Merchants
Financial Group

April 22, 2023

Dear Shareholder,

I am pleased to announce solid first quarter earnings for Merchants Financial Group, Inc. (MFGI) with year-to-date net income of $7.18 million. The continued strength and resilience of Merchants allowed your Board of Directors to approve with confidence an increase in the semi-annual dividend to $.34/share. The cash dividend will be paid on June 23 to Shareholders of record on May 19.

Our record of dividend payments over a period of decades is a source of pride for all of us and a testament to the long-standing strength and stability of Merchants Bank. While the broader industry and market confidence has been shaken to an extent as the result of recent isolated bank failures and media hype that has included some misinformation, it's my strong view that the vast majority of banks in the country are well-managed, well-capitalized and well-supervised by regulators. The bank stock sector will undoubtedly continue to experience volatility over the course of the next several months, but I believe your investment in Merchants – like the banking industry overall – is safe, stable, and resilient.

Our earnings performance for the first quarter exceeded our Plan by $830,549 but was $166,639 behind 2022 first quarter results. Contributing factors to this earnings report include:

- Continued loan growth with total loans now at $1.93 billion, a year-over-year increase of 21%.
- Primarily due to that loan growth, we increased our provision for Current Expected Credit Loss (CECL) reserves by $1 million in the first quarter. While that negatively impacted earnings, we have a healthy and conservative reserve position of 1.23% of total loans.
- Our deposit franchise remains strong, but we did continue to experience runoff during the first quarter as customers have moved to higher-yield offerings available elsewhere. Total deposits were $2.18 billion, a drop of 13.4% since Q1 of 2022.
- We continue to proactively manage our balance sheet in attempt to reduce low-yield investments and maintain liquidity. We sold approximately $60 million of investments in the first quarter. While modest loss on the liquidations of $248,000 had a negative impact on earnings, we have strengthened the portfolio, reduced levels of unrealized losses on available for sale instruments and positioned the balance sheet for the long term.
- Despite the shifting balance sheet, we continue to have strong liquidity, and have maintained a consistent overnight "selling position" of more than $100 million of excess deposits daily. In the current environment, we are intensely focused on maintaining a healthy liquidity cushion.

It was a true pleasure to have many of you in attendance at our Annual Shareholder meeting earlier this month and be able to celebrate in person for the first time since 2019. As I shared with the group in attendance, we will continue to be transparent about the inevitable challenges we expect for the balance of this year. I'm proud that our team continues to embrace those as opportunities, and we are very pleased with our first quarter results. Community banks like Merchants are the backbone of our local economies. Thank you for your loyalty and trust in the important work we do to help our customers and communities achieve hopes and dreams.

Very truly yours,

Gregory Evans

Gregory M. Evans
President and CEO

MERCHANTS FINANCIAL GROUP, INC. 2023 FIRST QUARTER UPDATE

Given recent bank failures, at our Annual Shareholders meeting earlier this month, we shared with those in attendance a comprehensive update on how Merchants is well-positioned for continued future strength and stability. Here is an updated Q&A that summarizes how we are positioned at end of Q1:

1. Given the recent failure of a few banks, is the banking industry in "crisis"?

We would not classify the current state of the industry in that manner. Historically, isolated bank failures have not been uncommon. The recent failures of Signature Bank and Silicon Valley Bank were primarily driven by the unique business model characteristics of those banks. The dramatic shift in monetary policy facilitated by the Federal Reserve to curb inflation over the past 15 months has created challenges for banks' balance sheet management programs. While there could continue to be isolated bank failures, the vast majority of the 4,200 banks in this country are well-capitalized, well-managed and well-supervised by their regulators. Overall, the banking industry is safe, stable and resilient.

2. How is Merchants' business model different from Signature Bank and/or Silicon Valley Bank?

The institutions that failed had business models that were very different from that of most banks and especially different than that of strong community banks like Merchants. The failed banks had high risk profiles that included unsustainable growth, flawed interest rate risk and balance sheet management programs, and, most notably, significant industry concentrations in volatile niche business market segments. Interest rate risk for these institutions was driven by excess liquidity being tied up in long-term investments. That strategy drove significant unrealized losses in their portfolios and limited liquidity management options as deposit customers lost confidence.

Specific measures that highlight the significant differences between Merchants and Silicon Valley Bank include the percentage of uninsured deposits, retail deposits and capital levels. At year-end 2022, Silicon Valley had 86.4% of its deposits uninsured and Merchants had 26.2%. Merchants' deposit franchise consisted of 56.7% from retail (consumer) customers, while Silicon Valley had just 2.0%. Merchants carried 10.9% of capital to assets at year-end 2022, whereas Silicon Valley had 7.4%. Capital is our cushion to absorb risk variations in the industry and our balance sheet. Merchants has always focused on having strong capital levels.

Merchants has very little concentration risk compared to that of most banks. Our business diversification is a tremendous strategic advantage. We also managed our balance sheet in very conservative fashion throughout the pandemic and resisted the temptation to take on significant duration risk in our portfolio by chasing modest yield gains. Sitting on significant excess cash positioned us extremely well as interest rates increased in 2022 and through the end of the first quarter of 2023; on average we were still consistently selling more than $100 million of excess deposits to the Federal Reserve on a daily basis.

3. What is our current Liquidity Risk?

While we have experienced deposit runoff over the course of the past 12 months, the overall strength of the deposit franchise for Merchants remains outstanding. Total deposits at the end of Q1 were $2.18 billion. Because of the importance of liquidity at this time, we did liquidate approximately $60 million of investments at the end of the first quarter. This was strategic in that the investments we sold had lower yields, so the losses that we absorbed we expect to earn back in the current rate environment during the balance of the year. We also reduced the level of unrealized losses in the portfolio, strengthening the balance sheet for the longer term. As referenced above, we continue to hold a healthy liquidity cushion with an overnight selling position with the Federal Reserve that was consistently above $100 million. And, we have on-hand liquidity availability from secondary sources in excess of $410 million. With strong loan growth in 2022 and through the first quarter of 2023, our loan-to-deposit ratio of 88% positions us well for both earnings optimization and liquidity.

4. What has contributed to the year-over-year reduction in total deposits?

Total deposits at the end of Q1 were $2.18 billion, which is a 13.4% decline from the end of the first quarter of 2022. A majority of the deposit run-off can be attributed to a decline of municipal deposits, as these customers have spent down government stimulus funds they received during the pandemic and because many of our municipal customers have a statuary obligation to invest excess funds in the highest-yielding options that meet safety standards available in the market. So, while we continue to be the primary depository institution for these clients, excess funds have been moved into other instruments. Our core retail deposit base remains very strong. Less than 2% of money movement out of the Bank in the past two months has been attributed to FDIC insurance concerns.

5. What is our current Credit Risk forecast?

Credit risk remains stable at this time, as we have seen no signs of quality deterioration within our consolidated loan portfolio, even as our borrowing customers are now faced with higher interest rates. Net charge-offs were just .01% of total loans in Q1 of 2023. Criticized assets were 5.22% of total loans and 33.81% of capital, classified loans were 3.52% of total loans and 22.79% of capital, and non-performing loans were just .39% of total loans and 2.51% of capital at the end of Q1. All of these asset quality metrics for Merchants have improved since Q1 of 2022 and are well within risk quality benchmarks typical for the industry. We reversed an additional $1 million out of income and into Current Expected Credit Loss (CECL) reserves at the end of Q1, but that was only to accommodate the continued loan growth we have experienced. Our current reserve position is at 1.23% of total loans.

6. What is our current Interest Margin & Sensitivity Risk?

Our interest margin has improved from 2.94% at the end of Q1 2022 to 3.69% this year. However, the current competitive environment for deposits as all banks manage to optimize liquidity is certain to drive margin pressure. We will undoubtedly experience accelerated deposit pricing inflation through the balance of this year as we protect our deposit franchise and ensure that our loyal deposit customers are getting a fair return in the current market.

Deposit “Beta” is a measure that quantifies the price sensitivity of our deposits to the change in the Fed Funds rate, and Merchants’ deposit betas highlight the recent pressure on deposit rates. For 2022, our deposit beta was 4.9%. Including the first quarter 2023, it increased to 10.7%. In the current environment, there is tremendous price sensitivity across all deposit categories, and we project continued acceleration of deposit betas throughout the balance of 2023. We will continue to manage our net interest margin in a prudent manner, while embracing an absolute priority of retaining deposits.

Additional statement regarding Forward Looking Statements

Statements in this letter regarding the Company that are not historical facts are "forward-looking statements" that involve risks and uncertainties. These statements may be identified by the use of forward-looking terminology, including the words “may,” “believe,” “will,” “expect,” “look,” “anticipate,” “estimate,” “continue,” or similar words.

There are a number of risks and uncertainties to which these forward-looking statements may be subject, including

(i) changes in general economic, market and regulatory conditions;

(ii) the severity and duration of banking industry volatility on economic and financial markets, potential regulatory actions, and modifications to our operations, products, and services relating from these events;

(iii) the development of an interest rate environment that may adversely affect the Company’s interest rate spread, other income or cash flow anticipated from the Company’s operations, investment and lending activities;

(iv) the fact that the price of our MFGI common stock may be affected by factors beyond our control,

(v) changes in laws and regulations affecting banks and bank holding companies; and

(vi) the Company’s ability to access financial resources in the amounts, at the times and on the terms required to support the Company’s ongoing and future business.

These risks and uncertainties could cause actual results, performance or achievements to differ materially from those projected in the forward-looking statements. The forward-looking statements speak only as of the date of this letter. The Company does not undertake to publicly revise or update forward-looking statements in this press release to reflect events or circumstances that arise after the date of this earnings release, except as may be required under applicable law.

Merchants Financial Consolidated

Consolidated Statements of Financial Condition

Unaudited

($ in thousands, except share data)	March 31, 2023	December 31, 2022
ASSETS		
Cash and cash equivalents	147,043	225,701
Federal funds sold	368	277
Available-for-sale securities	216,911	276,621
Held-to-maturity securities	40,772	37,070
Loans held for sale	4,198	6,202
Loans and direct financing leases, net	1,929,335	1,852,035
Operating lease assets	21,133	21,558
Premises and equipment	26,088	26,388
Investment in restricted stock	6,869	7,163
Other real estate and other personal property owned	866	806
Accrued interest receivable and other assets	14,572	13,976
Cash value of life insurance	58,562	58,197
Mortgage servicing rights, net	16,149	16,641
Goodwill	35,665	35,665
Intangibles	656	797
Deferred tax assets	-	1,275
Total assets	**2,519,186**	**2,580,373**
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits		
Noninterest-bearing	597,498	635,853
Interest-bearing	1,585,949	1,621,448
Total deposits	2,183,447	2,257,301
Federal funds purchased	-	-
Repurchase agreements	15,020	12,019
Notes payable	11,660	12,120
Subordinated debentures	41,254	41,254
Deferred tax liability	3,104	3,233
Accrued interest payable and other liabilities	16,691	13,286
Total liabilities	2,271,175	2,339,213
Stockholders' Equity		
Common stock, par value $.025 per share	68	68
Additional paid-in-capital	10,255	10,255
Retained earnings	260,386	254,087
Accumulated other comprehensive gain	(14,347)	(14,899)
Unearned ESOP shares	(8,352)	(8,352)
Total stockholders' equity	248,011	241,159
Total liabilities and stockholders' equity	**2,519,186**	**2,580,373**

Merchants Financial Consolidated

Consolidated Statements of Income

Unaudited

($ in thousands, except share data)	**March 31, 2023**	**March 31, 2022**
INTEREST INCOME:		
Loan interest	21,100	16,659
Loan fees	1,713	2,479
Securities	2,160	812
Direct financing leases	418	749
Other income	2,103	607
Total interest income	27,494	21,306
INTEREST EXPENSE:		
Deposits	4,236	1,302
Notes payable, federal funds purchased and repurchase agreements	66	66
Subordinated debentures	694	434
Total interest expense	4,996	1,802
	-	
Net interest income	22,497	19,504
	-	
Provision for loan and lease losses	977	(1,596)
	-	
Net interest income after provision for loan and lease losses	21,521	21,100
NON-INTEREST INCOME:		
Trust department	543	467
Service charges and other fees	1,510	1,258
Loan servicing fees	1,791	1,801
Net gain on sale of available-for sale securities	(248)	-
Net gain on sale of loans	251	940
Net gain(loss) on sale of other real estate & other personal prop.	-	-
Other income	1,844	1,577
Total Non-interest income	5,691	6,042
NON-INTEREST EXPENSE:		
Salaries and employee benefits	9,080	9,738
Occupancy	4,511	3,694
Net loss on disposal of premises and equipment	-	15
Mortgage servicing rights	670	722
Other expense	3,165	2,929
Total non-interest expense	17,426	17,098
Income before income taxes	9,786	10,044
Provision for income taxes	2,602	2,695
Net income	**7,184**	**7,349**

Merchants Financial Consolidated

Consolidated Financial Highlights

First Quarter 2023

Unaudited

		Quarterly					Year to Date	
($ in thousands, except share data)		**1st Qtr 2023**	**4th Qtr 2022**	**3rd Qtr 2022**	**2nd Qtr 2022**	**1st Qtr 2022**	**March 31, 2023**	**March 31, 2022**
$ Earnings								
Net Interest Income	$	22,497	25,160	23,629	20,829	19,504	22,497	19,504
Provision (Reversal) for loan loss	$	977	(390)	(496)	206	(1,596)	977	(1,596)
Other non-interest income		5,691	6,802	6,380	6,198	6,042	5,691	6,042
Security gains/losses	$	(248)	-	-	-	-	(248)	-
Other non-interest expense		17,426	21,228	19,033	18,018	17,098	17,426	17,098
Pre-tax income	$	9,786	10,852	11,294	8,805	10,044	9,786	10,044
Taxes	$	2,602	2,542	2,994	2,339	2,695	2,602	2,695
Net Income	$	**7,184**	**8,310**	**8,300**	**6,466**	**7,349**	**7,184**	**7,349**
Pre-tax, pre-provision earnings	$	10,763	10,462	10,798	9,010	8,448	10,763	8,448
Earnings per share	$	0.88	1.02	1.01	0.79	0.90	0.88	0.90
Performance Ratios								
Return on average assets		1.14%	1.26%	1.27%	0.95%	1.06%	1.14%	1.06%
Return on average equity		11.97%	14.14%	14.92%	11.27%	12.89%	11.97%	12.89%
Yield on earning assets		4.79%	4.63%	4.20%	3.54%	3.29%	4.79%	3.29%
Cost of funds (inc non-int bearing deposits)		1.20%	0.76%	0.39%	0.33%	0.37%	1.20%	0.37%
Net interest margin		3.60%	3.75%	3.61%	3.05%	2.80%	3.60%	2.80%
Efficiency ratio		60.89%	66.16%	62.80%	65.30%	65.94%	60.89%	65.94%
Net overhead ratio		2.65%	3.09%	2.79%	2.49%	2.35%	2.65%	2.35%
Capital								
Tier 1 leverage capital ratio		10.99%	10.11%	9.80%	9.43%	9.19%	10.99%	9.19%
Common equity risk-based capital ratio		10.28%	10.21%	10.25%	12.40%	11.09%	10.28%	11.09%
Tier 1 risk-based capital ratio		12.02%	11.99%	12.09%	14.69%	13.18%	12.02%	13.18%
Total risk-based capital ratio		13.07%	13.24%	13.34%	15.94%	14.43%	13.27%	14.43%
Tangible capital to tangible assets		8.47%	7.98%	7.60%	7.34%	6.93%	8.47%	6.93%
Book value per share	$	30.32	29.49	28.61	28.15	28.32	30.32	28.32
Tangible book value per share	$	23.91	22.99	22.08	21.58	21.75	23.91	21.75
Outstanding shares		8,178,741	8,178,741	8,178,741	2,726,247	2,726,247	8,178,741	2,726,247
Asset Quality								
Net charge-offs (recoveries) YTD	$	277	264	164	30	(26)	277	(26)
Net charge-offs (recoveries) to average loans		0.01%	0.01%	0.01%	0.00%	0.00%	0.01%	0.00%
Allowance for loan losses		24,008	26,110	26,600	27,230	27,080	24,008	27,080
Allowance to total loans		1.23%	1.39%	1.48%	1.61%	1.67%	1.23%	1.67%
Allowance to total loans (excluding PPP loans)		1.23%	1.39%	1.48%	1.61%	1.68%	1.23%	1.68%
Nonperforming loans (Non-accrual & 90 days Past Du	$	7,712	8,523	10,735	12,874	12,717	7,712	12,717
Other real estate owned	$	866	806	803	1,034	1,123	866	1,123
Nonperforming loans to total loans		0.39%	0.45%	0.60%	0.76%	0.78%	0.39%	0.78%
Nonperforming assets to total assets		0.34%	0.36%	0.44%	0.53%	0.49%	0.34%	0.49%
End of Period Balances								
Assets	$	2,519,186	2,580,373	2,610,794	2,647,781	2,823,191	2,519,186	2,823,191
Earning Assets	$	2,304,601	2,364,994	2,397,498	2,440,300	2,629,824	2,304,601	2,629,824
Total investments	$	323,459	379,396	349,991	328,707	293,943	323,459	293,943
Total loans	$	1,957,515	1,884,384	1,799,929	1,692,173	1,622,246	1,957,515	1,622,246
Paycheck Protection Program loans	$	-	575	980	3,307	10,112	-	10,112
Intangible assets	$	52,470	53,103	53,480	53,730	53,771	52,470	53,771
Deposit	$	2,183,447	2,257,301	2,301,431	2,340,997	2,522,497	2,183,447	2,522,497
Customer repurchase agreements	$	15,020	12,019	6,450	14,923	2	15,020	2
Borrowings	$	11,660	12,120	12,040	12,040	14,540	11,660	14,540
Shareholders' Equity	$	248,011	241,159	234,028	230,234	231,661	248,011	231,661
Average Balances								
Assets	$	2,562,819	2,623,438	2,594,556	2,733,221	2,824,581	2,562,819	2,824,581
Earning Assets	$	2,349,958	2,408,189	2,389,460	2,528,827	2,626,093	2,349,958	2,626,093
Total investments	$	373,068	368,803	336,860	305,710	286,201	373,068	286,201
Total loans	$	1,910,675	1,825,910	1,680,303	1,660,766	1,620,556	1,910,675	1,620,556
Paycheck Protection Program loans	.	287	778	2,144	6,710	15,299	287	15,299
Intangible assets	$	52,756	53,231	53,507	53,615	53,320	52,756	53,320
Deposit	$	2,237,256	2,308,114	2,355,357	2,422,069	2,511,768	2,237,256	2,511,768
Customer repurchase agreements	$	11,470	12,197	11,173	9,935	7,779	11,470	7,779
Borrowings	$	11,668	12,043	12,040	14,265	14,540	11,668	14,540
Shareholders' Equity	$	243,384	233,103	220,500	230,249	231,334	243,384	231,334
Stock Valuation								
Closing Market Price (OTCPink)	$	27.90	29.10	27.00	25.50	26.50	27.90	26.50
Multiple of Tangible Book Value		1.17	1.27	1.22	1.18	1.22	1.17	1.22

**Previous quarter per share data restated to reflect May 13, 2022 Stock Split