

MidWestOne Financial Group, Inc.

First Quarter 2022 Earnings Conference Call

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CORPORATE PARTICIPANTS

Charlie Funk, *Chief Executive Officer*

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Brendan Nosal, *Piper Sandler*

Terry McEvoy, *Stephens*

Jeffrey Rulis, *D.A. Davidson*

Damon DelMonte, *KBW*

Brian Martin, *Janney*

PRESENTATION

Operator

Hello, and welcome to today's MidWestOne Financial Group, Incorporated First Quarter 2022 Earnings Call.

This presentation contains forward-looking statements relating to the financial condition, results of operations, and business of MidWestOne Financial Group, Incorporated. Forward-looking statements generally include words such as believes, expect, anticipates, and other similar expressions. Actual results could differ materially from those indicated. Among the important factors that could cause actual results to differ 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, Incorporated 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 hand over to Charlie Funk, CEO, to begin. Please go ahead.

Charlie Funk

Thank you, Elliot, and good day, everyone.

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In the room today in Iowa City with me Barry Ray, our Chief Financial Officer, Gary Sims, our Chief Credit Officer, Jim Cantrell, our Treasurer and Chief Investment Officer, and our President, Len Devaisher.

I'll give a brief overview of the quarter and then let Barry and Len speak to some of the specifics as we did have a few unusual items in the report this quarter. We're very happy to report a fourth consecutive quarter of loan growth, which was around the 5%-mark length quarter annualized and we feel like there's a good pipeline in store for us as we go through the rest of the year.

It's notable that we did swing and miss on a number of deals because competition again is very, very keen. To give you an idea, we lost a fairly sizable loan that was in our portfolio about a month ago and the term was 330 fixed for 10 years. In some markets, not all, we do see the loan to values being pushed as well.

As I said, we have a good portfolio of construction loans funding as the year progresses. In terms of the growth that we saw in the quarter, I would specifically highlight the twin cities market, our Des Moines and Iowa City markets in Iowa, and Southwest Florida stood out in our quarter. We also were able to hire a senior commercial banker at a senior management level in our Iowa footprint, well known throughout Eastern Iowa, and we feel like that will be a huge benefit to our Company going forward.

As I said, we have a good pipeline to start the second quarter, and I would include Denver in that group as having a very strong pipeline. We did report a sizeable MSR adjustment, and that clearly helped our earnings during the quarter. I think several years ago, when we consciously decided to build our servicing portfolio, it was for times such as these, when mortgage production would be down usually due to rising interest rates. That would be partially offset by positive MSR adjustments, so it worked pretty well, at least in this quarter.

We thought our wealth management was pretty steady despite the negative pricing in the markets. Our LPL brokers continue with good production. We have a good pipeline in our trust department, but we know from experience that when portfolios move, it can often take several months to move a portfolio, but we do guide to the back half of this year, and we think we will see increasing revenues from our wealth management group. In terms of expenses, I have a few comments on expenses.

Expenses were much higher than in a normal quarter at MidWestOne. We did have significant legal fees, as well as some personnel procurement elevated costs that contributed to that. One of the things our Company has always been followed on is our expense management and we expect that to continue going forward.

Our normal run rate is definitely lower than it was this quarter. We do continue to spend significant dollars on technology because we realize that technology, the right technology, well-constructed, is a key to our future. One other comment on expenses, we do continue to monitor the appropriate number of offices and we will continue to assess that going forward.

We note, just an interesting sidelight, that in the first quarter, our branch teller transactions were down 11% from 2021 and our mobile logins were up double that, 22%. So clearly, fewer people are coming into our offices at MidWestOne and we expect that trend to continue. Asset quality stable to improving, net charge offs of 28 basis points. Those were loans that had been identified and we decided to move on. Otherwise, no real story in asset quality. At 1.42%, we think our allowance is solid and we see more progress in store on that horizon in 2022.

In terms of capital, we did move, as noted in the release, $1.25 billion of securities that held to maturity. That was effective 1/1/22. We did this with the belief and knowledge that our liquidity will continue to be

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strong. PCE declined 29 basis points to 7.20%, regulatory capital ratios remain strong, and we highlight CET 1 down slightly from the prior year at 9.82%.

We continue to be opportunistic with share repurchases. Last but not least, just to comment on the Iowa First transaction, we announced that deal on November 4, I believe it was the date of our announcement, and so on May 4, it'll be six months since we announced the acquisition.

We've had no push back at all from our regulators and are constantly being told that we're in the queue, but we still don't have approval. We will admit to some frustration that a deal of this size is taking this long for approval.

We also note that the increase in interest rates that we've seen since we announced that transaction should be a positive for 2022 and 2023 earnings accretion as a result of this transaction. We just need to close.

With that, I will turn it over to Barry Ray.

Barry Ray

Thank you, Charlie.

I'll walk through the financial statements beginning with our balance sheet, starting with assets. Core loans increased $32.8 million or 4.2% annualized from the linked quarter led by commercial loans, which increased $35 million or 5.4% annualized from the linked quarter.

The allowance for credit losses declined $2.5 million due to net charge of $2.2 million and a credit loss benefit related to loans of $0.3 million. The net charge offs stemmed primarily from two relationships and reflected our resolution plan for those credits.

Non-performing assets were $31.5 million at March 31, 2022, down slightly from year-end 2021, and down 31% from the prior year period.

Deposits were down slightly from the linked quarter, but up 6% from the prior year period. Our deposit mix improved slightly to favor non maturity deposits and our cost of total deposits and costs to funds each declined one basis point from the linked quarter.

Finishing the balance sheet, total shareholders equity was down $23 million from year-end 2021, due to a $33.2 million negative valuation adjustment on the debt securities portfolio.

As Charlie noted, during the first quarter of 2022, we reclassified approximately 50% of our debt securities portfolio to held a majority to mitigate the negative impact to tangible book value from rising rates.

Moving on to the income statement, net interest income of $37.3 million was down $1.3 million from the prior year period, but up $2.5 million or 7.5%, if you exclude PPP fee income and loan purchase discount accretion. For interest income, loan interest income declined from the prior year period, primarily due to less PPP benefit and loan discount accretion, while it was partially offset by increased income from our debt security portfolio.

Non-interest income was $11.6 million for the first quarter of 2022, which was up from the linked quarter primarily due to loan revenue. Loan revenue in the first quarter reflected a $2.7 million favorable adjustment to our mortgage servicing rights, whereas the linked quarter MSR increase was $0.9 million.

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Finishing with expenses. Non-interest expenses were $31.6 million for the first quarter of 2022, which was up from $30.4 million in the linked quarter.

As noted in our release, and as Charlie touched upon, legal and professional and occupancy expenses (inaudible) were elevated this quarter. While those costs were operating in nature, we do not believe they will recur at those same levels in future quarters. We believe our quarterly expense run rate is closer to $30 million, but expected to be above that level in the next quarter.

With that, I will turn it over to Len.

Len Devaisher

Thanks, Barry.

I want to speak just a few minutes about where we are focused from a priority perspective, and, of course, as you would expect, it's all about revenue. When we think about driving revenue in our business, Charlie spoke earlier about technology, and that technology spend is both about remaining relevant to our customers and efficient in our operation. The key lever for us from a revenue perspective is always about talent. The right people in the right places, doing the right things, and we're seeing encouraging results and pushing for more in that regard. You've heard on this call about commercial loan growth and the number that stands out to me, which I'm most proud, is that our commercial production in the first quarter is up over 8% from the same period in the prior year.

Charlie spoke to the pipeline as we look forward, and that includes two important components. One is new opportunities that we continue to work diligently. The second is that a lot of our production is in construction loans that will fund up across the balance of the year. As we look at the consumer side of the loan balance sheet, net production is basically level on a year-over-year basis, but we're seeing less cannibalization.

A year ago, this quarter, with the mortgage refi business being what it was, we saw cannibalization of consumer balances, but in the first quarter of this year, we're basically staying level as opposed to a 4% decline in the same period last year.

On the deposit front, while it's essentially a flat quarter in deposit balances, we are pleased that retail deposit sales, so new money coming from new retail households, is up 12% compared to the same period last year.

Importantly, we continue to enjoy net new accounts on both the consumer and the business side. We're growing and we're focused on continuing to grow. Wealth management revenue is up 6% on a quarter-over-quarter basis over the same period last year, with assets under management at 5%.

As Charlie spoke to at the top of the call, we're certainly continuing to drive for and expect wealth management income in the latter part of this year to be a growing contributor.

I would also point out just in terms of non-interest income, that we look forward to following industry best practice and keeping our customer at the center of our operation by enhancing our deposit offerings with respect to NSF fees.

The good news as we drive our business in that way, is that we think this positions us well competitively. It serves our customers and communities in alignment with our mission and purpose, and we've been able to make other fee adjustments to balance out the fee outlook for the rest of the year.

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Finally, I would just supplement Charlie's comments about our new commercial banking executive here in Iowa. We see that, not only as a great add for the Company, but a real compliment to the wealth management team we spoke of in the Cedar Rapids market in earlier calls.

With that, I'm pleased to open it up for questions.

Operator

Thank you.

Our first question today comes from Brendan Nosal from Piper Sandler. Your line is open.

Brendan Nosal

Hey, good morning, folks. How are you?

Len Devaisher

Morning.

Charlie Funk

Good morning.

Brendan Nosal

Good. Maybe just to start off here on the securities portfolio. I mean, the move to health and maturity was clearly a very prudent move given what we've seen so far on the yield curve this year. I'm kind of curious about two things. One, would you consider making another move in that book to HDM? Two, can you just remind us how much of that portfolio is either variable or adjustable rates?

Barry Ray

Brendan, this is Barry. I'll start and say the answer to your first question is, we do not expect to make any further adjustments with respect to reclassifying available for sale to held to maturity securities. I think it's fair to say that we don't necessarily expect to add a whole lot more to the held to maturities portfolio. That's where our current thinking is. Jim, can you speak to the fixed variable?

Jim Cantrell

Yes, I can. I will. We do own a few variable rate securities in LIBOR and SOFR based corporate securities. The amount is somewhere in the neighborhood of between $125 million and $150 million of variable rate securities (inaudible).

Brendan Nosal

Got it. Okay. That's helpful, and then I just want to make sure that I heard Charlie's comments on expenses correctly. It sounds like the underlying run rate you think is closer to $30 million, but it might be elevated a little bit again in the second quarter before kind of dropping off to that level later in the year. Of course, that's the deal?

Barry Ray

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You've got the important part there at the end there, Brendan, ex the deal, correct. Yes, that's what we expect right now.

Brendan Nosal

Understood. All right. Thank you for taking the questions.

Barry Ray

Thank you, Brendan.

Operator

Our next question comes from Terry McEvoy from Stephens. Your line is open.

Terry McEvoy

Hi, good morning everyone.

Barry Ray

Morning.

Terry McEvoy

Maybe a question on deposits. Overall, could you just talk about deposit pricing competition in your marketplace and what you think expectations are? And then just looking at your average balance sheet, you've got $884 million of average time deposits at 49 basis points. Maybe if you could discuss the opportunities to reprice that lower this year.

Jim Cantrell

Yes. Terry, this is Jim. I will start out on that one. I wish I believed that we had a lot of opportunity to reprice the CD lower. I suspect that we're probably close to the trough bottom of deposit costs. We have seen some local market competition here in Eastern Iowa already, mostly credit union competition start to raise CD rates, not appreciably, but they're probably sitting 50 basis points, maybe 75 of both where we are. As of the first fed tightening that happened in the middle of March, we have not moved CD rates nor any other rates on the deposits yet.

I'm somewhat optimistic that we'll be able to hold the core account types of rates, the savings accounts, the checking accounts, pretty steady, but I think we'll see some competition move on the CDs and that's sort of the question mark in my mind, is, how slow we'll be able to move those rates. But the plan is to move fairly slowly.

Terry McEvoy

Maybe a follow up. Could you talk about the health of your agricultural borrowers within your markets? I know commodity prices are higher, but there seems to be a lot of concerns around just inflation and fertilizer costs, etc.

Gary Sims

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Sure. This is Gary. I'll start that conversation, and Charlie, if you have anything to add, please do. You're on the right track. The '21 crop season was a good one. We had good yields in Eastern Iowa where our ad exposure is, and combined with the prices that you mentioned, it was a good '21. We're going into the '22 season with our borrower group in probably the best shape they've been in in the past five, six, maybe even more years.

For '22, most of our borrowers, the vast majority of our borrowers did lock in their input costs in terms of fertilizer, probably one of the main ones that we have to think about. So, we do anticipate '22 being another good solid year. Good prices. Again, input costs are under control for '22.

As we look forward, '23 will be the year that we will be challenged with having to deal with higher input costs and even, more specifically, the fertilizers. That's kind of our outlook at this point. Does that help?

Terry McEvoy

It does, I appreciate it and thank you for taking my questions.

Barry Ray

You bet. Elliot, are there other questions?

Jim Cantrell

Is this still connected?

Barry Ray

It still shows connected. Hello?

Terry McEvoy

This is Terry McEvoy, can you hear me? Am I still in the queue?

Barry Ray

You're still on. We still hear you.

Terry McEvoy

Okay. I tried to step aside, so hopefully the Operator can move the call forward.

Operator

Our next question comes from Jeffrey Rulis from D.A. Davidson. Jeffrey, please go ahead.

Jeffrey Rulis

Thank you. Good morning.

Barry Ray

Hi, Jeff.

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Len Devaisher

Jeff, it's nice to hear your from you.

Barry Ray

Yes, it is.

Jeffrey Rulis

Yes. I was just wondering if it's something I did. I just wanted to check in, Charlie, perhaps on Iowa first. Since the early November announcement, just wanted to kind of see about how operations have gone there in terms of growth, expenses, just expectations on that transaction and as we kind of head towards a potential close in 2Q.

Charlie Funk

Well, thank you. Yes, generally positive. The cooperation we've got, particularly from the Muscatine Bank, which is the largest bank in the Company, about 70% or so of their assets, has been great. As you know, or as anyone would know, the longer these things drag out, the harder it gets to get to close because employees leave. We're dealing with a little bit of that, but overall, I would say pretty positive.

We just found out this week that the Muscatine Bank has increased its lending significantly since the deal was announced. I think all the trend, most of the trends there are still pretty good and I think when it does close, as I said in my opening comments, we do expect to see a little bit better earnings accretion maybe than we had thought.

That's primarily driven by the higher interest rates that we have because they do have a large securities portfolio and they've kept it very, very short as they have waited for the merger. I hope that helps a little bit.

Jeffrey Rulis

It does, and I mean, you sort of are at the mercy of regulators. Any idea on kind of a May or a June close? The second one would be conversion timing at this time.

Charlie Funk

Those are good questions. I wish I could give you a definitive answer. If you would've asked on the last earnings call, we would've thought that we could probably get this thing closed in April. Now, I mean we expect to hear any day, but we've been expecting to hear any day for the last month.

Again, there's been no pushback, no concerns expressed by the regulators, so I'll guide you to mid-May or June 1 as the likely days. Probably as I sit here today, maybe June 1.

Barry Ray

Jeff, this is Barry.

With respect to the conversion dates, if we hit those dates, those close dates that Charlie just outlined, we should still be in good shape to complete our conversions as planned, which are July and September.

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Obviously, if it pushes beyond that at a minimum, that July conversion date gets a little bit more potentially problematic, but so far, we're still okay on that front.

Jeffrey Rulis

Appreciate it. Thanks, and maybe Barry, I wanted to kind of a interrelated PPP and margin. Do you have a core margin if you ex PPP and accretion linked quarter?

Barry Ray

I do, Jeff. The core margin ex PPP and accretion, one second, please. Two sixty nine is what I've got for the core margin for the first quarter, Jeff, and 266 would've been the linked quarter for margin ex PPP and purchase accounting.

Jeffrey Rulis

Okay, and one follow on. The PPP interested fees linked quarter, or just the reduction, or if you have the absolute balances, that's great.

Barry Ray

I have the absolute. The PPP interest in fees in the first quarter, $834,000. In the fourth quarter, $2,128,000.

Jeffrey Rulis

Great. The last one while we're housekeeping here. The line utilization, I think you mentioned that was up. What was that linked quarter, the improvement?

Len Devaisher

Jeff, this is Len. At the end of March, we were at 35%.

Jeffrey Rulis

Okay, and up from some number turning higher, I suppose.

Len Devaisher

Excuse me, yes, up from 33 at end of December.

Jeffrey Rulis

Okay. Fair enough. I'll step back. Thank you.

Barry Ray

Thank you, Jeff.

Operator

Our next question comes from Damon DelMonte from KBW. Please go ahead.

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Damon DelMonte

Good morning guys. Hope everybody's doing well today. First question, just to…

Charlie Funk

Hi, Damon.

Damon DelMonte

Hey, Charlie.

Just to circle back on from Jeff's question about the core margin. Barry, if 269 is the core margin here in the first quarter, can you just give a little perspective on how you think that reacts with like each 25 basis point move by the Fed? If not that specific, then just kind of some of the puts and takes as we look out over the next few quarters.

Barry Ray

Yes. I'll start with that, Damon, and, Jim, jump in here if you feel compelled. We've kind of been talking about it in terms of every 100 basis points increase impact to the margin and we believe the margin may benefit 5 to 10 basis points for every 100 basis points of rate increase.

Jim Cantrell

The color I would add there is that, that sort of is presuming we're pretty successful in lagging our deposit increases. Our models would say we're fairly neutral, but that assumes kind of a normal beta, which for us would be the 20% to 25%.

We think we at least for the first 100 basis points of increase, we'll likely be able to raise rates at a below beta normal beta historic beta rate. I think Barry's right. In a 100 basis point move, by the time we get to the end of the year, we might be 5 to 10 better than we are today.

Damon DelMonte

Okay, and Jim, can you just remind us what percentage of the portfolio is floating and what percentage has floors and where they are relative to those floors?

Jim Cantrell

Yes, in terms floating versus sits on the loan book, we're looking at between 30% and 40% of the portfolio is a variable rate. Many of those do not have floors. Those that are with floors, after the first 25 basis point increase, I'd say we have about another $100 million to $150 million in loans that still have some amount of floor.

If we get 50 basis points next week as the market expects, it'll just be a very few loans that are left below their floor rates.

Damon DelMonte

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Got it. Okay. All right. That's helpful. Thank you, and then I think, Len, you made the comment about kind of moving to reduce NSF fees kind of as the best practice. Could you clarify the timing of that and are you able to quantify what the expected impact is to that line item?

Len Devaisher

Sure.

Damon, we are—actually, we'll be formally announcing the program on Monday, so you can see the details of it. I can tell you from a financial statement impact perspective, we modeled it on an annualized run rate at 400,000, and we have been able to identify offsetting fee adjustments from loan fees, non-customer ATM fees, as well as some treasury management other deposit fees that we feel like will offset that impact. So net neutral.

Damon DelMonte

Got it. Okay. That's good. Okay. That's all that I have for now. Thanks a lot, guys.

Charlie Funk

Thank you, Damon.

Operator

Our next question comes from Brian Martin from Janney. Please go ahead.

Brian Martin

Hey, good morning, everyone.

Charlie Funk

Hello, Brian.

Brian Martin

Maybe just one from me, or just back to the last one on margin just for a minute. I mean, Jim, are you suggesting that the—when you say 30% is variable, it's probably about a billion dollars, maybe a little bit less. Is that moving immediately with rates or is that just variable? They're going to be priced over time. Just if you clarify a little bit on that, or can you give any additional color?

Jim Cantrell

I know Barry's looking at his screen, he may have some fresh numbers, but my recollection is, you're right. Not all of that price is instantaneously, so it may be right around $1 billion, maybe a little more if I count. If you count term CMT adjustable loans, it may not be priced for some time, but immediately adjustable is probably about, I'm guessing—I'm not guessing, I think it's about half of that amount.

Then we have some again, CMT based loans, which are going to price over the course of the next year. So, even some of our prime loans don't price instantaneously. They reprice once a month. A few of them even price just once a quarter, but most of them are going to be repricing in the next three months.

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Brian Martin

Got you. Okay. All right, and then how about just, I don't know maybe for Barry, just on the fee income, I guess, or Len, you guys talked about the wealth being up maybe a little bit, but you've got the impact of higher rates.

Can you just talk a little bit about how you're thinking about fee income and aggregate? I guess there's a couple of items, how they're going to ebb and flow and kind of the run rate of how we should think about that going forward. I don't know that there's much as far as mortgage recapture the remains, but is that a potential that there's more of that to come?

Barry Ray

Brian, this is Barry, I'll start. I think with respect to fee income in the aggregate, I'm thinking about it really with respect to $9 million to $9.5 million per quarter and this is exclusive of the acquisition, Brian. I'm kind of thinking about it on that type of run rate is where I'm thinking about it.

With respect to the mortgage servicing, if that's your question, that's a non-linear function and so we've captured a good chunk of that in the first quarter. We do not expect that kind of magnitude of increase in future periods.

Brian Martin

Got you. Okay, and maybe just one on the expenses. It sounds as though you may, given the branch visits are lower, that may be something that's on the table later in the year. I guess if we think about the potential that occurs, is most of that savings potentially if you announce something, is it reinvested in the Company? Is that how you would think about something along that front?

Barry Ray

That's how I would think about it, yes. I think that we would reinvest those proceeds into continued technology investment.

Charlie Funk

Yes. To give you some perspective, Brian, if you go back to 2019, we had 62 offices in the Company. Today, we have 55, and as I think we've said on past calls, we're in a lot of markets where we just have one office in the market.

So, we don't perhaps have the density of a company that would be located primarily in metro markets. We just need to be thoughtful about this and we don't see anything that's huge in terms of numbers on the horizon, but we do think we've got some room to continue to trim around the edges.

Brian Martin

Got you. Okay, and just as far as the last one for me, is just on the rate sensitivity guidance, just the acquisition, how you're thinking about that to impact the margin and kind of your rate conversations?

Jim Cantrell

Brian, this is Jim.

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I will take that. First of all, the acquisition is, in terms of balance sheet size, it's relatively small. I would say the target balance sheet is similar in composition to ours in terms of deposit makeup, in terms of loan, in terms of the asset mix, in terms of loans versus securities. So they're going to look a little bit like us coming over.

I would expect that they have a little bit of liquidity and we will convert some of their securities into securities that look a little bit more like ours. I think we'll get a little bit of an increase in net interest income. I think that will be positive.

On the margin, it may be a slight drag to the margin. I just think they'd probably hold a little more cash and securities than we do. Mix is probably a little less favorable, but again, it's a 10% of the legacy bank tax. It won't have a huge impact on margin.

Brian Martin

Yes. Got you. Okay. Perfect. Well, thank you for taking the questions, guys. I appreciate it.

Charlie Funk

Thank you, Brian.

Operator

We have no further questions. I'll now hand back to Charlie Funk for closing remarks.

Charlie Funk

Thank you, Elliot, and thanks to everyone who joined the call today. As always, if any of you have further questions or need further clarification, please contact us. Any of us would be happy to respond. Wish everyone a great day and a great weekend.

Operator

Today's call has now concluded. We'd like to thank you for your participation. You may now disconnect your lines.

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