SB Financial Group

Third-Quarter 2016 Financial Results

Friday, October 21, 2016, 11:00 A.M. Eastern

CORPORATE PARTICIPANTS

Melissa Martin - *IR*

Mark Klein - *Chairman, President and CEO*

Tony Cosentino - *CFO*

Jon Gathman - *Senior Lending Officer*

PRESENTATION

Operator

Good morning and welcome to the SB Financial Group Third-Quarter 2016 Conference Call and Webcast. I would like to inform you that this conference call is being recorded and that all participants are in a listen-only mode. We will begin with remarks by management and then open the conference up to the investment community for questions and answers. I will now turn the conference over to Melissa Martin with SB Financial. Please go ahead, Melissa.

Melissa Martin

Good morning, everyone. I would like to remind you that this conference call is being broadcast live over the Internet and will also be archived and available on our website at www.yoursbfinancial.com under Investor Relations. Joining me today are Mark Klein, Chairman, President and CEO; Tony Cosentino, Chief Financial Officer; and Jon Gathman, Senior Lending Officer. Before I turn the call over to Mr. Klein, let me add that this call may contain certain forward-looking statements regarding SB Financial Group's financial performance, anticipated plans, operational results, and objectives. Forward-looking statements are based on management's expectations and are subject to a number of risks and uncertainties that could cause actual results to differ materially from those expressed or implied on our call today. We have identified a number of different factors within the forward-looking statements at the end of our earnings release and you are encouraged to review those factors. SB Financial Group undertakes no obligation to update any forward-looking statement, except as required by law, after the date of this call. In addition to the financial results presented in accordance with GAAP, this call will also contain certain non-GAAP financial measures. I will now turn the call over to Mr. Klein.

Mark Klein

Thank you, Melissa, and good morning everyone. Welcome to our third-quarter webcast for 2016. The positive trends and the earnings momentum that we reported in the first half of 2016 accelerated this quarter. Our strategies are sound and execution here is noteworthy. Our double-digit growth and net income reflected similar size increases in loans, deposits, and mortgage originations that enable us to deliver significant increases in noninterest income and net interest income. Collectively, these drove operating revenue higher by over 16%. Overall, the successful performance of our six distinct business lines delivered our quarterly ROA of 1.28%. Now a few highlights for the quarter. GAAP net income for the quarter $2.55 million, a 12.5% improvement over the linked quarter, and a 12.5% improvement over the year-ago quarter. Likewise, our performance reflected a return on average assets, as I mentioned, of 1.28% for the quarter and 1.1%, year-to-date. Net income available to common shares for the quarter was $2.3 million, or $0.40 per share, representing a 14% improvement over the linked quarter and year ago quarters. Loan balances grew another $15 million, or 2.4%. Year-to-date, we have delivered over $60 million in loan growth, or 14% annualized. Loan growth over last year’s third-quarter reflects an expansion of over $78 million, or 15%. Top line revenue grew by $956,000, or 9%, to complement last quarter's growth of over 12%. Aggregately, year-over-year revenue expanded by over $1.6 million, or approximately 17%. Expenses increased 7% from a linked quarter and represent the expansion of our fee based business lines and support staff as well as market expansions. Assets under management and our wealth management division grew 2.3% and 11.4% over the prior-year quarter, with revenue up 8.1%. Mortgage origination volume for the quarter was over $117 million, or 6% over the linked quarter and approximately $30 million, or 35% improvement over the year-ago quarter. Our loan volume continues to come from new households. This quarter, approximately 88% of our 640 loans represents new households. Ninety percent of our year-to-date volume of nearly $300 million represents new clients to State Bank.

Asset quality remains strong and resulted in even better metrics this quarter. And finally, our SBA volume and loan sale gains remained an integral portion of our overall strategy to grow and diversify our sources of non-interest income.

Each of the above metrics strategically links to one of our five strategic themes to become and remain a high performing institution. As we discussed before, we continue to diversify revenue through growth in net interest margin and fee-based business lines, strengthen penetration in all markets to add scale to our operation, expand product service utilization through cross selling while attracting new clients, provide that world class client experience to our client for life, and lastly, deliver the top tier asset quality metrics that we know is so important to our franchise. Now I'd like to expand a bit on each.

Revenue diversity: As of prior quarters, we continue to drive our total revenue higher through organic balance sheet growth and the expansion of our fee-based business line. As a result, we were able to expand operating income over 13% to $3.7 million from a linked quarter and over 10% from the year-ago quarter. This resulted in improvement in our non-interest income to total revenue of 43%. The stabilization of the ten-year treasury also enabled us to recover $70,000 of our aggregate impairment for the year, which now stands at $1.5 million and Tony will touch on this momentarily again.

Mortgage lending remains a competitive advantage for our Company. With diverse markets, high producers, robust product line up, and supporting technology, we continue to take market share. Our $117 million in loan volume produced record high net mortgage banking revenue of over $2.7 million or on average 2.5% gain on loans sold. As a result of our past successes, our servicing portfolio now stands at over $868 million. In order to continue to drive this key source of non-interest income, we are identifying new expansion opportunities. This past quarter, we opened our sixth residential loan production office in Warsaw, Indiana.

In order to continue to diversify our sources of non-interest income, we have developed specific strategies to leverage our expertise in both agricultural lending and small business administration sold loans. This quarter, we sold nearly $1.3 million in guaranteed credits for loan sale gains of $197,000. Year-to-date, we have produced $728,000 in SBA loan sale gains and $199,000 in FSA sold agricultural credits. As a result of our strategy to build this SBA business line into a meaningful contributor to our bottom line, we currently rank 10th out of 59 banks in our Ohio footprint, or the 83rd percentile, with over $9 million in loan originations, year-to-date. Our vision is to become a top-five performer in this arena in Ohio. One of our key strategies to accomplish this is to alter our production structure to accommodate seasoned business development officers in our lower-share, higher-growth Metropolitan markets.

Assisting our clients with managing growing their wealth remains a focus for our Company. We currently have over $375 million under our care, representing growth of $38 million over the year-ago quarter or an increase of 11%. To ensure we remain relevant in this core business line, we recently named Chris Jakyma as head of our wealth management group at State Bank. Chris comes to us from Eastern Ohio with 25 years of experience in investment, advisory services, planning, and management, most recently at Private Trust Company and First Merit. Chris has an undergraduate from Baldwin Wallace and a JD from Marshall College of Law. The addition of Chris adds critical depth to our staff and business line and prepares us for more growth. Under his leadership, we intend to continue to drive business line growth further in our newer, largely untapped urban markets of Fort Wayne, Findlay, and Columbus.

The final component of our fee based segment is deposit services. This quarter, our overdraft income declined by 20% compared to the same quarter last year and by 11% year-to-date over the same period. This trend represents the actions of a more prudent, healthier consumer as well as the availability of lower cost alternative funding sources. Conversely, our debit card fee income was up by 5.4% over the year-ago quarter, reflecting a consumer take ratio of over 73% for new DDA clients with our debit cards. In an effort to replace the lost overdraft revenue, we intend to leverage our presence with the deployment of technology based initiatives in the treasury services arena that now include ACH Manager and Positive Pay and, in the first quarter of 2017, Mobility for Businesses. Our overarching goal is to leverage new technology platforms with more defined treasury services sales initiatives in order to expand on our lower cost deposit base.

Our second initiative remains to strengthen penetration in all markets served and add more scale to our operation. Our newest office in Findlay, Ohio, is providing organic loan and deposit growth. At the end of the quarter, our loan balance stood at $20 million and deposits at $8 million. Clearly, our expertise in the private client and commercial lending arenas, coupled with our mortgage lending leaders, is providing results. With our diverse experienced team in place, we intend to continue to build on our successes and tap this potential of this desirable growing market. Our Columbus full service operation continues to provide organic balance sheet growth. As of quarter end, loan balances stood at $155 million and deposits at $22 million. With each of our business lines calling in this coveted market, we are poised to continue to leverage our expertise and help drive bottom line contribution.

And finally, we have begun to identify and track talent to drive more organic loan growth in our newest expansion market of Bowling Green, Ohio. Mark Cassin, a 30-year career banker with local ties has been named as our regional leader. Under his leadership we are developing a strategy to integrate our six business lines into this stable northwest Ohio college town. Organic loan growth remains the center post of our strategies to continue to improve financial performance. The quarter, as I mentioned, we grew our loan book by another $15 million. This expansion includes all categories, commercial real estate, CNI, agriculture, residential, and consumer. This increase was a result of progress in our newer higher growth markets of Fort Wayne, Columbus, Toledo, and Findlay. Competition in all of our markets has increased throughout 2016; however, our consistent calling efforts continue to allow us to build our loan pipeline.

Our third initiative is to expand the product service utilization. Our cross selling and onboarding initiatives have enabled us to add scale to our operation. As of quarter end, our number of products stood at over $55,000, up from $53,600 at year end, or a 3.2% improvement. This expansion also enabled us to expand our total products and services per household to now 2.77. We also continue to expand our credit card portfolio. As of quarter end, our higher yielding balances have increased to nearly $1.8 million, up from $1.5 million a year ago, or 18%. Also, our number of accounts now stands at over 1,100, up from 977 a year ago, or 14.2% improvement.

Operational excellence remains that fourth key theme to build franchise value. This quarter, our number of households grew to over 27,000 from approximately 26,000 at year end, or a 3.9% increase. One of the key drivers of this success is the growth in our residential real estate business line. This quarter, we expanded our number of mortgage loans to 7,289, up from 6,714 at year end, representing an increase of 7.7%. Once we have established a relationship with a new mortgage client, our goal remains to grow and develop it more deeply with the intent to retain it for life. Additionally, our onboarding and reboarding initiatives with new and existing clients have been the impetus to grow our referral book. This quarter, we identified another 704 potential client needs that led to 260 closed referrals for over $28 million in new business for our Company. Our goal is always to work in our client's best interest in mind as we collaborate with our business partners to solve financial needs.

Fifth and final strategic initiative, to build a high-performance company, remains to deliver that top tier asset quality that we've worked so hard to get. Loan growth, year-over-year, of $78 million, or 14.5%, has accompanied a corresponding improvement in all of our asset quality measures. Year-over-year, nonperforming assets have declined by over 50%. Net charge-offs have declined by 100%. Provision expense was down by 74%. Classified assets down by over 26% to $5.4 million and past due loans were down by 58%. As a result, our loan loss allowance coverage of our non-performing assets now stands at 163%. And now, I'd like to ask Tony Cosentino, our CFO, to provide a little more color on our quarterly performance. Tony?

Tony Cosentino
Thanks, Mark. Good morning, everyone. For the quarter, as Mark said, we had net income of $2.5 million, or $0.40 per diluted earnings per share. That EPS was up $0.05 from both the prior year and the linked quarter, or 14%. Through nine months, diluted EPS of $1.01 is also up 14% from the prior year. So let's quickly review some highlights. Total operating revenue on a fully taxable equivalent basis for the quarter was up 9.6% from the prior year and up 3.8% from the linked quarter. Loan growth was up $79 million from the prior year, or 14.5%. Loan sales delivered gains of $2.8 million from mortgage, small business, and agriculture, which is up 41% from the prior-year quarter. And lastly, we had a large commercial real estate nonperforming credit payoff in full, which reduced nonperforming loans by $3.5 million and recaptured interest income of approximately $120,000.

As we breakdown the third-quarter income statement, let's begin with our margin. Net interest income on a fully taxable equivalent basis was up from the prior year by 9.6% and up 3.8% from the linked quarter. End of period loan balances from the prior year were up $78.5 million, an increase of 14.5%, and were up $14.6 million, or 9.6% annualized from the linked quarter. This quarter's loan growth continued the very strong momentum of the first two quarters of 2016 when we added $27.6 million and $19.5 million of balance sheet growth in each quarter. We grew our loan book without sacrificing quality or price. Our average loan yield adjusted for the nonperforming recapture decreased by 7 basis points from the prior year. Overall, earning asset yield was up 2 basis points from the prior year, reflecting the nonperforming interest and our mix trending slightly away from bonds into loans. On the funding side, we did experience an increase in the cost of our interest bearing liabilities, coming in at 56 basis points, up 7 basis points from the prior year. Our need for retail funding to facilitate loan growth is driving deposit costs higher. Net interest margin, at 3.82%, was down 5 basis points from the prior year, but up from the linked quarter due to the interest recapture. Total interest costs, interest expense costs have risen by nearly 30% from the prior year; however, the variance is tied exclusively to the increased level of volume.

Loan activity has had a major impact on margin income from the prior year, with total loan interest income of $7 million, up 13%. Clearly $79 million of increased loan balance, which was the net result of $243 million in loan production over the last four quarters, is a key driver. We remain pleased that pricing has not been compromised with our average loan yield down just three basis points for the current quarter and on a year to-date basis loan yields are flat to the prior year.

Total noninterest income of $5 million was up 27% from the prior year and up 16% from the linked quarter. The income as a percentage of total revenue was nearly 43%, which is the highest percentage we have seen since mid-2015. Absent a slight impairment in recapture, this quarter's results are linked directly to the significant volume from our business lines.

For the quarter, mortgage originations of $117.2 million were up from the prior year by $30.2 million, or 35%, and were up $7 million or 6% from the linked quarter. As we have noted, this quarter's new purchase volume was 88% and we expect to maintain that level into the fourth quarter. Total gains on residential mortgage sale came in at $2.5 million, which was nearly 2.5% on our sold volume of $101 million.

Servicing portfolio, now at $869 million, provided revenue for the quarter of $531,000 and this portfolio has increased by $117.8 million or 16% from the prior year on sold volume for that period of $312 million. The market value of our mortgage servicing rights increased slightly this quarter, calculated fair value of 79 basis points, was down 12 basis points from the prior year but up 1 basis point from the linked quarter and resulted in the $71,000 recapture. Through the first nine months, the impairment has negatively impacted our mortgage business by $1.2 million. At quarter end our mortgage servicing rights were $6.9 million, up slightly from the third quarter of 2015 and up 6% from the linked quarter with a total temporary impairment remaining of $1.5 million.

Other fee income for the quarter at $2.3 million was up from the prior year by 6%, the growth driven by nonresidential loan sale gains, increases in deposit fees, and securities gains. We had SBA loan sale gains of nearly $200,000 in the quarter and wealth management fees were up 8% from the prior year, reflecting good performance from our brokerage business.

Operating expenses this quarter were up $1.3 million or 19.7% from the prior year and compared to the linked quarter, expenses were up $0.5 million or 7.1%. Total headcount for the Company is up by 15 from the prior year, reflecting staffing levels for our two new locations, in addition to the added resources and compliance loan review and mortgage administration. These higher staffing levels as well as merit adjustments and incentive costs make up the bulk of our year-over-year total expense increase. This quarter obviously also included higher commission expense as a result of our record mortgage volume.

Now as we turn to the balance sheet, loan outstandings at September 30th stood at $619.4 million, which was 77.3% of the total assets of the Company. We had growth of $78.5 million from the prior year and $14.6 million from the linked quarter. These growth levels were 14.5% and 9.6% annualized, respectively. Compared to the prior year, our loan growth was diverse with commercial real estate leading the way at $37.2 million, C&I at $17.5 million, and residential real estate at $12.9 million. On the deposit side, we are up from the prior year by $88.6 million, which is a 15.4% growth rate and up from the linked quarter by $13.8 million. Due to the strength of our loan pipeline, we continue to be more aggressive on deposit pricing and marketing in order to meet our funding needs. Matching our loan growth for the last 12 months with lower cost retail funding has been a key accomplishment. Our balance sheet continues to be in an asset sensitive position with the trend line over the last five quarters becoming more asset sensitive. We feel that this strategy is prudent as we have maintained short-term cash flow and flexibility. With this structure, we are prepared to move resources into higher yielding products and to take advantage of potential rate increases.

As we look at our capital position, we finished the quarter at $86.3 million, up $5.9 million or 7.4% from the prior year. The equity to asset ratio of 10.8% was down slightly from the prior year, which reflects the growth in our loan outstandings. As we announced prior, we have a share repurchase program that we announced late in the second quarter and thus far, we have reduced our share count by approximately 39,000. We expect to continue to buy in the coming quarters in line with our approved buyback level. And these acquired shares will provide the treasury supply we need to meet the needs of our compensation programs in the near-term without issuing new shares at a future higher price.

Finally, regarding asset quality, total nonperforming assets now stand at $4.6 million or 0.57% of total assets, 98% of which are in nonperforming loans and just 2%, or $73,000 in one OREO property. The total level of nonperforming assets is down $4 million from the prior year and down $3.7 million to the linked quarter. As we said, this quarter reflects the full principal and interest payoff of the large commercial real estate credit that became nonperforming in the third quarter of 2015. At that time, we were confident the credit would be resolved without any loss to State Bank, which has come to pass. Currently, we have only one nonperforming item with a balance in excess of $1 million. Included in our nonperforming asset total is nearly $1.6 million in accruing restructured credits, which are nearly all maturity extensions and which elevate our nonperforming asset level by 20 basis points. Absent these accruing restructured credits, total nonperforming asset ratio would be just 37 basis points at the end of the quarter. Provision expense, as we have said, for the quarter was zero, down from $100,000 in the third quarter of 2015 and the same as the linked quarter. Our absolute level of loan loss allowance is up from the prior year by 3.5%, which is due to our loan losses for the quarter of $130,000 and for the year, net recoveries being $80,000. Due to loan growth, our allowance to total loans percentage has declined from 1.31% in the prior year to 1.18% currently. This allowance level still places us at the median of our peer group, which bodes very well given our top quartile peer nonperforming asset ratio.

So, as we summarize the quarter, mortgage volume and improved asset quality resulted in reporting diluted EPS of $0.40 a share, up 14% with a trailing 12-month EPS of a $1.30 a share. In addition, we have grown total assets under our care from the prior year by more than 11% to $2.05 billion. I'll now turn the call back over to Mark for some summary comments.

Mark Klein
Thank you, Tony. Overall, it was the best quarterly performance for our Company in over 13 years. It has been said that a mediocre strategy executed with precision would trump a great strategy poorly executed every time. Our belief is that it takes both a great strategy and precise execution to achieve our vision of a high-performance company. At SB Financial, we think about how to capitalize on our opportunities with insight and innovation and then plan diligently to execute on each of those strategies. We look forward to reporting to you our full-year performance in January. And now for questions and answers, I would like to turn it back over to Melissa.

Melissa Martin
Thank you, Mark. Carrie, we are now ready for our first question.

QUESTIONS AND ANSWERS

Operator
Thanks, Melissa. 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). At this time, we will pause momentarily to assemble our roster.

Melissa Martin
While we're waiting for additional questions, I would like to remind you that today's call will be accessible on our website at www.yoursbfinancial.com under Investor Relations.

Operator
Once again, if you have a question, you may press star (*) and one (1). I'm seeing no questions at this time, Melissa.

Melissa Martin
Thank you, Carrie. As there are no further questions, I'll now turn the call back over to Mr. Klein.

CONCLUSION

Mark Klein
Once again, thank you all for joining us this morning. We look forward to speaking with you again in January to report our full-year earnings. Good-bye and have a good weekend.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines. Have a great day.