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# MidWestOne Financial Group, Inc.

## Fourth Quarter 2021 Earnings Conference Call

## January 28, 2022

## CORPORATE PARTICIPANTS

**Charlie Funk,** *Chief Executive Officer*

**Barry Ray,** *Senior Executive Vice President and Chief Financial Officer*

**Len Devaisher,** *President and Chief Operating Officer*

**Jim Cantrell,** *Senior Executive Vice President, Chief Investment Officer and Treasurer*

**Gary Sims,** *Senior Vice President and Chief Credit Officer*

## CONFERENCE CALL PARTICIPANTS

**Brendan Nosal,** *Piper Sandler*

**Jeff Rulis,** *D.A. Davidson*

**Terry McEvoy,** *Stephens*

**Damon DelMonte,** *KBW*

**Brian Martin,** *Janney Montgomery*

## PRESENTATION

**Charlie Funk**

Good morning or good afternoon to all who've joined us this morning and we certainly thank you for joining us on our call. I'll make a few introductory remarks. And would tell you that I'm joined in the room by Len Devaisher, our President; Barry Ray, our Chief Financial Officer; Gary Sims, our Chief Credit Officer; and our Treasurer and Chief Investment Officer, Jim Cantrell.

I'll begin with stating the obvious, 2021 was a record year for MidWestOne with earnings of $69.5 million and $4.37 a share. And we would be the first to acknowledge that we did have tailwinds during the year from PPP and also from continued asset quality improvement, which allowed us to release credit reserves during the year. Fourth quarter earnings were driven by loan growth and solid trends in non-interest income, and that includes especially wealth management. I think we're making excellent progress with our commercial loan origination despite very high payoff levels in the quarter four. Almost unprecedented payoff levels for us and we still were able to eke out a gain in commercial loans and in loans overall ex PPP.



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We start 2022 with a very strong pipeline as we look forward to what happens later this year. We did take a very small provision during the quarter, and that was almost entirely due to the loan growth that we saw during the quarter. We're certainly excited—continue to be excited about the growth potential in our wealth management area. And we think the talent we've added over the last 18 months will show very significant fruit in 2022 and beyond. I also have to note that asset quality continues a three-year improvement and we expect more improvement in early to mid-2022 in our asset quality. We continue to invest in technology. And I would highlight a few notable developments in technology. We continue enhancement in our retail digital platform. We've continued to integrate enterprise work flow solutions that have saved literally hundreds of back office hours during 2021.

We are in the process of streamlining our business lending platform, and that's something that we will continue to work on over the balance this year. We're also integrating a new trust system. Since our AT merger, we've been running with two trust systems, and during 2022 we will merge those systems. It will be more efficient for our staff and much better for our customers once integrated. I think the bottom line on that is we are embracing change. We know change is necessary to remain relevant to our customers, and that is our goal in 2022 and beyond.

I would conclude by saying that, with a 5.5% increase in our dividend, we continue to exhibit a modest payout percentage. We think our capital levels are adequate, especially on our risk-adjusted basis where we've fallen only slightly year to year, and would also note that our CET1 regulatory ratio, just under 10%, at 9.94%, which we regard as more than adequate for our level of risk at MidWestOne.

I now want to let Barry Ray, our Chief Financial Officer, offer some comments, and that'll be followed by our President, Len Devaisher.

**Barry Ray**

Thank you, Charlie.

Fourth quarter 2021 earnings of $14.3 million were down from $16.3 million in the linked quarter. Higher revenue in the current quarter was offset by higher expenses. And as Charlie alluded to, we also recognized a small credit loss expense of $622,000 in the fourth quarter compared to a recapture of $1.1 million in the third quarter, or the linked quarter. On a per-share basis, fourth quarter diluted earnings per share of $0.91 were down from $1.03 on linked quarter, lower earnings described above earlier, partially offset by reduced share count from share repurchases during the quarter. Also, as Charlie alluded to for the year 2021, earnings were a Company record of $69.5 million.

Moving on to net interest income and the margin, net interest income of $38.8 million in the fourth quarter was down $1.5 million from $40.3 million in the linked quarter. PPP fee income of $2 million in the fourth quarter was down $1.6 million from the linked quarter where it was $3.6 million.

PPP loans were $30.8 million at year-end 2021, and though the rate of forgiveness tapered in the fourth quarter, we do expect most of that will be forgiven by the end of the first quarter, but very likely some will still remain—some small balance will likely remain throughout the year. Unearned PPP fees at year-end 2021 were $0.9 million.

We reported a net interest margin of 2.83% in the fourth quarter 2021, which was down 17 basis points from the linked quarter. If we break that into the earning asset yields and the cost of fund earning assets, earning asset yields were down 19 basis points and the cost of funds was down 2 basis points.



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Moving to the earning asset yield, 8 basis points of that decline was attributable to PPPC accretion, 2 basis points from loan purchase discount, and the balance being a combination of mix shift in the earning assets and lower coupon at loan origination.

With respect to funding costs, deposit costs were down 2 basis points, as I said, and that was principally from time deposit re-pricing at lower rates.

Moving on to our credit risk profile and credit loss expense.

Nonperforming assets were $31.9 million at year-end 2021, which was down 6.6% from the linked quarter and 29% from the prior year-end. If credit quality measures continue to improve and economic forecasts do not deteriorate and thus driving the increase in expected credit losses, we believe the allowance coverage ratio will drift downward over the course of 2022. Having said that, I will note the potential impact of 2022 credit loss expense from our planned Iowa First acquisition and additional credit loss expense that we will likely recognize from the so-called CECL double count.

Fee income, non-interest income was $11.2 million in the fourth quarter of 2021, up from $9.2 million on a linked quarter. Mortgage business finished 2021 strong, though 2022 mortgage origination forecast are approximately 30% lower than 2021. Positively, as Charlie alluded to, we expect recent investments in wealth management teams to provide some buffer to the mortgage revenue decline.

With respect to expenses and efficiency, non-interest expenses were $30.4 million for the fourth quarter 2021, up $29.8 million on a linked quarter. With the Iowa First acquisition plan for early in 2022, we expect the fourth quarter of 2022 to really be the next clean quarter for expenses. And we expect the efficiency ratio there will be elevated in 2022 compared to 2021, just based upon the revenue.

With respect to capital, our tangible common equity ratio was 7.49% at December 31, 2021, and that's down from 7.71% at September 30. The Company's target tangible common equity ratio remains in the 8% to 8.5% range. We have a negative impact from AOCI adjustment, which we expect to increase given higher market interest rates and larger available for-sale debt securities portfolio compared to prior years. In addition, the Iowa First acquisition will put some additional downward pressure on near-term capital levels, as that's an all cash deal. But we do expect to build back capital levels thereafter.

Finally, with respect to Iowa First, a brief update. Integration activities continue. Still awaiting regulatory approval, but as of today, we don't expect any issues with that. And we're on track for a late first quarter, early second quarter close.

With that, I will turn it over to Len Devaisher.

**Len Devaisher**

Thanks, Barry.

I would say for 2021, the headline for MidWestOne Financial Group is a really a year of advancing our sales culture, emphasizing two themes. First, execution. Second, talent. We are pleased that that combination is driving a growth in households, both consumer and business, and the growth in referral activity. All of that leading to a growth in revenue. So, I'd like to share with you a little bit of what we're thinking about and what we see on the revenue drivers.

Core commercial loan balances remain a top priority. And we're pleased with the progress. As you know, first quarter marked a low point in our balances. But since then, we've seen three quarters of growth. The biggest drivers, growth markets in Denver and Twin Cities. The latter of which you'll recall we've made



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some key talent investments. But it's important to note that the growth has been broad-based and includes much of our legacy Iowa footprint, including here in our headquarter city of Iowa City. It's notable that fourth quarter was our highest production quarter of the entire year, generating net growth despite elevated payoffs.

I will also add we're gratified to see retail loan balances increasing in the fourth quarter as well. Barry spoke to the strength of the deposit franchise that was evident in '21 and I would say the metric we're probably most excited about is having more than 10% year-over-year growth in non-interest-bearing deposits. We think and talk a lot about being a primary bank for our customers. And so another important related indicator of that strength of the deposit franchise is the increase in card revenue.

Speaking of fee income, we clearly benefited from a strong mortgage contribution across the year. And while it's moderated with the rest of the industry, we are pleased that origination income was essentially level on a linked-quarter basis.

Charlie spoke about wealth management outperformance. And we see our investment in that area across our footprint as an example of why we believe our talent strategy will continue to pay dividends. While we did see softness in swap revenue in '21, we are encouraged by two quarters of growth in that line, and we hope that the current interest rate outlook continues to follow that increasing trend.

I will just close by emphasizing where we're focused for '22 to deliver a return for our shareholders. Number one is revenue. We're focused on loan growth, especially commercial and continued core deposit growth. In the fee line, we look to realize return on our investments in the wealth business and pursue continued momentum in card and swap income. We expect to continue our trend of strengthening the credit risk profile. The teams are progressing well and preparing for the integration of Iowa First, as Barry mentioned.

And finally, we know that thoughtful expense management is paramount. We're clear eyed about losing the tailwind of PPP fees. So we know that expense discipline is a non-negotiable. And for us, that means reducing expenses and finding efficiencies where we can so that we can continue to invest in a business where we can drive growth. Just as you heard from Charlie, consistent with what you've heard from us all along, priorities for those investments would be talent and technology.

With that, Juan, we'd be pleased to take questions.

**Operator**

Thank you. The first question comes from Brendan Nosal from Piper Sandler. Please, Brendan, your line is now open.

**Brendan Nosal**

Hi, good morning, everybody. How are you doing?

**Charlie Funk**

Morning, Brendan.

**Len Devaisher**

Good morning.



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**Brendan Nosal**

Maybe just to start off on the loan growth side of things. As you guys alluded to, you guys start to get these three quarters of nice mid-single-digit growth, and it sounds like the gross activity this quarter outside of paydowns was stronger than even it has been in some time. So just curious about the puts and takes within loan growth as we move through 2022 and what you think is a reasonable expectation for loan growth for the year.

**Len Devaisher**

Sure. Brendan, this is Len.

I would start the response there by saying, one of the reasons we have for optimism would be a lot of the production we're seeing includes some construction, development-type loans so that we see those drawing up across the year. Of course, we continue to see elevated payoff activity, as we referenced in the fourth quarter. But as we sit here today with our pipeline remaining steady, we continue to expect and push for growth across the year.

**Brendan Nosal**

Got it. That's helpful color. Maybe one more from me. Just kind of looking at the securities portfolio, and you guys have put so much liquidity to work in that book already. So just give us some color on your ability to reinvest that book as rates move higher. How much is that portfolio cash flowing per quarter, just things like that.

**Jim Cantrell**

Brendan, this is Jim, I'll take that one.

You're absolutely right. We've got a little over $2 billion in the investment portfolio, and it is supplying a good deal of cash flow in the current—in its current form. My expectation is it will be—the portfolio will generate in the neighborhood of $300 million of cash flow this year in 2022, maybe a little bit less than that next year. So it gives us, I think, some flexibility to answer your question. It sort of depends on what happens on the liability side and how quickly we grow loans. My hope would be that we could let almost all of the investment portfolio run off and those balances will be replaced by loan growth. If that is not the case, if loan growth—or if we continue to see deposit growth at a pretty rapid pace and we don't have loan growth, we would invest slowly in the investment portfolio. But I think that's kind of the range of outcomes that I see as most likely.

**Brendan Nosal**

Understood. Yes. Thank you for your thoughts there. Appreciate taking the questions.

**Operator**

Thank you. Our next question comes from Jeff Rulis from D.A. Davidson. Please, Jeff, your line is now open.

**Jeff Rulis**

Thanks. Good morning.



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**Charlie Funk**

Good morning, Jeff.

**Jeff Rulis**

On the loan growth front—hi there. I didn't quite hear a number of expectations on '22. I guess we'll keep it optimistic and monitor pay activity, but maybe one you could speak to is the historical or Q4 performance of Iowa First. Any high level or specific comments about their growth credit margin, how they did in the fourth quarter on that end, and yes, would that impact its thoughts on accretion if you're more confident in the figures that you've announced that announcement? Thanks.

**Charlie Funk**

Yes. I'll start on that, Jeff. Good question.

I think our guidance all along has been mid-single-digit in the 4% to 6% range on loan growth. Right now, from what I see, I think it might be at the higher end of that. But, as you know, payoffs are going to determine a lot of that. Obviously, we saw a lot of payoffs in the fourth quarter. Iowa First has been very consistent. They were profitable in the fourth quarter. It's no secret that one of the two banks and Iowa First had some asset quality problems, but those seem to have been addressed pretty well, at least to our satisfaction. They had a solid fourth quarter of earnings.

**Jeff Rulis**

Great. Thanks, Charlie.

And Barry, maybe just for you, the expense run rate, I guess if we exclude the moderate merger costs. I know that you said you probably don't get back to a clean number until the fourth quarter of the coming year or this year. But any sort of thoughts on back down to 11 and change, and then we just take on Iowa First from there?

**Barry Ray**

Yes. My thought on that, Jeff, is that we do our whole company salary increases on January 1 of each year. So the $30 million, it's probably, excluding Iowa First, not a bad estimate of go-forward run rate for quarterly expenses. Excluding the merger-related costs and other types of things, I would expect that Iowa First is going to add around $2 million to $2.5 million per quarter starting in the second quarter. Again, there are a lot of obviously merger-related expenses in there as well.

**Jeff Rulis**

Got it. I think I may have misquoted that expense.

**Barry Ray**

Yes.

**Jeff Rulis**

So you said kind of $30 million run rate, and then add-on, tack-on (multiple speakers).



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**Barry Ray**

(Multiple speakers).

**Jeff Rulis**

Thanks. And lastly, on the tax rate, any kind of ’22 and change for ‘21, but seemed a little higher than historic, but is that kind of the new—is that a good run rate for tax rate?

**Barry Ray**

Yes, we had an uptick in the tax rate based upon a true-up of our tax expense at year-end 2021. To your question, I think the effective tax rate in 2022, barring some action from the Federal Government or otherwise, is probably going to be in the 20% to 21% rate, Jeff.

**Jeff Rulis**

Okay. Thank you.

**Charlie Funk**

Jeff, this is Charlie and I might just also interject.

I think we're no different from most companies that there's certainly upward pressure in the inflationary environment on expenses. I don't know that we can forecast what that'll be, but I think all of us in the industry are dealing with—almost every line item of our expense budget is under some pressure. So I think we all need to allow for that.

**Jeff Rulis**

Okay. Thanks, Charlie.

**Operator**

Thank you. Our next question comes from Terry McEvoy from Stephens. Please, Terry, your line is now open.

**Terry Mcevoy**

Thank you. Good morning, everyone.

**Charlie Funk**

Hi, Terry

**Jim Cantrell**

Good morning, Terry.

**Terry Mcevoy**



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Within the press release, you talked about the continued low credit line usage in the fourth quarter. I was wondering if you could put some numbers behind that. And within your outlook for 2022, would you expect the usage rates to increase?

**Len Devaisher**

Yes. We have seen some positive signs at the tail end of the fourth quarter. But they're still historically low, Terry. So our line usage rate at the end of the fourth quarter was at 32%, as I recall. But we did see, again, some uptick quarter over quarter because of the loan production. So kind of holding constant in usage, but additional production driving some balance gain. So our outlook would be, as we move through '22, that we would continue to see that number gradually move upward and be some tailwind for us on balances.

**Terry Mcevoy**

Understood. Thank you. And then as a follow-up, I'm wondering if you just update us on your interest rate sensitivity and specifically deposit re-pricing as rates rise. Do you think you'll be able to lag your deposits? Particularly in your—I guess in your presentation, your rural (phon) core deposit base that you referenced in the presentation.

**Jim Cantrell**

Yes. Terry, this is Jim, I will—I'll take a first shot at that question.

I guess I would start by saying when we look at ALCO and the models, and we do a fair amount of modeling, what we see in a rising rate environment, at least in the first year, is pretty neutral. I mean the model results would show fairly neutral in the first year and then some benefits as you move through time. So the late in the first year, starting in the second year, we would start to expect to see benefits as some of the fixed rate assets reprice up.

I do think there's the potential, as you suggest, for some unmodeled, what I would call, unmodeled benefit, and that will lag our deposit increases more than say the model would indicate we will. There's a small amount of potential upside in the near—in the front quarters of a rate increase; but it's not, I don't want to oversell it, it's not a lot in terms of basis points on the margin. It's measured in terms basis points on the margin, not tens of basis points on the margin in the early stages.

**Terry Mcevoy**

Great. Thank you for that. And have a nice weekend, everyone.

**Charlie Funk**

Thank you, Terry.

**Jim Cantrell**

You too.

**Operator**

Thank you. The next question comes from Damon DelMonte from KBW. Please, Damon, your line is now.



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**Damon DelMonte**

Hi, good afternoon, everyone.

Just to follow up on Terry's question with interest rate sensitivity. So as we look at the core margin over the upcoming couple of quarters here, with the expectation that rates for maybe at one hike in March and then a couple more towards the middle to the back half of the year, do you think you can keep that core margin flat from this quarter's level, or do you think there's still some downward pressure before it actually inflects and begins to rise up?

**Jim Cantrell**

Yes. Damon, this is Jim again.

I think there are a couple of factors that may work in our favor. One we just talked about is, I do think as rates—we get those first of those rate hikes that are expected in the marketplace coming as early as March. We will see some increases in our floating rate, our prime-based loan portfolio. There's very few of our liabilities that will move up immediately. Some CDs will start to reprice, but that will take place over time. But most of our non-maturing-type deposit money market savings, DDAs and the like, I think for the first couple of increases, that increase as well will be likely to hold those fairly steady. So I do think that will work in our favour.

The other factors, I'm starting to see signs. We talked about maybe letting the portfolio run off. Now that PPP forgiveness has run its course, I think the composition of the balance sheet will shift more towards loans and less towards securities. That will also, I think, contribute to a little—maybe a little bit better than flat margin as we move forward.

**Damon DelMonte**

Thanks. That's very helpful. Then with regard to fee income, obviously mortgage banking is a sensitive area in the industry right now with rates moving around and stuff. But how do you look at your core run rate based off of what you've seen over the last two quarters here?

**Barry Ray**

Damon, this is Barry.

As I look at it and I look back, I would say that probably the—and I'm going to exclude the mortgage servicing rate (phon) adjustment out of this, Damon. I would say that probably the third quarter of 2021 run rate of around $9 million to $9.5 million is probably a good run rate for fee income going forward. Obviously that also was core run rate excluding Iowa First.

**Damon DelMonte**

Right. Right. I mean, they don't contribute too much, right? Maybe like a million bucks?

**Barry Ray**

I think Iowa First would be—yes, that's a number that I have is about a million bucks a quarter, Damon.

**Damon Delmonte**



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Okay. Great. Everything else has been asked and answered. Thank you very much.

**Charlie Funk**

Thank you, Damon.

**Operator**

Thank you. The next question comes from Brian Martin from Janney Montgomery. Please, Brian, your line is now open.

**Brian Martin**

Hi, good morning, guys.

**Charlie Funk**

Morning, Brian.

**Jim Cantrell**

Morning, Brian.

**Brian Martin**

Maybe just one more on the margin, Jim, just on the variable rate loans. What percentage of your loans are variable today that would reprice upward?

**Jim Cantrell**

Yes, and depending on the timing of that variability, some of it happens right upfront. Those are prime-based loans, but I would say the general answer is 40% of the loans, maybe a touch less, between a third and 40—a third of the loans and 40% of variable to some degree.

**Brian Martin**

Okay. (Multiple speakers).

**Jim Cantrell**

Some will have more (phon), so will take a little bit of time to get off the floors.

**Brian Martin**

Got you. Okay, and in the benefit—from a 25 basis point rate hike on each rate hike, I mean, how would you think about that benefit to the margin when it does begin to accrue as you kind of get through some of those floors? I mean, just in total, I guess—or how you'd characterize it, how you're thinking about the rate increases that we are seemingly going to get here?

**Jim Cantrell**



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Yes. Brian, I do think there's some benefit in the early quarters of a rate hike—hiking cycle, but it's small in terms of basis points. I think over time, a year after the first hike, it's probably up in the tens of basis points expansion, but it's at one or two basis points per quarter, so it's small, incremental in the early stages. I think it builds momentum over time, but the early stages, I don't expect to see big margin changes with the Fed increase, just small ones.

**Brian Martin**

Okay, got you. And then your core margin today, Jim, as you sit and kind of talk about it maybe being flattish here in the near term, what kind of reference point from a core standpoint are you looking at? Are you just taking PPP out of that or, I guess, what are you kind of removing from there to kind of take a look at your core level?

**Len Devaisher**

What do we have? In the margin, what's reported? The 283?

**Jim Cantrell**

We reported the margin at 283. Right? If you back out of that, the PPP. That would put—I have it at around 270.

**Len Devaisher**

Yes. We got about 8 basis points on PPP is what I recall and a couple of basis point—2 basis points on purchase accounting.

**Brian Martin**

Okay, so 270 is where you are seeing the margin stabilize and then trend upwards from there. That's the big picture how you're thinking about it?

**Len Devaisher**

That's how I view it, yes.

**Brian Martin**

Yes, okay. Perfect. That's helpful. Then maybe, I don't know for whom, but Charlie, you referenced maybe a little bit better credit quality outlook as you go into '22 here. But I guess, can you just talk about what you're seeing on the credit quality front that's improving?

And then maybe when you talked about the reserve level, I think somebody mentioned maybe the trend is a bit lower. Just when you factor in Iowa First, I mean, where are you all in? Where do you guys see yourselves landing? Is it post Iowa First as you get later in the year, I guess? Can you give any context on just how we should think about that?

**Charlie Funk**

Yes. I would just say, Brian, I think the biggest story for us on asset quality is if you go back a couple of years and you look at the continual progress, and I believe I'm going from memory here, I believe we



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were down 23 basis points on MPAs from the prior year. And I think you will continue to see lower levels of MPAs as the year progresses.

In terms of specifics, I think we all benefit from hearing from Gary Sims in terms of his outlook on asset quality. So I'd give it the Gary.

**Gary Sims**

Sure. I would—just to continue what Charlie was saying in terms of the momentum that we see in the non-performers and the reductions. Really, what we're seeing is our ability to resolve existing non-performers is outpacing any deterioration, if any, that we're seeing in any given quarter. So over the course of the year, I believe you're going to see that trend continue. That really equates to, I believe, what you're going to see from the loan loss reserve as well. I believe that over the course of the year we will have a bias towards that loan loss reserve migrating down.

**Brian Martin**

Got you. As far as where you see that trending over time when you get Iowa First assimilated, where do you see it tracking if things continue to hold up pretty well like you're expecting?

**Gary Sims**

I'm going to ask Barry to help me.

**Charlie Funk**

That's a good question, Brian.

**Gary Sims**

(Multiple speakers), Barry.

**Barry Ray**

Yes, a difficult question to answer. Obviously, it's a factor of how things are going to shake out in the evaluation. I would say, Brian, when we looked ahead when we're doing our budget, we we're drifting our coverage ratio down probably like 10 basis points, I believe. That's what we were thinking. Then the impact of Iowa First, it's difficult to measure the impact of the CECL double count, but that could raise that coverage ratio up a little bit just mathematically. But again, I think our bias is towards drifting it down.

**Brian Martin**

Good. Thank you. Okay. All right. And I guess maybe just—you guys made a comment earlier, Barry, maybe I missed it, but just did you comment on what the impact on the expense side from Iowa First? I guess, was there a $2.5 million number? I forget what you said, but you said something earlier about the expense impact from Iowa First.

**Barry Ray**

Right. Yes, and what I said, Brian, was $2 million to $2.5 million, and that was what I would call a clean run rate of additional expenses from Iowa First. That's what we expect it to be quarterly.



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**Brian Martin**

Okay, and that—okay. And that quarter, when you're clean would be when—what, Barry? Maybe you said that. If you said that, I apologize.

**Barry Ray**

(Inaudible) it's probably the earliest one. I think it was the fourth quarter of this—fourth quarter 2022 would be the earliest clean quarter, I expect.

**Brian Martin**

Got you. Okay. All right. That's all I had, guys. I appreciate it. Thanks.

**Charlie Funk**

Thank you, Brian.

**Operator**

Thank you. We currently have no further questions. I will hand over back to Charlie Funk for any final remarks.

**Charlie Funk**

Thank you, Juan.

Thanks to everyone who's joined us today on the call. We appreciate your listening participation and your active participation. Since we are in the Midwest, we are going to say stay warm and stay healthy. Thanks again.



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