County Bancorp, Inc.

Earnings Release for December 31, 2019

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CORPORATE PARTICIPANTS

Tim Schneider - *President and Chief Executive Officer*

Glen Stiteley - *Chief Financial Officer and Treasurer*

PRESENTATION

Operator
Good morning, and welcome to the County Bancorp, Incorporated Earnings Release for December 31, 2019 Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. Please note, this event is being recorded.

I would now like to turn the conference over to Tim Schneider, President of County Bancorp. Please go ahead, sir.

Tim Schneider
Good morning, everyone. Welcome to our earnings call for the fourth quarter of 2019. We will ask you to advance the slides through the presentation on your own manually, we had a little glitch in that, and we'll announce which slides we'll be on as we move through the presentation. As a reminder, we have our disclaimer on the use of forward-looking statements on slide 2 of our presentation.

I'd like to start with the year in review. Before we get into the quarterly results, I want to take a step back and reflect on the year we had in 2019 on slide 3. There was a lot of uncertainty going into 2019 as we faced lower milk prices, increasing classified assets and a challenging interest rate environment. To navigate these headwinds, we set three strategic goals to guide our efforts throughout 2019. They included maintain profitability, reduce classified assets and deleverage our balance sheet.

Thanks to the hard work of our team, I'm proud to say we have accomplished all three of these in 2019. We had a record year of profitability, driven partly by our ability to sell loans off balance sheet with the servicing spread and associated loan servicing rights. We reduced our classified asset ratio from 57% to 39%. Finally, we reduced our wholesale funding by $203 million year-over-year, almost doubling our goal of $120 million by year-end. The reduction in wholesale funding also shifted our mix from 38% of our funding to 27% year-over-year.

We remain optimistic about the current ag environment, the Phase 1 China trade deal is signed and agreed to by both parties and in the process of being implemented. The USMCA is all but done; we are just waiting for final ratification by Canada. Weather issues and wildfires in the Oceania region, which are very unfortunate, should also create opportunity for Wisconsin dairy exports.

Lastly, feed costs remain low, which, combined with improved milk prices, should positively impact our dairy ag client performance. We have seen some pockets of stress from the trade wars on the commercial side, but we do not see that as a major issue at this time.

We are going to move to asset quality now on slide 4. We continue to be encouraged by the current level of milk prices. A year ago forward 12-month CME Class III milk prices averaged $15.88. We are now averaging $17.88 a hundred. As we show on the charts, there has been clear correlation over the last few years between rising milk prices and a reduced coverage ratio. We hope this will continue to show improvement in overall classified assets in 2020 as we embark on the 2019 year-end ag credit review process.

We were disappointed that one of our classified ag customers, who totaled $6 million, and one classified commercial customer totaling $3.9 million, both split into non-accrual, but this was offset by the payoff of on one commercial classified loan as well as several OREO sales.

Now, I'll turn the call over to Glen to walk through our financials.

Glen Stiteley
Thanks, Tim. Moving to slide 5, as we announced during our fourth quarter 2018 conference call, we continued to focus on deleveraging our balance sheet in the fourth quarter of '19 by continuing to use loan participation sales with servicing income attached. This initiative has allowed us to continue to maintain profitability while also improving the funding mix on the right side of our balance sheet.

We increased loans sold and serviced by $14.9 million this quarter. This, combined with $17.8 million in client deposit growth, allowed us to continue to reduce wholesale funding by $58.7 million this quarter. As Tim noted, we are really pleased with the change in our funding mix, but we are still very focused on growing client deposits. Wholesale funding is now down $248.1 million, and client deposits were up $81.2 million in 2019. Our client deposit funding now represents 73% of total funding compared to 57% a year ago.

We believe our overall focus on reducing wholesale funding will level off in 2020. Now and in the future, we're going to look to utilize wholesale as a liquidity and interest rate management tool and not a primary growth tool. We currently like the optionality of call brokered CDs. Three year, three month call brokered, are at about 1.85% compared to one year "bullets" at 1.7%. FHLB advances are at 1.79% for one year and 1.73% for three years. We really like the optionality with the lower cost of call protection that's currently offered.

Turning to slide 6. Our net interest income decreased this quarter due to non-accrual activity on the loan side as well as continued loan participations moving balances off our balance sheet. The Fed rate cut in Q4 also impacted overall loan yields. However, we were able to continue to cut rates off on all the deposit products, with an immediate impact to interest bearing accounts such as NOW, savings, and money market. We also had positive impacts with net interest income from a reduction of national CDs and brokered deposits during the quarter.

Turning to slide 7. Loans sold and serviced increased $14.9 million this quarter, as I mentioned, which helped our loan servicing fee income increase to $1.8 million for this quarter. We were also able to increase our loan servicing spread from 94 basis points to 96 basis points in the fourth quarter. Our increase in loans sold and serviced in the fourth quarter also attributed to $1.1 million of loan servicing right origination income.

Turning to slide 8. During the quarter we had a historical tax credit which resulted in a $0.3 million positive impact to net income. The accounting for this required us to record $1.4 million in credits to income tax expense, which was offset by a $1.1 million impairment to other expense, resulting, again, in a $0.3 million positive impact to net income.

As we alluded on our last call, our incentive compensation expense increased in the fourth quarter, as we accomplished the strategic initiatives that Tim mentioned in his opening remarks.

Now, Tim and I will give a look into what is coming in 2020.

Tim Schneider
Thanks, Glen. As we look ahead to 2020, we feel very optimistic about our overall outlook for the year. We have five strategic initiatives going into 2020, as you'll see on slide 9. We are going to make investments in technology and data analytic tools that help us to better serve our customers. We have already invested in a profitability system that allows us to dive into profitability at the client level and allows our account officers to have better visibility into how pricing decisions impact our overall profitability. We feel we have only scratched the surface on the use of this tool.

In 2020 we will make an investment in a CRM system so that we can better serve and market to our existing and prospective clients. We will use the CRM system long-term to drive digital adoption and drive at core deposit growth and additional fee income opportunities. We will also roll out our concierge banking platform. Our concierge bankers will be focused on full banking relationships, including residential, mortgage, and lending opportunities that we currently are not reaching.

We will continue to focus on ag lending opportunities throughout our footprint. Because of our strength in this area we continue to be able to attract talent, with two additional new hires, including one who is focused on non-dairy lending. All of our lenders are seeing tremendous opportunities, especially those where we can push off balance sheet and drive servicing income, and we will continue to utilize the loan participations to manage our balance sheet growth relative to our core deposits, as well as continuing to drive non-interest income opportunities.

We continue to be laser focused on continuing to reduce our classified assets through diligent monitoring. We hope that current levels of milk price will continue to yield cash flows of our dairy ag clients into 2020. We will continue to focus on commercial opportunities throughout our footprint, and are continually looking to add commercial talent. With the ultimate goal of maximizing shareholder value, we believe improved milk prices and reduced classified assets allow us to deploy some of our excess capital. We are in the process of evaluating a stock buyback program and increased common dividend with our Board, and hope to have an announcement soon on both fronts.

And now I'll turn it back over to Glen to give some insights into our 2020 financials.

Glen Stiteley
Thanks, Tim. As you'll see on slide 10, we anticipate 4% on balance sheet loan growth, with about a 5% growth mark in client deposits. As I mentioned earlier, we anticipate keeping wholesale funding flat, shifting to more callable brokered during 2020, and we'll always continue to look at that, depending on where the interest rate environment is. We will look to expand margins in 2020 through a shift of excess cash into investments and bank-owned life insurance and continued re-pricing of certificate of deposits and lower rates.

We anticipate about an 8% growth of loans sold and serviced, with about 15% of that in Q1, 16% in Q2, and 25% in Q3 and flat in Q4. We will be increasing overall salaries and benefits, but this number should be more along the lines of our Q3 2019 expense on a quarter-by-quarter basis that you saw. We expect occupancy to remain flat.

We'll be making technology investments in a new website, and we expect to see a spend of about $200,000 on that line item spread across the last three quarters of 2020 in the business development line item.

On the professional fee side, we hope to see some reduction in solicitation of collection fees, but that will be somewhat offset by additional fees related to Sarbanes–Oxley implementation.

Information processing will go up about $600,000 due to the investment in the CRM system as noted by Tim, as well as continued upgrades on the IT side. We expect more normalized other non-interest expense and tax rate in 2020 driven by the noise of the historic tax credit in Q4 2019.

And now I'd like to open it up to questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press star then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble our roster.

The first question will come from Brendan Nosal with Piper Sandler. Please go ahead.

Brendan Nosal
Hey, good morning guys. How are you?

Tim Schneider
Good, Brendan; how are you?

Brendan Nosal
Good, thanks. I just want to start off here on the two classified loans that moved into non-accrual in the quarter. I guess one, any more detail you can provide and color as to kind of what drove that? And then I guess, specifically on the dairy credit, I was a little surprised to see the negative migration, just given that we have higher milk prices today. So what was the tipping point on that credit?

Tim Schneider
This particular credit was a credit that expanded right after the prices started to decline and had some challenges with the operation throughout this lower milk price environment and ultimately has decided that they are going to file Chapter 12 bankruptcy, which we feel is a good thing, as they should be able to flush their accounts payable and then hopefully give them some longer-term viability. This particular deal has strong FSA guarantee usage, and we do not expect any substantial loss in this operation if it should fail. But we're much more confident that that operation will be able to succeed moving forward.

Brendan Nosal
All right, perfect. Thank you. And then on credit more broadly, there were some mixed signals this quarter; on the one hand no charge-offs, no provision and classified assets improved, and then on the other hand negative migration within classified into non-accrual. So, at a top level, just update us how you're thinking on credit more broadly just as we contemplate these cross currents?

Tim Schneider
Well, obviously we're in a much better milk price environment. The particular credit that you asked about, is potentially an outlier, but there are some operations that have dug themselves some fairly big holes and need to be able to dig out at this point. We think pretty optimistically about the future of our operations, and we think we're going to see continued improvement in our portfolio.

We're already seeing some early reviews that are coming through, and the numbers for 2019 are looking much more solid from a performance perspective. So we feel pretty good about it. We do have some additional activity that's occurring in our ORE bucket that should see some more sales which should occur this first quarter, and overall we're feeling much better about the portfolio at this point, especially if milk prices are maintained.

Brendan Nosal
All right, fantastic. That's helpful. And then last one from me and then I'll step back. Just thinking about the margin, you alluded to putting some cash to work throughout the year which is resulting in some

expansion. I'm just curious in terms of magnitude what you think that opportunity can do for the NIM?

Glen Stiteley
Brendan, this is Glen. So I think it's going to be probably about a 15 basis point bump. It's going to take a little bit of time to ramp that up. The investment opportunities– it's been a little bit difficult to find really great investment opportunities on the bond side, but we're slowly deploying the cash. We'll probably get the BOLI investment done, it will probably be January or February timeframe, so that's about $10 million.

Brendan Nosal
All right. So over the course of the year it sounds like 15 basis points on the NIM, maybe a little bit slower at first, but net-net 15?

Glen Stiteley
Yes, we're continuing to see re-pricing of the CD portfolio, but that takes some time. The one thing that's just been difficult to estimate obviously is the drain from when things go on non-accrual, so that's probably been as much headwind as anything.

Brendan Nosal
Perfect. Thanks so much for the color.

Operator
The next question comes from Jeff Rulis with D.A. Davidson. Please go ahead.

Jeff Rulis
Thanks, good morning.

Tim Schneider
Good morning, Jeff.

Glen Stiteley
Good morning, Jeff.

Jeff Rulis
Glen, just following up on that, what was the basis point impact this quarter on the loans put on non-accrual to margin?

Glen Stiteley
It's around probably 7 basis points.

Tim Schneider
In total? Just 3.

Glen Stiteley
Does that answer your question?

Jeff Rulis
Yes. So, effectively absent that move core margin is pretty steady.

Glen Stiteley
Yes, the rate cuts definitely had an impact too, so I don't want to minimize the impact of those. But the non-accrual activity definitely, that's the part that's been difficult to predict out.

Jeff Rulis
Right, okay. Then just following up on that kind of guidance to tackling maybe overall operating expense and tax rate together, kind of some moving pieces given the tax credit, but what were those figures again?

Glen Stiteley
The historic tax credit was a $1.1 million impact to non-interest expense.

Jeff Rulis
Right. I guess the guide for ’20, absent Q4 kind of looking forward what would be the tax rate?

Glen Stiteley
From a non-interest expense, we're up, when you back that off I think we're up probably about $600,000 for the year overall.

Jeff Rulis
And so, I'm pointing to ’20 both on tax rate and expense, are you looking for a similar bump on core expenses, and tax rate to revert to what level?

Glen Stiteley
The tax rate, we don’t have a ton of taxes at income, so it’s probably in about the 26% range, 26%, 26.5%.

Jeff Rulis
Okay, got you. Okay, I will step back. Thanks.

Glen Stiteley
Yes.

Operator
The next question comes from Terry McEvoy with Stephens. Please go ahead.

Terry McEvoy
Hey guys, good morning.

Tim Schneider
Good morning, Terry.

Terry McEvoy
The year-end ag review, will you see the results in the first quarter, or will it take a few quarters for the review to be completed?

Tim Schneider
We will see some results in the first quarter. As I mentioned earlier, we're already seeing some early reviews that are seeing some upgrades, but I think the final conclusion on the entire ag book is going to be kind of in the second quarter before we have the whole picture.

Terry McEvoy
And then, Glen, you talked about just time deposits, taking some time for cost yields to come down. They’re actually up a little bit in the fourth quarter, 6 basis points. What are your thoughts on just the progression of time deposit costs trending lower in 2020? Are there any quarters that stand out where

you see just some buckets of re-pricing opportunities?

Glen Stiteley
No, it's pretty smooth, Terry, throughout the year.

Terry McEvoy
And then just last, the commercial loan that moved to non-accrual, was that ag or dairy related at all?

Tim Schneider
No, it wasn't. It was a commercial manufacturing company, kind of a specialized manufacturer in Central Wisconsin that we originated about four or five years ago. One of the owners was in a similar business and it was kind of quasi-startup that we had an SBA 504 loan plan for and they just haven't hit the mark. They continue to kind of struggle to find top line revenue. So we ultimately decided to move it into non-performing. We did have a re-appraisal done which discounted some of the equipment, the specialized equipment, and unfortunately because of that we had to take a little bit larger impairment on this one. There's still some hope it may be able to pull things out, but time will tell.

Terry McEvoy
Okay. Thanks, guys.

Operator
Again, if you have a question, please press * then one. The next question will be from Brian Martin with Janney. Please go ahead.

Brian Martin
Hey, good morning, guys.

Tim Schneider
Hi, Brian.

Brian Martin
Hey Glen, or I guess Tim, with the improvement you're seeing with the milk prices, can you just talk a little bit about how you're thinking about provisioning this year? I don't know what percentage you're through that year-end review, but it sounds pretty minimal. But should we see the provisioning come down a bit, I guess given your optimism on how the credit picture is going to maybe unfold in 2020?

Glen Stiteley
Brian, it's Glen. We think it's going to be probably similar to what the dollar amount was this year. If we start to see more upgrades than expected, then that will obviously improve. So we feel pretty good that we've got things flushed out overall though.

Brian Martin
Okay. And just remind me, within the ag portfolio, is it pretty granular as far as the size of these credits, or are there some chunkier credits in there, in this portfolio that could kind of move things in a given quarter?

Glen Stiteley
Well, obviously we have some larger credits. As these operations have continued to expand, we've got larger exposure. But as I've mentioned before, we use the FSA guarantee program, again, very broadly and position those in the right position to really not provide a lot of impact from an impairment perspective, if there are any that slide down the scale.

Brian Martin
Got you, okay. And then just the loan originations this year, the new loans, do you anticipate most of that to be the commercial, or are you still going to continue to grow the ag part of the portfolio, I assume, but how are you thinking about the growth you put on this year and that mix?

Tim Schneider
Yes, I think it will be a combination. Our commercial bankers are continuing to see opportunities out there as well and as we mentioned in the script, we also have a couple of new ag bankers that we've hired recently from one of our primary competitors, one that's a kind of a non-dairy specialist in the ag space, so that will help from a diversification standpoint.

We will continue to manage the on balance sheet growth there to make sure it's matching our core funding, but as you know, our non-interest income model, with some of the participations in sales and nice spreads we can make as well as with the FSA guarantee, should help us drive continued fairly strong non-interest income.

Brian Martin
Okay. And maybe I missed it, Glen, but this level of fee income this quarter, is this a pretty good level to think about going forward? I think you called out one item, I thought it was like $250,000, but am I thinking about that right?

Glen Stiteley
Brian, I'm sorry. I'm not sure I follow what you're asking.

Brian Martin
Just on the fee income part of the P&L, just how to think about that going forward. Is this quarter's run rate a pretty good level to think about as you go into 2020?

Glen Stiteley
Yes, on the servicing fee income, we should see some increase there. We are baking in about an 8% growth rate during the year, so you should see that continue to creep up. The origination right side should back off a bit from what you saw levels this year. But as long as originations remain kind of over that, what I would say, $10 million a quarter, that should usually lead to some origination right income.

Tim Schneider
We've got a continued fairly strong pipeline, and the FSA guarantees, I looked at our pipeline this morning, probably not as strong as third and fourth quarter, but first quarter is generally a little slower. And with the new ag bankers that we've hired, I think we'll continue to see some decent non-interest income, both, as I said from an FSA guarantee origination standpoint and participation standpoint.

Brian Martin
Got you, okay. That's helpful. That takes care of my questions. Thanks so much.

Operator
The next question is a follow-up from Brendan Nosal with Piper Sandler. Please go ahead.

Brendan Nosal
Hey guys, just one more from me on the potential for a buyback, and I appreciate that it's being considered. Now, you actually probably can't say a ton, but just trying to gauge how active you might eventually be. As I think about it, you obviously have ample capital from both a regulatory and a TCE perspective, but it kind of feels like the classified asset ratio might be the boundary on that, that 50%

level. How do you kind of weigh those factors in terms of how aggressive you might be down the road?

Glen Stiteley
We're still in the process of evaluating with the Board, so I don't want to comment too much on it. We're we're fairly cautious when we do things, so we will definitely watch the classified ratio milk prices as a boundary to kind of how we look at the buyback on a month-by-month or quarter-to-quarter basis. I don't want to comment too much on how aggressive we're going to be on that.

Brendan Nosal
No worries. Thanks for taking the follow-up.

Glen Stiteley
Yes.

CONCLUSION

Operator
Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Tim Schneider for any closing remarks.

Tim Schneider
Thank you all for joining us. We felt we had a pretty strong 2019, as well as a strong fourth quarter, especially given the fact that we had the three major strategic initiatives that we are driving for and we feel like we had some success on all three of those. So a solid year, and we're looking forward to a decent year in 2020 as well as long as milk prices continue to stay strong, which we're fairly optimistic about. So thank you all for joining us.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.