MidWestOne Financial Group, Inc.

Q1 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Charles Funk - *Chief Executive Officer*

Len Devaisher - *President and Chief Operating Officer*

Gary Sims - *Chief Credit Officer*

James Cantrell - *Treasurer and Chief Investment Officer*

Barry Ray - *Chief Financial Officer*

PRESENTATION

Operator
Good day and welcome to the MidWestOne Financial Group First Quarter 2020 [sic] Earnings 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 1. Please note that this event is being recorded.

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And now I would like to turn the conference over to Mr. Charlie Funk, Chief Executive Officer. Please go ahead, sir.

Charles Funk
Thank you very much, Cole, and good afternoon or good morning as the case may be to everyone and thank you for joining us today. In the room with me in Iowa City I have our Chief Financial Officer, Barry Ray; our Chief Credit Officer, Gary Sims; President Len Devaisher; and Treasurer and Chief Investment Officer, Jim Cantrell.

A few opening comments. I would just say that clearly it was a great bottom-line quarter for MidWestOne, the best in our company's history, and it's fair to say that we've never quite gotten to a result such as this in the way we did it, and we'll talk about that a little bit more as the call goes on.

The first thing I should say is that our listeners will recall that we did take a very, very large provision for credit loss in the first quarter of 2020 that was related primarily to our adoption of CECL as well as the pandemic and the economic forecast caused by the pandemic, and other than the negative provision — and there's more of that to come later — I think the biggest stories of the quarter were continued inflow of deposits were clearly awash in cash in our company and in our economy. We had solid non-interest income led by our Mortgage Center and Wealth Management and the PPP ramp-up, and of course the negative provision, which somewhat makes up and counteracts the large provision that was taken in the year-ago quarter.

On the balance sheet, deposits, as I've said, continue to flow in, and it's very apparent to all of us that a portion, maybe even a large portion, of the stimulus payments and the PPP forgiveness payments have yet to be spent and are sitting in our bank in core deposit accounts. In terms of loans, loans ex-PPP were down roughly 4 percent linked quarter. We noted in the earnings release that our line usage fell by almost a third from the prior year quarter. We're seeing brutal price competition, and to give you an idea of some of the price competition we're seeing, we're seeing two handles on five-year loans in parts of our footprint for strong credits. We're also seeing fixed rates that are in the low 3s, if not 3 percent, for 10 years and in some

cases 15 years, and we're seeing a little bit of relaxation in underwriting standards, and I would just say that this is the banking industry's response in trying to put all of these excess deposits to work. So, nothing unusual there, but it is — it's brutal competition for good loans right now.

In terms of our outlook and the pipeline, right now we have about $60 million, maybe a little bit more than that, of loans that have been approved and are ready to close and we have several times that number in the pipeline that are in various stages of process, and, quite frankly, we know that not all of those will close, but we do have a fairly good pipeline of activity.

We don't have any big paydowns that we know of that are on the horizon, and one other thing that I would add is that we did just name this past week a new Head of Commercial Banking who came from within our company, and we think that's very positive for the outlook going forward.

In terms of PPP, you'll recall that we did roughly $345 million of PPP loans in round 1. We stand right now at about $152 million, and as we understand it, the money could run out in the next week or so, so, that's probably about what we're going to do, maybe a little bit more than that, depending on what comes in and what we're able to get through the system.

I also would say that you'll notice in our balance sheet that the investment portfolio is now north of $2 billion, so, with that kind of an investment portfolio, any slope — increasing slope we get to the three-month to five-year part of the interest rate curve is welcome. And for those who — and you ask this from time to time and I'll just tell you, our investment strategy hasn't changed. We continue to buy a combination of high cash flow shorter-term investments that throw off much cash flow in the first two or three years of their investment horizon and also we're buying some longer municipal bonds, high-quality municipal bonds, generally AA and above, to take advantage of the slope in the yield curve. I think it's an understatement to say we have ample liquidity in our company right now.

In terms of the margin, the core margin hung in there for the quarter, 302 versus 301 the prior quarter. We need to see loan growth and a steeper yield curve to offset the pressures that we see on the net interest margin. I don't think it's much more complicated than that.

In terms of non-interest income, the Home Mortgage Center continues to be very, very strong. It's a bright spot in our company. The former American Trust in Dubuque is right now providing about 50 percent of the volume in our Home Mortgage Center, which is a credit to them and a credit to the merger integration that took place there.

To give you a little bit of a perspective on the mortgage production in our company, first quarter 2020 we did $63 million in mortgage loans. That had grown to $128 million by the fourth quarter of 2020 and we fell back to $94 million in the first quarter of 2021, so $63 [million] to $128 [million], back to $94 [million]. There's still a pretty god pipeline, but we definitely see a slowing down. Nevertheless, I think the next couple of quarters, or at least the next quarter, should be above average in terms of mortgage production.

We did record a positive MSR adjustment of $900,000. It's always good to see a black number and not a red number when we talk about the MSR. Also positive, our Wealth Management, which consists of Investment Services and Trust, up 12.6 percent in terms of revenues linked quarter and up 11.8 percent on a year-over-year basis, so strong results there.

There is some potential for loan swap revenue in the second and third quarters of this year, but I — you never know until the loans close on that sort of thing, but there are some discussions, and we feel somewhat optimistic that we can incorporate some swap revenue into our fee income for the second and third quarters.

I don't really have a lot of comments on expenses. I think they were well controlled. I would remind everyone that we had a lot of one-time expenses in the fourth quarter of 2020 and would remind everyone as well that we took a $600,000 charge in the fourth quarter that related to our new contract with our core processor, and importantly, we began to realize the savings from that core processor contract in this quarter and that will be ongoing for the next few years.

In terms of asset quality, I think it's a good story, maybe a better-than-good story. There was a lot of cleanup and progress that was made in terms of our asset quality during the quarter, and that was masked by an ag loan that we put on in non-accrual in the last week of the quarter. That ag loan happens to be very well secured, but as frequent listeners to this call will remember, it takes a long time to collect an ag loan, once it goes into a collection process. But the NPAs were up $1.7 million. Again, that number masks a lot of cleanup that happened during the quarter. The allowance for credit losses at 1.63 percent ex-PPP as of the end of the quarter, we think that's sufficient to withstand any challenges that we may encounter in the quarters ahead.

A brief ag update and the agricultural outlook is very good compared to what you've heard over the last couple of years. Very, very good conditions, and maybe all you have to know is that corn is over $6 a bushel and beans are over $15 a bushel, and that's good news for our growers. The land prices — price indexes that we see are flat year over year; however, we have anecdotal evidence that there are very big prices being paid for farm ground right now, and I think these indexes will reflect that in the quarters ahead. There is a lot of demand for high-quality farm ground right now in our footprint.

I would also note that conditions for our dairy farmers are also better than they have been in a while as well. Also, a bit of good news, if you look at our substandard agricultural loans, they continue to fall as a percentage of the ag portfolio and they're under 7 percent of the ag portfolio, and that's the best number we've seen since December of 2017. Watch-rated credits in the ag portfolio at 10.6 percent and there were a number of upgrades from watch to pass that happened, not just one or two, but a number of different borrowers were upgraded from watch to pass during the quarter.

The ag portfolio right now is 7½ percent of total loans. We'd like to make more ag loans and, I have to get on the soap box just a little bit right now and tell you that the competition we're getting from Farm Credit Services is significant and the rates they're able to offer because of their funding mechanisms are very, very hard to compete with, so we're seeing high 2's and low 3's for longer-term loans from the farm credit system, and I think not just MidWestOne but many banks struggle to compete with those rates. So, just an acknowledgement on that, but the ag portfolio's is about as good a shape as it's been for a long time.

In terms of capital, you'll note that all of the regulatory capital ratios improved during the quarter. The tangible common equity fell to 7.52 percent, which is a function of more deposits and consequently more assets and also the AOCI adjustment, which was negative from the prior quarter, this particular quarter.

We were active in our share repurchase program, especially in the middle of the quarter, and we'll continue to be active in that program, when we think it makes sense for our shareholders.

So, to summarize, I would conclude by saying we do think we have our arms around asset quality. We very much need loan growth. We will continue to focus on technology and have additional focus that's ongoing, and we just continue to be amazed by how long deposits have stuck around on our balance sheet, much longer than we forecast whenever we got our budget together for 2021.

So, Cole, with that, that's what I have to say, and we'd be happy to answer any questions that you might have.

QUESTIONS AND ANSWERS

Operator
And we will now begin the question-and-answer session. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. And once again that is star, then 1 to ask a question. And at this time, we will pause momentarily to assemble the roster.

And or first question today will come from Brendan Nosal of Piper Sandler. Please go ahead.

Brendan Nosal
Hi, good afternoon, everybody, how are you doing?

Charles Funk
Hi, Brendan.

Male Speaker
Hi, Brendan.

Brendan Nosal
I just want to start off here on the reserve and the provisioning. You have had two quarters of pretty large negative provisions. Your reserve is still really, really healthy at that buck, 63 ex-PPP. As we're kind of thinking about where you would have been with CECL before COVID, I think it was at 96 basis points reserve after adopting CECL. So, just given how the year is shaping up, how do you think about your provisioning needs or maybe lack thereof and where the reserve is headed over the next couple of periods?

Gary Sims
Hi, Brendan, this is Gary. I'll start to answer the question, and then ask for my colleagues to help me out if I miss anything. I think you're seeing our view of the reserve appropriately. As we've — as the economic conditions have improved and as our credit quality has stabilized, we've taken the position that we're more comfortable with our reserve position and adequately reserved, and, as a result, that's why you see the releases.

I think as you look at 2021 on subsequent quarters, that trend is — right now we believe that will continue to be the case. We believe our credit quality will continue to stabilize as the economy

continues to improve. So, that will get the answer started. Charlie, Barry, anything to add there?

Barry Ray
[Inaudible]

Gary Sims
Okay, good.

Charles Funk
Yes, I think that's sufficient. I've — maybe just one more thing, Brendan. We've always thought, and this goes back a decade or more and acquisitions have skewed this from time to time, but for a bank like ours, under normal economic conditions if we're in the 140-to-160 range in terms of the portfolio, the reserve to the portfolio, that's usually a comfortable range for us.

Gary Sims
And that's a good point, Charlie. The range that you land in there is kind of going to depend upon your view of the economy at that point in time, and as the economy continues to improve, our view improves as well.
Charles Funk
Yeah.

Brendan Nosal
All right, great. That's helpful. Maybe one more for me just moving to kind of the loan side of things. I get that, you know, demand sounded quite soft this quarter, but I'm curious, speaking geographically, what parts of the footprint this quarter were seeing some of the more robust demand versus what pieces were seeing softer demand?

Len Devaisher
Yes, Brendan, this is Len. So we are continuing to see pockets of strength. I see activity in the Twin Cities, continue to see consistency in Colorado, in Denver, and then I would also point to here in our home market of Iowa City, I see some nice signs of strength.

Brendan Nosal
All right. Thank you for taking the questions.

Charles Funk
Thank you, Brendan.

Operator
And our next question will come from Jeff Rulis with DA Davidson. Please go ahead.

Jeff Rulis
Thanks, good morning.

Male Speaker
Good morning Jeff.

Charles Funk
Hi, Jeff.

Male Speaker
Hi, Jeff.

Jeff Rulis
Charlie, you alluded to, and it makes sense, the margin direction pretty dependent on yield curve and loan growth, but I don't know if that environment — you've had a pretty stable margin last couple quarters. So, the thought is, are you fair — do you have some confidence that you're bouncing along the bottom, and from here you do see further yield curve improvement or loan growth pick-up? It's more of an expansion, and until that point, it's holding the line on margin? I just want to make sure I get your expectations on the margin side.

Charles Funk
Yes, I would repeat what I said, and then I'll let Jim dive into that a little bit, but I really do think that loan growth is key, and the — I don't think we've watched the slope of the yield curve as closely as we do now for many years. And specifically, we're looking at that three-month to five-year portion of the curve and when it's steepened, maybe a month ago or six weeks ago, that was really a good thing for us. When it comes back in, it does make a difference in terms of the yields we're able to buy, but I'll let Jim expand on that a little bit.

James Cantrell
Sure. Jeff, I would say you were right on it. We've had a tremendous shift in the asset mix, and that has had implications on our margin. I think on the go-forward view, I could see us bumping along the bottom here for a little bit, but that view is predicated on a couple of things. One is that we don't see additional deposit growth, and that deposit growth has really forced us to put on assets at a much lower margin than we would normally do in the last year. So, assuming that we see sort of a stability on the deposit side of things, then I think we're into a period where we could see a fairly stable market.

The one item that I know that's coming due that will have an impact on that — and this gets away from core margin a little bit, but we do have some PPP loans on the books that will be forgiven. That will offset some of the loans that we're expecting to come on. So, it depends on how that interplay works out a little bit, but that's a long-winded answer to I think we're in for a bit of stability on the margin.

Jeff Rulis
Okay. I appreciate it. And maybe a question on the fee income front, a pretty strong wealth management result. Just looking over the balance of the year, Charlie referenced — I think we all think that mortgage banking has been strong and maybe it's still got a tail, but maybe that fades a bit. I think you talked about some swap potential later in the year. So, balling that all up, a strong wealth management, is that — can that continue, but as you see the — it's a pretty high number on the fee income for this quarter. Any thoughts on the sustainability?

Charles Funk
Yes, well, mortgage, any of us can guess on mortgage. It's dependent on the economy and interest rates and affordability and all those things. In terms of our trust and wealth management, we typically budget in the 5 to 8 percent range in terms of fee income growth, and more often than not, they're able to hit that. Sometimes they do a little better; sometimes they do a little worse, but that's what we expect from them each year. And of course the direction of equity markets has a big impact on that. So, that's what I would offer, Jeff, on wealth management, and I do think there will be some commercial swap activity at some point this year, but that's dependent upon us getting to the finish line on the loans.

Jeff Rulis
Sounds good. Thank you.

Charles Funk
Thank you.

James Cantrell
Thanks, Jeff.

Operator
And our next question will come from Terry McEvoy with Stephens. Please go ahead.

Terry McEvoy
Hi. Thanks. Good afternoon, everyone.

Multiple Speakers
Hi, Terry.

Terry McEvoy
The question is, is there any indication out there that deposit growth is slowing? And then, if I look at the deposit balances in the first quarter, I'm just curious, the jumbo deposit's up, call it $90 million, and given the 70 percent loan-to-deposit ratio, just curious where that jump came from and maybe why there wasn't some thought putting — put into maybe shrinking some of those higher-costing funds.

James Cantrell
Hi, Terry, this is Jim. I'll take a crack at that one. There has been a little bit of deposit growth in the first quarter. I think what we've seen in the latter part of the quarter and now into the second quarter is sort of a slowdown of some of that growth. Specifically, some of that growth took place on the public funds side. We've been able to bid on public funds, and we've continued to bid on some of our local public fund depositors but at rates that are very — what I would consider attractive, 30 basis points for one-year money as an example. And so we've — we have maintained a bid for that type of deposit.

In terms of the non-maturing business or consumer deposits, I think they've been relatively flat in the latter part of the first quarter, and so, my expectation, based on that short period of time, is that we'll see a flatness. We had originally thought that the PPP forgiveness might cause a little bit of an exodus of deposits, as some of those businesses took some of those excess funding and distributed them. Haven't seen that yet. That's still in the back of our mind that that could be a coming event later this year.

Terry McEvoy
And then as a follow-up, mortgage has been strong, and it sounds like that's going to continue over to the near term. I guess my question is assuming rates go higher and mortgage revenue declines, could you just talk about any flexibility you have on the expense side, just so as we model out the next couple years, we may capture some of the expense reduction that would occur in theory if revenue does come under pressure?

Barry Ray
This is Barry, Terry. I think with respect to the flexibility that we have on the expense side, a part of the things that we're looking at right now is related to our branch network infrastructure, and where we have opportunity there. I would say that's going to be at least one lever that we have to pull, but I would also say that we know we're going to have to continue to invest in technology as well. And so, obviously we continue to diligently monitor expenses, and I think the first quarter results s how that.

Charles Funk
And I would add to that too, specifically to your question, we might not take the approach that some of our — some of the larger banks take in terms of mortgage and with wholesale reductions in personnel. With that being said, the head of our mortgage unit's been in the business for a long time, and I think that the answer is, yes, there would be some rationalization of expenses over time, but it would be done very thoughtfully, if that makes sense, Terry.

Len Devaisher
And a big piece of that too — this is Len — one big piece of that of course is that variable comp that goes with the mortgage, right, a big piece of the mortgage comp expense is directly variable with the income.

Terry McEvoy
Great. Thanks, everyone.

Charles Funk
Yes, thank you.

Len Devaisher
Thank you.

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

Damon DelMonte
Good afternoon, guys, hope everybody's doing well today.

Charles Fund
Hello, Damon.

Multiple Speakers
Good afternoon.

Damon DelMonte
Excellent. Great. My first question is just a question on the outlook for expenses. Barry, I think last quarter you guys were saying $29 million to $30 million. I think that was for the first quarter, but is that how we should think about the future quarters, even though this quarter came in much better than that?

Barry Ray
Right. Yeah, we tried to articulate as best that we could, Damon, in the release, some of the nuances in the expense run rate for this quarter. I think if you take a look at that and you adjust for those items, that should give you a pretty good sense of where we landed with respect to

this quarter again. For example, some of the positives that we had this quarter was PPP origination costs, which were a benefit, so I think if you adjust for those items, you should have a pretty good sense of where the expense run rate will land.

Damon DelMonte
Got it. Okay. I'll check that out, then. With regards to the accretable yields this quarter, I think it was like $1.1 million, which is down from last quarter and down substantially from the previous quarters in 2020. Should we look at this as the go-forward run rate for accretable yield?

Barry Ray
I would think that the million dollars a year, Damon, is a reasonable —

Charles Funk
A quarter,

Barry Ray
A quarter, yes, a million — sorry, I said year. A million dollars a quarter is a reasonable assumption for the near term, but again, that slows over time, and so probably in the latter half of this year it may be slightly lower than that.

Damon DelMonte
Okay. Great. And then I guess just the securities portfolio, it's almost double the size from the year-ago quarter, and I just want to confirm like that's just the reallocation of the liquidity that's come on the balance sheet, right, or did you guys put on some additional leverage inside of that?

James Cantrell
This is Jim. Yes, I tell Charlie, I'm going to start charging him by the trade ticket, because that's — as opposed to just a regular salary. Yes, that was not a designed — it was a reaction to the deposit growth that we had and nothing more than that. So, it was our attempt to put to use the excess liquidity in as thoughtful a way as we could, keeping in mind the constraints of the interest rate risk that we're undertaking when we do buy investments, which tend to be a little bit longer. So, as Charlie said, we're really trying to focus on mortgaged securities that are cash flowing at this point. That probably comprises more than 50 percent of the bonds that we're buying, and so, they're high-credit quality and just throwing off a lot of cash flow in the event that we're going to need it to fund liabilities that run off at some point.

Damon DelMonte
Got it. Okay. So, eventually over time, we should expect that to kind of normalize as a percentage of average earning assets and go back to a historical level?

James Cantrell
Yes, I mean, again, that's sort of predicated that the balance sheet normalizes, as you say, and the deposits do flow out at some point and loan growth kicks in, and so we — it's over some period of time. I don't know what period that might be, but we would expect to go back to a more normal 20, 25 percent of the balance sheet in the investment portfolio as compared to where it is now.

Damon DelMonte
Great. Appreciate the color. Thanks a lot, guys.

Charles Funk
Thank you, Damon.

Operator
And once again, if you'd like to ask a question, please press star, then 1.

Our next question will come from Brian Martin with Janney Montgomery. Please go ahead.

Brian Martin
Hi, good morning, guys.

Charles Funk
Hi, Brian.

Male Speakers
Good morning, Brian.

Brian Martin
Hey, just one — a couple for me. Just on just the M&A and the buyback. Charlie, you touched a little bit on the buyback in your prepared remarks, but just M&A, I mean, there's been a lot of discussion and activity in the markets. Can you just give us an update on how you guys are — I guess how you feel about that today and how dialogue is and just remind us or give us some update on the recent period here?

Charles Funk
Sure. It's a good question. I would say that the first thing is on the buyback, as I've said in the opening comments, we'll continue to proceed there when we think it's beneficial for our shareholders to do so. In terms of M&A, there's definitely more conversation than there has been. During 2020, there wasn't a whole lot, and there's more conversation. We don't really have anything that's imminent, but there are some opportunities during the past 60 days that we've looked at and continue to monitor. So, yes, there is more chatter, and I would say it's banks of varying sizes as well.

Brian Martin
Okay. And I guess just from a — maybe just jumping to credit quality for a minute — the positive trends you say in the criticized and classified this quarter, I guess, would your expectation be that — you know, it sounds as though things are stabilizing and improving on the credit side, that there's more of that to come as you look at criticized and classifieds over the next several quarters, you still see some positive migration there of those trending lower?

Gary Sims
Yes, Brian, this is Gary, and I think that's a good way to look at it. I see opportunity for continued improvement in those ratios over the coming quarters. As we look at the portfolio, we worked through the deterioration that we had and now we're coming out the other end, and each quarter, I think, we should see positive trends.

Brian Martin
Gotcha. Okay. And then just the last two for me. Just the — maybe one for Jim, just on the margin on the — when you talk about the core margin, Jim, I think you went through some things last quarter, but when you make your adjustments to — for the accretion and the PPP, is your belief that the core margin is somewhere in the 275-, 277-type of range, that type of level,

and you just make those adjustments and that's the core level you're talking about? When you talk about bouncing around at the bottom, kind of absent the noise, it's that level and then make our adjustments on that — those other two items that are a little bit more volatile?

James Cantrell
I feel like, Brian, you're looking at my piece of paper here. You — the numbers, yeah, once adjusted for PPP and regular loan accretion, I do get a number that's in the neighborhood of between 275, 280, in that range for a core margin in the current period. And again, we'll — the future will be — of that margin will be dependent on a lot of things, including the asset mix and the things we've talked about already.

Brian Martin
Yes, okay. Okay. I just wanted to make sure I had the right starting point. And then just — I don't know, just on the PPP, can you guys — do you have the — how many loans were originated in round 2 and just what the — I guess what the remaining — you gave the remaining fees in total — just what they were for round 1 and 2 at this point, or if not, I can get that offline, but just — or that would just be — if you have the round 2 originations that would be helpful.

Charles Funk
Yes, we're at roughly 152 in terms of applications right now and we — if they run out of money in the next week, that might go up a little bit, but it certainly won't go up materially. In terms of round 1, and I'm looking at Gary here, I think if we did 345, I think we're between 200 and 210 maybe, that have been forgiven.

Gary Sims
Yes.

Charles Funk
And to be honest, there are two things that play there. Number one, we've been surprised that more folks haven't come forward for forgiveness, but also the larger loans, $2 million and over, the SBA has really not acted to forgive them to any large degree, if at all. So, those two factors are at play, but 200 to 210 out of 345 is where we stand on round 1.

Brian Martin
Okay, and then just the remaining fees on round 1, do you have that, ballpark?

Charles Funk
That —

Gary Sims
No, we don't have the remaining fees on round 1. We put the remaining fees for the whole thing in the pages of the release.

Brian Martin
Okay, that's okay. I'm okay with that, then. Thank you.

Gary Sims
Thanks, Brian.

Charles Funk
Yes, thank you, Brian.

Operator
And this will conclude the question-and-answer session. I'd like to turn the conference back over to Charlie Funk for any closing remarks.

CONCLUSION

Charles Funk
Thank you, everyone, for being on the call. Stay safe, stay healthy, and have a great weekend. Back to you, Cole. Thank you.

Operator
Thank you. And the conference has now concluded. Thank you for attending today's presentation, and at this time, you may now disconnect your lines.