Heartland Financial USA, Inc. (NASDAQ:HTLF) Q1 2021 Results Conference Call April 27, 2021 5:00 PM ET

Company Participants

Lynn Fuller - Executive Operating Chairman

Bruce Lee - President and CEO

Bryan McKeag - EVP and CFO

Nathan Jones - EVP and Chief Credit Officer

Conference Call Participants

Jeff Rulis - D.A. Davidson

Terry McEvoy - Stephens

Andrew Liesch - Piper Sandler

Damon DelMonte - KBW

Operator

Greetings, and welcome to the HTLF First Quarter 2021 Conference Call. This afternoon, HTLF distributed its first quarter press release, and hopefully, you 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 HTLF'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 falls 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 the 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. Additional information on these factors is included from time-to-time in the Company's 10-K and 10-Q filings, which may be obtained on the Company's website or the SEC's website.

At this time, I would now like to turn the call over to Mr. Lynn Fuller at HTLF. Please go ahead, sir.

Lynn Fuller

Thank you, Elaine, and good afternoon, everyone. Welcome to HTLF's first quarter 2021 earnings conference call under our new brand, HTLF. We appreciate everyone joining us today as we discuss the Company's performance for the first quarter of 2021.

For the next few minutes, I'll 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 then Bryan McKeag, our EVP and CFO will provide additional color around HTLF's results. Also joining us today is Nathan Jones, EVP and Chief Credit Officer, who will be available to answer questions regarding credit.

Now, on to Heartland's financial highlights. And as you will see, we are off to a great start for 2021. We set a new record for net income in the first quarter at $52.8 million, and after our preferred dividend of $2 million net income available to common shareholders was $50.8 million, compared to $20 million for the first quarter of 2020. Now, that's an increase of $30.8 million, or 153% increase. Diluted per common share of $1.20, compared to $0.54 for the first quarter of last year, an increase of $0.66 a share, or 122% increase. Annualized return on average common equity, and average tangible common equity was 10.49% and 15.9%, respectively. Annualized return on average assets was 1.19%, in line with our goal of 1% or greater. The net interest margin on a fully tax equivalent basis was 3.48% for the quarter, and our efficiency ratio was 56.61%, and our credit metrics continued to improve. Bruce and Bryan will share more detail in their comments. Book value and tangible book value per common share continued to increase ending the quarter at $46.13 and $31.53, respectively. Now, that's a 9% increase for both from a year ago.

On the M&A front, in February, we had a very successful virtual systems conversion on our largest acquisition ever, the AimBank transaction in West Texas, which was merged into Heartland's Lubbock, Texas-based subsidiary First Bank and Trust is now Heartland's largest bank, with assets totaling nearly $3 billion. Subsequent to conversion, seven of the AimBank branches were transferred to Heartland's New Mexico Bank and Trust subsidiary.

As I've said in the past, our priority has been to expand in our current footprint, and work toward our goal of achieving $1 billion in assets in each state where we operate. Currently, 9 of our 11 banks have assets exceeding $1 billion. We continue to have a very deep pipeline of acquisition opportunities across our footprint with a number of active opportunities currently in process. And as such, I anticipate acquired growth to be similar to what we experienced last year.

Also, as part of our M&A process, we continue to explore and model branch sales as part of our branch rationalization strategy. Well, at this month's meeting, Heartland's Board of Directors approved a $0.22 per common share dividend, payable May 31, 2021, to shareholders of record on May 17, 2021. The Board also approved a preferred dividend of $175, payable on July 15th, 2021 to shareholders of record on June 30, 2021.

Now, our annual stockholder meeting is scheduled for May 19, 2021. And that's at 1 p.m. Central Time, and it will once again be held virtually. We continue to add directors with unique skills and talents, while at the same time adding diversity to our Board. I'm sad to report that this year, we will lose two of our highly valued long-term independent directors, Mark Falb and Mike McCoy. I want to publicly thank both of them for their years of service and for their guidance, counsel and dedicated support. Now, that said, I'm pleased to report that we will be adding two new independent Directors, Kathryn Graves Unger, and Chris Hylen. You may recall that Chris joined the Board just prior to year-end 2020. Both will be standing for election as Class One Directors at this year's annual stockholder meeting, along with Susan Murphy, Marty Schmitz, and myself.

I'll now turn the call over to Bruce Lee, HTLF's, President and CEO, who will provide an overview of the Company's operating performance and credit. Bruce?

Bruce Lee

Thank you, Lynn. Good afternoon, everyone. Welcome to our first quarter earnings call.

I'm proud to introduce you to our new branding, HTLF. You're familiar with the letters HTLF, as our stock ticker symbol. Now, those same four letters are the brand name of our Company. We refreshed our branding to better reflect our continued growth and who we are today. Our tagline, Strength, Insight, Growth, are what we bring to our customers, and what our unique business model and diverse footprint brings to our shareholders, as over 60% of our assets are now in the west and southwest regions.

Our banks are powered by HTLF technology, efficiency and strength. It's community banking with the scale to compete at any level. The response to HTLF has been excellent. And we're excited about how the brand positions us with our employees, customers and investors. We're off to an excellent start in 2021. We had a very clean first quarter. We delivered $1.20 earnings per share, which we will build upon throughout the year. Bryan McKeag, our Chief Financial Officer, will discuss our outlook further in his comments.

Total assets grew to $18.2 billion, an increase of $336 million in the quarter. Assets are up $4.9 billion or 37% from a year ago. Pre-provision net revenue was a record $67.5 million, an increase of 42% from a year ago and 2% from the linked quarter. Our efficiency ratio was 56.61%, 521 basis points lower than a year ago. Our ability to drive efficiency, while strategically investing for growth and enriching the customer experience continues to differentiate us. And our strong results delivered a record quarterly net income of $52.8 million, a 164% increase from a year ago and 33% increase from the linked quarter. We delivered another solid quarter of deposit growth.

Total deposits were $15.6 billion, an increase of $579 million from the linked quarter and $4.4 billion or 39% from a year ago. The growth was primarily in commercial. Non-time deposits totaled $14.4 billion, an increase of $647 million or 5% during the quarter. We've maintained our exceptional deposit mix. 40% of deposits are in non-interest bearing accounts and 92% in non-time account balances. Our disciplined deposit pricing, reduced total deposit costs to 12 basis points for the quarter, a decrease of 2 basis points from the linked quarter and 41 basis points from a year ago.

Turning to loans, including PPP, total loans increased $27 million, less than 1% from the linked quarter. Excluding PPP, total loans were down $170 million or 2%. This breaks down as follows: Total commercial, excluding PPP, decreased $74 million from the linked quarter. Commercial continues to be affected by decreased C&I line utilization, which was down $75 million in the quarter. Agriculture decreased seasonally, $31 million from the linked quarter, residential mortgage was down $53 million and consumer loan decreased $12 million. We expect to deliver commercial and agricultural loan growth in excess of $100 million next quarter. The manufacturing, wholesale, distribution and healthcare sectors are leading the way with strength at our banks in Arizona, California, Colorado, and Iowa.

We're strategically adding talent to our commercial team and taking advantage of competitive disruption in certain markets. We're building momentum and our pipeline has grown considerably in the last six months. We've introduced new consumer loan products and have a strong pipeline. We expect to deliver $20 million in consumer loan growth in the second quarter. I've been back on the road meeting with clients and bankers, and I'm encouraged. Commercial clients are optimistic and looking ahead to strong growth in the second half of the year. However, they're still experiencing some headwinds. Rising raw material costs, supply chain disruption, and hiring and retaining skilled labor are common themes that could impact the speed of economic recovery and growth.

HTLF is proud to have helped another 2,600 small businesses obtain loans, totaling $429 million, during the second draw of PPP. Once again, our teams helped provide a critical lifeline in our community.

In addition to PPP2, we're supporting small businesses through our Buy Local program. Our banks are offering consumer loans up to $5,000 at 0% interest for 36 months to help them make needed purchases and generate important business growth within our communities. In 2021, we have funded more than 1,300 Buy Local loans of $6.4 million.

Turning to key credit metrics. We continue to see stable credit quality and remain cautiously optimistic about the overall outlook. We are maintaining economic qualitative factors, consistent with previous quarters, until there is more clarity about the pandemic and the economy. Therefore, we did not release any reserves this quarter. Our nonperforming loans represented 91 basis points of total loans at the end of the first quarter, a slight increase of 3 basis points from the linked quarter, but a decrease of 4 basis points from a year ago. Non-performing assets as a percentage of total assets decreased to 54 basis points compared to 64 basis points a year ago.

The delinquency ratio decreased to 16 basis points from 23 basis points in the linked quarter and significantly lower than 38 basis points a year ago. Non-pass-rated loans increased to 11.5% from 10.8% in the linked quarter, primarily due to an increase in watch loans, while substandard loans decreased by $31 million for 6%.

Lastly, net loan charge-offs for the quarter were $1.5 million or 6 basis points of average loan, a slight increase of 5 basis points from the linked quarter and significantly lower than 24 basis points from a year ago.

We continue to invest in our growth through Operation Customer Compass, our multiyear strategic initiative. We're developing products and implementing technology that will enhance the service we provide to our commercial and consumer customers. Later this year, we will begin delivering digital banking enhancements, including expanded self service applications, document management tools, online appointment scheduling, and customer service live chat option.

In February, we successfully converted systems for AimBank. We also transferred seven AimBank branches in New Mexico Bank and Trust, completing Heartland's largest acquisition to-date. Commercial and consumer customer retention has been stronger than expected. We're pleased with the operating performance of the combined entity in the first quarter.

Our strategic acquisitions in growth markets have provided scale, added talent and brought new products and services to acquired customers. We continue to have a deep pipeline of attractive prospects with a number of active opportunities. In the first quarter, we consolidated nine branch locations, six were legacy branches and three were recently acquired AimBank branches. We continue to rationalize our branch footprint to more efficiently serve our customers.

The health and safety of our employees and customers continues to be our top priority. We are encouraged by the expanded rollout of vaccines, and states within our footprint have loosened restrictions. Across the country, we're opening more of our branches for full service. Bankers are meeting more customers face to face, and we're providing more options to deliver the high level of service customers expect from our banks.

HTLF corporate employees will begin a gradual return to the office in May. As a company, we've learned how to connect in many ways over the past year. As we return to working together in person,, we'll be even stronger than before. I continue to be impressed by our employees, their ability to adapt and their commitment to serving our customer and communities. I'm grateful for their hard work and dedication that has strengthened our Company. We'll continue to adapt to local conditions. But, we're optimistic and well-positioned to serve our customers and communities as they emerge from the pandemic.

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

Bryan McKeag

Thanks, Bruce, and good afternoon, everyone.

I'll begin today with earnings per share, which was reported at $1.20 this quarter. The only significant item this quarter was acquisition and integration costs of $2.9 million or

$0.05 per share after tax, which related to the system's conversion integration of AimBank in February. So, again, this quarter, our core results were strong.

Before I go in my detailed comments, I would like to remind everybody that our updated first quarter investor presentation is available in the IR section of our website.

So, I'll start my detailed comments today with the provision for credit losses, which totaled to $648,000 benefit this quarter, and reflects the following components. First, total loan balances excluding PPP, declined $170 million; Second, we continue to have some loan downgrades that result in a small increase in reserves; Third, the consensus economic forecast continue to show some moderate improvement. However, the economic outlook factors and components used to develop the allowance were left unchanged, reflecting our assessment that the -- there is still a significant level of economic uncertainty; and last, net charge-offs were low again this quarter at just under $1.5 million or 6 basis points of average total loans.

So, at quarter-end, the allowance for credit losses for loans was $160.2 million or 1.3% of total loans. The allowance for credit losses on unfunded loan commitments was $14.6 million or 14 basis points of total loans. Together, these two allowances result in a total allowance for lending-related credit losses of $144.8 million or 1.44% of total loans.

When the PPP loan balances are excluded, the total allowance for lending-related credit losses stands at 1.63% of loans compared to 1.62% last quarter. In addition, at quarter end, we had unamortized purchase loan valuations on the balance sheet totaling $28.1 million or 32 basis points of total loans, excluding PPP.

Moving to the rest of the balance sheet. Investments grew $239 million this quarter and comprised 36% of assets with a tax equivalent yield of 2.28%, a duration of just under six years and generate $65 million to $70 million of average monthly cash flow. Borrowings decreased $135 million to end the quarter at $490 million or 2.69% of assets.

Tangible common equity ratio declined 27 basis points to 7.54% at quarter-end. Ratio declines of 34 basis points from the decrease in market value of investments and 15 basis points due to the larger balance sheet were partially offset by a 22 basis-point increase from retained earnings.

Heartland's regulatory capital ratios also remained strong with the Common Equity ratio -- or Common Equity Tier 1 ratio at just under 11.5% and the total risk-based ratio at just over 15.3%. So, the balance sheet continues to be very strong and well-positioned.

Moving to the income statement. Net interest income totaled $139.6 million this quarter or $7 million higher than the prior quarter. The net interest margin on a tax equivalent basis this quarter was 3.48%, down 7 basis points compared to last quarter, as a 10 basis-point decline in investment yields and 4 basis-point decrease in loan yields was partially offset by a 4 basis-point drop in interest costs. The decrease in the margin was also impacted by a $1.4 million reduction in fees recognized for PPP loan forgiveness and amortization, which reduced the net interest margin by 3 basis points compared to last quarter. We exited the quarter with just under $25 million of unamortized PPP loan fees remaining on our books.

This quarter, the net interest margin includes 12 basis points of purchase accounting accretion, which is up 2 basis points from the prior quarter. Noninterest income totaled $30.3 million for the quarter, down $2.3 million from last quarter, as all components of mortgage banking income combined were flat, and security gains decreased $3 million compared to last quarter. In addition, service charges were $1 million higher this quarter, primarily reflecting a full quarter run rate from our new acquisitions.

Shifting to noninterest expense. Expenses remain well-managed, totaling $102.4 million for the quarter, up $3.2 million. Excluding noncore acquisition, integration, restructuring and tax credit costs, as well as asset gains and losses, our core expenses increased $6.7 million to $99.3 million compared to $92.6 million last quarter. This increase reflects a full quarter of run rate costs from our new acquisitions.

So, as we look ahead to the rest of 2021, we believe HTLF will continue to deliver strong results highlighted by, first, our improving loan pipelines, leading to an expected loan growth rate, ex PPP in the 1% to 1.5% range next quarter with improving growth rates in the back half of 2021 as the economy continues to strengthen. Remaining round 1 PPP forgiveness will happen largely over the next two quarters, and the new round of PPP, which ended the quarter at $416 million net of fees deferred is expected to grow but is likely to stay below $475 million.

Our non-time deposit growth is expected to be modest next quarter and then flatten and could even show some runoff in the back half of the year.

Net interest margin will continue to see some modest pressure. However, net interest income is expected to grow 1.5% to 2% per quarter going forward.

Provision for credit losses are expected to remain low and could be negative over the next quarter or two, and then return to more normal levels as loan growth picks up and the economy has stabilized. Noninterest income, excluding investment gains or losses in total is expected to increase by 5% next quarter to about $32 million, then flatten in Q3 and decline somewhat back to Q1 levels in the fourth quarter.

Core expenses are expected to increase just slightly into the $100 million to $101 million range in Q2 and then settle into the $100 million range thereafter. We believe a 22% tax rate is a reasonable full year run rate, assuming no tax law changes. And lastly, we expect the TCE ratio to climb back above 8.25% by the year-end as we get about 25 basis points increase from retained earnings per quarter. However, higher long-term rates could continue to weigh on the ratio.

And with that, I’ll turn the call back over to Bruce for questions.

Bruce Lee

Elaine, if you could open up the line to questions from analysts?

Question-and-Answer Session

Operator

[Operator Instructions] And our first question comes from the line of Jeff Rulis from D.A. Davidson.

Jeff Rulis

Thank you. Good afternoon. So, a lot to impact there, I guess, Bryan, on the expense side. So, that's -- maybe I'll just take a step back. The branch rationalization expectation for the -- what you completed recently, but is there more on the horizon -- some continued in this year?

Bryan McKeag

I think there might be one or two that's built into the numbers I talked about, but not a lot more. We're continuing to look at those. So, I haven't put those in yet.

Bruce Lee

Yes. So Jeff, this is Bruce. So, the last couple of quarters, we've indicated that about 10% of our branches have been under sort of review. And the vast majority of those changes occurred last quarter. So, I would really just echo what Bryan said. There's probably still a handful that we're looking at. But, I would say, it's -- we're going to get some benefit, but it's not going to be a material benefit going forward from any cost reductions associated with branch closures.

Jeff Rulis

Okay. So, if I -- and with the conversion behind us, and we have what I would assume, a lot of the merger costs kind of go away, that gets you right to that 100. So, I mean, I suppose cost savings from there, it's more of a -- if we see efficiency improvement, it's more a revenue equation rather than net expense decline.

Bryan McKeag

Yes. I think you'd hold expenses relatively flat. Like I said, they might up just a little bit this quarter, only because we've got salary increases that go up. There are some things that cleaned up in the first quarter. And then, you've got a little bit of the Aim efficiencies that will come in as we kind of get a full quarter after our -- after the conversion. So, all those things kind of net to close to maybe slight uptick, and then it should settle down and be really pretty flat going forward.

Jeff Rulis

Okay. And then, last one is just to confirm the core margin. Do you have a figure relative to maybe the 3.48 with -- that excludes PPP and the accounting adjustments?

Bryan McKeag

Yes. I think, it's around 3.32, give or take, a basis point.

Jeff Rulis

Okay. And how does that match with the fourth quarter?

Bryan McKeag

I think, that's down about 6 basis points. We were down -- I get there is we were down 7 basis points. You had a negative 3 from PPP, but a positive 2 -- so, I'm sorry, the other way around it. Positive 3 and negative 2, it gets you to right around that 6 basis-point range.

Jeff Rulis

Core compression. Got it. Okay. I'll step back. Thank you.

Bruce Lee

Thanks, Jeff.

Operator

And your next question comes from Terry McEvoy from Stephens.

Terry McEvoy

Bryan, maybe just a quick question for you, and I appreciate all the forward-looking commentary. The net interest income guide for the second quarter, how does that incorporate PPP, either as the first quarter or out into the second quarter? I just want to make sure I understand your outlook correctly there.

Bryan McKeag

Yes. I would say, I put just a little bit of additional peak since it was down this quarter. And really, forgiveness really slowed down at the end of the first quarter. I think that number could be flat to up just a little bit, kind of left the amortization P&A, purchase accounting, the same. So, really, what it's about is the loan growth that Bruce talked about. And we probably won't grow the balance sheet to do that. We probably would just use cash flow off the investment securities and use that to kind of increase the mix. So, that'll help the NIM, and also we get an extra day next quarter. So, all that, when you put it in, I get to somewhere between 1.5% and 2% increase.

Bruce Lee

As Bryan said, it was around PPP. We're going to see a pickup in the second quarter because we didn't see as much as we were working on the originations of PPP2 in the first quarter.

Terry McEvoy

Thanks for that, Bruce. And then, just an M&A question. In the prepared remarks, it sounds like you'd love to acquire a similar amount of assets in '21 as you did in '20. And after your experience with Aim and the integration of a larger deal, would your preference be -- and I know you need to take what the market gives you, would your preference be one larger transaction, or are you really open to anything in order to build the scale that you discussed?

Lynn Fuller

Yes. Terry, I've addressed this in the past. And all things being equal, which is never the case, obviously, but assuming that all things are equal, we would always take a larger transaction versus a smaller transaction. We would always favor an in market acquisition versus a new market. And the current deals that we have in the pipe that are active would be both in our Western markets and in our Midwest markets. So, being in 12 states, we see an awful lot of deals. And so, now the balancing that is just to make sure we've got the most accretive acquisitions that give us the best returns.

Operator

And the next question is from Andrew Liesch from Piper Sandler.

Andrew Liesch

Just the securities book has increased the last several quarters. And I mean it sounds like you want to use cash flows off it as well as the ongoing build in credit funds and other cash to fund loan growth. But, how should we look at the size of the securities book? Are you going to add more to it, or do you think it's reached a peak and should decline from here?

Bryan McKeag

Really depends on the inflows as much as anything, Andrew. But, I would say, we'd like to keep that about the size, maybe even down a little bit if deposits slow down, and we can generate the loans, and we can sort of shift that asset from investments to loans. That would be our -- that would probably be the perfect scenario. I think it's the right thing to wait for rates that go up before we would start wanting to grow that portfolio at all. It's 36% of assets. So, it's pretty big for us. I think normal times, we'd love that to be more like 25% -- between 20% and 25%. So, we've got a ways to go to kind of hold that down if we can.

Andrew Liesch

Got it. And then, I'm just curious like, what securities were you purchasing? Just curious with the yields that were being added in the first quarter were.

Bryan McKeag

Yes. I think we've probably been doing agency paper, trying to stay on the lower side of -- in terms of duration. So, we're talking low to mid-1s probably. Not something to get too excited about, but it's better than zero, or just a couple of basis points sitting in cash, so.

Operator

And the last question comes from Damon DelMonte from KBW.

Damon DelMonte

So, most of my questions have been asked and answered, but just wanted to follow up on the margin. So, Bryan, I think with the 12 basis points or so of accretable yield, that's somewhere like around $5 million. So, should we be modeling in like $5 million per quarter going forward for at least the next two or three quarters?

Bryan McKeag

Yes, I would think plus or minus that. It's really hard to project. It really depends on how loans -- and I don't -- I always get surprised by that number, which way it goes a few basis points. So, I think kind of consistent would be what I would do, Damon.

Damon DelMonte

Okay. And then, just directionally, the core margin is expected to still kind of trend a little bit lower, right, for the next couple of quarters. Is that what you said before?

Bryan McKeag

Yes. Like I say, it really depends on how well we can do on the loan growth. If we can get the loan to replace some of the investments, I think we can hold it flatter. If that doesn't happen or if we get a lot more liquidity that we can't put into loans, it could come down a bit. Went down 6 basis points. I wouldn't think it would go down any more than that, but I would think it should try to be pretty flat.

Damon DelMonte

And then, Bruce, some of the commentary on the expected loan growth. Can you just give a little bit more color on like kind of what's giving you that confidence? Are you looking at your loan pipelines and things are progressing pretty steadily and you expect these deals to be closing and hitting the books, like imminently? Is that kind of how you're feeling comfortable with some of that commercial and ag expectations?

Bruce Lee

Yes. Damon, that's exactly it. When you look at closing dates and you look at -- I mean, today, we're basically a third of the way through the quarter, and what has already closed gives me a lot of confidence in the numbers, the 100 of commercial and ag growth, as well as we should have some consumer growth as well.

Operator

Thank you. As there are no further questions at this time, I would like to turn the call back over to Mr. Lee for closing comments.

Bruce Lee

Thank you, Elaine. In closing, HTLF had an excellent quarter. We delivered a record quarterly net income of $52.8 million; pre-provision net revenue was also a record, $67.5 million; total assets grew to another record, $18.2 billion; total deposits, $15.6 billion; and our efficiency ratio was 56.61, a record low for the first quarter. And we successfully converted systems for AimBank, completing our largest acquisition to-date.

HTLF has momentum, and we're well-positioned for continued growth in the remainder of 2021 and beyond. I'd like to thank everyone for joining us today. Our next quarterly earnings call will be in late July.

Have a good evening.

Operator

This concludes today's conference call. You may now disconnect.