MidWestOne Financial Group, Inc.

2016 Second Quarter Earnings Conference Call

July 29, 2016 at 12:00 p.m. Eastern

CORPORATE PARTICIPANTS

Charles Funk, *President & Chief Executive Officer*

Kent Jehle, , *Chief Risk Officer*

Gary Ortale, *Chief Financial Officer*

Katie Lorenson, *Chief Financial Officer in Waiting*

PRESENTATION

Operator
Welcome to the MidWestOne Financial Group 2016 Second Quarter Earnings Conference Call. All participants will be in 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. To ask a question, you may press star, then 1 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

I would now like to turn the conference over to Charles Funk, President and CEO. Please go ahead.

Charles Funk
Thank you very much, Bianca. Good morning or good afternoon, as the case may be, to everyone, and thank you for joining us on the call. As I always do, I want to read the forward-looking statement, which simply says this presentation contains forward-looking statements relating to the financial condition and results of operations and business of MidWestOne Financial Group. 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, change 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 SEC. MOFG undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances after the date of this presentation.

And, with that, let me begin and say that there's no question we're disappointed with the second quarter. That said, I think we do expect better results, and we believe that the second half of the year will be materially better than the first half of the year, and we'll go into that in some detail as we go forward.

Let me start with the balance sheet. The big thing, if you look at our balance sheet, it looks a little different than it had in prior quarters. Loan volume slowed down, was much slower than anticipated. I would say that there are probably three reasons for this. The first one is that many of our AG lines paid down, because we had a spike in crop prices early in the quarter, and our borrowers took advantage to sell whatever they had of last year's crop, and that really has a positive impact on our credit quality but had a negative impact on our lines. We also hope, we don't know for sure, but we hope that they also took advantage of that price spike to further lock in prices, because, as many of you might know, prices have fallen since then. So it was a great opportunity, and that did serve to reduce the AG line somewhat.

We also lost a few deals to rate. It's very competitive. We chose not to compete in large part on rate during the quarter, and I have to say that we got caught a little bit on that because we probably held the line on rate a little longer, and then when the Brexit episode hit and interest rates tumbled, I think, hindsight's 20/20, that probably wasn't the best decision. We are more in the game on rate today than we would have been 90 days ago, but it's very competitive out there, and by choosing not to compete on rate, it probably — well, I shouldn't say probably, it did cost us loan volume during the quarter. And we got paid off on a few deals, but I would say that of the three reasons I just cited, that payoffs or loss of customers was by far the least of the three.

Then, if you combine that, we had wonderful deposit growth, and we talked a little bit about that on the call last quarter, and so the deposit growth came late in the first quarter and early in the second quarter, which left us with a very large Fed funds balance, or if it wasn't Fed funds, it was held at the Fed, and so that really had an impact on net interest income and on our margin; and I think if you look at our margin overall and net interest income, as we get those funds invested, either in the investment portfolio or hopefully in loans, that will help the margin and should help net interest income some during the next quarter. Having said that, I do think that the macro environment is not good for net interest margins, and I think that there will continue to be pressure as we bring on, and our competitors bring on, loans at 3.50, 3 5/8, 3.75. That just really doesn't leave room to have a healthy net interest margin, but we do think going forward that we will get a lift as the funds get invested during the third quarter.

To talk a minute about non-interest income, I'll just go through that briefly. Wealth Management is putting together a flat to slightly down year. Investment Services and Insurance are lagging last year. Our Trust Department continues to run a little bit above last year in terms of net income. Service charges, which we've talked about, continue to show a good trend. I think that good trend should continue as we've rolled out revised fees in the old Central Bank footprint, and we expect that the positive trend will continue.

Our Mortgage continues to be a grind, but we do expect a decent third quarter out of Mortgage because of the external environment. The fourth quarter is anybody's guess, because that tends to be a slow time, but we expect Mortgage should continue to move forward at a decent clip.

Non-interest expense, whether it was a lot of severance — we did have the severance results, but once you take that out of the mix and look forward, we're well ahead of where we thought we would be in terms of expense reduction. In fact, we're not that far from the original goal that we set, so our run rate will be coming down in the third quarter on non-interest expense. It's my personal opinion in this environment of low interest rates that efficiency probably matters more than if interest rates were 3 percent above the levels they are now, so we understand that. We have the consultants that we've talked about are in and working in our bank. I would think by the time we have this call next quarter, we will have some idea of what the magnitude of their work is, but they're off to a very good start, and I would think as we get into 2017, that we will see the results of that. I guess that's — what I'm saying is it would — it would be my hope that we would exceed the original projections that we laid out at the time of the merger, simply because we're almost there now. So we're not there yet, but we're moving in the right direction.

Asset quality, you can ask Kent more specific questions, but the big picture would be that that's slightly improved from last quarter. I think it's fair to say that we have not shied away from a fairly aggressive approach to building our reserve, and, in fact, the loan loss reserve to non-acquired loans now stands at 131 basis points, which we feel very, very good about. One thing that happened during the quarter is our 30-to-89 day spiked, and, I can't say that none of that — that's a double negative — but we don't think any of that is from, or much of that is from credit quality concerns, and we can account for the bulk of that as just not getting loans renewed or other factors that tend to be more operational, but we do have an eye on that, because there was a spike there.

The one large non-accrual loan that we've talked about, there's not much movement there, but there is some movement, and the movement is in a positive direction, but there's still more to come there.

As promised, we did do a stress test on the Ag portfolio. We talked about that in the earnings release. We think the most likely scenario is that there's really not much impact on credit quality, certainly for the next three or four quarters, and even in the doomsday, what we thought was a doomsday scenario, it wasn't anything that really would upset the applecart too much. I think it was maybe one or two months of earnings to go to the provision, and that was the doomsday scenario in the stress test.

Relative to credit quality overall, we think it's a time to be very careful. We see not only competition on rate but also on terms. As we look, we see our competitors taking large amounts of loans to one borrower, and we're going to be very measured about that, and we are looking for the next quarter at a decent pipeline. It may not all close during the quarter, but as we have started to look forward, I think that it's fair to say that we expect loan volume to build, because we've shown the ability to increase loans in the past, particularly in the Twin Cities and Iowa City and in Cedar Falls, and I think that will happen again.

Capital levels, we feel fine about the capital levels. That's one reason we did authorize a share repurchase and extend that. We feel like that at the appropriate price, we would certainly feel good about repurchasing our stock.

In terms of M&A, there is some activity in M&A, and we've had the opportunity to look at banks during the past quarter in both of our footprints, and I think that it's fair to say that we expect that to continue. I think there are a lot of conversations that are taking place. There's certainly not anything imminent with our company, but just the landscape, I think, especially with smaller banks, I think more and more it just appears that there will be more deals, I would think, over the next six to 12 months.

Looking to the last six months of the year, I think we still think that our formula is a good formula, and I think the formula to get our earnings back to where they need to be is fairly straightforward. Number one, we need to get back to the business of growing loans again, so we have become, as I said before, more competitive on rates. We are starting to see more and more deals that are being worked up in credit and starting to find their way to the loan committee. It takes a while for those things to close, but, again, I think as we move through the quarter, we would expect to see our loan volumes starting to move forward again.

Expenses, as I said, we think we'll have a much better run rate for Quarter 3 and Quarter 4 and then as some of the other recommendations begin to take effect into 2017. And I would also make the point that even if some of these cash balances wind up in our investment portfolio that they'll wind up in our investment portfolio probably at 150 basis points, maybe 175 basis points on average above the yield that they had for most of the second quarter.

So I guess the conclusion is that again, disappointing second quarter by our standards but feel very optimistic that the last half of the year will be much, much better.

I did not introduce those who are also in the room, but available to address any of your questions, we've got Gary Ortale on his last earnings call as our Chief Financial Officer. We have our Chief Financial Officer in Waiting, Katie Lorenson. We also have our Chief Credit Officer, Kent Jehle in the room, and, with that, Bianca, we would turn it back to you.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-=and-answer session. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. At this time, we will pause momentarily to assemble our roster.

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

Jeff Rulis
Thanks. Good morning.

Male Speakers
Good morning.

Jeff Rulis
Could you break out the $1.8 million in merger cost by expense category, or is a lot of that in the comp line?

Gary Ortale
Yeah, Jeff, this is Gary. About $1,340,000 of it is in severance or in the salary compensation line. There's another $300,000 in professional fees. There's probably $50,000 in DP and $100,000 in other operating expense.

Jeff Rulis
Got it. And then just to — Charlie, just to kind of wind down your discussion on the lower expense rate, I guess if we got the $1.8 million, that brings it to $21 [million] would you say that that base is — do you get immediately there, or there's still some merger costs to go? Is there some growth, maybe the run rate of that in the second half and then, I guess, beyond into '17?

Gary Ortale
Yeah, Jeff, this is Gary. I'll try and take that question as well. As you indicated, we got $21 million — or $22.8 million this quarter. You back out the merger-related; you're right at the $21 million level. We've consistently talked about the fact that in that $21 [million], there's still almost a million dollars that relates to the amortization of the premium on the purchase. You back that out; we're down to a run rate of $20 million, even though we're going to have that purchase accounting investment for some time yet.

Our goal, though, is to get down to the $19 million per quarter range, and I think everything that we've done — we did make a concerted effort to try and get all of the merger-related expenses in this quarter. We're hopeful that in the next couple of quarters here this year, there will be little or none, at least negligible expense, but with the impact of the severance this quarter on those officers that left, we're looking for the run rate on the salaries, especially, to decrease going forward, and each quarter going forward, we're looking for less and less in the way of data processing and legal, especially. So we are optimistic that we're going to get the non-interest expense down closer to the $20 million and even into the $19 million range by the fourth quarter.

Jeff Rulis
Okay. So a sub-$21 [million] number's — in Q3, Q4 is definitely doable?

Gary Ortale
Yes.

Jeff Rulis
Okay. Great. And then one last one on — Charlie, you mentioned of the disappointment on the loan volumes, the weakest of — or the least impactful was the payoffs, but how were those payoffs in Q2 versus Q1? Was it pretty steady, or did you see a small increase quarter to quarter?

Kent Jehle
Jeff, this is Kent. I'll take that. And when you look at payoffs also and comparable to decreases in lines, I would say they were pretty — they were flat from quarter to quarter, because we did have more in payoffs on lines of credit in the first quarter from the Ag side and also on the construction side, so those would have been comparable when you add those two areas together with what the term payoffs were in the second. So I wouldn't say it was significant as far as the payoff portion of the portfolio.

Jeff Rulis
Great. And then just, I guess, the pipeline, then, in the second half, you guys seem more confident that that will rebuild and part of that being a little more competitive on rate. Is that the case? Certainly, the growth is expected to return in the back half.

Kent Jehle
We do. The initial feedback with our adjustment in rate, you've heard us talk in terms of being around that 4 percent range on non — on commercial real estate and Ag real estate, we are now in that 3¾ range, and, again, when I talk about that, it's a five-year rate that we're in the conversation more now. We're not at the low end of the rate when you look at our competitors, and we're not at the high end, but it certainly has gotten us into the conversation and has created more activity, and, as Charlie alluded to, we see those in the credit area pipeline, and we're starting to see them — we anticipate those hitting the loan committee and then, obviously, we've got to move forward with closing on — executing on the closings on those, which will happen throughout the third quarter, and, again, probably into the fourth quarter, is what we see right now.

Jeff Rulis
Okay. Thanks for your comments.

Charles Funk
Thank you.

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

Andrew Liesch
Good morning, everyone.

Male Speakers
Good morning, Andrew.

Andrew Liesch

Just some clarification on the loan growth expectations, because you have the $33 million that are going away with the Davenport sale. So do you still expect to grow the portfolio in the third quarter or just offset that sale?

Kent Jehle
Andrew, Kent again. Our goal is to offset that at a minimum. That's a hard target when you look at what's in the pipeline right now and the stage of the pipeline. We do have what I would consider a couple of larger opportunities. It would just be dependent on when those actually close and when they fund, so that could slide into the fourth quarter overall when you take Davenport into consideration, but we're looking at our net growth right now from where we sit, and then, of course, we have the target of the Davenport side of things as well.

Andrew Liesch
Okay. And then before the deal, MidWestOne was doing about mid-single digit growth, Central doing a little bit better than that on a blended basis. Just for now, being more competitive, is that something we could get back to in 2017? Could we see that, or just kind of curious what your thoughts are a year from now.

Charles Funk
I think if you break our footprint into Iowa and the Twin Cities, that — I think the Twin Cities, on average, will still produce better growth than Iowa. Iowa City continues to show a lot of growth, but the rural markets, there's just been very, very little new loan volume out of the rural markets. So most of the loan growth's going to come from Iowa City and from the Twin Cities, and so I would say probably if you're talking about loan growth, I still think 4 to 6 percent is something on an annualized basis we should do in this economy, and I think I'm a little more optimistic on deposit growth. I think deposit growth can probably be in roughly the same — probably not as high as — well, maybe 3 to 5 [percent] in deposit growth. But we feel a little bit better about some of the things we're doing on the deposit side. We just need to get them invested. So 4 to 6 [percent] and 3 to 5 [percent], Andrew.

Andrew Liesch
Gotcha. Thank you very much.

Charles Funk
Thank you.

Operator
The next question is from Daniel Cardenas with Raymond James. Please go ahead.

Daniel Cardenas
Morning, guys.

Male Speakers
Good morning, Dan.

Daniel Cardenas
On the deposit side, is that growth, is that planned growth? Are you guys perhaps being a little bit more aggressive in trying to bring those deposits in via rate, or what's kind of the driver behind the growth that we saw at the end of Q1 and in the beginning of Q2?

Charles Funk

Well, the driver is that — that's a great question, Dan, and the driver is that, as you know, for a long time, our model is to have a loan-to-deposit ratio in the 80s, and we were running up really into the high 80s and our forecast that we would move into the 90s, and we just really wanted to have more of a focus on core deposits, so we executed on that plan and brought in some nice, large deposits. We paid a premium, but the premium might not have been any more than 5 or 10 basis points, so it's not like we were paying large — and they were not CDs, they're core deposits. And, unfortunately, that all came at a time whenever our loan demand sort of went stagnant, so we're still running at an 87, 88 percent loan-to-deposit ratio, and we're okay with that, but those that know our company and know us very well, we're not going to be one that's going to move up toward 100 percent loan-to-deposit ratio, at least we're not going to do that willingly. It would be something — have to be a special situation before that would happen. So I hope that answers your question.

Daniel Cardenas
Yeah. Yeah. Okay. And then you said you're kind of lowering your — you've lowered your rates as you go out in search of loan growth. What's the range? You're at 3.75 right now, it seems like on average, what's — you said you guys fit in in the middle of that — of the range in terms of what your competitors are doing. Did I hear that correctly?

Charles Funk
Yeah, I think, and I'll let Kent add to this when I'm finished, but I think what we found was as we went out and looked for loans, that if we weren't willing to, especially on commercial real estate, if we weren't willing to be in the 3.75, 3.80 range, we couldn't even get into the conversation. Now, at 3.75, we get into the conversation, we don't get all the deals because there are people out there doing 3.50, 3-5/8, but, no, there are other loans that are being made. In fact, I just saw one in loan committee this week that was done at 4.25, so it's — but the large deals in C&I and in commercial real estate tend to be sub-4 right now.

Kent Jehle
Yeah, that certainly is right on — right on target, and, Dan, the range I would say consistently we're hearing is 3½ up to 4½, again depending on size and term, so as we look at that 3¾ from our standpoint, I would look at — we're at 3¾ up to the 4½ range. I would also add that we did pass on an opportunity that was at 3¼, and it just didn't make sense based on the overall structure of the deal itself, so there is some aggressive rates that are out there, that's for sure.

Daniel Cardenas
All right. Okay. Good. And then one last question here on the tax rate. What was the reason for the increase this quarter?

Gary Ortale
Yeah, Dan, this is Gary. I don't know that I have anything more specific than just the fact that a lot of the merger-related expenses that we incurred were not deductible expenses. I'd like to say it was something more than that, but that's probably the one thing that I could — only the one thing I could focus on or identify.

Daniel Cardenas
All right. So, then, looking forward to the back half of the year, should we expect that rate to — where should we expect that rate to be?

Gary Ortale

Well, again, I think the effective rate this quarter was 27. I think for some time now I’ve said we’re usually in that 25 to 27 percent range. I don't know that I can give you a specific number, but I would suspect it will be still in that range.

Daniel Cardenas
Perfect. All right. I’ll step back. Gary, congrats, and good luck in retirement.

Gary Ortale
Yeah, thank you, Dan.

Operator
Again, if you have a question, please press star, then 1. The next question comes from Brian Martin with FIG Partners. Please go ahead.

Brian Martin
Hi, guys.

Male Speakers
Hey, Brian.

Male Speaker
Hi, Brian.

Brian Martin
Just one question, Charlie, just, I guess, for whomever, just on the margin. It sounds like if you’re kind of notching back the pricing on the loans a bit, I mean, I guess, can you talk about just reconciling the core margin this quarter, kind of where you see the core margin and just kind of how your outlook going forward, especially as you get maybe a little bit more competitive on price and maybe to the extent there are not any rate increases as people, at least at one point, were thinking would be in there.

Charles Funk
Yeah, Gary or Katie may wish to chime in when I’m finished. I think I’d go back — I think you’ve got two things, two dynamics at work that conflict with each other. The one dynamic is the fact that our margin was clearly hurt by all the money that was sitting at the Fed or in Fed funds, and that will, in large part, we think, be redeployed during the quarter, which will help the margin compared to the prior quarter and also help net interest income, but the macro environment is such that I think all banks that are running a margin at the level that ours is are going to be under a lot of pressure, and I’m not sure I can give you any specific guidance, because I’m not sure we know how it’s all going to play out, but, Gary and Katie, if you want to add anything, feel free to.

Gary Ortale
Yeah, Brian, this is Gary. I would just say that if you look at kind of our core margin, these past two quarters we fell from a 3.76 to 3.70 range, and, yeah, I’m not sure that I’m as optimistic about the quarters going forward in terms of, as Charlie just mentioned, the pressure that’s on there, But, again, if we can get the cash that we had this last quarter, especially fully invested, that will obviously bode well for the net interest margin yield, but I think we’ve about bottomed out on costs. A little bit depends on — our home loan advance rates went up significantly this quarter. If we don’t get the loan volume that we anticipate, we may let some of that run off, so I

kind of anticipate a pretty much flat margin going forward and maybe a little bit of pressure on it continuing.

I do think the net interest income number, however, will be continuing to rise. We didn't talk too much about this kind of accretion yet, and that obviously plays into the loan yield, and I think we're a little more optimistic about 2017 than we are 2016 for various reasons, but certainly the discount accretion was impactful this quarter and probably will be — I mean, the fact that it wasn't as high as we expected or as high as we've had in prior quarters, and we're kind of expecting that for the third and fourth quarter but are hopeful the first quarter of '17 and beyond will be much better.

Brian Martin
Okay, and just reconciling it, Gary, back to kind of where it was at, I mean, reported versus — how much — how much accretion was in there? Was it just the 700 this quarter? Is that the number?

Charles Funk
Katie, why don't you take that one?

Katie Lorenson
Sure, I'll take that. In the loan interest income, there was about 700, and then there was another 280 or so in the cost-of-funds interest expense.

Brian Martin
Okay, so all in, the accretion was about — just about a million bucks?

Katie Lorenson
Yes, sir. Yeah.

Brian Martin
Okay and that million dollars in— okay. That's helpful. All right. And then — and just the — your comment, Charlie, was just that the core number — at least you're thinking today, the environment we're in just is down modestly from — or just down — is it on a downward trend, is how we should think about it?

Charles Funk
Downward trend, but I think that's an industry issue, not a company-specific issue, and I don't mean to imply I think it's going to fall by 30 basis points in a quarter or anything like that. I just think there's a — the macro environment is not conducive to building net interest margins right now.

Brian Martin
No. Understood. I got that. So — and then just kind of going back to your comments about the M&A activity in the market and kind of getting the Central deal done and kind of all the cost savings and everything you've got, I mean, how interested in M&A are you today based on kind of getting everything put together with Central? Do you want to get that done before you look at something, or are you willing to look at something today opportunity wise, and kind of just if you can comment in general on the opportunities out there, what's important to you in a transaction going forward?

Charles Funk

Yeah, no, it's good — it's a fair question, Brian. Let me be a little more specific but not absolutely specific. During the quarter, we looked at one opportunity we decided to pass on. It was a nice opportunity. We decided to pass on it, and it wasn't because we thought we couldn't execute the transaction. We also looked at another opportunity that we were very interested in. This particular bank wound up remaining independent and not selling, so I think what we're looking for is deals that are of a size that we can easily absorb and that we feel like the execution risk is very low. And on the one that we were interested in, the execution risk we judged to be very, very low and with some nice take-outs in cost.

Brian Martin
Okay. So, I mean, it sounds like they're more in-market deals than out-of-market deals. Is that fair?

Charles Funk
Well, we've looked at both, but the one we were most interested in was an in-market deal.

Brian Martin
Okay. And just broadly, just kind of size wise, when you say kind of digestible, if you put a fence around what's — how do you — what do you consider, is that 25 percent of your footprint in smaller — or size or smaller, or is it at a reasonable kind of range?

Charles Funk
Yeah, 20 percent or smaller, I would say.

Brian Martin
Okay. All right. That's helpful. And then just, maybe just a separate question just on fee income in general. I think, kind of when you strip out the kind of the one-time gains and whatnot in the quarter, the securities gains and the OREO or the sale on — was maybe on the low 5's, $5.2 million range. How do you view that run rate in fees going forward, kind of puts and takes on how to think about that?

Gary Ortale
Yeah, Brian, this is Gary. I will take that to start with, and then I may hand off to Katie too, but I think as we've talked, we think that the run rate is in that $5.5 [million] to $5.6 [million], probably closer to the $5.6 [million] range. I would hope that you'd notice that we did break out a little better. It was a little messy on our fee income in the first quarter, but we did separately break out the gain or loss on the sale of the fixed assets and the branches and got them all out of the other service charge category, so those first four line items are pretty much the run rate going forward, because the other line items have the typically non-recurring stuff, but I think, as Katie and I talked, our best estimate going forward is at $5.5 [million] to $5.6 [million], with more of a tendency to the $5.6 [million]. I think it depends a little bit on, again, origination, mortgage origination picking up here and maybe the investment services area as well. Those are the two that have been probably the most anemic so far this year.

Brian Martin
Okay. Yeah, that's helpful, and then I think just the last thing I had was just on the — Charlie, you talked about in the past, it's been that the expenses weren't on track. Now they're ahead of pace, and you mentioned in the release that there were some officers that left. Were those part of the planned reductions, or just kind of what areas were those folks in that you highlighted left? Were they lenders, or were these guys just operational folks, or —

Charles Funk
Yeah, that's a good question, Brian. The officers that left were all in the Twin Cities area, and I would say they were all unplanned, and of the ones that left, there was really only one that had a lot of customer responsibility. And that one was early in the quarter. There's been a little bit of a loss of business out of that, but not a great deal, certainly not in a company our size and maybe not as much as we would have thought. The others were management people, and, quite frankly, we decided to part ways, and probably that's just the best way to leave it, but it's one of the reasons I feel so good about our future, is I think we've got the people here who want to be here and who are willing to execute on the plans. And I do appreciate the question.

Brian Martin
Yeah. Okay. All right. I appreciate you guys taking the questions, and I'll step back. And congrats, Gary.

Gary Ortale
Thanks, Brian.

Charles Funk
Thank you, Brian.

Operator
We have no more questions at this time. This concludes our question-and-answer session. I would like to turn the conference back over to Charles Funk for any closing remarks.

CONCLUSION

Charles Funk
Thanks again for being on the call this morning and if there's anything that any of us can provide going forward or any questions we didn't answer, feel free to call any of us who spoke on the call today. Thank you very much for being on the call.

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