MidWestOne Financial Group Inc

Third Quarter 2014 Earnings Call

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CORPORATE PARTICIPANTS

Charles Funk - *President and Chief Executive Officer*

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

Kent Hailey - *Chief Credit Officer*

PRESENTATION

Operator
Good day and welcome to the MidWestOne Financial Group Inc. Third Quarter 2014 Earnings 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 "*" then "1" on a touchtone phone, to withdraw your question, please press "*" then "2." Please note this event is being recorded.

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

Charles Funk
Thank you Zilda, and good day to everyone. I would begin by saying that this presentation contains forward-looking statements relating to the financial condition, results of operations in 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, and among the important factors that could cause actual results to differ materially or interest rates changes in the midst of the company's business, competitive pressures, general economic conditions and the risk factors detailed in the company's periodic reports and registration statements which are filed with the SEC. MidWestOne Financial Group 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, I will begin and tell you that Gary Ortale was in here and was sitting with me, and we do have Kent Hailey from a remote location, our Chief Credit Officer, who will also be available to answer questions during the Q&A. Obviously, it was a very good quarter for our company. Last quarter, the second quarter I think, I had termed that a meat and potatoes or grinded-out quarter. I think this time it was a little bit different, we didn't get there exactly in a traditional way, but nevertheless we are happy with the results.

Our balance sheet growth came from some large deposits, we just had some seasonal things that happened, probably the most unusual was we had one deposit which was, I think, $12 million or $13 million, that came in on September 30, and then left the bank on October 1, that's the extreme example. There were some other seasonality in the deposits, but nevertheless, we are very happy that we have got our earnings assets moving in the right direction. And I think some of the other seasonal deposits could easily stay on the balance sheet for the next three, four five months.

Loan growth, I think, finally, at quarter end we got to September 1 and we were wondering where the loan growth was, but September was a good month for loan growth. We are still waiting to be paid off on a credit that we talked about on the last earnings call, and it's roughly $5 million. And as I indicated, we don't necessarily mind that credit leaving the bank, so we expect that to be a reduction in the fourth quarter. Nevertheless, we do have what we think is a pretty good pipeline, if we can get things closed in the fourth quarter. So we are optimistic that the loan growth can continue through year end.

We made a comment or two about the agricultural portfolio in the earnings release and Kent certainly can answer specific questions. I think the only thing I would say is that we are not overly concerned, but our antennas are up and we are monitoring the situation with our borrowers, primarily due to the reduction in the price of soybeans and corn. And in a perverse sort of way, it probably means that AG lines may not pay off fully, or may not pay off as quickly perhaps, as they would have been in prior years, which were very good years in the AG sector.

Overall, if you look at lending in our footprint, pricing remains very, very tough. I am not so sure that we've seen a lot of credit quality concessions on the part of our competitors during the past quarter, but pricing is, I think it is everywhere. I just returned from the ABA convention and it was a prime topic of conversation among bankers at the ABA convention.

I would be remiss if I didn't once again acknowledge the fine contribution that our investment portfolio makes to our margin, and would share with you that we have one of our fixed income vendors evaluate our portfolio over the past couple of weeks. And one of the things that they came back and told us was that they calculated that the yield on our portfolio is 216 basis points over the interpolated 3.8 year treasury. And we think that the average life of our portfolio right now is roughly 3.8 years. They deem that to be excellent, one of the best they have seen, but I think more importantly, they talked about that the price volatility that we have in our portfolio was also deemed to be very, very good.

So, I think we've done a pretty good job at MidWestOne in terms of taking what we can get from the bond markets, but still we understand that interest rate risk remains important. And we think that interest rate risk remains in good shape in terms of our balance sheet. So I can't emphasize enough the importance that the investment portfolio has made in terms of our good results.

In terms of non-interest income, I think that it's fair to say wealth management continues to contribute at all levels, that would be insurance, investment services and the trust department. We did have a negative event, it was a positive event for earnings, but it was an overwhelmingly negative event in our company, our largest-sales person, our best sales person in our trust department died suddenly, died in his sleep in August. And so, you see the increased bully income, and that's what that's from, but it was a terrific loss for our company. We have just announced a hire to succeed this person, but it leaves a hole in our hearts and things like that, I don't think you ever get used to.

Elsewhere on non-interest income, fee income collection continues to be good, and that's the results of efforts that were undertaken in the fourth quarter last year and the first quarter of this year. And we continue to see improvement in our fee income collection. The only way to talk about our home mortgage area would be to say that we continue to struggle there in some of our markets. We are aware that we are struggling to build volume, and I think part of that would reflect on us and the need for us to do better, and part of it would reflect the fact that while the market is okay, it's certainly not robust by any stretch of imagination.

Moving on, there's probably a little bit of non-recurring expense in quarter three and there may be a little bit in quarter four. And that may elevate the run rate a little bit in a short time, but I don't know that that's a longer term consideration whenever we look at non-interest expense. So overall, I think the quarter run rate is okay.

Asset quality is fine. I think when we look at this first as our peers, we continue to stack up well, and knock on wood when I say this, but I think the best thing that has happened on asset quality is that our negative surprises have been relatively small surprises. So, we think that our reserve is adequate, we more than cover our non-performers and the raw number seems to be very, very good.

Same story on capital as in prior quarters, I think it's fair to say that we think we have lots of flexibility. We will reevaluate the dividend in January, as we do every year in January. We will continue to repurchase the stock when we think it makes sense, and when we are able to. And in terms of M&A, there continues to be some dialogue, but I think if you look around the State of Iowa, that at least from what we can tell in our footprints, there are not a lot of banks that are for sale, nor are they even considering sale.

I think going forward, and I'll open it up to questions after this comment, but I think going forward, the lower interest rates, I think have hurt many of us in our industry, and I think going forward it probably has somewhat of a negative effect on our margin. We've held up a little bit better than I would have thought. Looking back eighteen months, if you would have said eighteen months ago that our margin would be what it was the last quarter, I wouldn't have believed you. But while we were pessimistic then, I think we performed pretty well, but going forward, it may be a little bit of a tougher slog.

The higher level of earning assets probably comes at the expense of a smaller margin, or a lower margin, but also hopefully more net interest income, that's the idea there to leverage our capital a little bit. But going forward, I think this was a particularly good quarter due to the bully had a big effect on maybe exceeding our internal expectations. But I think we are setup okay for the fourth quarter and we just need to continue to grow loans and core deposits. And I also think that we will benefit in 2015 from getting some of these things that we haven't been doing and our home mortgage center figured out, so that the home mortgage center can begin to make a bigger contribution to our bottom line.

And with that, I will end my comments and turn it over to our moderator Zilda for questions.

QUESTION AND ANSWER

Operator
Thank you, sir. We will now begin the question and answer session. To ask a question, you may press "*" and then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble our roster.

And the first question comes from Andrew Liesch from Sandler O'Neill. Please go ahead.

Andrew Liesch
Hi, guys.

Charles Funk
Good morning.

Andrew Liesch
I just want to take a look at securities portfolio, it looks like you added about $18 million there, just curious, is there a level that you'd like to run that at, just how and then, what did you add, what sorts of yields were you adding there?

Charles Funk
I can't speak specifically, but I can tell you it was mostly relatively short-term types of investments. I know there was one large agency purchase that was slightly below 1%, and I haven't seen many purchases at that yield level for a while. But I will also tell you, Andrew, that most of the purchases were done before the recent drop in interest rates and we've been sitting out, other than maybe a few municipal bond purchases, we've been sitting out at these new low levels, so most of that came in August and maybe the first part of September. I don't have an average yield for you, but certainly what was purchased was lower than the average yield on the portfolio, which will probably cause that to come down a little bit.

Andrew Liesch
Okay. And then just the margin in general, just curious were you thinking it can go from here, obviously the pools can have it vary from one quarter to the next, but what do you think on new loan pricing, and do you think that just if you can shift the earning asset mix maybe you could have a better margin?

Charles Funk
That's hard to say. I don't know that I'd look for much expansion in the margin. Loan pricing, the stuff that we see, the typical deal where you might fix a rate for five years, that's been done maybe at depending on the customer, 3.3/4%,4%, 4.25%, perhaps, on some of the smaller deals, variable rate to be a little bit lower than those levels, depending on size. So I would say that what you see in this report is probably indicative of the fourth quarter, maybe down a little bit, but I don't know if there is a large change, I don't know Gary, you want to comment on that?

Gary Ortale
I would only comment on it from a yield perspective, Andrew. And as I am looking at the quarter yields for the loan portfolio, you know, it's been coming down a couple of basis points per quarter. So I've seen all these and with the current pricing for that not to continue. Charlie mentioned the bond yields, and we are seeing a similar trend there, and that if you go back and look quarter-to-quarter-to-quarter, then you will see at least a 5 basis points drop there.

The other thing that's certainly impacted is the pools, and while we had an okay quarter this year, maybe not quite as bad as the other, the same quarter a year ago, year-to-date, we are running probably twice as well as we had anticipated we would run on that loan pool. So they certainly are a factor in that yield, but I would expect that we will continue to see that earning asset and yield come down a few basis points. The key to me is going to be the cost side because, as Charlie indicated, you will see that the margin yield quarter-to-quarter did drop 13 basis points. A lot of that had to do with those temporary funds that came in this past quarter, they were probably a little on the expensive side. But as that runs out, we should see that cost come down again.

Andrew Liesch
Okay.

Charles Funk
Andrew, I would just say one thing on that to reiterate your point on the pools, they are so volatile and during this quarter, July was a horrible month, August was not much better and September was a big month. And so it came out okay for the quarter, but it's certainly not consistent, and we just don't know from quarter-to-quarter or even month-to-month how that's going to play out.

Andrew Liesch
Got you. Okay. That's very helpful, thank you.

Charles Funk
Thank you.

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

Daniel Cardenas
Good morning, guys.

Charles Funk
Good morning, Dan.

Daniel Cardenas
Sorry, I missed your comment; what impact does the inflow of deposits have on the margin this quarter?

Charles Funk
Yes, I would guess there is probably at least 3 to 4 basis point impact from those. We had about $50 million to $60 million worth of seasonal deposits come in. We probably paid a little bit to get those in here, but I would say it was in that 3 to 4 basis point range, Dan.

Daniel Cardenas
So do you think you can recoup that in 4Q, I know, Charlie, you said around $12 million or $13 million came in one day and left the next?

Charles Funk
Yes, I think the bulk of those will probably be here through the fourth quarter and into the early part of next year, Dan.

Gary Ortale
Yes, and probably out sometime before income tax day.

Daniel Cardenas
Okay. And then kind of looking at the AG portfolio, it sounds like maybe a little heightened sense of awareness about the portfolio. What are land values looking like right now, have they moderated from peak levels and if so, how much?

Charles Funk
The answer on your last question is yes, and I'll let Kent take the rest of that.

Kent Jehle
Yes, thanks Dan. On the AG side, we are really in the full swing of the harvest season and the actual production is coming in at traditional levels, actually a little above. So what we are focused on is the marketing side, i.e. what are they are selling their crops for, what do they have they have locked in. We've had some early visits with our clients and we will continue to do so with their availability, but our plan is being proactive with our customer to get a handle on those that, because of the prices of corn and beans, may have trouble meeting all of their obligations

and have a bit of carryover. And also part of that on the marketing side is, we work with them and should be working with them on to carry the grain, and Charlie alluded to our loan volumes. We may be carrying a little additional loan volume in the next year, just because of that, if they don't sell their grain into the spring or summer of next year. So the key from our perspective, as I said, is being proactive and getting in front of our customers and finding out where they sit with pricing their production this year, and then how we set the stage for next year.

Daniel Cardenas
Okay, but the concern really isn't so much that you are perhaps allocating additional reserves to the portfolio?

Kent Jehle
Not at this point. We've got less than a handful of clients that we've identified that may not be able to make their annual term payments. The good news is, as you know, the last three years have been very strong. There has been lot liquidity provided which means they haven't borrowed much money, i.e. on buying equipment, and put a sizable amount of cash down on land. So that's going to create opportunity to work with the clients as we move forward, but again, we want to have those identified that may have some additional risk that we want to work through with them.

Charles Funk
And I would tag on, Dan, that we think we've been proactive and trying to get out ahead of this because many of these borrowers look to their bankers to provide good solid financial advice, and we've just encouraged all of our commercial bank and AG bankers to be proactive and contacting our customers. Normally, we will be having these meetings in January and February, but if they have time and they are not in the field, we just want to be out ahead of the game. So I would think on the next call we'd have a lot more concrete information, but it's a little early to give you specifics now.

Daniel Cardenas
Okay, fair enough. And then on the loan pipeline, you said that's looking good, comparable to what it looked like a quarter ago?

Charles Funk
Look…..

Kent Jehle
Can I jump back in again, Dan, this is Kent. Two areas, one, in the third quarter we dig it a lift from our AG lines. Traditionally we have a strong funding and we saw only $4 million additional funding out of AG lines. We will see a little more of that in the fourth quarter, maybe half of that amount from that area. And then, yes, the actual pipeline of new production would be comparable to what we saw in the third quarter, barring the pay down that Charlie alluded to, we would anticipate a typical growth level that you saw in the third quarter.

Daniel Cardenas
Okay. And how is the line utilization looking like right now? Has that picked up?

Kent Jehle
Yes, on the AG lines, as I said, it was roughly about $4 million increase on the AG side, and we would anticipate as they wrap up year, that could increase to about half of that amount.

Daniel Cardenas
Okay. And then in terms of competition, what are you seeing, is it still very intense and are you seeing the bigger players coming to the market?

Kent Jehle
Bigger players, primarily the large credit union we deal with, is real aggressive on the commercial real estate side. And that's where we see the most competition, other larger community banks as well. If it comes down to price, typically they may be in that 3.5% range on a commercial real estate five year loan. And as Charlie alluded to, we are in that 4%, plus or minus, so we take each opportunity and look at it, and depending on the relationship will determine where we are going to be priced at, but yes, that does have a effect on the volumes as it has in the past.

Daniel Cardenas
Okay. Are you seeing any give on the structural side?

Charles Funk
No, not particularly on the structure, maybe more, if anything, on the amortization side with that and we take a hard look at that, we are seeing 25 year or plus on commercial real estate with some of our competitors on an amortization.

Daniel Cardenas
Okay, right. I'll step back. Thanks guys.

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

Matt Petkun
Hi, good morning. This is actually Matt in for Jeff.

Charles Funk
Good morning, Matt.

Kent Jehle
Hi, Matt.

Matt Petkun
Hi, I may have missed it, but the…you said there was a little bit of non-recurring expense in this quarter. I was wondering if you could quantify that?

Kent Jehle
A little bit, yes, if you recall, and Charlie made a reference to the service charge income coming in considerably higher due to some efforts that really began towards the end of last year and early part of this year. And we will really be getting to see the service charge income pick up as a result of those efforts. Obviously, there was a cost associated with that, and most of that cost was borne in this third quarter.

Charles Funk
I had also said there is a little more legal expense, and there may be some in the fourth quarter, but it's just in the ebb and flow of commercial banking.

Matt Petkun
Sure, okay. And then one more, the growth that you are seeing on the loans by geography, is it pretty broad-based or where they are coming from?

Charles Funk
No, I think, just as it has been for most of this year, that most of our loan growth, not all, but most of our loan growth is coming from the Iowa City market and from the Cedar Falls-Waterloo market. And then also, there is one loan in the pipeline that's a nice size, if we can get it closed, and there was another loan that was consummated, that was a nice size, they were bank stock loans and they are one in our footprint and one slightly out of our footprint, but we know the bank pretty well. So that gives us a nice lift as well, but most of it, to answer your question specifically, Iowa City and Cedar Falls-Waterloo.

Matt Petkun
Got it, okay. My other questions have been answered, thank you, guys.

Charles Funk
Yes, thank you.

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

Brian Martin
Hi, guys.

Charles Funk
Hello, Brian.

Kent Jehle
Hi, Brian.

Brian Martin
Hey Charlie, it seems you are a little bit less optimistic on M&A, is that the read or am I reading too much into that by your commentary?

Charles Funk
No, I'd say my comments and mood about that would tend to be parallel with prior quarters, which is that if you compare with a year ago, it's certainly is more discussion and conversation, but nothing we are going to announce today, let's put it that way, or nothing eminent.

Brian Martin
Okay. And so nothing in the near-term, and okay, and then back to that expense question, the kind of the non-recurring piece that was this quarter. Is that something that technology was kind of one and done, or is it systemic, where it's adding personnel, or is it is going to continue going forward?

Charles Funk
It's not adding personnel. It's totally related to the service charge and revenue generation process that we went through. The other thing I would mention, if I recall correctly, as well that I didn't mention earlier, I think there was a higher level of OREO related expenses this time and maybe even an OREO write down in this particular quarter that was maybe a little larger than normal.

Brian Martin
Okay, perfect. And then just maybe think about the balance sheet perspective, which are the earning asset and the loan growth, is it fair to think that the earning asset growth lags loan growth going forward, or is that more parallel with that, how are you thinking about the growth in this kind of bond portfolio in general?

Charles Funk
The realistic answer is that loan growth might be a little bit better than earning asset growth and that over the next 6 to 12 months, I would think loan growth might be somewhat faster than deposit growth, so it could be funded easily out of maturing investments. But if we get deposit growth and it's solid core deposit growth that we don't have the loan demand to support it, it will eventually get reinvested into the investment portfolio. I've heard a lot of CEOs comment, and talked to a number of CEOs who've held large fed funds balances, waiting for interest rates to go up. And I just think the opportunity cost is too great to do that. So we've tried to manage that and always keep in mind what our interest rate risk is, our risk profile and that to the extent that it fits to our risk profile, we are going to buy bonds.

Brian Martin
Okay. The margin decline in the quarter, you talked about some of the liquidity, it seems like the bond portfolio, that was also down in the quarter, is that accurate, on the yields and the bonds during the quarter?

Charles Funk
Yes.

Kent Jehle
Yes.

Brian Martin
Okay. Last question, Charlie, more a big picture question. But the focus, it seems like the last couple of quarters, was on getting those deposits moving in the right direction, which you guys have done. As you sit and look at the budgeting process in '15, what's the big focus as you look at '15? My sense is that some of it's obviously the mortgage part you talked about, but anything beyond that that you can point to as, where you guys are focused on improving or getting better or increasing?

Charles Funk
Well, that's a great question, Brian, and I'll try to give you a succinct answer. Some of it would be expected, we want to see 4% to 6% loan growth. We think the economy supports that in our footprint. We are probably not going to do much better than that, because of our underwriting standards. We'd like to see better core deposit growth, a lot of this deposit growth are large deposits, and they are not permanent deposits, and we just need to do a better job of core deposit growth.

Having said that, it's very, very difficult in our footprint, given the large credit unions that we have and all you have to do is look at the State of Iowa, where their growth rate is six times the growth rate of commercial banks for deposits. But we have not done a good job on the treasury management side, but I still think we've got the infrastructure, and I think that will bear some fruit in 2015 and that will be commercial deposits. So that's where the deposit growth should come from.

We have an opportunity, as I said in my comments, on non-interest income and our home mortgage center. And we are in the process of building a better home mortgage center. And then, we already have a good efficiency ratio, but I really think that we are going to have to focus on efficiency and trimming a little bit around the edges, so that we are able to fund technology expenditures.

One of the things that our industry is facing is that you really have to be faster on the adoption of technology than you did 10 years ago, just because our society trends that way and younger customers, especially, want that now, and we can't take four years to develop things. We have to develop them in 6 to 12 months, so when the Wells Fargos and the US Banks come out with something, we need to be quickly behind them, and we probably need to pay for that through some increasing efficiency, and we don't have all that figured out by the way, but those are conversations that we need to have. And if we can do that successfully then it really cements our future as a viable and leading community bank in Iowa and hopefully, eventually, elsewhere. So I hope I've answered your question.

Brian Martin
Yes, no that's helpful, I appreciate it. Okay, thanks very much.

Charles Funk
Yes, thank you Brian.

Operator
Once again, if you have a question, please press "*" then "1." The next question comes from Daniel Cardenas from Raymond James. Please go ahead.

Daniel Cardenas
Hey guys, just a quick housekeeping question, what's left in your buyback program right now?

Charles Funk
I think $3.8 million, perhaps.

Kent Jehle
Yes, I think that's about right, Dan.

Daniel Cardenas
All right. Thanks.

Operator
This concludes our question and answer session. I would like now to turn the conference back over to Mr. Charles Funk for any closing remarks. Please go ahead.

CONCLUSION
Charles Funk
Thank you for joining us on the call this morning. As always, if you have further questions, please call me or please call Gary. We are always happy to talk to you, and Zilda, I will give it back to you. Good day, everyone.

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