MidWestOne Financial Group
"Q2 2014 Earnings Call"

Friday, July 25, 2014, 12:00 PM ET
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OPERATOR: Good day and welcome to the MidWestOne Financial Group Q2 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 your telephone keypad. 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, sir.

CHARLES FUNK: Thank you very much, Chad. Good morning or good afternoon to everyone on the call. And I will begin, as I always do with forward-looking statements, and remind you that this presentation contains forward-looking statements relating to the financial condition, results of operations and business of MidWestOne Financial Group Inc.

Forward-looking statements generally include words, such as, beliefs, 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 or 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.

MidWestOne Financial Group bank 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 out of the way, I would make a few comments and then, of course, allow as many questions as you care to ask.

I think it's fair to say that the first six months are slightly ahead of our internal expectations and we are clearly very pleased with the results. And I think if you look at the results, the thing that has surprised us and definitely pleased us the most is the fact that our net interest margin has continued to expand a little bit. And when you look at our net interest margin, I think it's fair to say the loan pools make it a little bit better than the core margin would be, but the core margin in the bank is also very, very strong.

In terms of the balance sheet, loan growth rebounded a little bit in the second quarter; I would say it's a little shy of our expectations. And I think we have a modest pipeline going into the third quarter. Deposit growth remains a challenge in our footprint but we started seeing a little bit of improvement in late May and June. We'll have to see how that goes, but we are hoping that we've turned the corner on that, not ready to declare that definitively, yet.

In terms of non-interest income, there's no doubt mortgage remains slow, servicing adjustment was a slight negative this quarter due to the decline in long term rates. Wealth management continues to be steady, and you see the reported results. The results were fine in wealth management even though our investment services were a little bit weaker in May and June, but they have a good pipeline for July and August. So we think that wealth management could continue to roll along at a pretty nice rate.

I think if you look at non-interest income, for us the most pleasant surprise is that we've had four consecutive months in the bank of service charges…better results in service charges. We talked about that on the last call, we talked about that at the end of last year, the need to tighten up the waves inside of our company and we've done that. I think there is still room to do a little bit better, but we've done that.

And we also started charging for some things that frankly we probably should have been charging for the last couple of years. And I think the most important takeaway for us is there hasn't really been a lot of negative customer pushback. And I think that shows our leaders did a pretty good job of identifying what we should charge for and would be accepted by the consumers and what probably we needed to stay away from, and that will continue to be an ongoing area of focus in our company.

In terms of the efficiency ratio, good, if you look at MidWestOne Bank depending on the month, that's been running between 52.5% and 54.5% at MidWestOne Bank. And that's certainly a good number for us when you look at the number of offices we have, and the asset size that we have.

Asset quality, I will let Kent address that if you like in the Q&A, but nothing has really changed materially. We do have our eyes on our AG portfolio and I know that many of you know that we are at a roughly a four year low on the price of corn right now, and maybe the…somewhat counterbalancing that is that we are expecting a bumper crop in most of our…throughout most of our footprint.

The loan pools, they continue to be lumpy in terms of income, but you know when you boil it all down to a net return, even though it's a little bit less than last year, it's a reasonable return, it's an okay return. And I would think we would expect similar progress in the second half of the year although you know there will be good months and bad months, but it should come out to a reasonable return.

Final comments, I would comment a little bit about our capital levels. There is no doubt that our capital levels have our attention. And I think you saw that in terms of both the share repurchase activity that occurred during the quarter, as well as the increase in the authorization per share repurchase. And it's very fair to say that we had our last board meeting for MOFG was on July 17th and I would say that it's the unanimous opinion of our board that we think our share price is attractive and this will continue to have our attention as we go forward into the third quarter.

Update on M&A, I would…a few small Iowa banks have sold or in the process of being sold and while the prices that were paid for those banks were not necessarily public information, the information does make its way through the net working and the Iowa bankers. And I would just say that multiples are very high even for small banks within the state of Iowa. And I think you can see the effect of excess capital and the fact that we continue to have a high number of banks in our state. And we do continue to have good conversations in terms of exploring how we can grow our company through organic growth as well as acquisition.

During the quarter, there was a failed bank transaction that we were a bidder on and our attorneys have advised that that's probably all we should say, but we were an active bidder and we were disappointed in the outcome, but did put our best foot forward in terms of that transaction.

In terms of looking ahead to the third quarter, loan growth could be a little bit less than planned. And I think one of the reasons for that is, we anticipate a large payoff. And frankly, we didn't fight to keep this particular loan in our portfolio, and we regard the payoff as being a net positive, all things considered for our company. But because that we have the payoff, that's one that we will have to replace. Having said that, we do have a portfolio of a few reasonably-sized loans that we expect to close during the third quarter or early fourth quarter.

Last comment would be in relation to our bond portfolio. I think, we've been very fortunate in the management of our bond portfolio. And we get questions about the size of our portfolio relative to the size of our company. But the average life of our portfolio really hasn't changed much over the last two years and it's been anywhere from 3.8 to 4.2 years depending on the level of interest rates because there is a little bit of negative convexity in the portfolio. But right now, the portfolio is right at four years in terms of average life, and the average yield in our portfolio is in the 3.30, 3.35, 3.40 range.

And as I talk to other bankers around the country, I think that's definitely an asset and probably one of the reasons that that we've been able to maintain such a good net interest margin. And I think the management has been outstanding, but also the fact that we continue to focus on total return characteristics as opposed to just absolute yield and hopefully that will continue to service well in the long run.

We have taken some gains, the gain we took just to remind you in the first quarter was to completely liquidate our CDO TruP portfolio that was unplanned, but when we had the large gain we took the gain. But I think it's fair to say at this point in the interest rate cycle we may continue to harvest a few gains. I don't think they will be large in terms of this particular second quarter. But I think it's fair to assume going forward that activity such as we had in the second quarter, we may have in the third and fourth quarter because from where we think we are in the interest rate cycle it just seems to make sense to harvest some of those gains.

And with that, I will turn it back to our host, and be happy to answer any questions you care to ask.

Q&A

OPERATOR: Thank you. We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your telephone keypad. If you are using a speakerphone, please pickup your handset before pressing the keys. If at anytime your question has been addressed and you would like to withdraw your question, please press "*" then "2." Once again, pressing "*" then "1" will allow you to ask a question. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Andrew Liesch with Sandler O'Neill.

ANDREW LIESCH: Hi, guys.

CHARLES FUNK: Good morning, Andrew.

COMPANY REPRESENTATIVE: Good morning Andrew.

ANDREW LIESCH: I just want to touch base a little bit on the deposits growth, the decline this quarter. I'm just curious, what sort of things have you been looking at it implementing to try to reverse that trend?

CHARLES FUNK: Well, we've instituted a couple of special rates which we don't plan to continue indefinitely on the retail side, the under $100,000 side. As you know, the credit union competition in our larger markets in our footprint is fierce. And they continue to grow their deposits at between 10% and 20% a year. So you know where that's coming from. It's coming from the commercial banks in the footprint. So we've done that, and as we've talked about in prior calls, we've also have hired a very capable person to lead for the first time in our company's history, our treasury management function.

We've added or are in the process of adding some products that will make us competitive with some of the larger banks and probably give us a superior product line to the small community banks in our footprint. And we think over the next year, well, let's just say we will be very disappointed if we can't add business and core deposits, business deposits because of our calling efforts. So I think it's not particularly complicated, but we just have to…we have to compete a little bit on rate and yet not give away all the gains we've made in our margin. We would be happy to sacrifice a few basis points in margin if we could get a little bit better growth, but it's…I won't lie to you; it's a very, very tough nut to crack.

ANDREW LIESCH: Okay. And then just turning to the capital levels a little bit, the…was there any discussion at the board about maybe raising the dividend intra-year?

CHARLES FUNK: None. I think what we continue to think is, we think our dividend is reasonably competitive. We also think that we have room to do more next year whenever we talk about that. But as we've said in the past, we are on a schedule now unless something unusual happens, we would typically review the dividend at the January meeting of the board, and I think that will be the approach we will take this year as well.

ANDREW LIESCH: Great. Thanks guys.

CHARLES FUNK: Yes, you're welcome. Thanks for the questions.

OPERATOR: Our next question comes from Daniel Cardenas of Raymond James.

DANIEL CARDENAS: Good morning, guys.

CHARLES FUNK: Good morning, Dan.

COMPANY REPRESENTATIVE: Good morning, Dan.

DANIEL CARDENAS: Can you tell us what role, if any, payoffs played in this quarter's loan performance?

KENT JEHLE: Dan, this is Kent, I'll take that. We really did not…we did not realize any larger payoff this quarter, it's been more seasonal pay down or contractualized (Ph) pay down a little bit because of the time in the year as they rolled into the sales in the second quarter. And that will start rebounding in our opinion as we go into the third; there is no real sizable payoffs similar, you know, like we received in the first quarter of the year.

DANIEL CARDENAS: Okay. And then maybe if you could tell us what's the yields on new production look like versus the legacy portfolio?

KENT JEHLE: At this point, most credits that we are looking at would be in the mid 4% range, we may be dipping down closer to 4% on a sizable opportunity. Lines of credit typically will be at that…again; when I say that these are credits north of a million dollars that would be going to committee (Ph), would be in the 4% plus or minus range then. But overall, I would say the portfolio on new additions would be 4.25% to 4.5% on average.

DANIEL CARDENAS: And then, as you continue to watch your AG portfolio, how are the underlying collateral values holding up in that segment?

KENT JEHLE: Yes, we've seen land prices level out. I don't think they have turned over to the other direction from the reports we're seeing, maybe down slightly. But nothing… certainly on the rise, and again that's hit and miss because of how transactions occur as if the neighbor competing against another neighbor that may be a little bit higher of an opportunity. As far as other collateral obviously we are in the middle part of the growing season. And I will tell you, I just looked at the report from Monday, from the state, and 77% of the corn crop was reported good to excellent and 74% of the bean crop was good to excellent. So we are anticipating as Charlie alluded to in our footprint and looking at our customers and we are in the process of doing our mid-year reviews and getting out and checking the crops. We are anticipating a good production season for our customers. That will be offset as we see it by potentially some lower prices, but we have seen customers already lock in prices as they entered into 2014 so some of that is already covered based on how they locked prices coming into the year.

CHARLES FUNK: And Dan, I might jump in and your prior question on pricing to give you a little bit of an idea. We just lost a small deal to one of our customers who banks with another community bank in our footprint and us. And the deal basically got priced at 4% for roughly five years. The interesting thing about this deal that Kent pointed out when he came in and we were talking about losing the deal is that had he gone to the local credit union, and our local credit union recently had their business lending cap removed, they could have gotten somewhere in the neighborhood of 3.25 to 3.50 for the same loans. So that gets to be a problem too. When we compete with commercial banks, we don't…we win some and we lose some, but the credit union threat again in our footprint is significant. And we are going to start to see that a little bit more I think in terms of business loans and especially commercial real estate loans. Sorry to interrupt, but I wanted to just add that.

DANIEL CARDENAS: Okay. So does that suggest that the margin could come under some pressure in the back half of the year?

CHARLES FUNK: I wouldn't say that it's based on half and we see them, I wouldn't say that it's…that would enter into the margin, it may enter into growth just a little bit, we may lose a deal here and there because they get in the game that compete, and it becomes rate only. But I don't think…I don't see that as being a negative effect on the margin, no.

DANIEL CARDENAS: Okay, great. Well, I'll step back for now. Thank you, guys.

CHARLES FUNK: Thank you.

OPERATOR: Our next question is from Jeff Rulis of DA Davidson.

JEFF RULIS: Hi good morning, this is Matt in for Jeff.

CHARLES FUNK: Good morning.

KENT JEHLE: Good morning.

MATT: Hey, I was wondering about the operating expenses, they are up a little bit from Q1, was there anything one-time or kind of unusual this quarter that was pushing it up?

GARY ORTALE: Yes, Matt this is Gary. I would say there was probably a couple of things that may be impacted that. We've got an OREO property in the eastern part of the state that we have devoted significant level of expenses to in the second quarter. And we also had some consulting fees related to the income generation that we talked about on the revenue side or the service charge side. So both of those were pretty much taken care of in the second quarter, but we may see a little carryover to the third quarter as well.

JEFF RULIS: Okay great. All my other questions have been answered. Thanks guys.

CHARLES FUNK: Thank you.

GARY ORTALE: Thank you.

OPERATOR: Again as a reminder, if you have a question, please press "*" then "1." Our next question comes from Brian Martin of Fig Partners.

BRIAN MARTIN: Hi guys.

CHARLES FUNK: Hi Brian.

COMPANY REPRESENTATIVE: Good morning, Brian.

BRIAN MARTIN: Hey, maybe just one question on just, maybe back to Gary or Charlie on the fee income side. Just two things and the progress you have made on the deposit service charges is pretty impressive. I guess as far as the level of sustainability of that as you look forward, I mean it seems like some of the seasonality impact was evident in the second quarter as well, and then the actions you guys have taken. But the level you guys have kind of gotten that back up to is the highest it's been in quite some time, I guess. Your thoughts as far as how that plays out the next year or two, I guess is that type of level sustainable?

GARY ORTALE: Yes, I don't know about the next year or two Brian, but I think at this point in time we don't see any reason why we shouldn't see this sustained over the next year or more. I think we've been averaging roughly $30,000 a month in terms of increased service charge income related to this program. I think maybe something that also contributed to it looking a little higher this time was that the first quarter NSF charges were…it seems like down a little bit more than what our normal trend would be. So that may have also kind of led to the fact that this quarter seemed abnormally high compared to the first quarter. But I think we have every reason to believe that we will continue to see the $30,000 a month improvement going forward.

Again, that's probably dependent somewhat too on, some of the fees that were initiated or instituted are things like statement fees for not having electronic statements, but if the consumer learns or the customer learns that maybe I am better off without the paper statement then obviously the revenues will go down a little bit as a result. But so far we just…it's been pretty consistently at 30,000 a month.

BRIAN MARTIN: Okay, perfect. And then how about…on the mortgage side, it seems like a lot of our banks this quarter has seen kind of a jump back up from first to second quarter in mortgages. I guess that wasn't the case with you guys, I guess. What… was there anything unusual as you said, maybe Charlie said this, maybe an MSR adjustment, I guess how much was that, or was that a big factor or how is mortgage trending?

CHARLES FUNK: The MSR was not a major factor. It was a factor. What was it, Gary?

GARY ORTALE: Well, I would say, it was a factor from the point of view, it was a negative adjustment this time, was only, maybe only $50,000.

CHARLES FUNK: Right.

GARY ORTALE: But compared to the adjustments we had been having up 75 to 100 or 150, that was pretty significant.

CHARLES FUNK: Right, yes. So you are talking about the difference between a minus 50 and a plus 100 or plus 150. So yes, on that standpoint it would be. But I would also say, I think we've said on past calls, we've identified that we are probably not doing as well as we should be doing in terms of generation of our mortgage loans. And I would say that's a work in process, and it's going to be better in the future, but we haven't gotten there yet. So I think it's a little bit of both, Brian.

BRIAN MARTIN: Okay, so I mean that line should trend back up as in an adjustment next quarter I guess that would be, you know…

CHARLES FUNK: Yes, you know what I've…it's probably too simplistic. But as I just look at the level of interest rates, and when interest rates tend to trend up during the quarter, we seem to get a positive adjustment depending on how far up they go. And when they go down they're worth a little bit less and we have to take a negative adjustment. And that may not always be the case, but the last four to six quarters, just knowing what the level of interest rates are that kind of helps you predict whether it's positive or negative.

BRIAN MARTIN: Okay, all right. That's helpful. And then, maybe just going back to the margin for a minute, it seem like the yield on the pools contributed to the margin being up a little bit this quarter. I am just wondering on the deposit initiative you guys have kind of out there, what role that has on the margin prospectively, and I guess my assumption was it would come under a little bit of pressure, but maybe just kind of your outlook on what dynamics are going to…

CHARLES FUNK: Yes excuse me. Yes, we looked at that before we rolled it out and we sort of felt that if the initiative was successful which I think it will be that the most it would impact the margin would be 2 or 3 basis points or 4, and we haven't seen that yet. We may see that, but I don't think it's a huge number. As far as the pools its anybodies guess. When we budget we budget 2%-3%, and if we are over that that's great. And they've done a nice job in Omaha managing the pools, but it's entirely possible some quarter it could come in below that or even negative, you just never know because of the lumpiness of the cash flows.

BRIAN MARTIN: Okay. And as far as the outlook, the drivers of the margin prospectively, I guess more of a downward bias. It sounds as though that's kind of what you are articulating. And just in general with the…some rate pressure and this deposit initiative, if anything it's more likely to be a touch lower than a touch higher?

CHARLES FUNK: You know we've said that and you know I go back 18 months ago, Brian, and we were entirely wrong in terms of how we forecasted the margin. And I think the difference has been that there have been a couple of differences, number one, the investment portfolio of yield has held up far better because of the types of bonds we buy that focus on total return rather than just strictly yield. And I think also, we've been able to lower our cost of deposits far more than we thought was possible. And yet I saw, I saw one of our…the other Iowa banks reported today, and I believe if I am not mistaken they reported the cost of funds in the low 20s. So that's the markets they are in. In our markets looking at the credit union competition I think we've done a really good job going further than we thought we could. So could that go lower, yes, it could. But I think if I were to forecast it it would be a few basis points lower rather than a few basis points higher. I do think we will still continue to have loan growth even despite the payoff that we are expecting, but we will see. Sorry to give you such an indefinite answer, but as you know it's a moving target.

BRIAN MARTIN: Sure, no, that's helpful, and maybe just lastly on the M&A. The pricing, does that seem to articulate that maybe there is less activity in your fund possible as the pricing is getting a bit higher. I mean it seems like the better take is repurchasing your shares rather than doing something at a ridiculous multiple that may not make sense. Is that kind of where the market is at today and just kind of take what it gives you, is that the outlook?

CHARLES FUNK: Yes, well I would hope that we wouldn't do anything that would not be good for our shareholders. But I think that, I think the point I was trying to make is that these particular examples that I talked about are very small banks and they were not banks that we were involved with. They are just things where I've heard the chatter. And I think our targets tend to be a little bit larger than that. And when you get to larger targets you are talking probably about public companies and the multiples become a little bit more reasonable if that makes sense to you.

BRIAN MARTIN: Sure, okay. All right, I appreciate it. Thanks guys.

CHARLES FUNK: Yes, thank you, Brian.

OPERATOR: There appears to be no further questions at this time. So I'd like to turn the conference back over to Charles Funk for any closing remarks.

CHARLES FUNK: Yes, well thank you to everyone who joined us on the call. And as always, if we can help you in the future, please email us or call us, we will be happy to discuss it further. Thanks for joining us today.

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