Heartland Financial USA, Inc. (NASDAQ:HTLF) Q2 2020 Earnings Conference Call July 27, 2020 5:00 PM ET

Company Participants

Lynn Fuller - Executive Operating Chairman

Bruce Lee - President and Chief Executive Officer

Bryan McKeag - Executive Vice President and Chief Financial Officer

Conference Call Participants

Jeff Rulis - D.A. Davidson

Terry McEvoy - Stephens

Andrew Liesch - Piper Sandler

Damon DelMonte - KBW

David Long - Raymond James

Operator

Greetings and welcome to the Heartland Financial USA, Inc Second Quarter 2020 Conference Call. This afternoon, Heartland distributed its second 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 falls under the guidelines of forward-looking statements as defined by the Securities and

Exchange Commission. As part of those guidelines, I must point out of 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 will now turn the call over to Mr. Lynn Fuller at Heartland. Please go ahead, sir.

Lynn Fuller

Thank you, Ashley and good afternoon. Welcome to Heartland's second quarter 2020 earnings conference call. We appreciate everyone joining us today as we discuss the company's performance for the second quarter of 2020. For the next few minutes, I will touch on the highlights for the quarter. I will 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.

Well during these very challenging times, our priority has been the safety of our employees, the ongoing support of our customers, our shareholders and communities. Since 1981, Heartland's 39 years of consistent profitability and growth has been grounded in a culture of taking extremely good care of all of our constituents. We continue to differentiate ourselves through our strong capital, liquidity, credit and financial performance metrics. Bruce Lee and Brian McKeag will provide more detail on the many things we are doing to support, protect and care for our employees, customers, shareholders and communities.

So, now on to the financial highlights for the second quarter of 2020. I am pleased to report that we had a very good second quarter. Net income available to common shareholders was $30.1 million compared to $20 million for the linked quarter. Earnings per diluted common share was $0.82 compared to $0.54 for the linked quarter and return on average tangible common equity was 11.97% compared to 8% for the linked quarter. Our second quarter results were very strong on a tax-affected pre-provision, acquisition, integration and restructuring cost basis outperforming the four prior quarters.

Now, using the same calculation, we achieved the following results. Adjusted net income available to common shareholders this quarter was $51.8 million compared to $49.8 million for Q2 2019, which included $18 million in gain-on-sale of our mortgage servicing portfolio at Dubuque Bank and Trust and the gains from several branch sales. Adjusted earnings per diluted common share was $1.40 compared to $1.39 for Q2 2019 and adjusted return on average tangible common equity was 20.02% compared to 21.41% for the same quarter in 2019. While assets crossed the $15 billion mark at the end of the second quarter and this achievement is a tremendous milestone for our company and a testament to the hard work and success of our employees in growing our company both organically and through acquisitions.

The net interest margin, on a fully tax equivalent basis, was strong at 3.85% and our efficiency ratio showed substantial improvement at 55.7%. Bruce and Bryan will share more detail in their comments. Book value and tangible book value this quarter were at $44.42 and $31.14 respectively, an increase over Q2 2019 of 7% and 10% respectively. The tangible common equity ratio declined 40 basis points to 7.89% at quarter-end from 8.29% last quarter. The decline was driven by the significant growth in our balance sheet, which included the addition of $1.1 billion in net Payroll Protection Program loans. Now that said, our TCE would be approximately 8.5% excluding the income and balances of the PPP loans booked in the quarter.

Now on the M&A front, in June, we announced that our Arizona Bank & Trust franchise in Phoenix had entered into a purchase and assumption agreement to acquire certain assets and assume substantially all of the deposits and other liabilities of Johnson Bank's Arizona operations. Johnson Bank is a wholly owned subsidiary of Johnson Financial Group, located in Racine, Wisconsin. Currently, eight of Heartland's member banks have assets exceeding $1 billion. When the branch transaction is completed in December of this year, Arizona Bank & Trust will become Heartland's ninth bank subsidiary to cross $1 billion in assets, with approximately $1.1 billion in assets and 10 banking centers. With respect to the AimBank transaction in West Texas, we will be closing in the third quarter of this year. AimBank, a $1.8 billion asset bank when merged with and into Heartland's Lubbock, Texas-based subsidiary, First Bank and Trust, will be Heartland's largest independent bank charter with approximately $3 billion in assets. This will be the fifth largest bank headquartered in West Texas, and the third largest deposit market share bank in Lubbock.

Now in closing, I am pleased to report that last week Heartland's Board of Directors approved a $0.20 per share common dividend payable August 29, 2020 to shareholders of record on August 7, 2020. The Board also approved a preferred dividend of $211.94 payable on October 15, 2020 to shareholders of record on September 30, 2020.

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

Bruce Lee

Thank you, Lynn. Good afternoon. As our country continues to navigate the coronavirus pandemic, I wanted to take a moment to recognize our employees and say how proud I am of their commitment to each other, our customers and our communities. Heartland's strong results reflect their passion and dedication.

During the second quarter, we delivered $155 million pre-provision revenue, an increase of 12% over the linked-quarter. Core margin also improved to 3.79%, up slightly from the linked quarter, and we delivered our lowest ever efficiency ratio of 55.75% for the quarter. Year-to-date, our efficiency ratio is 58.64%. These outstanding results demonstrate our focus on our core business and customers, our discipline in holding the line on costs and our ability to operate in a low interest rate environment, all while responding to the extraordinary operating circumstances and expenses associated with COVID-19. The pandemic situation continues to evolve and our team has been dynamic anticipating challenges and pivoting when necessary.

But one constant has been Heartland's unwavering commitment to the health and safety of our employees. We continue to operate under our pandemic management plan, protecting employees, while enabling business continuity and providing relief and support to customers and communities that are facing challenges from the impacts of COVID-19. Employees, who can work from home, continue to do so, while those who come into bank locations are on rotating teams to limit potential exposure. All in-person events and large meetings have been held virtually or canceled. Our expanded time-off program and enhanced healthcare coverage for COVID-19 related testing and treatments are in place, and certain customer-facing employees are receiving a 20% wage premium.

Heartland's diverse geographic footprint has been strength during the pandemic. After closing most of our bank lobbies in March and April, we reopened gradually on a state-by-state basis, shared key learnings on operations and safety. We were cautiously optimistic about expanding our in-person services in May and June. Recent outbreaks in some states have led us to pull back and close bank lobbies again in certain locations to protect the health and safety of our employees and customers. We recognize this will likely continue to occur across our footprint and our country. We are prepared and confident in our ability to operate in this environment for the foreseeable future and continue to deliver the high level of service our customers and communities expect from us.

We are living our mission of enriching lives, one customer, employee and community at a time. We're putting people first and our employees and customers have noticed. Our recent employee engagement survey generated the highest scores we've ever received. We are earning goodwill with our employees and customers through our relief programs and contributions we have made in our communities. In April, we donated $1.2 million to organizations that are working directly with those affected by COVID-19. Despite many headwinds, Heartland continues to grow, and in the second quarter, our total assets surpassed $15 billion, an increase of $1.7 billion from the linked quarter. This was driven by deposit growth, our support of the Paycheck Protection Program, and the successful completion of our $115 million preferred stock offering.

Turning to deposits, during the second quarter, non-time deposits increased 15% or $1.6 billion. This significant increase was comprised of $142 million of consumer deposits and $1.4 billion of commercial deposits. 9 of our 11 banks saw double-digit percentage growth from the linked quarter. Minnesota Bank & Trust increased non-time deposits by 29% and Premier Valley Bank increased non-time deposits by 25%. Branch transactions have decreased 27% since the end of the second quarter in 2019. This was accelerated by branch lobby closures during the pandemic, but also highlights the consumer behavior shift to digital. While in-branch service and cash transactions are declining, digital usage is increasing.

We were prepared to respond when the Fed cut interest rates. In the second quarter, the average rate paid on interest-bearing deposits was 32 basis points, down 47 basis points from the linked quarter. Our deposit pricing strategies, along with our previously implemented interest rate floors on commercial loans enabled us to increase core interest margin by 4 basis points. Last month, the Nielsen report announced that Heartland's commercial credit card program was ranked among the top 35 purchasing card programs for growth in 2019, a result of our commitment to providing best-in-class technology and personalized service for our customers.

Turning to loans our total commercial lending portfolio increased by $979 million, which includes $1.1 billion in PPP loans. More specifically, the commercial and business loan portfolio, excluding PPP loans declined by $184 million, while commercial real estate lending grew $38 million. The primary driver of the decline in commercial lending balances was lower utilization of revolving credit lines, which decreased to 33% from 42%, resulting in a decline of $234 million in loan balances during the quarter. If line utilization would have been maintained at historical levels, commercial loan growth would have been approximately $88 million for the quarter. We continued to see run-off in our remaining portfolios, as the agricultural portfolio declined to $29 million and residential and consumer loans decreased by a total of $77 million from the linked quarter. Next, I will provide an overview of our participation in the Paycheck Protection Program. Heartland is proud to have helped thousands of small businesses obtain PPP loans. In total, we processed more than 4,800 PPP loans for $1.2 billion and helped preserve more than 112,000 jobs.

Turning to credit, we continued to see stable credit quality. Our non-performing loans represented 1% of total loans at the end of the second quarter, which is a small increase when compared to 95 basis points at the end of the linked quarter. Overall, non-performing assets as a percent of total assets increased slightly to 66 basis points in the second quarter compared to 64 basis points in the linked quarter. Excluding PPP, non-performing assets were 71 basis points. Other real estate decreased to $5.5 million from $6 million over the same period. Excluding PPP, the delinquency ratio decreased to 26 basis points from 38 basis points in the linked quarter. Non-pass rated loans increased to 8.5% from 6.4% in the linked quarter, excluding PPP. The ratio remains at historically low levels. However, we are starting to see a shift in the risk ratings due to the pandemic.

Lastly, net charge-offs for the second quarter were reported at $2.4 million or 12 basis points, excluding PPP. That’s lower than the previous quarter number of $5 million or 24 basis points. We’ve made loan modifications on $1.1 billion of loans in our portfolio. 58% of these are interest-only for 90 days and the remainder, are primarily principal and interest deferments for 90 days. Through close collaboration and consultation with our customers, as of July 23, we have returned $348 million to their original payment structure. We are taking proactive steps to prepare for the future and help our customers stabilize their positions. Based on regular conversations with customers, we expect that 70% of the remaining loan modifications will end in the third quarter. We anticipate less than 30% of the balances will require additional support through further modifications. We have posted a presentation on our Investor Relations website that provides further details on loan modifications and exposure in COVID-impacted industries.

The allowance for credit losses on loans increased $22.6 million, $11.6 million of which relates to a sand fracking company that operates in an industry that's been negatively impacted by the pandemic. We do not have any additional exposure in the fracking industry. We recognize that communication, collaboration and counsel with our customers is more important than ever in these challenging times. We have tripled the resources in our Special Assets Group to help them navigate a path forward. We have also added experienced leadership and recently announced that Nathan Jones who joined Heartland as our new Chief Credit Officer, Nathan brings 20 years of proven experience in managing large scale credit and banking operations.

As Lynn mentioned earlier, we continue to seek strategic M&A opportunities that are good geographic and cultural fits in growth markets. In June, we announced that Arizona Bank & Trust entered into a purchase agreement with Johnson Bank for four banking centers in the Phoenix market. Upon the targeted close in December, Arizona Bank & Trust will have approximately $1.1 billion in assets and be Heartland's ninth bank with more than $1 billion in assets. The AIM acquisition is targeted to close in the third quarter and complete the system integration in the fourth quarter. AimBank, combined with First Bank will create Heartland's largest bank with approximately $3 billion in assets. The investments we made in Operation Customer Compass in 2019 allowed us to quickly shift operations to meet changing customer needs. We recently completed the implementation of our new commercial online banking platform and now have half of our banks using our new loan origination platform and the Salesforce CRM solution.

Based upon our proven success of implementing best-in-class technology, streamlining processes, increasing capacity and improving operations to provide enhanced customer experiences, all while achieving an all-time low efficiency ratio, we continue to make strategic investments in Operation Customer Compass. In 2020, we will upgrade our entire ATM network, which we expect to finish early this fall, modernize and consolidate our lock box operations, implement enhanced authentication measures across our digital channels to protect our customers from fraud, and implement video banking solutions and other digital-first programs that allow our bankers to meet with and service our customers virtually and build convenient temporary customer experiences.

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

Bryan McKeag

Thanks, Bruce and good afternoon. I will begin today by referencing the press release, which shows reported earnings per share of $0.82 this quarter. This includes provisions for credit losses of $26.8 million and acquisition integration costs of $700,000. Excluding these items, Heartland's after-tax, pre-provision and acquisition, and integration costs earnings per share was $1.40. For the quarter, one additional significant item of note was a $1.2 billion of PPP loans originated during the quarter, which produced $6 million of interest and fee income and added $0.13 to earnings per share. So again this quarter, core 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 $26.8 million, with approximately $6 million of the provision attributed to the continued deterioration in the economic forecast since the prior quarter. Provisions to increase reserves on individually assessed impaired loans totaled $12 million largely related to one fracking sand credit, as Bruce mentioned. The remaining provision of $9 million is attributed to loan downgrades and balanced changes within the portfolios. In total, the quarterly provision, net of $2.4 million in net charge-offs resulted in a reserve build during the quarter of just over $24 million, which represents a 22% increase from the prior quarter reserves.

At quarter end, the allowance for credit losses on loans was $119.9 million or 1.3% of total loans, and the allowance for credit losses on unfunded loan commitments was $17.4 million or 19 basis points of total loans. Together, these two allowances result in a total allowance for lending-related credit losses of $137.3 million or 1.49% of total loans. When the PPP loan balances are excluded, total allowance for lending-related credit losses increases 20 basis points to 1.69% of loans. We used the June 14 consensus macroeconomic baseline forecast from Moody’s as our most likely economic scenario. As the economy outlook continues to evolve and our pandemic-related loss profiles and experience develops, we will adjust our allowance for lending, losses and provisioning accordingly.

Moving on to the rest of the balance sheet, total assets grew $1.7 billion, ending the quarter just over $15 billion with a loan-to-deposit ratio of 73% Tangible common equity ratio declined 40 basis points to 7.89% from 8.29% last quarter, as increases from retained earnings and the fair value marks on the bond portfolio were more than offset by the impact of a $1.7 billion increase in assets. That increase in assets was driven by the addition of $1.1 billion in net PPP loans and a $600 million increase in the bond portfolio. Excluding the impact of the PPP loans, the ratio would have increased 62 basis points to 8.51%. In addition, on June 26, we issued $115 million of preferred stock, which will ensure that our capital – regulatory capital ratios will remain strong after the closing of the AIM transaction that will trigger The Collins Amendment to the Sarbanes-Oxley legislation, resulting in $145 million of TRUPS losing Tier 1 capital treatment. Investments also grew $637 million this quarter and comprised 28% of assets, with a tax equivalent yield of 2.91% a duration of just under 6 years and generate $37 million of average monthly cash flow. Total borrowings remained low at $395 million or 2.6% of assets. At June 30, our banking network had approximately $4.7 billion of unused borrowing capacity. So Heartland's balance sheet is very strong with solid capital base, healthy loss reserves, ample liquidity and low leverage, all of which puts Heartland in great position to successfully navigate through the turbulent economic times ahead.

Moving to the income statement, net interest income totaled $124.1 million this quarter or $11.6 million higher than the prior quarter and includes the $6 million of interest and fee income on PPP loans. The net interest margin on a tax equivalent basis this quarter was 3.85% or 1 basis point higher than last quarter and includes a decline of 43 basis points in loan yield which was largely due to the low yield on the PPP loans. The lower loan yields were offset by much lower interest costs on deposits and borrowings, which decreased 48 basis points compared to last quarter. The PPP loan interest income and fee income of $6 million [ph] on average balances of $916 million results in a yield of 2.64%, which lowered this quarter's net interest margin by 10 basis points. This quarter, the net interest margin includes 16 basis points of purchase accounting accretion, compared to 9 basis points in the prior quarter. So as a result, the margin excluding purchase accounting and PPP loans was 3.79%, which is 4 basis points higher than last quarter. Non-interest income totaled $30.6 million for the quarter, up $4.8 million from last quarter as the gain on sale of loans was up $3.2 million on higher mortgage loan activity, and total security gains increased $1.3 million compared to last quarter.

Moving to non-interest expense, non-interest expenses continued to be well managed, totaling $90.4 million this quarter, down $400,000 compared to last quarter. On a core run rate basis, which excludes acquisition, integration and restructuring costs, tax credit costs and asset gains and losses, core run rate costs decreased $1 million to $88.3 million compared to $89.3 million last quarter. More specifically, salary and benefits were flat at approximately $50 million, again this quarter, and occupancy, furniture and equipment costs totaling $90.5 million also remained flat this quarter. These categories account for two-thirds of our core costs and have been at this level for the past nine quarters. In addition, FTEs of 1,821 also remained flat this quarter, and over the last nine quarters have declined by 395 or 18% from a peak of 2,216 FTEs in the second quarter of 2018.

During that same period, assets have increased $3.7 billion or 33%. These results demonstrate the leverage and increased productivity we have achieved as we worked to restructure the company, trimmed our branch network and implemented the many Customer Compass Productivity improvements we identified over the past 2 years, all while continuing the company's significant growth. As a result, the efficiency ratio, as Lynn and Bruce mentioned, improved significantly this quarter, coming in at 55.75% for the quarter, which is an over 600 basis points improvement from last quarter and over 800 basis points better than the same quarter last year. The effective tax rate for the quarter was 19.75% compared to 22.77% last quarter, with the decline being primarily due to higher tax credits recognized this quarter.

Now with regard to upcoming M&A activities, the AimBank acquisition which was due to close in Q3 will have the following impacts. First, loans held to maturity will increase about $1.1 billion, net of an estimated loan mark in the 3% to 3.5% range, and investments should increase about $400 million. Total deposits will increase nearly $1.6 million – billion with approximately $500 million in non-interest bearing accounts. AIM carries a net interest margin of 4% – in the 4% range, as core non-interest income run rate of approximately $2 million per quarter net of Durbin and the non-interest expense run rate before cost saves of $11 million to $12 million per quarter. Second, at closing, we will issue approximately 1.5 million shares of Heartland common stock. We are currently estimating goodwill of $60 million to $70 million and the core deposit intangible of $10 million to $15 million. These estimates could change once all the fair value marks are finalized and will primarily depend on Heartland's stock price at the closing date. Third, we expect integration and conversion costs will be near $3.5 million spread over the next two quarters, and with system conversion currently planned for mid-fourth quarter, we will not begin to realize the full benefit of the estimated 30% cost saves until the first quarter of 2021.

Finally, with regards to the acquisition of the four Johnson Bank branches in Arizona, which is expected to close and convert to our systems in early December, we are currently estimating that loans will increase by $150 million to $170 million and deposits will increase by $350 million to $400 million with 35% to 40% being in non-interest bearing accounts. We are currently estimating goodwill of $30 million to $35 million, and deposit and tangibles of $3 million to $5 million. Non-interest income run rate is expected to be $300,000 to $400,000 per month and non-interest expense run rates are $500 million to $600 million per month. Integration and conversion costs will be between $1 million and $1.5 million and should be largely booked in the fourth quarter of 2020.

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

Bruce Lee

We will now take questions.

Question-and-Answer Session

Operator

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

Jeff Rulis

Thanks. Good afternoon.

Bruce Lee

Hi, Jeff.

Bryan McKeag

Good afternoon, Jeff.

Jeff Rulis

Hi. I think, Bryan, thanks for the detail at the end there, you kind of rattled through it, I just wanted to confirm a couple of things. The AIM closing more specifically in the quarter, is it looking kind of early, mid, late on that one?

Bryan McKeag

I would say for you guys. I would probably not put much in for AIM this quarter. It might get – we might get a month, we might get a half a month, we will see. So I think you are really looking at a fourth quarter from a financial impact to your model. Does that helps?

Jeff Rulis

Sure. That does. And then I think you have rattled through the – I missed the Arizona branch contribution on non-interest income and non-interest expense, that was on a monthly basis?

Bryan McKeag

Yes. I did that on a monthly basis since we are closing in early December. So, if you want to you could pickup a month and that was for non-interest income, $300,000 to $400,000 per month and non-interest expense is $500,000 to $600,000 per month.

Jeff Rulis

Great. Okay, thanks. And I wanted to maybe circle back on the – what was it – the cost of funds and really the decline in that level pretty impressive. I guess, was there anything other kind of one-time in there, or it was just sort of continued decline in borrowings and good success on lowering other core deposits? If you could just speak to that because I think that was a pretty big effort in the quarter?

Bruce Lee

Yes, Jeff, I would say that we were prepared. We had – our banks were ready for the Fed cut, so we acted very quickly. And we basically after the second cut, went to zero, really, the only thing that we are paying significant amounts of interest on right now are certificates of deposits.

Bryan McKeag

So we will come down over time as we are now offering – our new offering rates are much lower as well, so…

Bruce Lee

So there was nothing one-time in there at all. It was just quick action and preparation by our banks when the Fed cuts occurred and we did get the benefit of the loans hitting floors. That also helped which we have been talking about that for over a year.

Jeff Rulis

Yes. And then I guess just the outlook on margin, – thanks for AIM, AIM I think is on a core basis is a little higher. And you have got some flexibility there. But just on a core basis, what do you think you had from here?

Bryan McKeag

Yes, I think on the core, we should be able to keep it somewhere – where it is to maybe down to 3.75%. So you might see 4 basis point, 5 basis point and things are going to grind down as we go forward as loans continue to re-price and the bond portfolio, as that cash flow has to get reinvested is going to grind it down somewhat. So I think next quarter if you saw 3.75% core and then you had PPP and you had the purchase accounting, you might be at – come back to 3.80% or so for a reported NIM. And then AIM might help a little bit in the quarter, but it will help in the fourth quarter for sure. I haven't funded that altogether. It might help a tick or two given its relative size.

Jeff Rulis

Okay. And I guess it triggered one last question, just the timing on the PPP, I guess, what are you modeling for, I guess forgiveness, or what do you think you carry in the balance at the end of the year, any internal projections?

Bryan McKeag

Yes, it's really hard to project. I think our thoughts are – and Bruce you can jump in here, we probably see 90% to 95% should be forgiven. And I think that's going to be fourth – largely a fourth quarter, maybe some into the first quarter of 2021 event. We might get a few in the third quarter, but I think it's going to be largely fourth quarter and then some into the first quarter before we get them all done. So I think that's the most we know right now.

Jeff Rulis

Okay, thanks for all the detail.

Operator

Your next question comes from Terry McEvoy from Stephens. Your line is open.

Terry McEvoy

Good afternoon, everybody.

Bruce Lee

Hi, Terry.

Bryan McKeag

Hi, Terry.

Terry McEvoy

I was wondering if you could just talk about some regional differences across your franchise, specific to the COVID-19 portfolio. Bruce, in your prepared remarks, you talked about kind of an opening and then a closing in certain markets and I was just wondering from a high level, if you have noticed any regional differences?

Bruce Lee

Yes, great question Terry. I would say in the loan portfolio, we are really not seeing much of a regional difference at all, but certainly from consumer behaviors and our opening and kind of closing, we definitely saw that. We saw it in Texas, where we are operating with no lobbies open and we saw it in Arizona, where we also closed all of our lobbies there. We also closed some lobbies in Colorado, although they are still operating with, I believe, 10 of our branches there, the lobbies are also open. But we really have not seen it on the loan side. We really are seeing it more on the transaction in which branches are open.

Terry McEvoy

Thank you. And then as a follow-up, the reserve ratio increased again in the second quarter, the commentary right from the press release said, expect higher charge-offs and higher non-performing loans. So I guess was that – with that assumption, does that suggest additional reserve build in the third and the fourth quarter or was that captured here in the second quarter?

Bruce Lee

Yes. I would say – again, it's hard to gauge. But I think our reserve build is going to slow down and we are probably going to see charge-offs pick up a bit, and so we use up some of that reserve. I could see us covering charge-offs may be a little bit more in provisions. But hopefully, it really depends on what the economy is going to do if that lengthens out, and we have continuing lag of poor economic results, obviously the reserve won't be able to come down and we will have to maintain it even if we have charge-offs but I don’t think you’re going to see the size of builds that we had in the first two quarters, certainly, maybe a little bit in the third quarter, but after that if things go the way they should, we should see flat to – starting to use some of the reserve against losses that actually come, that we expected, as we dealt the reserve.

Terry McEvoy

Great. Thanks for taking my questions, and pretty impressive job by your guys lowering the deposit cost there. I’m sure that didn’t come to detail, so just wanted to know Jeff’s question earlier. Thank you.

Bruce Lee

Thanks, Terry.

Bryan McKeag

Thanks, Terry.

Operator

Your next question comes from Andrew Liesch from Piper Sandler. Your line is open.

Andrew Liesch

Good afternoon, everyone.

Bruce Lee

Hi, Andrew.

Andrew Liesch

Hi. On the mortgage side, the gain on sale, was that driven by improvement in the gain on sale premium or was it volume? What was the driver behind that?

Bryan McKeag

Yes. I think it was probably a little bit of both. We did have great volumes and because of the great volumes we were probably able to push our margins a little more. And so I think we did get both. So I mean the guys at PrimeWest really did a great job this quarter getting to that number. We are hoping they can keep that rolling. And we will see if the economy – if the housing market is as strong as it appears like everybody says it is going to be, we hope that will continue for another quarter, and then you will get the seasonal drop off I think like we would normally get.

Bruce Lee

Yes. They are seeing their – rate locks continue to be very strong and their margins, they have been able to really increase margins. So we feel that they are going to have another pretty strong quarter here in the third quarter.

Andrew Liesch

Got you. And then, did I hear you correctly that the shares issued for AimBank about $1.5 million, is that correct?

Bryan McKeag

Yes, Janet pointed out. I misread that, it's $5.1 million.

Andrew Liesch

Okay.

Bryan McKeag

I was reading through fast and got the numbers transposed. Sorry about that.

Andrew Liesch

Alright. I thought I had missed something that had gone on over the last few months, but okay. And then, if you just look at the deferrals and what your borrowers are telling you, and it sounds like a small portion of them will remain on deferral, or maybe need to more deferral period, but at what point do you think – that is when you start to see charge-offs right or criticized loans increase, is that going to be later this year and really what would trigger – you guys have started making – more downgrades in some of these loan types?

Bruce Lee

Yes, we are making downgrades as some of the borrowers are asking for additional support. So even if we make an additional 90-day modification, you will probably start to see downgrades, but when they would move into either charge-offs or non-accruals that would probably be after that next 90 days. So we really think that it is related a little bit to the reserve build on the question that Terry asked. It probably will depend a lot on what happens to those modifications and whether it's the 30% that we anticipate or whether it's better than that as to how that reserve build the curves.

Bryan McKeag

And the economy and how things open up or have to re-close is going to play a big – as you would guess will play a big – and that and then the government programs.

Bruce Lee

Yes, there is – it really depends on the stimulus package that they are talking about in Washington and who that supports.

Andrew Liesch

Right, right. Great. That covers all my questions. Thanks so much.

Bryan McKeag

Thanks.

Operator

Your next question comes from Damon DelMonte from KBW. Your line is open.

Damon DelMonte

Hi, good afternoon guys. How is everybody doing today?

Bryan McKeag

Good, Damon.

Bruce Lee

Great, Damon.

Damon DelMonte

Good to hear. So just a question on credit, a little bit, so part of the provision you said was for $11.6 million for a fracking-related credit. What was the size of the total credit?

Bruce Lee

About $14.5 million.

Damon DelMonte

Okay. Can you disclose where that was located?

Bryan McKeag

Yes, it's in the upper Midwest, it's where the sand, the white sands come from.

Damon DelMonte

Got you, okay. So you provided $11.6 million toward the $14.5 million. So pretty healthy reserve there, and you expect favorable resolution on this, are you guys kind of thinking that it's probably going to be charged-off next quarter?

Bryan McKeag

I think in the next two quarters it will resolve probably.

Bruce Lee

Yes. It happened very, very quickly at the end of last quarter. The loan was current and the market turned quickly and we are in negotiations, but are prepared to begin liquidating if necessary. So that is why we took the significant reserve. And I think it will definitely resolve itself before the end of the year. I would hate to say exactly which quarter.

Bryan McKeag

But I think it will well be a fairly sizable charge-off.

Bruce Lee

Right.

Damon DelMonte

Okay, alright. And then securities went up by a decent amount this quarter, can you just give a little perspective on the thought process there?

Bryan McKeag

Yes. I mean we just have so much liquidity, Damon, with the deposits growing the way they did and we grew – the PPP money came and moved over to deposits primarily, and then we grew an additional $400 million, $500 million past that. And we were liquid already. So yes, Zack had a lot of money to put to work as Treasurer of the company. And so we tried to get that, yet still stay liquid because money could flow the other way fairly quickly depending upon how the economy goes. So it really was that. We just had a really great deposit quarter.

Bruce Lee

Yes. And Damon, there is one – couple other things that we were thinking about through this process is corporations, companies, businesses shrank their balance sheets, generated cash, paid down lines and then there is a whole bunch of cash on our balance sheet. We don't know what all the burn rates are there, plus if PPP starts to get forgiven, we are going to get all that cash back. So we are trying to be very conservative in our estimates right now. More liquid than we would normally be.

Damon DelMonte

Got you. Okay. And then, I guess, just lastly on expenses, Bryan, obviously you have couple of moving parts with the AIM deal closing and then later on with Arizona, but what are you thinking about for core expense run rate kind of going forward from here?

Bryan McKeag

Yes. If I were to say, I think our core is at $88 million today. I think it is going to be close to that and might get a little bit with AIM, may be one month at most – so you might get $2 million, $3 million added to that if they come in October – or September, sorry. Then the next quarter, I still think the core of Heartland is going to stay relatively flat at $88 million, but then you are going to add another $12 million probably on for AIM. So you could be at $100 million of core there and then may be one month of $0.5 million or so with the addition of Johnson branches. So you could be $100 million to $101 million. I think that is – so I think we can do maybe better than that, but that is what I would say is pretty reasonable for right now.

Bruce Lee

Don't forget the cost saves.

Bryan McKeag

Yes. And we'll get that in cost saves.

Bruce Lee

They will be in 2021.

Bryan McKeag

In 2021, the number that I quoted on the Johnson Banks' is net of the cost saves. Yes. Just because we are going to convert that on day one, so we should get any cost saves starting to kick in right away.

Damon DelMonte

Got it. Okay. So it's – so that $100 million to $101 million, it is kind of like for the fourth quarter. And then you kind of stepped it up, as you said $2 million to $3 million if AIM comes on in September, in the third quarter. Okay, alright. I think that's all that I had. Thank you very much for taking my questions.

Bruce Lee

Sure. Thanks, Damon.

Operator

Your next question comes from David Long from Raymond James. Your line is open.

David Long

Thank you. Good afternoon, everyone.

Bruce Lee

Hi, David.

Bryan McKeag

Hi.

David Long

Hi. Just looking at your affected – industries affected by the COVID-19 and I see lodging at little over 4% of loans, restaurant, bars, industries that may be impacted for an extended period of time. So my question is when you are talking about the deferrals and you have got 90-day deferrals out there, you have got another 90-day going, how do you foresee things playing out after you get to 180 days?

Bryan McKeag

Well, the first thing is where we have to get through the first 90-days, which we are not all the way through all of these borrowers because many of them are just coming off here in – they will come off in July and August for their first 90-days. And it really depends, I mean, they are all responding very differently. And that is honestly it's a little bit of the unknown, that we are going through this. And lodging, it depends the type of facility it is and where it's located, and if it's in any sort of a recreational area, we are seeing occupancies above breakeven. If it's in a kind of a downtown center that was more business travel, I mean there is still struggling. So everyone is a little different and it also depends on the sponsor and the liquidity that they have. So I am not really sure I can give you as a group guidance there.

Bruce Lee

I mean, I do think David what we said in our comments, as, we would see may be a third left having to get kind of reupped for another 90 days. And then when you get to the end of that second 90-day we have to make if anybody still needs modifications, that is going to be a fairly hard discussion because I think then we will be into troubled debt restructuring territory and a lot of other things. So I think you are going to see a dwindling number now just the economy does not get better and support does not work whatever, then you got a whole different ballgame. Kind of what we think will happen now, based on the economic forecasts showing an improvement as we kind of move out of last half of the year, that's kind of our general thought right now.

David Long

Okay. As a follow-up, have you had discussions with the regulators at this point about how you would be treating those from an accounting perspective after the 180 days? Assuming just thinking worst case scenario, and you had some of that, have to go pass that if you had discussions on how that would be accounted for, or is that still to be determined?

Bryan McKeag

We have not talked to the regulators. I know when we have talked to our accountants, KPMG, we kind of think when we get past 180 days, we are going to have to do an assessment for TDRs from a GAAP perspective. Now whether the regulators will give us any different treatment from regulatory, I haven't heard anything different. But, I think for accounting purposes, after 180 days, we are going to have to – anything that's still being modified it's going to have to go through a TDR review.

David Long

Got it. Thanks for the color. Appreciate it.

Operator

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

Lynn Fuller

Thanks, Ashley. In closing, once again, we were very pleased with our financial performance for the second quarter. Our staff just did a great job, providing a lifeline to more than 4,800 small business customers by processing $1.2 billion in PPP loans. We showed substantial growth of $1.6

billion in non-time deposits, while at the same time, doing a great job, maintaining our net interest margin at 3.85%. We were very pleased with our lowest ever efficiency ratio at 55.75% for the quarter and 58.64% year-to-date. Our balance sheet is extremely liquid and credit issues remain relatively benign. We issued $115 million of perpetual preferred to bolster our Tier 1 capital with all other capital ratios remaining strong. And under CECL, we continue to significantly build our reserves for loan losses, while at the same time, on a tax-affected pre-provision, acquisition, integration and restructuring cost basis, most of our financial performance metrics are as good or better than this quarter last year. And last, we are very excited to welcome our new merger partners AimBank of West Texas in the third quarter and the four Johnson Bank branches in Phoenix, Arizona in early December. So I would like to thank everyone for joining us today and hope you can all join us again for our next quarterly conference call in late October 2020. Have a great evening everyone.

Operator

Ladies and gentlemen, this concludes today’s conference call. Thank you for participating. You may now disconnect.