County Bancorp, Inc.

Third Quarter 2018 Conference Call

Monday, October 22, 2018, 4:00 PM Eastern

CORPORATE PARTICIPANTS

Tim Schneider - *President*

Glen Stiteley - *Chief Financial Officer*

PRESENTATION

Operator
Good afternoon and welcome to the County Bancorp Incorporated Third Quarter 2018 Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the "*" key followed by "0." After today's presentation, there will be an opportunity to ask questions. To ask a question you may press "*" then "1" on your telephone keypad, to withdraw your question, please press "*" then "2." Please note this event is being recorded.

I would now like to turn the conference over to Mr. Tim Schneider, President of County Bancorp. Please go ahead.

Tim Schneider
Thank you for the introduction. Welcome, everyone. Our financial performance this quarter was solid. We are starting to see some positive traction on asset re-pricing as reflected in the 21 basis point asset yield improvement from last quarter. Deposit market remains competitive with interest-bearing liability yields increasing 19 basis points compared to last quarter.

During the third quarter of 2018, we had solid loan growth of $21.4 million in on-balance sheet and $16.5 billion in sold and serviced loans. We expect the loan growth to be balanced with our ability to grow core deposits, which grew by $15.1 million during the third quarter. Brokered deposits, national deposits, and FHLB advances decreased by $22.6 million in that same timeframe.

Our provisions for loan losses increased in the third quarter compared to the second quarter due to specific reserves and a newly added impaired agricultural loan in addition to an increase in sub standard rated credits that are not considered impaired. This was partially offset by continued principal pay downs on impaired loans. We believe we are managing this challenging agricultural economy well, and we are encouraged by the announcement of the pending revision to the North American Free Trade Agreement among the U.S., Canada and Mexico, which included a pledge to curb protection for Canada's dairy industry.

Long term, we feel this revised agreement, called the United States-Mexico-Canada Agreement, will have a positive impact on overall dairy prices. We continue to be diligent in monitoring our classified agricultural credits and remain committed to working through this cycle in agriculture.

Now I'll turn it over to Glen to give some additional color on our financial performance for the quarter.

Glen Stiteley
Thanks Tim. As Tim mentioned, we did have another solid quarter of loan growth. That loan growth was split fairly evenly between agriculture and commercial lending. We were able to utilize our access cash from the second quarter and pay down some of our wholesale funding, reducing our reliance on brokered CDs, national CDs and FHLB advances. On the income side, we decreased $333,000 from Q2 to Q3, our gains on net interest income were offset by an increase of loan loss provision, as Tim noted.

Our margins did increase 2 basis points from the quarter from 2.87% to 2.89%, and we are starting to see some loan yields which are trending higher, going from 4.84% Q2 to 5.02% in Q3. We are still seeing some pressure on interest cost, those are interest bearing liabilities went from a 1.75% yield to 1.94%. Our sub that we added in Q2 also had a full quarter impact on our Q3 results, which had a negative impact on our margins from last quarter.

We are seeing somewhat of a slowdown in deposit costs funding intra quarter. Our deposit cost of funds were going up by 5 to 7 basis points on a month-to-month basis from January to May that slowed down to about 2 to 4 basis points of gains on a monthly basis from June to September. Loan yields were fairly flat from June through August but we did see a nice uptick in September on loan yields. Again, we are hoping that the repricing of loan yields starts to take over the repricing of deposit yields.

On the non-interest expense side, we did have a one-time expense of around $200,000 for an employment contract that we won't see in Q4 and going forward. We also completed our move to our new build…our corporate headquarters in the third quarter and there were some smaller expenses related to the move then but we will have…have some more positive impact going forward on a cost structure.

Tim Schneider
We would like to open it up to questions now.

QUESTION AND ANSWERS

Operator
We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your telephone keypad. If you are using a speakerphone please pick up your handset before pressing the keys, to withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble our roster.

The first question comes from Brendan Nosal with Sandler O'Neill & Partners. Please go ahead.

Brendan Nosal
Hi, good afternoon guys. How are you?

Tim Schneider
Good. How are you?

Glen Stiteley
Hi, Brendan.

Brendan Nosal
Good, thanks. I just want to start off on the margin here. Overall I would say, was a good deal better than I was looking for. I know, there were lot of puts and takes [indiscernible] last quarter went away, now you had a full quarter's impact of the [indiscernible] less wholesale funding mix. You already hit a bit on this, but just talk about some of the major puts and takes in the margin this quarter, and then I think more importantly, where you see it trending going forward given that you now see some better repricing on the asset side, as well as a slow bump in the liability pricing?

Glen Stiteley
Brendan this is Glen. Much of our growth in the third quarter was a mix of DDA money market and CDs. We are subject when rates go up our repricing on deposit side is going to go up quite

a bit faster than the loan side just because of our unique funding structure with efficient branches. Just from a trend line, we have had another rate bump here in September; we haven't had to move our rates probably as quickly as we had in other quarters. We are trying to I think better manage what our growth is in that respect, just bringing in a lot of funding and boosting our liquidity. I'm not going to win, but I am hopeful we can slow down the pace of increase in our funding costs more than the loan side. So….

Brendan Nosal
Alright, great, that's helpful. Then, shifting gears a little bit, just want to get your updated thoughts on the dairy industry. In terms of the tariffs a lot of positive news out of Canada and Mexico, the NAFTA renegotiation, but it seems like on the China side of things not a lot of progress there. If you look at class 3 milk prices, I think it definitely improved from the summer lose but are still low overall. Just top-level updated thoughts you guys have on the dairy space how you and your borrowers are feeling.

Tim Schneider
Yes, and as we mentioned in previous calls the Mexican part of that deal is more important than the Canadian part. Mexico is our largest trading partner on the dairy side. I know that was announced that they were going to do a unilateral arrangement with Mexico; but having this whole deal bundled together I think it will help. Obviously, we have got some time to go before a final agreement is to be reached, but at least some positive news and we saw some response in the futures market, although it's fallen off a little bit since then.

The pricing if you look out next 12 months is still probably better than the first half of 2018. We are optimistic we will see some improvement there, the whole Chinese agreement is probably a ways out yet, but I did see some commentary from Jamie Diamond recently indicating that he thinks that they'll come to some agreement at some point. That would be beneficial for the dairy industry as well. We're feeling a little more optimistic than we felt in a while. It's been a slow slog here for the last three or four years, but we're more optimistic than we've been in a while.

Brendan Nosal
Alright, great. Then, last one from me before I step back here. It looks like NPA creation has slowed a good amount this quarter, the lowest one out of the past three quarters. At this point, do you feel like you've identified all of the potential problematic credits that are in the books just given where price levels are?

Tim Schneider
Well, I think a lot of it will surface as we move through the 2018 review cycle on the tax returns and the financial performance of some of our operators, but we are trying to stay on top of the operations that we feel have had some challenges through this low milk price cycle and no guarantees that we've surpassed all of them. We may see a bit more of a creep there as we get through that review cycle in early '19, but overall, we think we've got a pretty good pulse on who the survivors are through this downturn.

Brendan Nosal
Alright, awesome. Thanks for taking my questions.

Tim Schneider
We are also, just one other thing Brendan, I should mention, we're hopeful for some movement out of NPAs as we've got a few [indiscernible] assets that we're in some discussions with

various buyers to potentially purchase some of the ag assets in particular and we're hopeful that we can see some movement out on that side to at least keep the trend line fairly stable.

Brendan Nosal
Got it, got it. Okay, that's great. Thanks.

Operator
Okay, the next question comes from Kevin Fitzsimmons with FIG partners. Please go ahead.

Kevin Fitzsimmons
Hi, good afternoon, guys.

Glen Stiteley
Hi, Kevin.

Tim Schneider
Hi, Kevin,

Kevin Fitzsimmons
Just one additional question on credit. I know this is tough to think of in terms of our run rate, but as we're looking out over the next two to three quarters, when you look at the pace we saw this quarter, should we expect a higher pace of provisioning like we saw this quarter? Or is it just going to really be very lumpy and you would characterize this one as more on the elevated side versus what we should expect? Thanks.

Glen Stiteley
Kevin, this is Glen. Really, the gains are really not from growth but more from movement in the rating cycle. It really just depends and if we have more movement on loans going from a special mention or a watch, non impaired, as Tim said, we think we've got things locked down in that regard. This one might be a tad bit lumpy just because of the movement of the one credit that had a specific reserve and we had some dollars move into the substandard bucket as well, so this quarter may be a little lumpy.

Kevin Fitzsimmons
Okay, thanks, Glen. Just one additional question on capital-related, how are you guys feeling right now about M&A opportunities? I know the stock multiple doesn't probably lend the opportunity to go out and use stock unless it's for smaller private companies, but how's the pace of discussions going there, and what would you expect? Then, alternatively, how do you guys view the prospect of buying back your shares given where they're trading right now? Thanks.

Tim Schneider
Yes. On the M&A front, we've articulated the fact that we're seeking opportunities. I still think ultimately with the expectations out there from a pricing standpoint that where our stock is valued today, it’s going to be difficult, unfortunately, to maybe pull the trigger on any kind of deal that might be out there. Seems like the activity of banks potentially looking to sell is picked up, we’ve been receiving a fair amount of calls from various investment bankers about opportunities, but in the end I think it’s going to be a little challenging with our valuation today to find an opportunity that’s going to fit for both parties, unfortunately.

Glen Stiteley

Kevin on the stock buyback; this is Glen, we just decided to hold off and even though that's an attractive [indiscernible] offers to buy stock back. I think with the challenge we do have in the ag environment, if think we want to make sure we protect our dry powder from a capital perspective.

Kevin Fitzsimmons
Got it, understood. Thanks guys.

Operator
Okay. The next question comes from Terry McEvoy with Stephens Inc. Please go ahead.

Terry McEvoy
Hey guys, good afternoon.

Glen Stiteley
Hi Terry.

Tim Schneider
Hi Terry.

Terry McEvoy
Could you just talk about the loan growth in the quarter? Was that coming from new customers, any specific markets that may have stood out last quarter? Then, in the commentary in the press release, it talked about loan growth matching up with deposit growth. As a follow up question, could loan growth be a bit stronger had the deposit inflows been a little more robust last quarter?

Tim Schneider
To answer your last question first, I think they could have been and you saw the amount of loans that we participated or sold off the balance sheet and we are again trying to manage that to our, what we define as core deposit growth which includes CDs, money markets, and DDAs from our clients. It could have been a little bit more robust, but again, we are trying to manage some of that.

On the growth side, I'd say I think it was an even mix between commercial and ag this quarter, on balance sheet and the commercial side continues to find opportunities for us across the board with CNI and CRE deals. Ag deals, we've been continuing to be very selective about the deals that we're picking up on the ag side and that pipeline, although fairly strong most of this year, I think at this stage of the cycle probably will slow down a little bit given we're moving into winter. We typically see a little seasonal slowdown until spring again.

Terry McEvoy
Then Glen, you mentioned the new building in the third quarter and a little bit of benefit in the fourth quarter. Any other anticipated expenses that may change the growth rate as you think about the next two to four quarters on the expense line?

Glen Stiteley
Yes, on the expense side, I think we're going to see if somewhat stable as far as our, what I'll call, our building costs. It may fall into that maybe the next quarter or two into that somewhere in between where we were at the end of the first and second quarter. Then the first quarter, we'll see probably normal increases in salaries and benefits, but we did increase our spend on

upgrades to the software and things like that in the first quarter this year, so I'm not expecting any big ads for next year, just right now.

Terry McEvoy
Okay. That's great. Thanks guys.

Operator
Again, if you have a question, please press "*" then "1."

The next question comes from Kevin Reevey with D.A. Davidson. Please go ahead.

Kevin Reevey
Hey guys, how are you?

Tim Schneider
Hey Kevin.

Glen Stiteley
Good. How are you?

Kevin Reevey
Good, thanks. Could you give us some color on the $15 million increase in your watch loan bucket, as far as the type of loan that was and what's secured by?

Tim Schneider
When you define watch loans you are referring to classifieds increasing that we mentioned?

Kevin Reevey
Okay.

Tim Schneider
It was a couple of relationships that are linked to one guarantor on the commercial side, some non-owner occupied CRE that slid into non-performing assets here this quarter. We are working through some potential resolutions with reduction in some of that here as we speak, so we are hopeful by the end of the year that some of that will be moved down the road. Then, we have continued to have some migration as we alluded to in the earnings release on the ag side, one dairy deal in particular that slid into the impaired territory. As we are getting through the review cycle and finishing off some of the credits, we are starting to get through that process of reviewing all of our ag credits, a couple more surface there as well.

Kevin Reevey
Then how are your dairy borrowers faring, as far as financially?

Tim Schneider
Well, this current milk price that we are at now since the new trade agreement was announcement, I think most dairy operations, I would say the majority of them probably are at a point where they can break even. Unfortunately, there are still a few that are challenged that these price environments either constrain from the standpoint of too much debt or don't have an operating model that supports some of this. We are continuing to go through that review process and trying to have conversations with some of those dairies that maybe can't paint a more viable picture long term to exit the business. Asset values in particular on the real estate

side are still held up fairly strong in the markets that we are in, so I am trying to have those conversations about liquidation with those clients.

Kevin Reevey
Then lastly, you loan yields were up about 18 basis points linked quarter which was much higher than what we were looking for. Were there any prepayment fees or anything unusual going on in the quarter?

Glen Stiteley
No, that's all, this is Glen, it's all yield pick-up, Kevin, so we didn't have anything really unusual in those numbers. We had a big accretion in June last year, but really didn't have anything like that this quarter.

Kevin Reevey
Great, thank you very much.

Operator
Okay. The next question comes from Joe Fenech with Hovde Group. Please go ahead.

Joe Fenech
Good afternoon, guys. Most of my questions were answered but just Tim, you just touched on in your response to the last question, but can you expand little bit on how land values are holding up? You made a comment in the past that that really is one of the more important factors and that you see weak ends selling out the stronger hand. Is that how this is playing out and if that continues, guys, should be able to muddle through this just fine? Just interested in your thoughts on that.

Tim Schneider
Yes, the land that becomes available in some of these liquidation scenarios generally, if it is in the right pocket in the state has competition for it from some of the stronger borrowers or farms in that market to pick up additional land again for feed for their animals and for manure disposal for their dairy operation, so that continues to be strong. We really haven't seen any signs that land values at least in the areas that we are serving have seen any drop off in valuations at this point. As I have said before, that's generally the biggest part of our collateral base anyway on these operations, so that's helpful.

Joe Fenech
Great. That's all I have. Thanks, guys.

Operator
Okay. We have a follow-up question from Brendan Nosal with Sandler O'Neill & Partners. Please go ahead.

Brendan Nosal
Hi, just similar one from me, just thinking about the reduction in wholesale funding this quarter both FHLBs and then wholesale deposits, you have been able to bring them down a couple of quarters in a row now. Just talk a little bit about your core deposit gathering initiatives and what we should be expecting on the wholesale side going forward.

Glen Stiteley

Brendan, this is Glen. I think we have really tried hard to have really targeted core deposit growth. Since we started strategic planning back in the summer '17 and continuing into this year, it's really been a key focus for us. Our target is really to keep moving that down, that needle down and we are going to manage that in some respects from loan growth perspective too. We are just going to continue to look for opportunities that hack away with that as best we can. It's a dogfight right now on the core funding side, everybody is chasing it. We are in ultra-competitive markets from a credit union and big banks and everywhere in between in our markets. We are going to really manage that pretty tightly, I think, going forward.

Brendan Nosal
Alright great. Then, last one from me, can you just help us understand the cost today for new deposit funding, your own core time deposits versus the national and the brokerage, and then throw in the FHLBs in there as well? How you all are stacked up on pricing perspective today?

Glen Stiteley
I think in general our cost of raising deposits these days is actually north of what we can probably get brokered or FHLB advances and…

Tim Schneider
Well, on the local side and it's unlike on a one-year CD, we are getting about 2.35 in an FHLB borrowings and brokered is a little bit higher than that. Obviously, that we can't get them as chunky on the local side as we can in the brokerage or FHLB setting, but we have been able to raise some local CDs, as you saw some of our growth this year. I think that's really accelerated the last quarter too in that regard, there was a certain slowdown, a little bit maybe inter-quarter, and then third quarter, but overall we have been able to still make some dents in that.

Brendan Nosal
Alright, great. Well, that's all from me. Nice quarter guys.

Tim Schneider
Thank you.

Operator
Again, if you have a question, please press "*" then "1".

Seeing no further questions in the queue, this concludes our question-and-answer session. I would like to turn the conference back over to Tim Schneider for any closing remarks.

CONCLUSION

Tim Schneider
We again appreciate everybody's time today and if you have any additional follow-up questions and details as you are looking over earning release for this call, feel free to give Glen or I a call and we will respond to you, okay? Thank you.

Glen Stiteley
Thanks everybody.

Operator
The conference has now concluded, thank you for attending today's presentation. You may now disconnect.