MidWestOne Financial Group, Inc.

2015 Third Quarter Earnings Release

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CORPORATE PARTICIPANTS

Charles Funk – *President and Chief Executive Officer*

Kent Jehle – *Executive Vice President and CCO*

Gary Ortale – *Executive Vice President, Chief Financial Officer*

Katie Lorenson – *Chief Financial Officer, Central Bank*

PRESENTATION

Operator
Good day, everyone and welcome to the MidWestOne Financial Group, Inc. 2015 Q3 Earnings Release Conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the * key followed by 0. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press * and then 1. To withdraw your question, you may press *2. Please also note that today's event is being recorded.

This time I would like to turn the conference over to Mr. Charles Funk, President and CEO. Sir, please go ahead.

Charles Funk
Thank you very much, Jamie. Good morning, everyone and I would begin to make sure that our accountants and attorneys are pleased by reminding you that this presentation contains forward-looking statements relating to the financial conditions, 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 that are filed with the SEC. MOFG undertakes no obligation to publicly revise or update these forward-looking statements to reflect the events or circumstances after the date of the presentation.

And with that out of the way, I would thank everyone for joining us this morning and make a few preliminary comments. I think the headline numbers were pretty good and we're pleased with the progress we are making, especially on our merger integration. Of course, there were again this quarter a number of noteworthy items of interest that I will discuss a little bit more fully in my comments.

First of all, the historic tax credits we recognized on the renovation of our 1900s building that we're renovating in downtown Iowa City, we did have a larger than expected provision and I think it's really important to understand that has far more to do with loan growth and renewals of the acquired loan portfolios than deterioration of credit.

Balance sheet growth we thought was good, loan growth was solid and I think as you look at our company now and as Central Bank continues to work down the FDIC assisted portfolio that they have, that portfolio continues to pay down at a pretty good clip. So the growth that we've had at Central Bank is net of those pay-downs. Very, very pleased with that. We also had growth in the Iowa portfolio.

Deposit growth, very good, generally came late in the quarter. The last two or three weeks of the quarter there were several very large deposits. Some will stick for a while, 12 to 18 months; others could be here for 3 to 6 months, perhaps longer, but they did come in good chunks and we're running well above our year-to-date average in deposits right now at MidWestOne Bank in Iowa.

It is fair to say that competition has become even more fierce for loans. Kent can talk about that a little more fully, if you like, and it's both in Minnesota and in Iowa. I think the underlying result there is with the current Fed policy that there are just fewer and fewer levers for banks to pull. And we are seeing an easing of terms, we're seeing more 25 year amortizations on commercial real estate deals. We're seeing at times higher loan to values and the price competition continues, that really hasn't changed. But we're starting to see 7 and 10 year fixed rates below 4%. And it's not just confined to small banks or large banks. It seems to be a mix of the two. And I would just say that we have to navigate through this; it is a minefield and as I said Kent can talk about it more in the Q&A if you like.

We continue to be on track for the merger of Central Bank and MidWestOne Bank and we've identified April 2nd as the date. Excuse me, there is a lot of preparation that goes into that. I am extremely pleased with the preparation thus far for the merging of the banks and that is I think by far the biggest item of the merger thus far is to get it correct, is to do it right whenever we merge these two banks together.

We continue to identify cost reductions. And to refresh your memory, the cost reduction target is based on the 12/31/13 non-interest expense run rate for Central Bank and that is $8 million. I would estimate that we're roughly 75% of the way there in terms of identifying what the reductions are going to be. We continue to be focused on the last 25%. It may be that the cost reductions could come just a little bit slower perhaps than anticipated, and the reason for that is we want to do it right; we don't want to do in a hasty matter, we want to do it right. But I have every confidence that we will get to the target in good time and we will do it correctly and we'll get the numbers we said we were going to get.

We did, of course, announce the sale of three of our offices during the quarter. I think over the long-term that allows our company to be much more efficient. And we do believe we can replace the lost income in our growth markets of Iowa City and the Twin Cities and perhaps a few other markets. But for the long-term, we think this is the right thing to do for our company.

Capital balance sheet growth did not allow us to make perhaps too much progress on our equity to tangible assets targets, but the office sales will help to improve this ratio. I think the key thing here is we believe we have ample room to grow in our balance sheet and get to the desired 8.5% range in the foreseeable future and we did make a comment about that in the earnings release.

Asset quality at this time seems fine with excellent reserve coverage. And again, I will reiterate that the reserve build this quarter, a little above our expectations, but it had more to do with providing for growth and allocating for the marked loans that have come up for renewal. We do believe we're taking a conservative approach, but I think you're all used to bankers saying that they take a conservative approach and conservative is always in the eye of the beholder. And again, net charge-offs continue to remain minimal in our company, but we also note for many banks in our industry.

So in summary, the numbers seem to be pretty good; 103 ROA for the quarter, return on tangible equity in the mid to high-15s, and efficiency ratio of 58%. The efficiency ratio, again, seems a little low to me. I think when things settle out it just seems that our efficiency will be in the low-60s, 63, 64 would be a guess, but we also understand that we are enjoying a tailwind right now from the discount accretion and that the regular run rates are somewhat below this. But nevertheless, we are very pleased with where we are at this particular point in time and have every confidence that the merger will continue to progress in good fashion.

So, Jamie, with that, that would conclude my comments. I will say that we have Gary Ortale, our Chief Financial Officer of MidWestOne Financial Group; Kent Jehle, our Chief Credit Officer in Iowa City. We also have Katie Lorenson on the phone who is the Chief Financial Officer for Central Bank and Katie has been invaluable in many regards, but especially in the accounting for purchased accounting and all that goes into that. So all three of us, all four of us would be available to answer any questions you might have.

So it's back to you, Jamie.

QUESTIONS AND ANSWERS

Operator
Ladies and gentlemen, at this time we'll begin the question-and-answer session. To ask a question, you may press * and then 1. If you are using a speakerphone, we do ask that you please pick up your handset before pressing the keys to ensure the best sound quality. If at any time your question has been addressed and you would like to withdraw your question, you may press * and 2. Again, that is * and then 1 to ask a question.

And our first question today comes from Jeff Rulis from D.A. Davidson. Please go ahead with your question.

Jeff Rulis
Thanks, good morning.

Charles Funk
Good morning.

Jeff Rulis
I was hoping you could provide a little more loan segment color. In the release you talked about commercial real estate, one to four family, and C&I is the strongest, but could you quantify that bid and provide maybe some color about what you saw in the quarter and perhaps also kind of the pipeline going forward?

Kent Jehle
Hey Jeff, this is Kent. I will answer that question and maybe start with the pipeline. If we look at the pipeline today from both banks perspective and aggregate that it, it would be in the mid $20 million range. As I look at that, the majority of that would be in commercial real estate with the balance being C&I activity that we're experiencing right now.

The other thing that you didn't allude to is we continue to see a lift in our ag lines of credit during the third quarter that helped in our growth and that is something we are looking at and will be a variable going forward as the harvest is completed and we determine how much of that will be paid in conjunction with harvest, how much then would we anticipate being carried over in the next year before they sell the crops. So that's a variable that's out there that could affect our overall net growth as we move forward.

But primarily we would see a majority of our loan growth in the commercial real estate area, combination none are occupied and/or are occupied, but also the C&I activity continues to be what I would say pretty good if not well above average.

Charles Funk
And I would just add that during the quarter, I probably should have said this in the opening comments, we did walk away from several deals either because of rate or because of term and they were fairly sizable deals, but we just chose not to participate at the rate and/or the terms that were being shown to us.

Kent Jehle
Correct.

Jeff Rulis
How does that pipeline compare to last quarter?

Kent Jehle
It would be slightly stronger, again, because we started, the merger occurred on May 2nd, so we didn't have a full quarter. So as I look at it, it would be stronger from that standpoint then we were in the second quarter. But overall, on a net basis, and we've talked in terms of an annualized growth rate in the 6% range, we were slightly under that in the second quarter, but we still hold that as a net growth rate that we would forecast going forward.

Jeff Rulis
Okay. Thank you, and then maybe one other one just on the margin and maybe for Charlie, you talked about the loan competition, you got a late surge deposits this quarter, so maybe some extra funding and I guess the outlook you've been guarded on margins and I guess excluding the accretion income just kind of a core basis, how does that outlook look for margins?

Charles Funk
Gary did some homework on that. Gary might want to share the homework he has done on that.

Gary Ortale
Yes, Jeff, I would say it this way, our margin as you saw came in at 408. Without the discount accretion that was reflected this quarter, it probably adjusts down to the 382 range. And if you recall from last quarter I think when we made that same adjustment, the margin came in, in the low 370 range.

What I would tell you, though, is that we were still working through some of the provisional adjustments during this past quarter. I won't get into the details of that, but the numbers were moving around a little bit, but if I were to hazard a guess, after seeing a 371 last quarter and 382 this quarter, my guess is the margin, the core margin would be somewhere in between those two numbers at this point, more or less in the high 370s range would be where I would put that.

Jeff Rulis
Okay. I'll step back. Thank you.

Operator
Our next question comes from Andrew Liesch from Sandler O'Neill. Please go ahead with your question.

Andrew Liesch
Hello, everyone.

Charles Funk
Hi, Andrew.

Andrew Liesch
Just following up more on the margin here. It seemed like purchase accounting affected it more than I had anticipated. Just kind of curious, and maybe, Katie, you can help here, what are some of the payoffs on the FDIC loan? What's your experience been, are these paying down faster than they have been over the last year?

Charles Funk
You can take that, Katie.

Katie Lorenson
Thank you, Andrew. There are not paying down faster; it's more of a sustained payoff, which I think we do anticipate these loans tailing off in the pay downs. But it has been sustained from what we have experienced in prior periods.

Andrew Liesch
Okay. And then just one quick question on the tax line. Was there anything other than the historic tax credit that affected that, or I'm just trying to get at what tax rate we should be using going forward?

Gary Ortale
No, there was nothing really, Andrew, that affected the tax number other than the tax credits. I would say, however, we didn't really make it entirely clear in the announcement, the total credits between federal and state were in the $1.3 million range. But what we didn't share was, believe it or not, there is an after tax effect or with and without. In other words, we did the calculation with and without the credits and that difference was roughly one million, not a $1.3 million. So I wasn't sure who said, I think someone indicated in the preliminary comments that the impact was in the $0.11 per share range. I would probably put it more in the $0.09 per share range. But that's probably a little more detail than you'd like. But believe it or not, there is a tax effect on the tax credit, so we probably should have mentioned that in the release as well.

But other than that, no, there was nothing out of the ordinary that I can recall.

Andrew Liesch
Okay, that's very helpful. And I think was at least one of the people that mentioned that it was $0.11. Anyway, thank you. I'll step back.

Operator
Our next question comes from Daniel Cardenas from Raymond James. Please go ahead with your question.

Daniel Cardenas
Good morning, guys.

Charles Funk
Good morning.

Daniel Cardenas
Charlie, I apologize, I missed your comments on the cost saves. Could you go through those again for me?

Charles Funk
On the cost saves. Yes, basically, Dan, just a reminder that our cost save projections and targets were based on the 12/31 run rate for non-interest expense as Central Bank and they totaled roughly $8 million. And we think that right now we've identified about $6 million of the $8 million. It hasn't all been implemented yet, of course. And the implementation might be a little bit short or a little bit longer simply because we want to do it right and not rush it. With that said, we still feel very confident that we will get to where we need to be in terms of the stated goals that we all agreed upon for expense reduction.

Daniel Cardenas
So when you say it may take you a little bit longer, what are you talking a couple of quarters here?

Charles Funk
Yes, yes. There have been some specific things that we had targeted for 2016 that perhaps at mid-year that may not happen until January 2017, so you're talking exactly a couple of quarters, nothing longer than that.

Daniel Cardenas
Good. That's all I have for right now. I'll step back.

Operator
Once again, if you would like to ask a question, please press * and 1. Our next question comes from Brian Martin from FIG Partners. Please go ahead with your question.

Brian Martin
Hey, guys.

Charles Funk
Hi, Brian.

Brian Martin
Could one of you guys just talk a little bit about the central operation and the loan generation they're putting on up in their markets? It sounds like you are still putting through some payoffs. What are the originations versus payoffs look like maybe in the last two quarters? Is it pretty typical? Have there been more or less payoffs versus origination? It sounds like activity up there is definitely stronger than maybe originally expected.

Kent Jehle
Yes, Brian, this is Kent. I will answer that, and certainly if Katie wants to add anything, she can. Katie alluded to the run rate on the FDIC loss share portfolio, which the dollar amount is staying pretty constant, so when you look at the topline originations, they would be on average in that 8% to 10% range pretty consistently. The summer months, early in the summer months are little slower, but as we look at the pipeline, as we look at the overall activity, that 8% to 10% origination rate can hold true. So that is where we had originally modeled things when we were first getting together with Central Bank.

So, we're pretty positive, a lot of that is in the commercial real estate area activity that we see at this point in time and certainly, as Charlie alluded to in his opening comments, the competition for that is as fierce in the Twin Cities as we're seeing in our markets as well.

Brian Martin
Okay. Helpful. And in the deposit side, Kent, what's happening out there? It sounds like there is just lumpier credits you saw or just kind of what's the deposit strategy up in the Minnesota market?

Charles Funk
The deposit strategy in the Minnesota market is still being worked on. We are going to take a couple of our retail products up to that market that we think will generate some deposit growth. That's in the process of being rolled out right now. My guess is it will be a quarter or two before you are going to see much of a lift from that, but we think specifically it's an interest checking account that we've had since 2008 in Iowa that they don't offer and so we think that has good potential.

We also continue to work on treasury management products in Iowa. We haven't seen the lift in Iowa that, quite frankly, that we had hoped, but we still like our strategy, we still like our products and we really do want to roll that out in the Twin Cities market.

I mean, just to be candid about it, Brian, Central Bank has never focused on deposits. And if you look at the last three or four years, as they acquired all these banks they were letting the high cost deposits runoff at the same time they were building their loan to deposit ratio. And so I just think that particular bank will benefit from a more balanced approach where they continue to emphasize loans, of course, but also put just as much of an emphasis on deposit generation.

Brian Martin
Okay. That's helpful. Thanks. And how about just a couple other things. Gary, the tax rate, it sounds like nothing unusual, so this rate that we saw in this quarter is pretty good to think about going forward?

Gary Ortale
Well, I don't know that I would say this rate going forward. I could tell you that the effective rate that you see for the nine months might be a better indicator, especially as we bring on more of Central into this year and given that they really have very minimal tax exempt items. I would also tell you, however, that this was just a partial tax credit that we took for the historical tax credit and we have more credits to come. How much we'll take again next quarter remains to be seen, so I hate to say that I can't be any more specific than that, but we will have some more tax credits coming certainly in the next quarter.

Brian Martin
Okay. And just one other clarification, the accretion income in the quarter, I mean last quarter you had a piece that was related to CD mark. Was that similar to what it was last quarter, was that included in that accretion income number that you guys put in the release or—?

Gary Ortale
No, that was not included, Brian. The CD mark is the one I alluded to earlier. That was a provisional item last quarter and we did not have any impact this quarter on the margin, so that's why I qualified my earlier discussion with Jeff about the core margin being between the 372 and 384. I put it in the high 370s, because if we had had that CD mark this quarter that we had last quarter that would have brought that down a little bit more. So hopefully we've got most of our provisional items resolved. I think the only one outstanding at this time is the deferred tax, but we hope that in the fourth quarter here we'll have what we would consider a good run rate, so that would be the color I would add to that.

Brian Martin
Okay. And lastly, I guess Charlie talked about the branches you closed. Are there more on the slate, I know you've got some operations in Florida. How are you thinking about the branch footprint at this point and further opportunities for consolidation?

Charles Funk
I think when you look at Florida, we have roughly, I think we're approaching $100 million in loans there and maybe 80, 85 in deposits. Right now we have no plans other than to continue to operate in Florida. And quite frankly have not even talked about that at the board level. What we've told our employees, because anytime you announce something like this internally, of course, it does create a lot of chattering in the halls and elsewhere, and what we've told our employees is of course we're always going to be analyzing all of our offices for efficiency and that sort of thing, but the two that we've announced during the past quarter, those have been on the horizon for quite a while. And so now sort of back to just running our bank. But [indiscernible] evaluating any opportunities we might have.

Brian Martin
Okay. And then maybe just a last thing. On the fee income, it sounds like the expenses maybe at a similar type of level for a bit if these cost saves take a little bit longer. What's the run rate on fee income this quarter, if on a core basis? Is that a pretty good number and where is there, I guess is there room for upside as you take your products into the essential markets and just kind of how are you thinking about fee income prospectively?

Charles Funk
I can start that and perhaps Gary can add. I think in terms of the central market, when we standardize our fees I think there will be a little bit of a lift there in terms of fee income from the central portion of the footprint. We didn't just take the MidWestOne Bank fees and overlay them to Central Bank; we took a more thoughtful approach. So in some cases there were some reductions in fees perhaps in Iowa. But I think overall there will be a little bit of a lift, which I can't quantify in terms of fee income, but I do think there will be some opportunity there for fee income growth in the aggregate.

Gary Ortale
Yes, Brian. The only thing I would add to that is, I think as you look at this quarter's fee income, it's a pretty uneventful quarter in that there were no security gains and there was no unusual losses. I think we took the loss on the sale of the pools last quarter. There was nothing like that this quarter. So the only other thing I would maybe add to that is just the normal ebb and flow of the wealth management area given the stock market decline that we saw in the third, particularly in the third quarter, hopefully that has come back and so we may see some of that reflected in the fourth quarter. And the same with the loan fees, as we see the ebb and flows in that market during this peak periods and not so good the winter season.

So I think this is a pretty good run rate. And again, Charlie's comment about, I think we do have some service charge opportunities particularly up north, so this will be a good starting point for future numbers.

Charles Funk
Even though, Brian, it's a small part of the overall, I think the wealth management fees, as Gary said, they are all on target to hit budget. Insurance investment services and trust, they are all on target to hit budget this year. So I think the run rate you've been seeing for wealth management is probably pretty indicative of what you'll see in the fourth quarter and first quarter of next year.

Brian Martin
Okay. And maybe just for Kent. Just how do you think about when you guys are looking at provisioning and reserve levels going forward, can you give any thoughts, I mean like you said this quarter's provision was a bit on the higher side to provide for the growth and the portfolio renewals. I guess will this type of level be a reasonable assumption? I guess just kind of big picture, how are you guys thinking about that?

Kent Jehle
Yes, Brian, that's certainly a good question. And the simple answer is, we could see this being comparable going forward, but you also got to remember there are various components into that number now that we didn't have prior to the merger. And I will start with MidWestOne, we looked at our provisions very typical to what we've done in the past, it was in the $450,000 range, we're still north of our indicated reserve and we looked at that just like we have as I mentioned in previous quarters.

Then you get into the rest of it and you have other components like loan origination at Central Bank needed to be provided for and then loans that are being renewed out of the legacy Central Bank portfolio that are moving over now also need to be reserved for. That brought another $900,000 almost a $1 million into the mix, just on those two areas, and those are areas certainly we can forecast, but, again, loan originations and renewals versus payoffs certainly can be something that creates a variable aspect to it.

The balance of that was made up just for any new identified impairments in the Central Bank portfolio and then an additional build-up of the reserve that we added given as Charlie alluded to the nature of how we look at providing in our overall company was also included in the balance of what would have been in that number. So the variable pieces I look at really are the loans originated at Central Bank and anything being renewed out of their legacy portfolio. Hopefully that helps.

Brian Martin
Definitely. I appreciate it, Kent. Thanks, guys. That's all for me then. Thanks.

CONCLUSION

Operator
And once again, if you'd like to ask a question, please press * and 1. And ladies and gentlemen at this time I'm showing no additional questions. I'd like to turn the conference call back over for any closing remarks.

Charles Funk
I just say thank you to all who joined us this morning. Continue to ask us questions, as questions come up and I think the four of us who are on the call this morning are always going to be accessible to answer any questions or concerns you might have. So back to you, Jamie. Thank you to everyone and have a great weekend.

Operator
Ladies and gentlemen, that does conclude today's conference call. We thank you for attending. You may now disconnect your telephone lines.