County Bancorp, Inc.

July 18, 2019, Earnings Release Conference Call

Thursday, July 18, 2019, 2:30 P.M. Eastern

CORPORATE PARTICIPANTS

Tim Schneider – *President*

Glen Stiteley – *Chief Financial Officer and Treasurer*

PRESENTATION

Operator

Good day, and welcome to the County Bancorp Inc. July 18, 2019, Earnings Release Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key (*) followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*), then one (1) on your telephone keypad. To withdraw your question, please press star (*), then two (2). Please note this event is being recorded.

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

Tim Schneider

Thank you, and thanks all for joining us today. Before we start, I'd like to direct you to Slide 2 of our deck, which is our forward-looking statement disclosure. And I'd like to start with ag credit updates. We saw an increase in classified assets this past quarter, as well as increases in loans rated special mention. The increase in special mention loans from the prior quarter is driven primarily by three ag relationships. We placed loans in special mention as a temporary grade. We monitor these credits monthly to see if their proposed changes in their business plans are successful, and we anticipate updating their loan grading by the end of Q4.

Increase in substandard performing loans is driven by six ag relationships and one commercial relationship. The ag relationships downgraded are related to getting through our annual financial reviews of these relationships. The commercial relationship was a startup manufacturing business, which is having challenges on their sales cycle extending, which has created stress in their cash flows.

We previously had this rated as a special mention in Q2. We also moved one commercial credit from substandard performing to OREO and charged off of a portion of our specific reserve that we had allocated in Q1. While we have seen some credit stress from a handful of commercial deals, overall our commercial portfolio continues to perform well.

From an agricultural perspective, we are about 80% of the way through our total dollars on the credit review process of our watch and lower classified credits. We continue to manage as aggressively as possible the reduction of classifieds, with a few liquidations of farm operations occurring this spring and a few more ongoing through fall, and some solid activity on more of our ORE currently. Up to 80% of watch or worse credits reviewed, we were selective in reviewing the credits we felt were more sensitive to the recent low milk price cycle and the size of the relationship. We have seen continued improvement in milk prices on the Chicago Mercantile Exchange Class III futures market. The 12-month forward-looking average is $17.04 per hundredweight this quarter, up from $16 a hundredweight last quarter. Since we use a three-year average of cash flows when determining a loan's credit rating, the uptick in milk prices in 2019 and the drop off of the lower cash flows from 2016 should have some positive impact on the overall credit quality in 2020, when we go through the reviews.

The Chicago Mercantile Exchange Class III 2019 milk prices actual through June and futures for the balance of the year are at $16.31 per hundredweight, and this is the best year-over-year price that we have seen since 2014, which as you recall was a record high milk price year. We also had a couple of commercial deals bubble up and have been downgraded, including one involving a deed renewal related to the regional retailer that filed bankruptcy, which I alluded to earlier, and that did have a specific reserve in quarter one that was charged off that quarter.

Now from a client deposit growth standpoint, we continue to be focused on client deposit growth and have been really pleased by our growth in such a competitive landscape. Client deposits are up $39.6 million, or 5.2% since last quarter, and up $96.3 million, or 13.7% year-over-year.

And now, I will turn it over to Glen Stiteley.

Glen Stiteley
Thanks, Tim. Couple of things. First off, on deposit pricing, we are closely watching the inversion of the yield curve that is occurring, and we are reflecting that in our deposit pricing strategies. We have begun to cut back on our rates across the board to more closely mirror wholesale funding rates. Our aggressive reduction in FHLB advances during 2019 will also allow us flexibility, in case we have to plug any liquidity holes by the end of the year.

On the wholesale funding front, as we have talked about, we will continue to focus on reducing our wholesale funding especially on the broker deposit side. And as we talked about earlier, we are targeting $120 million reduction in wholesale funding this year, focused mostly on brokered CDs. We saw a reduction of $51.7 million this quarter and $92.9 million year-to-date. In this challenging rate environment, we will continue to be aggressive in paying off wholesale as it comes due.

In regards to Russell reconstitution, at the end of June, we were taken out of the Russell 2000 Index. So far in July, we have not seen an overall negative impact to trading volumes in comparison to the trading volumes during the first two weeks in July a year ago.

I think that it concludes our prepared remarks, and we will be happy to open it up for questions.

QUESTIONS AND ANSWERS

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

Our first question today comes from Brendan Nosal with Sandler O'Neill and Partners. Please go ahead.

Brendan Nosal
Hi good afternoon guys. How are you?

Tim Schneider
Good Brendan. How are you?

Brendan Nosal
Good, thanks. Just want to start off on the commercial book. I know that the one credit that drew loss content this quarter have been discussed previously and been reserved for. But it sounds like there are a couple of other commercial credits that you mentioned that you are kind of keeping a closer eye on. I mean is there something broader that is going on in the commercial book? Or are these more or less a handful of isolated credits that probably would not be very noteworthy if dairy were not so pressured currently?

Tim Schneider
They are really handful of isolated credits and definitely obviously with our higher level of classified assets in the ag side is obviously raising the question, but there is nothing systemic that is occurring in the portfolio on the commercial side right now. Generally, it is very, very healthy.

Brendan Nosal
Okay. Good. Thanks. And then, moving over to the review of the dairy book. So it sounds like you are about 80% of the way through the dollars here. I mean, I know it caused some migration, but have you found any big surprises where certain borrowers were much worth off and you would have assumed going in there. Have things pretty much played out as you would have expected?

Tim Schneider
I think they played out as we expected maybe even a little bit better than we expected earlier in the year. And as we have talked before, our ag lenders, our ag bankers that are out in the farms quite often were obtaining interim financial statements. So, we are keeping a close eye on things and I do not think we had any real surprises at this point.

Brendan Nosal
Okay. Good. And then one more from me before I step back. Just on the margin, I mean, obviously a lot of moving parts here. Loan balances have kept declining, which of course you give up some earning asset yield on, but you do keep shedding the wholesale funding and you are a bit liability sensitive. So, how do you see the NIM trajecting throughout the course of the year, especially if we get one or two rate cuts in the second half of the year here?

Glen Stiteley
Hi, Brendan, this is Glen. Just let me speak first to the kind of current rate environment, and I can talk about the rate drops.

So, kind of inter quarter…kind of May, June, we saw some creep up in loan yields, so we hope that is a positive sign that things are still repricing. So that is kind of higher rate environment from a… kind of from the last year too as things refinanced. And on the deposit side, we have seen things kind of flatten out right now. So, we are hoping that is positive on the margin side going forward, based on the current rate environment, because I am hoping it is competition, I talked about deposit price. I think it feels like folks are being more disciplined and kind of working on ratcheting back rates and thinking that is going to really help the deposit side.

We are not really liability sensitive. We are asset sensitive, but we are not aggressively asset sensitive, so we are subject to near-term rate increases first and foremost on the liability side, but long term, we are asset sensitive. So, if we see some rate cuts, I am hoping that is going to have, hopefully, some more positive impact to us on the margin side in the short term so.

Brendan Nosal
Got it. Okay. Thanks for taking my questions.

Glen Stiteley
Yes.

Tim Schneider

Thanks, Brendan.

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

Kevin Reevey
Good afternoon, gentlemen. How are you?

Glen Stiteley
Hi, Kevin.

Tim Schneider
Great, Kevin. How are you?

Kevin Reevey
Good. Thanks. So, first question is on the reserving and net charge-off assumptions. How should we think about those two items as we are modeling out the next two quarters?

Glen Stiteley
This is Glen, Kevin. So, the charge-offs, especially, if we have got reserve specifics built in, it has not seemed to have as much impact yet, because they have been fairly manageable. I think what's had more impact on the movement of our allowance is the loan gradings. We tend to put in some flat percentages for loans that are not impaired but are in the special mention and substandard performing buckets. So, the movement of loan grading seems to have had as much impact as charge-offs right now, again, not kind of we would. Hopefully, they are manageable on the charge-offs side. So, if we keep them in, again, the $1 million to $2 million range, if we have any, it seems to not have as much impact, so.

Kevin Reevey
And then–and given the outside charge-off that you had this quarter, how should we think about the charge-off side of that equation as we model out?

Glen Stiteley
That is a good question. I don't know if anything we have got specific reserves on is headed to charge-off in the immediate future. So, I don't anticipate anything right now for the next couple quarters. So, I mean, obviously, something can bubble up, but we have not seen anything yet that we think is going to in the charge-off.

Tim Schneider
And we have articulated what occurred with that situation in the past. So, I think we knew that was coming down the pike, and that seems to be sort of a one-off at this point, but as Glen said, we don't have anything that we are watching closely from that standpoint from a charge-off for the next couple of quarters.

Glen Stiteley
Yes. As we talked about the charge-off was from a regional retail bank, kind of a larger shopping center bankruptcy that we took. We just decided to move in OREO this quarter, so.

Kevin Reevey

Okay. And then lastly, you are participating out in loans. Can you give us some color? Is there kind of what your risk is as far as them being put back if there is a credit issue? And is there also any risk of a valuation, negative valuation adjustment on those loans?

Tim Schneider
No. On both fronts, those are sales that the buyer ultimately has to take the risk. They cannot put them back to us. And the only risk we have is that maturity that they could not agree to renew and it might force us to do some other things, and then from an allowance standpoint or a valuation standpoint, there really is not anything that there that would impact our valuation in the servicing side either.

Kevin Reevey
All right. I will step back and I will go back in the queue. Thanks.

Tim Schneider
Thanks, Kevin.

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

Terry McElroy
Good afternoon guys.

Tim Schneider
Hi, Terry.

Glen Stiteley
Hi, Terry.

Terry McElroy
I maybe just start with expenses. If I look at the quarterly expenses and remove the write-down of OREO, it is kind of a $7.2 million run rate. As you think about the second half of this year, what are your thoughts on expenses, again, kind of isolating OREO?

Glen Stiteley
Yes. Sure, this is Glen. I think the run rate is pretty level. I mean, I don't anticipate any big changes in those kind of in the last two quarters of the year or so.

Tim Schneider
It might be just slightly higher as we filled, I don't know, handful of positions that we have had open for a while here just recently and I think most of those people are starting in the next couple of weeks or so.

Glen Stiteley
Yes. On a percentage basis, I do not see any big changes, but we may have a little bit of an uptick on the dollars but not significant.

Terry McElroy
Okay. And then just as a follow-up, I went to your website 30 minutes ago and lucky 13 CD product, the 2.35, has that come down at all? And I guess, I was looking your average time deposit rate of 2.26% versus the CD product, it seems like, if that is the peak product out there,

we are getting close to at the CD prices or CD rates at your bank kind of peaking out. Is my math correct? And do you see that 2.35 potentially at the top there?

Glen Stiteley
Yes. We just introduced that it was a couple weeks ago. So, we are going to constantly be will be looking at- if we need to start pulling back on everything as far as rates goes. So right now, we are pretty comfortable with that. We still want to attract good client relationships. I do not think that is overboard kind of where the market is right now. Like you said, we have really tried to ratchet back, kind of the most, kind of our RAC rates that you will see hopefully, if you track and there you will see we have cut back those quite a bit again to mirror the FHLB advance rates more or so.

Terry McElroy
Maybe one last question, if I could. Loan yields went up 4--I'm sorry, 5.14% to 5.26% quarter-over-quarter. Just talk about any impact loan yield--loan fees had or TDRs or any call it, noise that impacted the rates?

Glen Stiteley
I do not think we had anything material in the first quarter that would have taken that one down or anything that is used in this quarter, Terry. So we are obviously still dealing with the non-accrual situation as far as the overall level of loan yield. But I don't think there is anything unusual to back out.

Terry McElroy
Great. Thanks guys.

Tim Schneider
Thanks, Terry.

Operator
Our next question comes from Feddie Strickland with Janney. Please go ahead.

Feddie Strickland
Hi, Tim and Glen. How are you guys doing?

Glen Stiteley
Great.

Tim Schneider
Hi, Feddie. How are you?

Feddie Strickland
Good, good. I think most of mine have been answered, but just one quick question. How far are you guys through the balance sheet reduction? And how much more do you think you are going to have on the loan side there too?

Glen Stiteley
Yes. We had some commercial payoffs that we didn't expect. We kind of targeted going down $40 million this year. So, we are obviously a little bit past that. I do not know that we are going to go much further than that right now because I think we really feel good about our overall liquidity. So, we are kind of in the mode now, we will try to maybe fill a little bit of that. We went

over $40 million, but I do not know that we are going to aggressively grow from here on out for the next 18 months here, but things could change as we see better metrics on the milk prices and also the classifieds too so. I mean--and it is just really just governed by our ability to continue to generate client deposits too. So, we are really trying to manage our growth--our ability to bringing good deposits.

Feddie Strickland
Got it. thanks. So, relatively flat, I guess, then is kind of how we should be looking at total assets then.

Tim Schneider
Yes, maybe little uptick between now and the end of 2020, but I do not anticipate being material right now, especially, again, based on our ability to bring in the client deposit so.

Feddie Strickland
Got you. Thanks so much.

Tim Schneider
Yes.

Operator
Again, if you have a question, please press star (*), then one (1).

Our next question comes from Ross Haberman with RLH Investments. Please go ahead.

Ross Haberman
How are you gentlemen. Just one or two quick questions. What is your total exposure from the loan book on retail today?

Tim Schneider
Retail strip centers you are talking about, retail shopping centers, that is the thing.

Ross Haberman
Yes, exactly.

Tim Schneider
It is pretty minimal. I do not know the exact percentage, but it is insignificant relative to a concentration or anything. We have got a few, but not many.

Ross Haberman
Okay. And then on the ag loans. Are most of them collateralized by land or would it be land and/or facilities, warehouses, and so on and so forth?

Tim Schneider
Everything. When we take an ag client in and it is almost without exception, we have their entire asset base as collateral, all the land, all their facilities, all their cattle, their equipment, their crops, their feed, it is all cross-collateralized.

Ross Haberman
Has there been any significant weakness in the land sales side? And if so, what have you seen there in the last year?

Tim Schneider
No, they've--land values have continued to remain strong out. Obviously, there are pockets that there may not be as much competition for land, but in the situations where the farmers have been liquidating their assets in the land, in particular, the values have been maintained.

Ross Haberman
Okay. And then--and just one last question regarding ag loans going forward. What sort of your emphasis or your adjusted parameters in terms of making additional new loans today, particularly in dairy?

Tim Schneider
Well, there are still producers out there that have made money through this entire lower milk price cycle and we are being obviously very selective. There is not much expansion occurring, but there have been a few deals that we've book that are brand-new relationships, but to manage the overall exposure on our books, we are generally selling or participating the vast majority of those deals and those relationships where we can make a nice servicing spread, but there has not been a lot of organic growth occurring over the last 12 months or so. We are definitely managing that pretty tightly.

Ross Haberman
And a final question. Do you think we peaked in terms of your not the non-performers, but your...

Tim Schneider
Classified assets?

Ross Haberman
Your classified, yes, correct.

Tim Schneider
Hard to say, I mean, with the futures price on milk right now and I alluded to in my comments earlier, even though that $16 or so average $16.31 for this year may be seems closer to that breakeven point. The reality is the early part of 2019 year had some quite low milk prices in January and February in that $13, $14 range. What we are seeing out the next six months is pretty much all over $17 and even approaching $18, a hundredweight for their base price.

So we are feeling better about the operations out there and whether breakeven points are in the fact that at this stage if those milk prices hold that the majority of our operators will be able to make money.

Ross Haberman
Okay, guys. Best of luck. Thank you.

Tim Schneider
Okay. Thank you.

Operator
Our next question is a follow-up from Kevin Reevey with D.A. Davidson. Please go ahead.

Kevin Reevey

Just curious if you have not updated stress analysis from an effectiveness that you shared with us when you had your earnings call last quarter. And if there have been any changes to that stress analysis?

Glen Stiteley
No. Kevin, this is Glen. So, we will probably only do that once a year. And it does not pay off to do it more than that. The leveraging of our balance sheet and continued earnings is only going to help that what we call that cushion. So, we hope it will continue to improve.

Kevin Reevey
And then lastly, if I understand you correctly, what is the breakeven for milk pricing for your farmers on average? Is it around $16 or is it higher than that?

Tim Schneider
No, I think that is kind of the range that if you average it all out there, we have said that is probably in the ballpark for breakeven. Obviously, every operation depending upon efficiency and management, they vary, but that is probably a reasonable and that is the base price that I was referencing earlier with the CME.

The dairy farmers are receiving anywhere from $1 to $2 a hundredweight of additional bases on top of that for components. So if you add that on to the $17 milk price, we are looking at the balance of the year, a lot of them will be making $18, $19 a hundredweight. And we call it mailbox price, that is the final price they receive from the dairy plant.

Kevin Reevey
Great, thank you. That's helpful. Appreciate.

Operator
The next question is a follow-up from Brendan Nosal with Sandler O'Neill and Partners. Please go ahead.

Brendan Nosal
Hi, guys just a couple more from me here. First, can you just elaborate on the build in TDRs this quarter? Were these just credits you identified throughout the dairy review and not to restructure? Or any color there would be great.

Tim Schneider
Well, primarily, there were a couple of relationships that slid into there--that slid into substandard and we did some restructuring with them. They're substandard performing though. And I noticed in your note this morning that your NPA number was quite a bit more elevated. We have done these interest-only periods for these operators if we believe they have viability and can make it through the cycle, especially with some of the changes they are making in their business models. So, unfortunately with the TDR definition, we have been trying to stay conservative on that and, unfortunately, some of those numbers have elevated. But again, the performing TDRs, we feel good about and that is maybe where you are referencing that number.

Glen Stiteley
And Brendan, this is Glen, I mean so--because of their TDRs, we had to go through the impairment process and those two that Tim mentioned, we have not seen material impairments in those so.

Brendan Nosal
Got it. Okay. And then last one from me. I mean, if milk prices kind of hold in this $16-to-$17 range, let's say on average for the course of a year, how long will it take you to see a meaningful decline in either classified assets or in non-accruals?

Tim Schneider
Well, I think if we get another--if this milk prices sustain for the next 12 months, and we are at this point next year and are through 80% of our watch and worse review cycle, again, I think we will see some meaningful movement in both those numbers.

Glen Stiteley
By the end, but it's kind of year-over-year.

Tim Schneider
6/30/2020.

Brendan Nosal
Okay. But it sounds like we have taken another review process, which happens once a year to really work through that noise, and again, assuming we have stable milk prices.

Tim Schneider
Yes. We generally have not moved classifications in between years, and I think we have talked a little earlier about our score looks to the three-year milk price average and the benefit that is going to help us is that $16, which was kind of a low point for some of the milk prices here to last four years will fall off and 2019 as it appears should finish pretty strong and will add-on. So that should help our score on the classification side.

Brendan Nosal
Perfect. Thanks for taking the follow-up.

Tim Schneider
Yes.

Operator
Our next question comes from David Honold with Patriot. Please go ahead.

David Honold
Good afternoon guys.

Tim Schneider
Good afternoon, David.

David Honold
So just a follow-up on the balance sheet. Nice work sort of deleveraging during the quarter. How much more do you think you can do as it relates to reducing wholesale funding and selling off participations on the other side from here?

Glen Stiteley
Yes, so, Dave, this is Glen. So right now, we are essentially just using cash to pay off anything that comes due. We have got decent chunks of maturities coming up here this quarter, but we

should be able to take care of those with securities cash flow and deposits growth and principal payments on loans. So, I think we should be okay there. So, we should not have to do anything drastic as far as participations other than normal participations that we will do anyway so.

David Honold
Thank you.

Operator
This concludes our question-and-answer session.

I would now like to turn the conference back over to Tim Schneider for any closing remarks.

CONCLUSION

Tim Schneider
We appreciate all of you jumping on the call today. We feel pretty good about the quarter overall. I think core earnings were pretty solid. Unfortunately, the classified assets elevated a little bit, but we anticipated some of that as we got through the review cycle. We are also encouraged by the futures price on the CME right now that I think is helping and will help our dairy farmers moving forward, if these price is sustained. So, overall, we are feeling like we have got our arms wrapped around things, and hopefully, we will be on this call 90 days from now and be reporting good news again. Thank you all for joining us.

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