MidWestOne Financial Group, Inc

2014 Q4 Earnings Release Conference Call

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CORPORATE PARTICIPANTS

Charles Funk - *President and Chief Executive Officer***.**

Gary Ortale - *Chief Financial Officer*

Kent Jehle - *Chief Credit Officer*

Su Evans - *Chief Operating Officer*

PRESENTATION

Operator
Good day and welcome to the MidWestOne Financial Group, Inc, 2014 Q4 Earnings Release Conference 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 also note this event is being recorded.

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

Charles Funk
Thank you very much, Rocco and welcome to everyone who is on today's call. I will begin as I always do to keep our attorneys happy 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 believes, expects, anticipates and other similar expressions. Actual results could differ materially from those indicated. Among the important factors that could cause actual results to differ materially are interest rates, 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 that are 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. With that out of the way, the quarter I think was a standard quarter other than our big announcement that was made in November.

Certainly a good quarter, a good year, if we exclude one-time transaction cost, $2.31, certainly exceeded our expectations when we began this year. And I think the fact that we were able to get what I would say is a transformational deal to our company done during the fourth quarter, it was more than icing on the cake really, really made our year and made probably last two or three years. A little bit about the quarter and the year overall, loan growth, we finally got the loan growth that had been projecting, but it just came very, very late in the year. And fortunately, as I mentioned in the earnings release, had stayed strong into January, in the MidWestOne footprint.

We were surprised, again this year the loan pools performed very well, I would say. And even though they are down to roughly $20 million or a little bit less, they do contribute to our earnings whenever they have good performance and that performance has stayed good into January. So we have had some success in our footprint from our calling efforts that has resulted in both new business and new business commitments. As we all know, we are in a highly competitive environment. So when we are in a situation, where calling efforts are paying off, that is very, very gratifying.

Net interest margin, another pleasant surprise, I think we began to sound the alarm probably 18 months ago that we were concerned about our margin, but out margin had held up. 3.47% for the quarter, down a little bit from the year-to-date average, but still given what we face in terms of competitive pressure 3.47% is a good number. And as we go forward, perhaps a little bit of the margin coming in, but we don't foresee anything drastic. We are much the same as other banking companies, when we say that the low interest rate environment is certainly not helping us right now and it's something that we have to fight through.

I would say under non-interest income, there were three highlights. And I will highlight the three things in short order. Our trust department this year, on a pre-tax basis made more than $1 million, almost $1,100,000 for the first time in the history of our bank and we continue to have very, very good operating leverage in that trust department, where every dollar of income, a big percentage of that comes to the bottom line.

Our investment services area ended the year with pre-tax income just under $700,000. It may not sound like a large number, but if you would go back four or five years that number was perhaps $150,000 million, $175,000, $200,000, so very good progress there and I think good prospects going into 2015.

And then service charges and fees. I think we told you last year, I think probably on the second quarter call…may be the first quarter call; we had a companywide project to do a better job of fee collection and shore up our service charges. And I think you can see in the numbers we have started to turn that around. And in fact, we can get a little bit more of a lift, I think, from that project into the first quarter. So that was a very good accomplishment. A lot of people in our company had their hands in that and did a terrific job.

I would categorize expenses as relatively normal other than the merger-related expenses. And we continue to mind the efficiency ratio as best we can and the efficiency ratio for MidWestOne Bank I think is still well under 55% and we are really going to work hard to keep it there because we understand how important that is.

And I was interested in the comments by Mr. Davis (ph), the Chairman of US. Bank about the importance of the efficiency ratio on his quarterly call, and that we certainly reiterate that and it is one of the things we will have to focus on the next couple years as that ratio normally and naturally will rise with our acquisition and we need to work hard to get that back down to where it should be.

Asset quality, again solid with the reserve at 125%-plus of non-performers and I think those that follow of our company closely know that the TDRs represent a large percentage of our non-performers and I knock on the table, which is wood, as I say this. But I do think we have a chance to reduce a TDR or two in the first quarter or second quarter at the earliest. And while they may be performing loans, they are still TDRs, categorized as non-performing and we look forward to the day when a few of those are off of our balance sheet, which will make our numbers even better. I would also call your attention to the 30 to 89-day bucket, which is about as low as it has been for a long time and I am not sure that can go a whole lot lower. It is a very, very low level.

We continue to monitor the Ag situation. I would say that we are a touch more optimistic on Ag than we might have been three months ago or fourth months ago and that's not to say that there is a robust environment in agriculture. We are about a third to a half of the way through our renewal season. And what I would say is that we do see a little pressure with the borrowers that have had their lines renewed. But I don't know that we have anything that would even come close to alarming and that would include individual borrowers. I can't remember any discussion in our loan committee, where we were alarmed.

So Kent can address that more, if you care to during the Q&A, and I would say check back with us in the earnings call in late April, we will have a better idea of exactly where all that has shaken out.

Also, the other thing in our footprint that is a little bit of a concern economically is in the Cedar Falls/Waterloo Area, Black Hawk County. As many of you know, that is the home of a large John Deere operation factory. And they announced another round of layoffs, and so, that has started to ripple through that economy. And I did notice that the last time unemployment numbers were issued for that region, that the Black Hawk County had the highest unemployment rate in an 18-county region. I apologize for not having that number. I think it is right around 6%, I don't think it's any higher than that. But certainly for Iowa, a high number and that will have a little bit of a ripple effect into that community.

As far as the first quarter, as I said before, the loan growth has been good during the month of January. I think we have got a few to close yet during the month, so hopefully we can get off to a good start. We have had a little bit of shrinkage in deposits that I think is seasonal, but our company…and I hate to sound like a broken record, but we have a renewed emphasis on small business. And a lot of that will revolve around the deposit side and our treasury services area that will be occurring not only during the first quarter, but the entire year, it may be the major initiative that we have at MidWestOne Bank in terms of the Iowa footprint during 2015. Other than the Ag sector and what I talked about in Black Hawk County, I would say that economic activity is steady to growing slightly and we do see opportunities to grow the bank in Iowa during 2015.

Capital, strong, that will change. It will still be strong, but certainly not at the levels after our merger closes, than it is today. And I think that's one of the reasons you saw a dividend increase. We believe that it was very important to increase the dividend, but clearly, when our tangible common equity will soon be under the 8% mark, which is our target, it augured for a little bit more modest dividend increase, and yet, we do feel like that…what we did do is certainly prudent and is a way to reward our shareholders for the company's success.

As far as an update on the merger, I am a little bit constrained by what I can say because we haven't filed the prospectus yet, and probably won't for a few weeks. But application has been made with the Federal Reserve. I would say that we haven't heard anything that would cause us undue concerns. And we all know that can change with one phone call, but as of yet, we don't see anything that causes us a great alarm.

We hope that we can close this on May 1st, but that's dependent upon shareholder and regulatory approval. That is just a target at this point in time. We have obviously begun to work and prepare for the day when we close. And generally, I would say that we don't see any major surprises thus far. There is no question that we remain very, very upbeat about the possibilities for the company in the years ahead. We know there will be bumps in the road, but we also see great potential, great opportunity. And as I said in my opening remarks, I think this is indeed transformational for MidWestOne.

As I said before, we will look a little bit different once this closes, with tangible common equity probably in the mid-sevens upon close, but we also believe that we can grow that ratio back to the desired 8% through earnings…strong earnings in a relatively short period of time.

So with that, those would be my comments on the quarter. And I have Gary Ortale, our Chief Financial Officer, Kent Jehle, our Chief Credit Officer and Su Evans, our Chief Operating Officer in the room and we would welcome any questions you might have. So back to you, Rocco.

QUESTION AND ANSWER SESSION

Operator
Thank you, sir. We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your touchtone phone. If you are speakerphone, we ask you to please pickup 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 roaster.

Our first question comes from Jeff Rulis of D.A. Davidson. Please go ahead, sir.

Jeff Rulis
Thanks. Good morning.

Charles Funk
Good morning.

Jeff Rulis
Charlie, following-up on that sort of the loan growth carrying into Q1, I guess, how does that shape your '15 outlook versus '14 for the full-year?

Charles Funk
Kent may be able to expand more on this, but I think we have typically been a 4% to 5% loan growth type of company, at least in Iowa. And I would say that those numbers are probably what we plan on right now, but we were hoping that it will come earlier in the year, and therefore, be a little more accretive to earnings than perhaps the loan growth wound up being in 2014.

Kent Jehle
Yes. Jeff, this is Kent. Just to add to that, I would agree that we would will still be for an annual outlook in the 4% to 5% range, the one variable that comes into play here is we did see a lift in Ag balances towards the end of the year and we are not at this point, because of our review process, not sure how we will see that reduction from the past year's operating lines the pay down occur (ph) from that and maybe a little bit of a slower pay down that we saw in the first quarter 2014. So that comes into play how we look at the loan reduction we see from that area. So that is the variable that I would still put out there that keeps us in that 4% to 5% range because we will experience some pay down in the Ag side.

Jeff Rulis
Got you. And then I guess if the loan growth is coming late Q4 and then in the Q1, is there a sense that there is any sort of tailwind for the margin, and you have been vocal about the pressures against the margin in the past quarters, but given the loan growth momentum, does that…at least for Q1, are you confident that you can keep margins up early in the year?

Charles Funk
Yes, I would take the first stab at that and say we wouldn't forecast any more than a basis point or two of contraction, if that. Here is what's…and I'd meant to cover this in my opening remarks

and apologize that I didn't. One of the things that's going to be a little bit tricky about analyzing our balance sheet and income statement is that we are going to shrink the bank a little bit to a cap for the…what we need…going to need to do on the capital side in the merger. I would hope that in the way we shrink the bank, that it would…it might be slightly positive to our margin because if we don't want get rid of the high margin liabilities or assets, and so therefore, I think you could see some security sales, some Federal Home Loan Bank prepayments and it just becomes very messy to analyze what the core margin is. But at the core for the bank, if there is any shrinkage at all, I wouldn't think it would be any more than a basis point or two, but that's, Gary, I know you can add to that.

Gary Ortale
Yes. I don't know that I have much flavor. I am probably a little more optimistic again just because of the things that Charlie just mentioned. If we can sustain the loan growth that we have seen from the fourth into the first, and as we sell off some of the bond portfolio to encourage the shrinking and reduction in the home loan…as we reduce the home loan bank balances, you will be seeing in the cost side go down and probably the assets yields hold steady. So I think it is contrary to maybe what we were thinking early in the fourth quarter as we are going through the budget. I would probably be a little more optimistic in terms of our ability to hold to the margin, but we may see again, if it is a basis point or two change either way, I think it's in the ballpark, so…

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Jeff Rulis
Okay. That's good detail. Thanks. That's it from me.

Charles Funk
Thank you.

Operator
And ladies and gentlemen, once again, if you have a question, please press "*" then "1" on your touchtone phone at this time. Our next question comes from Daniel Cardenas of Raymond James. Please go ahead.

Daniel Cardenas
Hi, good morning, guys.

Charles Funk
Good morning, Dan.

Daniel Cardenas
Maybe a little color, have you guys had a chance to look at Central's fourth quarter numbers and general comments as to whether or not they were in line with your expectations?

Charles Funk
I can't comment because I don't think they've filed their call report yet, so it wouldn't be public information, but a general comment would be that the business activity is very robust in the Twin Cities and a general comment would be that that bank seems to be operating pretty well and experiencing good growth. That is about the best I can do and I hope that helps you a little bit anyway.

Daniel Cardenas
Yes, okay I think it does. And then maybe with some expectations for layoffs coming out of the John Deere factory, are you looking a little bit closer at the loan portfolio in that area and could we expect to see maybe an uptick in reserve levels?

Kent Jehle
Dan, this is Kent. Yes, a very good question. The other part of what we were looking at are companies that do a lot of work for John Deere, we have been proactive and reaching out to those customers. The good news that I see in a bad news scenario is they have already identified what they feel their sales would drop based on projected layoffs or reduction in work for John Deere. And at this point, we don't see where it is going to have a material impact on their business to where we have major concerns and what it does to the portfolio. I kind of categorized what's going on with the Ag industry. And production from John Deere is, if it's a one or two-year cycle, that's one thing, but if we get into a three to five, that's something totally different. So in a short run because of how well the customers have done, we can weather the storm in a one to two-year cycle without a, I don't think material deterioration, but if you get beyond that, we will be looking at a different scenario. So hopefully, that answers your question.

Daniel Cardenas
It does, okay. I think that is it from me right now. I will step back for a minute.

Operator
Thank you. And ladies and gentlemen, just as a final reminder, if you would like to ask a question, please press "*" then "1." Our next question comes from Andrew Liesch of Sandler O'Neill. Please go ahead.

Andrew Liesch
Hi, guys.

Charles Funk
Hi, Andrew.

Kent Jehle
Hi, Andrew.

Andrew Liesch
Question on the margin and more specifically the margin after the deal is done because I mean it looks like Central has been running close to the maybe 4.5% level, yours is around the 3.5% level, so I am just blending the two, I mean, should we be looking at it just shy of 4% in the back half of this year and into 2016?

Charles Funk
I think it is a little trickier with them, because of the importance of the FDIC, a loss share agreements on their margin and on their earnings. And I think that, we have experienced a little bit of that with the loan pools, and when the loan pools were $107 million, I think was their peak since our merger, they could have a serious impact on our margin one way or the other. So I think the core margin percent was probably in the high threes, if you take that out. Gary and Kent have done a little bit more work with that than I have, and they wish to weigh in. But I don't think that the combined margin will be even close to 4%, at least that's not my read no it.

Gary Ortale
Yes, Andrew, this is Gary. I would just add that as we go through the process, there will be some marks made and some of the discount accretion that they typically have been experiencing and pushing their yields up will perhaps go away to some extent. And so, as Charlie alluded to, it is a little difficult to say just exactly where it will be. But I am comfortable saying theirs will be higher most likely than ours. And so, the blend should complement one another, probably the only thing I could say there.

Charles Funk
Yes, they have a…as we pointed out in our…the data that we provided at the merger. They have more…they are $1.2 billion and we are $1.8 billion, and they have more non-interest bearing deposits than we do. So that clearly has a big effect on their margin and we expect them to carry a higher margin, just because you can get it in their markets.

Andrew Liesch
Certainly, and then the other question I have is on the salaries are benefits lines, it has been around $6.4 million or so this quarter a little less last quarter. Is that a good run rate going into 2015, maybe a little bit higher with some seasonal costs in the first quarter, but is that a good level to think about?

Gary Ortale
This is Gary. Andrew, I would say it's a good run rate. I don't, as I looked at the numbers quarter-to-quarter and year-to-year, I didn't really see anything in there that was out of the ordinary. And, of course, it is a little bit dependent to with, the mortgage activity has certainly fallen-off, from what it was a year ago, and so that's reflected there as well. But with the pickup that we have had on the fee side from…certainly the investment insurance area, we are probably seeing a lot higher numbers there. So all-in-all, though I would say it is a good run rate as we go forward.

Charles Funk
Yes, the raise is…the year-end raises this year were probably the highest by 10 or 15 basis points, that they have been in the last few years, but they were just over 3%, I think for the entire bank, maybe 3.1%,3.15% in that area.

Andrew Liesch
Alright, great. Thanks for taking my questions.

Operator
Our next question comes from Brian Martin of FIG Partners. Please go ahead.

Brian Martin
Hi, guys.

Charles Funk
Hi, Brian.

Gary Ortale
Hi, Brian.

Brian Martin

Maybe can you just quantify a little bit or just put a little bit more color around the shrinkage that you guys would expect here over the next couple of quarters before you close the transaction? Kind of what you are thing there?

Charles Funk
Yes, the shrinkage primarily would be accomplished by…as Gary said, selling investments, prepaying home loan advances and by and large the bond sales, I think would generate a net profit, the prepaying the advances will generate losses, I am not sure whether that will all fall-out. And then there are some high cost liabilities jumbo, public fund types of CDs and everything that as they mature, we may not renew them. We may not bid on them again. And I would say that, that would be the bulk of what we would accomplish.

Brian Martin
And as far as how much you actually shrink, I mean, is there a sense for how much that is in dollar terms?

Gary Ortale
Yes, Brian, this is Gary. I would just echo what Charlie said. I think right now we had initially targeted some reduction in some of our jumbo CDs et cetera, but the focus now is on the Home Loan Bank. We specifically identified about $90 million of advances that will be pre-paid. And as Charlie said, hopefully, securities gains will offset some of the penalties that we will incur there. But otherwise, the rest will come from the deposit base and we have kind of had projections of anywhere between total shrinkage of $100 million to $125 million.

Charles Funk
That was my number too, $100 million to $125 million.

Brian Martin
Okay, perfect. That's helpful. And maybe, can you just talk a little bit about the asset sensitivity or lack of as relative to once you close, kind of [indiscernible] and then post closing of a transaction, does it change significantly, is it about the same or how does that look?

Charles Funk
It is a great question, and I am going to presume I can talk about that. It is a great question and it does change significantly. We tend to be liability-sensitive, Central Bank is asset sensitive. And I am not sure the final verdicts then on that, but right now the way we look at it Brian, we would be slightly asset sensitive, when that occurs, and some of that could be driven by the fact that they so many non-interest bearing deposits, and we presume they are going to hold onto those. But as we look at it right now, we think the company would be slightly asset-sensitive.

Brian Martin
Okay, perfect. And I guess, so maybe just a couple of other things, the loan growth kind of the 4% to 5% outlook that you talked about kind of your traditional or historic type of range. How much does that change when you look in the out years post to transaction? I guess my assumption would be it does accelerate some of that given their footprint, but maybe just give a little color regarding how you are thinking about that might change?

Charles Funk
Well, some of that depends on the economies. And what I would say is, if you were talking about 2010 and 2011, you probably would have had more loan growth in Iowa than you would have had in the Twin Cities. Right now, it appears to me that the Twin Cities economy is much

more robust…it's more robust…much more robust, but it is more robust than the Iowa economy. So net-net, I would say, Brian, that we are expecting loan growth perhaps 100 to 200 basis points higher in the Central Bank footprint, than we would in the MidWestOne footprint today, but some of that is going to be economically dependent as well.

Brian Martin
Okay, perfect. And then just the last one, you talked about the efficiency ratio, Charlie, and kind of where is that at the bank level, and the importance of maintaining that. I guess, is your expectation that it's…I guess your goal was to try and hold it or to try and improve it or kind of how are you thinking about that as you look at the year, maybe just, I guess, on a core basis, given, sounds like there is going to be a little noise with some different items here.

Charles Funk
Well, we look at…there is a lot of ways to answer that question. And so, it is a fair question and it is a good question. We have got a graph that we have been putting in our shareholder presentation on efficiency ratio, and it would be one of the things we are most pleased about in our company that no matter what peer group you put us in. Our efficiency ratio is better than our peers. And so, we know that our efficiency ratio will go north of 60% during the year 2015 and probably into the '16, but we also know…and again, I refer back to Richard Davis' comments yesterday, that efficiency ratio is really important in driving the performance of a banking company. So I think, two things, we can't take our eye off the ball in Iowa and we have to continue to perform in Iowa and understand that revenue goes into that efficiency ratio. We have to do our job in Iowa and keep the efficiency ratio in Iowa in the mid-to-low 50s which it is at MidWestOne Bank. And then we have to work very hard on making sure that we get the Central Bank franchise to begin to make improvements so that we can get the entire company below 60%. I don't have a target for you for when we would like to get below 60%. But that would be a fair thing to ask over the next six months as we get more into this. But the short answer to your question is, we regard this as very, very important.

Brian Martin
Okay, alright. I appreciate you taking the questions. Thanks.

Charles Funk
Yes, great questions. Thank you, Brian.

Operator
Thank you, sir. And it appears there is no further question. So I'd like to conclude the question and answer session. I would like to turn the conference back over to Mr. Funk, actually, I apologize. It looks like we do have a last-minute question.

We have a follow-up from Daniel Cardenas from Raymond James. Please go ahead.

Daniel Cardenas
Sorry, guys. You may have said this and I may have missed it, I apologize. But in terms of the expected balance sheet shrinkage, is that kind of a 1Q event or does that bleed over into 2Q and beyond?

Charles Funk
No, I think, the bulk of that would be done before the merger closes on May 1. So how much of that is first quarter and how much of that is second quarter, I would suspect that the bulk of it

would be in the second quarter, but there is certainly going to be some of it in the first quarter. I just…I think the real answer is, we don't know and what I am telling you is an estimate.

Daniel Cardenas
Okay, great. Thank you.

Charles Funk
Yes.

Operator
Thank you. Once again, I am showing no further questions. I would like to turn the conference back over to Mr. Funk for any closing remarks.

CONCLUSION

Charles Funk
Well, thanks to everybody who joined us this morning, and as always, if you have further comments and/or questions, please give Gary or give me a call or an email. We will be happy to respond in an appropriate manner. Thanks again for joining us today.

Operator
Thank you very much for your time, gentlemen. The conference has now concluded and we thank you all for attending today's presentation. You may disconnect your lines and have a wonderful day.