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Earnings Call

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the MidWestOne Financial Group, Inc. First Quarter 2024 Earnings Call. [Operator Instructions]. As a reminder, this call is being recorded. And I would now like to turn the call over to Barry Ray, Chief Financial Officer of MidWestOne Financial Group. You may proceed.

Barry S. Ray
CFO & Senior Executive VP

Thank you, everyone, for joining us today. We appreciate your participation in our earnings conference call this morning. With me here on the call are Chip Reeves, our Chief Executive Officer; Len Devaisher, our President and Chief Operating Officer; and Gary Sims, our Chief Credit Officer. Following the conclusion of today's conference, a replay of this call will be available on our website. Additionally, a slide deck to complement today's presentation is also available on the Investor Relations section of our website.

Before we begin, let me remind everyone on the call that this presentation contains forward-looking statements related to the financial condition, results of operations and business of MidWestOne Financial Group, Inc. Forward-looking statements generally include words such as believes, expects, anticipates and other similar expressions. Actual results could differ materially from those indicated.

Among the important factors that could cause actual results to differ materially are interest rates, changes in the mix of the company's business, competitive pressures, general economic conditions and the risk factors detailed in the company's periodic reports and registration statements filed with the Securities and Exchange Commission.

MidWestOne Financial Group, Inc. undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances after the date of this presentation. I would now like to turn the call over to Chip.

Charles N. Reeves
CEO & Director

Thank you, Barry, and good morning. On today's call, I'll provide a high-level overview of our first quarter results and an update on the significant progress in executing our strategic plan initiatives. Len will provide an update on our lines of business, and then Barry will conclude with a more detailed review of our first quarter financial results.

Looking at our quarterly highlights, I'm pleased with the seamless closing and integration of Denver Bankshares, which added scale and a low-cost deposit franchise to our existing Denver operations. Our Denver franchise now has loans of $673 million and deposits of $429 million. As we've stated previously, our objective is for the Denver market to be a $1 billion franchise for us in the future. Len will speak further about our progress and our plans in this critical market.

Turning to our balance sheet trends. Excluding acquired Bank of Denver balances, we delivered 8% annualized loan growth for the first quarter as we continue to benefit from the expansion of our major market banking teams and our customer value proposition, emphasizing larger bank expertise delivered in a high-touch boutique fashion. Additionally, deposits were stable in what's normally a seasonally slow quarter, and we remain cautiously optimistic, will grow our core deposit franchise through the year ahead.

Importantly, in the quarter, because our strategic 2023 balance sheet actions, the acquisition of Denver Bankshares and continued loan growth, our net interest margin expanded in the first quarter, rising 11 basis points and leading to a 7% quarterly increase in our net interest income. Even if no rate cuts occur in 2024, we anticipate a slow build of margin for the remainder of the year. We continue to expand and up-tier our Commercial Banking and Wealth Management businesses and enjoyed solid loan and assets under management growth in our major metro markets, both the Twin Cities, Denver and Metro Iowa,

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specifically regarding our Wealth Management business, our investment in [talent] and platform as well as market valuations was the first quarter revenue of $3.5 million, a 10% quarterly and 19% year-over-year increase.

In January, we welcomed our new EVP and Head of Wealth Management, Steve Heimermann, and under his leadership, we look to achieve double-digit annual revenue growth in this business segment in the years to come. The first quarter and the beginning of the second quarter of 2024, has seen significant talent acquisition across our bank as we continue to mature and expand our operations consistent with our strategic plan. These senior hires are in commercial banking, credit administration, wealth management, marketing and treasury management investments. Even with these talent and platform investments, we remain pleased with our expense discipline as we funded the majority of these investments by reallocating expense reductions into more productive and profitable markets and departments.

To conclude, we've made substantial progress in the transformation of MidwestOne, positioning the bank for improved earnings power and returns. The execution of our strategic initiatives is progressing better than we've expected, and I remain very optimistic on what the future holds for our employees and shareholders.

I'd like to thank our employees for their continued hard work their expertise and their commitment to our company, customers and communities. This journey would not be possible without their unwavering support. Now I'd like to turn the call over to Len.

Len D. Devaisher
President & COO

Thank you, Chip. I'd like to provide some color on the results we're seeing in our deposit, commercial and wealth business line. So let us start with deposits. We are pleased that both February and March saw customer deposit gains mitigating seasonal decline we experienced in January. These gains exclude deposits assumed from the Bank of Denver transaction. In terms of Commercial Banking, slide 7 shows that it was Iowa Metro, Colorado and Twin Cities as our largest contributors to balanced growth.

The primary drivers include drawdowns on existing CRE construction loans and an acceleration in C&I in new production. This includes a nice win by our new agribusiness team, as well as a new manufacturer we brought across, both with a full relationship, including treasury management. Speaking of commercial, our government guarantee business continues to gain momentum. We see that our SBA gain on-sale business as a growing driver of fee income.

In the first 3 months of 2024. We recognized $213,000 or 65% of what we saw in all of last year. And we believe the next couple of quarters will outpace that strong start. As Slide 8 shows, asset quality metrics for the quarter were stable, including net charge-offs and 30- to 89-day delinquency of only 2 basis points and 20 basis points, respectively. Our nonperforming assets ratio saw a slight increase of 2 basis points, while our allowance grew to 1.27% of total loans.

As noted in our release, our classified assets ratio declined 36 basis points from the linked quarter. However, two large trucking relationships migrated from past to special mention in the quarter, driving an increase in our criticized loan balance. Turning to Slide 10. The momentum in Wealth Management continues with assets under administration up 11% and revenue up 19% from the same period 1 year ago. We are encouraged by new talent attraction efforts in this line of business, and we see that as a continuing opportunity for us in 2024.

Finally, I want to commend the exceptional work by the team with the Bank of Denver acquisition. From operations to IT, to retail ambassadors and learning and development, it was our smoothest conversion yet. And I can tell you from having been on the ground in Denver that our newest colleagues are settling in very nicely.

As Chip mentioned,we see continued upside in Denver. In fact, in the period since our Bank of Denver announcement, we have recruited a new SBA Business Development Officer, a new Treasury Management Officer and a new senior C&I commercial banker, as referenced in our strategic plan updates, selective

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talent acquisition in our target markets continues to be a focus. With that, I'm pleased to turn the call over to our CFO, Barry Ray, to discuss our financial results.

Barry S. Ray
CFO & Senior Executive VP

Thank you, Len. I'll walk through our financial statements beginning with the balance sheet on Slide 12. Starting with assets, loans increased $287.7 million or 7% from the linked quarter to $4.41 billion. Excluding the $207.1 million of loans acquired in the Bank of Denver acquisition, loan growth was $80.6 million or 8% annualized from the linked quarter. Strength in the first quarter was led by commercial and industrial loans, which increased $30.7 million or 12% annualized from the linked quarter.

The overall portfolio yield was 5.51%, a 17 basis point improvement from the linked quarter. The allowance for credit losses increased $4.4 million to $55.9 million or 1.27% of loans held for investment at March 31. The increase reflected $3.2 million in credit loss expense to establish the day 1 allowance for credit losses in connection with the Bank of Denver acquisition as well as additional allowance for credit losses for organic loan growth.

Turning to deposits. Total deposits increased $189.6 million to $5.59 billion at March 31 as compared to December 31. Excluding the $224.2 million of deposits assumed in the Bank of Denver acquisition, deposits were down $34.7 million from year-end 2023. Finishing the balance sheet. Total shareholders' equity increased $3.6 million to $528 million, driven primarily by a decrease in accumulated other comprehensive loss. The tangible common equity ratio was 6.43% March 31, 2024, down 47 basis points from year-end 2023 due primarily to the all-cash Denver Bankshares acquisition.

Turning to the income statement. On Slide 15, we earned net income of $3.3 million or $0.21 per diluted share. During the quarter, we completed the acquisition of Denver Bankshares resulting in merger-related expenses of $1.3 million and a day 1 credit loss expense of $3.2 million. In addition, we recorded a negative mortgage servicing right valuation of $368,000 and incurred nonmerger-related severance costs of $261,000. Adjusting for these items, adjusted net income was $7.2 million or $0.46 per diluted common share.

Net interest income increased $2.2 million in the first quarter to $34.7 million as compared to the linked quarter, due primarily to higher earning asset volumes and yields, partially offset by higher funding costs and volumes of interest-bearing liabilities. Loan interest income in the first quarter of 2024 included $1.2 million of loan purchase discount accretion, $458,000 of which was attributable to the bank of Denver required loans.

The attributable purchase discount for the Bank of Denver loans was provisionally measured during the first quarter at $8.2 million or 3.8% of acquired loans. We expect to recognize that discount in loan interest income over the 3.1 year weighted average portfolio life. Our tax equivalent net interest margin increased 11 basis points to 2.33% in the first quarter as compared to 2.22% in the linked quarter as asset yield increases outpaced funding cost increases.

Specifically, earning asset yields increased 20 basis points, partially offset by a 10 basis point increase in our funding costs. The cost of interest-bearing deposits grew much more modestly, up only 6 basis points quarter-over-quarter compared to the 34 basis point increase we experienced in the prior quarter. This outcome was a key driver in our net interest margin improvement. Noninterest income in the first quarter increased $5.9 million due primarily to the $5.7 million net loss on our security sale in the fourth quarter of 2023, which did not recur in the current quarter.

In addition, wealth management-related revenue increased $310,000 from a linked quarter. Finishing with expenses. Total noninterest expense in the first quarter was $35.6 million, an increase of $3.5 million or 11% from the linked quarter. The first quarter's expenses included $1.3 million of merger-related costs as well as nonmerger-related severance costs of $261,000. Adjusting for those charges, adjusted noninterest expense was $34 million or a 6% increase from the linked quarter.

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The increase was due to normal annual salary adjustments, incentive accruals and additional Bank of Denver employee costs. As a reminder, we expect to divest our Florida branches in June 2024, which will result in a reduction to our quarterly expense run rate of about $700,000 beginning in July 2024.
The Expense control remains a key focus of our management team, and we are very pleased with our execution. And with that, I'll turn it back to the operator to open the line for questions.

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Question and Answer

Operator

[Operator Instructions] And our first question is from the line of Brendan Nosal with Hovde.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Maybe just to start off here. I appreciate all the commentary you gave on early days of Denver, and I know that it is still quite early there. But just -- would love to hear you speak about some of the opportunities that you hope to get in front of now with the deal closed and the new team adds that you just weren't able to get in front of previously?

Len D. Devaisher
President & COO

Yes, Brendan, this is Len. And I would tell you that the story, I think, is compelling where folks -- we have a new story to tell. We've had, obviously, as you know, we've enjoyed a lot of growth out of Denver starting with the team looked at in 2017. But this is doubling down with our partnership with Bank of Denver, really allows us to show -- to [talent] what this market means to us.

And so I see that showing up since the announcement in the talent recruitment we've been able to achieve. And I would say that overall, I look at it as not only the new talent we've added on, the talent that we've acquired by way of Bank of Denver and then just looking at balances and having customer conversations having down in the ground that feel good about momentum.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

All right. Perfect. Perhaps one more for me. Can you folks offer a little more color on the trucking industry credits that drove the increase in special mention? Any details like what drove the migration? How lagy reserved and any line of sight to potential loss content you see at this point?

Gary L. Sims
Senior VP & Chief Credit Officer

Brendan, this is Gary Sims. We don't have a significant exposure to the trucking industry, just as a matter, of course, our exposure is primarily focused on customers in our markets that we're doing business with. Total exposure is $55 million across the industry. And as we started getting in the year-end financials from our customers, we recognize that some of our customers had experienced deterioration in 2023 that prompted us to downgrade a couple of those credits to special mention based on less than -- less-than-expected cash flow. Both of these credits are long-time customers that we do believe have the wherewithal and the staying power to make it through this industry downturn.

You did ask kind of what's driving that. It's really that the after-effect from the from the pandemic where you had an oversupply of capacity in that space that's caused trucking rates to decline. And so you've got that supply/demand mismatch that's been happening in the industry.

So we're watching those customers closely. When we saw the deterioration, we looked at the entire portfolio and the downgrades that you saw were really the ones that we said had some risk in them. I'll stop. Does that make sense, Brendan?

Operator

The next question is from the line of Terry McEvoy with Stephens.

Terence James McEvoy
Stephens Inc., Research Division

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Maybe, Barry, a question for you. How is the balance sheet position when you adjust for the two acquisitions? How is that positioned for a higher, for longer rate environment. I think Chip said earlier, the margin kind of grind higher without rate cuts, but wondering if you could expand on that.

Barry S. Ray
CFO & Senior Executive VP

Yes. we believe that even if we get no rate cuts in 2024, for example, Terry, yes, we think that the rate of increase of our asset yields, we still have opportunity where that's going to outpace the cost of funds with our current balance sheet position. We're getting about 4 basis points per month of loan yield increase and that's been something that's been holding in there.

We were pleased at the rate of funding costs slowed down dramatically in the quarter. So we feel cautiously optimistic that we have opportunity to expand the margin even with no cuts in 2024 because of that, if that kind of pattern holds for us. So the risk of that would be the deposit, the funding cost side, Terry.

Terence James McEvoy
Stephens Inc., Research Division

And then the question on Wealth Management, nice to see revenue up 10%, definitely had some help from the markets. Could you talk about new client acquisitions and maybe, do you have any thoughts on the full year revenue outlook for that business?

Len D. Devaisher
President & COO

Yes. Terry, this is Len. So I don't have the -- we don't disclose specific new client acquisition numbers. But what I can tell you is we see definitely fruit of the talent that we have been able to add to the organization. And specifically, what I would tell you is we see a lot of nice momentum in partnership between our wealth management bankers and our commercial bankers.

And so that's been an area of a really nice momentum. And in terms of growth, I'm looking for just given the investments in that business, including a new hire we made in the Des Moines market, I'd like to see that continue at that double-digit pace when I think about full year.

Operator

The next question is from the line of Nathan Race with Piper Sandler.

Nathan James Race
Piper Sandler & Co., Research Division

Happy Friday. Just wanted to -- kind of think about the expense run rate. Barry, I think you mentioned about $700,000 of cost savings once the Florida operation transaction closes. But just any thoughts on just kind of the run rate overall to 2Q as well.

Barry S. Ray
CFO & Senior Executive VP

Yes. I think 2Q will still be -- we don't expect the Florida transaction to close until late in the second quarter, May. So it will be higher in the second quarter. As we look at it and we move out to the third quarter where we think we'll be through some of these noisy Bank of Denver inverted divestitures, we're laying somewhere around the $34 million per quarter run rate is what we're expecting for expenses.

Nathan James Race
Piper Sandler & Co., Research Division

Okay. Great. I appreciate the earlier commentary around the outlook on the credit from particularly time of the trucking portfolio. But just in terms of how you guys see the reserve trending, you're still operating at pretty healthy levels, and loan growth is solid and it sounds like pipeline remains pretty strong over the

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balance of this year. So just curious thinking about the overall reserve, particularly in light of the rise this quarter tied to the deal in Denver.

Gary L. Sims
Senior VP & Chief Credit Officer

This is Gary. I'll start the conversation. And Barry, if I miss anything, please add in. I mean, what we see from the reserve currently and then on a go-forward basis. So we are experiencing loan growth, so we will continue to see us add to the reserves to support that loan growth over the course of time.

In terms of the existing portfolio and the risk we see in the portfolio, we believe we are adequately reserved for that risk to date. So I don't see us unless something changes being more aggressive in adding to existing reserves to try to support the existing portfolio. So on a go-forward basis, loan growth will be a key driver there.

Nathan James Race
Piper Sandler & Co., Research Division

If I can ask one last one on just the loan deposit growth. Obviously, legacy balances declined a little bit, but I know you guys have hired a number of relationship managers over the last several quarters. So I'm just curious, kind of the outlook for you guys to kind of resume some core deposit growth over the course of 2024.

Len D. Devaisher
President & COO

Yes, Nathan, this is Len. Certainly, I can tell you every line of business. So from private banking to commercial banking to obviously, our retail bankers. Everyone's focused -- continues to be the hand-to-hand combat. Obviously, as we think about managing the business, we're being very mindful of being prudent on pricing. And so we're pleased, for example, with the slowdown in the rise of interest-bearing deposit costs quarter-over-quarter, and also mindful of balances. So that balancing act continues. And my expectation is that's going to be an ongoing balancing act in 2024.

Nathan James Race
Piper Sandler & Co., Research Division

Okay. Great. And just one last one, sorry. Barry, can you just remind us of the margin impact as the rate cuts the occur?

Barry S. Ray
CFO & Senior Executive VP

Yes. I think it's the federal rate cut, again, we talked earlier about we still believe our balance sheet is positioned to have some amount of margin expansion without rate cuts just based upon the repricing dynamics. I think what we would see if we get rate cuts would be, we would have additional margin and expansion. I do think that, that would also be contingent upon the pace of the rate cuts as well as Len said the continued -- Len alluded to in his deposit comments, the continued kind of battle for deposit funding.

And so how all those dynamics come together. And so the best answer I can give you, Nate, is I think we expect to see some incremental margin improvement without cuts, and it would be a better margin improvement with some rate cuts.

Operator

The next question is from the line of David DelMonte with KBW.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

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Hope everybody is doing well today. Just wanted to see if you could remind us, Barry, kind of what the expectations are for commercial real estate maturities over the upcoming quarters and what type of open the repricing of those would have on the margin as well.

Barry S. Ray
CFO & Senior Executive VP

Yes. So about -- let me get the data. So about 60% of our portfolio would be commercial real estate. And then if I go to the -- yes, fixed piece of that, 60% or about $1.5 billion. If I look out over the course of the next year, Damon, what's repricing there in fixed rate, it's probably about $160 million of that repricing.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. That's helpful. And then kind of with regards to fee income, it sounds like you're kind of starting to hit your stride here in the wealth management, and that's driving revenue a little bit higher in the SBA platform as well. As we kind of think about a quarterly cadence for the fee income. Is it fair to kind of assume a little bit of a lift off this quarter's operating of, call it, $10.1 million to maybe closer to $10.5 million.

Charles N. Reeves
CEO & Director

Damon, rather -- this is Chip. Rather than give you a number about this. We were pleased with the first quarter of $10.1 million, especially the momentum in wealth management that Len spoke to. And I'd say that some of the other areas, lines of business are showing accelerated momentum from their first quarter run rate.

So we feel good about the momentum as we move into the second quarter, but probably not going to guide you to a specific number but we feel good about the start and where we're -- the trajectory.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Fair enough. That works. And then just lastly, on the tax rate. Barry, can you just remind us what a good effective tax rate we should be using?

Barry S. Ray
CFO & Senior Executive VP

Yes. I think we included in the release statement, I think probably around 22% is where we're landing for 2024 is what we expect.

Operator

The next question is from the line of Brian Martin with Itau BBA.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Just I guess one question, Barry. Just going back to the margin for just a moment, given the intra-quarter closing, I guess the March margin, how is that trending versus where you were for the full quarter, just to kind of give us an idea of what the launching point is.

Barry S. Ray
CFO & Senior Executive VP

Yes. The March margin, we were $2.33 for the quarter. The March margin, Brian, would be around $2.39. So a few basis points higher.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

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All right. And that -- okay, that would have most of it in there. Okay. And then as far as the -- you mentioned, Barry, the repricing, just maybe bigger picture. I mean how much do you expect either, I guess, kind of on the fixed rate side in total is repricing over the next 12 months or so?

I think you said maybe 150, was that just a real estate piece? I just don't know if there's other -- something else in there that would be more significant or that's kind of a good number to think about in terms of what's repricing kind of over the next 12 months?

Barry S. Ray
CFO & Senior Executive VP

No, entire. So I'll give the fixed rate. So yes, what I was talking about earlier was specific to -- I believe, Damon asked specific to CRE. Entire fixed rate over the next 12 months, that's about $250 million of fixed rate. And then we also have some adjustable rate that would be around $180 million.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Got you. Okay. And then the pickup on that, I mean, what kind of lift are you getting like with the new origination yields are today?

Barry S. Ray
CFO & Senior Executive VP

Yes. Our new origination yields for around 7.61,7.50,7.60. And so if you look at some of those yields on those repricing, probably in the high 4s to low 5s.

Charles N. Reeves
CEO & Director

Yes. I would just add to that a little bit, Brian, the mid-7s on the new originations are where we are. So that tends to be associated, if you think about new relationships more often, not always, but more often. Renewal -- our renewal rate is actually in the 8s, below 8. So that's sort of the trends we're seeing in the commercial book. I'm speaking to specifically there.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Yes. Got you. Okay. That's helpful. And how about Barry, you mentioned, I think, the accretion number, I guess, that should trend up a little bit next quarter. Is that how you think about it given the full quarter impact?

Barry S. Ray
CFO & Senior Executive VP

Correct. Yes. We had about $229,000 a month of benefit, so for 2 months of that, so 450,000 about. So I would say for next quarter, you would expect -- call it, $250,000 more attributable to the Bank of Denver transaction.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Got you. Okay. All right. And then maybe one -- just one for Gary. On the -- can you just -- Gary, can you just outside of trucking, I think in the past, you've talked about the health care and the office portfolio. Can you just remind us just in terms of how big those portfolios are and then just maybe what dollars of those are criticized or classified, just big picture.

Gary L. Sims
Senior VP & Chief Credit Officer

Yes. Sure thing, Brian. I'll -- and I'll clarify really, where we've seen weakness in the portfolio has been in the office space and in the senior living more specifically, not really health care as much as senior

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living. So I'll start with office. Our nonowner-occupied office is $166 million. That represents 3.8% of our portfolio.

In terms of what we've seen in terms of deterioration in that portfolio, getting to the numbers here. 28% of that portfolio is classified, 31% of it is criticized. So $46 million is classified and then $51 million is criticized. So that gives you an idea of what we see in the office portfolio. I'll stop for a second, Brian.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Yes, Yes, that makes sense. I appreciate it. Yes.

Gary L. Sims
Senior VP & Chief Credit Officer

Okay. Good deal. On the senior living, we have $241 million in that portfolio. That represents 5.5% of the portfolio. In terms of the deterioration we have in that portfolio. Classified is 24% of that portfolio. So $57.5 million of that portfolio is -- rate is substandard or worse. And we don't have any special mention credits in that portfolio. So the criticized portion of that portfolio is the same as the classified portion of the portfolio.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Got you. And no migration -- yes, and no migration this quarter in either of those portfolios to speak of.

Gary L. Sims
Senior VP & Chief Credit Officer

That's correct. The portfolio in terms of migration, both those categories were fairly stable this quarter. Yes.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Got you. Okay. Perfect. And last one for me, Barry, I think you mentioned some haircut on the -- from the divestiture of Florida on the expenses. Was that a -- I don't know if the number was it was a quarterly number annual number, but what was the impact on the expenses related to Florida?

Barry S. Ray
CFO & Senior Executive VP

Yes, in my comments, it was a quarterly number, Brian, and it was around $700,000 was the impact from Florida.

Operator

[Operator Instructions]. There are no additional questions waiting at this time. I would like to pass the conference over to the management team for any closing remarks.

Charles N. Reeves
CEO & Director

Great. This is Chip. Thank you, everyone, for joining today. We believe it was a very solid start to the year. We look forward to joining you in 90 days to continue our journey together as we execute our calendar strategic plan. Thank you.

Operator
That concludes the Midwest Wine Financial Group Inc. First Quarter 2024 Earnings Call. Thank you for your participation, and enjoy the rest of your day.

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