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MSBI - Q3 2017 Midland States Bancorp Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the third-quarter 2017 Midland States Bancorp, Inc. earnings conference call. (Operator Instructions). And as a reminder, this conference is being recorded.

I would like to introduce your host for today's conference, Ms. Allyson Pooley, from Financial Profiles. Ma'am, you may begin.

Allyson Pooley *- Financial Profiles, Inc. - IR*

Thank you, Amanda. Good morning, everyone, and thank you for joining us today for Midland States Bancorp's third-quarter 2017 conference call. On the call this morning from Midland's management team are Leon Holschbach, President and CEO; and Jeff Ludwig, CFO.

We will be using a slide presentation as part of our discussion this morning. If you haven't done so already, please visit the webcasts and presentations page of Midland's Investor Relations website to download a copy of the presentation.

Leon and Jeff will discuss the third-quarter results, and then we will open up the call for questions. Before we begin, I'd like to remind you that this conference call contains forward-looking statements with respect (technical difficulty) performance and financial condition of Midland States Bancorp that involve risks and instructors.

Various factors could cause actual results to be materially different from any future results expressed or implied by such forward-looking statements. These factors are discussed in the Company's SEC filings which are available on the Company's website. The Company disclaims any obligation to update any forward-looking statements made during the call.

Additionally, management may refer to non-GAAP measures, which are intended to supplement, but not substitute, for the most directly comparable GAAP measures. The press release, available on the website, contains the financial and other quantitative information to be discussed today, as well as the reconciliation of the GAAP to non-GAAP measures.

And with that, I'll turn the call over to Leon.

Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

Thank you, Allyson. Good morning, everyone. Welcome to Midland's earnings call. Let's start with slide 3, which summarizes a highlight for the third quarter and our most recent announcements.

Clearly, the most significant development was the announcement earlier this month of our definitive agreement to acquire Alpine Bancorporation. We were able to move quickly on the Alpine deal because of the efficiency with which we have integrated the Centrue acquisition. We completed the Centrue system conversion during the third quarter, and have phased in the majority of the cost savings that we projected for the transaction.

As we mentioned during our conference call last week, when the Alpine deal closes, we will have doubled the size of the Company since our IPO in 2016. We've done this by executing on transactions that increase the scale of our core community bank operations and our wealth management business. These are businesses that generate excellent returns and have good long-term growth opportunities.

With these areas of the Company increasing in scale, the commercial update today in residential mortgage banking businesses will still be meaningful contributors to our financial results, but they will be smaller components within our overall revenue mix.

During the third quarter, we made the decision to sell the majority of our mortgage servicing rights in the residential mortgage banking business, as this will eliminate a source of volatility in our earnings stream and also free up capital for the Alpine acquisition. The sale resulted in a $3.6 million loss as we marked the MSRs to market ahead of the sale.

As a result of the loss on the MSRs and the integration and acquisition-related expenses, we reported $0.10 per share in the third quarter. When these items are excluded, then we have $0.49 in adjusted earnings per share.

We saw positive revenue trends in the quarter as a result of the full quarter impact of adding Centrue's operations. Relative to the prior quarter, our net interest income was up 25% while our noninterest income was up 13%. A couple of themes that we talked about on the second-quarter call that continued to play out in the third quarter were our currently high loan to deposit ratio and the loss of our Colorado residential mortgage team and the impact that has on our residential mortgage business. We also had a lighter contribution from Love Funding in the quarter.

We ended the third quarter with a loan to deposit ratio of 95%. And while we see loan demand across our various markets, it's a more difficult environment for core deposit gathering. Therefore, we continue to be more selective in the loans that we originated this quarter, and opted not to match some of the more aggressive pricing that some of our current customers received from competing banks. This resulted in a lower level of originations and a higher level of payouts than we saw in the first half of the year, but we were also able to increase the average interest rate on new and renewed loans in the quarter by 48 basis points.

On a final note, as you saw yesterday, Kevin Thompson has left the Company to relocate to a larger market. We're in a fortunate situation to have Jeff Ludwig to step in and fill the CFO role on an interim basis. As you know, he has served as our CFO for the last 10 years. There isn't anybody better suited to manage our finance department while we conduct a search for a permanent replacement.

And so, with that, I will turn the call over to Jeff to walk through the details of our third-quarter performance. Go ahead, Jeff.

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Thanks, Leon. Starting with slide 4, I'll review our net interest income and net interest margin. Our net interest income increased by 25.1% from the second quarter. This was primarily the result of higher interest income on loans due to the full-quarter impact of Centrue. On a reported basis, our net interest margin increased 8 basis points to 3.78% due to a $1.7 million increase in accretion income. Excluding accretion income, our net interest margin declined 6 basis points due to the full-quarter impact of adding Centrue's lower yielding assets.

As a partial offset to this, the average rate on our new and renewed loans in the third quarter was 4.72%, 48 basis points higher than the prior quarter. This reflects the impact of the last Fed rate increase in June, as well as more selective approach we have taken to loan production and pricing that Leon discussed. Looking ahead to the fourth quarter, we would expect our accretion income to be lower. Excluding the impact of accretion income, we anticipate that our net interest margin will be relatively stable.

Moving to our noninterest income beginning on slide 5, total noninterest income increased $1.8 million or 13.1% from the prior quarter. The key driver of this increase was the 72% increase in service charges and interchange revenue which largely resulted from the full-quarter addition of Centrue. Our residential mortgage business had $2.3 million in revenue this quarter, which reflects the lower level of production following the departure of our Colorado loan production team.

With a smaller production team, it's likely that the loans we originate for sale will remain at this lower level. As we discussed on our last call, we plan to rebuild our residential mortgage production team by adding originators that focus on our core markets of Illinois and Missouri as we head into 2018.

Turning to slide 6, we're going to review wealth management. We had a strong quarter as we added approximately $72 million in assets under administration, of which approximately 50% was from net new business, and 50% from market appreciation. This put us over $2 billion in assets under administration for the first time in our history. As a result of the growth in assets, our wealth management revenue increased 2% from the prior quarter. Measuring the organic growth on a year-over-year basis, excluding the assets added from Sterling Trust and CedarPoint, our total assets under administration increased by $172 million or 14% as of September 30.

Turning to slide 7 and looking at Love Funding, we originated $112.5 million in rate lock commitments during the quarter, and had total commercial FHA revenue of $3.8 million. Through the first nine months of the year, excluding MSR impairment, Love Funding has generated total revenue of $15.8 million. This run rate is consistent with $18 million to $20 million of annual revenue and is generally what we expect to see in this business. Although there may be stronger years from time to time, we believe that this is a baseline that we can deliver each year.

Love Funding continues to be a business that we very much like. It provides consistent annual fee income, generates 20% to 25% pre-tax profit margins, and offers good margin loan opportunities through our bridge loan program, and we currently have approximately $120 million of these loans on our books. And most importantly, Love Funding provides a growing source of low-cost servicing deposits. Our average servicing deposits were $322 million in the third quarter, up 6% from the prior quarter and up 17% over the same quarter last year. Our weighted average cost on the servicing deposits was just 9 basis points.

Turning to slide 8, we'll take a look at our expenses and efficiency ratio. We incurred $8.3 million in integration and acquisition-related expenses in the quarter as well as a $3.6 million loss in on the mortgage servicing rights that we moved to held-for-sale. Excluding these items, our noninterest expense increased $6.2 million, or 20.7%, on a linked-quarter basis.

As Leon mentioned, we have largely phased in the cost savings projected for the Centrue acquisition. As a result, excluding integration and acquisition-related charges, we believe our operating expenses will be in the range of $35 million to $36 million in the fourth quarter.

Moving to the balance sheet on slide 9, we'll take a look at our loan portfolio. Total loans were essentially flat from the end of the prior quarter. We saw growth in our residential mortgage, construction, and consumer portfolios, which was offset by a decline in commercial loans. The decline in commercial loans was largely driven by payoffs related to companies or properties that were sold, as well as efforts to move lower rate credit out of the bank.

Turning to slide 10, we'll take a look at our deposits. During the quarter there was a lot of movement within our various deposit categories. Within our core banking group, average total deposits trended higher throughout the quarter, increasing approximately $30 million. This increase in deposits was offset by some repositioning we did with our non-core funding sources. We ran off some of our brokered CDs and replaced them with lower cost FHLB advances, and we had some fluctuations in our end-of-period servicing deposits.

At the end of the second quarter, we received some large payoffs on FHA loans that were then remitted in June. As a result, our end-of-period balances at September 30 reflect a more normalized level of servicing deposits. The net effect in the movement in our various deposit categories was $219 million decline in total deposits from the end of the prior quarter.

Moving to slide 11, we'll look at our asset quality. Our nonperforming loans increased $5.8 million from the end of the prior quarter. The increase was primarily attributed to one commercial real estate loan that was added to non-accrual during the quarter. Our net charge-offs were just $52,000 or 1 basis point of average loans.

We recorded a provision for loan loss of $1.5 million in the quarter. The provision was primarily related to specific reserves set against two nonperforming loans, one of which was the commercial property placed on non-accrual of this quarter. This provision brought our allowance plus credit marks to 99 basis points of total loans at September 30.

With that, I'll turn it back to Leon.

Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

Thanks, Jeff. So I'll wrap up on slide 12 with some comments on our outlook. We are very excited about what we've been able to accomplish this year. Through the acquisitions of Centrue and Alpine, we've been able to continue our strategy of making accretive acquisitions that enhance shareholder value. We are significantly increasing our scale and deepening our presence through the state of Illinois, and growing the contribution of the steady recurring revenue from wealth management. And we are increasing our base of low-cost core deposits.

When we have completed the Alpine acquisition and captured the synergies we project for the transaction, we believe we'll be a higher performing bank with a more consistent earnings stream. We believe that will result in significant value being created for our shareholders in the years ahead.

And, with that, we'll be happy to answer any questions that you might have. Operator, go ahead and open up the call line.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Kevin Reevey, D.A. Davidson.

Kevin Reevey - *D.A. Davidson & Co. - Analyst*

So, Jeff, just looking at the margin going into the fourth quarter, you said it should stabilize. Is that on a core basis or on a GAAP or reported basis?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

That would be on a excluding accretion basis. And there will be a little pressure on that number with the $40 million of sub debt that we took down as part of the Alpine acquisition, but we feel that that will be a stable rate going into the quarter.

Kevin Reevey - *D.A. Davidson & Co. - Analyst*

And then how do you think that should play out as we head into 2018?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

I think, as we said on the call, we are working real hard here increasing loan rates, and saw some good lift in the third quarter: a 48 basis point increase over the prior quarter on new and renewed loans. So I expect that trend to continue. So that will help the loan yields lift. And if we can hold deposit costs, we could see a slight increase in margin as we move forward.

Kevin Reevey - *D.A. Davidson & Co. - Analyst*

And these assumptions, is that assuming we do get a December rate hike? Or that assumes a steady-state?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

That's a steady state as we sit here today.

Kevin Reevey - *D.A. Davidson & Co. - Analyst*

Great, thank you.

Operator

Michael Perito, KBW.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

I have a handful of questions. Just a clarification question on the margin for Jeff. It sounds like the core ex-accretion margin is stable next quarter. And is that the function of -- because obviously the sub debt coming on would weigh on that. But is some of this initiative you're taking on the rate side with the loan and deposit -- and funding side seem -- the hope is that that will offset some of the drag from the debt?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes, that's kind of what we're thinking. Again, the sub debt does put pressure on, but I think we're going to -- with the focus on increasing yields in the loan portfolio, we're hopeful we can offset that increase.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. And then just how does is all factor in? There wasn't a ton of prospective commentary on balance sheet growth from here. Is there still opportunities to grow loans and deposits while being a bit more selective on rate? Or how should we be thinking about that organic level of origination capacity at Midland?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes, I think that we have opportunities on both fronts. I think we mentioned in the commentary that the community banking group did increase core deposits by $30 million in the quarter, so we are seeing opportunities to increase deposits. We are on the streets with some campaigns to increase deposits, so we're hopeful that we can continue to do that.

And then on the loan side, we're going to continue to be selective. We did have probably more payoffs in the current quarter than we've seen in prior quarters, but we're going to continue to be selective. But we still have, I'll say, a strong pipeline of opportunities to look at. So I think there's good opportunities, but the deposit side of this is probably the thing we're focused on most right now. And as we can start to drive deposits, we'll be able to drive the asset side.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. And then just on the residential -- the pending residential MSRs. And I'm sorry if I missed it, but when do you expect that to be completed? And you mentioned in your repaired remarks, Jeff, I believe that the residential mortgage revenue line should stay about where it is. Does that already take into account the strip-out of any servicing income that's going to be lost?

And secondly, there's still going to be some seasonality I guess, so will that drop off in the fourth and first quarter here? Or are there other things that we should be thinking about?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes. So, a little color on mortgage servicing rights, and it's not as easy as selling a bond, where you can sell it and it's off your balance sheet pretty quickly. So, we've got a letter of intent to sell. I think we're looking in November-December to actually execute the sale of the mortgage servicing rights themselves.

We will then be required to essentially sub-service the loans for 60 to 90 days until we can, if you will, de-convert the loans, and transfer the actual files and the servicing to the buyer. So that take some time, i.e., we're going to continue to have a servicing group that has work to do here until they are fully de-converted and through the conversion process, which will be probably in the first quarter.

So, we will -- so on the revenue side, we will lose some revenue. On the servicing side, once the sale happens, mostly towards the end of this quarter, and then that will continue into 2018. On the gain on sale side of our revenue, as you know, we're going into the fourth quarter, so in the residential mortgage business in the Midwest, it slows in the fourth quarter.

So, I wouldn't expect -- I would expect that revenue to come down a little bit from where it's at now, just from the seasonality of the business. We are looking at bringing on new producers here in the fourth quarter and probably in the first quarter, but the market in the fourth and first quarter is slower in general in the Midwest.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

And then the capital that you guys expect to free up, the regulatory capital from this, is it about $10 million, $12 million?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes; right about $10 million.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. And then just one last one for me, for you, Leon. As we think about -- and we appreciate the -- I appreciate the strategic remarks about where you think the bank is heading. So as we think about as we move into 2018, you still have the Alpine transaction pending. We got the MSR transaction ongoing.

Are we in a stage here where it is more internal than external focused, to try and rip out all the cost saves and get the bank operating on a more profitable, consistent level? Or are there still acquisitive and capital deployment opportunities that we should be considering over the next few quarters?

Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

Yes. Thanks, Mike. So, sure. Our plates are going to be full. We're just finishing up on the Centrue acquisition, which went real well. But we do a lot of training, and so on. That stresses some of the human resource assets in the quarter, [too after] all that's going well. And then Alpine, which would be a large and significant and important transaction for us. Yes, our objective will be to execute really effectively on those to deliver what the pro forma of that combined opportunity looks like into 2018. Yes, internal focus will be top priority.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Great. Thank you, guys. I appreciate all the color.

Operator

Andrew Liesch, Sandler O'Neill.

Andrew Liesch - *Sandler O'Neill & Partners - Analyst*

Just curious to the weaker credits that you mentioned that you -- that exited the bank. Were those loans that came over from Centrue that you didn't really have much interest in keeping? Or were they legacy Midland States loans? What's the nature behind those?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes, I would say more legacy, and probably legacy Heartland loans. That was where they came from. They were mostly pricing and terms related.

Andrew Liesch - *Sandler O'Neill & Partners - Analyst*

Okay. Is there more of that that you think might be coming? Like what -- is competition out there just that tough, that you guys just don't want to compete?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Well, I won't say we don't want to compete (multiple speakers).

Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

Sure, but just speaking specifically of the Heartland legacy deals, I think most of you know that St. Louis alone has over 120 banks operating in the greater MSA, and a ton of those banks are smaller community banks. And they -- it's the smaller community banks, often, that apply the most pricing and rate pressure. Not always, but often.

So yes, they have hard pressure for earnings increases. They work hard to steal business. And we're holding onto pricing and the underwriting terms, and I think that's the right thing to do.

Andrew Liesch - *Sandler O'Neill & Partners - Analyst*

Okay. And then on the last quarter, you said the balance sheet's still asset-sensitive. Does that still play out if we have a rate hike in December?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes, I think it does. We've seen it play out here in the last couple quarters, and another one should help it.

Andrew Liesch - *Sandler O'Neill & Partners - Analyst*

Got you. And then just lastly on the expenses. When you get the -- thanks for the color on the -- your expectation for the fourth quarter. But as you get through Alpine and the cost saves in there, where do you hope to have the expense base, say, to start the third quarter of next year?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

That's a long way away, Andrew. I don't have that in front of me. I mean, we've done our models. We kind of gave you a baseline of where our expenses are today. We've talked about what the cost saves at Alpine will be. So you can kind of get [there that] where I take to 36% cost saves out of Alpine's baseline, our baseline; and then obviously there's expense growth on top of that, and you're going to get pretty close.

Andrew Liesch - *Sandler O'Neill & Partners - Analyst*

Got you. Thank you. That's helpful.

Operator

(Operator Instructions). Terry McEvoy, Stephens.

Terry McEvoy - *Stephens Inc. - Analyst*

Just to start, when you were modeling out Centrue and discussed the earnings accretion when that deal was announced, did you assume the step-down in the margin because of their investment portfolio?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

That's probably the -- of all the assets that came over, that's the biggest driver. Their loan yields were lower than ours, but that was the big driver.

Terry McEvoy - *Stephens Inc. - Analyst*

And thanks for providing some insight into the full-year Love Funding revenue. And I recognize there's just one quarter to go. But if I just look at that range of $18 million to $20 million, it is telling us the revenue will be $3.3 million to $5.3 million, which is a pretty wide range.

And I guess my question is, on a quarter-to-quarter basis, is that the type of volatility that you internally are projecting? Or is there anything unique headed into the fourth quarter of this year that maybe adds to that range, either on the upside or the downside?

Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

Yes, so -- this is Leon, so thanks. Yes. We've talked about the fact that we look at this on an annual basis exactly because of the range that you mentioned. And the average size of their deal, which now runs just a little over $10 million, as those deals move between quarter ends for closing, yes, it can be that kind of range.

But on a full-year basis, looking at the last few years and looking at the last five or six quarters, you take out the top quarter of the last five or six and you annualize it -- that's what it looks like. And that's how we like to look at it.

As Jeff said, as an $18 million to $20 million business with a 20% to 25% pre-tax and a really inexpensive and stable deposit gathering machine, we like that business a lot. But we appreciated early on -- and I think that the world is getting this -- we appreciated early on that this is not one that you can throw darts on the quarter. It's just not going to work.

And so, yes; the range that you mentioned is about the right range. And it may be -- it will be right down to December as deals are locking or holding off to the end of the year; what kind of rate movement we have on the 10-year, for example, might influence borrowers to lock or hold for Q1.

And that's what we have come to appreciate and understand about how the business works, and why we are looking at and encouraging our investors to look at it on an annual basis.

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

But you're right, even internally, that -- those are the ranges, even as we sit, here a month into a quarter, those are the ranges and we're looking at. It's really even a quarter, in the quarter we are in, very difficult to project the actual number.

Terry McEvoy - *Stephens Inc. - Analyst*

And then, Jeff, can you just run through the change in deposits quarter over quarter? Love had deposits of $322 million at the end of the third quarter. Where was that in the second quarter? And then again, where did that -- on the bottom left of slide 10, where did that flow out of the deposit mix? Just want to make sure I understand that correctly.

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Yes, yes. So, in the increase and decrease in deposits, we're talking about end-of-period balances. When I talk about the average balances in servicing of $322 million, there's less volatility in our averages because this money comes in and out pretty quickly in a quarter.

So if we look at slide -- on slide 10, so the $108 million of servicing deposits, so what happened in -- at the end of June in the Love Funding servicing book -- so the loans that we service for Love -- we had $108 million of Ginnie Mae payoffs that happened.

That money comes into the bank as a deposit in cash, so we had an elevated cash position, as well, at the end of the second quarter. And then by June 15, those --

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Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

July.

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

Or, sorry, July 15, those dollars get remitted to Ginnie Mae and then come back off the balance sheet. So the $108 million is all in non-interest-bearing demand. So that's where it comes in, and then it goes out.

Terry McEvoy - *Stephens Inc. - Analyst*

Great. Thank you.

Operator

Michael Perito, KBW.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Jeff, I just have a couple quick questions. I'm hoping you can just give me some stats. I didn't see in the slide in the deck on the resi mortgage platform. I was just curious if you can give us the closings in the quarter. And then also I was just wondering what the size of the servicing book was at quarter end.

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

We're looking for the number. So secondary production was $63 million in the quarter. The servicing -- the total residential servicing, I assume you mean unpaid balance on loans, was right around $2 billion.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. And then was the refi purchase split fairly steady with last quarter?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

I think refi was -- yes, a little up, but a pretty small percentage of the production. So, I mean a couple headwinds: we lose the Colorado team; and the refi market has -- with rates kind of ticking up, hasn't been there either. And we're mostly a purchase shop, not a refi shop. But when it comes, it does help us.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

And there were no adjustments on any of -- whether the Love Funding or the residential servicing, in the quarter, correct?

Jeff Ludwig - *Midland States Bancorp, Inc. - EVP and CFO*

There's no impairment on residential, so that was all in the loss on the -- moving that asset to held-for-sale. There's, I think, a $100,000 impairment on the commercial side, so pretty insignificant.

Michael Perito - *Keefe, Bruyette & Woods, Inc. - Analyst*

Okay. Perfect. Thank you, guys.

Operator

Thank you. And at this time, I'm showing no further questions. I'd like to turn the conference back over to management for any closing remarks.

Leon Holschbach - *Midland States Bancorp, Inc. - Vice Chairman, President, and CEO*

Thank you all for joining us, and we'll talk again soon.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everybody have a great day.