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MSBI - Q2 2018 Midland States Bancorp Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2018 Midland States Bancorp Inc. Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

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

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

Thank you, Joelle. Good morning, everyone, and thank you for joining us today for the Midland States Bancorp second quarter 2018 earnings call.

Joining us from Midland's management team are Leon Holschbach, Chief Executive Officer; Jeff Ludwig, President; and Steve Erickson, Chief Financial Officer. 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.

The management team will discuss the second quarter results and then we'll open the call up for discussion -- for questions, excuse me.

Before we begin, I'd like to remind you that this conference call contains forward-looking statements with respect to the future performance and financial condition of Midland States Bancorp that involve risks and uncertainties. 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 J. Holschbach - *Midland States Bancorp, Inc. - Vice Chairman & CEO*

Thank you, Allyson, and good morning, everyone. Welcome to Midland.

I'll start with Slide 3, which is a summary of the highlights of the second quarter. With this being the first full quarter since the closing of our acquisition of Alpine Bank, we saw the initial benefits from the transaction. On an adjusted basis, excluding integration and acquisition expenses, we generated $0.59 in earnings per share. This is a notable increase from our level of profitability prior to the acquisition, despite a very weak quarter from Love Funding. We have executed very well on the Alpine integration, and we are ahead of schedule and realizing the projected cost savings for the transaction. We have already phased in approximately 80% of the cost saves, which positively impacted our expense levels in the second quarter.

As we have discussed, since announcing the Alpine deal, one of the key benefits of the transaction is shifting our revenue mix towards the more stable and predictable businesses within our core community banking and wealth management operations. We believe this shift improves the quality of earnings that we are generating and ultimately, has a positive impact on the value of our franchise.

Additionally, we grew loans while continuing to be very selective in our new originations in order to effectively manage your balance sheet and protect our net interest margin.

As a result of the disciplined approach to growth that we are taking, we were able to better manage our deposit costs in this challenging, rising interest rate environment.

Our cost of interest-bearing deposits increased just 2 basis points from the prior quarter, resulting in a low deposit data -- a lower deposit data than we have experienced in recent quarters. This helped us maintain a relatively stable net interest margin excluding accretion income.

Now I'll turn the call over to my partner, Jeff Ludwick, to walk through the performance of some of our major lines of business. Jeff?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Thanks, Leon. Starting with our loan portfolio on Slide 4. Our total loans outstanding increased $67 million from the end of the prior quarter which represents an annual -- annualized growth rate of 6.6%, a pickup from the more muted growth we had in the first quarter.

As Leon mentioned, we continue to be very selective in our originations, focusing our efforts around those lending areas that generate the most attractive risk-adjusted returns. The 2 strongest areas of production in the second quarter came from our consumer lending programs and our equipment finance business.

The consumer loan growth largely came from our home improvement loan program with GreenSky and these loans came on our books late in the quarter. So we should see more of the impact of these loans on our interest income next quarter.

We are seeing good production from the new equipment finance team, we brought on board in January. This team books credits that go in both our leasing portfolio and our C&I loan portfolio. So leasing portfolio alone doesn't capture all the production that we are getting from this group. Including both leases and commercial loans, the total amount of outstandings, from the equipment finance group, increased $38 million from the end of the prior quarter or 17%.

We also saw nice growth in our residential real estate and construction portfolios. The growth in these areas was offset by declines in our commercial real estate and commercial loan portfolios.

We continue to see elevated payoffs in our CRE portfolio as well as aggressive pricing on rates and structures that we are not willing to match.

The decline in our commercial loan portfolio was primarily related to the paydown of an FHA commercial warehouse line from one large customer, that tend to fluctuate from quarter-to-quarter. As a result of the selective approach to loan origination, we continue to see positive trends in our average rate on new and renewed loans, which increased 8 basis points from the prior quarter.

Turning to deposits on Slide 5. Total deposits were $4.16 billion at the end of the second quarter, a decline of approximately $74 million from the end of the prior quarter.

The decline was essentially split between DDA and interest-bearing deposits. The decline in DDA was primarily related to normal fluctuations that we see in our servicing deposits, as we had a large payoff in the commercial FHA business that was remitted [Jan-May] during the second -- or during the quarter. The decline in our interest-bearing deposits was primarily attributable to a reduction in broker deposits.

Turning to Wealth Management on Slide 6. At the end of the quarter, our assets under administration reached $3.2 billion, up approximately $64 million from the end of the prior quarter. 38% of the increase was due to new business development and the remainder was due to market appreciation. Our total revenue increased 30% from the prior quarter, primarily due to the full quarter contribution from Alpine's Wealth Management business. This is the first quarter that our Wealth Management revenue surpassed $5 million.

On a year-over-year basis, our Wealth Management revenue increased 59%. Measuring the organic growth on a year-over-year basis, excluding the assets added from Alpine, our total assets under administration increased by 8% as of June 30.

Turning to Love Funding on Slide 7. As we indicated on our last earnings call, we felt that there were some risk to Love Funding's performance this year for a number of reasons. And in the second quarter those issues became more pronounced. As a result, we had a very disappointing quarter, originating $11 million in rate lock commitments and generating commercial FHA revenue of approximately $300,000. The FHA -- commercial FHA market remains healthy, and we believe our FHA revenue will come back to the $3 million to $5 million quarterly level that we have seen in recent quarters.

We have taken 2 actions to improve the performance. First, we have made a change in leadership of the business. John Camps has been promoted to President and will lead Love Funding. John has spent the past 19 years at Love Funding and has been involved in every area of its operations, including serving as its Chief Underwriter for 5 years. We have great confidence in John's ability to lead Love Funding. John will report to Jeff Mefford, the President of Midland States Bank. This reporting structure will better align Love Funding with our other commercial lending activities and ensure that we are effectively leveraging all the resources that Midland has to support this business.

The second action we have taken is to reduce the cost structure of this business. These cost cuts will reduce annual operating expenses at Love Funding by approximately $2 million. We continue to have a solid pipeline at Love Funding, but we are seeing protracted times for loan closings due to a variety of reasons.

Given the weak revenue in the second quarter, we no longer expect Love Funding to reach our previous expectations for 2018. However, from a long-term perspective, we believe this business will generate annual revenue between $12 million and $20 million, with a pretax margin between 20% and 40%.

Now I'm going to turn the call over to Steve to walk through some additional details on our financial results.

Stephen A. Erickson - *Midland States Bancorp, Inc. - CFO*

Thank you, Jeff. Starting with our net interest income and net interest margin on Slide 8. Our net interest income increased by 26% from the first quarter. This was primarily the result of the full quarter contribution of Alpine. With respect to net interest margin, on a reported basis, margin increased 22 basis points to 3.91%. However, excluding the impact of accretion income, our net interest margin was relatively flat. Going forward, our scheduled accretion income is $3.1 million for the third quarter of 2018, $2.3 million for the fourth quarter and then a $72.0 million (sic) [$7.2 million] for the full year of 2019, although there will be some volatility caused by prepayments activity.

As we've indicated over the past few quarters, we continue to expect our net interest margin to be relatively flat going forward, excluding the impact of accretion income.

Moving to our noninterest income on Slide 9. Due to the minimal contribution from commercial FHA this quarter, our total noninterest income decreased approximately $700,000 or 4% from the prior quarter.

The decline in commercial FHA revenue was partially offset by increases in all of our other major fee generating areas, primarily due to the full quarter impact of Alpine's operations and the seasonal strength in residential mortgage banking, which increased 49% from the prior quarter.

Now turning to our expenses and efficiency ratio on Slide 10. We incurred $2 million in integration and acquisition expense in the second quarter. Excluding this expense, our noninterest expense increased 18.1% on a linked quarter basis. The increase is primarily due to the full quarter of expenses associated with the addition of Alpine's operations. Excluding the integration and acquisition expenses and a small loss on mortgage servicing rights held for sale, our adjusted efficiency ratio was 67.8% in the second quarter compared to 68.5% last quarter. The shortfall in commercial FHA revenue, obviously, had a negative impact on our efficiency ratio and masks the improvement we are seeing in expense control and efficiencies across the rest of the company. Provide a sense for how the rest of the company is performing, our adjusted efficiency ratio, excluding Love Funding, was 61.4% in the second quarter, an improvement from 66.3% last quarter.

As we have indicated in the past, operational excellence is one of our core strategic initiatives, we are continually evaluating all areas of the business to identify opportunities to reduce expenses and enhance efficiencies.

As a result of expense control measures we have taken as well as the cost savings from the Alpine acquisition, we expect our quarterly run rate for operating expenses to be approximately $43 million in 2019.

Moving to Slide 11, we'll look at our asset quality. We saw good stability in the portfolio during the second quarter and had just 13 basis points of net charge-offs. We reported a provision for loan losses of $1.9 million, which exceeded the company's net charge-offs of $1.3 million. This provision kept our allowance essentially stable at 45 basis points of total loans, as of June 30, and our credit marks accounted for another 81 basis points.

With that, I'll turn the call back to Leon. Leon?

Leon J. Holschbach - *Midland States Bancorp, Inc. - Vice Chairman & CEO*

Thanks, Steve. So I'll wrap up on Slide 12 with some comments on our outlook.

Over the coming quarters, we expect to remain disciplined in our balance sheet growth in order to manage your loan to deposit ratio and protect our net interest margin. We'll also continue to focus on controlling expenses and driving a higher level of efficiencies throughout the entire company.

Earlier this month we completed the system conversion for Alpine and the tradition -- the transition has gone very smoothly.

I'd like to thank all of our employees who worked so hard over the past 6 months to make this happen, our teams did a great job. Although, we still have some integration and acquisition expense coming in the third quarter, we are on track to enter the fourth quarter with substantially all of the cost savings in place. We believe this will put us in a good position to deliver additional earnings growth in 2019.

And with that, we would be happy to answer any questions that you might have. Operator, please open up the line for call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Michael Perito with KBW.

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

I have a few questions I wanted to touch on. First on the expenses, it's just looking [ballpark] based on your commentary but also the numbers, it seems like you're tracking a little healthy gain on the Alpine cost saves. But now with this -- sorry, you are not taking the core expenses [ex] the merger stuff that are about $44.5 million. So I guess, my question is, sounds like there's a little bit more that needs to come out from Alpine and then you have the $2 million annually that needs to come out. So I mean, does that run rate move down towards $43 million by the end of the year? Or there are any other, kind of, investments being made that swell that up? Is there any color you can give us on that dynamic?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes, Mike, it's Jeff. I think that's exactly how we view it. Those are the 2 areas where costs should start to come down and by the end of the year, fourth quarter, and mostly as we get into '19, we get to that $43 million expense run rate.

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

Okay. And as you look to next year, are there any kind of investments on the horizon that you guys are thinking, to that would -- could maybe boost expense growth more than, like, a few percentage points? Or at this point is it -- or you guys have pretty good transparency there and think that that's probably out there, 2%, 3% is a better growth rate post-Alpine?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes, I think that's right. We don't expect any big investments next year. And so I -- the $43 million and a little bit of expense growth in '19 would be right.

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

Okay. I was curious if you could maybe give us a little bit more color on the -- you said a lot of the consumer production, I think is what you said was in back -- kind of back-end loaded. Obviously, with Alpine on now, and I believe Alpine was about 6 basis points diluted to your name all in. And so obviously, the core NIM is held in pretty well here. So I mean it would seem like you're seeing some core NIM expansion underneath kind of under the hood here and I'm curious if you kind of expect that to continue? And will the consumer balances coming on, what yields are those and will that have a positive impact on NIM in the third quarter?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

It might have a slight positive to NIM, but it's not going to -- on a -- the balance sheet our size today, the incremental difference isn't going to make a huge move on the NIM. I do think we continue to be disciplined on the price side on the loan side, and we are seeing loan rates increase and we've been able to hold the beta on our deposit base. So we're -- I think we're comfortable that our NIM can be stable going forward.

Leon J. Holschbach - *Midland States Bancorp, Inc. - Vice Chairman & CEO*

Michael, this is Leon. And I would just add to that, offsetting some of those modest positive, it's going to be the continuing battle for funding which is industry-wide one, that we're engaged in. Doesn't look like it's going to go away anytime soon. I mean that's why what we're pointing to is stability in the margin because there will be headwinds in the funding gathering part of the business for sure.

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

And then just one more for me and then I'll let someone else take a go at it. But just the interchange revenue has really ramped up and I think it can move around a bit, but I was just curious if you can give us more color on what was in the number this quarter and the sustainability of that going forward?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes, so I think the big driver there was Alpine and Alpine had some nice interchange revenue that we got a full quarter benefit from, wherein the first quarter we had a month of the benefit.

Leon J. Holschbach - *Midland States Bancorp, Inc. - Vice Chairman & CEO*

So they have a stronger retail-based and we did too. They were a solid 50-50 retail, and that boosts the interchange relative to the size of their balance sheet compared to ours, so that was a nice pickup.

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes. And I did -- you're right, Mike, it moves around, we see it even month-to-month moving around based on how customers are behaving in different holiday weekends and things like that. So it does move around, but yes, we -- I think we have a strong quarter and expect to see those revenues to be pretty consistent moving forward, although there might be some bounce up and down a little.

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

And actually I'm going to sneak one more in, just on the tax rate, it's been a little up and down the last couple of quarters. There's any thoughts on where it could shake out for the back half of the year?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes I think we're still -- I think we guide like 24% last quarter. I think that's still where we think it is. And then -- we then have some discrete items that come in that might bring it down quarter-to-quarter. So -- but and that's how we plan here.

Operator

Our next question comes from Terry McEvoy with Stephens.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

Let's just start with Love Funding. I guess the direct question is, what happened? If I look back, it was a $7 million, $8 million quarterly business at 1 point, and I know it was going to be lumpy that's been the message all along. But was this very much an internal issue that's now been fixed and resolved or is there some fundamentals within that FHA commercial business that you needed to adapt to?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

I think it's probably all that, a little of all that. We are seeing -- these are big credits, and you go credit by credit and there is -- this issue or that one. It's this issue or this one that we can't get the loan to get to a rate lock position. So it's some of that. It's some of -- probably, the pipeline having a little bit of a low in it right now and pushing back. But I think overall, we feel that the revenue there is -- we're confident that the revenue will come back in the next quarter. And that, this quarter was really a little bit of an aberration to come in at like a 0. So we're optimistic and we -- I don't think we ever thought this was a $7 million a year. I think, we've done a half quarter, so it's going to be $7 million, then half quarter it's probably under $3 million. But I think for the majority of the quarters it's going to be between $3 million and $5 million and that's kind of why we said that in the call.

Leon J. Holschbach - *Midland States Bancorp, Inc. - Vice Chairman & CEO*

And then, if I could just add to that, Terry. The changes that we made in leadership there are important. In any of the mortgage businesses, the cyclicality and the volatility has to be managed as effectively as you can. You don't control most of it, but a key to effective management is to be able to respond to that when you think that going forward we'll be positioned better to more effectively respond to the low points in production. And then just one other thing, and it's not a boohoo about the industry, but it is understood that FHA, that the HUD office, excuse me, the HUD office has been significant understaffed for some time. They recently reported that the 150 open positions that they have are now expected to be filled by the end of the year. And we have a couple of key people on the focus group there, including our Head Underwriter and some improvements have been made there. Hopefully, to incrementally improve the pace of underwriting and the speed that we can turn deals at. That's not a major driver, but another little thorn that looks like it's going to be dissolved in the near term that should help. Meanwhile, the pipelines look reasonable. They're down from their high point, but they suggest a much better performance than this last quarter indicated. So we think the reset will get the job done.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

Okay. And then, Jeff ran through the impact of this business on loans and deposits. Could you just provide, maybe how much of Love is within the loan portfolio today and then, maybe, more importantly, on the deposit side, what's that dollar amount? I think you've disclosed it in the past. And then under this new structure, do you think it stabilizes or can you see some growth in those deposits?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes. So on the loan side, the loans that are being closed at Love Funding will show up in loans held for sale. So it's not impacting, kind of, portfolio loans. But I -- maybe you're talking bridge loans.

Terence James McEvoy - *Stephens Inc., Research Division - MD and Research Analyst*

Yes, that was it.

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes, yes. So bridge loans outstandings at the end of the quarter were almost $140 million. So we saw some growth in the quarter, but there is fair amount of construction loans that draw over time...

Leon J. Holschbach - *Midland States Bancorp, Inc. - Vice Chairman & CEO*

There is some over $200 million approved much of the difference in construction.

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes, there is a total of another $51 million of commitments that are out there, so we should continue to see that balance move up. On the deposit side, average deposits in the servicing book for Love was $291 million. I think that has moved up or fairly stable from the prior quarter. And with a light -- with not a lot of production in the current quarter we weren't held in the servicing book. So you would expect it to be fairly flat.

Operator

(Operator Instructions) Our next question comes from Andrew Liesch with Sandler O'Neill.

Andrew Brian Liesch - *Sandler O'Neill + Partners, L.P., Research Division - MD*

I appreciate the guidance on the $43 million run rate and the thoughts on how you're going to be able to get there on the expense side. But just now looking at the fee income side, with what you had this quarter with Alpine in there, several of these item -- line items, feel like they're near run rate residential mortgage banking, got the team there, then get the FHA business back up. Is, like, $21 million a good level to be using for the noninterest income side?

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Yes, I think it's a little less than that. As we've looked at kind of the analyst guidance, it looks like there's some additional revenue shipments some other income line items, but maybe got annualized out in the prior quarter. But we think it's probably a little less than that.

Andrew Brian Liesch - *Sandler O'Neill + Partners, L.P., Research Division - MD*

Okay. Actually...

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

Probably more than that $19 million, $20 million range.

Andrew Brian Liesch - *Sandler O'Neill + Partners, L.P., Research Division - MD*

Got you.

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

If Love performs in head range so (inaudible)

Operator

I'm not showing any further questions at this time. I would now like to turn the call back over to management for any further remarks.

Jeffrey G. Ludwig - *Midland States Bancorp, Inc. - President*

I'll just say, thanks, everyone, for joining us this morning and we will talk again in the quarter.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program, and you may all disconnect. Everyone, have a great day.