Heartland Financial USA Inc (HTLF) Q2 2020 Earnings Call Transcript

HTLF earnings call for the period ending September 30, 2020.

Heartland Financial USA Inc (NASDAQ:HTLF)
Q2 2020 Earnings Call
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Prepared Remarks:

Operator

Greetings, and welcome to the Heartland Financial USA, Inc.
Third Quarter 2020 Conference Call. This afternoon, Heartland distributed its third quarter press release and hopefully, you have had a chance to review the results. If there is anyone on this call who did not receive a copy, you may access it at Heartland's website at htlf.com. With us today from management are Lynn Fuller, Executive Operating Chairman; Bruce Lee, President and CEO; and Bryan McKeag, Executive Vice President and Chief Financial Officer. Management will provide a brief summary of the quarter and then we will open the call to your questions.

Before we begin the presentation, I would like to remind everyone that some of the information management will be providing today fall under the guidelines of forward-looking statements as defined by the Securities and Exchange Commission. As part of these guidelines, I must point out that any statements made during this presentation, concerning the company's hopes, beliefs, expectations and predictions of the future are forward-looking statements, and actual results could differ materially from those projected. Additionally, information on these factors is included from time-to-time in the company's 10-K and 10-Q filings, which may be obtained in the company's website or the SEC's website.

At this time, I would now turn the call over to Mr. Lynn Fuller at Heartland. Sir, please go ahead.

Lynn B. Fuller -- *Executive Operating Chairman*

Thank you, Towanda and good afternoon. Welcome to Heartland's third quarter 2020 earnings conference call. We appreciate everyone joining us today as we discuss the company's performance for the third quarter of 2020. For the next few minutes, I will touch on the highlights performance for the third quarter of 2020. For the next few minutes, I will touch on the highlights for the quarter. I'll then turn the call over to Heartland's President and CEO, Bruce Lee, who will cover business performance and our COVID-19 response. And then, Bryan McKeag, our EVP and CFO, will provide additional color around Heartland's results. Now also joining us today is Nathan Jones, EVP and Chief Credit Officer, who will be available to answer questions regarding credit.

During these very challenging times, our priority has been the safety of our employees and the ongoing support of our customers, our shareholders, and our communities. We continue to differentiate ourselves through our strong capital, liquidity, credit and financial performance metrics. Bruce Lee and Bryan McKeag will provide more detail on the many things that we're doing to support, protect and care for our employees, customers, shareholders and communities.

So now on to the financial highlights for the third quarter of 2020. I'm very pleased to report that we had an excellent third quarter. In fact, it was a record quarter, the best in our history, with net income available to common shareholders of $45.5 million compared to $30.1 million for the linked quarter. Net income before our Series E preferred dividend totaling 2,437,000 was nearly 48 million.

Earnings per diluted common share was $1.23 compared to $0.82 for the linked quarter. This was our second best quarter for EPS, second only to Q2 2019 at $1.26, which included $18 million of after-tax income from the gain on sale of our mortgage servicing portfolio at Dubuque Bank and Trust and gains from several branch sales. Annualized return on average common equity was 16.11%, which exceeded the prior four quarters. Additionally, annualized return on average assets at 1.19% also surpassed the prior four quarters. The net interest margin on a fully tax equivalent basis was strong at 3.55% for the quarter and 3.74% year-to-date. Book value and tangible book value this quarter were at $46.11 and $32.91, respectively, an increase over Q3 of 2019 of 8% and 11%, respectively.

But with respect to the balance sheet, assets reached a new record high at $15.6 billion, and we achieved substantial growth across all categories over the last four quarters. Assets were up an amazing $3 billion. Net loans were up $1.1 billion. Investments were up $1.9 billion. And non-maturity deposits, which is our focus, up $2.4 billion. And equity was up $248 million. With the substantial growth in our balance sheet, we still remain very liquid and all of our capital ratios, including our and all of our capital ratios remained strong. Our tangible common equity ratio improved to 8.03% at quarter end, up from 7.89% last quarter. On to M&A as we discussed last quarter, we are on target to close the AimBank transaction in West Texas in early December with the conversion set for mid-February 2021.

AimBank will be merged with and into Heartland's Lubbock, Texas-based subsidiary, FirstBank & Trust, contributing over $1.8 billion in assets and will substantially contribute to net income for 2021. With this acquisition, FirstBank & Trust will be Heartland's largest bank with approximately $3 billion in assets. They will become the fifth largest bank headquartered in West Texas and the third largest deposit market share bank in Lubbock. While also in early December, our Arizona Bank & Trust Bank in Phoenix, Arizona, will complete its purchase and assumption of the four Johnson Bank Phoenix branches. This will be a simultaneous close and conversion, adding approximately $392 million in deposits and $184 million in loans and will contribute nicely to net income for 2021. This transaction will take Arizona Bank & Trust assets to nearly $1.3 billion.

As I've said in the past, our priority has been to expand our current footprint and work toward our goal of $1 billion in assets in each state where we operate. And I'm pleased to report that 10 of our 11 banks have reached our goal of $1 billion or more in assets this past quarter. While the our 11 banks have reached our goal of $1 billion or more in assets this past quarter. While the industry continues to consolidate market share and market position become more and more important. We are top 10 deposit market share in 26 of our 38 MSAs and top five deposit market share in 13 of our 38 MSAs. In closing, last week, Heartland's Board of Directors approved a $0.20 per common share dividend payable November 30, 2010, to shareholders of record on November 13, 2020. The Board also approved a preferred dividend of $175 payable on January 15, 2021, to shareholders of record on December 31, 2020.

I'll now turn the call over to Bruce Lee, Heartland's President and CEO, who will provide an overview of the company's operating performance, COVID-19 response and credit. Bruce?

Bruce K. Lee -- *President and Chief Executive Officer*

Thank you, Lynn. Good afternoon, everyone. I want to start by expressing my gratitude and admiration for the teams across Heartland in each of our member banks. They have demonstrated an uncommon commitment to our company, customer and community. I'm humbled by their dedication, resiliency and creativity as we navigate the challenges and uncertainty caused by the COVID-19 pandemic. Heartland's record third quarter earnings highlight our continued focus on our customers, our core business and expense discipline, while operating in a low interest rate environment. In the third quarter, we delivered pre-provision net revenue of $65.1 million, an increase of 35% from a year ago and flat from the linked quarter.

Earnings per diluted common share of $1.23 compared to $0.94 a year ago, an increase of $0.29 or 31%. Net income available to common shareholders of $45.5 million, that's the most ever, a 32% increase from a year ago and a 51% increase from the linked quarter. Our lowest ever efficiency ratio of 54.67% for the quarter, 618 basis points lower than a year ago and 108 basis points lower than the linked quarter. Year-to-date, our efficiency ratio is 57.3%. After third quarter last year, our year-to-date efficiency ratio was 63.3%. I'm proud of how we're operating during a pandemic. Our banks are open for business. We're delivering the high level of service our customers expect, and Heartland continues to invest for growth. Employee and customer safety remains our top priority. We continue to operate under our pandemic management plan, protecting our employees and customers while effectively running our business.

Employees who can work from home do so. While those who come into bank locations and offices are on rotating teams to limit exposure. Heartland's diverse geographic footprint continues to be a strength during the pandemic. Only two of our 113 banking centers are closed and we are operating in 82 communities. We're serving customers in lobbies, drive-thrus or both as well as digitally. We've demonstrated our flexibility closing and reopening bank lobby as appropriate. A quarter of our banking centers are fully open and operating as normal. Three quarters currently operate drive-thru only or with restricted lobby access. We'll continue to adapt to local conditions and are comfortable and confident in our ability to operate in this environment for the foreseeable future.

Consumer behavior has changed as a result of the pandemic. Digital transactions continue to increase and branch transactions have decreased approximately 32% year-to-date. Given this ongoing consumer shift to digital, we continue to rationalize our branch footprint. In the third quarter, we approved six branch consolidation and an additional 10% of branches are under review. Turning to deposits, we delivered another strong quarter of deposit growth. Total deposits ended the quarter at $12.8 billion and non-time deposits totaled $11.8 billion, increasing $123 million or 1% during the quarter. Seven of our 11 banks delivered non-time deposit growth, led by Dubuque Bank and Trust with a 5% increase and Rocky Mountain Bank with a 4% increase.

Our deposit mix remains enviable with 39% in noninterest-bearing accounts and 92% in non-time account balances. We've also been diligent in executing our deposit pricing strategy and have reduced total deposit costs to 16 basis points for the quarter, down from 20 basis points in the second quarter and 70 basis points from the third quarter of last year. Turning to loans; our total commercial lending portfolio decreased slightly by 1% or $78 million from the linked quarter. In our remaining portfolio, agriculture decreased $12 million from the linked quarter, residential mortgage decreased $34 million, and commercial loans decreased $23 million. Earlier this month, the SBA began to process PPP forgiveness application. To-date, 24% of our borrowers have submitted forgiveness applications, representing $297 million of our $1.2 billion in PPP loans.

On October 8, the SBA released a simplified forgiveness application for PPP loans under $50,000. Approximately 40% of our client borrowers with balances representing less than 4% of our PPP loan portfolio are eligible. Many PPP borrowers are still waiting to begin the forgiveness process in anticipation of additional rule changes and clarification of tax implications. Turning to key credit metrics, our nonperforming loans decreased 12 basis points from the end of the second quarter, representing 89 basis points of total loans at the end of the third quarter. As a percentage of total assets, nonperforming assets declined 11 basis points from 66 basis points to 55 basis points over the same period. Other real estate also decreased to $5.1 million at the end of the third quarter from $5.5 million at the end of the second quarter.

The delinquency ratio continues to improve, decreasing to 17 basis points from 22 basis points over the prior period. Due to the pandemic, we anticipated a downward shift in risk rating. This has started but not to the extent expected. Non-pass rated loans from 8.1% in the second quarter to 8.7% in the third quarter. The ratio remained at a relatively low level. Substandard loans comprised 47% of total non-pass loans compared to 44% in the previous quarter. Lastly, net loan charge-offs for the third quarter were reported at $21.3 million or 92 basis points compared to $2.4 million or 11 basis points in the second quarter. This increase was driven by two commercial credits. First, a previously identified and reserved for charge-off of $11.6 million on a fracking sand company that operates in an industry that's been negatively impacted by the pandemic. We do not have additional exposure to the fracking sand industry. The second large charge-off was a newly identified $5.9 million loan in the wholesale wine industry in California.

Excluding charge-offs from these two large commercial borrowers, charge-offs would have remained close to flat from last quarter. And we are encouraged with the overall improvement in our credit metrics during the pandemic. As of September 30, of the approximately $1.1 billion of loans modified under COVID relief program, $860 million have returned to original payment terms and $133 million remain in their original deferral status, and only $122 million or 1.3% of total loans have received additional or second modification. 69% of these second modifications are principal and interest deferments for 90 days. The remainder are primarily interest-only payments for 90 days. More information about Heartland's loan exposure to customer segments we believe are more heavily impacted by COVID-19 is available in the table on page 3 of our news release.

The ultimate impact of the COVID-19 pandemic on Heartland's financial performance will depend on the severity and duration of the pandemic, related restrictions on business and consumer activity and the availability of government programs to alleviate economic stress. Turning to strategic investments, we are investing for growth and to enrich the customer experience through our companywide initiative, Operation Customer Compass, all while achieving an all-time low efficiency ratio. We completed the upgrade of our ATM network, installing more than 100 new

ATMs across our footprint. The new ATMs are state-of-the-art and offer significantly more convenience and fraud protection. New features, such as image deposits will benefit our small business customers, allowing them to make bulk deposits 24/7 without visiting a banking center.

We're already seeing the benefits of this upgrade. In the third quarter, deposits at our ATMs increased 17% from the previous quarter. We've also implemented enhanced authentication measures across our digital channels to protect our customers from fraud. In just last week, we began offering a video banking at Wisconsin Bank & Trust. This innovative video banking platform allows consumer customers to transact business, open accounts and apply for loans with a live banker via video. We will evaluate expanding the pilot program across our footprint based on customer feedback and acceptance. We know more customers are preferring the bank virtually

and we're committed to transforming the banking experience, taking a customer-first innovation-oriented approach.

We reached another significant milestone in September with the final transition onto the best-in-class Salesforce CRM and nCino loan origination platform. These tools enable commercial teams at each of our banks to better serve and meet the needs of our clients while supporting business development efforts. We're achieving our goal of delivering efficiency, speed and an improved internal and external customer experience, evidenced by a 25% decrease in the time from loan applications to funding. We've introduced solutions designed to make banking easier and more accessible for our commercial clients as they modify their business operations in this current environment. In the third quarter, we began rolling out our improved e-deposit products, a software solution that remotely capture and manages deposits, giving clients greater security and compatibility from almost any device.

We launched integrated payables, enhancing our electronic accounts payable product suite, giving commercial clients a single solution for all payment types. We are advancing our lock box capability to help business clients, including medical companies automate the process of securely collecting check payments while decreasing the potential for error or fraud. On the M&A front, we're scheduled to be close AimBank in December and complete system integration in February 2021. AimBank, combined with FirstBank & Trust, will create Heartland's largest bank with over $3 billion in assets. AimBank's third quarter performance was within our expectations. In December, Arizona Bank & Trust is scheduled to complete its acquisition of Johnson Bank's four banking centers in the Phoenix market.

The close and simultaneous conversion is expected to raise Arizona Bank & Trust assets to $1.3 billion. Part of Heartland's mission is to enrich lives in our community. On October 5, we announced the donation of more than $260,000 to high-need schools. This donation will provide teachers with money to purchase the supplies and materials they need to help students learn in a safe and healthy environment. I'm grateful that Heartland is providing this support to our schools, in addition to the $1.2 million we contributed in April to non-profit organizations responding to challenges created by COVID-19. These donations and our employees' volunteer hours make a meaningful difference in the communities where we live and work.

I will now turn the call over to Bryan McKeag, Heartland's Chief Financial Officer, for more details on our record performance and financials. Bryan?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Thanks, Bruce, and good afternoon. I'll begin today by referencing the press release, which shows reported earnings per share of $1.23 this quarter. This includes provisions for credit -- for losses reported earnings per share of $1.25 this quarter. This includes provisions for credit -- for losses of $1.7 million and acquisition and integration costs of $1.1 million. Excluding these items, Heartland's after-tax pre-provision acquisition and integration costs earnings per share was $1.29. I would also point you to our updated third quarter Investor Presentation, which is in the IR site on our website. Again, this quarter, core earnings and results were solid with financial trends and metrics also positive in almost all aspects. As I mentioned, the total provision for credit losses this quarter was $1.7 million, driven by a $5.9 million provision on new problem credit that was identified and fully charged off during the quarter and a $45 million increase in sub-rated loans.

These were largely offset by $147 million decline in loan balances and an $85 million decline in unfunded commitments. The updated consensus economic forecast showed improvement. However, the economic outlook factors and components we used to develop the allowance were not changed reflecting Heartland's assessment that a significant level of economic uncertainty remains. Net charge-offs this quarter totaled $21.3 million with $13.9 million attributed to loans that had already been fully reserved in the second quarter of 2020 and then the new $5.9 million charge-off of the previously mentioned loan. In total, the $1.7 million quarterly provision less the $21.3 million in net charge-offs resulted in a decrease in total allowance for lending-related credit losses of $19.6 million.

At the end of the quarter, allowance for credit losses on loans was $103.4 million or 1.14% of total loans. And the allowance for credit losses on unfunded commitments was $14.3 million or 15 basis points of total loans. Together, these two allowances result in total allowance for lending-related credit losses of $117.7 million or 1.29% of total loans. When PPP loans are excluded, the total allowance for lending-related credit losses increased 19 basis points to 1.48% of loans. Moving on to the rest of the balance sheet, total assets grew $600 million, ending the quarter at just over $15.6 billion with a loan to deposit ratio of 71%. Tangible common equity ratio increased 14 basis points to 8.03% from 7.89% last quarter as increases from retained earnings in fair value marks on bond portfolio were partially offset by the impact of the $600 million increase in assets. Heartland's regulatory ratios also remained strong with the common equity Tier 1 ratio at 11.29% and total risk-based capital ratio at 15.47%.

Investments grew $823 million this quarter as we invested some of our excess liquidity and pre-invested some of the expected cash flow from the PPP forgiveness. Investments now comprise 33% of assets with a tax equivalent yield of 2.54% with duration of just under six years and generate approximately $50 million of cash flow on a monthly basis. Borrowings increased $436 million due to the pre-investment strategy and totaled $831 million or 5.3% of assets at quarter end. At September 30, our banking network had approximately $4.1 billion of unused borrowing commitment capacity. So Heartland's balance sheet continues to be very strong with solid capital base, healthy loss reserves, ample liquidity and low leverage. Moving on to the income statement, net interest income totaled $122.5 million this quarter or $1.6 million lower than the prior quarter.

The net interest margin on a tax-equivalent basis this quarter was 3.55% or 30 basis points lower than last quarter, reflecting declines in loan and investment yields of 25 basis points and 37 basis points respectively. That was slightly offset by a 7 basis point drop in interest cost on borrowings and deposits compared to last quarter. This quarter, the net interest margin includes 10 basis points of purchase accounting accretion compared to 16 basis points in the prior quarter. Non-interest income totaled $31.2 million for the quarter, up $600,000 from last quarter as the gain on sales loans was up $1 million on higher mortgage activity, while total security gains decreased $1.2 million compared to last quarter. In addition, service charges, loan servicing fees and trust fees were all higher this quarter.

Moving to non-interest expense, non-interest expenses remained well-managed totaling $90.4 million this quarter or flat compared to last quarter. Core run rate costs, which exclude acquisition, integration and restructuring costs also excludes tax credit costs and asset gains or losses, decreased $1.7 million to $86.6 million compared to $88.3 million last quarter. More specifically, salary and benefits were up slightly at approximately $51 million and occupancy, furniture and equipment costs combined totaled $9.2 million, down slightly this quarter. These categories account for two-thirds of our core costs and at benefits level for the past 10 quarters.

In addition, our FTEs of 1,827 also remained relatively flat this quarter and over the last 10 quarters, has declined by 389 or 18% from a peak of 2,216 FTEs in quarter two 2018. During that same time period, assets have increased $4.3 billion or 38%. These results demonstrate the leverage and increased productivity we have achieved as we work to restructure the company, trim our branch network and implement the many Customer Compass productivity improvements we've identified over the past two and a half years, all while continuing the company's significant growth. One other expense item I would mention is losses and writedowns on assets, which totaled $1.8 million this quarter and included $1.2 million of writedown on branches as part of Heartland's ongoing branch optimization program.

As this program continues to progress, we expect additional branch writedowns to occur over the next one or two quarters. So going forward, excluding new acquisitions, we would expect the following trends to continue over the next one or two quarters, including muted loan growth, excluding PPP and modest deposit growth. PPP forgiveness timing remains uncertain but is likely to be slower than we have been estimating with more of the forgiveness moving into 2021. The net interest margin remain under pressure. However, declines should be much less than we saw in the third quarter. And mortgage activity will seasonally decline but will be higher than it has been in prior years during the same period. Core expenses should remain stable at $86 million to $87 million range.

With regard to the closing of our two upcoming M&A transactions that are both scheduled to close in early December, on a high level and on a combined basis, these transactions will add $1.3 billion to $1.4 billion in loans and $1.9 billion to $2 billion in deposits and approximately $96 million in goodwill and $17 million in deposit intangibles, and should provide an approximate 10% to 11% lift to our core EPS after cost saves are realized and after adding almost 5.1 million additional shares for the AIM transaction. And lastly, M&A and conversion-related costs of $4.5 million to $5 million should come in the next two quarters with $1.5 million next quarter and the remaining in Q1 of 2021. In the interest of time, I would also direct you to my comments from last quarter for additional details on these transactions.

And with that, I'll turn the call back over to Butch for questions.

Lynn B. Fuller -- *Executive Operating Chairman*

Very good. Thank you very much. We'll now open up the phone lines for your questions.

Questions and Answers:

Operator

Thank you [Operator Instructions]. Our first question comes from with Jeff Rulis of D.A. Davidson. Your line is open.

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

Thanks and good afternoon.

Lynn B. Fuller -- *Executive Operating Chairman*

Hi Jeff. Good afternoon.

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

A question on the net charge-offs you detailed $16.5 million in the two loans. The remaining, call it, $5 million, were those in categories that also COVID at risk or that you'd peg as -- maybe any more detail on the remaining bucket even though it was just smaller balances? Just any detail on that.

Lynn B. Fuller -- *Executive Operating Chairman*

This is Butch, and I'll let Nathan also chime in. But I would say there's nothing in the remaining balances after you get past those two large charge-offs that would, I guess, lead us in any direction, it's sort of normal activity for our portfolio size. Nathan, any other comments there?

Nathan Jones -- *Executive Vice President, Chief Credit Officer*

No. And Butch, you said it well. It's mostly across the usual suspects. You'd see it diverse across numerous credits, everything from development to Ag, to others.

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

Okay. And the commentary about expected to remain elevated. Bruce, I think you've mentioned that it's absent the two, the fracking and kind of wholesale wine credits, you would have had charge-offs similar to the prior quarters. Just trying to gauge that elevated comment. Is it -- are we in the 10 basis points to 15 basis points or are we somewhere north of that? Just trying to gauge -- and what is maybe driving that elevated, just I guess heading into as modifications sort of roll-off here?

Bruce K. Lee -- *President and Chief Executive Officer*

Yeah, I'll jump in and then Nathan, you can add. But I think you're picking that comment up from our earnings release. And I think it just reflects the fact that there's uncertainty going forward. Knocking on wood here, as we went through this quarter, we really took the charges that we saw there and there was I don't think any really big ones coming down the pipe that we knew of at that point, but things change fast. I mean, the $5.9 million charge that we did take this quarter showed up quick and had to be dealt with. So in this environment, I think we're always concerned that could -- we could get a surprise. But I think we're in pretty good shape.

Nathan Jones -- *Executive Vice President, Chief Credit Officer*

I think the other comment I might make is that while we're very pleased with the credit metrics, both the NPA numbers, the delinquency number are less than 2% and our loan portfolio remaining with some sort of deferral, we are seeing elevated increases in our non-pass credits. There's a lot of uncertainty around COVID. There's spikes happening in about half of the states that we operate in. So there's been sort of a little bit of a pullback from recent reopenings. And there's a tremendous amount of uncertainty around the government stimulus program. So I think we're just trying to be cautious with that statement more than anything specific that's showing up in our numbers.

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

Got it. Okay, that addressed that pretty well. Thanks. Maybe one last one. Just on the loan runoff and we got -- Bryan, got your comments on exceptions for muted loan growth. But in terms of absolute runoff in the quarter and what may continue to be a headwind. Is that -- and I'm going to guess, it's a combination but is that lower demand and/or your sort of tightening credit appetite? I'm just trying to get a sense for what is the force, maybe that -- which is greater; your hesitation on new loans or demand is drying up?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Yeah, so it's a couple of things. Let's first take the residential mortgage portfolio and consumer. That really is, as you know, other than in Texas, we pretty much exited the residential mortgage business. We did have a portfolio with rates remaining very, very low. Those loans are being refinanced away from us. We generally are able to maintain the deposit relationship but the loan itself is being refi-ed out as home values have continued to be steady or increasing. So that's the story there. The consumer book is a little bit the same way. Most of our consumer loans are home equity loans, which in this low rate environment, if people have balances there and home values continue to appreciate, they're refi-ing those into longer-term 15-year fixed rate, low interest rate mortgages. So as long as rates continue to be low, we would expect to see some runoff for those reasons in those portfolios.

We're actually feeling fairly confident in our commercial book and the new activity with our renewed focus on C&I operating companies. Where we're seeing a decrease there is we are seeing construction portfolio pay off as anticipated. Many of the loans that we funded during the construction phase are going into the secondary market. And there is some of the investment real estate that we've had on our books is being refinanced out, not necessarily for credit reasons, we'd like to keep them but more for pricing reasons. A lot of the community banks, smaller community banks, are taking those $2 million, $3 million, $4 million investment real estate deals, booking those in the mid-3s and we just don't think that's a good trade off. And so there is some of that refinancing away from us happening.

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

Okay. Appreciate it. Thank you. Got it. Thank you.

Operator

Thank you. Our next question comes from the line of Andrew Liesch with Piper Sandler. Your line is open.

Andrew Liesch -- *Piper Sandler -- Analyst*

Hi. Good afternoon everyone.

Bruce K. Lee -- *President and Chief Executive Officer*

Hi.

Andrew Liesch -- *Piper Sandler -- Analyst*

Hi. Bryan, appreciate your comments on the margin, but just curious kind of what this strategy taking on kind of pre-funding some securities with expected payoffs of PPP. Where do you think the margin sort of flattens out and how much pressure do you think remains in the coming quarters?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Yeah. Obviously, I got to couch this with a lot of ifs because [Indecipherable]. I think we probably have another 5 basis points to maybe 10 basis points of it dropping just given the mix change that we've seen with investments being a higher percentage, that wasn't there for the whole quarter. So there's probably a little bit of that. The PPP forgiveness, we'll see what the timing is of that. That could change just a little bit. But how much excess liquidity then shows up again this quarter with deposits and how much will loans grow. Certainly, loan growth would help a lot. We can get that to even switch out the cash flow from the investments and the loan portfolio would be great.

So I think before Johnson and AIM come in, I would say you probably got 5 basis points, maybe 10 basis points if things get a lot of liquidity and everything. But the size of the balance sheet is bigger. So I would say, Andrew, even though you might say our margin go down, I think net interest income is going to remain relatively flat to where it was this quarter. So I think we can hold a line there. Now Johnson is going to come in and AIM both have excess liquidity. The good news is AIM's portfolio has a -- they've been having a net interest margin that's north of 4 basis points and in fact almost 4.5 basis points. So that will help the margin when that comes in even when though we'll get some excess equity. So there's really a lot of moving parts. And obviously [Indecipherable] how we bring in those fees, that could also cloud what the fourth quarter looks like.

Andrew Liesch -- *Piper Sandler -- Analyst*

Right, right. And then on the loans that have gotten a second deferral, is there any sort of commonality among them and I guess what's the tone out of those borrowers? And then eventually, if they still need more deferrals after that. What's the process of resolving some of these relationships if they're still struggling at the time of that deferral payment ending?

Lynn B. Fuller -- *Executive Operating Chairman*

Nathan, you want to take that one?

Nathan Jones -- *Executive Vice President, Chief Credit Officer*

Yeah, the overwhelming majority is as probably it's being experienced by most other banks in the industry as well is really located within the lodging portfolio, really seeing the most stress there and needing the additional support of additional deferrals. We are seeing some positive movement where we're seeing capital raises, as well as pretty significant austerity measures being put in place, giving us some confidence in those customers. We will have to continue to address them as we move forward. But with so much still unknown at this point it's really hard to give a determination of kind of where it's going to resolve itself. But we do feel good about those customers and where they're at as of today. Bruce, anything you'd like to add to that?

Bruce K. Lee -- *President and Chief Executive Officer*

I think the only thing -- and this is getting a little in the weeds and maybe, Bryan, want to jump in. But if we have to continue to provide ongoing support then I think you're going to see us turn some of those loans into TDRs.

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Yeah. I mean, in fact, we had a couple of this quarter. If you look at our tables in the back of the

Yeah, I mean, in fact, we had a couple of this quarter. If you look at our tables in the back of the press release, I think we had $9 million. I'm doing it off the top of my head; I don't have that table right in front of me. I think there were $9 million of additional TDRs. And I believe if I'm not frowned you that those were couple of lodging credits that did come up for their second renewal. And based on the two and the credit we end up in TDR. So if that continues in the next 130, you know that that have yet to come through their deferral period and we do seconds, there could be some additional TDRs.

Lynn B. Fuller -- *Executive Operating Chairman*

The other comment that I might make, Andrew, is when the pandemic started, we like almost all banks, were fairly liberal in providing that first payment modification. The second go-around, it's a complete reunderwriting and it goes our complete process. So we've had a lot of eyes on it at the second go-around. And if there's anything beyond that, it probably will even be moved into our workout group.

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Which we beefed up [Indecipherable].

Lynn B. Fuller -- *Executive Operating Chairman*

Right.

Andrew Liesch -- *Piper Sandler -- Analyst*

Okay. Thank you very much. I appreciate that. I will step back. Thanks.

Operator

Thank you [Operator Instructions]. Our next question comes from the line of Terry McEvoy with Stephens. Your line is open.

Terry McEvoy -- *Stephens Inc. -- Analyst*

Hi. Good afternoon everyone.

Lynn B. Fuller -- *Executive Operating Chairman*

Hi Terry.

Bruce K. Lee -- *President and Chief Executive Officer*

Hi Terry.

Terry McEvoy -- *Stephens Inc. -- Analyst*

Maybe first question on the branch optimization, you covered the six branches, what are your thoughts on the cost savings and maybe how much of that will be reinvested into like you said, the ATM upgrade and some other investments you have on the tech side? And then, Bruce, you kind of said 10% of branches are under review. I guess I understand the meaning of that. But out of those 10%, do you think a fair share of them will not pass the review and will be consolidated?

Bruce K. Lee -- *President and Chief Executive Officer*

Let me take that question first, Terry, and then Bryan can talk about the cost saves. I think what we're doing right now on those 10%, there's definitely probably half of those that we will either sell or consolidate. I think the remaining 5%, it's really how long do we want to give those sell or consolidate. I think the remaining 5%, it's really how long do we want to give those because they might be in a growth market, but we just, over the last couple of years, haven't been able to grow our bank into them. So it's really not so -- they're in a good market. But for whatever reason, we haven't been able to make them grow the way that we want to. And we don't have another branch close or it doesn't make sense for us sell that one.

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

And I think the question is in this environment going so digital will they continue to grow? We need that to grow in some of those markets as well, so.

Bruce K. Lee -- *President and Chief Executive Officer*

And we really want to -- part of our strategy, as you know, we're much more commercially oriented and small business oriented. And historically, small businesses made decision based upon how closed branches worked. We really want to give it a little more time than just three or four months during this pandemic to see whether that behavior changes.

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

And Terry, the other part of your question, six branches had a cost base kind of on an annual basis close to $3.5 million, people and -- predominantly people the real estate costs. I think we'll probably get somewhere between 60% and 70% of that cost to go away. We'll have to keep some of the people as we consolidate because we'll have little bit more activity, presumably going to the branch so that's yet to be figured out to see how that happens in this digital environment. But I would estimate probably conservatively 65% or so right in that ballpark [Indecipherable] see a lot of that for sure.

Lynn B. Fuller -- *Executive Operating Chairman*

And Terry, as you know, as we started to consolidate and prune our branch system a little over a year ago, we have some pretty good historical numbers on when we consolidate branches. We've been maintaining over 90% of those deposits. We modeled much lower than that but we've been able to maintain right around 90%.

Terry McEvoy -- *Stephens Inc. -- Analyst*

Great. And then just as a follow-up question. Thanks for providing the non-pass rate that went from 8.1% to 8.7%. I'm just curious that COVID kind of sensitive portfolio. I don't know if you have the details in front of you. But what does the non-pass-rated loans look like in, say lodging or retail properties, some of those that you've called out now for a couple of quarters? How much higher are those specific portfolios than the portfolio average?

Lynn B. Fuller -- *Executive Operating Chairman*

Nathan, you want to take that one? Keep asking Nathan, he's not in the room with us, so.

Terry McEvoy -- *Stephens Inc. -- Analyst*

No problem.

Nathan Jones -- *Executive Vice President, Chief Credit Officer*

Yes, thank you. And while I don't have specific percentages as far as where they are individually for each one as far as their non-pass percentages. Again, the larger, the more impacted industries are the ones that are driving most of the decreases from a credit perspective with lodging being are the ones that are driving most of the decreases from a credit perspective with lodging being one of the largest ones of all. Specifically, as you noted, the one experiencing struggle or struggling from an industry as well and something we continue to monitor. One of the things we're doing proactively is we're actually having monthly meetings where we go through and look at all the individual credits, anything over of any size, really over 1 million and really going into them in depth, both with the individual RMs as well as senior management, just to make sure we're really understanding movement, both three going to non-pass and post, just to make sure we understand where they're at and that we're taking all the necessary measures that we can. Bruce, anything you'd like to add to that?

Bruce K. Lee -- *President and Chief Executive Officer*

No, I think it was fine. Bryan, did you [Indecipherable] point into the page?Well, and I was just going to say, Terry, as you recall, we've always had kind of an outsized component relative to its portfolio size, on Ag loans that sit in sub-rated. So I think that's continued to be one of the trends that drives that a little bit.

Terry McEvoy -- *Stephens Inc. -- Analyst*

That's great. Thanks for pointing that out and thanks everybody. Have a good night.

Bruce K. Lee -- *President and Chief Executive Officer*

Thanks Terry.

Lynn B. Fuller -- *Executive Operating Chairman*

Thanks Terry.

Operator

Thank you. Our next question comes from the line Damon DelMonte with KBW. Your line is open.

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

Good afternoon guys. How are we going today?

Lynn B. Fuller -- *Executive Operating Chairman*

Good Damon.

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

Good. So first question, just wanted to kind of circle back on the provision and kind of the outlook there. But before that, could you just explain a little bit why the reserve for the unfunded commitments was down, the $3.1 million this quarter. Is that just because of you had lower balances that you released some of that reserve?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Yeah, it's two things. The loans coming down, obviously, that had some effect on the commitments. We also, as Bruce mentioned, had quite a few construction loans that moved out or that moved up into their permanent owner-occupied or CRE category. And those tend to have a little bit low. Once they move, they have a little bit lower reserve. We have a higher reserve rate on our construction loans and so that mixed combination in the lower caused that to go down.

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

Got it, OK. And then as we try to think about the provision going forward, just kind of given the commentary about potential for elevated net charge-offs in the coming quarters and kind of ongoing economic uncertainties. I mean, it's probably fair to assume we're not going to see a provision as low as this quarter, but do you think we kind of go back somewhere closer to what we saw in the first half of the year?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

I don't think it's as high as the first half. If you step back and assume that we don't get the $3 million or so less on the investment or on the unfunded, we had close to $5 million provision for the, just the regular loans on the books. I would suspect somewhere between there and $10

million or $10 million, if my decimal point's right. Somewhere between that $5 million and $10 million is probably what we're looking at for the next couple of quarters. And then once you get past that and we do get t more normal times then it's really just loan growth changes and hopefully not a lot of charge-offs or changes in credit quality.

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

And I think you said the reserve or the ACL, I should say, ex-PPP loans was like 1.48% this quarter. So that's the level you're comfortable with, just kind of given some of the weaknesses across the footprint and just the rising spike of the virus?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Well, I mean, you never know, right? One of the things that I did is I look back, what was the worst year that we had during the Great Recession. We never had a year of more than 1.4% of loans for charge-offs. And it doesn't feel like we're at a bad a spot right now. So going in, I think we're in pretty good shape but obviously, if we don't pull out of this, if things continue to just trudge along and businesses can't keep going and there isn't enough stimulus money then things could change. That's part of the reason why what we didn't do, Damon, was we probably, if we'd have just done the math on CECL with the forecast coming -- looking a little bit better than we did last quarter, we probably could have just taken more -- a smaller provision.

We didn't think that was prudent given all the uncertainties. We wanted to leave that -- those factors where they were, which was on the high side just to make sure that we didn't get a false positive here and that this does get worse instead of really get better. And that gives us more room to take some additional charge-offs if that were to happen. So it's kind of long-winded answer. But I really do think in the next quarter or two, unless something changes, I don't see. We should be and I think somewhere in that $5 million to $10 million range.

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

Okay. And then on the margin, I may have missed this. But can you kind of just walk me down the 30 basis point quarter-over-quarter decline? I know you said you added liquidity. But was that entirely liquidity? Was there a drag from PPP? Were there any other factors in there?

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Yeah. I think we had both -- I'm just looking for a little thing that I did another sheet of paper. So PPP loans -- purchase accounting was 10 basis points. Again, PPP loans was about 9 basis points. It was 10 basis points last quarter. So it was about the same. But that yield is 265, so it does pull down our net interest margin. You have loans -- both the volume and rates were down in loans ex-PPP and ex purchase accounting. Investments, you have volume up but rates down. And then there's lift from liabilities with rates down and some volume up. So combination of a lot of things. I would say it's mostly liquidity and the fact that we have had a shift toward a lower earning asset in the assets that being investments from loans.

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

Okay. Just had -- yeah, that answers everything that I had. So thank you very much. Appreciate it.

Lynn B. Fuller -- *Executive Operating Chairman*

Thanks Damon.

Operator

Thank you. I'm showing no further questions at this time. I would now like to turn the floor over to Mr. Fuller for closing comments.

Lynn B. Fuller -- *Executive Operating Chairman*

Thank you, Towanda. In closing, again, we were very pleased with our financial performance for the third quarter, and we set a number of new records. First and foremost, net income available to common shareholders of $45.5 million was the best quarter in our history, earnings per diluted common share of $1.23 was our second best quarter for earnings per share. Our record efficiency ratio at 54.67% for the quarter and 57.28% year-to-date was the lowest in our history. Our assets reached a new record high of $15.6 billion with $3 billion in growth over the last four quarters. Our balance sheet remains extremely liquid, all capital ratios remain strong and credit issues remain relatively benign. 10 of our 11 charters achieved our goal of $1 billion or more in assets this last quarter. And last, we're excited to welcome our new merger partners, AimBank of West Texas and the four Johnson Bank branches in Phoenix, Arizona. We'd like to thank everyone for joining us today and hope you can join us again for our next quarterly conference call in late January 2021. Have a good evening, everyone.

Operator

[Operator Closing Remarks]

Duration: 60 minutes

Call participants:

Lynn B. Fuller -- *Executive Operating Chairman*

Bruce K. Lee -- *President and Chief Executive Officer*

Bryan R. McKeag -- *Executive Vice President, Chief Financial Officer*

Nathan Jones -- *Executive Vice President, Chief Credit Officer*

Jeffrey A. Rulis -- *D.A. Davidson & Co. -- Analyst*

Andrew Liesch -- *Piper Sandler -- Analyst*

Terry McEvoy -- *Stephens Inc. -- Analyst*

Damon DelMonte -- *Keefe Bruyette & Woods Inc. -- Analyst*

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