FARMERS & MERCHANTS BANCORP
Form 10-Q
November 07, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

T QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2008
or

£ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from ________ to ________

Commission File Number: 000-26099

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

Delaware (State or other jurisdiction of incorporation or organization)	94-3327828 (I.R.S. Employer Identification No.)
111 W. Pine Street, Lodi, California (Address of principal Executive offices)	95240 (Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes T No £

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

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

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

Number of shares of common stock of the registrant: Par value $0.01, authorized 20,000,000 shares; issued and outstanding 789,447 as of October 31, 2008.

FARMERS & MERCHANTS BANCORP

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PART I. - FINANCIAL INFORMATION

Item 1 - Financial Statements

FARMERS & MERCHANTS BANCORP
Consolidated Balance Sheets (Unaudited)

(in thousands)	Sept. 30, 2008	December 31, 2007	Sept. 30, 2007
Assets			
Cash and Cash Equivalents:			
Cash and Due From Banks	$ 51,900	$ 50,240	$ 43,406
Federal Funds Sold	28,300	1,150	700
Total Cash and Cash Equivalents	80,200	51,390	44,106
Investment Securities:			
Available-for-Sale	211,222	142,043	135,377
Held-to-Maturity	105,413	105,594	108,617
Total Investment Securities	316,635	247,637	243,994
Loans	1,161,506	1,140,969	1,122,515
Less: Allowance for Loan Losses	18,486	18,483	17,842
Loans, Net	1,143,020	1,122,486	1,104,673
Premises and Equipment, Net	22,039	20,188	19,566
Bank Owned Life Insurance	41,537	40,180	39,737
Interest Receivable and Other Assets	49,811	37,291	38,406
Total Assets	$ 1,653,242	$ 1,519,172	$ 1,490,482
Liabilities			
Deposits:			
Demand	$ 281,873	$ 307,299	$ 295,066
Interest Bearing Transaction	135,529	138,665	130,415
Savings	356,206	301,678	281,310
Time	627,095	563,148	579,243
Total Deposits	1,400,703	1,310,790	1,286,034
Securities Sold Under Agreement to Repurchase	60,000	-	-
Federal Home Loan Bank Advances	716	28,954	25,966
Subordinated Debentures	10,310	10,310	10,310
Interest Payable and Other Liabilities	28,394	25,700	25,108
Total Liabilities	1,500,123	1,375,754	1,347,418
Shareholders' Equity			
Preferred Stock	-	-	-
Common Stock	8	8	8
Additional Paid-In Capital	80,508	84,437	86,993
Retained Earnings	71,921	57,990	56,605
Accumulated Other Comprehensive Gain (Loss)	682	983	(542)
Total Shareholders' Equity	153,119	143,418	143,064
Total Liabilities & Shareholders' Equity	$ 1,653,242	$ 1,519,172	$ 1,490,482

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

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FARMERS & MERCHANTS BANCORP
Consolidated Statements of Income (Unaudited)
(in thousands except per share data)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Interest Income				
Interest and Fees on Loans	$ 19,294	$ 21,633	$ 58,837	$ 62,954
Interest on Federal Funds Sold and Securities Purchased Under Agreements to Resell	137	53	181	441
Interest on Investment Securities:				
Taxable	3,122	2,070	8,434	5,839
Tax-Exempt	757	811	2,293	2,442
Total Interest Income	23,310	24,567	69,745	71,676
Interest Expense				
Deposits	5,349	7,703	17,541	22,235
Borrowed Funds	552	622	1,219	1,360
Subordinated Debentures	149	217	491	645
Total Interest Expense	6,050	8,542	19,251	24,240
Net Interest Income	17,260	16,025	50,494	47,436
Provision for Loan Losses	765	-	5,370	250
Net Interest Income After Provision for Loan Losses	16,495	16,025	45,124	47,186
Non-Interest Income				
Service Charges on Deposit Accounts	1,866	1,890	5,381	5,424
Net Gain (Loss) on Investment Securities	1	(652)	536	(1,735)
Credit Card Merchant Fees	20	575	1,109	1,642
Increase in Cash Surrender Value of Life Insurance	464	442	1,356	1,293
ATM Fees	321	348	1,072	1,012
Other	(209)	933	3,836	3,783
Total Non-Interest Income	2,463	3,536	13,290	11,419
Non-Interest Expense				
Salaries & Employee Benefits	5,292	6,427	18,895	21,074
Occupancy	665	655	2,009	1,956
Equipment	862	839	1,985	2,144
Credit Card Merchant Expense	-	436	828	1,233
Marketing	131	92	388	316
Other	2,345	1,766	5,830	5,452
Total Non-Interest Expense	9,295	10,215	29,935	32,175
Income Before Income Taxes	9,663	9,346	28,479	26,430
Provision for Income Taxes	3,606	3,471	10,696	9,420
Net Income	$ 6,057	$ 5,875	$ 17,783	$ 17,010
Earnings Per Share	$ 7.63	$ 7.26	$ 22.34	$ 20.98

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

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

	Three Months Ended Sept 30,		Nine Months Ended Sept 30,	
	2008	2007	2008	2007
Net Income	$ 6,057	$ 5,875	$ 17,783	$ 17,010
Other Comprehensive Loss -				
Unrealized Gains on Derivative Instruments:				
Reclassification adjustment for realized gains included in net income, net of related income tax effects of $0 and $0 for the quarters ended September 30, 2008 and 2007, respectively, and $0 and $0 for the nine months ended September 30, 2008 and 2007, respectively.	-	(1)	-	-
Unrealized Gains (Losses) on Securities:				
Unrealized holding gains (losses) arising during the period, net of income tax provision (benefit) of $894 and $729 for the quarters ended September 30, 2007 and 2006, respectively, and of $7 and $(601) for the nine months ended September 30, 2008 and 2007, respectively.	1,232	1,006	10	(828)
Reclassification adjustment for realized losses included in net income, net of related income tax effects of $0 and $273 for the quarters ended September 30, 2008 and 2007, respectively, and of $(225) and $729 for the nine months ended September 30, 2008 and 2007, respectively.	(1)	379	(311)	1,006
Total Other Comprehensive Gain (Loss)	1,231	1,384	(301)	178
Comprehensive Income	$ 7,288	$ 7,259	$ 17,482	$ 17,188

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Changes in Shareholders' Equity (Unaudited)

(in thousands except share data)	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2006	811,933	$ 8	$ 89,926	$ 43,126	$ (720)	$ 132,340
Net Income		-	-	17,010	-	17,010
Cash Dividends Declared on Common Stock		-	-	(3,531)	-	(3,531)
Repurchase of Stock	(6,265)	-	(2,933)	-	-	(2,933)
Change in Net Unrealized Loss on Securities Available for Sale		-	-	-	178	178
Balance, September 30, 2007	805,668	$ 8	$ 86,993	$ 56,605	$ (542)	$ 143,064
Balance, December 31, 2007	800,112	$ 8	$ 84,437	$ 57,990	$ 983	$ 143,418
Net Income		-	-	17,783	-	17,783
Cash Dividends Declared on Common Stock		-	-	(3,852)	-	(3,852)
Repurchase of Stock	(8,590)	-	(3,929)	-	-	(3,929)
Change in Net Unrealized Gain on Securities Available for Sale		-	-	-	(301)	(301)
Balance, September 30, 2008	791,522	$ 8	$ 80,508	$ 71,921	$ 682	$ 153,119

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

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FARMERS & MERCHANTS BANCORP

Consolidated Statements of Cash Flows (Unaudited) (in thousands)	Nine Months Ended Sept 30, 2008	Nine Months Ended Sept 30, 2007
Operating Activities:		
Net Income	$ 17,783	$ 17,010
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:		
Provision for Loan Losses	5,370	250
Depreciation and Amortization	838	1,506
Net Amortization of Investment Security Discounts & Premium	88	50
Net (Gain) Loss on Investment Securities	(536)	1,735
Net Gain on Sale of Property & Equipment	(8)	-
Net Change in Operating Assets & Liabilities:		
Net Increase in Interest Receivable and Other Assets	(13,659)	(7,220)
Net Increase in Interest Payable and Other Liabilities	2,694	2,585
Net Cash Provided by Operating Activities	12,570	15,916
Investing Activities:		
Securities Available-for-Sale:		
Purchased	(131,979)	(33,409)
Sold, Matured or Called	62,808	29,237
Securities Held-to-Maturity:		
Purchased	(4,500)	(2,164)
Matured or Called	4,602	4,730
Net Loans Originated or Acquired	(26,183)	(76,322)
Principal Collected on Loans Previously Charged Off	279	212
Net Additions to Premises and Equipment	(2,689)	(576)
Proceeds from Sale of Property and Equipment	8	-
Net Cash Used by Investing Activities	(97,654)	(78,292)
Financing Activities:		
Net Increase in Demand, Interest-Bearing Transaction, and Savings Accounts	25,966	7,755
Increase in Time Deposits	63,947	79,751
Net Increase in Securities Sold Under Agreement to Repurchase	60,000	-
Net Decrease in Federal Home Loan Bank Advances	(28,238)	(21,566)
Cash Dividends	(3,852)	(3,531)
Stock Repurchases	(3,929)	(2,933)
Net Cash Provided by Financing Activities	113,894	59,476
Increase (Decrease) in Cash and Cash Equivalents	28,810	(2,900)
Cash and Cash Equivalents at Beginning of Year	51,390	47,006
Cash and Cash Equivalents as of Sept. 30, 2008 and Sept. 30, 2007	$ 80,200	$ 44,106

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

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FARMERS & MERCHANTS BANCORP

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

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

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

Basis of Presentation

The accompanying unaudited consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (which consist solely of normal recurring accruals) considered necessary for a fair presentation of the results for the interim periods presented have been included. The Company's interim consolidated financial statements and related notes, including its significant accounting policies, should be read in conjunction with the audited financial statements and related notes contained in the Company's 2007 Annual Report to Shareholders on Form 10-K. There have been no significant changes to our accounting policies since the 2007 10-K except due to adoption of FASB Statement No. 157 (SFAS 157), "Fair Value Measurements" as more fully described in Note 2.

The accompanying consolidated financial statements include the accounts of the Company and the Company's wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank's wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation. The results of operations for the nine-month period ended September 30, 2008 may not necessarily be indicative of the operating results for the full year 2008.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

2. Fair Value Measurements

Effective January 1, 2008, the Company adopted SFAS No. 157 (SFAS 157), "Fair Value Measurements." SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances. In this standard, the FASB clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, SFAS 157 establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy is as follows:

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Level 1 inputs – Unadjusted quoted process in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Securities classified as available-for-sale are reported at fair value on a recurring basis utilizing Level 2 inputs. (See Financial Condition – Investment Securities for a description of the accounting for unrealized gains or losses). For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things.

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired (see "Financial Condition – Non-Performing Assets") and an allowance for loan losses is established. Once a loan is identified as individually impaired, management measures impairment in accordance with SFAS 114, Accounting by Creditors for Impairment of a Loan (SFAS 114). The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2008, substantially all impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value which uses observable data, the Company records the impaired loan as nonrecurring Level 2. Otherwise, the Company records the impaired loan as nonrecurring Level 3.

Other Real Estate Owned ("OREO") is reported at fair value on a non-recurring basis. When the fair value of the OREO is based on an observable market price or a current appraised value which uses observable data, the Company records the OREO as nonrecurring Level 2. Otherwise, the Company records the OREO as nonrecurring Level 3.

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

(in thousands)		Fair Value Measurements At September 30, 2008, Using		
	Fair Value September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-Sale Securities	$ 211,222	$ -	$ 211,222	$ -

Total Assets Measured at Fair Value On a Recurring Basis	$	211,222	$	-	$	211,222	$	-

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

(in thousands)	Fair Value September 30, 2008	Fair Value Measurements At September 30, 2008, Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans	$ 6,291	$ -	$ 6,291	$ -
Other Real Estate Owned	6,393	-	6,393	-
Total Assets Measured at Fair Value On a Non-Recurring Basis	$ 12,684	$ -	$ 12,684	$ -

Impaired loans and OREO are measured for impairment using the fair value of the collateral because the loans/OREO are considered to be collateral dependent. Impaired loans were $7.6 million with an allowance for loan losses of $1.3 million and OREO was $6.9 million with a reserve of $500,000.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115." This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. The Company adopted SFAS 159 on January 1, 2008, and has not elected the fair value option for any financial assets or liabilities at September 30, 2008.

3. Accounting for Split-Dollar Life Insurance Arrangements

On January 1, 2008, the Company adopted Emerging Issue Task Force Issue ("EITF") No. 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Agreements, which established recognition of a liability and related compensation costs for endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods. The adoption of EITF 06-4 did not have a material impact on the Company's financial position or results of operations.

4. Dividends and Earnings Per Share

Farmers & Merchants Bancorp common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. On May 6, 2008, the Board of Directors of Farmers & Merchants Bancorp declared a mid-year cash dividend of $4.85 per share, an 11.5% increase over the $4.35 per share paid on July 1, 2007. The cash dividend was paid on July 1, 2008, to shareholders of record on June 9, 2008.

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

September 30, 2008 and 2007.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(net income in thousands)	2008	2007	2008	2007
Net Income	$ 6,057	$ 5,875	$ 17,783	$ 17,010
Average Number of Common Shares Outstanding	793,407	809,244	795,855	810,878
Per Share Amount	$ 7.63	$ 7.26	$ 22.34	$ 20.98

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5. Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141R, “Business Combinations.” SFAS No. 141R broadens the guidance of SFAS No. 141, extending its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations. SFAS No. 141R expands on required disclosures to improve the statement users’ abilities to evaluate the nature and financial effects of business combinations. SFAS No. 141R is effective for the first annual reporting period beginning on or after December 15, 2008. The provisions of SFAS No. 141R will not have an impact on the Company at the current time.

In March 2008, the FASB issued Statement No. 161, “Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133” (SFAS No. 161). SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. The provisions of SFAS No. 161 will not have an impact on the Company at the current time.

In May 2008, the FASB issued Statement No. 162, "The Hierarchy of Generally Accepted Accounting Principles.” (SFAS No. 162). This standard identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The provisions of SFAS No. 162 did not have a material impact on the Company’s financial condition and results of operations.

On October 10, 2008, the FASB issued FSP FAS 157-3, “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active.” The FSP clarifies the application of FASB Statement No. 157, “Fair Value Measurements”, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective immediately, and includes prior period financial statements that have not yet been issued, and therefore the Company is subject to the provision of the FSP effective September 30, 2008. The implementation of FSP FAS 157-3 did not affect the Company’s fair value measurement as of September 30, 2008.

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

The following is management’s discussion and analysis of the major factors that influenced our financial performance for the three and nine months ended September 30, 2008. This analysis should be read in conjunction with our 2007 Annual Report to Shareholders on Form 10-K, and with the unaudited financial statements and notes as set forth in this report.

Forward–Looking Statements

This Form 10-Q contains various forward-looking statements, usually containing the words “estimate,” “project,” “expect,” “objective,” “goal,” or similar expressions and includes assumptions concerning the Company’s operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risk and uncertainties. In connection with the “safe-harbor” provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (i) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (ii) the effect of changing regional and national economic conditions; (iii) significant changes in interest rates and prepayment speeds; (iv) credit risks of lending and investment activities; (v) changes in federal and state banking laws or regulations; (vi) competitive pressure in the banking industry; (vii) changes in governmental fiscal or monetary policies; (viii) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; and (ix) other factors discussed in Item 1A. Risk Factors of the Company's 2007 Annual Report on form 10-K.

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Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

Introduction

Farmers & Merchants Bancorp, or the Company, is a bank holding company formed March 10, 1999. Its subsidiary, Farmers & Merchants Bank of Central California, or the Bank, is a California state-chartered bank formed in 1916. The Bank serves the northern Central Valley of California through twenty-one banking offices and two stand-alone ATM's. The service area includes Sacramento, San Joaquin, Stanislaus and Merced Counties with branches in Sacramento, Elk Grove, Galt, Lodi, Stockton, Linden, Modesto, Turlock and Hilmar. Substantially all of the Company's business activities are conducted within its market area.

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System ("FRB"). As a California, state-chartered, non-fed member bank, the Bank is subject to regulation and examination by the California Department of Financial Institutions ("DFI") and the Federal Deposit Insurance Corporation ("FDIC").

Overview

The Company's primary service area encompasses the northern Central Valley of California, a region that is impacted by the seasonal needs of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations is influenced by the seasonal banking needs of its agricultural customers (e.g., during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in fall and winter as crops are harvested and sold).

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

For the three and nine months ended September 30, 2007, Farmers & Merchants Bancorp reported net income of $5,875,000 and $17,010,000, earnings per share of $7.26 and $20.98 and return on average assets of 1.60% and 1.57%, respectively. Return on average shareholders' equity was 16.79% and 16.44% for the three and nine months ended September 30, 2007.

The Company's improved earnings performance during the first nine months of 2008 as compared to the same period last year was primarily due to: (1) an increase in average earning assets (see "Net Interest Income/Net Interest Margin"); (2) an increase in non-interest income (see "Non-Interest Income"); partially offset by; (3) an increase in the loan loss provision (see "Provision and Allowance for Loan Losses").

The following is a summary of the financial results for the nine-month period ended September 30, 2008 compared to September 30, 2007.

- Net income increased 4.5% to $17.8 million from $17.0 million.
- Earnings per share increased 6.5% to $22.34 from $20.98.

- Total assets increased 10.9% to $1.6 billion.

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- Total loans increased 3.5% to $1.2 billion.
- Total deposits increased 8.9% to $1.4 billion.
- Net interest income increased 6.4% to $50.5 million from $47.4 million.

Results of Operations

Net Interest Income / Net Interest Margin
The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the three and nine-month periods ended September 30, 2008 and 2007.

The average yields on earning assets and average rates paid on interest-bearing liabilities have been computed on an annualized basis for purposes of comparability with full year data. Average balance amounts for assets and liabilities are the computed average of daily balances.

Net interest income is the amount by which the interest and fees on loans and other interest earning assets exceed the interest paid on interest bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as “taxable equivalent” and is noted wherever applicable.

The Volume and Rate Analysis of Net Interest Income summarizes the changes in interest income and interest expense based on changes in average asset and liability balances (volume) and changes in average rates (rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to: (1) changes in volume (change in volume multiplied by initial rate); (2) changes in rate (change in rate multiplied by initial volume); and (3) changes in rate/volume (allocated in proportion to the respective volume and rate components).

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

3rd Quarter 2008 vs. 3rd Quarter 2007
Net interest income for the third quarter of 2008 increased 7.7% or $1.2 million to $17.3 million. On a taxable equivalent basis, net interest income increased 7.3% and totaled $17.6 million for the third quarter of 2008. As more fully discussed below, the increase in net interest income was due to an increase in earning assets, partially offset by an eight basis point drop in net interest margin.

Net interest income on a taxable equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For the quarter ended September 30, 2008, the Company’s net interest margin was 4.71% compared to 4.79% for the quarter ended September 30, 2007. The Company continues to experience aggressive competitor pricing for both loans and deposits, which it has responded to in order to retain key customers. This trend will continue, in management’s opinion, to place pressure on the Company’s net interest margin in future quarters.

Loans, generally the Company’s highest earning assets, increased $39.0 million as of September 30, 2008 compared to September 30, 2007. See “Financial Condition – Loans” for further discussion on this increase. On an average balance basis, loans increased by $30.2 million for the quarter ended September 30, 2008. Despite a 325 basis point decrease in the prime rate occurring between September 19, 2007 and May 1, 2008, the yield on the loan portfolio only decreased 102 basis points or 13.2% to a yield of 6.71% for the quarter ended September 30, 2008 compared to a yield of 7.73% for the quarter ended September 30, 2007. Some of the resilience in loan yields is due to pricing floors that the Bank has placed in some of its customer loan agreements. However, these floors typically expire annually and are renegotiated based upon current market conditions. The growth in loan balances during the third quarter partially offset this decrease in yield resulting in interest revenue from loans decreasing only 10.8% to $19.3 million for the quarter ended September 30, 2008.

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The investment portfolio is the other main component of the Company's earning assets. The debt securities in the Company's investment portfolio are comprised primarily of Mortgage-backed securities, U.S. Government Agencies and high grade Municipals. All of the Mortgage-backed securities are issued by government-sponsored entities. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company has never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC".

Average investment securities were $314.8 million for the third quarter of 2008 an increase of $68.1 million compared to $246.7 million for the third quarter of 2007. See "Financial Condition – Investment Securities" for further discussion on this increase. Interest income on securities increased $965,000 to $4.2 million for the quarter ended September 30, 2008 compared to $3.3 million for the quarter ended September 30, 2007. The average yield, on a taxable equivalent basis (TE), in the investment portfolio was 5.39% for the third quarter of 2008 compared to 5.31% for the third quarter of 2007. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a taxable equivalent basis (TE), which is higher than net interest income on the Consolidated Statements of Income because of adjustments that relate to income on certain securities that are exempt from federal income taxes.

Average interest-bearing sources of funds increased $139.1 million or 13.5% during the third quarter of 2008 as compared to the third quarter of 2007. Of that increase, average borrowed funds (primarily FHLB Advances) decreased $45.1 million; interest-bearing deposits increased $124.2 million, subordinated debt remained unchanged and securities sold under agreement to repurchase, a new type of borrowing initially used during the first quarter of 2008 to assist in managing the Company's interest rate risk, increased $60 million.

The increase in average interest-bearing deposits was in time deposits, which grew $70.6 million, and lower cost savings and interest bearing DDA which increased by $53.6 million. Total interest expense on deposit accounts for the third quarter of 2008 was $5.3 million as compared to $7.7 million for the third quarter of 2007. The average rate paid on interest-bearing deposits was 1.93% in the third quarter of 2008 and 3.14% in the third quarter of 2007. See "Financial Condition – Deposits" for further discussion.

Nine Months Ending September 30, 2008 vs. Nine Months Ending September 30, 2007

During the first nine months of 2008, net interest income increased 6.4% to $50.5 million, compared to $47.4 million at September 30, 2007. On a taxable equivalent basis, net interest income increased 6.1% and totaled $51.6 million at September 30, 2008, compared to $48.6 million at September 30, 2007. The increase in net interest income was due to an increase in earning assets partially offset by a five basis point drop in net interest margin.

For the nine months ended September 30, 2008, the Company's net interest margin was 4.82% compared to 4.87% for the same period in 2007.

Loans, on an average balance basis, increased by $44.8 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. The yield on the loan portfolio decreased 80 basis points to 6.98% for the nine months ended September 30, 2008 compared to 7.78% for the nine months ended September 30, 2007. This decrease in yield, partially offset by an increase in average balances, resulted in interest revenue from loans decreasing 6.5% or $4.1 million for the first nine months of 2008.

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

	Three Months Ended Sept 30, 2008			Three Months Ended Sept 30, 2007		
Assets	Balance	Interest	Rate	Balance	Interest	Rate
Federal Funds Sold	$ 28,786	$ 137	1.89%	$ 4,209	$ 53	5.00%
Investment Securities Available-for-Sale						
Municipals - Non-Taxable	8,954	166	7.40%	11,078	200	7.21%
Mortgage Backed Securities	197,255	2,648	5.37%	120,960	1,598	5.28%
Other	3,384	88	6.59%	5,836	67	3.52%
Total Investment Securities Available-for-Sale	209,593	2,902	5.54%	137,874	1,865	5.41%
Investment Securities Held-to-Maturity						
U.S. Agencies	30,373	319	4.20%	30,477	317	4.16%
Municipals - Non-Taxable	67,176	955	5.68%	68,891	1,009	5.86%
Mortgage Backed Securities	5,708	55	3.85%	7,411	72	3.89%
Other	1,992	13	2.61%	2,107	16	3.04%
Total Investment Securities Held-to-Maturity	105,249	1,342	5.10%	108,886	1,414	5.19%
Loans						
Real Estate	667,068	11,446	6.81%	631,519	11,638	7.31%
Home Equity	65,162	1,070	6.51%	66,278	1,330	7.96%
Agricultural	188,981	3,208	6.73%	206,207	4,400	8.47%
Commercial	205,995	3,327	6.41%	186,547	3,837	8.16%
Consumer	12,156	239	7.80%	13,408	291	8.61%
Credit Card	0	0	0.00%	5,467	133	9.65%
Municipal	1,357	4	1.17%	1,140	4	1.39%
Total Loans	1,140,719	19,294	6.71%	1,110,566	21,633	7.73%
Total Earning Assets	1,484,347	$ 23,674	6.33%	1,361,535	$ 24,964	7.27%
Unrealized Loss on Securities Available-for-Sale	(1,772)			(2,547)		
Allowance for Loan Losses	(18,513)			(17,809)		
Cash and Due From Banks	35,264			38,782		

All Other Assets	112,935			92,430		
Total Assets	$ 1,612,261			$ 1,472,391		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						
Interest Bearing DDA	$ 129,686	$ 33	0.10%	$ 129,208	$ 30	0.09%
Savings	331,377	879	1.05%	278,224	1,076	1.53%
Time Deposits	636,785	4,437	2.76%	566,183	6,597	4.62%
Total Interest Bearing Deposits	1,097,848	5,349	1.93%	973,615	7,703	3.14%
Securities Sold Under Agreement to Repurchase	60,000	541	3.58%	-	-	0.00%
Other Borrowed Funds	724	11	6.03%	45,835	622	5.38%
Subordinated Debentures	10,310	149	5.73%	10,310	217	8.35%
Total Interest Bearing Liabilities	1,168,882	$ 6,050	2.05%	1,029,760	$ 8,542	3.29%
Interest Rate Spread			4.27%			3.98%
Demand Deposits (Non-Interest Bearing)	266,939			278,961		
All Other Liabilities	28,169			23,704		
Total Liabilities	1,463,990			1,332,425		
Shareholders' Equity	148,271			139,966		
Total Liabilities & Shareholders' Equity	$ 1,612,261			$ 1,472,391		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.44%			0.80%
Net Interest Income and Margin on Total Earning Assets		17,624	4.71%		16,422	4.79%
Tax Equivalent Adjustment		(364)			(397)	
Net Interest Income		$ 17,260	4.61%		$ 16,025	4.67%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $385,000 and $641,000 for the quarters ended September 30, 2008 and 2007, respectively. Yields on securities available-for-sale are based on historical cost.

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

	Nine Months Ended Sept. 30, 2008			Nine Months Ended Sept. 30, 2007		
Assets	Balance	Interest	Rate	Balance	Interest	Rate
Federal Funds Sold	$ 12,362	$ 181	1.96%	$ 11,137	$ 441	5.29%
Investment Securities Available-for-Sale						
Municipals - Non-Taxable	8,955	502	7.47%	11,334	602	7.08%
Mortgage Backed Securities	174,771	7,025	5.36%	112,602	4,388	5.20%
Other	3,504	240	5.88%	6,954	223	3.38%
Total Investment Securities Available-for-Sale	187,230	7,767	5.53%	130,890	5,213	5.31%
Investment Securities Held-to-Maturity						
U.S. Agencies	30,399	953	4.18%	30,503	953	4.17%
Municipals - Non-Taxable	66,459	2,892	5.80%	69,424	3,038	5.83%
Mortgage Backed Securities	6,124	177	3.85%	7,942	228	3.83%
Other	1,998	39	2.60%	2,110	47	2.97%
Total Investment Securities Held-to-Maturity	104,980	4,061	5.16%	109,979	4,266	5.17%
Loans						
Real Estate	661,124	34,304	6.94%	624,818	34,309	7.34%
Home Equity	65,007	3,293	6.77%	66,140	3,939	7.96%
Agricultural	183,499	9,964	7.26%	196,049	12,436	8.48%
Commercial	199,921	10,228	6.84%	174,770	10,957	8.38%
Consumer	12,489	772	8.26%	13,655	898	8.79%
Credit Card	3,506	265	10.11%	5,433	403	9.92%
Municipal	1,187	11	1.24%	1,075	12	1.49%
Total Loans	1,126,733	58,837	6.98%	1,081,940	62,954	7.78%
Total Earning Assets	1,431,305	$ 70,846	6.62%	1,333,946	$ 72,874	7.30%
Unrealized Gain (Loss) on Securities Available-for-Sale	1,163			(1,611)		
Allowance for Loan Losses	(18,790)			(17,981)		
Cash and Due From Banks	36,498			38,563		

All Other Assets	103,130			90,938		
Total Assets	$ 1,553,306			$ 1,443,855		
Liabilities & Shareholders' Equity						
Interest Bearing Deposits						
Interest Bearing DDA	$ 129,870	$ 90	0.09%	$ 129,895	$ 76	0.08%
Savings	321,197	2,716	1.13%	285,770	3,119	1.46%
Time Deposits	601,873	14,735	3.27%	549,823	19,040	4.63%
Total Interest Bearing Deposits	1,052,940	17,541	2.23%	965,488	22,235	3.08%
Securities Sold Under Agreement to Repurchase	38,102	987	3.46%	-	-	0.00%
Other Borrowed Funds	10,425	232	2.98%	34,280	1,360	5.30%
Subordinated Debentures	10,310	491	6.37%	10,310	645	8.36%
Total Interest Bearing Liabilities	1,111,777	$ 19,251	2.32%	1,010,078	$ 24,240	3.21%
Interest Rate Spread			4.30%			4.10%
Demand Deposits (Non-Interest Bearing)	267,698			273,897		
All Other Liabilities	26,095			21,949		
Total Liabilities	1,405,570			1,305,924		
Shareholders' Equity	147,736			137,931		
Total Liabilities & Shareholders' Equity	$ 1,553,306			$ 1,443,855		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.52%			0.78%
Net Interest Income and Margin on Total Earning Assets		51,595	4.82%		48,634	4.87%
Tax Equivalent Adjustment		(1,101)			(1,198)	
Net Interest Income		$ 50,494	4.72%		$ 47,436	4.75%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $1.7 million and $1.8 million for the nine months ended September 30, 2008 and 2007, respectively. Yields on securities available-for-sale are based on historical cost.

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

(in thousands)	Three Months Ended Sept. 30, 2008 compared to Sept. 30, 2007			Nine Months Ended Sept. 30, 2008 compared to Sept. 30, 2007		
Interest Earning Assets	Volume	Rate	Net Chg.	Volume	Rate	Net Chg.
Federal Funds Sold	$ 135	$ (51)	$ 84	$ 45	$ (305)	$ (260)
Investment Securities Available for Sale						
Municipals - Non-Taxable	(39)	5	(34)	(132)	32	(100)
Mortgage Backed Securities	1,024	26	1,050	2,495	142	2,637
Other	(23)	44	21	(98)	115	17
Total Investment Securities Available for Sale	962	75	1,037	2,265	289	2,554
Investment Securities Held to Maturity						
U.S. Agencies	(1)	3	2	(3)	3	0
Municipals - Non-Taxable	(24)	(30)	(54)	(129)	(17)	(146)
Mortgage Backed Securities	(16)	(1)	(17)	(52)	1	(51)
Other	(1)	(2)	(3)	(2)	(6)	(8)
Total Investment Securities Held to Maturity	(42)	(30)	(72)	(186)	(19)	(205)
Loans:						
Real Estate	629	(821)	(192)	1,942	(1,947)	(5)
Home Equity	(22)	(238)	(260)	(67)	(579)	(646)
Agricultural						