

County Bancorp

Fourth Quarter 2018 Earnings Conference
Call

February 11, 2019 at 12:30 PM Eastern

CORPORATE PARTICIPANTS

Glen Stiteley – *Chief Financial Officer*

Tim Schneider – *President and Director*

PRESENTATION

Operator

Good afternoon and welcome to the County Bancorp Fourth Quarter 2018 Earnings 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 (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 Glen Stiteley, Chief Financial Officer. Please go ahead, sir.

Glen Stiteley

Good morning or good afternoon, everyone, dependent on where you're at today. Tim and I have some prepared remarks related to slide 3 of our slide deck so you can follow along. As a reminder, this call contains forward-looking statements based on our current plans, projections, and these statements are subject to various risks, including the risks we've described in our SEC filings. Actual events may differ from these forward-looking statements. In addition, our past results of operations are not necessarily indicative of our future results.

Now that I've got the legalese out of the way, a couple things, and again related to our slide deck. First off, on auditor transition. On December 4, 2018, Schenk SC announced the sale to CliftonLarsonAllen. Our longtime auditor, Schenk had a large presence in our Northeast Wisconsin markets and they did work for most of our directors and executive team. This created a potential independence issue with Clifton, so rather than force all our folks to find new accountants or lose good directors, we decided to take some short-term pain and switch our auditors. Plante Moran was quickly engaged, and we started the transition process. Because of our unique dairy ag lending, it took some time to get Plante up to speed on our credit practices and delayed our originally planned earnings release date in January. We're pleased to say that Plante has identified no material audit issues during their work so far.

Now, I will turn it over to Tim Schneider for an update on the ag economy and credit.

Tim Schneider

Good day, everybody. On the ag front, credit quality continues to be our primary focus as the ag and dairy environment continues to be challenged as we're in our fourth year of the commodity price slump. We have devoted additional resources to assist in working through this challenging environment and managing our classified and nonperforming assets. Nonperforming assets level declined in the fourth quarter, primarily due to FSA guarantee claims that we collected, collateral liquidation, and a few write-downs. Classified asset level, which we illustrated in our earnings release this quarter, increased in the quarter, again primarily due to the strain in our dairy ag portfolio. Loan loss provision increased in the quarter related to charge-offs taken in the quarter as well. We continue to see land values, which is our primary collateral for most of our borrowers, remaining stable. Machinery and cattle values have softened a bit. Smaller dairy facilities or buildings and improvements have also softened a bit, as we've seen in the market.

As part of the farm bill passage, the new Farm Service Agency, or FSA guarantee limits have increased from \$1.429 million to \$1.75 million, and since the government offices reopened, we are now able to access additional FSA limits to allow us to refinance or restructure debt to our

viable borrowers and improve the Bank's risk position. We are working on a number of these types of opportunities as we speak. We still feel the finalization of the USMCA or U.S.-Mexico-Canada trade agreement and a long-term trade agreement with China is key to absorbing the excess milk production occurring and improving export activity, which should lead to improved pricing for our farmers. Because of the softening collateral values, sustained low milk prices, as well as unresolved trade issues, we foresee 2019 to be another challenging year on the credit side.

I'll speak to growth here a little bit. With a flattening yield curve and a challenging ag environment, we're going to continue to balance loan growth with core deposit growth. Our bankers will be ultra-focused on identifying core relationships. Over the past year, we have invested in technology that will assist us in identifying and maintaining our core relationships.

Now, I'll turn it back over to Glen for an update on wholesale funding and capital planning.

Glen Stiteley

Thanks, Tim. Just on the wholesale funding front, we talked a little bit about this in the earnings release, but we're going to take some time, or this time in 2019 to focus on reducing our wholesale funding levels. This will be accomplished through asset runoff as well as loan participations. We're targeting about a \$40 million reduction in loan balances here by the end of Q1 or early Q2 '19 and a flat growth through the remainder of 2019 from there. We are targeting currently about a \$120 million reduction in wholesale funding, focused mostly on our brokered CDs. We feel this will enhance our long-term profitability as well as improve the liquidity risk profile of the Bank.

Moving on to capital planning, right now, or as of Friday, our current market cap was \$114 million. You'll start to see some speculation articles coming out now, but we anticipate that our market cap would make us a target for falling out of the Russell 2000 Index as it stands today. Until we start to see some sustained improvement in our credit quality and final measurement on the Russell, we don't anticipate a stock buyback plan at this time as we've gotten some questions on that in the past. Our current capital stress testing shows that we have more than adequate capital to sustain our increased credit stress, but one of the key ratios that we watch internally as well as our regulators watch is the adverse asset coverage ratio, which is currently at 57%. Until we start to see some sustained movement of that ratio below 50%, we will need to continue to evaluate capital needs of the Company and the Bank. We hope to avoid raising common stock to current pricing levels even to fix the Russell fallout. We will continue to evaluate asset sales to improve credit quality ratios as we move into 2019.

And, now Tim and I will 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 (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 star (*) then two (2).

And our first question will come from Kevin Reevey of D.A. Davidson.

Kevin Reevey

Good afternoon. How are you?

Tim Schneider

Hi, Kevin.

Glen Stiteley

Hi, Kevin.

Kevin Reevey

So, first question is, Glen, at the beginning of your prepared remarks you talked about investment in technology to help your clients. Is this more on the deposit gathering side or more to help you manage and monitor credit and help your clients manage their finances, given this challenging time with commodity pricing and the like?

Glen Stiteley

Yeah, Kevin, it's, I'd say most of the investments have really been invested on what we call a client profitability model, and what that's really going to get at is, you know, what is a core relationship? How it's priced, and, you know, do we have all the accounts with them. That's kind of, that's really been the most investment, so that's our first swing at being able to identify a good core client from a profitability perspective. We've also got investments made in things like CECL and things like that, but that's not really going to get at that core relationship.

Kevin Reevey

And, then how should we think about for modeling purposes provisioning in 2019? Your provisions were elevated this past quarter versus the third quarter. Is this the new level we should work with or is that more of an anomaly?

Glen Stiteley

I think it's going to be pretty consistent. How we built our budget this year was very consistent to where we were at in 2019, or 2018, I'm sorry.

Kevin Reevey

So, the \$1.5 [million], \$1.6 million is the number we should use on a quarterly basis?

Glen Stiteley

No, I think the overall year-to-date is probably a better starting point, Kevin, so right around that \$3 million mark.

Kevin Reevey

Okay. I'll jump back in the queue. Thank you for taking my questions.

Glen Stiteley

And that was, Kevin, just to clarify, that \$3 million is a year-to-date number, not a quarterly number.

Kevin Reevey

Got it. Thanks.

Operator

And, our next question comes from Terry McEvoy of Stephens.

Terry McEvoy

Hey guys, good morning. How are you?

Glen Stiteley

Hey, Terry.

Tim Schneider

Hi, Terry.

Terry McEvoy

In the press release, and Tim, you mentioned on the call earlier, just another challenging year on the credit side. My question is there a certain milk price, or where do milk prices need to be where the outlook is more stable relative to what we're talking about today?

Tim Schneider

Yeah, when you look at the futures market today, unfortunately since the USMCA was announced and shortly after that, we saw some improvement in the futures price, across the board. It's definitely softened and it seems continue to push out month by month in a lower level. We're probably looking at \$16 to \$17 base price is where our dairy farmers need to be.

If you look at the futures market as of late last week, I didn't get a chance to look this morning. If you look out into July and August, they start getting at those kind of levels from base price perspective that makes it a little easier for most of our operators. Obviously, the breakeven points for our dairy operators are all over the board depending upon their business model and management capabilities. But, which is why I referenced in my comments that I really do think that if we get some stability in some of these trade agreements, we'll see some stability in the futures pricing as well and hopefully have a better environment for all of our customers.

Terry McEvoy

Thanks. And, then looking at deposit trends in the fourth quarter, some nice growth in demands, NOW, money market in the fourth quarter. I guess how much above market rates are you paying for those deposits?

Glen Stiteley

Terry, it's Glen. I think we're at towards the top of the market. I can't see where we're way above everybody. It's a fairly competitive market. We're within the range of median to the 75th percentile, so we're not overpaying for deposits. The DDA spike is a couple different things. Part of it's just milk checks coming in at the end of the month, part of it's just maybe a little bit of build-up from municipal deposits, so we'll see a little bit of drift. We've already seen some drift here in the first quarter in January, so those levels probably will drop down a bit as they do every year for us.

Terry McEvoy

Thanks. And, Glen, just one last question. The fourth quarter margin, any interest recoveries or accretion that was behind some of the quarter-over-quarter increase? And, then as you think about the balance sheet actions in Q1 and Q2 that you referenced earlier, what are your thoughts on the net interest margin?

Glen Stiteley

Yeah, so there wasn't any noise in the fourth quarter. Maybe a little bit of, if we put some in nonaccrual, but nothing major. As we're looking at margin right now, Terry, it's a wild ride with

where interest rates are at. As we mentioned in our press release, it's a little bit of a challenging environment for us because we price everything so short on the loan side but it's just challenging on the cost of funds side. From a margin perspective the way we looked at it for our budget is we looked at a fairly flat margin until we understand where rate hikes could or couldn't be. We are starting to see if deposit costs can stabilize, we will see a little bit of an uptick on the margin side, which we saw in January, but again, until I start to see some leveling off on deposit cost side, it's a little bit difficult to predict.

Terry McEvoy

Great. Thank you both.

Operator

And the next question comes from Kevin Fitzsimmons with FIG Partners.

Kevin Fitzsimmons

Hey, good afternoon, guys.

Glen Stiteley

Hey, Kevin

Tim Schneider

Hi, Kevin.

Kevin Fitzsimmons

Could you give us just a little color on the elevated pace of charge-offs, which is why you took the provision? Because, as far as I understood it, with the ag, you know, the challenging ag cycle, has, you know, what you guys have articulated is it leads to elevated problem loans, problem assets, but you tend to work through those and it doesn't necessarily translate into elevated losses, and so I'm just wondering was there something specific that happened this quarter or is it just a matter of things are getting to another level where there could be deeper losses emerging from the classified levels? Thanks.

Tim Schneider

Yeah, we had a couple of ORE write-downs, I believe, that were impacted by the charge-off level. We also had a farm liquidation that we're working through that is sort of a arranged settlement with them that created a bit of a loss on some of the personal property assets. I alluded to it in my comments that we're starting to see a little softness in cattle. We've been through this four-year slump in milk prices and we're starting to see cattle values drop a bit, especially on maybe some of the more average or marginal herds, and I think that's really impacting some of our valuation levels there. And, depending upon where we have the FSA guarantee positioned on the credits, could also impact our levels of charge-offs or loan loss reserve, so. I wouldn't say it's systemic, but we're definitely seeing a little bit of softness in the marketplace in certain asset classes that we're working through.

Glen Stiteley

Kevin, it's Glen. Just on the whole impairment side, if you look at our allowance coverage-to-loan ratio, it's still, or allowance-to-nonperforming loans, it still, it looks pretty light and that really is because of overall how we use the FSA guarantees. We just don't see the major impairments as of yet in the portfolio.

Kevin Fitzsimmons

Okay. And, as far as the decision to take the charge-offs, is that entirely you guys working through this or have you had any changed behavior from regulators in terms of, I would imagine you're educating the regulators more on dairy lending as opposed to them coming in and getting more aggressive, but just wondering if any of that factored in.

Tim Schneider

No, it's purely us and, you know, we have a grasp on what the market conditions are and market values and appraisals and valuations that we use to drive those decisions, are solely internally driven decisions here. It's not anything from regulatory perspective, or an audit perspective that's driven any of those decisions.

Glen Stiteley

Kevin, it's just really where the collection is in the cycle. When we feel like it's getting towards the end that's typically when we take our charge-offs. We may take them a little sooner occasionally, but that's really the process we follow.

Kevin Fitzsimmons

Okay. And, then just one last one, on the effort to it sounds like limit balance sheet growth this year so you can really focus on the funding, is it more just the blocking and tackling you've been doing in terms of growing core deposits and using that to fund reduction in wholesale deposits or is there something a little more larger or dramatic you can do in terms of restructuring type of transactions or anything like that that you've looked into?

Glen Stiteley

I'd say it's just continuation on blocking and tackling. Strategically, we just made a decision with the Board and management team that we just can't continue the pace of growth that we have with using as much wholesale as we have. We've got to get the right side shored up.

Number one, as I mentioned, it's just better profitability-wise first and foremost, but also just on liquidity risk side. When we start with how much wholesale funding we have plus the credit stress, it starts to make our liquidity look a little sketchy, so we want to make sure that we watch it very carefully, too.

Tim Schneider

And, I think as most of you know, and Glen alluded to it in the initial comments, we had some additional participations that we accessed in the fourth quarter, primarily on the ag side, and we're definitely going to be pushing that a little bit harder here in the first half of the year and I think we have opportunities to create some liquidity by doing some of that and paying down some wholesale funding.

Kevin Fitzsimmons

Great. Thanks, guys.

Operator

The next question will come from Ross Haberman of RLH Investments.

Ross Haberman

Good morning, guys. How are you? Could you reiterate, I didn't understand your Russell discussion? I just, I think I saw something today that said the cutoff is going to be about \$141 million, so you're clearly way below that. Is it strictly a liquidity issue why you won't even allocate a small amount of funds toward a buyback given that it sounds like you are going to be

[unintelligible] the index and everyone knows you know how much pressure you are seeing and will continue to see for awhile, given that?

Glen Stiteley

Ross, this is Glen. It's probably a foregone conclusion on the Russell side, so, but really it's just a matter of until we start to see some movement on the credit side, and positive improvements and going in the right direction, you know, it's just tough to really see where the bottom is. We, again, we haven't seen big impairments yet, but again we just want to make sure we keep our dry powder for things like that. I just can't imagine, and, it's like using your credit card to buy stock. I don't know if that's the best move for us right now.

Ross Haberman

Okay. Thank you very much, guys.

Tim Schneider

Thank you.

Operator

Again, if you would like to ask a question please press star (*) then one (1) at this time.

And, our next question will be a follow-up from Kevin Reevey of D.A. Davidson.

Kevin Reevey

Yes, in your earlier remarks you talked about devoting more resources to managing credit. How should we think about your operating expense numbers in 2019?

Glen Stiteley

Kevin, this is Glen, and Tim can add his \$0.02 on it, but from a noninterest expense level, I think we'll see an uptick from 2018 on a year-to-date basis. I'm thinking it's roughly about a 5% increase. Part of it's to allocate, we've got to bring in some horsepower on the work-out side from just a personnel perspective, so that's been budgeted in for 2019.

Tim Schneider

Yeah, and additionally I would say we've devoted one of our more senior ag banker's time and he raised his hand to assist with some of the additional challenged credits and he's devoting a significant amount of his time right now to assisting working through some of our challenging credits, which has probably been the biggest resource that we've allocated. We continue to look for some additional resources from a support perspective for the special assets area. John, Phil, and Jim, our relatively new Chief Credit Officer, has a strong special assets background. It's all hands on deck right now, and we've got additional resources devoted to that area, which we know is vitally important.

Glen Stiteley

Yeah, and just to follow-up on that, I'm looking at our noninterest expense levels, if I'm looking at a budget it's just going to be shy of the \$30 million mark for 2019, and that includes, like I said, the personnel costs but also includes some allocation for OREO write-downs as well as increased legal expenses on the collection side.

Kevin Reevey

And, then lastly, earlier in your prepared remarks, you talked about you did a stress analysis. Can you give us some color as to what your assumptions were and what capital levels you feel

you could get down to in a worst case scenario?

Glen Stiteley

Yeah, we haven't finalized that yet, Kevin, so I don't want to give too much out, but it does show we brought in the \$30 million in the sub debt issuance this last year, so it shows we've got significant cushions there. The issue is, as we look at it internally but plus how the regulators look at it, even with good, solid credit ratios, or capital ratios, you look at that adverse classified ratio, it starts to get over 50%, that's when they start to give a little bit more scrutiny to it, so even though our cap ratio may say we look okay, once that classified asset ratio gets out of balance, it's something we've just got to watch.

Kevin Reevey

So, in such a scenario, do you think that the regulators would make you raise additional capital or not?

Glen Stiteley

I don't know that they'll make us do it. Internally we've got to look at it and make sure we've got enough to get through this credit storm. So, right now, we think we're okay but we're going to have to continue to look at it, especially if we look at some distressed asset sales.

Kevin Reevey

Okay. Great. Thank you.

Operator

And 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 appreciate all of your time today and if you have any additional follow-up questions, feel free to reach out to Glen or I and we'll try to answer them as you look through our earnings release and again, apologize for the delay. Hopefully, it's understood given our auditor change, and we did the best we could to get it out to you as quickly as possible. So, thank you again.

Operator

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