# County Bancorp, Inc.

## Earnings Release Q3 2019 Conference Call

## October 18, 2019 at 9:30 a.m. Eastern

**CORPORATE PARTICIPANTS**

**Timothy Schneider** - *President and Director*

**Glen Stiteley** - *Chief Financial Officer and Treasurer*

## PRESENTATION

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

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

**Timothy Schneider**
Good morning, everyone. Welcome to our earnings call for the third quarter of 2019. As a reminder, we have our disclaimer on the use of forward-looking statements in our slide deck, which we currently have shown on the webcast.

I'll start with some comments on asset quality, which is on Slide 3. We are encouraged at the current level of milk prices. A year ago forward CME Class III milk prices were in the $15 to $16 range; we are now seeing forward milk prices in the $16 to $18 range. The improved milk prices were a contributor in the upgrading of one dairy ag relationship, which improved our adverse asset coverage ratio to 45.67% this quarter.

As you can see from our slide, there does appear to be a good correlation between milk price and our adverse asset coverage ratio. We are having positive conversations related to one substandard performing loan and a few of our ORE properties, which we hope will allow us to lower this ratio again in quarter four.

We also upgraded another dairy relationship from special mention to watch. The decrease in loans rated substandard performing and special mention allowed us to book $1.2 million credit to provision for loan losses this quarter. We allocate higher general reserves for loans rated watch, special mention, and substandard performing in our allowance for loan loss calculation. We expect that the current milk price levels will continue to lower the dollar amount of loans rated watch and worse into 2020, which could continue to lower our reserve levels.

We are currently 92% of the way through our annual reviews of watch and worse credits. Since we prioritize higher dollar relationships in our annual reviews, it should not have any material impact on the credit quality ratios or allowance levels. We continue to see overall stability in Wisconsin farmland values, which continues to contribute positively to the strength of our credit portfolio.

We are in the process of updating our capital plan during fourth quarter, and we will begin to evaluate a stock buyback plan for 2020, with continued positive trends in milk prices and our adverse asset coverage ratio.

I'll now turn it over to Glen.

**Glen Stiteley**
Thanks, Tim. Good morning, everybody. As we announced during our fourth quarter 2018 conference

call, we continued to deleverage our balance sheet by continuing to use loan participation sales with servicing income attached. Now this has allowed us to continue to maintain profitability while continuing to improve the funding mix in the right side of our balance sheet.

We increased loans sold and serviced by $41 million this quarter. Loan servicing income this quarter grew to $1.7 million and loan servicing right origination income grew to $1.7 million. That $1.7 million of loan servicing right origination income included $250,000 of servicing right valuation allowance, which will continue one more quarter in Q4. This, combined with $19 million in client deposit growth allowed us to continue reduce wholesale funding by $97 million this quarter.

We are really pleased with the change in our funding mix. Wholesale funding is now down $224 million and client deposits are up $100 million year-over-year. Our wholesale funding now represents 28% of total funding compared to 41% year-over-year. We will look to grow our loan balances over the next year, but this will be governed by our growth in client deposits. We would target a 4% to 5% growth rate. We are still very focused on relationship lending and profitable pricing.

Our net interest margin increased during the quarter due to increasing loan yields and flattening funding costs. Because of our asset sensitivity in 33% of our loan portfolio, being adjustable, we do expect to see some slight margin compression in Q4. We have been able to offset the impact of rate cuts in the loan portfolio, with aggressive cuts to interest rates paid on our client deposits.

For example, our rate on for money market accounts with the $100,000 and more has dropped from 1.95% at the end of June to 1.26% currently. Our one-year CD has dropped from 2.05% to 1.65% during that same time period. We haven't seen much in the way of client deposit outflows from our rate-cutting date, but we will have to be watchful of that as competition either increases or decreases.

And now I'd like to open it up for questions.

**QUESTIONS AND ANSWERS**

**Operator**
We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone phone. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two. At this time, we will pause momentarily to assemble our roster.

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

**Brendan Nosal**
Hi. Good morning, guys. How are you?

**Timothy Schneider**
Good morning, Brendan.

**Glen Stiteley**
Hi, Brendan.

**Brendan Nosal**
Good. I just want to start off on the expense base here. Thinking about the last quarter, if I recall correctly, we're thinking a run rate of around $7.2 million was kind of the expectation for the back half of the year. And then, obviously things were a bit higher this quarter after backing out the FDIC benefit.

Can you just help us understand what you expect for expenses in the final quarter of the year and then heading into 2020?

**Glen Stiteley**

Yes, Brendan. This is Glen. So one of the things that pops out is on employee compensation and benefits, we started to ratchet up our incentive comp, because we're hitting a lot of our targets this year. So we ramped it up in the quarter. I'd say employee compensation and benefits could go up about $500,000 from where you see that level.

The other level should be, I think, trending kind of similarly to what that was this quarter. So one of the contributors to employee compensation and benefits as we've started to fill some key positions, we've been looking for one on the treasury side and one on our concierge banking side. And again, a lot of it's just tied to us continuing to make sure we can be thoughtful about how we grow client deposits.

**Brendan Nosal**

Okay. So just to make sure I understand correctly, so I guess if you kind of add back your-–rather you move the FDIC benefit and then add another $500,000 of incentive comp, that kind of gets you around like $8.2 million to $8.3 million expense level for the fourth quarter?

**Glen Stiteley**

Yes. That sounds about right, so.

**Brendan Nosal**

Okay, all right. So.

**Glen Stiteley**

And I think as of right now, we're just starting our budgeting process now, so going into 2020, I think that should probably be a good level too, and we'll obviously update folks as we start to get through our budget process.

**Brendan Nosal**

Got it. Great. And then moving on to the net interest margin. There's a comment in the slide deck that you might see a little bit of compression in the fourth quarter of 2019. Could you just help size up what that might look like, and then will there be further pressure if the Fed continues to cut rates?

**Glen Stiteley**

Yes. I think it's maybe 1% to 2% at worst I think, compression. I mean we are seeing the loan yield start to–as we looked month-by-month in the third quarter, we did see some pressure on loan yields, but again, we're pretty aggressive on cutting rates that try to get ahead of this.

Part of it's just because, we had a lot of excess cash and we're trying to be cognizant of not paying up too much on rate on the deposit side. So we've been very successful with that. And again, we haven't seen any outflows, so like I said, I think 1% and 2% at worst would be what I'd be looking at.

**Brendan Nosal**

Okay, great.

**Glen Stiteley**

And when I say 1% to 2%, I'm talking about the rate, the net interest margin rate.

**Brendan Nosal**

You mean basis points or percent of the total?

**Glen Stiteley**
Yes.

**Brendan Nosal**
Okay. All right, good. And then final one for you before I step back. Just at top level, I mean, milk prices have obviously improved a great deal and the forward outlook is better. I mean, if milk prices hold near here for the next 12 months, and I know that's a big if, but how much reduction hypothetically could you see in overall problem asset levels?

**Timothy Schneider**
Well, I think if we continue to see this kind of current milk price level, we're hopeful that we can get under the 40%, maybe even to the mid-30s. That's just a guess at this point. But at this level, most if not all of our dairy farmers, are in a profitable level and the futures market is pointing to at least continued solid milk prices through the end of next year.

**Glen Stiteley**
Yes. Hi, Brendan, it was interesting, we added something to the slide deck, milk price versus the adverse asset coverage ratio, and you can see the kind of correlation there. So again, if we continue to see milk prices at this level, we think we can get that again under the 40% down to the 30 level, so-–30% I mean, so.

**Brendan Nosal**
All right. That's helpful. Thanks.

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

**Kevin Reevey**
Good morning.

**Timothy Schneider**
Good morning, Kevin.

**Glen Stiteley**
Hi, Kevin.

**Kevin Reevey**
So first question is, I believe the bank recently underwent a regulatory exam. Without giving away too much, can you give us a sense as to how that went?

**Glen Stiteley**
Tim, do you want to go first?

**Timothy Schneider**
I think it went pretty well. Obviously, our adverse asset coverage ratio is moving in the right direction, which they were pleased to see. They continue to compliment us in the way that we're managing through this cycle, managing our ag credits and how we're on top of them as well. They were pleased with our continued kind of wholesale reduction on the right side of the balance sheet and more core deposits. And obviously milk prices at this point have helped our overall ag portfolio to heal a little bit.

So that's positive news for all of us.

**Kevin Reevey**
Yes. That's great. And then as far as, we've been reading about negative weather issues impacting farmers. Are your farmers seeing any of that in Wisconsin at all?

**Timothy Schneider**
Yes. It's been a little more challenging at this point for harvest because of the continued rainfall, and it's creating a little bit more work for them, probably a little more expense relative to trying to get the corn out of the field in particular. But I think most of them have made headways in little windows that they've had here in between the rain showers. So we'll hope that it will hold off a little bit and they will be able to get the balance of the crop harvested. We're a little bit behind harvest at this point, but we've got some time left here yet.

**Kevin Reevey**
And then lastly, you'd mentioned in your prepared remarks that land values continue to improve. Are there regions within Wisconsin that you see that are doing much better than others, and then what are those regions?

**Timothy Schneider**
Yes. I'd say it depends upon where you are, but the east central part of the state, where the bank is located, our headquarters in Manitowoc is a very strong dairy area, and there still seems to be decent competition for land. You get into the kind of the northern parts of the state, it's maybe a less competitive.

I'd say that the southern two-thirds of the state overall are still pretty solid from a land values standpoint. You're not seeing a ton of softening anywhere. It's just there isn't maybe as much competition for the land in the northern third of the state.

**Kevin Reevey**
Excellent. Thank you very much.

**Timothy Schneider**
Thanks, Kevin.

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

**Terry McEvoy**
Good morning, guys.

**Timothy Schneider**
Good morning, Terry.

**Glen Stiteley**
Good morning.

**Terry McEvoy**
Glen, maybe just to start with you. I'm just trying to understand the size of the balance sheet and earning assets in fourth quarter and beyond. I know you talk about client deposit growth target 4% to 5%. Was that–what type of timeframe was there and how should we just think about kind of the runoff

of wholesale deposits, increasing core deposits, and then what you do on the asset side as that mix changes?

**Glen Stiteley**
Yes. I think the 4% to 5% is probably more our loan growth target, Terry. We're targeting a little bit higher on the client deposit side to stay ahead of that and just maintain liquidity. So client deposits I would say is probably in that 6% range.

We're going to continue to hammer on the wholesale funding. It probably won't be as aggressive as we've had been in the last year, but we're still going to continue to drive that down. I think long-term, we want to get at kind of in that 5% to 10% level compared to where we're at today, but that's still going to take some time.

**Terry McEvoy**
So as you think about 2020, do you expect the balance sheet to stabilize, grow from here?

**Glen Stiteley**
I would say client deposits and loans are going to grow. I'd say we're going to continue to hash away at wholesale, again, but not to the level today. So total assets may be up a little, but again we're going to focus on growing the kind of core relationships on the loan deposit side.

**Terry McEvoy**
And then a question on the loan servicing right origination, the $1.74 million in the quarter. You mentioned in the fourth quarter there will be another $250,000 gain on the loan servicing rights, which makes sense. What happens in 2020, and I guess what are your thoughts in that line ex the mortgage servicing rights in the fourth quarter?

**Glen Stiteley**
Yes. So fourth quarter, we just had so much in the sales this quarter that–usually what happens is, we have more modest sales. So the amortization of that really kind of offset the origination volume, but because the origination volume was so high this last quarter, I would think that kind of levels off. We may have a little bit of income, but I don't think it will be as aggressive as it was this quarter for sure.

**Terry McEvoy**
Okay. And then the last question, I mean, I understand upgrade in substandard performing, special mention is down and just feeling better about dairy overall, though just from reading the headlines around some of your customers, NAFTA deal, I guess it hasn't been kind of signed in and isn't a done deal yet, but, yes, we had the releasing of the reserve. And I guess my question is, is that just the internal formulas that you have spits out the reserve releasing, despite maybe the uncertainty that's still out there in the marketplace, particularly to your dairy related borrowers?

**Glen Stiteley**
Yes. Tim can jump in after I comment, Terry. But the way we look at it is, milk price kind of drives loan grading, but land values, that governs impairments. So I think there's a lot of things going on. I think there is some optimism in the marketplace on milk. Supplies are regulating now, they're down from where they used to be at all-time highs, a year or two ago, so there's a lot of positive momentum.

I think the trade agreements will definitely help sustain this kind of uptick in milk price. But everything that we're seeing and reading is that folks are not overly optimistic about milk price, but we think it's in a good spot and could hold for the immediate future. And Tim can kind of jump in on his thoughts there too.

**Timothy Schneider**
Yes. And we're definitely consistent with our application of how we apply our allowance for loan loss. We don't want to be jumping around, and we've taken some hits in the past in increases in loan loss because of milk prices and some of our challenges with our ag portfolio. But overall, as we've mentioned many times before, I mean, again, our heavy use of the FSA guarantee really kind of minimizes our loan loss exposure, and obviously some of the improvements with the milk prices now, and I think if milk prices stay here we should continue to see some more improvement in our classified assets, which will probably drive down our need for loan loss longer-term.

**Terry McEvoy**
That's good to hear. Thanks, guys.

**Glen Stiteley**
Yes.

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

Our next question comes from Brian Martin with Janney Montgomery. Please go ahead.

**Brian Martin**
Hi guys.

**Timothy Schneider**
Good morning, Brian.

**Glen Stiteley**
Hi, Brian.

**Brian Martin**
Hi, just one question, going back to the margins. I appreciate the color on this fourth quarter and just one more rate cuts. But I guess if you were to see multiple cuts from here, let's say you get two or three more cuts. I guess, can you just give any thought on how you think the margin behaves kind of in that scenario, if you were to get one in October, another in December and early next year. Does the pressure begin to alleviate the more cuts you get, or just any color on just multiple cuts?

**Glen Stiteley**
Yes. So we do have a very short loan portfolio. The duration on it, it's about a year and it's driven largely by the ag side. So we keep getting rate cuts. I mean, it is going to be hard for us to maintain margin, especially if there's like one a quarter that's when it gets a little challenging I think for us. But again, I'd say we're being very aggressive again on the deposit side, or as aggressive as we can be, so it's going to be hard for us to maintain margin levels if we get more than one.

**Brian Martin**
Okay. All right. That's helpful. And I guess maybe just one other question. You guys mentioned the buyback. I mean, I guess, there are certain hurdles you would have to kind of hit to make it more likely you'd go down that road, or I guess just what are kind of the key elements you're looking at to make that decision on the buyback and how to utilize that, or if you utilize it?

**Glen Stiteley**
Yes. I mean, I think we've been consistent when we're out in the road talking to folks. It's really governed by two things: milk price holding kind of where these levels are; and secondarily getting our classified ratio under 50%. And we kind of use the huddle and again there's no magic behind this, but if we get the classified ratio under 50% for two quarters straight and we feel good about milk prices, I think we feel a lot better about kind of utilizing some of our excess cash to start buying some stock back. So it's definitely on our radar and on our plate to discuss with our board here this quarter and hopefully have some more guidance on that as we get into the first quarter of next year or so.

**Brian Martin**
Okay. All right, perfect. And then just the last one or two for me, just the watch list, Glen, it looked like it was up. I mean, I guess the trend sound great with the milk pricing, but just the watch list looked like it was up a little bit linked quarters. Is there something in that number or is that just an anomaly the way those trends were this quarter or did I look at that wrong in the slide deck?

**Timothy Schneider**
Well, it's really a product of all the upgrades that we've had, the stats moving out of the classified bucket and one big deal, that move from special mention into watch and trending in the right direction. So that's why that number is up substantially.

**Brian Martin**
Okay. All right. Thanks, Tim. Just the comment you made about prices, maybe I'm just confused trying to understand that, when you say the prices of milk get better, if they're getting better, how that affects the adversely classified ratio versus just the price holding its own, the loans that you continue to look at as far as your rating and that's just how to think about that adversely classified ratio if the milk prices kind of stabilizes here versus gets better?

**Timothy Schneider**
Well, I think if milk prices stay where they're at right now, when we get through the review cycle of the vast majority of our credits in that bucket into early first quarter and second quarter of 2020, we should see some upgrades because they're going to have a stronger 2019 because of better milk prices, the last two-thirds of the year. And then if the projected milk prices moving forward continue to stay at least at this level, or maybe if we get some trade deals done, move up. We should see some more positive movement in that classified ratio.

**Glen Stiteley**
Brian, and another way to look at it is that we start the annual re-process probably starting in the late first quarter, but I think you'll see probably more material movements probably in the second quarter of next year. We may see some upgrades in the fourth quarter of this year and first of next year, but I think a lot of it could come in the second quarter.

**Brian Martin**
I got you. Okay, and can you just remind me, Glen, when you guys look at the process to upgrade a credit, it looks like kind of reading some of the comments here that you – some of that done intra-quarter, but I mean if there's a more traditionally done when you get an annual view. So to your point maybe the second quarter is when you start to see them more, or it sounds like you're upgrading intra-quarter as opposed to intra-year as opposed to just annual. Is that fair? Just how to think about that.

**Timothy Schneider**
We may do that selectively and we have done it selectively on certain deals, but I'd say the vast

majority of the movement is going to occur once we get through the review cycle late first quarter and in the second quarter next year. But there are certain deals that we feel have made significant improvement that are maybe still in that substandard bucket, which is what you saw in this last quarter. And as we watch them closely and see certain things change, we aren't afraid to make some of those moves intra- quarter.

**Glen Stiteley**
Brian, as you're looking, we’ve got $9 million in special mention. There's probably maybe $2 million to $3 million of that that could move here in the fourth quarter. The rest of it could move maybe first quarter. That's kind of an up or out category. It's not meant to be a permanent category. But we're watching those pretty–just like all of the watch and worse, we're watching them closely. But like I said, we may see a little bit of movement fourth quarter, but hopefully, first quarter we'll see the rest of it. We're optimistic, but again, we're watching pretty closely.

**Brian Martin**
Okay. All right. And I think just the last one for me Glen, that wholesale target, I thought you guys were at–was it 28% you were at this quarter?

**Glen Stiteley**
Yes.

**Brian Martin**
I mean did you say you're–I guess the longer-term target was, what 5% to 10%?

**Glen Stiteley**
Yes, I'm mixing it up, Brian. So the 5% to 10% is probably more as a percentage of assets. That 28% is just mixed pure–it's the funding mix based on the funding non-asset, so sorry to confuse the two topics.

**Brian Martin**
Understood. Okay. I appreciate it. Thanks, guys.

**Timothy Schneider**
Thanks, Brian.

**Glen Stiteley**
Thanks, Brian.

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

**Kevin Reevey**
Yes. Tim or Glen, could you remind us what the breakeven price level for milk is for farmers. Is it around $16, if I recall?

**Timothy Schneider**
Yes. I still think it's in that $16, $16.5 range, something like that. So at least that's–if you have averaged it out through our entire portfolio that's about where the breakeven point is for our book.

**Kevin Reevey**
Yes. That's what I thought. And Glen, just going back to the regulatory again, was that FDIC or was

that OCC?

**Timothy Schneider**
FDIC and state.

**Glen Stiteley**
FDIC and state.

**Kevin Reevey**
Great. Thank you.

**Operator**
Our next question is also a follow-up from Brendan Nosal with Sandler O'Neill & Partners. Please go ahead.

**Brendan Nosal**
Hi. So it looks like you're working on an update to this stress testing model that you guys ran last year. I'm just kind of curious as to the thought process behind that. I mean, the last test showed that you had plenty of capital, but since then milk prices have improved, and you haven't taken any dairy losses since that. So is it just to convey added comfort with the state of the portfolio?

**Glen Stiteley**
Yes. I mean, there's a definite expectation by regulators for anybody that's got a concentration like ours that we do more modeling around stress testing, whether it's risk rating migration and/or just overall capital stress testing. So we think it's an important tool for us to make sure that we can kind of watch where we're at on the risk migration cycle.

But it's also just a good capital planning tool for us to establish what we think we have, and establish our capital policy limits too, Brendan. So it's something we think is really important. We're working hard to get better data as part of this. We do provide room level data for this, but the collateral data has been not as good as we'd like, so we're working hard to get that better and tweaked so you can get better color around this.

**Brendan Nosal**
Understood. All right. Thanks for the question, and congrats on the good quarter.

**Glen Stiteley**
Thank you.

**Timothy Schneider**
Thanks, Brendan.

**CONCLUSION**

**Operator**
This concludes our question-and-answer session. I would like to turn the conference back over to Tim Schneider for any closing remarks.

**Timothy Schneider**
I'd like to thank you all for joining us this morning and we're excited about the strong quarter that we've

had and continued outlook for the dairy space, which is important to us, and feel like we're headed in a positive direction here. So again, thank you all for joining us, and if there are any follow-up questions, please feel free to call Glen or I and we'd be happy to answer your questions. Thank you.

**Glen Stiteley**
Thanks all.

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