Country Bancorp, Inc.

Second Quarter 2018 Conference Call

Thursday, July 19, 2018, 2:30 PM Eastern

CORPORATE PARTICIPANTS

Tim Schneider - *President*

Glen Stiteley - *Chief Financial Officer*

PRESENTATION

Operator
Good day and welcome to the County Bancorp's Second 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 Tim Schneider, President. Sir, please go ahead.

Tim Schneider
Thank you for your introduction, Steven. Welcome, everyone. I'd like to start by just making a forward-looking statements…comments. Forward-looking statements are subject to known and unknown risks and uncertainties, many of which may be beyond our control.

We again have a solid net income quarter. Deposit gathering has been competitive and the pressures have continued to place some strain on our net interest margin this quarter. Borrowers and depositors and competitors are adjusting to the new interest rate environment after nearly a decade of long low and flat interest rate environment. We remain disciplined in our approach to pricing loans and deposits.

Non-interest income again saw another solid quarter as the farm service agency government guaranteed loans and participation activity was strong boosting our servicing income. Non-performing assets do remain a challenge as our Ag portfolio has seen the impacts of the tariffs and trade war discussions occurring. As you know, the majority of our Ag portfolio and dairy pricing has softened some on the futures markets since trade discussions have occurred in Washington.

We expect additional stress on our dairy and non-dairy Ag clients for the balance of the year or at least until some…the trade discussions settle out. We remain diligent in supporting Ag through the cycle and are closely monitoring our customers.

We are very excited to have added a new Chief Credit Officer, John Fillingim during this past quarter. John has a wealth of credit knowledge including experience with Ag to help us continue to manage through this cycle. We have also been actively preparing for a move to our new corporate headquarters in August which we are extremely excited about.

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

Glen Stiteley
Thanks, Tim. We continue to see solid loan growth; loans have increased $17 million which is led by multi-family loan growth of $11.2 million during the quarter. In addition loans held for sale increased $5.1 million and loan sold and serviced grew $15.5 million in the quarter. And we continue to see traction in core deposit growth which totals $32.7 million which has allowed us to lessen reliance on wholesale funding during the quarter.

Net income decreased $204,000 from Q1 to Q2 mostly due to a large loan recovery in Q1, which led to lower loan loss provisions Q1 versus Q2. As Tim mentioned, net interest margin has continuously compressed from Q1 to Q2 we drive from 3.01% to 2.87% and we are encouraged by loan yields that certainly trend higher going from 4.67% in Q1 to 4.84% in Q2.

Our funding cost continues to increase and they continue to [indiscernible] gains in loan yields. Interest bearing liability costs increased from 1.52% to 1.75% in the Q. We've seen 18 to 24 basis points increases in money market accounts CDs including broker.

Our additional sub [ph] that has also added some stress to the margin that we had here in Q2. From January to May, deposit costs of funds have increased about 5 to 7 basis points monthly. In June, our cost of funds increased just 2 basis points, so we are seeing a little bit of a leveling out there.

Loan yields increased 8 basis points in May and 11 in June after adjusting for a one-time accretion in June. So we are starting to see loan yields are slowly catching up the deposit yields, probably we still see pressure on deposit costs going into Q3.

Non-performing loans increased $8.2 million during Q2; we had total impairment on these loans totaling 218,000. Non-interest income increased across several categories in Q1 to Q2 led by increased loan servicing rights due to the increase in loan sales during Q1.

Non-interest expense levels increased largely doing our preparation for a move to our…in our corporate headquarters here in Q3.

Tim Schneider
That's out presentation. I'd like to open it up to questions.

QUESTION AND ANSWER

Operator
Thank you. 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 pickup your handset before pressing the keys, to withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble the roster.

And our first question comes from Joe Fenech with Hovde Group. Please go ahead.

Joe Fenech
Good afternoon, guys.

Tim Schneider
Hi, Joe.

Glen Stiteley
Hi, Joe.

Joe Fenech
Hi, guys I have a big picture question to start may be Tim, can you may be just take a minute and educate us a bit on dairy industry exports and what looks like the clients that you bank and the State of Wisconsin generally, because the reason I asked is because we see this news everyday about tariffs and trade wars in China and Mexico and Canada and all this stuff. And when we think about the implications for dairy producers back home, I think it's hard for us from

a distance to sort of…sort through what's significant and what really isn't. So I know that's a lot to have to answer, but if you could just kind of give us a quick tutorial that would be really helpful?

Tim Schneider
Yes. Well, first of all just to clarify for those that aren't aware, dairy farmers aren't directly exporting product, I mean, their milk is actually being sent to a dairy plant which 90% of the milk in the State of Wisconsin is turned into cheese, and the cheese market is obviously the biggest majority of our exports that are occurring. Mexico is our largest trade partner and unfortunately the whole NAFTA conversation has constrained that a bit. Canada is a fairly substantial partner as well. The Fareast especially China has been a growing export partner for Wisconsin dairy products. And again, all of the trade war conversations that have been going on has put a damper on that and we are seeing that impact in the futures pricing of milk currently.

The futures market had rebounded fairly nicely then we felt in a fairly comfortable spot for most of our dairy farms here 30 to 45 days ago, but then unfortunately when these conversations started the futures had soften a bit again. So a lot of uncertainty out there, and uncertainty is never good for markets as you guys hear not just the dairy space and/or hoping to get some clarity on this in the not too distant future.

Joe Fenech
Tim, just a follow-up on that. So okay so Mexico is sort of at the top of the list here. Is it fair to say that, you know, the rhetoric at least recently around Mexican trade with NAFTA is a little bit less than what we've been hearing in the news about Canada and China? So are we…may be to think that, it's not quite as significant what's going on with Canada and China as it relates to your business as it would be, if things were at that level with Mexico. Is that make sense?

Tim Schneider
That makes sense Joe. I guess, just to clarify one other point that I should have clarified about 10% to 15% of the Wisconsin dairy products were exported to Mexico.

Joe Fenech
One more from me, guys, in terms of the process, Tim, of identifying problem assets and kind of where you stand with that, you feel like at this point, it's still kind of an evolving situation just because the news flow was still evolving every day and developing or do you feel like at this point, if things were to stabilize from here that you kind of got your arms around and identified the potential problems in the portfolio at this point?

Tim Schneider
Well, I think we have identified most of the problems, but as you can imagine as we are going on our fourth year of continued kind of lowered milk prices, continues to put some strain on our farm operation. So we expect if prices stay at this level, we are probably going to see a little bit more pain in a few more clients that are sliding into either classified territory or potentially nonperforming territory. So we are working through that and as we've mentioned many times that all of you on the phone in the past were very diligent in managing our clients and staying on top of the activity out in the farm.

Joe Fenech
Great. Thank you, guys.

Tim Schneider
Thank you, Joe.

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

Kevin Reevey
Good afternoon, guys, how are you?

Tim Schneider
Hi, Kevin, how are you doing?

Glen Stiteley
Hey, Kevin.

Kevin Reevey
Good. Thanks. So just a follow-up on Joe's question regarding kind of what's going with…what's happening in the dairy market. Have you changed any of your underwriting policies and procedures and your approach to underwriting these dairy loans?

Tim Schneider
I would say relative to new deals that are coming in, we are definitely scrutinizing much more thoroughly, and even now we are seeing some growth. We're definitely looking at breakeven points and trying to manage for may be a softer environment moving forward and making sure that we're bringing the right clients into the bank. Existing clients that we have, we are trying to work through with them. There are a handful of deals right now that we are having liquidation conservations with, now some of those in the NPA bucket. And I think as I have shared again with many of you in the past, generally, if we can have a cooperative liquidation where our bankers who have strong relationships with the borrowers can talk to client into self liquidating rather than having a contentious fight and this been dragging out a long legal battle, it's generally a better situation for both sides.

Kevin Reevey
And you're doing more stress testing of individual credit, particularly new ones, your booking for potentially lower dairy prices?

Tim Schneider
Yes. We're looking at breakeven points. We are looking out at the futures market for the balance of this year and into '19 and trying to use a conservative estimate as to what those projections might look like along with the…trying to evaluate some of the changes these dairy operations are making to weather some of the storm as well from a expense management standpoint.

Kevin Reevey
And then earlier in your comments you mentioned that loan yields are finally catching up to rates, is it fair to say that the pace of NIM compression going into the third and fourth quarters were lessened even though deposit cost continue to rise?

Glen Stiteley
Kevin, this is Glen, it's really tough to tell, where the loan yields are starting to accelerate, it's just really hard to predict right now where deposit costs are going. We had to increase our

deposit rates again here in June. It is just a highly competitive market up here. My market CD is kind of across the board, so it is just kind of hard to tell us though where the stopping point is on the deposit cost side.

Kevin Reevey
And then one last question from me relates to watchlist trends, can you give us a sense as to…I am assuming given the stress of me the Ag. Portfolio, I am assuming your watchlist trends are up quite a bit sequentially, is that a fair prediction or assessment?

Tim Schneider
Well, I'd be reluctant to answer that. We don't have a lot of detail relative to that in the earnings release, but we will have more detail in the queue when it comes out that you are going see some of trends in our classifieds and watchlist credits.

Kevin Reevey
Okay, great. Thank you.

Tim Schneider
Thank you, Kevin.

Operator
Our next question comes from Terry McEvoy with Stephens. Please go ahead.

Terry McEvoy
Hi guys, good afternoon.

Timothy Schneider
Hi Terry.

Terry McEvoy
Sorry, I missed the first few minutes, so I apologize if I ask a question that has been answered but just looking at CD rates, how much of a difference is there between wholesale CDs and then local CDs that are brought into the bank locally. Is there a pretty big gap between rates?

Glen Stiteley
No, Terry, just glance at it. You know the longer you go up to two years and above, I think they are pretty well matched which we brokered in local. There is a little bit of a premium of brokered over local medium or short, so it is a little cheaper to bring in funds locally when you give kind of shorter than a year I think, so…

Terry McEvoy
I guess if you adjust it for just operating fewer branches in expense adjusted basis, would you say it is still cheaper to utilize the wholesale market?

Glen Stiteley
If you are adding in the efficiencies from [indiscernible] branches, they are absolutely. So you know we are still going to balance as best we can kind of the wholesale funding strategy. You know we are trying to maintain kind of where is that now, we are…we have been able payoff some [indiscernible] in this quarter and we will continue to do so. So, yes, it is…you know it still pays for us to continue to maintain our current structure, so…

Terry McEvoy
And then Tim, a question for you, more as a follow-up, if I pull up class 3 milk futures, how many months out I guess do you look when you pull that up to monitor the health of your customers and is there a breakeven point on a certain month out that that you focus on a weekly basis as you are just monitoring trends in dairy.

Tim Schneider
Keep in mind that the milk in Wisconsin goes into class 3, so if you are looking at the futures market there is four classes, and class 3is where the milk goes from the state. We generally are looking out 12 months, and we have a number of farmers that have hedging strategies that are lacking in [indiscernible] calls, futures contracts that sort of thing. And, it's really farm dependent on where the breakeven points are. So having them…have a knowledge of where the breakeven levels are and locking in a portion or all of their production to make sure they are making a profit is something we definitely have been coaching and working with our customers on. But the break even points for dairies are just, generally all over the board depending upon management debt levels how efficient they are, that sort of thing.

Terry McEvoy
Understood.

Tim Schneider
And then the other that I should mention is, just you know where the class 3 prices isn't the only price they receive, they also receive a basis for the quality of their milk, butter fat content, protein, [indiscernible] which is the quality of the milk, all those factors add to a increase price over what you see in the futures market. And generally our dairy farmers are probably in that $1.50 to low $2 range for the premiums that they add on top of the class 3 price.

Terry McEvoy
Okay. And then, just the last one, and maybe I missed this. Were there any recoveries in the second quarter, I believe you saw someone in the first quarter that helped the charge off line?

Tim Schneider
Marginal, we have a couple of commercial deals that were sold…that we received some gains on, but they were less than 100 grand I would say in collectively 200 grand, okay.

Terry McEvoy
Okay.

Tim Schneider
[Multiple speakers] not anything like that first quarter windfall that we saw.

Terry McEvoy
Okay. Thanks guys.

Tim Schneider
Thanks, guys.

Operator
And as a reminder, if you have a question, please press "*"then "1" and our next question comes from Bryce Rowe with Baird. Please go ahead.

Bryce Rowe
Thanks, good afternoon.

Tim Schneider
Hi, Bryce.

Glen Stiteley
Hi, Bryce.

Bryce Rowe
Hi Glen, I noticed in the press release you called out that the 5 basis points of purchase accounting accretion. Just curious, what that number was in the first quarter and kind of how you see that maybe playing for the balance of the year?

Glen Stiteley
It was fairly minimal in Q1, in that the dollar amount related to that one was 129…120 was 40,000. So I am sorry, it was 40,000 in Q1 and about 129,000 in Q2, so…

Bryce Rowe
Okay.

Glen Stiteley
The large pay-off of a commercial real estate deal.

Bryce Rowe
Okay. So I would expect that would be relatively minimal you know, in the back half of the year?

Glen Stiteley
Correct.

Bryce Rowe
Okay, and then I want to just ask about maybe on the expense side and you know, with some of the new hires and the move to the newer headquarters is curious what, you know, what a good expense run rate maybe as we move into the back half of this year and into next year?

Glen Stiteley
We are still working through that, Terry [ph]. We will have a little bit more detail…I'm sorry, we will have a little bit more detail in the queue, but right now the run rate, we are still carrying our current building plus the new building, so there is a little bit of noise in this one from just recruitment expenses and things. So probably this quarter, I don't know that we are going to jump much from this quarter but…we should be, again we are going to still maintain pretty efficient operations here so.

Bryce Rowe
Okay, that's helpful. And then, maybe one for you Tim, just thinking about the pipeline for loan growth, given some of the weakness around dairy, I was curious what the pipeline looks like and how you would kind of characterize it, Ag versus Commercial? Thanks.

Tim Schneider
Our pipeline as we've articulated in past conversations with you guys in both sides of the house is still fairly robust. I'd say that the Ag is probably little softer right now, maybe just relative to seasonality in the year. But I…we continue to see some nice solid pipelines and especially in the commercial side which has been nice to see.

Bryce Rowe
Okay. Thank you, guys.

Tim Schneider
Thanks Bryce.

Operator
And this concludes our question and answer session, I like to turn the conference back over to Tim Schneider for any closing remarks.

CONCLUSION

Tim Schneider
Well, we appreciate all of you joining us on our first conference call. And I guess, if you have further questions, Glen and I will both will be available for any future follow-up questions that you might have.

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