Merchants Financial Group

July 27, 2020

Dear Shareholder,

Over the past few months, I've been reminded continuously how truly exceptional the Merchants team is – and that starts with the support of shareholders like you. In the face of challenging economic reality, I'm especially pleased with our banking team's commitment and solid mid-year earnings performance results. Much of our focus remains placed on COVID pandemic-related risks to our business, and you will find a detailed COVID update included with this report.

Consolidated net income for the Corporation through the first two quarters of 2020 was $8,442,992. This is $346,298 below the plan forecast we began the year with and $484,989 behind mid-year earnings of 2019. I was especially pleased that June earnings were profitable (net income of $2,039,415) even though we reversed nearly $4.6 million out of earnings as an additional Allowance for Loan/Lease Loss Reserves (ALLR) in the second quarter. This precautionary measure was prudent given the continued uncertainty associated with the long-term impact the global health pandemic may have on our borrowing customers.

The healthy diversification associated with our lines of business is what allows me to report solid earnings through two quarters. Most notably, the unbelievable market demand for residential mortgage loans in the current rate environment and the income associated with our commitment to mortgage origination is the positive offset to the ALLR expense. Through six months, our mortgage production has been $477 million in loan volume. Our total for all of 2019 was $538 million.

Other notable second quarter accomplishments include:

- Extraordinary year-over-year deposit growth of $660 million or 45.59% ($322 million above plan) – putting us in a healthy liquidity position at a time of economic uncertainty
- Loan growth of $414 million (27.98%), which is totally attributable to the addition of Northfield and our mobilization efforts associated with the COVID relief Paycheck Protection Program through the Small Business Administration. While the program opened in early April without clear guidance, we were positioned from program launch to assist our clients. We have assisted more than 1,500 small business owners by originating more than $200 million in loans through this program.
- The successful merger and systems integration of the First National Bank of Northfield into Merchants Bank. The complex project which we had been preparing for since taking ownership of the Bank last August culminated in mid-May. It's with great pride that we now have official Merchants Bank presence in the tremendous community of Northfield. We will continue to work hard every day to earn the same level of customer trust and confidence that First National had earned throughout its rich history.

As we look toward the remainder of 2020, we know we won't be immune to earnings challenges. To be transparent about what we expect, I encourage you to read the COVID response detail we have enclosed. I'm heartened to know that we have a strong, talented and dedicated team that will continue to work tirelessly as we embrace the ongoing challenges and opportunities. Thank you for your loyalty. I hope you and your families remain healthy and safe.

Very truly yours,

Gregory M. Evans
President and CEO

Balance Sheet Highlights

Period-end	June 30, 2020	March 31, 2020	Variance	December 31, 2019 *
Assets				
Cash & Fed Funds	$ 229,607,528	$ 131,931,489	74.04%	$ 94,783,266
Investments	127,523,898	134,212,276	-4.98%	143,203,122
Net Loans	1,903,472,135	1,719,233,826	10.72%	1,727,364,482
Intangible assets	38,611,788	38,901,522	-0.74%	39,204,841
Other assets	117,350,209	112,779,999	4.05%	108,138,081
Liabilities & Equity				
Deposits	2,107,480,634	1,834,113,261	14.90%	1,815,195,552
Trust Preferred Securities	41,254,000	41,254,000	0.00%	41,254,000
Other Liabilities	62,902,887	61,606,614	2.10%	58,989,884
Equity	204,928,037	200,085,237	2.42%	197,254,356

*Restated to align with audit reclassifications

Income Statement Highlights

	Six months ended			2019 -2020 Per Quarter Results			
	June 30, 2020	June 30, 2019 *					
	Actual	Actual	Variance	Second Quarter	First Quarter	Fourth Quarter	Third Quarter
Income							
Investments & Funds Sold	$ 1,987,907	$ 2,165,960	-8.22%	$ 703,465	$ 1,284,442	$ 1,253,964	$ 1,109,458
Loan Interest	43,193,728	37,989,817	13.70%	21,777,023	21,416,705	22,868,264	20,676,852
Total Interest Income	45,181,635	40,155,777	12.52%	22,480,488	22,701,147	24,122,228	21,786,310
Interest Expense	(7,122,227)	(6,550,215)	8.73%	(3,318,860)	(3,803,367)	(3,977,349)	(3,666,620)
Net Interest Income	38,059,408	33,605,562	13.25%	19,161,628	18,897,780	20,144,879	18,119,690
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Non-interest Income	18,248,843	10,806,157	68.87%	12,340,178	5,908,665	7,115,782	6,539,688
Non-interest expense	(38,554,496)	(30,743,633)	25.41%	(19,863,699)	(18,690,797)	(18,723,076)	(16,982,092)
Provision expense	(6,285,763)	(1,638,106)	283.72%	(5,327,992)	(957,771)	(542,803)	(73,803)
Pretax Income	11,467,992	12,029,980	-4.67%	6,310,115	5,157,877	7,994,782	7,603,483
Taxes	(3,025,000)	(3,102,000)	-2.48%	(1,674,001)	(1,350,999)	(2,686,029)	(2,073,000)
Net Income	8,442,992	8,927,980	-5.43%	4,636,114	3,806,878	5,308,753	5,530,483

Bank Yield and Margin Highlights

	June 30, 2020		March 31, 2020		December 31, 2019	
	Balances	Rate	Balances	Rate	Balances	Rate
Earning Assets						
Fed Funds Excess	$ 176,605,030	0.10%	$ 84,305,437	0.10%	$ 51,680,968	1.76%
Investments	$ 149,784,208	2.18%	$ 189,892,780	2.64%	$ 199,126,947	2.74%
Loans *	$ 1,862,457,601	3.67%	$ 1,696,323,641	4.14%	$ 1,675,345,449	4.29%
OREO & Non-accrual	$ 23,909,842	0.00%	$ 23,835,129	0.00%	$ 23,336,302	0.00%
Earning Assets Total	$ 2,212,756,681	3.23%	$ 1,994,356,987	3.78%	$ 1,949,489,666	4.19%
Paying Liabilities						
Non-interest deposits	$ 575,690,018	0.00%	$ 461,385,323	0.00%	$ 424,840,230	0.00%
Interest deposits	$ 1,532,637,921	0.69%	$ 1,392,222,104	0.89%	$ 1,389,996,422	0.95%
Non-core deposits	$ 17,245,485	0.90%	$ 15,078,655	1.04%	$ 9,453,637	1.17%
Borrowings	$ 20,000,000	2.30%	$ 25,000,000	2.17%	$ 25,000,000	2.17%
Fed Funds Purchased	$ -	0.00%	$ -	0.00%	$ -	0.00%
Paying Liabilities Total	$ 2,145,573,424	0.52%	$ 1,893,686,082	0.69%	$ 1,849,290,289	0.76%
Net Interest Spread		2.71%		3.09%		3.43%

* Paycheck Protection Loans reduce loan earning rate by 21 basis points.

Credit Quality Ratios

Period ended	June 30, 2020	March 31, 2020	December 31, 2019	September 30, 2019	June 30, 2019
Classified Loans to Total Loans	3.02%	3.89%	4.51%	4.43%	4.07%
Criticized Loans to Total Loans	4.35%	6.11%	7.50%	7.10%	6.35%
Classifed Loans to Capital	23.93%	28.62%	34.17%	31.52%	26.52%
Criticized Loans to Capital	34.50%	44.93%	56.83%	50.59%	41.32%
Non-accrual Loans to Total Loans *	1.18%	1.32%	1.26%	1.94%	1.65%
Past Due > 90 days to Total Loans *	0.38%	0.26%	0.23%	0.00%	0.00%
Net Charge-offs (Recoveries) to Total Loans *	0.00%	-0.01%	0.08%	0.10%	0.03%
Loss Reserve to Total Loans *	1.32%	1.19%	1.12%	1.23%	1.30%

* Total loans includes held for sale and operating leases

Key Ratios

Period-end	June 30, 2020	March 31, 2020	December 31, 2019	September 30, 2019	June 30, 2019
Internal Ratios					
Return on Average Assets	0.73%	0.71%	0.94%	0.96%	1.00%
Return on Ending Equity	8.30%	7.59%	10.04%	10.09%	9.60%
Efficiency Ratio	66.19%	74.14%	67.65%	67.86%	68.18%
Net Interest Margin	4.21%	4.04%	3.88%	3.77%	4.13%
Common Equity Tier 1	9.29%	9.11%	9.44%	10.29%	10.13%
Tier 1 Capital Ratio	11.42%	11.19%	11.51%	12.61%	12.49%
Total Capital Ratio	12.77%	12.25%	12.50%	13.70%	13.65%
Tier 1 Leverage Ratio	9.77%	10.21%	10.68%	11.44%	12.04%
Investor Ratios					
Number of Shares Outstanding	2,726,247	2,726,247	2,726,247	2,726,247	2,726,247
YTD Earnings Per Share	3.10	1.40	7.25	5.30	3.27
Book Value Per Share	75.17	73.39	72.35	70.30	68.28
Tangible Book Value (TBV)	61.01	59.12	57.97	55.81	59.82
Share price	53.00	60.75	73.35	72.75	72.50
Price to EPS	8.56	10.88	10.12	10.29	11.07
Price to TBV	86.88%	102.75%	126.52%	130.35%	121.20%

*Ratios with shares use outstanding shares versus GAAP weighted average shares

MERCHANTS FINANCIAL GROUP, INC 2020 SECOND QUARTER UPDATE

Given the impact of the COVID-19 global health pandemic, we intend to remain transparent in our quarterly updates relative to the state of the Company. Here is an updated Q&A through the end of the 2020 second quarter:

1. COVID-19: Operations & Business Continuity Planning response update

We continue to operate with the health and safety of all stakeholders as an intense priority. Specifically:

- As communicated previously, we closed access to customer traffic in our bank lobbies on March 19, 2020.
- We cautiously delayed reopening our lobbies to customer traffic until Monday, June 22, 2020. We conducted audits of all our locations prior to reopening them to ensure we could optimally implement appropriate personal protective equipment (PPE) as well as social distance parameter markings. We currently require all employees working in customer-facing areas to wear masks when clients are present, and we are asking our clients to honor our expectation that they do likewise, especially in locations where city mask requirements are in place.
- Our drive-through banking service has gone on uninterrupted throughout the period of pandemic response.
- We have taken steps to enable more than 65% of our workforce to work from home and have required employees capable of working in a distributed manner to continue to do so.
- We have accommodated and retained all our employees throughout the COVID-19 pandemic, with no instituted furloughs, layoffs, or reduction of compensation/benefits.
- We have effectively redeployed some front-line associates to support departments with unusually high work volumes.
- Our Executive Leadership Team adopted and continues to follow a schedule of work-from-home rotations to ensure appropriate health management and long-term continuity of leadership.

2. How has Merchants supported its borrowing customers and communities given the economic impact of the COVID-19 pandemic?

Consistent with our community banking mission, we have been a source of assistance for stakeholders hit hardest as a result of the pandemic. Specific actions include:

- We immediately instituted loan payment deferment programs across all product lines to provide short-term payment relief for businesses and individuals in good standing. On a consolidated basis, we have accommodated approximately 1,300 deferment requests for approximately $10 million in monthly payments from borrowing customers. Options extended were generally for periods of 30 to 90 days, depending on the type of loan. Many of the borrowers we worked with on the first round of deferment requests are already back to making payments with an agreed upon schedule**.** For customers hit hardest by the pandemic, we are working on extension of deferment options on a case-by-case basis.
- We mobilized immediately our participation in the Paycheck Protection Program (PPP) through the Small Business Administration. The program opened without clear federal government guidance as a source of loan relief for qualifying businesses on April 3,

2020. Merchants' credit administration team performed extraordinarily to meet the intense needs of our local small business customers while working to assess and mitigate unknown risk elements associated with the program as regulatory guidance evolved. Like other community banks, Merchants was a champion in keeping small businesses operational and our local workforce employed. By the end of Q2, we originated more than 1,500 PPP loans for a total of just over $200 million.

- Additionally, Merchants has made significant direct contributions in the form of grants to fund special emergency loan programs coordinated by several municipalities and non-profit organizations throughout our Minnesota and Wisconsin footprint.

3. What is our current Credit Risk forecast?

As you will note in the credit quality ratios in the financial detail that accompanies our mid-year report, aside from the effect of the COVID-19 pandemic, we continue to achieve overall improvement in credit quality. As noted above, however, many of our borrowing customers have experienced significant hardship associated with the pandemic. We will not be able to fully quantify the impact of this long-term elevation of risk in our portfolio until the economy shows signs of a sustainable return to normal. Although the injection of significant capital and liquidity into the economy by the federal government in the form of PPP loans and enhanced unemployment benefits has helped, we expect it may be as late as the first half of 2021 before we have a true assessment of long-term impact on our customers and our credit portfolio.

We are proactively conducting intense stress testing of our loan portfolio and have begun assessing levels of risk at a granular level associated with any concentrations in selected industries. As we closed our books at the end of Q2 2020, we reversed approximately $4 million from income and added it to our Allowance for Loan/Lease Loss Reserves (ALLR). This increased ALLR to 1.32% of total loans (compared to 1.12% at year-end 2019). As we navigate through the balance of the year, we expect this reserve analysis will continue to decrease our earnings to a greater degree than in prior years. Our approach is to have better quantifiable data to drive that calculation at the end of Q3 and again at year-end. We will adjust in a prudent and conservative manner as we always have.

4. What is our current Liquidity Risk?

The strength of the deposit franchise for Merchants remains outstanding. Total deposits at the end of Q2 were $2.11 billion. We have experienced deposit growth of 16.1% since year-end. We remain mindful of the critical importance of maintaining a healthy liquidity position at this time. The Bank Charter loan-to-deposit ratio of 88% compares to 98% a year ago, putting our balance sheet in a position of absolute strength.

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

As for many financial institutions, this is an area of concern. The sharp decline in interest rates that resulted from the onset of the pandemic has accelerated pressure on our net interest margin. Since year-end 2019, we have experienced interest margin compression of .72%. This has been contributed to, in part, by the growth of deposits and lack of traditional lending activity (PPP loan balances currently on the balance sheet have had a .21% impact on margin). We continue to manage pricing to the best of our ability on both sides of the balance sheet.

A continued advantage of the current interest rate environment is the diversification of our lines of business and the source of non-interest income that diversity creates, most notably in the area of residential mortgage lending. Through June 30, 2020, we had originated $478 million of mortgage loan volume compared to $538 million for all of 2019. The income component from these mortgage originations contributed significantly to offset the impact of increased provision to ALLR on our 2020 mid-year earnings.

6. **What is the current Cyber Security Risk?**

Incidents that result in heightened public fear and vulnerability create a prime environment for perpetrators of cybercrimes. During the 2020 second quarter, we completed our third-party penetration testing audit, with improved findings compared to mid-year 2019. We also continue to conduct robust testing of our information security layered systems and protocols. The nature of our business requires us to be in a constant state of high alert relative to information security and to protect the private client information we are entrusted with.

7. **Could you give us a current Merger and Acquisition activity update?**

We successfully merged the First National Bank of Northfield into Merchants Bank the weekend of May 15-17, 2020. The transition team planned and prepared extremely well for the merger. We were able to complete this complex undertaking with little service disruption for Northfield customers. That said, changes resulting from the merger and the need to become familiar with new systems has created some level of frustration for former First National Bank customers and employees. We continue to work very hard to manage any fallout and remain committed to earning trust and confidence from our new Northfield stakeholders.

Until the onset of the COVID-19 pandemic, we continued to pursue additional acquisition opportunities and were hopeful that something tangible would materialize. Our focus is now more appropriately placed on managing through a cycle of increased risk brought on by the pandemic, and we have temporarily suspended additional M&A activity. This should not be interpreted as a permanent shift associated with our long-term growth focus. We expect there will be tremendous strategic opportunities available as all banks work through the impact of the COVID-19 pandemic. We intend to be aggressive, yet disciplined, in pursuit of opportunities at the appropriate time.

8. **What comment would you make associated with the volatility and decline in Merchants stock price?**

As an OTC listed (albeit, thinly traded) Company, and with the presence of institutional investors within our shareholder base, we are not immune from the volatility being experienced in the broader stock market. The market share price of MFGI on June 30, 2020 was $53.00 per share compared to $60.75 per share at the end of Q1 and $73.35 per share at year-end 2019. We obviously cannot control market forces, and our focus remains on growing the fundamental value of the Company. It's rewarding to report that Tangible Book Value at the end of Q2 2020 grew to $61.01 per share (an increase of 3.1% from Q1 and a 5.2% increase from year-end 2019). The quarterly dividend of $.75 per share we paid in June 2020 reflects a very healthy annualized dividend yield of 2.83% based on the share price of $53.00 at quarter end.

We remain confident in our ability to grow the fundamental value of the Company, and we understand that market reaction and share price fluctuations are often driven by macro considerations that affect all financial stocks and the broader stock market.

9. **Given all of that, do you have an updated earnings forecast and what can I expect relative to the long-term value of my investment in Merchants?**

It remains impossible at this time to calculate the impact that we will undoubtedly experience from what has transpired without a crystal ball. We are pleased with our earnings performance for the first half of 2020, with relatively modest negative variance to both our 2020 plan and mid-year performance for 2019. We will continue to embrace the challenges that we will encounter through the balance of the year ahead as opportunities and we continue to navigate in the conservative and prudent manner that has served us well through our rich 145-year history. In consistent alignment with our business discipline, we will resist the temptation to sacrifice long-term strength as a tradeoff for short-term earnings performance considerations.

10. **What have you learned as a result of the COVID-19 pandemic that may influence the strategic priorities for the Company in the future?**

We have decided to accelerate our strategic planning cycle as a result of what we have learned in response to the pandemic. Our current plan expires at the end of 2020, and we have decided to mobilize aggressively now to review the current plan and reset strategic priorities. Some reasons to accelerate and take advantage of what we have learned include:

- Over the past four months, we were forced to implement innovative processes to support and respond to customer needs while having to limit personal interactions.
- We have had to maintain productivity and respond to heavy work volumes in all credit operations and administration areas with most of these employees now working from home.
- Leveraging what we have learned is possible as a result of the COVID-19 pandemic will be a key driver of our future – to include an ongoing emphasis on enhanced digital banking solutions as an important ingredient associated with shifting external customer service and experience expectations, and the internal focus associated with leveraging automation, process re-engineering and driving operational efficiency with a more agile workforce.
- The investment we have been making in the enhancement of our digital banking platforms and solutions for customers has been well-placed.
- Customer behaviors and transactional patterns may have shifted as a result of the COVID-19 pandemic and in ways that may become permanent. In light of this, it's also necessary to conduct a strategic review of our current branch delivery systems.
- We will continue to be a high-touch provider of financial services solutions with an intense client relationship focus.

To evaluate all of this, we have scheduled our strategic planning to be aggressively facilitated throughout the balance of the 2020 third quarter. This exercise will include the involvement of our Board of Directors and an emphasis on our continued responsibility to grow shareholder value in the face of market headwinds and industry challenges. We are excited about the upcoming engagement and will keep you informed as we, perhaps, set new strategic priorities while reaffirming several others that demand our attention as we chart the course for what we are confident will be a vibrant future for Merchants.

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) the Company’s ability to successfully and profitably integrate the Northfield operations;

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

(iii) the severity and duration of the COVID-19 coronavirus outbreak and the impact of the outbreak (including federal, state and local governments’ response to the outbreak) on economic and financial markets, potential regulatory actions, and modifications to our operations, products, and services relating from these events;

(iv) disruptions in our and our customers’ operations and loss of revenue due to widespread health emergencies, government-imposed travel/business restrictions, or outbreaks of infectious diseases such as the COVID-19 coronavirus, and the associated adverse impact on our financial position, liquidity, and our customers’ abilities to repay their obligations to us or willingness to obtain financial services products from the Company;

(v) 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;

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

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

(viii) 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.