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MSBI - Q3 2016 Midland States Bancorp Inc Earnings Call

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CORPORATE PARTICIPANTS

Allyson Pooley *Financial Profiles, Inc. - IR*

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

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

CONFERENCE CALL PARTICIPANTS

Michael Perito *Keefe, Bruyette & Woods - Analyst*

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

Terry McEvoy *Stephens Inc. - Analyst*

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

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Midland States Bancorp third-quarter 2016 earnings call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would now like to turn the call over to Ms. Allyson Pooley from Financial Profiles. Ma'am, you may begin.

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

Thank you, Chelsea, and good morning, everyone. Thanks for joining us today for the Midland States Bancorp third-quarter 2016 earnings call.

Today from Midland's management team with us are Leon Holschbach, President and Chief Executive Officer, and Jeff Ludwig, Executive Vice President and Chief Financial Officer.

We will be using a slide presentation as part of our discussion this morning. If you have not done so already, please visit the Webcast and Presentations page at Midland's Investor Relations website and download a copy of the presentation. Leon and Jeff will discuss our third-quarter results and then we'll open the call up 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 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 reconciliations of the GAAP to non-GAAP measures.

And with that I'd like to turn the call over to Leon.

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

Thank you, Allyson, and good morning, all. I'd like to start on slide 3 and walk through a summary of the third-quarter performance.

We generated $8.1 million in net income or $0.51 per diluted share. It was another good example of the highly diversified business model we've developed here. We're able to generate quality assets and fee income from a wide variety of sources.

The highlight of the quarter was our strong, well-balanced loan growth, with average loan balances increasing at 17.7% annualized. We had a double-digit annualized increase in our commercial real estate, residential real estate, consumer, and equipment leasing portfolios.

On the liability side, we continue to see an improvement in our overall deposit mix. Once again, we have significant contributions from our fee income-generating businesses, which resulted in our noninterest income accounting for more than 35% of our total revenue.

We had a strong quarter in residential mortgage banking and wealth management, which offset a lighter quarter in the commercial FHA business. And we're effectively driving enhanced efficiencies throughout our organization and improved our efficiency ratio for the third quarter in a row. As a result of our performance, we were able to generate a higher level of earnings and an improvement in our return on average assets.

Turning to slide 4 I'll talk a little bit about the performance of our major business units. I'm going to start with Love Funding, which is our commercial FHA loan origination and servicing business, which focuses on multifamily and healthcare facilities.

As we indicated on our last call, we expected the contribution of this business to be lower than the second quarter due to fewer loans in the later stages of the pipeline. This underscores the timing of the revenue that we see in this business, which results from the protracted underwriting and closing process for commercial FHA loans, as well as the larger average loan sizes that we originate in this business.

We originated approximately $73 million in rate lock commitments in the quarter, which was in line with our expectation. We had a higher mix of permanent loans within our overall rate lock commitments this quarter, which had a positive impact on our gain on sale margin.

Even with the lower level of originations this quarter, we saw growth in our average balance of servicing deposits, which increased by about $9 million in the third quarter to $275 million. Our weighted average cost of funds on these deposits in the quarter was 8 basis points.

The pipeline remains strong in this business, and we should see a higher level of production in the fourth quarter, as there are more loans in the later stages of the pipeline.

Turning to slide 5, we'll look at our residential mortgage business. We had a record quarter of loan production with $181 million in originations. That was an increase of 37% over last quarter and 25% over the same period last year.

We continue to see the mix of production weighted towards new purchases, which reflects the positive trends we are seeing in our local housing markets. Due to the higher production we had a nice increase in our mortgage banking revenue from the second quarter to $5 million.

Earlier this year we also launched a pilot program focused on originating residential mortgage loans for doctors. This program enables us to develop relationships with high-value customers that could potentially use a number of the other products and services that we offer, including, for example, wealth management.

We launched the pilot program in the St. Louis area and, as we've seen strong early results, we've now rolled it out into our other markets as well. Primarily as a result of this program, our residential real estate loan portfolio has grown by approximately $54 million this year.

Turning to slide 6 we'll look at Heartland Business Credit, our equipment leasing business. This business continued its strong growth and generated $22 million in originations, which is about 10% higher than the third quarter of last year. The total leasing portfolio has grown by more than 40% over the past year, and we continue to see very attractive yields in this business, with the average rate on this portfolio being 5.6%.

Turning to slide 7 we'll look at wealth management. We had a nice quarter of business development, and our assets under management increased by about $37 million or 3% from the end of the prior quarter. As a result, we saw an uptick in wealth management revenue in the third quarter to $1.94 million.

We currently expect to close our acquisition of Sterling Trust during the fourth quarter. This will increase our total assets under administration by about a third and take us up another level in terms of quarterly revenue.

Now I'll turn the call over to Jeff Ludwig to walk through some additional details on our third-quarter performance. Jeff?

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

Thanks, Leon. Starting with slide 8, I'll review our net interest income and net interest margin.

Our net interest income declined by 2.6% from the second quarter, primarily due to a $2.3 million decrease in accretion income. This offset the impact of higher average loan balances in the quarter, resulting from our strong loan growth.

Our net interest margin declined by 20 basis points due primarily to decreases in accretion income. Margin excluding accretion income increased by 14 basis points, primarily due to a favorable shift in our mix of earning assets.

Our average balance of cash and cash equivalents was approximately $77 million lower in the third quarter, with this liquidity redeployed into higher-yielding loans and securities. We also had a higher mix of non-interest-bearing deposits this quarter, which reduced our cost of funds.

Moving to our non-interest income on slide 9, once again our non-interest income accounted for more than a third of total revenue.

Overall, our non-interest income was 6.5% higher than last quarter. We had strong quarters in residential mortgage banking and wealth management, which offset a decline in revenue in the commercial FHA business.

Turning to slide 10, we'll take a look at our expenses and efficiency ratio. We continued our trend of improving efficiencies.

For the third consecutive quarter, we saw an improvement in our efficiency ratio, with the third-quarter ratio coming in at 64.6%, down from 67.1% last quarter. The improvement in efficiency ratio was primarily driven by a 7% reduction in operating expenses compared to the prior quarter.

We had a number of one-time expense items that we highlighted last quarter, which accounted for the majority of the reduction. Most of our expenses were within the normal range of variance, and we didn't have any notable one-time items in the quarter.

Moving to the balance sheet on slide 11, we'll take a look at our loan portfolio. We had another quarter of very strong loan growth, with total loans increasing by $152 million and the growth being generated across most of our portfolios.

Approximately $73 million of the increase was related to advances on a warehouse line of credit to a customer that originates commercial FHA loans, similar to our Love Funding business. In addition to providing a line of credit, we service the loans and maintain the deposits for the commercial FHA loans originated by this customer.

As with any warehouse line, the advances are short-term in nature and are paid off as the loans are sold into the secondary market. We had an unusually high level of advances outstanding at the end of the quarter, which contributed to the overall loan growth and the growth in the commercial loan portfolio in particular. Excluding the advances on this line, our total loan portfolio increased at an annualized rate of 14% in the third quarter, which is more reflective of the true growth rate in the portfolio.

Turning to slide 12, we'll take a look at our deposits, which were up 2.8% from the end of the prior quarter and 5% year-over-year. The increases came in our non-interest-bearing and NOW accounts, which enabled us to reduce some of our higher-cost time and broker deposits.

A portion of the increase in non-interest-bearing deposits was temporary in nature. We had approximately $82 million in loan originations and modification payments in our commercial FHA business in September that were held as deposits until being remitted to Ginnie Mae earlier this month.

Moving to slide 13, our nonperforming loans increased by $11.5 million from the end of the prior quarter. The increase was primarily related to one commercial real estate credit that was modified to a troubled debt restructuring during the quarter.

The tenant in the underlying property is performing well, however the building is part of a retail development that hasn't progressed as expected. As a result, our borrower has had to service a larger share of the municipality-issued debt, which has stressed their debt service coverage on our loan.

The terms of the troubled debt restructuring will provide them with some short-term cash flow relief, and there are opportunities over the next 12 months for the payments on the municipality-issued debt to be reduced. We believe that the credit will perform much better in the next year, and we aren't projecting any loss.

Aside from this one borrower, the rest of the credit trends were stable and our chargeoffs were once again minimal. We recorded a provision for loan losses of $1.4 million in the quarter, which primarily reflected the growth in the loan portfolio.

With that, I will turn the call back over to Leon.

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

Thanks, Jeff. Turning to slide 14, I'll wrap up our discussion with some comments on our outlook. Fundamentally, our outlook remains very positive and hasn't changed since we spoke last quarter.

Economic conditions continue to be healthy in our markets, and we're seeing good loan demand across all of our lending areas. Our loan pipelines remain strong, and we continue to expect low- to mid-teen loan growth for the balance of the year.

We continue to look at opportunities to develop new loan products that we think will be well received by our customers. A couple of examples are the bridge loans for construction financing that we now offer to our commercial FHA borrowers and the doctor loan program that I discussed earlier. Our product development initiatives not only add to our portfolio diversification, but they create new catalysts for driving balance sheet growth.

We also continue to make expense control a high priority, and we want to continue to drive improvements in our efficiency ratio.

I also want to mention the agreement we signed with the FDIC earlier this month for an early termination of our loss share agreements. This was an important step for the Company. By eliminating the loss share agreements we'll be able to simplify our financial reporting as well as improve the overall flexibility in our balance sheet and our ability to manage the credit risk in our investment portfolio.

We are feeling optimistic about our opportunities to continue to create shareholder value as we continue to generate quality balance sheet growth and maintain disciplined expense control. We expect to see a continuation of the positive trends in our business going forward.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Michael Perito, KBW.

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

Hey, good morning, guys. A few questions for me. Maybe starting on the commercial FHA business, appreciate the near-term commentary. Just curious.

As you guys look -- obviously, as that pipeline appears to be a bit longer-dated, I guess maybe you could see further out. I guess, how are you expecting next year on a year-over-year basis to shape out? Is that a business that's still very much growing, or are we getting closer to maturity origination level here?

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

Sure. Mike, this is Leon. The best we can always tell on that is what the pipeline looks like today. The good news about that is that the pipeline is as full as it has been. So there's no tip down in it.

And with the fourth quarter's business fairly well baked at this point, I think that's a good indicator for a solid performance for 2017 from Love Funding.

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

Okay. Then jumping over maybe to the core, the NIM performance, for Jeff. Obviously the accretable yield portion can jump around a bit, but the core NIM looked a bit better this quarter.

Was any of that benefit on the remix side related to the one advance on the warehouse credit? And I guess how should we think about the core NIM over the next couple quarters here in terms of trajectory from the 3Q level?

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

Yes. The warehouse line, it comes and goes in the quarters and actually drawn -- the line drew late in the quarter. So that had very little impact in the quarter.

Usually the line will stick, if you will, for about 30 days and then pay down. So it's not a driver.

The mix on the asset side of the balance sheet drove margin on an adjusted basis. So as we look forward, I think where we're at to maybe slightly lower would be where we would shake out, given that the mix change on the asset side we're not going to be able to reproduce next quarter.

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

Okay. So it sounds like the 3Q level is a pretty clean level; but obviously, just given where rates are and what not, we could see some modest compression going forward here?

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

Yes, I think so. Then on the accretion side, we think that's stabling at this point and will look a lot like -- the next quarter will look a lot like the third quarter. And then as we get into 2017, obviously, we'll continue to fall off.

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

Jeff, can you remind us, if we do see a 25 basis point hike in the Fed funds in the December, what the impact on your margin could potentially be?

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

I mean, generally, we are asset sensitive, so we should see an uptick in margin. But with 25 basis points, it's not a significant increase to make a significant change in our margin.

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

And we're not profoundly asset sensitive, just marginally asset sensitive.

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

Okay. One more question for me. Just with the loss share behind you now, can you maybe just provide some updated thoughts on that covered CMO portfolio? I guess maybe any -- what the impact to that would be with the loss share gone. And I guess, it would seem like you guys would have a bit more flexibility there now with what the plans are for that piece.

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

Sure, and we'll be working through that in the fourth quarter. But from my point of view as the CEO, one of the most important aspects of that -- and everyone understands this, but it's worth saying. For the last several years those assets, which have been primarily substandard assets, have been covered by the loss share agreement and had minimal impact on asset quality numbers.

Now, the portfolio has also gone from, I don't know, initially $200 million down to $60 million or $70 million, so it's less of an impact all the time. But there will be a number of issues around it that will be worth our attention, not the least of which will be managing the risk profile of the balance sheet.

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

Is that something where you guys would be able to sell or work it down rather quickly here? Or I guess any outlook commentary related to it?

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

Well, sure, we'll be looking at all of that. But at this point, I guess that's about all I would offer up, Mike.

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

Okay. Thanks, guys. Appreciate it.

Operator

Andrew Liesch, Sandler O'Neill.

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

Morning, guys; hi. Leon, I think last quarter you suggested that the gain on sale of the commercial mortgage banking line is going to be similar in the second half to the first. Does that still hold, just with what the revenue was in the third quarter? Or is it likely to decline relative to the first half?

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

Sure. In general, yes. But the range, because of the timing -- we'll continue to talk about this. Because of the timing on the closing of the credits, especially as we approach the end of the year, what slips into the first quarter we really can't control.

So in general, yes; I think we're looking at the fourth quarter to be something in between the first and second quarters, if you look at those numbers. Somewhere in the middle there I would be real confident about, with some range for movement based on timing of closings.

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

Okay. That's very helpful. Then just on the loan growth outlook, obviously I know the warehouse line is short-term, probably going to pay down pretty quickly.

But does your loan growth forecast imply the balances are going to end the year near this $2.3 billion level, with production offsetting some of the paydowns in the warehouse, just to get that mid-single-digit annualized growth number?

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

I think we're looking at annualized growth for the whole year in that mid-teens range. So fourth quarter, yes: Will the loan balance look a lot like it does this quarter, give or take some balance off of that? That's probably what we think as we sit here today.

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

Great. Thank you. Those are my questions.

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

Typically our fourth quarter is probably a little weaker in terms of growth historically.

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

Again, pipelines are good, but attention gets a little refocused in the world as we approach the holidays.

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

Understood. Thank you very much.

Operator

Terry McEvoy, Stephens.

Terry McEvoy - *Stephens Inc. - Analyst*

Hi, good morning, guys. Just a clarity here. In the press release there was an MSR impairment within the commercial FHA business of $1.1 million. That is, that $3.3 million you show as FHA revenue, that takes into consideration that impairment charge?

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

It does.

Terry McEvoy - *Stephens Inc. - Analyst*

And just curiosity. Is that just a function of rate movement? Or was there refinancing out of the actual portfolio that drove the $1.1 million impairment?

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

Yes, primarily driven by additional refinance activity, and not the value of the overall mortgage servicing rights in terms of basis points.

Terry McEvoy - *Stephens Inc. - Analyst*

Okay. Then I fully respect the lumpiness you're going to see quarter-to-quarter in that business. Leon, when you provide that revenue outlook, do you take into consideration MSR impairments? Or is that, again, difficult to model out?

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

Yes, right. So, no, I'm not. I'm just talking about the revenue generated from the business with not any consideration for impairment. We'll have to see how that goes throughout the quarter.

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

Yes, as you probably know, Terry, very difficult for us to project impairment going forward and recapture of impairment going forward.

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

And there's lots going on there. As Jeff said, some was driven by refinance and less so than in our single-family mortgage business; but as that 10-year starts to creep up that is likely to provide us somewhere between protection and maybe some enhancement. But upward movement in the 10-year, which looks like it's underway again, will be beneficial for us.

Terry McEvoy - *Stephens Inc. - Analyst*

Okay. Then the efficiency ratio has come down the last three, four quarters. You mentioned a few times it's expense management.

Could you just talk about what you've done so far in terms of managing expenses? And any thoughts on over the next 12 months some programs that you think will be put in place to be helpful for the efficiency ratio.

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

Yes. This is Jeff, Terry. I think most of the expense reduction from the prior quarter was driven by some one-time expenses that we had last quarter. I guess what we're saying is we're real focused on what -- I'll say additional spend at this point, and being very particular in what additional spend we're adding to our expense line. And I think as we go into next year, we'll probably talk a little bit more about maybe programs that we're exploring at this point.

Terry McEvoy - *Stephens Inc. - Analyst*

Then just lastly, save me a little bit of time, because I know it's been disclosed in the past: the yield in the Heartland Business Credit, 5.62% in the quarter. How have those tracked the last few quarters?

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

I think yields, new yields coming in are tracking about that level.

Terry McEvoy - *Stephens Inc. - Analyst*

Okay. Thanks, guys.

Operator

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

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

Good morning. Just a recap from -- I think it's been a while since we talked about -- since you guys talked about Sterling as far as the revenue contribution from that deal. Is that about $1 million a quarter additive to your wealth management fee line item?

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

Yes, that's exactly what it is.

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

And that transaction, are you looking for that to close -- is that going to be more towards the middle of the quarter or more towards the end of the quarter as far as timing?

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

Yes, I mean we --

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

Boy, we wish we could say that with certainty, because it's been stringing along. But I --

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

That's what I thought, yes.

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

Yes, thank you for that, but I think it's -- we're thinking early November.

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

Okay. Okay, great. That was helpful. Thank you.

Operator

Thank you. I'm showing no further questions at this time. I would now like to turn the call back to Mr. Leon Holschbach, President and Chief Executive Officer, for any closing remarks.

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

Thank you. And again thanks, everyone, for joining us and we'll be talking again after the end of the year. Thank you.

Operator

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