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Earnings Call

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the MidWestOne Financial Group, Inc. Second Quarter 2024 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.

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Thank you, everyone, for joining us today. We appreciate your participation in our earnings conference call this morning. 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. Good morning, and we truly appreciate everyone joining us for this quarter's call. Today, I'll provide a high-level overview of our second quarter results as well as an update on the continued execution of our strategic plan initiatives. Len will provide an update on our lines of business, and Barry will conclude with a more detailed review of our second quarter financial results.

Our first strategic pillar relates to employee and customer engagement. I'm so proud of our team members for their expertise and flat out hard work these first 6 months of 2024. We continue to transform this institution and even admits to a significant change. MidWestOne was once again honored to be named a 2024 Top Workplace in Iowa and USA. The quarter was highlighted by the completion of our geographic realignment announced last September with the successful divestiture of our Florida operations for an attractive net deposit premium.

Turning to our balance sheet trends. Excluding Florida divested balances, we delivered 3% annualized loan growth. This was accomplished even with significant paydowns, including many of which were classified or criticized loans. We continue to benefit from the expansion of our major market banking teams and our unique customer value proposition. Additionally, deposits were stable and deposit costs were well controlled.

We remain cautiously optimistic that we will grow our core deposit franchise in the latter half of 2024. Importantly, due to well-priced loan growth, repricing opportunities and controlled deposit costs, our net interest margin expanded an additional 8 basis points in the quarter, leading to a 5% quarterly increase in our net interest income. Len will discuss progress and results in our commercial banking and wealth lines of business, so I'll just simply notate that I'm very pleased with the trajectory of both businesses.

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Regarding credit, asset quality metrics trended positively for the quarter with limited charge-offs, lower NPAs and significantly reduced classified assets. The first half of 2024 has seen significant talent acquisition across our bank as we continue to mature and expand our operations consistent with our strategic plan. This quarter, senior hires include our new Chief Information Officer, our new Chief Marketing Officer and our new Cedar Rapids Commercial Banking Leader. All of these critical hires joined from leading regional financial institutions.

Even with significant talent and platform investments, we remain pleased with our expense discipline as we funded the majority of these investments by reallocating expense reductions into more productive and profitable people, markets and departments. To conclude, we've made substantial progress in the transformation of MidwestOne, positioning the bank for improved earnings power and returns, and I remain very optimistic on what the future holds for our employees and shareholders.

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

Len D. Devaisher
President & COO

Thanks, Chip. First, I'll provide an update on our deposit business. It's most helpful to look at the core deposits, excluding the Florida divestiture. On that basis, we were pleased to see balance increases in both May and June. Unfortunately, those increases were not enough to offset April's deposit outflows. So the net result is an essentially flat quarter. Encouragingly, we saw growth in commercial deposits across the quarter and our year-to-date net new account metrics are positive across our consumer and commercial customer segments. Perhaps, most importantly, that positive net new account trend holds for checking accounts as well as all account types.

Our commercial banking franchise continues to drive the earning asset growth. While the headline loan growth number was a modest 3%, it is important to note that our [pass] grade commercial loan balances grew at a rate of 6% on a linked quarter annualized basis. The reductions in criticized and classified assets in the second quarter improved the risk profile of our balance sheet, while the growth engine for our commercial business remains firmly engaged. That growth engine remains disciplined by a strong risk management approach and that is showing up in our mix. C&I growth rates are more than double CRE growth rates.

Notably, this C&I growth is despite a small decline in line usage. This reflects our concentrated efforts at growing our C&I segment with an emphasis on full relationships. Those efforts are showing up in other places, too, including treasury management analysis fees growing 6.3% year-over-year and a strong partnership between commercial and our wealth management business.

Speaking of wealth management, we're very pleased to see the 15.8% increase in revenues for the first half of 2024 compared to the same period in the prior year as assets under administration continue to climb. In the second quarter, we added another private wealth relationship manager in Cedar Rapids, who joined us from a large, regional competitor. We continue to see strong pipeline activity across this business line. And we remain focused on adding talent under the wealth leader we recruited in January of this year. Finally, my thanks to the IT and operations team who delivered a seamless divestiture of our Florida branches, generating a handsome deposit premium to bolster our capital.

With that, I'm pleased to turn the call over to Barry.

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Thank you, Len. The sale of our Florida operations created some noise in our second quarter financial results, so I will attempt to turn past to our quarterly core results. Beginning with the balance sheet on Slide 12, loans decreased $127.4 million or 3% from the linked quarter to $4.29 billion. Excluding the $163.6 million of loans sold in the Florida divestiture, loan growth was $36.2 million or 3% annualized from the linked quarter. Strength in the second quarter was led by commercial and industrial loans, which increased $17.9 million or 7% annualized from the linked quarter; and commercial real estate, which increased $18.7 million or 3% annualized from the linked quarter.

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The allowance for credit losses decreased $2 million to $53.9 million or 1.26% of loans held for investment at June 30. The decrease reflected $1.9 million of allowance reductions related to the sale of our Florida operations and net loan charge-offs of $524,000 or 5 basis points annualized from the linked quarter, partially offset by $467,000 in loan credit loss expense. The $1.9 million allowance reduction increased the net gain on sale recognized in connection with the Florida sale.

Goodwill decreased $1.7 million from March 31, 2024. That decrease reflected the goodwill associated with our Florida operations and the $1.7 million write-off reduced the related net gain on sale by that amount. Turning to deposits. Total deposits declined to $5.41 billion on June 30. Excluding the $133.3 million of deposits transferred in the Florida divestiture, period-end deposit balances were down $39.5 million from March 31 as net deposit growth in May and June was more than offset by net deposit outflows in the month of April.

Slide 13 of the presentation illustrates that average deposit balances increased $33.8 million quarter-over-quarter, and our bankers remain focused on growing our deposit franchise. Finishing the balance sheet. Total shareholders' equity increased $15.2 million to $543.3 million due primarily to retained earnings and a decrease in accumulated other comprehensive loss.

The tangible common equity ratio was 6.88% at June 30, 2024, up 45 basis points from March 31, 2024, as tangible equity growth outpaced tangible asset growth. Turning to the income statement on Slide 15. We earned net income of $15.8 million or $1 per diluted common share. Those results included on a pretax basis an $11.1 million net gain from the Florida sale, merger-related expenses of $854,000 and a positive mortgage servicing right adjustment of $129,000.

Adjusting for these items, adjusted net income was $8.2 million or $0.52 per diluted common share. Net interest income increased $1.6 million in the second quarter to $36.3 million as compared to the linked quarter, due primarily to higher earning asset volumes and yields, partially offset by higher funding costs and volumes of interest-bearing liabilities. Loan interest income in the second quarter of 2024 included $1.3 million of loan purchase discount accretion compared to $1.2 million in the linked quarter.

Our tax equivalent net interest margin increased 8 basis points to 2.41% in the second quarter compared to 2.33% in the linked quarter as a 16 basis point increase in earning asset yields was only partially offset by a 10 basis point increase in interest-bearing liability costs. The average loan portfolio yield for the second quarter was 5.69%, an 18 basis point improvement from the linked quarter. The average yield on new loan originations during the second quarter was 7.82%, up 10 basis points from the linked quarter.

On the liability side, total deposit costs increased 8 basis points from the linked quarter to 2.11% as funding cost pressures persist. For the month of June 2024, average loan yields were 5.75%, average total deposit costs were 2.16% and the tax equivalent net interest margin was 2.42%. Noninterest income in the second quarter of 2024 increased $11.8 million from the first quarter of 2024 due primarily to the $11.1 million gain on the Florida sale and the $497,000 swing in mortgage servicing right valuation adjustments.

Also contributing to the quarter-over-quarter increase was an additional $0.3 million recognized in connection with our customer back-to-back swap program. Finishing with expenses. Total noninterest expense in the first quarter was $35.8 million, an increase of $0.2 million or 1% from the linked quarter. Digging deeper into that change, an $860,000 quarter-over-quarter increase in core expenses was partially offset by a [$450,000] reduction in merger-related costs and a $204,000 reduction in nonmerger-related severance costs.

The $860,000 core expense increase was due primarily to a full quarter of costs associated with the former Bank of Denver operations, coupled with additional legal and professional costs and other expenses, including loan expenses and operating losses. As a reminder, our former Florida operations accounted for about $700,000 per quarter in expenses. So with the divestiture completed in June of 2024, we expect to realize that savings in our go-forward expense run rate. Expense control remains a 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] Our first question comes from the line of Brendan Nosal with Hovde Group.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

I just want to start off here on the top level note. I mean you guys have done a lot of heavy lifting as part of the strategic plan. It feels like a lot of the pieces are more or less in place now, especially with the Florida exit complete. Just curious, at this stage, what areas of your initiatives do you have the most enthusiasm for and which ones do you think can make the most impact to the bottom line?

Charles N. Reeves
CEO & Director

Yes, Brendan, this is Chip. I'll go first and probably turn it over to Len. But I would look at our commercial banking enterprise as well as our wealth management enterprise and initiatives that we have there, both are -- the trajectory is good. We will continue to invest in those areas, and I'm feeling very comfortable and good about those business lines. Len, anything...

Len D. Devaisher
President & COO

Yes, I would echo that, and I would as a point of reference our Board meeting this week we held out in Denver with the team there. And clearly, our investment there and our outlook for the Colorado market is a good example of where I see a lot of runway.

Brendan Jeffrey Nosal
Hovde Group, LLC, Research Division

Yes. Perfect. Perfect. One more for me before I step back. Just wondering whether there's anything else you guys have thought of doing with the securities portfolio heading into year-end that might help the margin move higher.

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes, Brendan, we continue to evaluate opportunities where we might be able -- where it might make sense for us to do something with the bond portfolio. There's certainly nothing, I would say, that we're looking at closely right now, but we continue to evaluate it, I would say, on a quarterly basis.

Operator

Our next question comes from the line of Terry McEvoy with Stephens.

Terence James McEvoy
Stephens Inc., Research Division

Barry, maybe if you could start with your outlook for quarterly expenses, just a lot of moving parts for the last couple of quarters. And as you continue to invest in certain lines and individuals as you talked about earlier, any kind of thoughts on that quarterly expense run rate?

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes, Terry, I think that in the near term, over the next couple of months with all the noise from Florida and Denver, I think we're probably going to land somewhere in the $34 million to $34.5 million range per quarter over the next couple of quarters is what I would expect. And then as we continue to invest and get

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into 2025, with the typical kind of year-end increases, we'll have a higher run rate there but $34 million to $35 million in the near term.

Terence James McEvoy
Stephens Inc., Research Division

And when I just look at, yes -- I look at Page 4 and the Denver market, 4 offices but $660 million of commercial loans, I guess, my question is what type of investments do you need to make in that market to get to the necessary scale? Do you need more locations? Or can this really be a kind of a commercial hub out of -- with a limited footprint?

Charles N. Reeves
CEO & Director

Terry, this is Chip. Our strategy there will likely be a branch-light strategy and then commercial and wealth heavy. So the commercial banking enterprise, we've stated in some prior or previous calls of additions that we've made, we're looking to incrementally add to the commercial banking enterprise and then also begin to add over the next couple of quarters wealth management into that market, too.

Terence James McEvoy
Stephens Inc., Research Division

And then maybe just one last one. Could you share any financial targets on wealth management? I mean, looking at the slide, a lot of investment, a lot going on. What would you like that business to be relative to total revenue or size or growth? Anything would be helpful.

Len D. Devaisher
President & COO

Sure, Terry. This is Len. I would just tell you that pleased with where we are at the first half of the year. And of course, as you think about that, there's 2 main levers or factors. So one is the market, and that's obviously helped us. But importantly, when I think about net new assets and new client acquisition. So we're focused on the latter obviously, and to Chip's point, adding talent to help us do so.

And from a target, I would say, we have less of assets under administration target, more of a revenue target. Obviously, we've been at the 3.5 in the last 2 quarters, pleased with that number. As I look longer -- medium horizon, I would like to see in the high single to low double-digit growth for wealth as we continue to grow that business.

Operator

Our next question comes from the line of Nathan Race with Piper Sandler.

Nathan James Race
Piper Sandler & Co., Research Division

Obviously, great to see some credit improvement in the quarter. Just curious how you guys are thinking about the reserve trajectory over the next couple of quarters. Does it feel like you expect to maintain the level you're at coming out of the quarter and just provide for growth going forward? Or just kind of any thoughts on that front would be helpful.

Gary L. Sims
Senior VP & Chief Credit Officer

Nate, this is Gary. And I would say that the way you're thinking about it is directionally the way we're thinking about it as well. We feel comfortable with the current reserve levels relative to the risk profile of the portfolio. And as the portfolio grows, we do see continuing to add to that reserve to maintain similar coverage on a go-forward basis. Does that help?

Nathan James Race
Piper Sandler & Co., Research Division

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Yes, that's helpful. Thank you, Gary. Changing gears a little bit, obviously, you just had Florida kind of stub period in the quarter, just given that it closed in early June. So just given that you'll have the full quarter without Florida in the third quarter, just curious how you guys are thinking about NII growth prospects in the back half of the year in light of what I expect to see some additional expansion in margin.

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes, this is Barry, Nate. So Florida was about $1 million a quarter of NII. And so I think what we expect, obviously, that will not be in the run rate going forward. But we do expect to see some amount of incremental net interest margin improvement based upon the trends that we're seeing with asset yields and costs. So that's kind of how we're thinking about the NII going forward. Does that answer your question?

Nathan James Race
Piper Sandler & Co., Research Division

Yes, that's helpful. Maybe one last one. You guys are building capital. Profitability is improving. The stock is still trading kind of near tangible book. So just curious, how you guys are thinking about share repurchases going forward.

Barry S. Ray
Senior Executive VP, CFO & Treasurer

This is Barry, again, Nate. Yes, I kind of view it as a -- we're in a capital build mode. And so I don't think that share repurchases will necessarily be something that we will be doing a lot of in the near term.

Operator

Our next question comes from the line of Damon DelMonte with KBW.

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

So first question I had was regarding the securities portfolio. Barry, we've seen a pretty steady decline of run off the last handful of quarters or so. Should we expect that to continue going forward and those cash flows being used to fund loan growth?

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes, absolutely correct, Damon. We expect to continue to allow the securities portfolio to run off to fund loan growth. We can fund about 4% loan growth with the annual loan growth with the cash flows that come off of the portfolio. For the balance of 2024, we'll have about $109 million repricing from a yield of 2.87. So we repriced that up to loan portfolios at -- loan portfolio yield of about 7%, 8%. That's somewhere around $5 million of additional interest income. So I anticipate to allow the portfolio to continue to run down. I would desire the portfolio level to be about 15% to 20% of assets, Damon.

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

Great color. And can you just remind us if the Fed does cut rates here in the back half of the year and especially as we go into '25, kind of what the dynamic is on the margin?

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes. Well, with respect to the -- whether or not there's a rate cut or not and the impact on the margin, we continue to model from an ALM perspective as liability is sensitive. So we would expect some benefit to net interest income and the margin from a rate cut. I think that benefit would be predicated upon the magnitude of the rate cuts, i.e., a single 25 basis point cut maybe we don't see as much benefit from that

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just based upon competitive deposit pricing dynamics as well as asset repricing. But we model as liability sensitive, and so we would expect to recognize some benefit with those conditions, I would say.

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

Got it. Okay. Great. And then just lastly, can you just provide an update on some of the new lending verticals that you guys are looking to expand into like the agri business and the SBA.

Len D. Devaisher
President & COO

Yes, Damon, this is Len. And I would say a couple of things. On agribusiness, in particular, we do see some new nameplates, and we look at our community region loan balances. We see nice growth in that. So we see the contribution there. And I would even call it early days for where we are at agribusiness. But the one where I feel the most momentum as I look forward is in government-guaranteed lending and that was basically level quarter-over-quarter because I look at the back half of the year I see fee income upside for us in that line of business. And I see just the pipeline being really robust there. So I'd point to those 2 in particular as bright spots.

We've identified, obviously, CRE, which has been an important piece for us historically. As you might expect in the current environment, just given rates and so forth, we see more softness in CRE. But nonetheless, we remain well positioned to take advantage there when 237% of capital, right, for nonowner occupied, we've got room. So we're positioned to take advantage when the deal is right.

Charles N. Reeves
CEO & Director

Damon, just 1 -- this is Chip. Just one more comment in terms of the CRE vertical. In times like this, when the CRE and some asset classes are obviously a little bit more stressed, we spend a lot of time in terms of the expertise that we're building in that CRE vertical for portfolio management and frankly, in exiting some of the loan relationships or loan transactions that we do not wish to be in and you started to see some of that here in the quarter, you're likely to see more of that in the third and fourth quarter as well and that's driven really by that partnership between our CRE vertical, the expertise there and then our credit administration department.

Operator

Our next question comes from the line of Brian Martin with Janney.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Just a question, Barry, on just -- on the margin, if you can just talk about just the kind of repricing opportunities within the loan book over the next 6 to 12 months, kind of what opportunities you have there? And kind of what's coming off? And then what -- you've already given the yields and what's coming on.

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes. With respect to the loan book -- earlier, I spoke to the securities, with respect to the loan book, I've got about $227 million of fixed rate loans repricing over the balance of the year. The yield on those loans is about 4.87%. So reinvestment opportunity there if it goes to 7% to 8% is probably somewhere around $6 million of additional net interest income.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. And that was fixed rate or variable rate, Barry, I missed what you said there?

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Barry S. Ray
Senior Executive VP, CFO & Treasurer

That was fixed rate, Brian.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. And then as far as variable goes, do you have other assets repricing in there as well?

Barry S. Ray
Senior Executive VP, CFO & Treasurer

Yes, we do. We have the variable reprices every quarter. So I didn't mention that just because it's kind of already approaching kind of the normal rates that we yield right now, but there's $1 billion of variable repricings.

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Okay. All right. That's perfect. And then just in terms of credit quality, the story was pretty positive, the story this quarter. Just wondering in terms of if you're seeing any stress within kind of the C&I categories at all? Or is there any early areas of concern on that portfolio?

Gary L. Sims
Senior VP & Chief Credit Officer

Brian, this is Gary. Most of the stress that we have seen in our portfolio has been in the CRE book. If you recall, I believe in the first quarter, we did downgrade some of our trucking portfolio. We don't have a big trucking portfolio, but we did downgrade some credits in that portfolio. I'd really attribute that to the macro issues associated with the transportation and logistics industry. So that would be an example where we have seen some deterioration in C&I. But overall, we're not seeing deterioration in that side of the portfolio. Does that help, Brian?

Brian Joseph Martin
Janney Montgomery Scott LLC, Research Division

Yes. No, for sure. Just checking in on that, I know it seems like you've kind of got your arms around the CRE piece at this point. Just wondering if there's anything new that might be something mindful to watch. And then maybe just the last one for me is more for Chip. Just kind of big picture, Chip, just kind of thinking about the road map here as we go the next 4 to 6 quarters in terms of profitability, kind of where you're thinking that you can get to given all the investments you've made. And if we kind of look at 4 quarters out in terms of ROA, kind of where the scorecard would be as far as where you think you can be approaching.

Charles N. Reeves
CEO & Director

Brian, Thanks for the question. And ultimately, there, it will be a function of the -- what the Fed does in terms of the interest rate environment and the cuts, the magnitude of the cuts, the frequency of the cuts. Let's go in a static environment. In a static environment, we continue to see slow margin build over the following or the next 12 months. We continue to see better or more improvement in noninterest income. I think we'll have positive operating leverage. And we'll move into the increased profitability.

But in a static environment, it will likely take us a couple of years to move to the -- truly the 1% return on assets. If rates do fall that will materialize much quicker. And then we also continue to, on a quarterly basis, I think this is appropriate for our Board to review and our management team to review every quarter in terms of opportunistic opportunities within that securities book to see if there's anything more to do to accelerate that pace of profit improvement.

Brian Joseph Martin

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Janney Montgomery Scott LLC, Research Division

Got you. Okay. And you outlined all the hires you've made through the first half, I guess. Are there -- to kind of get to the buildup of the fee income and kind of the business lines you've kind of talked about, are there -- is there more staff that has to be added in your mind? Or is it -- you kind of have the team in place now and it's just executing on getting the production? Or is there other key hires you really expect to be making here in the next 6 to 12 months?

Charles N. Reeves
CEO & Director

Yes. What I'd say there, Brian, is instead of that, what I'd call, the executive level or even the senior operating level, we have essentially completed the transformation of the organization there. But what I'd say is in some of our target markets and target lines of business, we will continue to expand there in terms of revenue producers. So think Twin Cities, think Denver, think Cedar Rapids think, Des Moines, think commercial banking, think wealth management. We will continue to invest there.

Operator

Thank you for your question. There are currently no questions registered. [Operator Instructions] There are currently no questions registered. [Operator Instructions] There are no additional questions at this time. I would now like to pass the conference back to the management team for closing remarks.

Charles N. Reeves
CEO & Director

Great. This is Chip Reeves. Thank you again for joining us today, and we look forward to getting together in 90 days as we continue to track the progress that MidwestOne is making. Thank you, everyone. Bye-bye.

Operator
That concludes today's call. Thank you for your participation, and enjoy the rest of your day.

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