MidWestOne Financial Group, Inc.
"MOFG Q1 2014 Earnings Call"

Friday, April 25, 2014, 12:00 P.M. Eastern
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OPERATOR: Good day and welcome to the MidWestOne Financial Group, Inc. Q1 2014 earnings call. All participants will be in listen only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed bay zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then one (1) on a touchtone phone. To withdraw your question, please press star (*) then two (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: Reminding you this presentation contains forward-looking statements relating to the financial condition results of operations and business of MidWestOne Financial Group. Forward-looking statements generally include words such as believes, expects, anticipates and other similar expressions. Actual results could differ materially from those indicated and among the important factors that could cause actual results to differ materially are interest rates, changes in the mix of the Company's business, competitive pressures, general economic conditions and the risk factors detailed in the Company's periodic reports and registration statements filed with the SEC. MOFG undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances after the date of this presentation. And with that, I will just offer a few comments on the quarter.

First of all, obviously, a good quarter from a net income point of view, our metrics are all good. We probably didn't get there the way that we would have thought we would have gotten there. I, just a word about the gain on the CDO, all of the CDO's are now gone from our portfolio and, to remind you, under the original guidance that was provided by our regulators when they came out in December with the interpretation of the Volcker Rule, we would have had to write this portfolio down by $1.1 million as of 12/31/13, and then, once the regulators reversed their position on that, it was interesting, the market strengthened and it strengthened so much that we had an $800,000 gain and decided to sell the whole portfolio, so we're happy to put that chapter behind us and that was a pleasant but unexpected surprise that we got in January.

The margin in our Company continues to be very strong, probably surprises us a little bit and I have to be honest, we're starting to ask ourselves if we've sacrificed a little bit of net interest margin for growth in order to preserve the margin. But this isn't the first time in my career that these discussions have gone on and I think banks all over the country have these discussions from time to time. So we continue to evaluate that. One of the things that weighs, I think, positively in terms of the margin is that, if you look at the last three or four quarters of our loan portfolio yield, it would appear that it's bumping along the bottom. It really hasn't gone down that much, a basis point here, a basis point there, but it would appear that right now the loan portfolio is at least in the process of forming a bottom in terms of yield.

The investment portfolio had started that several quarters ago, but with the investment portfolio, that's always going to depend on what's running off in a given quarter and what that coupon is, but overall I think that is a positive sign in terms of our margin. You, I'm sure, have all, everyone who read our quarterly earnings report saw that our loan portfolio declined roughly $15 million in the quarter from yearend, still up nicely, year over year. If you look at that reduction, 13 of the $15 million really was in the AG portfolio and that really didn't come from payoffs. We did some further analysis and, if you look at the lines, the AG lines, they'll start to get drawn on from this point forward as our farmers start to put the crops in. A year ago, we had roughly a 60% usage on our AG lines, it happens to be in the high 40's this year. The high 40's is probably a little bit more normal, but we do expect to see a pickup in the usage of lines in the second quarter.

Our C&I portfolio was actually up $8, $9, $10 million during the quarter, The one thing that was a little surprising, commercial real estate was down by $7 million. We did have a couple of payoffs, one of them very normal, but we also, and you get this from time to time, had a competitor come in and pay us off on a couple million dollars just by offering a much lower rate than what was on our books that we chose not to match it and that was that. So the other thing is we do have some construction and development loans in the second quarter that we'll continue to fund, and so I think it bodes well. We will see a rebound in our loan portfolio in Quarter 2. For whatever reason, deposit growth has lagged and I just would say that everyone in our quarter, in our Company is working very, very hard to get that turned around and if we do have a number one priority, I think it would be deposit growth right now, in our Company.

Non-interest income, wealth management continues to be strong and that's led by our investment services group, which continues to put up numbers that I think surprised all of us, but they're very, very positive numbers and I think they're doing it the right way – not by product pushing but consultative selling and, in many cases, putting on business that has a recurring fee, year over year, as opposed to taking the big fee up front and then not having anything going forward. Trust department continues to be solid, certainly not spectacular, but solid, and our insurance group continues to improve. I think the improvement, many of us would like to see it be faster but they do continue to show improvement.

Service charges continue to falter, however, there's been an internal effort to work on that and I think going forward, you will start to see that particular part of our non-interest income begin to reverse itself and perhaps move higher and I think that'll happen over a number of quarters. It's not going to happen overnight, but I'm optimistic that we will see a reversal in that and that will be good news going forward for non-interest income. Home mortgage, like many banks, just a horrible first quarter. Bad weather, I think, accounts for a lot of that and we had our share of bad weather in Iowa. But I also say that we're underperforming in our Company in this area and we know that and we are making every effort to improve our home mortgage effort and become more competitive in that arena. It's something that we need to do well to succeed in the future and we're working on it and we'll continue to update you on that as we can.

Non-interest expense, I think, very good, I think everybody sees that. There could be some timing issues in terms of expenses that we might have expected to happen in the first quarter but didn't. So, I'm not sure how much more improvement you're going to see in non-interest expense, but I think it appears to be well controlled right now. In terms of asset quality, the numbers speak for themselves. If you look at our loan loss reserve, we have a range and the reserve is at the top of the range. We chose to take a provision again this particular quarter, but there's no doubt that, as our loan portfolio sits right now and our reserve sits, we appear to be in good shape in the range.

We may have some recoveries in the second and third quarter, they wouldn't be huge. You never want to say that you're going to get a recovery until it's in the bank, so there's no guarantee there, but I do think, and if you care to ask Ken about that later, you can, but I do think there's a possibility of a recovery or two that would be somewhat noteworthy, not large, but somewhat noteworthy. Capital, same story. We certainly have more tangible common equity that we carry, than we care to carry as it would cross the 10% threshold.

During the quarter we did begin to repurchase our stock again and we did most of that in the first part of the quarter. We then stepped aside because ESOP buys – our ESOP makes an annual contribution and we certainly don't want to compete with our ESOP when it's buying, so for the most of the rest of the quarter, our ESOP was buying and so we were out of the market again. But I will say that we have more room there and we do think our stock, as it's currently valued, is a good value, so perhaps there'll be some more activity there.

M&A, always questions about M&A. We've had a number of conversations, a fairly good amount of conversations and we do see opportunity for shareholder value and shareholder friendly deals, but until you have a seller, you don't have a deal, so you really don't have anything. So, until folks decide that they might want to sell their companies, there's nothing to talk about. But, again, as I've said for the last two or three or four quarters on this call, there are many more conversations than there were two, three, four years ago.

So if I summarize, I would say that deposit growth and improvement in our home mortgage lending process are the two things that can drive revenues that we're working hard on. Expect to see a gradual increase in our service charge collection and, believe me, I'll be very disappointed if that doesn't happen, but I'm thinking that there's a good chance you'll see that happen and I think that during the second quarter, it's fair to expect loan growth to continue to resume and that should be led by the building of AG lines, as well as construction and development funding, things that we're already funding that will continue to ramp up as the weather improves. So, with that, Kate, I can turn it back to you. We would be happy to answer any questions you might have.

OPERATOR: Thank you. We will now begin the question and answer session. To ask a question, you may press star (*) then one (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 star (*) then two (2). At this time, we will pause momentarily to assemble our roster. Our first question comes from Jeff Rulis from DA Davidson. Please go ahead.

JEFF RULIS: Thanks, hi guys.

[Multiple speakers]: Good morning.

JEFF RULIS: I think you mentioned on the last call a 5% loan growth for the full year would be a nice goal to reach. I guess that run off and, subsequently an optimism for Q2 is that a number you'd still view as attainable?

CHARLES FUNK: 4-5%. I wouldn't back off of that. We still hear a lot of talk about deals that are going to be coming to committee, so I think for right now 4-5% is reasonable and I don't know that we'd want to back off of that just yet.

JEFF RULIS: Yeah, and Charlie, you mentioned some increased competition on loans, is that, is there a primary group that's, is it larger banks, thrifts, other, and maybe is it pricing or terms?

CHARLES FUNK: Yeah, it's a little bit of both. I can defer to Kent, who's probably got a little bit better memory, but it's both, it's also, in some cases, credit unions that are, that seem to be much more involved in the commercial real estate arena, but I think it's a little bit of everything. I'll give you one example that we just saw this week and I'll take the industry out of it because I don't want to give anything away, private information away, but we had the opportunity in our footprint to consider a fairly large for us loan to an entity that would be certainly, probably okay, but certainly not what it was five year ago, the trends are not good. And so we put together a package that we thought reflected fair risk based pricing and they were looking for a long-term deal with no prepayment penalties, and we were willing to go 5 years and we're not even going to be considered because it came back, 10 years, 15 years fixed rate, no prepayment penalties. And I don't know about the terms, I can't say the terms were easier because I didn't see that, but we thought, for us, we had a good risk based price and we weren't even close. And the fact that we missed this particular loan, I don't think it leaves any of us disappointed but it leaves us a little bit surprised that others might not have viewed this the same way we did. So, and I'll let Kent comment further because he's got more specific knowledge, I'm sure.

KENT JEHLE: And, Jeff, the only thing I would add to Charlie's comment is related to the AG sector and we do see farms credit quite a bit and that is certainly driven by price and term because of the amortization they're able to do compared to what we're deal on an in-house basis. So that certainly is a huge competition when it comes to the AG sector, especially on the farmland side of things. They're still very aggressive with rates.

JEFF RULIS: Okay, appreciate it, and then maybe one quick last one on the, a little bump in expenses after several quarters of decline, you think you're hitting sort of a bottom there or did Q1 include some seasonally high stuff in there?

GARY ORTALE: Yeah, Jeff, this is Gary. Yeah, I think we saw a little bit of bum, you know, like you said, in the first quarter, but I don't think it was anything out of the ordinary other than the normal salary increases and commissions related to our home mortgage activity. I think that activity hit a, the mortgage activity hit a low in that fourth quarter and it rebounded just a tad here in the first quarter, which, of course, affected the commission levels. The only other thing I can think of, Charlie alluded to the fact that we had a cold and snowy winter this past winter and a lot of the expenses related to the utilities, the snow removal, certainly impacted [technical difficulty] a little bit more here in the first quarter than they did in the fourth quarter of last year and certainly the same quarter a year ago.

JEFF RULIS: Okay.

GARY ORTALE: Nothing else out of the ordinary.

JEFF RULIS: Okay, great, thank you. That's it for me.

OPERATOR: Our next question comes from Brad Milsaps of Sandler O'Neill. Please go ahead.

BRAD MILSAPS: Hey, Charlie.

CHARLES FUNK: Hi, Brad.

BRAD MILSAPS: Hey, just any thoughts on the NIM going forward. I joined a few minutes late, so I apologize if you addressed it, but it looks like doing a little better on deposit cost funding. Just kind of curious on the core NIM, kind of what you're outlook would be there?

CHARLES FUNK: Yeah, I did talk about it but I'd be happy to revisit just a little bit. The one thing that might be positive on the margin is that it would appear that, over the last two, three, four quarters, our loan portfolio yields tend to be in a process of bottoming. At least, if you chart them, that's what it looks like. And our investment portfolio, it won't be absolute there because it always depends on the run off and what the coupon is on the run off, but our investment portfolio has not been declining as it was a year or two ago. So that's positive. We have to get something figured out on the deposit side. The one thing is, we are not going to be driven by rate on deposits, we can't be because we compete with so many credit unions and every time you raise your rates, they see that and raise it a quarter. So we can't be totally driven by rate, but there's obviously sometimes a tradeoff between the margins and the growth in earning assets and I'm not sure we've got that exactly figured out. And as I've said in my earlier comments, this isn't the first time in my career that I've seen this tradeoff. But we have to figure that out but the NIM, right now, appears to be, and let me, and also say the loan pools will have an effect, from quarter to quarter, on the net interest margin, but the 4% yield on the loan pools this quarter, we would think, would be a reasonably normal yield. So it didn't – the net interest margin you see for this quarter should be pretty reflective of what went on in the banks. So I think it's in this neighborhood and if we see much erosion, it would be because we grew a little bit, but it's just something we have to figure out. Now, it's a long answer, but I hope I answered your question.

BRAD MILSAPS: Yeah, no, just, it was up quite a bit, linked quarter, and obviously, some nice performance there, but, again, you had a lot of moving parts with some payoffs and then a little bit of less liquidity, so, no, that's helpful. So you think you can kind of run in this range and, hopefully, hold net interest income sort of in this range, depending upon the level of the loan pools?

CHARLES FUNK: Yeah. The level of earning assets, I would say 355 is a little, that's surprised us a little bit on the up side, but 345 to 355, with 355, I think, being on the high end of that, and understanding the loan pools will affect that both positively and negatively. A year ago, the loan pools had an 11% yield and that, obviously, was a big positive.

BRAD MILSAPS: Sure, sure. Okay, very helpful, thank you, guys.

OPERATOR: Again, if you have a question, please press star (*) then one (1). Our next question comes from Brian Martin from FIG Partners. Please go ahead.

BRIAN MARTIN: Hey, Charlie.

CHARLES FUNK: Hello, Brian.

BRIAN MARTIN: Hey, Charlie, just touching on that margin for a minute, what surprised you the most this quarter on the margin? I mean, it seemed like, in the past, you know, getting north of a 345 type of number was kind of a challenge and then you see this quarter with it being up as much as it was. So I guess where was the biggest surprise on your end that caused the uptick this quarter?

CHARLES FUNK: Well, that's a great question. That's a great question, Brian, and I haven't really thought about that but I would say the fact that our loan portfolio yields appear to be in the process of bottoming, I think that was a pleasant surprise when we heard that because we had sort of anticipated that that would continue to ratchet downward. I think what that tells you is that we haven't had to compete quite as much on price for loans as we were a year ago or 18 months ago or two years ago, and I think that's because most of our competitors, not all, but most of our competitors at least seem to be giving some credence to the possibility rates might rise at some point in the future and they'd better be careful. So, probably the loan portfolio yield, off the top of my head, would be the biggest surprise.

BRIAN MARTIN: Okay and is there anything out of the ordinary that's running off? You talked about, in the bond portfolio that could be an impact in the near term or is that [multiple speakers]

CHARLES FUNK: There could be, but, given the way our bond portfolio works, we have a lot of June maturities in municipal bonds, so there could be some high yielding municipals that would be running off in June. I don't have the specific information, but other than June, there wouldn't be anything that would stand out to me and I don't have a number for you, and I apologize for that.

BRIAN MARTIN: That's okay. How about just, you talked about the other area of focus, at least one of them being the mortgage. Where are you guys, based on kind of the work you've done so far, where are you guys deficient on, it sounds like there's a lot of room for improvement on the mortgage side. I guess, on a cursory view, where is the kind of low hanging fruit as you guys kind of improve things on that, in that area?

CHARLES FUNK: Well, I don't think there's low hanging fruit. I don't think the competition allows in our markets for low hanging fruit. I think, when you look at our footprint, you have to divide the mortgage area up between the rural areas, where I think we do a pretty good job for the most part, and the Johnson County market, which is Iowa City, where we haven't done as good a job, and part of that's that we have very good competition, not only from a large credit union, but also from a large commercial bank. So, I think the first thing is, we have to become a little more relevant than we, as we have in the past in the Johnson County markets. That's number one. The other thing is, maybe more than some other companies, I think we had a focus on compliance in our mortgage area and most of that focus was in 2011 and early 2012, I should say late 2011 and all of 2012, and I think there's still a carryover from that. I'm sure everybody knows that mortgage compliance is much more difficult than it has been, well, here it had everybody's affected by it, so we're no different than any other bank. I think, in our case, we got a little too carried away and we had a little too much of a focus there and you all know, when you focus internally, you don't focus externally and so I'm just being honest and candid with you, but those two areas, I think, I think the second one we're getting beyond, the compliance part. We're not there yet, but we're getting beyond it. The part about becoming more relevant in Johnson County, I think, is still a work in process but we are very committed to getting it figured out.

BRIAN MARTIN: Okay, that's helpful and just the last two things, you mentioned, maybe more a question for Kent, on the recovery, is what that outlook is or just kind of where you're seeing potential?

KENT JEHLE: Yeah, Brian, it's in a development, one development that we're involved in that's currently in the non-accrual bucket that we marked very well. And the way I would characterize the recovery is that we're looking at it'd be in lieu of a monthly provision. So it'd be in that range, if you look what our provision rate was in the first quarter, that's what we would estimate could come in the next quarter or two.

BRIAN MARTIN: Okay, so the recovery would be a, the quarterly provision or a monthly provision?

KENT JEHLE: Monthly.

BRIAN MARTIN: Monthly, okay. And, all right, and maybe just the last thing for Charlie, just kind of a hang up on M&A, as you guys look at it. I mean there's obviously, you said more discussions, where's the holdup, I guess, in your mind, in the discussions you've had that you don't seem to be willing to come to terms?

CHARLES FUNK: Brian, what I would say is that, as I understand it, well, I've been in one bank in my career that decided to sell and the way that usually works is that boards have to decide that they're ready to take that step and my understanding of what I know is that there are few boards that are talking about it, some more seriously than others, but they just have never gotten to the point where they said this is what we want to do. Based on what I understand, some of those companies weren't having those discussions two or three years ago. They're at least starting to have the discussions now and I probably shouldn't be any more specific than that, and in some cases, it's just making calls on companies that you think would be a good fit and planting seeds and it takes a while for those seeds to sprout. But as I've said, I think we can make a pretty good case that there are a number of shareholder friendly deals that are around, but you just have to wait for the right time, and you have to wait for the seeds to germinate. That's a good answer from an Iowa banker. How's that?

BRIAN MARTIN: That's great. I appreciate all the color, Charlie. Thanks, and nice quarter, you guys.

CHARLES FUNK: Thank you.

KENT JEHLE: Thanks.

OPERATOR: Our next question comes from Daniel Cardenas from Raymond James. Please go ahead.

DANIEL CARDENAS: Good morning, guys.

CHARLES FUNK: Hello, Dan.

KENT JEHLE: Good morning.

GARY ORTALE: Good morning.

DANIEL CARENAS: Just a quick question on cash flows on the security portfolio. How much is that annually? And is that going to be used primarily to help fund loan growth?

CHARLES FUNK: Well, it has been and, you know, a lot of that depends on deposit growth. If we have the core deposit, low cost deposit growth, to the extent that the, you've got securities and you've got loans and if the loan growth doesn't absorb all of that, you could get a little bit of securities in there. But, yeah, most of that would be to fund loan growth and if you look at our securities portfolio, typically, we disclose that, but typically, we've got 20-25% in the next 12 months that would be cash flow. I mean, that's the projection, some of that is going to be dependent upon the mortgage flows and you do a best case estimate on that. But 20-25%, is that fair, Gary?

GARY ORTALE: That's fair. I mean, I think, Dan, you've seen our average life has gotten up over four years, but anywhere in that $80 to $100 million level is what we've got coming due this year.

CHARLES FUNK: And I would, let me add, Gary mentioned average life, just, we usually get a question on that. The real reason that's lengthened is some of our mortgages have lengthened. But I've noticed, in the last ninety days, we are definitely buying shorter term bonds, shorter maturity bonds than we have been, so we're in the process, hopefully, of bringing that down below four years.

DANIEL CARENAS: Okay, good. And then in terms of capital allocation, capital deployment, given that you're trading about 120 of tangible book right now, thoughts about continued stock repurchases?

CHARLES FUNK: Yeah, I mean, that's always dependent on the price of the stock, but I think, you know, we talked about this at our Board meeting last week and I think we think, as a Company, from top to bottom, that our stock's a good value so, as long as we're authorized, I think it's fair to say that we'll be considering that.

DANIEL CARENAS: And what's left in your current plan right now?

GARY ORTALE: Yeah, we were, we have, we were authorized to spend up to around $5 million, Dan, through the end of this year. We've spent maybe two of it, so we've got about $3 million or so to go. And that's not to say that we might not add some more.

CHARLES FUNK: Absolutely. I mean you approve these at the Board in $5 million increments, but I think the discussion at the Board last week would indicate that we feel it's a good value, so you can, I think you can interpolate where we're going there.

DANIEL CARENAS: Right, right. Okay and then, Gary, what the expense for the quarter for snow removal and other kind of winter related items that potentially could not be reoccurring going forward?

CHARLES FUNK: I want to hear this one!

GARY ORTALE: Yeah, I can't give you the specific numbers but I can just tell you that the utility costs and the snow removal costs were substantial. I think we had our third highest snow level on record in this area, so we had pretty extensive snow. I can't give you, you know, it may have been up $50-$60,000.00 for the quarter over the prior quarters and the same quarter a year ago, but that's about as close as I can get, Dan, there.

CHARLES FUNK: And the electricity, I know

GARY ORTALE: Yeah.

CHARLES FUNK: The electricity was a killer, as well, and that might even be bigger yet.

GARY ORTALE: Yeah, yeah.

DANIEL CARENAS: Okay, and then with the freezes and the thaws, I mean, is it, are you going to have to maybe upgrade some of the facilities that are a little bit older and?

CHARLES FUNK: I don't know that we're going to have to upgrade anything. We've, we are in the process of doing some work here in town and also in Iowa City and also in Oskaloosa and, actually, Oskaloosa is going through a, I'm not sure what the term they're using, but like a downtown city, downtown upgrade sidewalk upgrade, whatever you want to call it and we've run into some issues there which probably haven't been reflected in the expense yet. But, yeah, I would say this was a little out of the ordinary winter for us.

DANIEL CARENAS: Okay. All right, all right, good, no, that does it for me, so good quarter. Thanks, guys.

GARY ORTALE: Thank you.

CHARLES FUNK: Thank you, Dan.

OPERATOR: As there are no further questions, this concludes our question and answer session. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.