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Q3 2018 Midland States Bancorp Inc Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Midland States Bancorp Third Quarter 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, Allyson Pooley. Ma'am, you may begin.

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

Thank you, Ashley, and thanks, everyone, for joining us today for the Midland States Bancorp Third Quarter 2018 Earnings Call. From -- 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 presentation this morning. If you haven't done so already, please visit the webcasts and presentations page of the Investor Relations website to download a copy of the presentation.

The management team will discuss the third quarter results and then we will open the call for questions.

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 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***

Thanks, Allyson. Good morning, everyone. Welcome to Midland.

Slide 3 summarizes the highlights of the third quarter. As you can see, we executed well in the quarter and delivered a strong increase in our adjusted earnings per share relative to the prior quarter. On an adjusted basis, excluding integration and acquisition expenses, we generated $0.64 in earnings per share, up from $0.59 in the prior quarter.

Moving to our balance sheet trends. We continue to implement the prudent approach to loan production and deposit gathering that was adopted this year. It continues to be a challenging environment for deposit pricing, and we believe our approach to balance sheet management is serving us well. As we try to closely match loan and deposit growth, we are focusing our new loan production around those areas that produce the most attractive risk-adjusted yields, most notably, equipment finance and consumer lending. Our average rate on new and renewed loans increased 15 basis points to 5.49% from the prior quarter, reflecting our ongoing shift in the mix of new loan production. The focus on the portfolios with the more attractive risk-adjusted yield helped us to keep our net interest margin relatively stable in the quarter, excluding the impact of accretion income. One of the key factors in our earnings growth is the improved efficiencies we're seeing as a result of the Alpine acquisition. We completed the conversion during the third quarter and realized additional cost savings, resulting in our efficiency ratio improving to 63% in the third quarter. Another driver of our earnings growth was a return to a more normalized level of commercial FHA banking revenues consistent with our expectations. Commercial FHA revenue is back within the expected range of $3 million to $5 million. And with the changes that we have made in the business line's cost structure, it's now operating more profitably at this level of revenue.

Finally, as you saw last week, we announced the next step in our CEO succession plan. I will be retiring from the CEO position at the end of this year but will remain involved in the company as Vice Chairman of the Board of Directors. Jeff Ludwig, who's been my -- by my side as we've built the Midland franchise over the past decade, will become the new CEO of Midland States Bancorp upon my retirement.

The board has put a lot of thought into the succession plan over the past few years, including Jeff's promotions to President of the company and CEO of the bank, where he has demonstrated great leadership and capabilities in each role. We believe the succession plan has paved the way for a seamless, well-coordinated transition that will serve the company, our employees and our shareholders well, and I'd like to extend my congratulations to you, Mr. Ludwig, on that promotion, and I'll turn the call over to you now, but I'm not going to call you Mr. Ludwig all day, so that was it. I hope you enjoyed that.

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

Thanks, Leon, and thanks for your kind words. It's been a great experience to work with you to build Midland into 1 of the largest commodity banks in Illinois. I'm excited to lead the continued growth of our company. We have a very clear strategic plan that has helped us build a strong franchise based around our core community bank and Wealth Management operations. And through the continued execution of our strategic plan, I'm confident that we can continue to enhance the value of our franchise.

Now turning back to our financial results, I'm going to start with our loan portfolio on Slide 4. Our total loans outstanding increased $61 million from the end of the prior quarter, which represents an annualized growth rate of 5.9%. The strongest growth in the portfolio came in our commercial loan and leases and consumer lending areas. Our equipment finance group continues to perform well and our total outstanding balances increased by $46 million or 17% from the end of the prior quarter. On a year-to-date basis, through September 30, this portfolio was up $106 million or 51%. The biggest contributor to our consumer loan growth was our loan program with GreenSky, which continues to produce loans with attractive risk-adjusted yield and excellent credit quality. With the shift in focus and new loan production, we have deemphasized the origination of residential mortgage loans that we retain on our balance sheet. Accordingly, we saw a decline in this portfolio during the third quarter that is likely to continue for the foreseeable future.

Turning to deposits on Slide 5. Total deposits were $4.14 billion at the end of the third quarter, a decline of approximately $17 million from the end of the prior quarter. The decline came across all our deposit categories with the exception of interest-bearing checking accounts, which increased by $23 million. The decline in deposits was primarily attributable to expected attrition in the Alpine deposit base following the system conversion. We also continue to focus on managing our deposit costs, which contributed to some of the decline during the quarter.

Turning to Wealth Management on Slide 6. At the end of the quarter, our assets under administration were $3.2 billion, up approximately $29 million from the end of the prior quarter. As expected, Wealth Management is providing a very consistent source of reoccurring revenue, increasing from the prior quarter to $5.5 million. On a year-over-year basis, our Wealth Management revenue increased 57%. Measuring the organic growth on a year-over-year basis, excluding assets added from Alpine, our total assets under administration increased by 7% as of September 30.

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 7. Our net interest income decreased by 6.6% from the second quarter. This was a result of decline in accretion income, which was $3.8 million lower than in the prior quarter. Excluding accretion income, net interest income increased $600,000, which is a 5.6% annualized increase from the prior quarter. During the third quarter, we finalized the purchase accounting adjustments for the Alpine acquisition. We expect scheduled accretion income to be approximately $2 million to $2.5 million for the fourth quarter and approximately $7 million to $7.5 million for the full year 2019, although there will be some volatility caused by prepayment activity. The decrease in accretion income was also the main driver of the decline in our reported net interest margin. Excluding the impact of accretion income, our net interest margin declined 2 basis points, as the increase in our cost of interest-bearing liabilities was slightly higher than the increase we saw in earning asset yields. 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 8. Our total noninterest income increased 15.3% from the prior quarter. This increase was primarily due to the rebound in commercial FHA revenue. This was offset, in part, by decline in residential mortgage banking revenue. Consistent with the trends across the mortgage industry, we are seeing lower demand. We anticipate that our residential mortgage banking revenue will remain at this lower level for the foreseeable future, although there will continue to be some variances in quarterly revenues due to seasonality in this business. As Jeff mentioned, our Wealth Management revenue increased to $5.5 million in the third quarter, and following the Alpine acquisition, it remains our largest single contributor to noninterest income.

Turning to our expenses and efficiency ratio on Slide 9. We incurred $9.6 million in integration and acquisition expense in the third quarter and approximately $300,000 in loss on mortgage servicing rights held for sale. Excluding these expenses, our noninterest expense decreased by 8.5% on a linked-quarter basis. A portion of the decrease was driven by the realization of additional cost savings from the Alpine acquisition, following the system conversion. We've also realized cost savings from the previously announced expense reductions taken at Love Funding as well as some back-office reductions made in our residential mortgage banking business to reflect the lower level of production that we are seeing. Compared to the prior quarter, we also have lower variable compensation and lower professional fees contributing to the overall decline in expenses. As a result of the lower expense levels, our efficiency ratio improved to 63% from 67.8%. We expect that our quarterly run rate of operating expenses in 2019 will still be in the $43 million range that we guided to previously.

Moving to Slide 10, we'll look at our asset quality. Our nonperforming loans increased by approximately $10 million, which is primarily attributable to the downgrade of 2 commercial loans and 1 commercial real estate loan. However, we continue to experience a very low level of credit losses, which is 7 basis points of net charge-offs in the quarter. We recorded a provision for loan losses of $2.1 million, which exceeded the company's net charge-offs of $700,000. This provision increased our allowance to 47 basis points of total loans as of September 30, and our credit marks accounted for another 59 basis points.

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

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

Thank you, Steve. We will wrap up on Slide 11 with some comments on our outlook. Now that we've substantially completed the Alpine integration, we expect our improved earnings power to be more apparent in our reported results going forward. For the foreseeable future, our formula for driving earnings growth will continue to be prudent balance sheet management, protecting our interest margin, growing our recurring sources of noninterest income and continuing to drive more operating leverage from the increase of scale, resulting from our recent acquisitions. We're comfortable growing loans in the low to mid-single digits with a continued focus on higher risk-adjusted yields and strong credit quality. As we continue to harvest the synergies from our recent acquisitions, we believe the greater operating efficiencies will enable us to drive higher profitability as we go forward.

And as this will be my last earnings call, I'd like to take a moment to thank our shareholders who have invested in our company. It has been gratifying to lead Midland from a company that had 6 branches and a relatively local shareholder base 10 years ago to a company that has almost 100 locations today and close to 150 institutional investors across the country. I've enjoyed the opportunity to meet and engage with our analysts and our shareholders across the country. If you ever find yourself in Effingham, stop by. Meanwhile, I'll be watching from the boardroom and the shareholder meetings.

With that, we'll be happy to answer any questions that you might have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Michael Perito with KBW.

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

A couple of questions. Wanted to start maybe on the credit side. So you guys mentioned going forward the growth will be tilted, it seems towards equipment finance and consumer lending, with residential mortgage portfolio shrinking. And I guess my question is, how do you kind of expect that to impact provisioning going forward and the reserve? I mean, should we expect the reserve to continue to build? As my guess is the reserve on those 2 growing asset classes is a bit higher than the shrinking one.

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

Yes, I think that's right. I mean, I think this quarter is a quarter that would look like quarters going forward, as we described on the call, and so that level of provisioning seems to be about right as we look forward.

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

Okay. And then on capital. So with the balance sheet growth at low to mid-single digits and the return profile improving here, I mean obviously, not necessarily today, but in the near future you guys will be accreting capital and those levels will be building. I'm just curious how we should be thinking about Midland's capital deployment going forward? Obviously organic growth is up there and you guys have a had a steady track record on the dividend, but beyond that, I mean is there any change or any updated views that we should be thinking about as you guys think about how to kind of manage those capital levels and not let them build to too excessive levels going forward?

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

I'll be happy...

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

Yes, I'll be -- Jeff, you jump on that, but Mike, it's Leon. I'll be very happy to be challenged with having a little more capital than we need, but we're going to do some capital building. Go ahead, Jeff.

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

So yes, I think our TCE ratio is just over 7% at the end of the quarter. As we look forward, we'll be pushing -- we should be pushing the 8% as we get to the back part of '19. Yes, I think this is probably a bigger conversation as we get into 2020 probably, Mike. I think we're -- we believe we need to build some capital and bring the TCE level up after doing 2 fairly large acquisitions over the last couple of years. So that would be the focus at least in the short-term, meaning in the next 12 to 18 months.

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

Okay. And then just lastly in Love funding. Can you talk about the -- what you've seen thus far and some of the adjustments in the expense infrastructure and leadership you made, I think, last quarter? And then also just how that pipeline looks as we head into year-end and then into 2019?

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

Yes. So I think the leadership adjustments that we made are working really well. Jon Camps, who we promoted into the position as President, is doing a really nice job leading the team. The team is rallying around Jon and doing a lot of the right things. The pipeline is -- I think, maybe growing slightly. It's not decreasing, not growing rapidly. It's pretty stable and in a good position to deliver the range of results that we've talked about, that $3 million to $5 million a quarter type of revenue range, we still feel real good about going into '19 and, frankly, into the fourth quarter, so.

Operator

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

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

Just start maybe with a question on expenses. If I adjust the 3Q expense rate down by the $9.6 million I'm at around 40 -- kind of $40.5 million to $41 million. Could you just talk about that step up to the $43 million? And specifically where that increase is going to come from?

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

Terry, this is Steve. So in the third quarter, I mean the biggest impact was in variable compensation along with some professional fees. We're not anticipating that in the fourth quarter that variable comp or professional fees, that we see a similar type decline in those items. So that's why we're staying right at that $43 million expected amount.

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

Okay. And then on the deposit flows, just kind of post the conversion, was that more a reflection of just an adjustment in rates? Or was there some customer disruption in connection with that process? Just want to make sure I understand that statement.

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

Yes, Terry, this is Jeff. It's a little bit of both. When we go through conversions, there's a fair amount of customer disruption as we're moving customers from one system to another, changing debit cards, changing lots of things for them. So there is some disruption and we typically see some customer attrition in that -- in those time frames, so there is some of that. And then we've been, at this point, not aggressive in rates in the markets at this point, so in the CD money market area we probably have seen some accounts migrate away. So, a combination of both.

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

And then just lastly, if I look at the residential mortgage business, is the expense base, has it been rightsized for a rising rate environment and just slowing industry volumes? Or is there some work to be done there?

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

Yes, so we've made those adjustments. I think, the work today is, can we bring some additional revenue -- how can we grow the revenue base to enhance profitability. I think we're, for the most part, through the bulk of that expense reduction and looking now to try to build some revenue back into the business.

Operator

And our next question comes from the line of Kevin Reevey with D.A. Davidson.

Kevin Kennedy Reevey ***D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst***

Leon, congratulations on your retirement. Enjoyed working with you. And Jeff, congratulations on your well-deserved promotion. So my question is the decline in the core operating expenses in the third quarter from the second quarter. What was the split between the cost saves from Alpine versus the efficiency enhancements that you've implemented?

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

As far as the -- and this is Steve, I'm sorry. As far as the cost saves from Alpine, there were probably just a handful of additional employees that were there through part of the quarter, so that was not an overly material amount of that decline. It was primarily the reduction in the professional fees and the variable comp that caused that drop from second to third.

Kevin Kennedy Reevey ***D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst***

Got it. And then over the last 12 months, your asset size has grown considerably. Do you feel like that you have -- you made enough investment in the operational infrastructure to grow -- continue to grow from here?

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

Yes, I think we've made the investments and we -- I think, I personally feel pretty good about where we're at with systems. I think where we're going to spend some time in the next 12 months is looking at -- you know, we've gotten to be a much larger company in the last 2 years, and I think there's some scale opportunities to continue to look at process, procedures, how we do things and drive more operating leverage through the P&L.

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

Sure, in the last 15 months, and I appreciate you saying 2 years, it was actually in the last 15 months that we added over $2 billion to the balance sheet and increased Wealth Management by 50%, and you guys know the story around those, is very powerful for us. So yes, there is opportunity now and this will be as I suggested, and one of our main focuses, as we go forward, is now to harvest the value out of that and we'll have some time to do that and that will be our focus.

Kevin Kennedy Reevey ***D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst***

And then lastly, a lot of the other banks that I cover, they're also focusing on growing their consumer loan balances. Can you talk about the competitive landscape in consumer lending today?

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

Yes, so in markets, in branches, it's competitive, right? Customers are not coming into the branch to get their consumer loan, to get their auto loan or...

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

Home improvement.

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

Home improvement loan or those type of loans. We're growing our balances through our GreenSky relationship, which is point of -- right, the consumer lending is going to point-of-sale and they have a great point-of-sale program that we're participating in, so that's where we're getting our consumer flow, not necessarily through our branches, which we think from a cost point of view is a real economic win for us, right? We don't need to go out in the market and market a lot of dollars to get people to come in our branches to try to drive consumer lending.

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

So that's going to be such a competitive advantage as we go forward, just to reiterate, from previous conversations. We don't have origination cost, we don't have marketing cost, we don't have collection cost. We have a bit of backroom finance cost and a relatively lower provision because of the credit enhancement that is inherent in the deal, the waterfall of the payments that flow to the participating banks. And as a result of that, looking at NIM regarding GreenSky, it looks good. Looking at pretax on it, it looks significantly better and that is going to be competitive advantage for us as we've talked a little bit about before as you go forward.

Operator

(Operator Instructions) And our next question comes from the line of Andrew Liesch with Sandler O'Neill.

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

Just some questions on the new nonperformers here. Is there anything that's consistent between the 3 loans? Are they in similar locations? Or just any other clarity you can provide surrounding these?

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

Yes, Andrew, this is Steve. They are about as completely independent from each other as they can be. So out of the 3, 1 is a hotel property, 1 is a straight C&I deal and the other is basically an ag loan, production-type company. They are all 3 in different geographies and, as I said, all 3 in completely different industries. So nothing systematic at all.

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

Okay. And then just to -- you guided towards maybe a stable core margin here, it certainly seems like funding costs be rising. What are some things that you can do here on the asset side to keep the margin stable?

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

Yes, and I think we -- that our remarks, it's the equipment finance business, which is -- grew $46 million within the quarter at yields ahead of where -- I think, we said our new and renewed loans in the quarter were 5.46% -- 5.49%. And the lease production in this quarter was -- is closer to 6%. So that helps and that's probably the biggest driver, and as we are bringing new loans and renewing loans, there is a bigger focus internally on the yield of those loans. So we are seeing nice lifts in loan yields as we're bringing in new and renewed loans.

Operator

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

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

No, thank you. That's all we have. Thanks for joining us, everyone. And Mr. Ludwig and Steve will be sharing the next quarterly update with you later this year. Thanks.

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 beautiful day.