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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 4 LOANS**

Loans were as follows (in thousands):

|                           | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---------------------------|--------------------------|------------------------------|
| Commercial                | \$ 429,639               | \$ 416,135                   |
| Commercial mortgage       | 875,847                  | 875,717                      |
| Residential mortgage      | 230,776                  | 224,836                      |
| Consumer                  | 188,511                  | 194,762                      |
|                           | <u>1,724,773</u>         | <u>1,711,450</u>             |
| Allowance for loan losses | (23,943)                 | (23,259)                     |
|                           | <u>\$ 1,700,830</u>      | <u>\$ 1,688,191</u>          |

Activity in the allowance for loan losses was as follows (in thousands):

|                                | <b>Three Months<br/>Ended<br/>June 30, 2007</b> | <b>Three Months<br/>Ended<br/>June 30, 2006</b> | <b>Six Months<br/>Ended<br/>June 30, 2007</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|--------------------------------|---|---|---|---|
| Balance at beginning of period | \$ 23,689                                       | \$ 21,391                                       | \$ 23,259                                     | \$ 20,992                                     |
| Provision for loan losses      | 965   | 800   | 1,840   | 1,500   |
| Charge-offs                    | (789)   | (248)   | (1,295)                                       | (579)   |
| Recoveries                     | 78  | 202   | 139   | 232   |
|                                | <u>\$ 23,943</u>                                | <u>\$ 22,145</u>                                | <u>\$ 23,943</u>                              | <u>\$ 22,145</u>                              |

**NOTE 5 DEPOSITS.**

Deposits are summarized as follows (in thousands):

|                            | <b>June 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|----------------------------|--------------------------|------------------------------|
| Noninterest-bearing demand | \$ 170,308               | \$ 180,032                   |
| Money market               | 474,981                  | 459,230                      |
| NOW and Super NOW          | 268,513                  | 265,679                      |
| Savings                    | 42,180                   | 40,160                       |
| Certificates of deposit    | 705,704                  | 722,456                      |
|                            | <u>\$ 1,661,686</u>      | <u>\$ 1,667,557</u>          |

Approximately \$469,126,000 and \$504,274,000 in time certificates of deposit were in denominations of \$100,000 or more at June 30, 2007 and December 31, 2006.

Brokered deposits totaled approximately \$223,964,000 and \$272,896,000 at June 30, 2007 and December 31, 2006. At June 30, 2007 and December 31, 2006, brokered deposits had interest rates ranging from 3.95% to 4.55%, and 3.30% to 5.49%, respectively. At June 30, 2007, maturities ranged from one month to thirty-eight months.



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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 6 OTHER BORROWED FUNDS**

Other borrowed funds include advances from the Federal Home Loan Bank and securities sold under agreements to repurchase, and were as follows (in thousands):

**Federal Home Loan Bank Advances**

| <b>Principal Terms</b>              | <b>Advance Amount</b> | <b>Range of Maturities</b>      | <b>Weighted Average Interest Rate</b> |
|-------------------------------------|-----------------------|---------------------------------|---------------------------------------|
| June 30, 2007                       |                       |                                 |                                       |
| Single maturity fixed rate advances | \$ 120,000            | July 2007 to May 2010           | 4.73%                                 |
| Putable advances                    | 31,000                | September 2009 to December 2010 | 5.80%                                 |
| Amortizable mortgage advances       | 8,760                 | February 2008 to July 2018      | 3.80%                                 |
|                                     | <u>\$ 159,760</u>     |                                 |                                       |
| December 31, 2006                   |                       |                                 |                                       |
| Single maturity fixed rate advances | \$ 132,000            | April 2007 to May 2010          | 4.63%                                 |
| Putable advances                    | 31,000                | September 2009 to December 2010 | 5.80%                                 |
| Amortizable mortgage advances       | 9,018                 | February 2008 to July 2018      | 3.86%                                 |
|                                     | <u>\$ 172,018</u>     |                                 |                                       |

Each advance is payable at its maturity date and contains a prepayment penalty. These advances were collateralized by residential and commercial real estate loans totaling \$598,331,000 and \$596,829,000 under a blanket lien arrangement at June 30, 2007 and December 31, 2006. Maturities as of June 30, 2007 were as follows (in thousands):

|            |                   |
|------------|-------------------|
| 2007       | \$ 15,000         |
| 2008       | 70,523            |
| 2009       | 25,237            |
| 2010       | 41,000            |
| 2011       | --                |
| Thereafter | 8,000             |
|            | <u>\$ 159,760</u> |

**Securities Sold Under Agreements to Repurchase**

| <b>Principal Terms</b>   | <b>Amount</b>    | <b>Range of Maturities</b>  | <b>Weighted Average Interest Rate</b> |
|--------------------------|------------------|-----------------------------|---------------------------------------|
| June 30, 2007            |                  |                             |                                       |
| Fixed rate borrowings    | \$ 65,000        | February 2009 to March 2010 | 4.83%                                 |
| Floating rate borrowings | 20,000           | August 2009 to August 2010  | 5.72%                                 |
|                          | <u>\$ 85,000</u> |                             |                                       |

December 31, 2006

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**Securities Sold Under Agreements to Repurchase**

|                          |    |        |                            |       |
|--------------------------|----|--------|----------------------------|-------|
| Floating rate borrowings | \$ | 20,000 | August 2009 to August 2010 | 5.78% |
|--------------------------|----|--------|----------------------------|-------|

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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 6 OTHER BORROWED FUNDS (continued)**

Securities sold under agreements to repurchase ( repo borrowings ) are financing arrangements secured by U.S. federal agency securities. These borrowings were collateralized by securities that had a carrying amount of approximately \$90,214,000 and \$21,399,000 at June 30, 2007 and December 31, 2006. At maturity, the securities underlying the arrangements are returned to the company. Maturities as of June 30, 2007 were as follows (in thousands):

|            |    |               |
|------------|----|---------------|
| 2007       | \$ | --            |
| 2008       |    | --            |
| 2009       |    | 45,000        |
| 2010       |    | 40,000        |
| 2011       |    | --            |
| Thereafter |    | --            |
|            | \$ | <u>85,000</u> |

**NOTE 7 STOCK-BASED COMPENSATION**

The Company has stock-based compensation plans for its employees (the Employees Plans) and directors (the Directors Plans). The Employees Plans permit the grant of stock options or the issuance of restricted stock for up to 1,917,210 shares of common stock. The Directors Plans permit the grant of stock options or the issuance of restricted stock for up to 473,278 shares of common stock. There were 822,564 shares under the Employees Plans and 175,711 shares under the Directors Plans available for future issuance as of June 30, 2007. All per share amounts and average shares outstanding have been adjusted for all periods presented to reflect the 5% stock dividend distributed on May 30, 2007, the 5% stock dividend distributed on May 30, 2006 and the 3-for-2 stock split distributed on June 29, 2006. The Company issues new shares under its stock-based compensation plans from its authorized but unissued shares.

**Stock Options**

Option awards are granted with an exercise price equal to the market price at the date of grant. Option awards have vesting periods ranging from one to three years and have ten year contractual terms.

A summary of option activity in the plans is as follows (dollars in thousands, except per option data):

| <u>Options</u>                 | <u>Number Outstanding</u> | <u>Weighted-Average Exercise Price</u> | <u>Weighted-Average Remaining Contractual Life in Years</u> | <u>Aggregate Intrinsic Value</u> |
|--------------------------------|---------------------------|--|---|----------------------------------|
| Outstanding at January 1, 2007 | 1,025,783                 | \$ 14.29                               |   |                                  |
| Exercised                      | (25,054)                  | 9.53                                   |   |                                  |
| Forfeited                      | (4,957)                   | 22.77                                  |   |                                  |
| Outstanding at June 30, 2007   | <u>995,772</u>            | <u>\$ 14.36</u>                        | <u>6.34</u>   | <u>\$ 3,441</u>                  |
| Exercisable at June 30, 2007   | <u>744,827</u>            | <u>\$ 11.94</u>                        | <u>4.59</u>   | <u>\$ 3,441</u>                  |

MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

**NOTE 7 STOCK-BASED COMPENSATION** (continued)

There were no options granted during the three and six months ended June 30, 2007. The weighted-average fair value of the 4,710 options granted during the three and six months ended June 30, 2006 was \$5.65 per option.

The total intrinsic value of options exercised during the three months ended June 30, 2007 and 2006 was \$45,000 and \$248,000, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2007 and 2006 was \$222,000 and \$1.5 million, respectively.

There were no options vested during the three and six months ended June 30, 2007. The total fair value of options vested during the three and six months ended June 30, 2006 was \$8,417 and \$32,276, respectively.

As of June 30, 2007, there was approximately \$826,000 of total unrecognized compensation cost related to nonvested stock options granted under the Company's stock-based compensation plans. The cost is expected to be recognized over a weighted-average period of 1.9 years.

**Restricted Stock Awards**

A summary of nonvested stock awards activity in the plans is as follows (dollars in thousands, except per option data):

| <u>Nonvested Stock Awards</u> | <u>Shares</u> | <u>Weighted-Average<br/>Grant-Date<br/>Fair Value</u> |
|-------------------------------|---------------|---|
| Nonvested at January 1, 2007  | 22,491        | \$ 19.52  |
| Granted                       | 157           | 19.02   |
| Vested                        | ---           | ---   |
| Forfeited                     | (1,259)       | 19.52   |
| Nonvested at June 30, 2007    | <u>21,389</u> | <u>\$ 19.52</u>                                       |

As of June 30, 2007, there was \$345,000 of total unrecognized compensation cost related to nonvested shares granted under the Company's stock-based compensation plans. The cost is expected to be recognized over a weighted-average period of 2.5 years. There were no shares vested during the three and six month periods ended June 30, 2007 and 2006.



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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 8 EARNINGS PER SHARE**

A reconciliation of the numerators and denominators of basic and diluted earnings per share for the three and six month periods ended June 30, 2007 and 2006 are as follows (dollars in thousands, except per share data):

|  | <b>Three Months<br/>Ended<br/>June 30, 2007</b> | <b>Three Months<br/>Ended<br/>June 30, 2006</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> | <b>Six Months<br/>Ended<br/>June 30, 2006</b> |
|--|---|---|---|---|
| Basic earnings per share   |   |   |   |   |
| Net income   | \$ 4,590  | \$ 5,756  | \$ 9,425                                      | \$ 10,977                                     |
| Weighted average common shares outstanding                               | 17,191,063                                      | 17,010,181                                      | 17,195,050                                    | 16,990,802                                    |
| Basic earnings per share   | <u>\$ 0.27</u>                                  | <u>\$ 0.34</u>                                  | <u>\$ 0.55</u>                                | <u>\$ 0.65</u>                                |
| Diluted earnings per share   |   |   |   |   |
| Net income   | \$ 4,590  | \$ 5,756  | \$ 9,425                                      | \$ 10,977                                     |
| Weighted average common shares outstanding                               | 17,191,063                                      | 17,010,181                                      | 17,195,050                                    | 16,990,802                                    |
| Add: Dilutive effects of assumed exercise of stock options               | 213,955   | 359,057   | 248,050                                       | 399,947                                       |
| Weighted average common and dilutive potential common shares outstanding | <u>17,405,018</u>                               | <u>17,369,238</u>                               | <u>17,443,100</u>                             | <u>17,390,749</u>                             |
| Diluted earnings per share   | <u>\$ 0.26</u>                                  | <u>\$ 0.33</u>                                  | <u>\$ 0.54</u>                                | <u>\$ 0.63</u>                                |

Stock options and restricted stock awards for 360,963 and 241,478 shares of common stock for both the three and six month ended June 30, 2007 and June 30, 2006, respectively were not considered in computing diluted earnings per share because they were antidilutive.

MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
(Unaudited)

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**NOTE 9 CONTINGENCIES**

The Company and its subsidiaries periodically become defendants in certain claims and legal actions arising in the ordinary course of business.

On July 8, 2003, the Company filed a Form 8-K (dated July 1, 2003) with the Securities and Exchange Commission reporting events related to a former trust customer, Trade Partners, Inc. ( Trade Partners ), of the former Grand Bank, which the Company acquired effective April 1, 2002. Trade Partners was involved in purchasing and selling interests in viaticals, which are interests in life insurance policies of the terminally ill or elderly. Beginning in 1996, Grand Bank served as a custodian and escrow agent with respect to viaticals purchased by Trade Partners and sold to investors. Two lawsuits were filed, one in December 2002 and another in March 2003, against Trade Partners, Grand Bank and the Company alleging that Grand Bank breached certain escrow agreements related to viatical settlement contracts. Both of these lawsuits have been dismissed although the plaintiffs reserved the right to pursue the claims in the future. A third lawsuit was filed in April 2003 by two individual investors against Grand Bank, the Company, Trade Partners and certain individuals and entities associated with Trade Partners. The claims against Grand Bank and the Company in this lawsuit have been settled and dismissed with prejudice. In May 2003 a purported class action complaint was filed against the Company. As amended, this suit alleges that Grand Bank breached escrow agreements and fiduciary duties and violated the Michigan Uniform Securities Act with respect to the investments secured by the purported class in viaticals and in interests in limited partnerships which made loans to Trade Partners secured by viaticals, and with respect to loans made by purported class members directly to Trade Partners. The Company has answered the complaint denying the material allegations and raising certain affirmative defenses. In November 2006 the court denied class certification in this case. The Company believes that the class action, if it had been approved by the court, might have involved as many as 2,000 to 3,000 individual claimants. Since that denial of class certification, nine new actions, none of which is a class action, raising substantially the same allegations as the former class action have been filed in several jurisdictions on behalf of approximately 1,300 Trade Partners investors. Management believes the Company has strong defenses and will vigorously defend the cases.

Trade Partners is now in receivership. The supervising court authorized the receiver to borrow money from Macatawa Bank to pay premiums, if needed. Macatawa Bank extended a \$4 million line of credit to the receiver, conditioned upon obtaining a security interest in the viaticals. No draws were made against the line, and the line expired during the fourth quarter of 2004.

It is possible that one or more additional legal actions may be initiated involving the custodial and escrow agent services provided by Grand Bank in connection with Trade Partners. If any such legal actions are commenced, the Company intends to defend them vigorously. To the extent any pending or future claims allege errors or omissions on the part of Grand Bank or Macatawa Bank, management believes that some or all liability, if any is proven or established, will be covered by errors and omissions insurance maintained by Grand Bank and Macatawa Bank. The Company has reported the Trade Partners matter to its two insurance carriers. Federal Insurance Company has assumed the Company's defense and has advanced a portion of its defense costs pursuant to a reservation of rights letter asserting certain coverage defenses, and an Interim Funding Agreement. Federal Insurance Company on July 21, 2006 notified the Company that it had filed an Arbitration Demand with the American Arbitration Association, seeking a declaration that based on its asserted coverage defenses its policy does not cover this matter. The Company and Federal Insurance Company have agreed to defer any proceedings with respect to this Arbitration Demand. The Company believes that Federal Insurance Company is obligated to provide coverage, and the Company intends to vigorously pursue its rights under the insurance policy. The other carrier has taken the position that the duty of defense rests solely with the first carrier, and reserves its rights with respect to indemnity.

The legal actions involving Trade Partners have not progressed to trial and the outcome of such actions is uncertain. While we are therefore unable to determine at this time whether or to what extent these actions may impact the Company, the Company believes it has strong defenses and fully intends to defend any and all such actions vigorously.

MACATAWA BANK CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 10 HEDGING ACTIVITIES**

The Company's asset/liability management policy includes guidelines for measuring and monitoring interest rate risk. Within these guidelines, parameters have been established for maximum fluctuations in net interest income. Possible fluctuations are measured and monitored using simulation analysis. The policies provide for the use of derivative instruments and hedging activities to aid in managing interest rate risk to within the policy parameters.

The Company's assets are comprised of a large portion of loans on which the interest rates are variable. As such, the Company may periodically enter into derivative financial instruments to mitigate exposure to fluctuations in cash flows resulting from changes in interest rates. Interest rate swap arrangements may be utilized to hedge against these fluctuations in cash flows.

The Company has entered into interest rate swap arrangements ( swaps ), all of which are classified as cash flow hedges that convert the variable rate cash inflows on certain of its loans to fixed rates of interest. These swaps pay interest to the Company at a fixed rate and require interest payments from the Company at a variable rate. All of these swaps were fully effective during 2006 and the first six months of 2007. At June 30, 2007, it is anticipated that approximately \$564,000, net of tax, of net unrealized losses on these cash flow hedges will be reclassified to earnings over the next twelve months.

Summary information about interest rate swaps were as follows (dollars in thousands).

|  | <b>June 30,<br/>2007</b>    | <b>December 31,<br/>2006</b> |
|--|-----------------------------|------------------------------|
|  | <u>                    </u> | <u>                    </u>  |
| Notional amounts                               | \$ 60,000                   | \$ 80,000                    |
| Weighted average pay rates                     | 8.25%                       | 8.25%                        |
| Weighted average receive rates                 | 6.65%                       | 6.42%                        |
| Weighted average maturity                      | 2.0 years                   | 2.0 years                    |
| Unrealized loss related to interest rate swaps | \$ (1,553)                  | \$ (1,762)                   |

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MACATAWA BANK CORPORATION  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)  
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**NOTE 11 REGULATORY MATTERS**

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five classifications, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If the Bank is only adequately capitalized, regulatory approval is required to accept brokered deposits; and if the Bank is undercapitalized, capital distributions are limited, as is asset growth and expansion, and plans for capital restoration are required.

At June 30, 2007 and December 31, 2006, actual capital levels and minimum required levels were (in thousands):

|  | Actual     |       | Minimum Required<br>For Capital<br>Adequacy Purposes |       | To Be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Regulations |       |
|--|------------|-------|--|-------|--|-------|
|  | Amount     | Ratio | Amount   | Ratio | Amount   | Ratio |
| <u>June 30, 2007</u>                     |            |       |  |       |  |       |
| Total capital (to risk weighted assets)  |            |       |  |       |  |       |
| Consolidated                             | \$ 201,136 | 11.0% | \$ 146,150   | 8.0%  | N/A  | N/A   |
| Bank                                     | 195,865    | 10.7  | 146,193  | 8.0   | \$ 182,742   | 10.0  |
| Tier 1 capital (to risk weighted assets) |            |       |  |       |  |       |
| Consolidated                             | 178,300    | 9.8   | 73,075   | 4.0   | N/A  | N/A   |
| Bank                                     | 173,022    | 9.5   | 73,097   | 4.0   | 109,645  | 6.0   |
| Tier 1 capital (to average assets)       |            |       |  |       |  |       |
| Consolidated                             | 178,300    | 8.5   | 83,519   | 4.0   | N/A  | N/A   |
| Bank                                     | 173,022    | 8.3   | 83,407   | 4.0   | 104,258  | 5.0   |
| <u>December 31, 2006</u>                 |            |       |  |       |  |       |
| Total capital (to risk weighted assets)  |            |       |  |       |  |       |
| Consolidated                             | \$ 196,256 | 10.9% | \$ 144,677   | 8.0%  | N/A  | N/A   |
| Bank                                     | 189,403    | 10.5  | 144,492  | 8.0   | \$ 180,615   | 10.0  |
| Tier 1 capital (to risk weighted assets) |            |       |  |       |  |       |
| Consolidated                             | 171,650    | 9.5   | 72,338   | 4.0   | N/A  | N/A   |
| Bank                                     | 166,826    | 9.2   | 72,246   | 4.0   | 108,369  | 6.0   |
| Tier 1 capital (to average assets)       |            |       |  |       |  |       |
| Consolidated                             | 171,650    | 8.5   | 80,746   | 4.0   | N/A  | N/A   |
| Bank                                     | 166,826    | 8.3   | 80,602   | 4.0   | 100,752  | 5.0   |

The Bank was categorized as well capitalized at June 30, 2007 and December 31, 2006. There are no conditions or events since June 30, 2007 that management believes have changed its category.

**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION**

Macatawa Bank Corporation is a Michigan corporation and is the holding company for a wholly owned subsidiary, Macatawa Bank and for two trusts, Macatawa Statutory Trust I and Macatawa Statutory Trust II. Macatawa Bank Corporation is a financial holding company pursuant to Title I of the Gramm-Leach-Bliley Act. Macatawa Bank is a Michigan chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation. The bank operates twenty-six branch offices and a lending and operational service facility, providing a full range of commercial and consumer banking and trust and brokerage services in Kent County, Ottawa County, and northern Allegan County, Michigan. As also more fully discussed in the company's Form 8-K dated October 11, 2006, Macatawa Bank Corporation entered into an Agreement and Plan of Merger with the Smith & Associates investment advisory firm based in Holland, Michigan. The Smith & Associates acquisition became effective on January 1, 2007 and that business is now part of Macatawa Bank. Macatawa Statutory Trusts I and II are grantor trusts and issued \$20.0 million each of pooled trust preferred securities. These trusts are not consolidated in the Corporation's financial statements. For further information regarding consolidation, see the Notes to the Consolidated Financial Statements included herein. Macatawa Bank Mortgage Company, a subsidiary of Macatawa Bank, originates and sells residential mortgage loans into the secondary market on a servicing released basis.

We have experienced rapid and substantial growth since opening Macatawa Bank in November of 1997. We believe that growth in core deposits is key to our long-term success and is our primary funding source for asset growth. Establishing a branching network in our markets has been of high importance in order to facilitate this core deposit growth. We have gained community awareness and acceptance in our markets through our expanding branch network and high quality service standards.

The West Michigan markets within which we operate continue to provide significant expansion opportunities for us. We opened our twenty-sixth branch in Cascade on the east side of the greater Grand Rapids area during the second quarter of 2007. Because of the significance of the greater Grand Rapids market and the great opportunity for market share growth, we anticipate additional branch openings in this market. We also continue to enjoy success in building new and existing relationships in both our Holland/Zeeland and Grand Haven markets. We anticipate that we will continue to experience growth in our balance sheet and in our earnings due to these expansion opportunities.

## RESULTS OF OPERATIONS

**Summary:** Net income for the quarter ended June 30, 2007 was \$4.6 million, a decrease of 20% as compared to second quarter 2006 net income of \$5.8 million. Earnings per share on a diluted basis were \$0.26 for the second quarter of 2007 compared to \$0.33 for the same period in 2006. Net income for the six months ended June 30, 2007 was \$9.4 million, a decrease of 14% compared to the \$11.0 million for the same period in the prior year. Earnings per share on a diluted basis were \$0.54 for the six months ended June 30, 2007 compared to \$0.63 for the same period in the prior year.

The decreases in net income for both the three and six months ended June 30, 2007 compared to the same periods in the prior year were primarily due to decreases in net interest income and increases in noninterest expense partially offset by increases in noninterest income. Also contributing to the overall decreases in net income for both the three and six months ended June 30, 2007 was an increase in the provision for loan losses.

**Net Interest Income:** Net interest income totaled \$16.3 million for the second quarter of 2007, a decrease of \$640,000, or 4%, as compared to the second quarter of 2006. Net interest income for the first six months of 2007 totaled \$32.4 million, a decrease of \$894,000 or 3% as compared to \$33.2 million for the same period in 2006. The decrease in net interest income for both the three and six month periods was from a decline in the net interest margin partially offset by an increase in average earning assets. Average earning assets increased \$151.2 million, or 8%, to \$1.97 billion for the second quarter of 2007 compared to \$1.82 billion for the second quarter of 2006. Average earning assets increased \$172.2 million, or 10%, to \$1.95 billion for the six month period ended June 30, 2007 compared to \$1.78 billion for the same period of the prior year. The net interest margin decreased 42 basis points to 3.32% for the second quarter of 2007 and 43 basis points to 3.33% for the first six months of 2007 when compared to the same periods in the prior year.

During both the three and six month periods, the increase in the cost of funds exceeded the increase in the yield on earning assets and is the primary reason for the decrease in the net interest margin. The yield on earning assets increased by one basis point and 14 basis points for both the three and six months ended June 30, 2007 as compared to the same periods in the prior year. The cost of funds increased 44 basis points and 59 basis points, respectively, for the three and six months ended June 30, 2007 as compared to the same periods in the prior year. The increases in short-term rates that began in mid-2004 and continued through June of 2006 is the primary reason for the overall increase in the yield on assets. The increase in the yield on earning assets has stabilized over the past several quarters as loan customers have preferred the generally lower rate fixed rate products over variable rate products. Fixed rate products have been priced lower than their variable rate counterparts due to the nature of the interest rate environment that has existed since June 2006 in which long-term rates have been lower than shorter-term rates. In addition, the increase in nonperforming loans that has occurred in 2007 has also had a negative impact on the overall loan portfolio yield. An increase in the rates paid on our deposit accounts, the rollover of time deposits at higher rates and a shift to higher costing sources of funds are the primary reasons for the increase in the cost of funds. The rates paid on time deposits and other rate sensitive products have reached attractive levels causing deposit customers to shift funds from transaction accounts, primarily non-interest demand and money market accounts, into these higher rate accounts. The increase in the cost of funds, however, has stabilized recently as the majority of time deposits have repriced within the current rate environment, and the extent of balances shifting to higher costing sources has declined.

Anticipated growth in earning assets is expected to slow to levels lower than we have experienced in the past due to the generally weak economic conditions in Michigan. We also expect the current interest rate environment, in which long-term rates remain close to short-term rates, to still place moderate pressure on our net interest margin.

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The following table shows an analysis of net interest margin for the three-month periods ending June 30, 2007 and 2006.

### For the three months ended June 30,

|   | 2007               |                               |                             | 2006               |                               |                             |
|---|--------------------|-------------------------------|-----------------------------|--------------------|-------------------------------|-----------------------------|
|   | Average<br>Balance | Interest<br>Earned or<br>paid | Average<br>Yield<br>or cost | Average<br>Balance | Interest<br>Earned or<br>paid | Average<br>Yield or<br>cost |
| (Dollars in thousands)  |                    |                               |                             |                    |                               |                             |
| <u>Assets</u>   |                    |                               |                             |                    |                               |                             |
| Taxable securities  | \$ 148,593         | \$ 1,644                      | 4.42%                       | \$ 122,195         | \$ 1,265                      | 4.14%                       |
| Tax-exempt securities (1)   | 52,105             | 548                           | 6.48%                       | 50,811             | 534                           | 6.47%                       |
| Loans(2)  | 1,733,992          | 33,105                        | 7.57%                       | 1,627,407          | 30,889                        | 7.52%                       |
| Federal Home Loan Bank stock  | 12,275             | 123                           | 3.95%                       | 13,910             | 191                           | 5.42%                       |
| Federal funds sold  | 20,090             | 263                           | 5.18%                       | 1,484              | 17                            | 4.67%                       |
| <br>  |                    |                               |                             |                    |                               |                             |
| Total interest earning assets (1)   | 1,967,055          | 35,683                        | 7.26%                       | 1,815,807          | 32,896                        | 7.25%                       |
| Noninterest earning assets:   |                    |                               |                             |                    |                               |                             |
| Cash and due from banks   | 30,919             |                               |                             | 35,949             |                               |                             |
| Other   | 117,000            |                               |                             | 97,643             |                               |                             |
| <br>  |                    |                               |                             |                    |                               |                             |
| Total assets  | \$ 2,114,974       |                               |                             | \$ 1,949,399       |                               |                             |
| <br><u>Liabilities</u>  |                    |                               |                             |                    |                               |                             |
| NOWs and MMDAs  | \$ 739,338         | 6,735                         | 3.65%                       | \$ 629,203         | 4,890                         | 3.12%                       |
| Savings   | 42,514             | 61                            | 0.58%                       | 42,118             | 61                            | 0.58%                       |
| IRAs  | 43,103             | 513                           | 4.78%                       | 36,013             | 378                           | 4.21%                       |
| Time deposits   | 656,362            | 7,987                         | 4.88%                       | 683,121            | 7,504                         | 4.40%                       |
| Other borrowed funds  | 248,549            | 3,102                         | 4.94%                       | 175,667            | 2,004                         | 4.51%                       |
| Long-term debt  | 41,238             | 860                           | 8.25%                       | 41,238             | 824                           | 7.91%                       |
| Federal funds borrowed  | 6,548              | 90                            | 5.44%                       | 20,531             | 260                           | 5.01%                       |
| <br>  |                    |                               |                             |                    |                               |                             |
| Total interest bearing liabilities  | 1,777,652          | 19,348                        | 4.35%                       | 1,627,891          | 15,921                        | 3.91%                       |
| Noninterest bearing liabilities:  |                    |                               |                             |                    |                               |                             |
| Noninterest bearing demand accounts   | 164,532            |                               |                             | 166,257            |                               |                             |
| Other noninterest bearing liabilities..   | 7,088              |                               |                             | 6,999              |                               |                             |
| Shareholders' equity  | 165,702            |                               |                             | 148,252            |                               |                             |
| <br>  |                    |                               |                             |                    |                               |                             |
| Total liabilities and shareholders' equity  | \$ 2,114,974       |                               |                             | \$ 1,949,399       |                               |                             |
| <br>  |                    |                               |                             |                    |                               |                             |
| Net interest income   |                    | \$ 16,335                     |                             |                    | \$ 16,975                     |                             |
| <br>  |                    |                               |                             |                    |                               |                             |
| Net interest spread (1)   |                    |                               | 2.91%                       |                    |                               | 3.34%                       |
| Net interest margin (1)   |                    |                               | 3.32%                       |                    |                               | 3.74%                       |
| Ratio of average interest earning assets to<br>average interest bearing liabilities | 110.65%            |                               |                             | 111.54%            |                               |                             |

(1) Yield adjusted to fully tax equivalent.

(2) Includes non-accrual loans.





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The following table shows an analysis of net interest margin for the six-month periods ending June 30, 2007 and 2006.

**For the six months ended June 30,**

|   | 2007                |                               |                             | 2006                |                               |                             |
|---|---------------------|-------------------------------|-----------------------------|---------------------|-------------------------------|-----------------------------|
|   | Average<br>Balance  | Interest<br>Earned or<br>paid | Average<br>Yield<br>or cost | Average<br>Balance  | Interest<br>Earned or<br>paid | Average<br>Yield or<br>cost |
| (Dollars in thousands)  |                     |                               |                             |                     |                               |                             |
| <u>Assets</u>   |                     |                               |                             |                     |                               |                             |
| Taxable securities  | \$ 149,570          | \$ 3,308                      | 4.42%                       | \$ 118,057          | \$ 2,411                      | 4.08%                       |
| Tax-exempt securities (1)   | 52,244              | 1,100                         | 6.48%                       | 50,940              | 1,073                         | 6.48%                       |
| Loans(2)  | 1,724,251           | 65,563                        | 7.58%                       | 1,596,188           | 59,268                        | 7.40%                       |
| Federal Home Loan Bank stock  | 12,275              | 280                           | 4.54%                       | 13,910              | 362                           | 5.18%                       |
| Federal funds sold  | 13,965              | 364                           | 5.19%                       | 983                 | 23                            | 4.56%                       |
| <b>Total interest earning assets (1)</b>  | <b>1,952,305</b>    | <b>70,615</b>                 | <b>7.27%</b>                | <b>1,780,078</b>    | <b>63,137</b>                 | <b>7.13%</b>                |
| Noninterest earning assets:   |                     |                               |                             |                     |                               |                             |
| Cash and due from banks   | 31,067              |                               |                             | 36,085              |                               |                             |
| Other   | 113,466             |                               |                             | 97,094              |                               |                             |
| <b>Total assets</b>   | <b>\$ 2,096,838</b> |                               |                             | <b>\$ 1,913,257</b> |                               |                             |
| <u>Liabilities</u>  |                     |                               |                             |                     |                               |                             |
| NOWs and MMDAs  | \$ 733,888          | 13,293                        | 3.66%                       | \$ 616,015          | 8,978                         | 2.94%                       |
| Savings   | 41,557              | 120                           | 0.58%                       | 41,424              | 119                           | 0.58%                       |
| IRAs  | 42,174              | 988                           | 4.72%                       | 34,957              | 710                           | 4.10%                       |
| Time deposits   | 667,196             | 16,133                        | 4.78%                       | 681,083             | 14,506                        | 4.29%                       |
| Other borrowed funds  | 232,477             | 5,751                         | 4.92%                       | 159,035             | 3,425                         | 4.28%                       |
| Long-term debt  | 41,238              | 1,712                         | 8.26%                       | 41,238              | 1,594                         | 7.69%                       |
| Federal funds borrowed  | 8,138               | 223                           | 5.45%                       | 21,244              | 516                           | 4.83%                       |
| <b>Total interest bearing liabilities</b>   | <b>1,766,668</b>    | <b>38,220</b>                 | <b>4.35%</b>                | <b>1,594,996</b>    | <b>29,848</b>                 | <b>3.76%</b>                |
| Noninterest bearing liabilities:  |                     |                               |                             |                     |                               |                             |
| Noninterest bearing demand accounts   | 161,013             |                               |                             | 163,716             |                               |                             |
| Other noninterest bearing liabilities..   | 6,117               |                               |                             | 7,592               |                               |                             |
| Shareholders' equity  | 163,040             |                               |                             | 146,953             |                               |                             |
| <b>Total liabilities and shareholders' equity</b>                                   | <b>\$ 2,096,838</b> |                               |                             | <b>\$ 1,913,257</b> |                               |                             |
| <b>Net interest income</b>  |                     | <b>\$ 32,395</b>              |                             |                     | <b>\$ 33,289</b>              |                             |
| Net interest spread (1)   |                     |                               | 2.92%                       |                     |                               | 3.37%                       |
| Net interest margin (1)   |                     |                               | 3.33%                       |                     |                               | 3.76%                       |
| Ratio of average interest earning assets to<br>average interest bearing liabilities | 110.51%             |                               |                             | 111.60%             |                               |                             |

(1) Yield adjusted to fully tax equivalent.

(2) Includes non-accrual loans.



**Provision for Loan Losses:** The provision for loan losses for the three and six month periods ended June 30, 2007 was \$965,000 and \$1.8 million compared to \$800,000 and \$1.5 million for the same periods in the prior year. The provision for loan losses was up primarily due to higher levels of net charge-offs in both the three and six month periods ended when compared to the same periods in the prior year. The amounts of loan loss provision in both the current and prior year period were a byproduct of establishing our allowance for loan losses at levels deemed necessary in our methodology for determining the adequacy of the allowance. For more information about our allowance for loan losses and our methodology for establishing its level, see the discussion below under Portfolio Loans and Asset Quality.

**Noninterest Income:** Noninterest income for the three and six month periods ended June 30, 2007 increased to \$4.0 million and \$7.8 million, respectively, from \$3.6 million and \$6.8 million for the same periods in the prior year. An increase in trust fee income of \$413,000 and \$784,000 for the three and six month periods was the primary reason for the overall increase in noninterest income. The majority of the increase in trust fees is related to the impact of customer relationships added from the Smith & Associates acquisition on January 1, 2007. The increase of \$113,000 and \$196,000 in other income for the three and six month periods was primarily from an increase in ATM/Debit card fees from an increase in card usage. Revenue from service charges on deposits increased modestly, while we saw slight declines in gains on loans sold during both the three and six month periods. Gains on loans sold during the three and six month periods in the prior year included gains of \$59,000 on the sale of SBA guaranteed loans.

**Noninterest Expense:** Noninterest expense for the three and six month periods ended June 30, 2007 increased to \$12.6 million and \$24.3 million, respectively, from \$11.3 million and \$22.4 for the same periods in the prior year. Increases in salary and benefits, occupancy and furniture and equipment costs for both the three and six month periods are primarily associated with the new Asset Management Services group and the opening of four new facilities since the beginning of the year. The increase of \$766,000 and \$1,075,000 in other expense for the three and six month periods include costs associated with the new service and facility additions, carrying costs associated with nonperforming assets and increased FDIC assessments. FDIC assessments increased by \$228,000 and \$405,000 for three and six month periods related to a change in the FDIC assessment rate for all banks effective January 1, 2007. Also included in other expense for the quarter was a nonrecurring loss of \$170,000 related to a deposit account. Although we expect noninterest expense levels to generally rise with our growth, we expect efficiency to improve by better utilizing our capacity as we grow. We believe the additional capacity within our branch network will continue to provide future growth opportunities without significant additional costs.

## **FINANCIAL CONDITION**

**Summary:** Total assets were \$2.12 billion at June 30, 2007, an increase of \$41 million from \$2.07 billion at December 31, 2006. The growth in assets was primarily from an increase of \$30.0 million in fed funds sold and \$13.3 million in total portfolio loans funded by an increase in borrowed funds.

**Securities Available for Sale:** Securities available for sale were \$194.1 million at June 30, 2007 compared to \$198.5 million at December 31, 2006. The decrease was primarily due to calls and maturities of U.S. Government Agency bonds, partially offset by purchases of U.S. Government Agency bonds.

**Portfolio Loans and Asset Quality:** Total portfolio loans were \$1.72 billion at June 30, 2007 compared to \$1.71 billion at December 31, 2006. Commercial loans continue to lead our loan portfolio growth. Of the \$13.3 million in total loan growth during the first six months of 2007, \$13.7 million was from our commercial loan portfolios. Commercial and commercial real estate loans accounted for approximately 76% of the total loan portfolio at June 30, 2007 and approximately 75% at December 31, 2006.

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A further breakdown of the composition of commercial real estate loans is shown in the table below (in thousands):

|                                    | <b>June 30, 2007</b> | <b>December 31, 2006</b> |
|------------------------------------|----------------------|--------------------------|
| Construction                       | \$ 148,837           | \$ 153,903               |
| Land Development                   | 199,673              | 206,469                  |
| Farmland and Agriculture           | 27,890               | 37,426                   |
| Nonfarm, Nonresidential            | 462,805              | 439,436                  |
| Multi-family                       | 36,642               | 38,483                   |
| <br>                               |                      |                          |
| Total Commercial Real Estate Loans | 875,847              | 875,717                  |
| Commercial and Industrial          | 429,639              | 416,135                  |
| <br>                               |                      |                          |
| Total Commercial Loans             | \$ 1,305,486         | \$ 1,291,852             |

Approximately 60% of the balance in the construction and land development category and approximately 91% of the balance in the multi-family category were comprised of non-owner occupied loans at June 30, 2007. Approximately two-thirds of the balance in the construction and land development category and the entire balance in the multi-family category were comprised of non-owner occupied loans at December 31, 2006.

Residential mortgages increased \$5.9 million while consumer loans declined by \$6.3 million in our consumer loan portfolio. Residential mortgage loans comprised 13% of the portfolio, while consumer loans were 11% of total loans at June 30, 2007.

The slower loan growth in recent quarters is a reflection of the weak economic conditions in West Michigan and our interest in maintaining the quality of our loan portfolio. In particular, deterioration in residential land development has impacted both asset growth and asset quality.

Nonperforming assets are comprised of nonperforming loans, foreclosed assets and repossessed assets. Our nonperforming loans include loans on non-accrual status, restructured loans, as well as loans delinquent more than 90 days, but still accruing. Foreclosed and repossessed assets include assets acquired in settlement of loans. Nonperforming loans to total loans increased to 1.71% at June 30, 2007 from 1.30% at December 31, 2006. The balance of nonperforming loans at December 31, 2006 included one large commercial relationship totaling approximately \$15.2 million. Approximately \$10.5 million from this relationship was renewed in January of 2007 and returned to a performing status. The remaining \$4.7 million was restructured with a reduced interest rate for a period of one year. The resultant increase in nonperforming loans since December 31, 2006 primarily relates to commercial loans associated with residential land development. Of the \$29.5 million of nonperforming loans at June 30, 2007, approximately two-thirds, or \$20 million, relates to residential land development. Of this amount, approximately \$10 million relates to two large commercial borrowers classified as nonaccrual and \$4.7 million restructured loan discussed above and classified as renegotiated at June 30, 2007. The remaining balance of nonperforming loans are primarily a number of smaller balance commercial loans considered to be well collateralized or adequately reserved. Foreclosed assets at June 30, 2007 are comprised of a number of smaller commercial and residential properties for which carrying values are considered to be fully collectible.

The following table shows the composition and amount of our nonperforming assets.

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(Dollars in thousands)

|   | June 30, 2007    | December 31, 2006 |
|---|------------------|-------------------|
| Nonaccrual loans                          | \$ 19,959        | \$ 5,811          |
| Renegotiated loans                        | 4,764            | --                |
| Loans 90 days past due and still accruing | 4,747            | 16,479            |
| <b>Total nonperforming loans</b>          | <b>29,470</b>    | <b>22,290</b>     |
| Foreclosed assets                         | 5,678            | 3,212             |
| Repossessed assets                        | 624              | 81                |
| <b>Total nonperforming assets</b>         | <b>\$ 35,772</b> | <b>\$ 25,583</b>  |

|                                      |       |       |
|--------------------------------------|-------|-------|
| Nonperforming loans to total loans   | 1.71% | 1.30% |
| Nonperforming assets to total assets | 1.69% | 1.23% |

**Allowance for loan losses:** The allowance for loan losses as of June 30, 2007 was \$23.9 million, or 1.39% of total portfolio loans, compared to \$23.3 million, or 1.36% of total portfolio loans at December 31, 2006. Net charge-offs for the six months ended June 30, 2007 totaled \$1.2 million as compared to \$347,000 for the same period in 2006. The ratio of net charge-offs to average loans was 0.13% on an annualized basis for the first six months of 2007 compared to 0.04% for the first six months of 2006. The provision for loan losses increased \$340,000 to \$1.8 million for the six months ended June 30, 2007 compared to \$1.5 million for the same period of the prior year primarily due to the increase in net charge-offs.

Our allowance for loan losses is maintained at a level considered appropriate based upon our regular, quarterly assessments of the probable estimated losses inherent in the loan portfolio. Our methodology for measuring the appropriate level of allowance relies on several key elements, which include specific allowances for loans considered impaired, formula allowance for graded loans, general allocations based on historical trends for pools of similar loan types and under certain circumstances, and an unallocated reserve related to current market conditions that are pertinent to certain aspects of the loan portfolio.

During the fourth quarter of 2006, regulatory authorities reached a conceptual consensus on the method for determining the allowance. In addition to reaffirming the importance of experience grounded, objectively determinable amounts, they acknowledged the appropriateness of considering other subjective factors in determining the proper level of the allowance. We believe our process conforms to this guidance.

Specific allowances are established in cases where senior credit management has identified significant conditions or circumstances related to an individually impaired credit that we believe indicates the probability that a loss has been incurred. This amount is determined by methods prescribed by SFAS No. 114, Accounting by Creditors for Impairment of a Loan. The specific allowance for impaired loans was \$2.6 million at June 30, 2007 and \$400,000 at December 31, 2006. The increase is primarily due to the growing weakness in our land development loans.

The allowance allocated to commercial loans that are not considered to be impaired is based upon the internal risk grade of such loans or based on similar types of loans for which a change in market conditions exists. We use a loan rating method based upon an eight point system. Loans are assigned a loss allocation factor for each loan classification category. The lower the grade assigned to a loan category, the greater the allocation percentage that is applied. Changes in risk grade of loans affect the amount of the allowance allocation. In addition, similar types of graded loans may be segregated based on collateral or purpose characteristics. An allowance for these types may be established due to a change in economic conditions and trends for that type. Our loan portfolio has grown rapidly since our inception. As a result, a significant portion of our loan portfolio remains relatively unseasoned and our actual historical loan loss experience is limited. Accordingly, the determination of our loss factors includes consideration of the banking industry's historical loan loss experience by loan type and the historical loan loss experience within our geographic markets, as well as our own loan loss experience and trends. These factors are regularly monitored and adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the analysis date. The commercial loan allowance was \$19.4 million at June 30, 2007 compared to \$21.0 million at December 31, 2006 and decreased primarily in response to the migration of certain commercial loans to an impaired status.

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Groups of homogeneous loans, such as residential real estate, open- and closed-end consumer loans, etc., receive allowance allocations based on loan type. As with commercial loans, the determination of the allowance allocation percentage includes consideration of historical loss trends based on industry and peer experience as well as our historical loss experience. General economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience are considered in connection with allocation factors for these similar pools of loans. The homogeneous loan allowance was \$1.9 million at June 30, 2007 compared to \$1.8 million at December 31, 2006.

**Deposits and Other Borrowings:** Total deposits decreased \$5.9 million to \$1.66 billion at June 30, 2007 compared to \$1.67 billion at December 31, 2006. Brokered deposits decreased \$48.9 million during the first six months. An increase of \$43 million in deposits within the Company's markets and an increase in other borrowings at more attractive terms and pricing, allowed the Company to reduce its reliance on brokered deposits. The growth in deposits within the Company's markets was primarily from interest earning checking accounts and money market and certificates of deposit, as deposit customers continue to prefer such accounts within the generally high rate environment. With our continued focus on quality customer service, the desire of customers to deal with a local bank, and the convenience of our expanding and maturing branch network, we expect further growth in our core transaction deposits.

The increase in other borrowed funds of \$52.7 million was related to an increase in securities sold under agreements to repurchase (repo borrowings). Since the third quarter of 2006, the bank has utilized repo borrowings as an alternative source of funds. The terms and structure of these instruments were considered more favorable compared to other alternatives and was the reason for the increase during the quarter. Repo borrowings increased \$65.0 million during the first six months and were offset by a decrease in FHLB borrowings of \$12 million.

### **CAPITAL RESOURCES AND LIQUIDITY**

**Capital Resources:** Total shareholders' equity increased \$6.7 million during the first six months to \$163.5 million at June 30, 2007 primarily from the retention of earnings. Also contributing to the increase was an additional \$3.1 million in capital related to the issuance of common shares for the acquisition of Smith & Associates.

Net income generated during the first six months of 2007 of \$9.4 million was partially offset by cash dividends of \$4.4 million, or \$.25 per share. We began paying cash dividends at the end of 2000 and have increased the amount of the dividend each year since then. It is anticipated that we will continue to pay quarterly cash dividends in the future. We have also paid a stock dividend each year beginning in 2001. On May 30, 2007, a 5% stock dividend was paid to shareholders of record as of May 11, 2007, representing our seventh consecutive annual stock dividend. All per share and average share information in this report has been adjusted to reflect the effect of the dividend and the split.

The \$1.1 million reduction in accumulated other comprehensive income was primarily from a decrease in the market value of securities available for sale as market interest rates have slowly increased since the beginning of the year.

During the second quarter of 2007, the Company's Board of Directors authorized a stock repurchase program under which the Company may acquire up to \$30 million of its outstanding stock. At June 30, 2007, the Company had repurchased 60,000 shares costing approximately \$924,000. For further details regarding the stock repurchase program, refer to Part II, Item 2, Changes in Securities and Use of Proceeds.

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Our total capital to risk-weighted assets was 11.0% at June 30, 2007 and 10.9% at December 31, 2006. Our Tier 1 Capital as a percent of average assets was 8.5% at both June 30, 2007 and December 31, 2006. Both ratios continue to be maintained at levels in excess of the regulatory minimums for *adequately capitalized* institutions, the highest classification for bank holding companies. The ratios remained flat since the beginning of the year primarily because our retained earnings have kept pace with the growth in our assets.

**Liquidity:** The liquidity of a financial institution reflects its ability to measure and monitor a variety of sources and uses of funds. Our Consolidated Statements of Cash Flows categorize these sources and uses into operating, investing and financing activities. We primarily focus on developing access to a variety of borrowing sources to supplement our deposit gathering activities and provide funds for growing our investment and loan portfolios. Our sources of liquidity include our borrowing capacity with the Federal Home Loan Bank, structured repo borrowings and federal funds purchased lines with our correspondent banks, loan payments by our borrowers, maturities and sales of our securities available for sale, growth of our deposits and deposit equivalents, federal funds sold, and the various capital resources discussed above. Liquidity management involves the ability to meet the cash flow requirements of our customers. Our customers may be either borrowers with credit needs or depositors wanting to withdraw funds. We feel our liquidity position is sufficient to meet these needs.

### Forward Looking Statements

This report includes forward-looking statements as that term is used in the securities laws. All statements regarding our expected financial position, business and strategies are forward-looking statements. In addition, the words anticipates, believes, estimates, seeks, expects, plans, intends, and similar expressions, as they relate to us or our management, are intended to identify forward-looking statements. The presentation and discussion of the provision and allowance for loan losses, statements concerning future profitability or future growth or increases, and statements about the adequacy of our capital resources are examples of inherently forward looking statements in that they involve judgments and statements of belief as to the outcome of future events. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse affect on our operations and our future prospects include, but are not limited to, changes in: interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in our market area and accounting principles, policies and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Further information concerning us and our business, including additional factors that could materially affect our financial results, is included in our filings with the Securities and Exchange Commission.

**Item 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**Market Risk Analysis

Our primary market risk exposure is interest rate risk and, to a lesser extent, liquidity risk. All of our transactions are denominated in U.S. dollars with no specific foreign exchange exposure. Macatawa Bank has only limited agricultural-related loan assets, and therefore has no significant exposure to changes in commodity prices.

Our balance sheet has sensitivity, in various categories of assets and liabilities, to changes in prevailing rates in the U.S. for prime rate, mortgage rates, U.S. Treasury rates and various money market indexes. Our asset/liability management process aids us in providing liquidity while maintaining a balance between interest earning assets and interest bearing liabilities.

We utilize a simulation model as our primary tool to assess the direction and magnitude of variations in net interest income and the economic value of equity ( EVE ) resulting from potential changes in market interest rates. Key assumptions in the model include contractual cash flows and maturities of interest-sensitive assets and interest-sensitive liabilities, prepayment speeds on certain assets, and changes in market conditions impacting loan and deposit pricing. We also include pricing floors on discretionary priced liability products which limit how low various checking and savings products could go under declining interest rates. These floors reflect our pricing philosophy in response to changing interest rates.

We forecast the next twelve months of net interest income under an assumed environment of gradual changes in market interest rates under various scenarios. The resulting change in net interest income is an indication of the sensitivity of our earnings to directional changes in market interest rates. The simulation also measures the change in EVE, or the net present value of our assets and liabilities, under an immediate shift, or shock, in interest rates under various scenarios, as calculated by discounting the estimated future cash flows using market-based discount rates.

The following table shows the impact of changes in interest rates on net interest income over the next twelve months and EVE based on our balance sheet as of June 30, 2007 (dollars in thousands).

| <b>Interest Rate Scenario</b>        | <b>Economic Value<br/>of Equity</b> | <b>Percent<br/>Change</b> | <b>Net Interest<br/>Income</b> | <b>Percent<br/>Change</b> |
|--------------------------------------|-------------------------------------|---------------------------|--------------------------------|---------------------------|
| Interest rates up 200 basis points   | \$ 148,879                          | (17.71)%                  | \$ 65,739                      | 0.46%                     |
| Interest rates up 100 basis points   | 164,835                             | (8.89)                    | 65,641                         | 0.31                      |
| No change in interest rates          | 180,925                             | ---                       | 65,441                         | ---                       |
| Interest rates down 100 basis points | 193,855                             | 7.15                      | 65,082                         | (0.55)                    |
| Interest rates down 200 basis points | 204,725                             | 13.15                     | 64,634                         | (1.23)                    |

If interest rates were to increase, this analysis suggests that we are positioned for a slight improvement in net interest income over the next twelve months.

We also forecast the impact of immediate and parallel interest rate shocks on net interest income under various scenarios to measure the sensitivity of our earnings under extreme conditions.

The quarterly simulation analysis is monitored against acceptable interest rate risk parameters by the Asset/Liability Committee and reported to the Board of Directors.

In addition to changes in interest rates, the level of future net interest income is also dependent on a number of other variables, including: the growth, composition and absolute levels of loans, deposits, and other earning assets and interest-bearing liabilities; economic and competitive conditions; potential changes in lending, investing and deposit gathering strategies; and client preferences.



**Item 4: CONTROLS AND PROCEDURES**

- (a) Evaluation of Disclosure Controls and Procedures. The Company's Chief Executive Officer and Chief Financial Officer, after evaluating the effectiveness of the company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Form 10-Q Quarterly Report, have concluded that the Company's disclosure controls and procedures were adequate and effective to ensure that material information relating to the Company would be made known to them by others within the company, particularly during the period in which this Form 10-Q Quarterly Report was being prepared.
- (b) Changes in Internal Controls. During the period covered by this report, there have been no changes in the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

Please refer to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, (Part II, Item 1 Legal Proceedings) for information concerning legal proceedings related to Trade Partners, Inc.

A lawsuit was filed in April 2003 by John and Kathryn Brand in Oklahoma state court against Grand Bank, the Company, Trade Partners and certain individuals and entities associated with Trade Partners. The complaint seeks damages for the asserted breach of certain escrow agreements for which Grand Bank served as custodian and escrow agent. The claims asserted against the Company and Grand Bank in this action have been settled and dismissed with prejudice.

In May 2003, a purported class action complaint was filed by Forrest W. Jenkins and Russell S. Vail against the Company in the United States District Court for the District of Western Michigan. As amended, this suit alleges that Grand Bank breached escrow agreements and fiduciary duties and violated the Michigan Uniform Securities Act with respect to the investments secured by the purported class in viaticals and in interests in limited partnerships which made loans to Trade Partners secured by viaticals, and with respect to loans made by purported class members directly to Trade Partners. Plaintiffs' motion for class certification was denied in November 2006. The Company has answered this complaint denying the material allegations and raising certain affirmative defenses.

Following denial of class certification in the Jenkins case, nine new cases were filed in several different jurisdictions. These complaints are identical in all material respects other than the identity of the plaintiffs, and are substantially identical to the complaint in the Jenkins litigation. None of these complaints contain class action allegations, but the total number of named plaintiffs in all the nine cases is about 1,300. The cases are: Ronald Ash, et. al. v. Macatawa Bank Corporation, et. al. filed November 17, 2006 in the District Court for Oklahoma County, Oklahoma, subsequently removed by the Company to the United States District Court for the Western District of Oklahoma; Steven M. Adamson, et. al. v. Macatawa Bank Corporation, et. al. filed November 15, 2006 in the United States District Court for the Western District of Oklahoma; James Lee Myers et. al. v. Macatawa Bank Corporation, et. al. filed November 14, 2006 in the Superior Court for Los Angeles County, California, subsequently removed by the Company to the United States District Court for the Central District of California; Frank V. Bailey et. al. v. Macatawa Bank Corporation, et. al. filed November 29, 2006 in the United States District Court for the Northern District of Texas; Eddie Elkins, et. al. v. Macatawa Bank Corporation filed January 29, 2007 in the United States District Court for the Western District of Oklahoma; William A. Giese, et. al. v. Macatawa Bank Corporation, et. al. filed November 17, 2006 in the Circuit Court for Kent County, Michigan; Gerald Abraham, et. al. v. Macatawa Bank Corporation, et. al. filed November 29, 2006 in the Circuit Court for Kent County, Michigan; Jorge Acevedo, et. al. v. Macatawa Bank Corporation, et. al. filed December 17, 2006 in the Circuit Court for Kent County, Michigan; and Jose Javier Acasuso, et. al. v. Macatawa Bank Corporation, et. al. filed January 17, 2007 in the Circuit Court for Kent County, Michigan.

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The Company believes it has meritorious defenses and intends to vigorously defend these cases.

On April 15, 2003, the United States District Court for the Western District of Michigan appointed a receiver for Trade Partners. In order to prevent or minimize any loss to investors in the viaticals sold by Trade Partners to investors, the court-appointed receiver has been coordinating the payment of premiums on the approximately 1,000 outstanding viaticated insurance policies in the Trade Partners portfolio so that the policies do not lapse. The receiver informed the Company that nine policies with a total face value of approximately \$1.4 million lapsed for failure to pay premiums prior to the receiver's coordination efforts. In addition, the receiver unsuccessfully contested a partial lapse totaling about \$700,000.

On July 1, 2003, the United States District Court for the Western District of Michigan authorized the receiver to borrow money from Macatawa Bank to pay premiums, if needed. Macatawa Bank agreed to extend a \$4 million line of credit to the receiver, conditioned upon obtaining a security interest in the viaticals. No draws were made against the line, and the line expired during the fourth quarter of 2004.

The receiver received authorization from the Court in July 2005 to sell the entire portfolio, which the receiver said had a face value of approximately \$170 million, to Universal Settlements International, Inc., a Canadian company, for an amount equal to 26.58% of face value. Under the terms of the sale, payments are to be made by Universal Settlements to the receivership as policy transfers are processed by the issuing insurance companies. The receiver has reported that as of July 15, 2007 he had received sale payments of approximately \$35.5 million and proceeds of maturities aggregating another \$31.5 million.

The receiver on July 21, 2006 filed a proposed amended plan of distribution and related disclosure statement, contemplating a complete liquidation of the assets of Trade Partners. The plan was approved by the Court on January 7, 2007. The receiver reported as of April 15, 2007 that claims against the receivership estate totaling \$169,430,383.85, and that all claims have now been processed.

The receiver reports that he commenced distributions on January 19, 2007, and that \$47,557,216 had been distributed as of July 15, 2007. The initial distributions are approximately 26.987% of each allowed and approved claim. There may be additional distributions, but the Company does not know when they might be made or in what amount.

It is possible that one or more additional legal actions may be initiated involving the custodial and escrow agent services provided by Grand Bank in connection with Trade Partners. If any such legal actions are commenced, the Company intends to defend them vigorously. To the extent any pending or future claims allege errors or omissions on the part of Grand Bank or Macatawa Bank, Management believes that some or all liability, if any is proven or established, will be covered by errors and omissions insurance maintained by Grand Bank and Macatawa Bank. The Company has reported the Trade Partners matter to its two insurance carriers. Federal Insurance Company has assumed the Company's defense and has advanced a portion of its defense costs pursuant to a reservation of rights letter asserting certain coverage defenses, and an Interim Funding Agreement. Federal Insurance Company notified the Company on July 21, 2006 that it has filed an Arbitration Demand with the American Arbitration Association, seeking a declaration that based upon its asserted coverage defenses its policy does not cover this matter. The Company and Federal Insurance Company have agreed to defer any proceedings with respect to this Arbitration Demand. The Company believes that Federal Insurance Company is obligated to provide coverage, and the Company intends to vigorously pursue its rights under the insurance policy. The other carrier has taken the position that the duty of defense rests solely with the first carrier, and reserves its rights with respect to indemnity pursuant to a reservation letter asserting certain coverage defenses.

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As of the date hereof, except as disclosed above, there were no material pending legal proceedings, other than routine litigation incidental to the business of banking to which we or any of our subsidiaries are a party of or which any of our properties are the subject.

### Item 1A. Risk Factors.

There have been no material changes in the risk factors applicable to the Company from those disclosed in its Annual Report on Form 10-K for the year ended December 31, 2006.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

On May 17, 2007, the Corporation announced a repurchase plan that authorized share repurchases of up to \$30 million of the Corporation's common stock. In the second quarter of 2007, the Corporation repurchased 60,000 shares of its common stock in open market transactions under the repurchase plan. The shares were purchased at an average price of \$15.39 per share. The Corporation has remaining authority to repurchase up to \$29,076,350 of market value of its common stock under the repurchase plan.

#### ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of<br>Shares Purchased | Average Price Paid<br>per Share | Total Number of<br>Shares Purchased as<br>a Part of Publicly<br>Announced Plans<br>or Programs | Maximum Approximate<br>Dollar Value of<br>Shares that May yet<br>Be Purchased Under<br>the Approved Plan |
|--------|-------------------------------------|---------------------------------|--|--|
| April  | ---                                 | ---                             | ---  | ---  |
| May    | 20,000                              | \$ 15.47                        | 20,000   | \$ 29,670,700  |
| June   | 40,000                              | \$ 15.36                        | 40,000   | \$ 29,076,350  |
| Total  | 60,000                              | \$ 15.39                        | 60,000   | \$ 29,076,350  |

**Item 3. Defaults Upon Senior Securities. None.**

**Item 4. Submission of Matters to a Vote of Securities Holders.**

- a) The annual meeting of shareholders was held on April 19, 2007, at which the shareholders of Macatawa Bank Corporation voted to elect two directors for a term of three years. The results are as follows:

| <u>Director Nominee</u> | <u>For</u> | <u>Withheld</u> |
|-------------------------|------------|-----------------|
| John F. Koetje          | 14,733,129 | 362,730         |
| Philip J. Koning        | 14,428,097 | 667,762         |

**Item 5. Other Information.**

**Item 6. Exhibits.**

- 31.1 Certificate of the Chief Executive Officer of Macatawa Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certificate of the Chief Financial Officer of Macatawa Bank Corporation pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certificate of the Chief Executive Officer and the Chief Financial Officer of Macatawa Bank Corporation pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Quarterly Report on Form 10-Q for the quarter ended June 30, 2007, to be signed on its behalf by the undersigned, thereunto duly authorized.

MACATAWA BANK CORPORATION

/s/ Benj. A. Smith, III

Benj. A. Smith, III  
Chairman and Chief Executive Officer

/s/ Jon W. Swets

Jon W. Swets  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

DATE: August 7, 2007

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EXHIBIT INDEX

| <u>Exhibit</u> | <u>Description</u>  |
|----------------|---|
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