MidWestOne Financial Group, Inc.

Fourth Quarter 2017 Earnings

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CORPORATE PARTICIPANTS

Charles Funk - *President and CEO*

Kent Jehle - *Chief Credit Officer*

James Cantrell - *Chief Investment Officer, interim CFO*

Kevin Kramer - *Chief Operating Officer*

PRESENTATION

Operator
Good morning and welcome to the MidWestOne Fourth Quarter 2017 Earnings conference call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your telephone keypad. 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, sir.

Charles Funk
Thank you very much, Chad, and good morning or good afternoon to everyone and thank you for joining us on the call. Let me begin with reminding you that this presentation contains forward-looking statements related 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 rate changes in the mix of the company's business, competitive pressures, general economic conditions and the risk factors detailed in the company's periodic reports and registration statements 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. Thank you again for joining us and let's begin straight away with credit, which was the big story of this past quarter, and I just have to simply say that we have no excuses to account for the two loans that created our credit surprises in the third and fourth quarters.

We know shareholders have high expectations and our expectations internally are even higher. I think the important thing here is how we react to what has happened, and we are certainly focused on the road ahead of us. As such, we have already instituted a number of changes to our credit administration process, and I really think these changes will make a repeat performance much, much less likely in the future.

I think it's very important to learn from one's mistakes, and I assure everyone we have learned, but the proof will be in the execution the next few quarters, and I'm very optimistic that we will put this behind us. In regard to the large Iowa Credit that resulted in the preannouncement that we issued just before Christmas, let me give you a brief update. We think that by the end of the second quarter, there will be resolution to this credit or there will be foreclosure.

We think we're properly marked at this time, and one of the things we probably should have indicated this in the release, but didn't, the $5 million increase in the non-accrual loans came from putting their line of credit on non-accrual. Again, in retrospect, I wish we would have announced that in the fourth quarter, but we didn't.

We also have, if you look at a non-performing section, we have a $3 million TDR that's in one of our Iowa communities, and quite frankly this TDR does not cause us undue concern, and we think that it's more than likely that once they "Get out of TDR jail," that they will be back in a performing status within a year, certainly.

We don't see any undue concern on this credit, but because of the accounting rules, it is classified as a TDR. We are well into the renewal season for ag borrowers. I would say we're beyond the 50% mark for renewals, and I think the headline on that is not really much different than what I've been saying for the past six months and that is I think we will be adding to our reserves, but we don't expect significant charge-offs in our ag portfolio.

Collateral margins remain decent on most credits, and I will give you some numbers. The first number I would give you is that if you look at the entire agricultural portfolio, which is roughly 10% of our loans, 15% are in the watch category, 5% are in substandard. 20% of the entire ag portfolio is rated either watch or substandard.

If you look at the entire portfolio for the whole bank, 30% of our watch credits are ag, 15% of the substandard credits are ag and so you can see that it only represents 10% of our portfolio, but they do have elevated credit issues. We don't expect a lot of charge offs. Most borrowers are being very cooperative, and I can tell you that when you have difficult economic situations, if the borrowers are cooperative, that is a huge positive.

People ask about land prices, and the most recent data we have for land prices in Iowa for the whole state is that land prices were up about 3% over the past 12 months. My personal opinion on land prices is that ultimately they follow interest rates, I think land prices, if we did see a sharp increase, especially in intermediate and long-term interest rates, that would affect land prices in a negative way, but so far very, very stable land prices.

If you look at our footprint, the toughest ag conditions are in southern Iowa. Southern Iowa only represents 5% of our ag portfolio, which is another way of saying that 95% of our ag portfolio saw pretty good conditions this year in terms of yield. The headline is that we are going to be adding to our reserves because we're increasing watch and substandard loans in our ag portfolio, but we continue to not expect large chargeoffs in that portfolio.

For those who might be wondering, we have about $5 million in our budget for the provision for 2018, and we think that will cover charge-offs and loan growth in our loan portfolio. As I have said many times inside the walls of MidWestOne, that this is my 38th year in banking, and when you have credit issues in your company, it dwarfs everything else, but I think it is important to say and to recognize that we had a lot of positive things happen in our company in 2017.

Let me review both the fourth quarter and 2017 from that perspective. Our topline revenue growth was just over 4-1/2%, and that came despite a drop in mortgages. We're very pleased with our mortgage area, but as most people realize, It was a down year for mortgage due to lesser refinance activity.

Loan growth for the year up just over 5-1/2%. That's the best loan growth we've had in a long time. In the fourth quarter, it was much like the second quarter. Much of the loan growth came in the last 15 days of the calendar year, the quarter averages won't reflect the strong performances we had, and we--I checked this morning and we are right at $2.3 billion in loans right now.

We've continued to see an increase into the new year. In terms of specific geographies, and this is in no particular order, just how I wrote it down, Denver ended the year with $48-1/2 million. Almost all of that is in C&I loans. Florida had very, very good growth. They're up to $148 million as of year-end, and their loan portfolio, they had strong commercial real estate growth especially. More than $60 million of growth from the Twin Cities market, and that includes Western Wisconsin.

The Iowa footprint was down modestly in terms of its loan totals during the year, and it all added up to 5.6%, which we're very pleased about. Deposits, we've got some seasonal inflows, but also some strong successes during the fourth quarter, up 5% for the year. Most offices in the footprints showed increases in deposits. Iowa city very, very strong.

One of the things that might be a little surprising is that rural Iowa and western Wisconsin, which tends to be a little more rural, had very, very strong deposit performance. The Twin Cities footprint, and I'm aggregating here, looked to be right around 5%, and I think there's even more potential, but very good performance from the Twin Cities footprint, and our Florida operations are now over $100 million in deposits, and they were right around 80 when we announced our merger, they've continued to see nice deposit growth in Florida.

I will say that we've had some seasonal outflow since year-end. We're down about $30 million in deposits, and most of that is entirely due to seasonality. Wealth management, strong year, up 11 % in topline revenues. Our insurance agency is the smallest component of the wealth management. They had a one-time item or two in 2017, they probably will not repeat their very strong performance.

Trusts and investment services are the bulk of our wealth management, and we think that they will continue to see nice growth into 2018. I do think that to get above average growth in this area is going to depend on hiring new producers, and I'll talk a little bit more about that toward the end of this call.

A few comments about the home mortgage center. I've talked about our inability in the past to execute in this area of our bank, very, very good progress. To give you one example of the progress, six months ago we were taking more than two months to close our one to four family loans. We're down to under 50 days now, and on our way to a goal of between 40 and 45 days to close one to four family.

We've shown an ability to attract producers to our company good producers who are team players. We are, targeting Florida to add a producer to, and in the next 90 days we'll be successful in that endeavor, and we continue to build our servicing portfolio. Our servicing portfolio ended the year at $288 million, which is up from about 250 million around a year ago.

In terms of expenses, expenses have jumped around a little bit. We did accelerate some expenses into the fourth quarter due to the tax bill, and just in round terms, I would say that accounted for about a penny a share in terms of accelerating expenses. Our expense run rate looks a little higher from the third quarter to the fourth quarter.

What I just talked about would be one reason, but also we had a one-time reversal in expenses in the other expense category of quarter three that makes quarter four look a little higher in other expenses, but the quarter four run rate is probably closer to the true run rate.

In terms of efficiency ratio, I think it's fair to say that our efficiency ratio went up a little bit, and we could see that rise a little bit in 2018. Some of that depends on the net interest margin, but I think our expense control is good. What we found going through the budget process is that we do have a commitment to fintech, but fintech is expensive, and I'll talk a little bit more about that in a minute, but we know we have to invest in our future, and fintech is, we think, a big part of our future.

Also, a few random notes, the hiring of David Lindstrom, which was publicized. But David came on and was working as the Minneapolis president, west Minneapolis president for a large banking company in the Twin Cities.

David is senior vice president and head of our retail banking operation. He's been here a couple of weeks. He's been very warmly and well-received throughout the company, and we think David will be a key part of above-average revenue generation going forward.

We do have an active CFO search underway. There's been a lot of interest in that, and I have every confidence that within the next 90 days, we should be able to announce a very, very good and qualified candidate to come onboard, but again we've been very pleased with the caliber of candidates we've seen.

In terms of capital, we sit in a good place on capital. The dividend increase, reflects the board's competence and management's competence in our future and specifically 2018 prospects.

As far as 2018, we expect loan growth to be 5-6%. It's going to be driven by the same players that have driven loan growth in the past. Denver, southwest Florida, the Twin Cities and we think that Iowa City will have a much better performance in terms of 2018 loan growth than was the case in 2017.

I would use the same targets for deposit growth, and I think one of the things that's very critical is that we have buy-in throughout our footprint in terms of the importance of deposits, and especially in 2018, because in 2018, we think that deposits are going to be ever tougher to acquire as bank loan-to-deposit ratios continue to go up.

People are going to ask about the beta, and I just put question marks after the beta. I can say that we are paying market rates for larger amounts of money now and we've negotiated those rates with a fair amount of customers, and I think that that would not be inconsistent with others within our industry. I think we are close in our company to showing some increases in some of our core rates.

We're not quite there yet, but we're closer, all of that comes down to a conclusion that we are somewhat cautious on the margin, and that is entirely due to the fact we think the time is almost at hand to start moving some of our core rates. One thing that we are actively looking for, proven revenue generators, not just in the bank, but in our mortgage area, as I said before, and also in our wealth management area.

Acquisitions, we had a number of discussions in the later part of 2017. We did jointly walk away from one opportunity late in the year. Things seemed to slow down over Christmas and into January, but we do think that there will be some more discussions as we go forward into 2018. Certainly nothing is imminent.

And we also have a few wealth management opportunities--not large, but small--that we will be exploring as we speak, really. And I do think that in our wealth management area, we're going to have to bring on more producers to continue to show above-average revenue growth.

I'd like to end my portion of the comments by talking a little bit about the tax cut. We think that about one half of the benefit of the tax cut will flow to our bottom line. We did make an increased contribution in our company to the MidWestOne Foundation as our gesture of a way to give back to our communities.

We did put another $500,000 into our fintech initiatives. Like I said, we went through the budget process and had to cut a few things out, we restored that as a way to invest in our future with increased fintech spending. We just have a predisposition that capitalism is going to work its wonders and that we're going to see increased pressure for loans and deposits as folks have lower marginal tax rates that will extend into the personnel area as well, especially with top-performing employees.

we're very, very cautious, and we've made some assumptions relative to margin and personnel expense, but overall we think that about half of the tax cut, roughly $2 million, will come to the bottom line. It could be better than that. Could be slightly worse, but we'll have to see how the year goes.

I will return to where I started. We recognize that our credit performance has to improve, and I truly believe that it will. 2017 had a lot of things go right, but credit dwarfed many of those good things. It's important to recognize many of the positive things that went on that set us up for good performance in the future.

Chad, with that, I will send it back to you. I did not say who was in the room, but we have Jim Cantrell, our Chief Investment Officer and interim CFO, Kevin Kramer, our Chief Operating officer and Ken Jehle, our Chief Credit Officer, and we would be happy to take any questions you might have.

QUESTION AND ANSWER

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

The first question will come from Jeff Rulis with DA Davidson. Please go ahead.

Jeff Rulis
Good morning. I guess Charlie, I want to follow up with your comment on the provision expectations for '18. Is that 1.2 or 1.3 million quarterly or 5 million annually? Is that kind of what you had mentioned?

Charles Funk
Five million annually, 1.25 million per quarter.

Jeff Rulis
Got it. Great. Then on, your margin outlook, Charlie, you mentioned some cautiousness, and particularly we could be looking at the funding side. Maybe the outlook on margin, just a little more detail about the balance of the year, what you think you'll see.

Charles Funk

We're going to have less accretion come into the margins, which is a part of that, but I'll let Jim Cantrell take the bulk of this one, Jeff.

James Cantrell
Yeah, there are a couple things right off the bat that I would mention on the margin. Next year, some of which are not really operating. Because of the lower tax rate, and we do have some tax-exempt income, we think that alone, because margin is calculated on an FTE basis, that alone is going to cause us to lose about six basis points on the margin.

Charlie mentioned the purchase accounting. We do have loans on the books at a discount. We will see a reduction in the purchase accounting accretion of about 1.8 million. that's not insignificant--those are kind of two significant headwinds that we have on the margin. Otherwise, I look at loan yields. We had a slight down-tick in the fourth quarter for loan yields, a little unusual.

We did get a Fed increase here in December. Not all of that, obviously a very small percentage of that got into the income statement in the fourth quarter. I had expected a little bump because of that in the first quarter of '18. But as Charlie alluded to, it just feels like we saw a little bit off an acceleration in our cost of funds. We are doing some exception pricing. We're probably pricing some of the larger deposits at a higher rate.

We did increase the rate on one of our sweep repo product, which is a product that's available to large depositors. There's 40 basis points that came in right at the end of the quarter that'll flow through now into the first quarter. There's a couple items right there that give me some pause.

Those are the reasons we feel like we're a little cautious on the margin.

Jeff Rulis
Jim, if I could follow up, what was the accretion benefit by basis point this quarter versus last?

James Cantrell
Accretion in the fourth quarter was worth, on the loan balance--not on the margin--on the loan balance, the accretion was about 19 basis points this quarter. 23 basis points, and we saw a reduction of about $115,000, translates into, on an annualized basis, roughly--what'd I say, four basis points in loan yields, less than that on the margin.

Jeff Rulis
Okay. fair enough. And maybe one last one, just the effective tax rate expectation for '18.

James Cantrell
Yeah. I thought I might get this question. Prior to the tax reform, our marginal tax rate, effective tax rate, was in the low 30s, 31. Now the 21% marginal tax rate, our all-in, state and local marginal tax rate is going to be right around 21% when all is said and done as we move forward.

The one thing that might affect that going forward, we are finding tax exempt assets, municipals, less attractive. We may, over the course of the year and several years, decrease the amount off tax-exempt income we have, which might raise that rate a little bit over time, but that's a real slow process.

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

Andrew Liesch
Hey, everyone. Charlie, your comments related to loan growth, beyond just seeing what the balance is here just today at 2.3 billion, what else are you seeing in your markets to give you that optimism for loan growth going forward?

Charles Funk
I'll let Kevin Kramer amplify if I leave anything out, but there continues to be very, very good activity out of our Denver office. We've got a couple of nice opportunities that may not have been approved yet in Florida that are coming on board, and quite frankly the Twin Cities market looks pretty good, and I think there will be some activity in Iowa, specifically Iowa City, over the first six months that might help. I don't know, Kevin, if you want to add to that.

Kevin Kramer
No, I think, Charlie, for the most part you did hit it on the head. We do expect Iowa City to have a stronger year in 2018 than they did in 2017 in terms of new production. We'll have a full year run-rate in Denver, and we did notice, in Florida, that we did see, especially in the second half of the year, much better pipelines, stronger pipelines going into 2018, so that's been stronger.

Minneapolis, the Twin Cities, we've done a little bit of restructuring to put the leadership, the bankers in the right structure going forward, we believe just a few structure changes in that market will help us. They had a strong year in 2017. We expect that strike to continue in 2018.

Charles Funk
And I would add, Andrew, that we did finally, after almost a year, we were able to find what we think is a very good SBA lender in our Denver market. When we went to Denver, we thought that SBA would be one of our good opportunities, and it took us a while to find the right person, but that that has a lot of potential as well.

So you add all that up, and as long as the economy stays good, we probably could do this.

Andrew Liesch
Okay. And this all sounds positive. Last year, loan growth was 5-6%, right in the middle there. Like you said, with Denver on for the full year, Florida is doing well, Minnesota has got opportunities to do better or to be more streamlined. Iowa is doing well. Why wouldn't you expect growth to be even better than last year?

Charles Funk
Well you still have to look at the fact that roughly 35% of our footprint is in a--has challenged economic conditions, and you may see a little bit of runoff in those communities. You may not, either, but that's not our hope. It would reflect some cautiousness on our part, but we feel pretty good about being able to deliver 5-6%. Your question is well-taken, and it's a good one, however.

Andrew Liesch
Okay. Just with the $500,000 for the fintech initiatives. Is that going to just be bled in over the course of this year or is it going to be up front? Just curious how that's going to hit the expense base.

Charles Funk
Let me just say we're contributing more than 500,000. We threw an extra 500,000 in, but I would say you could probably just level that out over the year. I was very clear with our head of IT and who's leading the fintech initiative. Don't spend all this money in the first quarter, and he won't. I would say equally disbursed over the year.

Andrew Liesch
Okay, very good. Thanks so much.

Operator
The next question will come from Damon DelMonte with KBW. Please go ahead.

Damon DelMonte
Just to follow up on that last question by Andrew, with regards to the fintech spending and kind of how that plays into the overall expense base, could you give some parameters around what you'd expect for our quarterly run rate during '18?

James Cantrell
Okay, this is Jim. I've been looking at where we wound up in the fourth quarter in terms of both non-interest income and on the expense side. Just total line numbers, I'm looking at probably a small improvement over fourth quarter run rate. I'm looking at total non-interest expense here.

Some of the line items will shift around a little bit. As Charlie mentioned, the fourth quarter is probably a better representation of our run rate than the third quarter where we had some run time friendly events that kind of dominated the income statement.

That's not real specific as to where the fintech spending is going to be, but it's a little guidance on overall expense level of the company.

Charles Funk
Yeah, and don't forget we do have salary increases in the first quarter, you get a little bit of a bump for that. We should be in the 3% range, give or take, for salaries and benefits in terms of an increase.

Damon DelMonte
Okay, the additional fintech spending would be about a half a million spread out throughout the year?

Charles Funk
I would look at the fourth quarter and say the run rate may be around there, maybe even a little better including the fintech. I wouldn't add that to your model. I wouldn't add necessarily the 500,000 for the year to the model. I'd look at the fourth quarter and I'd say we'd maybe incorporate the 500 and be flat, maybe possibly even do a little bit better than the fourth quarter of '17.

Damon DelMonte
Okay, if you had that 20.1 million in the fourth quarter and then you have a roughly 3% increase in salaries and then you have the fintech coming in at some point, do you have other expense initiatives or something in the background that could be offsetting that growth?

Charles Funk

We do, there are some offsets elsewhere. We have a benefits offset to some of that, and so, what I'm giving you is a total, all-out number, and there are some moving parts, without getting into too much detail. We do have some offsets to the salary increases. We may be down in a number of people, even though everybody who's here is going to get an on-average, 3% increase. The bottom-line number, we feel pretty good about not moving up from fourth quarter levels.

Damon DelMonte
Fair enough. That's really good color, thank you. With regards to the provisioning, Charlie, you had mentioned that you're probably going to have to allocate some more dollars to the ag component of your reserve, which obviously would come into the way of provisioning. Is that included in the $5 million guidance for the year or is that in addition to that?

Charles Funk
No, that's included. We anticipated that.

Damon DelMonte
Okay. Great. And then just my last question, you touched on this in your commentary on M&A. You talk about maybe adding some depth to your wealth management platform, and you've talked about hiring some folks. Are you open to doing a business acquisition, or is it more about just acquiring individual talent?

Charles Funk
Both.

Damon DelMonte
Both. Okay. All right, that's all that I had for now. Thanks a lot. Appreciate it.

Operator
The next question will be from Nathan Race off Piper Jaffary. Please go ahead.

Nathan Race
I wanted to continue on the discussion around loan growth for 2018, and Charlie I appreciate all your comments around the softness in the ag space, which is really driving some other kind of tepidness within those regions. But just curious, is the softness that you see in ag, is that mainly driving your concern in terms of loan growth for 2018? And just any expectations for overall ag growth this year, as you continue to work with some borrowers that could be somewhat stressed in the current environment?

Charles Funk
Probably the most realistic scenario is flat. There are a few business development efforts going on inside the ag space, but to be honest with you, some borrowers aren't going to get any new credit. Some are going to be working out of, and our better customers continue to be called on by other banks because they're very strong, the best--when you net all of that out, if you were flat in those communities, that'd probably be a pretty good performance in 2018.

Nathan Race
Got it. that makes sense. All my other questions have already been answered. Thank you.

Charles Funk
I might add one more thing to Jim's prior comment on expenses. Let me go back to what I said, and say that in the fourth quarter, we had accelerated some expenses due to the tax change so

our run rate went up in the fourth quarter for that reason, and that's why Jim says that you could probably carry that on into the new year. That might be another way to look at Damon's question. I would add to that.

Operator
Again, if you have a question, please press star then one. Our next question comes from Brian Martin with FIG partners. Please go ahead.

Brian Martin
Just a couple follow-ups. Maybe, Jim, if you can give a little context around, we appreciate a comment on the margin, but just can you talk about maybe where the starting point is with the adjustments. A, the rate hike in December, and B kind of the tax change to where you think the core margin at least sets up for first quarter, and then we can make some assumptions in there, but just kind of what do you have the core margin at in the fourth quarter, and just kind of an estimation or some kind of a guidepost about how we should think about where it starts in the first quarter.

James Cantrell
We've got 377 posted for fourth quarter here. That is a good starting place. With all the moving parts that we've talked about, you can back off, as we talked about maybe six basis points going forward for the tax effective piece of that, if you are tracking or if you care. I assume your models are taking that into account.

There are an awful lot of moving parts. I do think that we have seen some increases on some of our deposits, again, an acceleration That margin is going to contract a little bit. I mentioned the 1.8 million in purchase accounting adjustments, that's not core necessarily, but we are going to see a decrease of somewhere in that neighborhood and income flowing through the margin for 2018.

We have seen an acceleration in the cost of funds on our CD portfolio. It's a pretty short book and it's repricing, at the low-water mark, gosh, 2014 probably at 1%, and we're up in the 120s now, and heading higher. As I look back a year ago, we were about 10 basis points lower on cost of funds. The next year we're going to be more than 10 basis points higher in cost of funds when we're talking about the fourth quarter of 2018 a year from now.

That'd be my guidance to you, Brian, unless you have something more specific.

Brian Martin
Yeah, I appreciate it, Jim. Just the one comment. If you posted 377 but you take out the accretion and omit that for a minute, you're at a low 360s type of level, 362ish is kind of what I was estimating. That 362 level, you would expect it to be lower by some degree in the first quarter, as when you complete the first quarter, that's kind of what you're suggesting here based on the tax reform and then we make adjustments from there.

But maybe five, six basis points below that 362 level on the core, and then make our other assumptions. Is that kind of fair with what you're saying?

James Cantrell
Yeah, if you're dropping for the tax, I think that's exactly right. I would take it down right off the bat for the tax effect, and I think the trend is going to be lower than the low 360s. The influences on the margin are going to be in the whole or in the main negative.

Charles Funk
And we do get some benefit from the increase in the prime rate.

James Cantrell
We will. We have several hundred million dollars of prime-based loans, there's a timing issue and that'll flow through as a positive.

Brian Martin
Okay, I think you answered, whatever we reset into, your sense is that the general trend in the core margin throughout 2018 would be a little tick down from wherever you got first quarter, it still may go a little bit lower throughout the year is kind of how you're thinking about it today?

James Cantrell
And it's going to be small movement, I would say, Brian. We have offsets, as Charlie mentioned. We do have some increase in loans that will offset some of this. There's a mix phenomenon going. We're having a hard time keeping hold of zero interest deposits. That's an area where we struggled and so that part of the mix is going to shift against us and has already.

I don't see that getting any better. Part of my thought process is we're going to see a little degradation in the mix of our funding costs, too.

Brian Martin
Okay. That's all helpful. I appreciate it, Jim, and maybe another one for you or, just since you brought it up earlier, you talked about the fee income and Charlie talked about a few of the initiatives and maybe hiring your thinking about or looking for this year. But, in general, if you look at fourth quarter's run rate, is that a pretty good barometer?

You talked about some positive events in third quarter being in there. When you look at fourth quarter being pretty representative of how you feel as a minimum baseline, and you've got some growth off of that run rate into '18. Is that how you're thinking about it?

Charles Funk
No, I would continue to forecast increases for our wealth management area, even though they may not be 11%, that they were last year, but we think nice increases. Fees are an interesting thing. We have some opportunity in our company to do a better job on fees, I'd be disappointed if fees didn't improve modestly, and that would be because of better collection throughout the company in 2018, and then Kevin can comment on mortgage, but I think we think that the run rate's a little better on mortgage.

James Cantrell
Yeah, Brian, especially from a fee perspective, part of the strategy in mortgage is to retain as much servicing rights on the portfolios as possible. When you look at 2016, of the loans possible, about 34% of the servicing rights. In 2017, that number is over 80%. What that means is that while you retain the servicing rights, you don't get as much up front when you sell these loans into Fannie or one of those other conduits, you eventually earn that back, and that payback is about 16 months.

With our average life of our mortgage loans being about seven years on the books, we'll end up making, on our average loan, about $3,000 more by retaining the servicing rights than if we would have sold it off at the beginning. You pay a little bit of a penalty, which we started to in late 2016 and through 2017 by retaining the servicing rights and thus not receiving as much up-front income, but about that 16-month timeframe is where it starts to be accretive to the overall revenue.

We'll start to see that flow in in 2018 and we'll hit full force by the time we get to the end of 2018. Not a huge move, but a nice move upwards in terms of fees for us.

Brian Martin
Okay, that's helpful. Just the last two was on the expense number, not to beat a dead horse, but it sounds like about where we're at and the little benefit we have in the fourth quarter on expenses. Somewhere the low $80 million for '18, if you just annualize the 20 and then maybe a little bit on top of that kind of seems like how you guys are thinking at this point from an expense standpoint. Is that fair based on the comments you made?

James Cantrell
Yeah, this is Jim. Round numbers, I think that's pretty accurate. I think that works out pretty neatly at 80 and 20 if you just straight line it.

Brian Martin
All right, and then last one, and for whomever, but probably Charlie, just on M&A, Charlie, you talked a couple calls ago, I don't recall when it was, but it seemed like there was more activity in the Iowa market from an M&A perspective and you talked about not putting something up last year or walked away from one or something that happened last year, but just the activity today.

Can you just talk a little bit about where that's at? Certainly I understand the interest on your part, but where is activity today and is it up or down, or if you could just characterize that a bit and just remind us just where, size-wise, or markets you're more focused on.

Charles Funk
Yeah, thank you. That's a good question, Brian. In terms of size, it's smaller just because that's what's available, and smaller banks are coming to the realization that now might be the time. We're still sluggish from the holidays. Activity will pick up based on anecdotal things that I might know. I've said this before in some forums.

We are looking primarily for opportunities within our footprint, specifically in Minnesota and in Iowa, the lower loan deposit but good, core stable deposit banks, even though they may not be good earners, if we have expense opportunities, deposits are going to be very, very valuable to have, whereas we might not have been so interested three years ago, we might be a little bit more interested now just because of the benefit that comes from having stable funding that could be loaned out elsewhere in our footprint. Those opportunities don't exist in the home footprint.

Smaller probably will pick up in terms of activity, but that's yet to be seen. I hope I answered your question.

Brian Martin
Yeah. That's very helpful. I think that was all I had, guys, so I appreciate it. Thanks for taking the questions.

Operator

Once again, if you'd like to ask a question, please press star, then one. I'm showing no further questions. I would like to turn the conference back over to Charles Funk for any closing remarks.

CONCLUSION

Charles Funk
Only that we thank everyone for being on the call this morning and we wish everyone a good rest of the first quarter and a good January. Thank you, Chad.

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