MidWestOne Financial Group, Inc.

First Quarter 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Charles Funk, *President & Chief Executive Officer*

Kent Jehle, , *Chief Credit Officer*

Katie Lorenson, *Chief Financial Officer*

James Cantrell, *Treasurer*

Kevin Kramer, *Chief Operating Officer*

PRESENTATION

Operator
Good day and welcome to the MidWestOne Financial Group, Inc. First Quarter 2017 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 telephone keypad. 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 & CEO. Sir, please go ahead

Charles Funk
Thank you very much, Steven, and welcome to the conference call for this month — or for this quarter. And I will begin as I always do with the forward-looking statement, which says this presentation contains forward-looking statements relating 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, 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.

We have today our Chief Financial Officer, Katie Lorenson; Jim Cantrell, our Treasurer; Kevin Kramer, our COO; and Kent Jehle, our Chief Credit Officer.

If I would choose one word to describe the first quarter, it would be better. We're certainly not where we want to be or planned to be, but we are making progress, of course, the goal is to make consistent and steady progress, and I do think we achieved that this quarter. One thing I do want to point out, we reported, when we do the comparative periods with last year, we do it with merger-related expenses and without, but I would also note that when you compare to last year's first quarter, that we did have two branch sales of Rice Lake and Barron, Wisconsin, where we realized a gain, a one-time gain during that period.

If you look at our overall numbers, return on assets of 89 basis points, our return on tangible equity of almost 12¾, efficiency ratio down just over 61 percent, a very good improvement, I think, but, again, not where we wanted to be but certainly a good first step. We also put our tangible equity and — tangible common equity well above 8 percent, and that was a big event for us, and we were gratified during the quarter by the reception we had in the March transaction from the investment community.

Looking at the balance sheet, loans, as you can see, were relatively flat. We did have a few large payoffs during the quarter which were planned for the most part. We do have a nice pipeline on the board. I wish I could say the pipeline was going to close early in the quarter. It looks to me like most of the pipeline will close in late May or during June. We would estimate that to be in the $60 to $70 million range as we see it right now.

If you look at the flat loan growth, I noticed this morning that the GDP was reported at up 0.8 percent, and we certainly see that in part of our footprint. If you look in our footprint, most of the loan growth is going to come from the Twin Cities Metro, from Iowa City, and from our new Denver market, which we do plan to open on Monday. Florida continues to be consistent. I wouldn't call our Florida operation explosive, but they continue to consistently add loans and deposits each quarter.

So on the surface, our numbers would appear to be weak, but I think there is some progress, and that progress will be manifested during the second quarter. I would also note that the competition for loans is fierce, especially in Iowa City and the Twin Cities. We're seeing community banks offer five-year deals well inside of 200 basis points over the Treasury curve. We're also seeing a little bit of what we think is compromise on credit standards. We also realize that this sort of thing is transitory. It comes and goes, but right now, it's very, very competitive as there are a lot of especially community banks that are competing and competing very, very hard.

We also have seen a number of deals that we wouldn't do, that we've passed on. We probably could have had some loan growth but didn't, and I think we just need to be true to the credit disciplines that we've had over the years, and the future will take care of itself just fine.

Deposit activity during the quarter was, I would say very, very strong, although, as we said in the report, some of that is seasonal and has already left our company, but I would note that we do have strong deposit growth in the Iowa City market. Denver, we think will get off to a very good start, and we think that Denver deposit activity over the next year or two should be above the projections that we had whenever we began this initiative.

I would also note that a couple of our smaller rural markets in Iowa have done a very nice job of bringing in some larger deposit customers, so I am very encouraged, because at the end of the day, we think we're going to have loan demand, and we have to be able to fund the loan demand with core deposits.

One note on the deposit activity, maybe anticipating some questions that might be asked, we are having to pay up at the margin for some of the larger deposits. We have not had to raise our core accounts, and they seem to be holding very steadily, but I think as maybe is the case with other companies, we have our special project — our special deposit product ready to go if and when it's needed, but at this point in time, we really haven't seen much movement in the core rates. At the margin, however, there is some movement in rate.

On non-interest income, really a nice quarter for Wealth Management. All three units were solid insurance, the brokerage area, and the Trust Department. Mortgage was slow, although we did have a nice adjustment to the servicing rights, but our new head of mortgage has started, and I feel very, very encouraged that within a quarter or two, we will see much better production and expense control in the mortgage area. I do note that we recently hired one mortgage originator in the Twin Cities, and we will continue to look to hire producers to come on and join our, the new head of mortgage, R. J. Lang, who joined us about a month ago.

I think the expense line was good. I would note that there's some Denver expenses in there, and then there are some expenses that were associated with the shareholder sale during the quarter that were a little unanticipated, but overall on expenses, I would say we're ahead of our projections in terms of cost reduction, and I think it's fair to say expenses are being managed closely, and we'll see some continued improvement on expenses as the year goes on.

Turning to asset quality, 13 basis points. Net charge-off rate was really inflated a little bit. We had a final resolution of one of the loans that we disclosed in the fourth quarter, and that particular one is closed out, but that represented not quite half of the net charge-off for the quarter, so I think we're back to a more normalized charge-off rate now for the company. So as we disclosed, there is a little movement within the category, and I'll give you a little more color on that in terms of non-performers. I think the most notable was we had a performing PBR that has been on our books since the MidWestOne merger of 2008, and that is now in collection mode, so it's over 90 days, and we're very well secured on that, but it could take a while to go through foreclosure, but we expect a full recovery of principal and interest, accrued interest and feel very, very confident of our collateral position. The large $10.4 million non-accrual loan in the Iowa City area that's' been on non-accrual for a little over a year now, you know, the goal is to get that to performing PBR status. I'm hesitant to give a date on that, so we're not going to declare victory yet, but I do think that we have a lot of progress, but victory will not be declared until we have signed documents, but we do expect that this year and, if not, this quarter .

If you look at our footprint and you look at the state of Iowa, the state of Iowa has held up very, very well during the recession we had, but if you follow state government, state revenues are languishing, they're just up marginally over the prior year, and that's primarily due to a slow ag sector which bleeds over into Main Street Iowa and, as most know, 60 percent of our footprint in Iowa, it's fair to say is affected in one way or another by ag. If you look at Iowa, the Des Moines market is very strong, the Iowa City market is very strong, and the Cedar Rapids market is strong. The rest of the state, I would not consider to be strong, so that's definitely in play when you look at our company and you look at the loan growth that we may have.

There's really no meaningful update on ag beyond prior guidance that we've given in these calls. If there is any deterioration in the ag portfolio, the deterioration mostly has been a few loans that have been moved from past to watch but certainly not to substandard or anything worse than that. If you have further questions on that, Kent can certainly address that during the Q&A.

Our reserve levels are above the required reserve at the end of the quarter. We did have an FDIC Safety and Soundness Exam that was completed during the quarter, and we have nothing further to report on that, which is good news. And, again, to repeat what I've said at the beginning of the call, I think we took a good first step in this quarter. We do have more work to do, and I think to some extent, the second quarter will be influenced by the timing of the loan closings, but the good news is that we do have a nice pipeline that's ready to go, and, again, at this point in time, we would expect that to be between $60 and $70 million of production.

So with that, Steven, I can turn it back to you, and if anyone has questions, we're happy to address them.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then 1 on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2.

And our first question comes from Nathan Race with Piper Jaffray. Please go ahead.

Nathan Race
Hey, guys, good morning.

Multiple Speakers
Good morning.

Nathan Race
I had a housecleaning question, just to start off. Can you guys give us an amount of one-time expenses that you guys had in the quarter tied to the stock offering in 1Q, that are probably non-recurring going forward?

Katie Lorenson
Yeah, hi, Nathan, this is Katie. It was about $200,000 on the stock expense and about just over $100,000 related to Denver.

Nathan Race
Okay. Got it. And then can you kind of just update us on what you're seeing across the ag environment in Iowa. I appreciate Charlie's comments in terms of not seeing any additional deterioration across the portfolio, but can you kind of give us an update of what you're seeing as we sit here today, particularly with commodity prices kind of finding a new equilibrium at current levels, so to speak?

Male Speaker
[Inaudible at 13:03] for corn.

Kent Jehle
Yeah, Nathan, certainly we've gone through the season and you're starting to see our clients out in the fields at this point in time getting the corn in the ground. And our projections that we've put together do show that we'd be in a breakeven mode based on current commodity prices as you described. We did — as we went through the renewal season, obviously analyzed from a credit risk standpoint, and we did see a migration of credits from the lowest pass rating to watch, and we have tracked those and will continue to monitor those credits as we get into the season. Primarily into July/August, we will be coming back with further review from that aspect and to match up with the projections that have been put together. And in anticipation of what the yields will be, we'll have a better feel as we get into the August/September timeframe. just as an overall, and this doesn't include all loans, we had a net migration of $24 million, approximately, from the past rating into the watch-rated category in our portfolio based on the review of the credits going over the first quarter timeframe. So hopefully that answers your question.

Nathan Race
Yeah. No, that's great color. I appreciate that, Kent. And if I could just sneak one last in for Katie. Can you just kind of share any updated thoughts in terms of the margin going forward and perhaps within the context of how much loans you have at floors after the rate hike we had in March?

Katie Lorenson
Yes, no problem. So our core net interest margin was stable again this quarter at about the 363, so it's helped steady the past three quarters. We did see the loan yields remain stable. The investment portfolio dollars that we put in helped lift and offset an increase in the time

deposits portfolio that is up about 9 basis points, core, quarter over quarter — or, excuse me — year over year, flat for the quarter, and overall cost of funds stable for the quarter. I'll let Jim answer the question on the portfolio.

James Cantrell
Yeah, portfolio yields, I think, on a taxable basis, if you just want to look at that category, are in the low 3's right now. It's hard to replicate the low 3's on any new investments, so we may see a little bit of downward movement on the investment portfolio. I expect on the deposit side, you know, I'm not going to forecast Fed rates, but I think globally, I think, we're pretty neutral to interest rates if we do get a Fed increase in the next quarter or so. I don't see a lot of movement in the margin going forward. We haven't changed deposit rates for the first 75 basis points of Fed move. I'm not sure we're going to be able to say that for the next 75, so that's kind of the caution that we're giving folks.

Nathan Race
Okay, that's helpful. And just quickly on the tax rate, Katie, any updated thoughts on that going forward?

Katie Lorenson
No, I'm still sticking to the 30 percent, despite the — you know, we did have some reverse loans, some over accrual this quarter, and we had some favorable adjustments for the accounting change related to restricted stock, but I think forward looking, 30 percent is a good rate.

Nathan Race
Got it. I appreciate all the color, guys.

Charles Funk
Thank you.

James Cantrell
Thanks.

Operator
Our next question comes from Damon DelMonte with KBW. Please go ahead.

Damon DelMonte
Hey, good morning, everyone. How's it going today?

Charles Funk
Good morning, Damon.

Male Speaker
Good morning.

Damon DelMonte
So I guess my first question is relating to the loan growth outlook. Charlie, you gave some good color as to what the expectations are for closings here in the second quarter. Just wondering kind of how you're viewing the full year growth expectation for loans.

Charles Funk

I think that we've, unfortunately, talked about a large loan in the fourth quarter of last year that still hasn't closed. I mean, it's more than $15 million, and we still expect that to close, although not in the second quarter, so we think that we're going to put that in our full year 2017 projection. But I think 4 to 5 percent is probably still reasonable for the company, because we do think that, especially when you add Denver in and everything that's going on out there, I think 4 to 5 percent, and if you had to pin me down, I might be at the lower end of that, but I think we still feel reasonably confident in that.

Damon DelMonte
Okay, that's helpful. Thanks. And then kind of with regards to the Denver expansion, can you just give us a little update on the progress that the new commercial bankers have made so far? I mean, are they actually booking loans currently, or is that going to be more of a second quarter event?

Charles Funk
It's a second quarter event. our office really isn't open yet, but we're going to open next week, and we've hired a third commercial banker out there that we think can bring some immediate loans as well, so we expect Denver, I can't really give you a number from Denver for the quarter, but we think the next couple of quarters there will be nice activity from Denver.

Damon DelMonte
Okay, great. And then I guess my last question relates to the fee income. Any expectations on the reverse loans, some maybe seasonal trends that we could have seen this quarter, particularly in service charges or mortgage banking related?

Charles Funk
Well, mortgage banking should improve just based on seasonality. In terms of service charges, I don't know of anything that's unusual on service charges.

Katie Lorenson
This is Katie. We did have Charlie, referenced the insurance agency, the contingency income there, that was about $100,000, and that's a first quarter event, so that would kind of be the outlier, and the MSR write-up was over $200,000, although I will say a portion of that adjustment was related to increasing the volume, which is our strategic plan this year to put more into that portfolio. So other than that, again, the volume and such in the mortgage should continue this year, and that would be the only kind of outlier in the non-interest income this quarter.

Damon DelMonte
Okay. That's helpful. That's all that I had. Thank you.

Charles Funk
Thank you, Damon.

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

Andrew Liesch
Morning everyone.

Multiple Speakers
Good morning Andrew.

Andrew Liesch
Charlie, I'm wondering if your expectations of getting the efficiency ratio down toward 60 percent by the fourth quarter is that still your expectation and what additional levers can you pull to get there?

Charles Funk
It is still the expectation, and we've been very clear that we expect the run rate either in the fourth quarter or the first quarter of next year to be right around in the 60 area. Some of that depends how you calculate it too. That's based on the way we calculate it. In terms of levers, I think it's just ongoing. We've had some — you know, a number of initiatives that are in play that are scheduled to be rolled out, but the great thing about the efficiency ratio, as you well know, is it also takes into consideration revenue increases, and we expect to get a little bit of a lift from net interest income and the loans we're going to be putting on. nothing really magical in terms of pulling levers, but I just think ongoing progress of what we've already planned to do.

Andrew Liesch
Great. You guys have covered all my other questions, so thanks.

Charles Funk
Yes, thank you.

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

Matt Yamamoto
Good morning, this is Matt on for Jeff. I just had a couple questions, and the first one relating to credit quality, you guys said you added seven loans to TDRs in the quarter. Could you provide more color on those, and are you seeing any trends in regards to that?

Charles Funk
We can, and I'll let Kent answer the question.

Kent Jehle
Yeah, Matt, seven loans, three customer relationships added up to the $3 million that were added to the TDR status. Two are in the light manufacturing area, and one is in the professional services area, a smaller one of $500,000. All were related to going to interest only beyond the six-month period of time that is allowed without going to the TDR status, and the other color I would add is all three did not require any impairment in going to that status. Therefore, we do view those as temporary in nature and will be viewed as performing TDRs as we progress down the line.

Matt Yamamoto
Thank you. And also, I just wanted to ask, how do you plan on redeploying the capital from the underwritten public offering?

Charles Funk
Well, that's a good question. Certainly, we think it gives the balance sheet room to grow, which may well come into play, given what we're seeing in Denver. And then it does give us a little bit more flexibility as we analyze any potential acquisitions that we might have, but those would be the two primary factors there.

Matt Yamamoto
And just one more question. Along with the public offering, we saw John Morrison sold most of his position in MOFG. Do you think you could provide more details on that? What exactly are his intentions in this, and is he still going for re-election in 2020?

Charles Funk
Yes, oh, in 2020, he was just re-elected to the Board at our annual meeting. John just coincidentally, the day that we announced this, it was also his 80th birthday, and I think it's just a natural progression for John. If you know John's history, John has bought and sold more than 100 banks during his career, and we made the statement publicly that he remains on the Board. He's not the chairman. He was the chairman the first year of our merger. But we don't necessarily expect John to serve out the entire term of this particular Board term. He still owns a little bit of stock in his foundation and in his trust, but I just think this is a natural progression. It's something that John and I had talked about for the last nine months, and, quite frankly, I don't want to speak for John, but I think he saw a nice opportunity as a result of what we've seen since the presidential election last November.

Matt Yamamoto
That's perfect. Thank you very much. I'll step back.

Charles Funk
You're welcome. Thank you.

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

Brian Martin
Hey, good morning, everyone.

Multiple speakers
Good morning, Brian.

Brian Martin
Hey, Charlie, maybe, or maybe more for Kent, just on the kind of the outlook for credit, it feels like it's as you guys kind of talked about, maybe beginning to stabilize or stabilize here. You know, the outlook for provisioning and kind of reserve in going forward, giving still a watchful eye on ag and maybe some improving trends or some more stabilizing trends elsewhere, what's the best way to think about that going forward?

Charles Funk
Yeah, Brian, I'll talk about the, as you look at the actual portfolio, obviously we have the purchase accounting side of it that impacts this, and certainly Katie can add flavor, but as we sit today and as we forecast over the next few quarters in our classified list, we don't see any material changes, so the allocation that was provided in the first quarter is something we feel comfortable with, given the current classification list we have in place and the impairments as we have identified to work through those more severely classified credits that are on the radar. But beyond that, on the purchase accounting, because that certainly does come into play as we migrate credits across, I would ask Katie to add more color on that.

Katie Lorenson
Yeah, I think, Brian, as we've discussed before, as long as renewals keep on the pace that we've experienced, the run rate that you saw in Q1 will sustain going forward, barring no other changes. Again, if those renewals, if we see an uptick in those, then we'll see an uptick on the P&L side on the discount accretion income to offset any additional expense.

Brian Martin
Okay. Alright. That's fair enough. And then maybe one for maybe Charlie or Steve, just the the core margin, I guess you kind of talked about it being stable here, and you had the rate increase, I guess. If we get more rate increases — kind of our — seem to be expected going forward, where is the bias on the core margin going forward? It sounds as though you're not really feeling a whole lot of pressure from a funding perspective today, and it's kind of staying stable. I mean, could it possibly have a downward bias, or would it just be more of an upward bias but just modestly as you think about additional rate increases going forward?

Charles Funk
Yeah, I think it's a great question, and I think it's one that every organization's dealing with, and I think the answer is you tell me what the beta is on the next 25 basis points, and we can give you an idea. I heard someone say that, and I can't remember who it was now, but somebody said that the beta might be 30 percent, but the net 25 basis points might be 100 percent. And I don't know if that's necessarily true for our footprint or not, but I know it's something that we think, if you get two more increases this year, certainly, the core rates are going to have to change, and the question is how much. Brian, I would just say that if you factor all those into the equation, that we're probably neutral, and we're going to do everything we can to sustain that.

The thing that's puzzling to me is that even though the Fed's increased interest rates, and generally the bond market has, even though it rallied recently, but the bond rates are higher than they were last year at this time, and yet some of the five-year loan rates appear to be just where they were, and because there's this feeding frenzy, especially on commercial real estate loans, and I don't think that argues well for margins to the extent that people participate in that to a big degree. What we've tried to do is be selective on where we participate at these rates, but, for the most part, we've been able to get little higher rates on the production that's in the pipeline, but I won't kid anyone. We're having to be selective to retain and add customers and just hope we're making good credit decisions when we do that.

Brian Martin
Gotcha. Okay. And just a couple last things. On the expense side, you talked about a couple kind of unusual or kind of maybe non-recurring items in the quarter that were called out, but can you just give us an update on how the expenses trend over the balance of the year and just kind of how you're thinking about that, maybe in the context that are there additional costs coming as a result of Denver? I mean, maybe there are more additional folks who you're going to hire on the fee-based side or just any thought on how the expenses play out would be helpful.

Katie Lorenson
Sure. Thanks, Brian. Our run rate without the amortization and, again, without those non-recurring expense, excluding Denver, is at about $19.2 for the quarter, and that stays, that trends down just slightly each quarter. Our amortization helps with that, obviously too, but with adding Denver, we will see the salary expense and the occupancy kind of where it's at, I think, this quarter going forward. We do have some triggers in the salaries line item, but those are

likely second half of the year events. So I think we're forecasting to get to around the $19 million in Q4 but not a significant amount of change in the overall non-interest expense.

Brian Martin
Okay. And then just housekeeping. Your calculation, Charlie, talked about the efficiency and kind of that 60 percent threshold or target. What methodology I guess, what are you guys including or excluding from that to kind of get your target 60 percent number?

Katie Lorenson
Yeah. we exclude the amortization, and we include the tax equivalent income adjustments. And that's about the gist of it. We also exclude the non-recurring gains, which there were minimal amounts of in Q1, but that's out methodology.

Brian Martin
Okay. Fair enough. Alright. And then, let's see, maybe just the last question was more on the just the pipeline. Charlie, you talked about there was a fair amount of credits you passed on, but that the current credits out there. what's the difference or so you're seeing in the credits you've got in the pipeline versus what you passed on and just trying to understand what the biggest differences were there.

Kent Jehle
Well, Brian, this is Kent, and what I would add to that is when you say "passed on," it's ones that we didn't obtain the bid on, and that was over primarily, rate would be the main driver with that, that they would be sub-4 percent on ones that we would have been more in the 4¼ or higher range, so that 4 percent or slightly under. A little bit where we truly pass would be if the terms, i.e., higher loan to values or amortizations, just didn't fit into how we would normally look at the specific credit, but primarily the ones that we missed out on would be driven by the rate and the length of the rate being offered.

Brian Martin
Okay, and, Kent, would you consider the Denver market as competitive as what you're seeing in Iowa? they were going to be able to bring a book of business over, but the competition out there is, I guess, how would you quantify that?

Kent Jehle
Well, at this point, what we're looking at, as you alluded to, are the credits that they have strong relationships with and they're bringing over, and we're seeing those all fairly priced based on how we would view the overall market in Denver as competitive, so I think that's something that we'll get more of a handle on as we go through the transition of relationships being brought on the books and they continue their calling efforts. So it's probably a little early from my standpoint, unless there's others that would want to add to that.

Charles Funk
I think Kent said it very well. I think it's probably too early to call, but we really do like what we've seen so far.

Brian Martin
I see.

Kent Jehle
Right.

Brian Martin
Yeah, okay. Alright. And then maybe the last one, Charlie, just on the M&A front, can you give any update on how you're thinking about things? I guess are you more focused on getting your own house in order to that 60 percent level before you entertain looking at something else, or is there a — what appetite do you have from an M&A and what are the opportunities out there today?

Charles Funk
I think that well; there is an appetite for M&A. I think they would tend to be smaller deals, maybe under $600 or $700 million, and I think the beauty of our company right now in the early second quarter of 2017, is that if we don't do any M&A, I think we have a lot of potential and opportunity inside our own company as it stands now. With that said, there are some banks for sale. Some we're interested in, perhaps some we're not, but there's really nothing substantive to report on this call.

Brian Martin
Okay, and are those, I guess, would you put those in existing markets? Would they be new markets, and would they be more based off of or more targeted towards attractive funding bases, or is there any color you can provide on that?

Charles Funk
Existing markets, and there's a range, some with low loan-to-deposit ratios, some with higher loan-to-deposit ratios, but, as I said, there's certainly nothing imminent. That's for sure.

Brian Martin
Yeah. Okay. Alright. I appreciate you taking the questions. Thanks, guys.

Charles Funk
Thanks, Brian.

Kent Jehle
Thanks, Brian.

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to Charles Funk for closing remarks.

CONCLUSION

Charles Funk
Yes, thank you to all for joining us this morning, and if there are any questions that you need further clarification on, please feel free to contact any of us who are on the call this morning. Back to you, Steven. Thank you.

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