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Earnings Call

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Call Participants

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the MidWestOne Financial Group Third Quarter 2023 Earnings Call. [Operator Instructions] As a reminder, this call is being recorded.

I would now like to turn the call over to Barry Ray, Chief Financial Officer of MidWestOne Financial Group. Please go ahead.

Barry S. Ray
CFO & Senior Executive VP

Thank you, everyone, for joining us today. We appreciate your participation in our third quarter 2023 earnings conference call. With me here on the call are Chip Reeves, our Chief Executive Officer; Len Devaisher, our President and Chief Operating Officer; and Gary Sims, our Chief Credit Officer.

Following the conclusion of today's conference, a replay of this call will be available on our website. Additionally, a slide deck to complement today's presentation is also available on the Investor Relations section of our website.

Before we begin, let me remind everyone on the call 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 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 call over to Chip.

Charles N. Reeves
CEO & Director

Thank you, Barry, and good morning. On today's call, I'll provide an update on the continued progress of our strategic plan execution. Len will then provide an update on our lines of business, and Barry will conclude with a review of our third quarter financial results.

As discussed on our first quarter call and outlined on Page 4 of our earnings presentation, we've developed a strategic plan with 5 key pillars. Despite a difficult interest rate environment, which continues to impact our net interest margin, I could not be more pleased with our strategic plan execution, as outlined on Slide 5.

A key tenet of our strategic plan was a review of our geographic footprint with a focus on improving our scale in attractive markets and accelerating our profitability. Our September announcement of the sale of our Florida operations with the proceeds reinvested into the acquisition of Denver Bankshares is a significant step towards the realization of our goals.

Importantly, this merger accelerates our Denver market growth by 3 to 4 years, while enabling us to more effectively recruit bankers to further accelerate our already attractive growth trajectory. Another pillar of our strategic plan is to expand and move up tier in our Commercial Banking and Wealth Management businesses with a focus on our major metro markets of the Twin Cities, Denver and Metro Iowa.

During the third quarter, in addition to the Denver Bankshares announcement, we also made progress in the Twin Cities, having recruited a seasoned banker who led the C&I team for a larger regional bank in

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this important market. At MOFG, he will lead our middle-market C&I lending team, which is an untapped opportunity and one that we're focused on further building out as we drive scale in the Twin Cities. We are very excited to be able to attract such a talented lender to lead our middle-market team.

Treasury management is also a strategic imperative to our C&I uptiering strategy, and we've been investing to expand our talent, platform and product offerings. Here in the third quarter, we made strong progress as we named a new Director of Treasury Management, combined our sales and service organizations, promoted a team sales leader and recruited 2 additional experienced treasury management salespeople in our metro markets. Overall, we expect to see a significant improvement in fee income over the next 12 months.

Turning to our Wealth Management business. Our focus has been to build our wealth business through team lift-outs, like the recruiting of the wealth teams in the Twin Cities and Cedar Rapids, which has contributed to significant asset growth over the last several years. To further propel this segment, we started an executive search for the leader who will transform our wealth business as we invest and grow the business to the next tier. We'll also continue to actively recruit wealth management teams in our core markets to drive asset growth and fee income.

In our specialty business lines, we hired an experienced agribusiness lending team from a Midwestern-based regional bank, late in the second quarter. The team's already closed their first relationships and their pipeline has built to more than $40 million. They'll be pivotal as we move upmarket and go after opportunities with larger growers, producers and suppliers.

Government guaranteed lending is also a natural fit for our local and metro bank markets, and our desire is to become one of the leading banks' 7(a) lenders in our footprint. Our 2023 originations have increased by 39%, and we believe we'll have additional SBA business development officers recruited in the fourth quarter and first quarter of next year. As such, we continue to anticipate this initiative will be a meaningful fee income contributor in 2024 and beyond.

Overall, we've been very pleased with our success recruiting bankers to MidWestOne and the client relationships that they are generating. As I previewed last quarter, we did expect loan growth to moderate in the third quarter to the mid-single digits given the general economic outlook and our own selectivity. Looking forward, we expect to deliver mid-single-digit loan growth in the fourth quarter before reaccelerating to high single-digit growth in both 2024 and 2025.

Turning our focus to improving our operational effectiveness. We outlined a plan to reduce our operating expense base by 5% and then reallocate 2.5% into more productive, profitable markets and departments. I'm very pleased with the initial results of our operating expense review, which can be seen in our third quarter noninterest expense performance.

Looking forward, we'll be reinvesting a portion of these cost saves into people and capabilities to accelerate revenue, while also continuing to look for further expense saves and operational efficiencies. Our focus is to drive excellence across the bank in all facets of our business.

To conclude, we've made substantial progress executing our strategic initiatives over the last 2 quarters as we work to create the foundation to become a high-performing bank that delivers consistent financial results. We've accomplished much while also navigating a very challenging market environment. While we have more to do, I could not be more pleased with the successes that we've achieved.

Importantly, none of this would be possible without our employees' continued commitment to our company, customers and communities while in the midst of significant change. I'm very proud of their hard work and excited for what the future holds for our team, our customers and all of our stakeholders.

Now I'd like to turn the call over to Len.

Len D. Devaisher
President & COO

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Thank you, Chip, and good morning, everyone. As I discussed on our second quarter call, our sales teams across the bank have remained focused on retaining and gathering deposits. And the results are showing.

We are pleased with the third quarter having generated strong core deposit growth, as highlighted on Slide 6. This increase in customer deposits positioned us to reduce higher-cost broker deposits. Notably, we see consumer deposits stable and commercial deposits increasing, more than offsetting declines in public fund balances.

Our commercial banking team is driving strong growth on the asset side of the balance sheet, too. Our nearly $37 million of commercial loan growth in the third quarter was driven by our focused metro markets. Denver accounted for more than half of the growth. and Twin Cities continues to show steady progress. Growth in CRE and ag helped offset a $20 million decline in line utilization. The commercial team also helped our borrowers navigate the current interest rate environment, generating $600,000 of swap income in the quarter.

Our loan story is about growth, but also about profitability and soundness. We are pleased that our weighted average coupon of new commercial originations in the third quarter was 7.49%, up from 6.85% in the second quarter.

As outlined on Slide 8, our asset quality metrics were impacted by 1 senior living credit that was moved to nonaccrual, which drove the rise in our nonperforming assets. That said, our credit risk profile remains solid with low net charge-offs of only 4 basis points and the leading indicator of 30-plus day delinquency at a very low 16 basis points.

As Slide 9 shows, we are well positioned with a diversified loan portfolio without outsized concentration in CRE and only 3.7% and nonowner-occupied office exposure.

Turning to Slide 10. The talent investments in wealth also continue to bear fruit. Year-to-date, the Wealth team has been entrusted with new assets under management of $170 million. As Chip mentioned, we see an opportunity to further grow our wealth business with talent additions at the executive leader and relationship management levels.

With that, I'm pleased to turn the call over to our CFO, Barry Ray, to discuss our financial results.

Barry S. Ray
CFO & Senior Executive VP

Thank you Len. I'll walk through our financial statements beginning with the balance sheet on Slide 12.

Starting with assets. Loans increased $47.4 million or 4.8% annualized from the linked quarter to $4.07 billion. Strength in the third quarter was led by commercial real estate loans, which increased $41.4 million or 8% annualized from the linked quarter. The overall portfolio yield was 5.19%, a 14 basis point improvement from the linked quarter.

During the quarter, the allowance for credit losses increased $1.2 million, to $51.6 million or 1.27% of loans held for investment at September 30. The increase was due to credit loss expense of $1.6 million attributable to organic loan growth.

Turning to deposits. Our core deposits increased $83.2 million or 1.8% from the linked quarter. Core deposit growth in the third quarter positioned us to reduce our broker deposits by $145.6 million to $220.1 million at quarter end as compared to $365.6 million at the end of the second quarter. Taken together, Total deposits declined $82.1 million to $5.36 billion at September 30 as compared to June 30.

The rising interest rate environment continued to pressure deposit costs and our total funding costs in the third quarter. Specifically, the cost of interest-bearing liabilities rose 35 basis points to 2.33%, comprised of increases to our interest-bearing deposits, short-term borrowings and long-term debt costs.

Finishing the balance sheet, Total shareholders' equity experienced an increase of $4.1 million to $505.4 million driven primarily by third quarter net income, partially offset by an increase in accumulated other comprehensive loss and dividends paid during the third quarter of 2023.

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Turning to the income statement on Slide 15, net interest income declined $2.4 million in the third quarter to $34.6 million, as compared to the linked quarter, due primarily to higher funding costs and volumes and lower interest-earning asset volumes, partially offset by higher interest-earning asset yields.

Our tax equivalent net interest margin declined 17 basis points to 2.35% in the third quarter as compared to 2.52% in the linked quarter. Our NIM in the third quarter continued to be impacted by the Federal Reserve's rising interest rates, resulting in an increase in our funding costs, which significantly outpaced the increase of 12 basis points in our total interest-earning asset yields.

Noninterest income in the third quarter increased $1.1 million, primarily due to a $0.6 million favorable change in loan revenue, coupled with a $0.5 million increase in other revenue.

Finishing with expenses. Total noninterest expense in the third quarter was $31.5 million, a decrease of $3.4 million or 9.7% from the linked quarter.

As Chip discussed, improving our efficiency in operations, including cost reductions is a key pillar of our strategic plan, and our lower expenses in the third quarter reflected our focus on expense management. It's important to point out that we continue to invest in our business. And as a result, we expect our run rate noninterest expense to gradually increase going forward.

Importantly, we remain on track to reduce our annual expense run rate by approximately $3.25 million, with the eventual reallocation of another $3.25 million of our annual expense base into more productive, profitable markets and departments. Expense control is a key focus of our management team, and we are very pleased with our execution.
And with that, I'll turn it back to the operator to open the line for questions.

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Question and Answer

Operator

[Operator Instructions] We do have our first question, comes from Terry McEvoy from Stephens .

Terence James McEvoy
Stephens Inc., Research Division

Maybe -- first, I have a question for Barry on the expenses. I was trying to follow along there. But can you help us think about the fourth quarter expense run rate? I know in the third quarter, there were some medical insurance benefits that contributed to a bit of a decline.

And I guess, maybe just clear up a little bit, the savings versus the reinvestment. And how you think that will actually impact or what expenses will look like?

Barry S. Ray
CFO & Senior Executive VP

Yes. Kind of how we're looking at the fourth quarter, Terry, is, we expect probably around $32.5 million be the run rate for the fourth quarter. And as we said in our prepared remarks, when you look into 2024, obviously, there's going to be some typical annual increases. And so we probably get up to the $33.5 million, $34 million range in the beginning of 2024.

Terence James McEvoy
Stephens Inc., Research Division

Okay. And then sticking on '24. How should we think about the loan growth comments we heard from Chip earlier? How do we -- how are you thinking about the size of the balance sheet overall, in terms of growth next year?

Barry S. Ray
CFO & Senior Executive VP

I think -- this is Barry, Terry. I think we'll probably see loan growth of the -- let's call it, mid-single digits.

Charles N. Reeves
CEO & Director

And Terry, this is Chip, too. So I think in the loan growth, we -- in my prepared comments, we mentioned reaccelerating to the high single digits. And so -- we just hit the middle of that high mid-single and go 8%. We believe that's very feasible with the originations that we're seeing and the talent that we are bringing on.

Then in terms of our deposit base for 2024, we've seen stabilization and some increase here in Q3, and we're seeing that, frankly, the same at the beginning of Q4. So if we extrapolate that and it's still a hand-to-hand combat battle on the deposit front. But if we extrapolate that a little bit, we'll probably end up 2%, 3% deposit growth in 2024 and then the remaining of the fundings of the loan growth will come from the securities cash flow.

Terence James McEvoy
Stephens Inc., Research Division

Perfect. Okay. And maybe one last question. On the first quarter call, you provided some financial targets for the end of '24 and I believe end of '25. And when I look at the ROA and efficiency at least in the third quarter, it's quite a bit of a step-up to get there, and I don't know if that's feasible.

So Chip, is it really just the interest rate environment and the pressure on net interest income that's going to keep the ROA below that target? Or are there some other things that I'm not -- I just can't see as an outsider.

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Charles N. Reeves
CEO & Director

No. Terry, I think that's extremely well set. I'm very pleased in terms of the strategic plan execution that we've laid out from April to here in the end of September. I think it's actually -- we probably achieved more in a quicker time frame than even I had laid out previously, especially when you consider the strategic announcements we did at the end of September, the decrease in our noninterest expense run rate as quickly as we've been able to achieve such, some of that talent hiring. It truly is the movement of the forward curve from where we were in February, March time frame to where we stand today.

And as you know, we have a liability-sensitive balance sheet. So that higher longer is the -- truly about the only reason that those metrics are a little bit off today.

Operator

[Operator Instructions] Our next question comes from Damon DelMonte from KBW.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Just wanted to start off on the margin and kind of the outlook there. Barry, could you maybe just provide a little bit more context and color around some of the dynamics you're seeing here going into year-end. It was a pretty sizable step down this quarter compared to what I think most of us were looking for. So how do we kind of think about the margin over the next, say, couple of quarters and where it may trough?

Barry S. Ray
CFO & Senior Executive VP

Yes. Thank you, Damon. So here are some of the dynamics that we're seeing on the margin. I would say on the asset side, on the loan yield, we're seeing about 4 basis points per month of increased in asset yield. And so that's been a fairly standard pattern over the past 6 months as our loans repriced and renew.

And then if I flip to the liability side, our cost of deposits, that pace has slowed, such that it's around 6 basis points per month. And so as we look out into 2024, and assuming that the FOMC is mostly done with their moves, and we continue to experience the deposit stabilization that we're seeing right now, we think that there's still some room for margin compression certainly in the fourth quarter, perhaps not quite of the magnitude we observed quarter-over-quarter this quarter, perhaps some additional compression and starting to trough in the first half of 2024, Damon. Those are the dynamics that we're seeing.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Great. That's helpful. And then with regards to the outlook here for credit, you did note that there is 1 commercial relationship that went into nonperforming status and I think you said it was like a senior living center or something.

Any update on that as far as like -- what the resolution would be there? It doesn't appear that much, if any of it came through in charge-offs. So are you optimistic about being able to resolve this and exit without any material losses associated with this?

Charles N. Reeves
CEO & Director

Damon, this is Chip. And our Chief Credit Officer, Gary Sims, is with us today. So we'll turn it over to Gary for that.

Gary L. Sims
Senior VP & Chief Credit Officer

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Yes. Damon, the -- really, the move to nonperformers in that asset was driven by the [Indiscernible]. Good. During the quarter, that entity went into receivership. So it's actually in the hands of receiver right now and being managed by a third-party management company. The goal being to stabilize that asset for eventual sale.

So in the quarter, we actually did take a reserve against that $15.3 million asset of $2.4 million. So that really positions us well to be able to work with the receiver to manage that asset to a conclusion. Sometime in the future, senior living assets take a while to work through and get moved on, but we feel confident that we have a clear path.

Damon Paul DelMonte
Keefe, Bruyette, & Woods, Inc., Research Division

Great. I appreciate that color. And then with regards to -- kind of the outlook for provision. How should we think about that? If the loan growth slows a little bit and credit maintains pretty stable levels, would you kind of -- keep the provision levels similar to this quarter or maybe a little bit lower?

Gary L. Sims
Senior VP & Chief Credit Officer

Damon, I really see the provision being in the range of what you've seen over the past quarter to a few quarters. I think that's pretty representative of what we're going to see on a go-forward basis.

Operator

Our next question comes from Brian Martin from Janney.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Just one more follow-up for Gary, just on the increase in the quarter in the special mention category. Was there something driving that as well? Or is that this one credit you were referring to? I guess it was, looked like it was up about $30 million in the quarter.

Gary L. Sims
Senior VP & Chief Credit Officer

Right. Brian, it was not the asset that we just discussed, the senior living asset. That credit was already a substandard and then went to substandard nonaccrual. The increase in special mention for the quarter, really, was driven by a couple of assets in our Twin Cities markets. They were CRE assets, specifically office and multifamily, and we recognized potential weakness in those credits. So it really was associated with those two.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. So of the office exposure, then how much of the office exposure is currently classified or special mention today? I mean, what's the -- is that -- that sounds like it's moved up a little bit, not a lot.

Gary L. Sims
Senior VP & Chief Credit Officer

You're right, Brian. It has moved up a little bit. Right now, we have $151 million in office exposure. That represents 3.7% of our loans. Of that exposure, 33% is criticized and 13% is classified.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. 33% and 13%. Okay. All right. Fair enough. And then how about just flipping over to -- maybe just one for Chip. I think, Chip, you talked about the substantial pickup? Or have you qualified it on the fee income front, just from a couple of items. I mean, the specialty business, obviously, and the treasury management services.

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Can you give us some way to think about that? I mean, as far as the magnitude given -- this is -- a lot of new initiatives kind of coming on board here. And the best way to think about how to -- how much of a contribution we could see from that in the coming periods.

Charles N. Reeves
CEO & Director

So as we look through the various specialty lines here, Brian, one you saw in this quarter, we had some uptick perhaps you could call it significant increase in our swap income customer hedging program. We believe that will continue at a good pace, perhaps around the same levels. We did not sell any SBA or government-guaranteed loans into the marketplace in Q3, and we believe is for Q4 and into 2024 we will have increased activity there.

And I believe between the swap as well as the gain on sale from SBA activity. Those will probably end up being $500,000 to $750,000 or so a quarter in 2024. And then our treasury management initiatives, that will be a slower build. But by the fourth quarter of next year, we expect that to have some more meaningful impact for us.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. So not much -- so really mostly driven by the specialty rather than the treasury management in the near term. And then as far as the -- kind of the efficiency, I mean, just as you make these investments and get that out of -- and how should we think about the efficiency ratio as you proceed over the next 4, 5 quarters from where it's at today, can you give any thought on that, to just kind of manage that, where you think that directionally trending to?

Charles N. Reeves
CEO & Director

Yes. So I'll let Barry speak to the specifics of the efficiency ratio. But let me just give you some additional highlights of what we've been reviewing in the expense side here, Brian.

For instance, what you saw in the third quarter was really the actions that we took in, primarily Q2, we announced, obviously, a voluntary retirement program, but the individuals that accepted that program, really did not leave the institution until early to mid-September. So we still have some run rate, if you want to call it, a reduction from that.

We've also announced internally as well as with the FDIC, that we have a branch closure that will occur in the fourth quarter. And so there's a few other pieces that we have, then as Barry mentioned and as did I, we'll continue to reinvest into our franchise. What that means for the overall efficiency ratio and the guidance that Barry gave on the expense side as we go to probably a 32.5% in Q4, that probably rises to 33.5%, perhaps 34% as we migrate throughout the quarters of 2024. But -- Barry, from the efficiency ratios?

Barry S. Ray
CFO & Senior Executive VP

Yes. I think from an efficiency ratio, Brian, the challenge on the efficiency ratio is going to be the revenue side of the house on that. And so managing the efficiency ratio is certainly going to be really a function of what's happening on the revenue side. And so -- I guess I would say it's going to be difficult to maintain the efficiency ratio. And until we start to see some relief on the rate side.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Yes. And I guess -- I'm really trying to get at where you guys exit 2024, given the investments you're making sound like they start like -- Chip just outlined, start to kind of come together where you start seeing that pickup, even if it's specialty side early and then treasury management later, as you kind of exit '24. Do you expect to be a fair amount lower than where you are today, even if we're just kind of talking

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4Q as opposed to the annual, I understand the ramp-up that's going to occur and as the dynamics play out. But is that how we should be thinking about it?

Charles N. Reeves
CEO & Director

Brian, I think we have actually a pretty darn good control in terms of our -- what I'll call noninterest expense run rate today, as well as the reinvestment and we'll, frankly, overachieve in terms of our strategic plan of the 5%, and that's the 2.5% reallocation.

What is difficult to say, to your answer to your question is, our efficiency ratio itself will likely be more driven by the overall interest rate environment as we move through 2024. So I think that's the hesitancy for us to truly answer that question. If rates come down by 150 basis points, our efficiency ratio will be better than it is today. If we're at exactly the same rate in fourth quarter of '24 as we are today, that efficiency ratio will probably be about the same, maybe even a tick higher.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Got you. Okay. Well, that's helpful. I appreciate the color around it. I know it's difficult, just trying to think about it and kind of put some thoughts together.

And just the last one for me was just on the margin. Maybe just -- Barry, if you can just give us what the -- you had -- what the spot margin was for September. And I'm just curious, the other item was how many -- how much in the way of fixed rate loans you guys have, repricing over the next 12 months? Just how to think about that impact of the flow-through margin.

Barry S. Ray
CFO & Senior Executive VP

Yes. Brian, the September net interest margin was 2.31%, 2.31% compared to 2.35% for the quarter.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. Okay. And any thought on...

Len D. Devaisher
President & COO

Well, Barry's following up on that, Brian, just a little color on that, too. I highlighted -- this is Len. I highlighted in my comments about our coupon on origination. I'd also point out on the renewal side, that's been nice for us. So average in '23 in the commercial book, our average month is about $50 million of renewal.

And in September, that weighted average was 8.33%. So that gives you a bit of a flavor of just what we're seeing that way on the renewal side of the house.

Barry S. Ray
CFO & Senior Executive VP

And Brian, we have about -- so about 60% of our -- about 60% of our loan portfolio is fixed. And so about $2.5 million. And maybe 10% of that reprices in the next over a 3-year period, more than that 33% of it over a 3-year period, maybe 1/3 of it.

Operator

We currently have no further questions. So I would like to hand the call back to the management team for closing remarks. Thank you.

Charles N. Reeves
CEO & Director

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Great. Thank you for joining us today and we look forward for your continued support. We look forward to speaking to you all again at the -- in January for our fourth quarter report. Thank you all.

Operator
Ladies and gentlemen, this concludes today's call. Thank you for joining. You may now disconnect your lines. Thank you.

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