MidWestOne Financial Group, Inc.

Second Quarter 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Charles Funk, *Chief Executive Officer*

Len Devaisher, *President*

Gary Sims, *Chief Credit Officer*

James Cantrell, *Chief Investment Officer*

Barry Ray, *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the MidWestOne Financial Group, Inc.'s Second Quarter 2021 Earnings Call. All participants will be in listenonly 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 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

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 filed with the Securities and Exchange Commission. MidWestOne Financial Group, Inc. undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances after the date of this presentation.

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

Charles Funk
Thank you very much, Eilee, and we welcome everyone and thank you for joining us this morning or afternoon if you're in the Eastern time zone. And I would say that I am joined today by Gary Sims, our Chief Credit Officer; Barry Ray, our Chief Financial Officer; Jim Cantrell, our Chief Investment Officer; and Len Devaisher, the President of the company. And I would make a few introductory comments and just say that overall it was really an interesting quarter and certainly a good quarter financially, and I think one of the highlights of the quarter is that we're beginning to see just a few green shoots in terms of loan demand in our footprint.

A few other general comments, we did have continued decent deposit generation. Although the period-to-period numbers are pretty flat, I think that's due to a few large — vary large temporary deposits that were parked in the bank on 3/31, that left during the quarter. Very pleased to report that asset quality is stable-to-improving, and I think we have positive momentum in terms of asset quality in our company. Net interest margin remains a challenge for us, and I think a challenge for our industry, not just MidWestOne. And in terms of capital, we feel very good about the tangible common equity ratio back near 8 percent, and I would remind all of our listeners that for many years, more than a decade, our target for tangible common equity has been in the 8 to 8½ percent range, so we're very comfortable with where we stand right now.

Specifically, I'll talk just a little bit about the balance sheet and say that the PPP forgiveness has ramped up the past 45 days or so. Ex-PPP, as we put in the earnings release, our loan totals grew 2.2 percent from the — in the late quarter. The primary producers of the growth in our loan portfolio came from Denver and from the Twin Cities, although we do see positive momentum out of our Iowa City market as well as our Southwest Florida market, and would also say that line usage on our lines of credit continues to be in the low-30 percent range, and normally at this time of the year, it would probably be in the mid-40s. So down about a third, and we really don't see that changing in the near term, but we will continue to watch that and report on it as we are able.

Competition for good loans, I would categorize as brutal. There's a lot of stretching and, as one noted economist said this week, stooping for yield. We are seeing rates quoted in the 2's for out to five years and occasionally longer than five years in the high 2's. We don't see a lot of compromise on asset quality, perhaps a little bit, but not a lot. I think most of the competition right now is in the rate category, and that really does make it tough on maintaining a good margin, but we are competing when we feel that we need to. And in the ag space, as we've said on past calls, Farm Credit Services remains a very, very strong competitor, offering long-term fixed rates in the 2's, and it's very, very difficult to compete with that.

Overall, we are still seeing paydowns in our footprint, not in one region or another, but there are paydowns and most of the paydowns seem to be coming from sale of businesses, and we see a little bit of that continuing into the third quarter. In terms of our loan pipeline, for the third quarter, I would say that it's not robust, but it's not sparse. I'd call it a reasonable pipeline, and we're off to a good start in July in terms of loan production.

Our deposits, as I said, were flat 3/31 to 6/30, but again reflective — that's reflective of a few very large loans on our balance sheet at 3/31 that left during the quarter, and we continue to actively pursue good core deposit customers throughout our footprint.

In terms of the net interest margin, as stated, the margin's a challenge, and I think it will continue to be a challenge in this rate environment. Loan growth can help mitigate some of the pressure on the net interest margin, and PPP fees will continue to flow in the next two quarters, which also helps greatly. What we need is — in addition to loan growth, is a steeper yield curve in the three-month to five-year area of the yield curve, and that is not a new comment. I've made that comment on prior calls.

We did proactively sell a number of long-duration bonds at the end of the quarter, and we did this for a couple reasons. We did it to increase asset sensitivity as well as open room for slightly longer-duration loans on our balance sheet when we feel that's appropriate. There really wasn't a large gain or loss. Some bonds were sold at a gain some at a loss. We did that out of an abundance of caution and really taking a proactive approach to interest rate risk management.

Turning to non-interest income, very, very pleased with our Home Mortgage Center in the company. It continues to be strong. You did see a little slowing in the revenue. What's interesting about the flattish or slightly declining mortgage revenue is that the volume of mortgage loans originated was about the same, but the gain on sale was less because that reflects narrower margins on gain and sale as competition has increased in the mortgage market as well.

In past calls, I've given a call out to our Dubuque and Dyersville, Iowa, locations, which were part of the former AT. They continue to do an excellent job of mortgage production and that is about 50 percent of our mortgage production year to date. We expect good results going forward from mortgage, probably not at the booming levels that we've seen in Q4 of 2020 and Q1 of 2021, so I think mortgage should hang in there for at least another quarter, and we feel pretty good about where we are there.

Also, Wealth Management, a very good story in our company. Our Investment Services area, which is comprised of LPL-registered representatives just continues to hit the ball out of the park in terms of their results, and we did add a new representative, investment representative, in Southwest Florida, and that's the first time in our company we've been able to have an investment rep in that part of our footprint. You will also remember that we did hire a group of trust bankers in Minnesota, and they've been working in the Twin Cities market. They continue to gain momentum, and I think a year from now what you will see is a significant amount of

assets under management. They've just come into our company and really done a nice job, and overall our Trust Department continues to produce consistent growth and really a key component of our non-interest income in our company.

Also, a positive trend in card revenue, which is nice to see. I think that was a little bit unexpected, but we'll take it, and we continue to see momentum there as well. What we would love to see in non-interest income is a better and more favorable market for interest rate swaps that we could offer to our loan customers, but we just don't have the market for that right now, at least the way we see it.

In terms of non-interest expense, very few comments here. There were some one-time adjustments in the salaries and benefits line item, but we feel okay about where our non-interest expense is at this particular point in time.

Turning to asset quality, again, as I said in the opening comments, a good story. MPAs are coming down slowly, but the trend is good. We had minimal charge-offs again this quarter. In the ag portfolio, ag continues to diminish a little bit as a percentage of our portfolio. It's a little over 7 percent of our portfolio right now, but the ag portfolio's in pretty good shape because prices have been good for soybeans, for dairy, and for corn, and probably the only thing that we keep an eye on is in some parts of our footprint, especially the northern part of our footprint in Iowa, lack of rainfall has gotten to be a problem, although we did get a good rain in the last week or so. And some parts of our footprint look just extremely good in terms of crops. So I think the outlook for this year is pretty good in terms of our agricultural portfolio.

If you look at the watched and sub-standard in our ag portfolio, it's down nicely from a year ago, and we expect that trend to continue. I jotted down four reasons why I think that ag loans have been a struggle in terms of growing the portfolio. The first one is we've worked out of some problem credits, which diminishes the outstandings. The second reason, not unlike commercial banking, is that PPP funds were made available to the ag borrowers in the second round of PPP, and we did over $10 million, over $10½ million, of PPP loans to our ag customers, and what that means is fewer draws on their credit lines, on their working capital lines. We also see some balances that remain from insurance proceeds last year from the 2020 [Unintelligible] Show, and then of course Farm Credit Services continues to be a strong competitor. Overall, the reserve release reflects our continuing confidence in asset quality and that we think the outlook for the next few quarters and beyond is an improving outlook, and that's the main reason for the reserve release.

In terms of capital, we've been active repurchasers, and especially in the last 30 days have been active repurchasers, and we remain adamant that MidWestIOne Financial Group's stock is a compelling value. Tangible common equity, 7.86 percent at quarter end, and I would also note that our tangible book value per share climbed to $27.90 per share.

So overall a good performance. We need to continue to show loan growth, and we need to continue to manage the heck out of the net interest margin, and I think those are the two biggest challenges that we have for the quarters ahead.

And with that, Eilee, I think we're all ready for Q&A and I will turn it back to you.

QUESTIONS AND ANSWERS

Operator
We will now begin the questionandanswer 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.

Our first question today will come from Brendan Nosal with Piper Sandler. Please go ahead.

Brendan Nosal
Hey, good morning, everybody.

Multiple Speakers
Good morning, Brendan.

Brendan Nosal
Charlie, I appreciate your comments on liquidity flow during the quarter and the fact that year-end deposits probably matched what's still going on, given some movement there with the larger [inaudible]. Could you expand a little bit on kind of the pace of liquidity flows you continue to see, and whether or not the slowdown a little bit [inaudible] continuing at these record levels?

James Cantrell
Brendan, this is Jim. I guess I'll start. Charlie is right, I think we did see some large — fairly large balance deposits running out in the month. My sense is that we've — as I look at the second quarter, we probably hit close to our peak. We're down off the peak as we ended the quarter, down off the peak of our total deposit balances, but we're just not seeing the pace of growth that we were seeing through, the prior four or five quarters. So I would — my sense is that deposit growth, while not negative, has slowed down considerably here in the latter part of the second quarter and now moving into the third quarter.

Brendan Nosal
Okay, great. That's helpful. And then maybe on a related note, if liquidity flows are indeed slowing down or stopping entirely, I feel like that has been one of the largest variables for the margin over the past couple of quarters, a couple with ones that were [unintelligible] imaginable. Would you —- given the liquidities are slowing, any thoughts on your ability to defend the margin from this point, or without a steeper curve is there going to be kind of a bit of a further growing down?

Male Speaker
Yeah, well, a steeper curve would certainly help, and what we've had happen to the yield curve in the last three or four weeks probably is not a positive for the margin, because we've had curve flattening over that period, but as I see the mix, a couple of things are going on. One, we will have some PPP forgiveness still remaining. I think there were $184 million worth of PPP loans on the books at the end of the quarter. What we've seen over the last month or month and a half is that as those loans have been forgiven, they've been replaced with either shrinking the wholesale funding side or with loans coming on the books, so over the last 45 days to two months, we really haven't been in a position where we've had to buy any new securities, which has been somewhat of a luxury. The last major purchase we did was probably at the beginning of the second quarter in April, and so if that trend holds where we don't have to add to the securities portfolio and we see that the PPP loan forgiveness is going to be replaced with regular loan production, then I think we'll have a good chance of defending the margin.

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

Charles Funk
Thank you, Brendan.

Operator
Our next question comes from Jeff Rulis with D.A. Davidson.

Charles Funk
Hi, Jeff.

Jeff Rulis
Thanks. Good morning.

Multiple Speakers
Good morning.

Jeff Rulis
Charlie, you spoke on the buyback appetite. It sounds like that's going to be a tool that you continue to use, particularly it's stepped up of late. I guess we — just circling back to kind of M&A, they've been kind of on the sidelines for a bit, and just kind of revisit where you sit on sort of capital allocation and the opportunities that you see.

Charles Funk
We think right now buying back our stock is a very good use of our capital, especially at these levels. Even slightly higher levels, we still think it's a very good investment for our shareholders. We're aware of M&A opportunities. We've looked at a number this year, but we also have to understand what we're able to pay for as a company that would benefit our shareholders, and if we find opportunities — and there may be some-that would be of benefit to our shareholders, we certainly would pursue them and we think we have the means to do so.

Jeff Rulis
Okay. And, Charlie, on the loan pipeline, you mentioned sort of they're reasonable, I suppose, and you also talked about some paydowns. So I'm trying to peg where you are, and it sounds like more of an optimistic tone and as things kind of re-open, but just getting a sense for your expectations, is it safe to say that you're slightly less maybe defensively minded on credit if that's more comfortable, and just expectations, I guess, kind of second half of the year and maybe into '22 on kind of growth, are we approaching a mid-single digit expectation or not quite there yet given still pretty brutal competition as you said?

Charles Funk
Well, we can compete and we're certainly willing to compete on price. We're not willing to compete by stretching credit terms too far; however, I think mid-single digits would seem kind of high to me, but I think the expectation here is that we would continue to grow our loan portfolio at a measured pace. Again, the 30 percent line usage doesn't help us, and I know others are experiencing the same thing. When folks sell their businesses, that doesn't help us, but, yeah, we've got some things in the pipeline, and I think it probably depends more on paydowns than it does on production, because I think we're going to be able to produce based on what I see in the pipeline.

Jeff Rulis
Okay.

Charles Funk
And I hope that helps you.

Jeff Rulis
Yeah. No, it's all — I think we're all kind of dealing with businesses flush with cash and how this sort of unwinds, but I'm just trying to — it's helpful to have some additional color. But I did have one last one for maybe Barry. The tax rate, kind of '21, '22, sort of the expectation that we're kind of hugging in the middle of that range. Where do you think the rate will [inaudible]?

Barry Ray
Yeah, I would use — I would utilize something around that for the full year, yeah.

Jeff Rulis
Okay. That's it for me. Thanks.

Charles Funk
Thank you, Jeff.

Operator
Our next question comes from Terry McEvoy with Stephens.

Terry McEvoy
Good morning, everyone.

Charles Funk
Hello, Terry.

Multiple Speakers
Good morning, Terry.

Terry McEvoy
I have a question on the non-PP commercial loan growth. I know you mentioned Denver and Twin Cities as two markets that kind of stood out. I was hoping you could maybe just expand on the green shoots that you were seeing. Were there any consistent themes among those borrowers in the second quarter? And just kind of layering in, when the PPP loan is forgiven, what are those customers doing? Are they then having conversations with you about their lending relationship, and are they an area of growth going forward?

Charles Funk
I'll let our President, Len, take the first crack at that, and Gary may want to weigh in following.

Len Devaisher
Thanks, Charlie. Yeah, I do — in response to, Terry, your second question about when the loans are forgiven, so one of the things that is a core part of our process as a relationship-focused bank, is of course spending time with those customers and coming alongside them to — as they look forward and look ahead. So to our point earlier, that's a line usage, right? We see that PPP — those dollars as a major pressure point online usage, and so — but we — as customers, depending on where they're situated and where their outlook is, we're obviously coming alongside them to talk about how we can participate in helping them grow their business. So, yeah, that's a very active part of the PPP forgiveness process.

And with respect to themes of the loan growth and so forth, the thing that I'm encouraged by is that there's a fair amount of diversity across ventilated markets, because of both Twin Cities, Colorado, Florida, and Iowa City, but also in terms of the types of deals that we're seeing, so I mean there's certainly CRE deals and so forth, but I also see some non-profit opportunities in those numbers. And I see a nice kind of mix where we're not becoming — we're not running the

risk of any kind of concentration there. So that part feels good to me and that's what I see in our pipeline as well.

Terry McEvoy
Thanks for that, and then —

Charles Funk
I think Gary may — Terry, I think Gary may have something to add.

Terry McEvoy
Perfect. Perfect. Great.

Gary Sims
Terry, I was going to just reinforce what Len is saying and seeing in the marketplace. I think a general theme that I'm seeing from the credit side is that the activity around utilization of capital is increasing. In other words, people are getting off the sidelines and starting to make decisions about deploying capital, and it's really happening on both the buy side and the sell side. And I think that's really what Charlie was saying earlier relative to the paydowns could add pressure to our loan growth. I think that's what's driving that, is we have customers that are making sell decisions, and we have customers that are making buy decisions, so it's really increasing the activity in the marketplace.

Terry McEvoy
Okay. Thank you both for that. And then just as a follow-up, on the mortgage business, in the release, it said it's still operating above normal. I'm just wondering, on a quarterly run rate basis, is normal something closer to call it, $2 million? And then if that's the case, how do I think about the expense adjustment in a lower mortgage revenue environment?

Barry Ray
Yeah, if we look back — this is Barry, Terry— with respect to paying on sale dollars, I will say maybe — I'd go back to the second quarter of last year for example — $2 million would have been the rate about where we were running. So — and then add on top of that the servicing income and then obviously a big wild card is the servicing right adjustments, but — and then most of our — the costs associated with our mortgage business, there is a variable nature to it that you're alluding to, and I would probably reduce that cost pro rata with respect to any reduction that you make in the revenue.

Terry McEvoy
Thank you, Barry.

Operator
Our next question comes from Damon DelMonte with KBW.

Damon DelMonte
Hey, good morning, everyone. I hope everybody's doing well today.

Charles Funk
Hi, Damon.

Male Speaker
Good morning, Damon.

Damon DelMonte

So my first question, kind of looking at, the credit trends obviously continuing to do quite well there and reflective with the second quarter in a row of provisionary capture, how should we think about the back half of the year? Do you think that the reserve is adequate enough where you could see further release given these trends continuing?

Gary Sims
Hey, Damon, Gary here. I'll start to answer that question as well. What you're seeing in the portfolio, and even more specifically in the reserve, is really the culmination of how we've been proactive in managing our portfolio through the pandemic, and you monitored with us as we increased criticizing classifieds and NPAs previously, and really that proactiveness has created the resolutions that you're seeing today and the positive trends that you're seeing today. And all of that is resulting in the provision releases that you're seeing today, and, as Charlie was saying earlier, I think you're going to continue to see the positive trends in the assets and the credit portfolio and that will create — I'm going to call it a bias towards continuing to moderate our reserve on a go-forward basis.

Damon DelMonte
Okay, that's helpful. Thank you. And then I guess just a quick question here on expenses, probably for Barry. You guys, from the commentary, I take it you're kind of comfortable here in this upper $28 million range as a good run rate going forward?

Barry Ray
Yeah, Damon, this is Barry. Yeah, there were — as Charlie alluded to, there were a few puts and takes, but I think the range that we had for this particular quarter on our expense run rate is a fairly good representation of what we think the near-term run rate could be.

Damon DelMonte
Okay, great. That's all that I had. Thanks a lot, guys, appreciate it.

Charles Funk
Thank you, Damon.

Male Speaker
Thanks Damon.

Operator
If you have further questions, please press star, 1 to join our queue. Our next question comes from Brian Martin with Janney Montgomery.

Brian Martin
Hey, good morning.

Charles Funk
Hi, Brian.

Multiple Speakers
Hi, Brian. Good morning.

Brian Martin
Hey, guys, just wanted to ask you, on the — just maybe jumping back to the core margin for a minute, I guess just given your comments about the volume, the origination volume replacing the PPP and holding the margin, I mean I guess, given Charlie's comments about the pipeline, I guess would your expectation be that kind of based on what the current pipeline looks like, that that's possible? I guess there was — that maybe volume's not enough and if that volume's not

enough, I guess you could see a little drip lower on the core margin kind of ex the PPP and accretion number.

Male Speaker
I think you've hit on the mechanics of it. I think you're right; they could drift a little lower. Like I said, we have $184 million of PPP-unforgiven loans on the balance sheet as of the end of the quarter. Depending on the pace of those — and we will spend some money to pay off some wholesale funding along the way but unfortunately, there's not a lot of wholesale funding. Maybe $10 [million] or $15 million a quarter, is what we've got left. So we'll spend some money on that, and we'll spend some money on loan production, and to the extent it's offset by that PPP forgiveness — it's kind of a balancing act — it is certainly possible that PPP outruns — forgiveness outruns loan production. But, as I said, for the last 45 days, two months, it's been pretty even, so that's sort of what I'm basing my forecast on, is what we've seen over the last couple of months.

Brian Martin
Gotcha. Okay. And then just — I'm not sure for who — on the PPP, appreciate the commentary about the pick-up here. Just should we think about the remaining fees and the forgiveness kind of — the bulk of that occurs in the second half here, that — with the remaining fees are all collected here? Is that fair to think about based on the pace of activity and what you're seeing currently, or do you think there's still some bleed into next year?

Barry Ray
Brian, this is Barry. The fact pattern that you just outlined is kind of what we would expect, I would say. However, it's very difficult for us to triangulate on the timing of what the SBA is going to do, and so, for example, I would say that PPP Round 1 forgiveness slowed down whenever they had PPP Round 2, and so there's a lot of — there could be uncertainty in the timing. We expect the latter half of this year there'd be a larger volume of PPP forgiveness and perhaps completely, but it could very well be some amount that trickles into 2022.

Gary Sims
Yeah, that's fair, Brian. This is Gary. Most, but probably not all, in the latter half.

Barry Ray
Yeah.

Brian Martin
Okay, perfect. And I don't know if this may be for Barry, just that comment earlier about just kind of the fee income, kind of the level of mortgage that's core, just when you think about mortgage does normalize, but to Charlie's point about maybe the wealth side getting some benefits from the people you've hired, I mean, is it fair to think about a $9 million type of run rate as kind of w here we think about these are as you kind of normalize, and maybe after next quarter with mortgage and then building from there? Is that fair, Barry, or [inaudible]?

Barry Ray
Yeah, the range that I have in my mind, Brian, for the fee income in total is about $8½ to $9½ in the near term.

Male Speaker
That's what I'm thinking.

Brian Martin
Gotcha. Okay. And then just remind me, Barry, what — the remaining accretion to bring through, where does that stand today? I think the amount this quarter was $800 or $900.

Barry Ray
Oh, for the loan purchase discount? [Inaudible]

Brian Martin
Yeah.

Barry Ray
Yeah, June 30th, Brian, that was $7 million, is what's left.

Brian Martin
Okay. And just remind me, the timing of how you think that plays out, I guess.

Barry Ray
I think it's very — I think it's going to play out similarly to what we've observed with respect to the notion of the quarterly accretion is recognized more upfront and we've see that back pattern play out. And so, the amount that we recognized this quarter, which, yeah, I think it was what — $800,000 or so? I anticipate that it will — future quarters will be that and then lower.

Brian Martin
Gotcha. Okay. Perfect. That's all I had. Thanks for taking my questions.

Charles Funk
Yeah, thank you, Brian.

Male Speaker
[Inaudible], Brian.

Operator
This concludes our questionandanswer session. I'd like to turn the call back over to Charlie Funk for any closing remarks.

CONCLUSION

Charles Funk
Thanks to everyone who joined us this morning. For those who need further clarification on the earnings release, please contact any one of us and we'll be responsive to your inquiries. And with that, we wish everyone a good day and a good weekend. And back to you, Eilee.

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