Premier Financial Corp.

Q2 2021 Earnings Conference Call

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CORPORATE PARTICIPANTS

Tera Murphy – *Vice President, Corporate Communications Manager*

Gary Small – *President and Chief Executive Officer*

Paul Nungester – *Executive Vice President and Chief Financial Officer*

Matt Garrity – *Executive Vice President, Chief Lending Officer and Head of Residential Lending*

PRESENTATION

Operator
Good day and welcome to the Premier Financial Corp.'s Second Quarter 2021 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded. I'd now like to turn the conference over to Tera Murphy, Vice President of Corporate Communications. Please go ahead.

Tera Murphy
Thank you. Good morning, everyone, and thank you for joining us for today's second quarter 2021 earnings conference call. This call is also being webcast and the audio replay will be available at the Premier Financial Corp. website at premierfincorp.com.

Following leadership's prepared comments on the company's strategy and performance, they will be available to take your questions. Before we begin, I'd like to remind you that during the conference call today, including during the question-and-answer period, you may hear forward-looking statements related to future financial results and business operations for Premier Financial Corp. Actual results may differ materially from current management forecasts and projections as a result of factors over which the company has no control. Information on these risk factors and additional information on forward-looking statements are included in the news release and in the company's reports on file with the Securities and Exchange Commission.

Now I'll turn the call over to Mr. Small for his comments.

Gary Small
Thank you, Tera, and good morning to all. We appreciate having you with us today. The Premier team delivered a strong performance in the second quarter. New business activity was very robust, cost and credit was managed well, and we're taking steps and making the necessary adjustments to deliver on the year we outlined back in January from a performance perspective.

Earnings came in at $31.4 million or $0.84 a share, generating a return on assets of 1.67% and over 19% on tangible capital. The quarter saw a continuation of many of the positive drivers we discussed in our first quarter call. In each of the five markets, state markets across our footprint, we are seeing a credit demand on the rise. All households are in strong shape, and the general economy is expanding.

New business production for all of our lending segments, commercial, consumer and residential real estate, are strong and we experienced linked quarter total loan growth of 3.6% when you exclude the PPP impact, with the commercial and consumer business growing over 4.4%, each of those numbers is on an annualized basis. Given the fact that the commercial line utilization continues to be at historically low levels, we were very pleased to turn the corner in Q2 on core loan growth. That was a bit sooner than we had anticipated and communicated last quarter. The loan portfolio quality remains very strong and the economic factors that shape our loan loss allowance, combined with the net recovery position that we're in for the year, have resulted in another meaningful release of loan loss reserves for the quarter that ended with a $3.9 million credit provision.

A robust expansion of our consumer activities is driving a double-digit growth in our consumer-related fees, so think debit cards, account fees, ATM fees and the like, and we continue to work hard to drive net interest income and maintain margin in this difficult rate environment. The continued strength of our clients' balance sheets are certainly creating excess liquidity for the organization. We, in turn, are driving growth in our securities portfolio; and we've taken some additional meaningful steps to reduce our balance sheet rate sensitivity and position it so that we would be favorably affected from a net interest income position going forward.

We managed to trim our core expenses and run rate from Q2 versus Q1, consistent with our commitments made on the first-quarter call, and we have actions in place that will provide additional benefits for upcoming quarters as well.

The residential mortgage business line story is the one with the most variation from our first quarter performance. Overall, residential loan generation remained at very strong levels for the quarter, right on target. However, pricing did tighten early in the quarter; and our focus turned to the better price construction business, which drove more of our actual production into the portfolio, less was sold than normal, more loans found their way into the portfolio.

This assisted in driving our net interest margin in a positive direction for the quarter. This obviously affected the mix between salable and portfolio loans with our salable percentage falling below 60% for the quarter, and that tempered our gain from a gain-on-sales perspective for the quarter. The retreat of the 10-year treasury rate over the course of the quarter also produced an unfavorable effect on our MSR valuation of close to $500,000. You might remember, it was about $5 million positive in the first quarter, so a lot of volatility between the linked quarters on that factor alone.

The pipeline at quarter end, combined with visibility we have as we look at July activity reflects a continuation of really good residential loan production. We've taken steps to improve our salable percentage, returning to targeted levels. Pricing has afforded us [the] best opportunity to jump back in that space; and while always competitive, we think we can compete comfortably as we had originally planned. Rates have stabilized, and our hedging costs are a little bit less going forward and more than norm than they were during the second quarter. We expect quarterly mortgage profitability to return to more typical levels over the remainder of the year with the unknown being the effect of the 10-year treasury rate volatility as that really does impact our MSR valuation. You may recall, as I said in the first quarter, a very, very large benefit; and we felt that was a full year benefit that was recognized in the first quarter and that we were likely to give some back, and we certainly did in the second quarter. But at current rates today, we are generally in line with our planning expectations that we had at the beginning of the year for where the 10-year would be. So it would be good to go relative to our overall plan if we stay put as we are. At this point, I'm going to turn it over to Paul, and we'll come back with some comments at the end with some guidance updates.

Paul Nungester
Thank you, Gary. Good morning, everyone. I'll review our second quarter and year-to-date results, starting with the balance sheet, which was relatively flat with deposits down slightly point to point. The mix declined a bit as businesses began using liquidity, but we did continue to reduce our all-in cost of funds, which fell five basis points to 0.26% this quarter.

For assets, we are pleased to report $45 million of loan growth this quarter, excluding PPP, led by commercial, which was up $36 million or 4.4% annualized. During 2Q, we also added $360 million of securities from our excess liquidity position until loans began to rebound in June. We remain focused on net interest income growth, and we'll continue to act prudently as loan and deposit trends dictate.

Next is the allowance, which decreased $3.4 million due to a provision credit for loans of $3.6 million and net recoveries of $244,000. This decrease is primarily related to a further improvement in economic forecasts, offset slightly by an increase in non-PPP balances plus a lack of charge-offs that helped expense by over $3 million. At June 30, our allowance coverage, excluding PPP loans and including acquisition marks, was 1.57%, down from 1.69% at 3/31, but still not back to pre-pandemic levels. Finishing the balance sheet is capital, where we ended 2Q with over $1 billion of equity with the increase primarily due to net earnings in excess of dividends. We also completed about $126,000 of share buybacks for $3.7 million in the quarter.

At June 30, our tangible equity ratio was 9.8%, excluding PPP loans, and our total risk-based capital was about 13.7%.

Next I'll turn to the income statement, starting with net interest income of $57 million, which is up 1% on a linked quarter basis. Excluding the impact of marks and PPP, our net interest margin was 3.20%, down from 3.25% in the first quarter. This is consistent with expectations given our focus on investing excess liquidity while awaiting loan growth.

NIM could possibly see a little more pressure, depending on how fast loan growth rebounds and whether or not deposits were to revert back to high growth. We also executed on a swap during 2Q that reduces our asset sensitivity and is expected to improve our net interest income by approximately $3 million annually. Noninterest income was $17.5 million for 2Q, which is down from prior quarter and prior year, primarily due to mortgage banking. Mortgage gains were $2.7 million in 2Q, which is down $3 million from 1Q and almost $9 million from second quarter 2020.

Matt will provide more color in a moment, but this was generally due to lower margins, as well as a decline in salable mix with total mortgage production meeting expectations. Additionally, we saw a retreat in the 10-year, which dropped from 1.74% at 3/31 to 1.45% at 6/30. So, we had to give back about $0.5 million of MSR valuation after the big $5.3 million recovery in 1Q when the 10-year spiked. Separately, we had a net $0.7 million security gains with $1.5 million of gain from where we took advantage of pricing to realize those gains and reinvest to generate higher income over the next three years.

This was offset by a $0.8 million loss related to our bank equities, which was down due to the market downturn for these in 2Q. Insurance commissions of $4.1 million are down from 1Q due to the $1.1 million of contingent commissions that are earned in the first quarter of each year; and last, other income included a $1.3 million nonrecurring settlement payment this quarter.

Next is expenses, which were $38.4 million, down 1% on a linked-quarter basis. As mentioned last quarter, we began addressing run rate items starting in the latter half of 2Q, which helped lead to the decline, but there are also some items such as costs related to ATM and debit card usage that have good guys up in revenues as seen by the strong performance in service fees. We still currently estimate full year expenses to end around $153 million, as previously noted.

Further, our year-to-date efficiency ratio remains below 50%, and we still expect 50% or better for the full year. Additionally, our second-quarter pre-tax pre-provision income was $36 million, which led to a strong 1.9% ROA for second quarter and 2.16% year-to-date.

Bottom line, we reported net income of $31 million or $0.84 per share for second quarter 2021, which is ahead of expectations due to the good guys in and provision and security gains, offset partly by lower mortgage banking income. That completes my financial review.

Now I'll turn the call over to Matt for a discussion of lending and credit. Matt...

Matt Garrity
Thanks, Paul. I'll be providing an update on our commercial and residential mortgage areas, as well as an update on asset quality. In our commercial business, we're encouraged by the increased levels of loan production and a return to balanced growth when excluding the impact of PPP during the second quarter. Commercial loan production increased approximately 19% when comparing the second quarter of 2021 to the first quarter of 2021, and we're encouraged by the pace of lending activity as we exited the quarter and head into the second half of the year. We're also encouraged by our improvement in C&I originations, which has been a focus for us. C&I originations as a percentage of total originations were 35.6% in the second quarter as we continue to build this segment of our business. In terms of balance growth, we delivered growth at an annualized rate of 4.4%, exclusive of PPP.

While this level of growth is less than our historical performance, it's a solid improvement over the first quarter of 2021; and we believe it is a precursor for more normalized growth during the second half of this year. For the remainder of the year, we foresee increasing levels of loan production and balance growth, reflective of the increased activity in our markets.

In our residential mortgage business, we were pleased with our overall level of loan production in light of the operating environment. While refinance activity has returned to more normalized levels across the industry, our construction firm business has helped provide a degree of buffer to the impact of lower refinance volume.

Mortgage banking gain on sales softened during the second quarter, as Paul mentioned, as we experienced a reduction in our mix of salable volume as well as continued margin compression, which we had mentioned on our call last quarter. At the industry level, we've experienced this race to the bottom during previous mortgage cycles; and it's a reflection of the overcapacity that has come into our industry over the past year. Overall, mortgage banking revenue for the first half of 2021 is running approximately 18% ahead of the first half of 2020, driven by the MSR valuation adjustments. Looking ahead, we expect the operating environment to be with us throughout the second half of the year, although we do expect to see improvement in salable mix in the coming quarters in comparison to 2Q. Long term, we believe our mortgage business is positioned for continued success, and it's a business line that we will continue to invest in and grow.

With respect to asset quality, our story for the second quarter remains largely consistent with prior quarters. We're very pleased with the overall performance of the portfolio. Nonperforming loan levels improved over 16% when comparing the second quarter of 2021 to the first quarter, and classified loan levels declined approximately 12% in the second quarter in comparison to the first quarter, and we have another quarter of net recoveries in the charge-off category.

We're also happy to report that the remaining COVID deferrals have largely returned to their scheduled payments. While we're pleased by the performance of the portfolio during what has been a challenging 18-month period, we remain focused on our portfolio and working proactively with our clients. I'd now like to turn the call over to Gary Small. Gary…

Gary Small
Thank you, Matt, and I'll quickly give you a few thoughts on guidance. From a loan balance perspective, we affirm our commitment to achieving our end of year loan growth targets that we

communicated back in January, and that would be roughly just north of 5% for the total portfolio and mid-single digits to mid-higher-single digits on the commercial book. While we may benefit from line utilization improvement by year end, we believe we can hit our targets regardless of that improvement. From a credit perspective, continued loan loss reserve recapture will be the theme for the day, although not nearly to the same extent, perhaps, as we saw in the first half.

We continue to expect net charge-offs for the full year to significantly outperform our initial expectations, consistent with what we expressed at the first quarter call. Noninterest income, we expect to achieve the original targets for the category as strength in the consumer deposit fees are helping to offset any potential shortfall, we may experience in mortgage banking.

Our balance sheet growth, $7.75 billion remains a reasonable expectation. The continuation of unemployment benefits in the enhanced childcare credit program, combined with some municipal dollars that are still on the way, are driving our net interest income up and our NIM down, but again, that's the right answer for us here in '21.

From a capital perspective, I just acknowledge that we are authorized well on the buyback stand; and I would expect to see more activity on that front as we move forward.

With that, operator, I'll turn it over for questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star (*) then one (1) on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*) then two (2). At this time, we will pause momentarily to assemble our roster. Our first question comes from Scott Siefers from Piper Sandler. Please go ahead.

Scott Siefers
Good morning guys. Thanks for taking the question. I guess first question is just on the tactics regarding the available for sale portfolio, just the overall securities build, so you've got a portfolio of about $1.3 billion now. I think, Paul, in your comments, you had noted that you've been increasing the size until loan growth resumed, and what are the plans for that $1.3 billion from here? Does it continue to grow? Or have we sort of leveled it out?

Paul Nungester
Yes. For the most part, Scott, it's leveled off. We're now back in the loan growth mode, having hit that, especially in June and for the quarter as a whole. So, our intent now going forward is generally to maintain that level at the securities book.

We'll always look for the right opportunities if we see something in there to maybe do some repositioning; but really, we plan on deploying our funds into the loan growth side. Now having said that if deposits were to skyrocket again like they did in the first quarter in excess of loans, then we'll look if we should put some more into securities or just park it temporarily for additional loans.

Gary Small
Scott, at this point, we've laddered the duration of that to match what we expect to be the loan growth so that we can comfortably move from one to the other as we know the environment now.

Scott Siefers
Okay. All right. Great. Thank you, and then just on mortgage and fee income. When you talk about going back to normal mortgage profitability in the second half, are you speaking dollars of revenues there? And I guess, if so, what does normal mortgage look like these days? And I guess [unintelligible] $2.6 million-ish base. So, we've just had such extraordinary swings over the course of the last year or so.

Matt Garrity
Good morning, Scott. This is Matt. I think for the second half of the year, you should pencil in your expectations between that $4 million and $5 million range on a quarterly basis in the second half.

Paul Nungester
For gains.

Matt Garrity
Yes.

Scott Siefers
Perfect. Excellent, and then just one final sort of ticky-tack question, you guys have the remaining under PPP fees and just sort of a thought on sort of cadence of how those get recognized?

Gary Small
Yes. So those are getting recognized now on an accelerated basis through the forgiveness program, right? So, at this point, things are moving a little quicker than we had originally anticipated for the round one staff that we originated last year in 2020 and high odds that if the rest of the $2 million because we saw a little movement start in the $2 million bucket-- if those were to continue, that could all be gone certainly by the end of the year; and then round two, which we just brought on here in the second quarter, we need to wait and see when that will start. It could start later this year. Most likely, we'll have some still trickle over in the next year; but in both cases, when we put them on, we have to amortize that fee over the duration, which in the case of the round two is five years, and then at the point of forgiveness, we can bring it all forward at that time.

Scott Siefers
Yes, and do you have the amount of the remaining unearned fee?

Paul Nungester
Yes, but I don't want to miss speak; I don't have it off the top of my head, so I can get that to you, Scott.

Scott Siefers
Okay.

Paul Nungester
Yes, we will be posting our normal quarterly investor deck here soon. It will probably be Monday or Tuesday, and it will be in there, so.

Scott Siefers
Okay. Perfect. Thank you, guys, very much.

Gary Small
Thank you, Scott.

Operator
Again, if you have a question, please press star (*) and then one (1). Our next question comes from Feddie Strickland from Janney Montgomery Scott. Please go ahead.

Feddie Strickland
Hi. Good morning.

Gary Small
Good morning.

Feddie Strickland
I was just wondering kind of a broader question. From your prepared comments, it sounds like things are going pretty well across your footprint. Now I was just wondering what you're hearing from your customers. Has there been any kind of incremental positive or negative in business sentiment lately?

Gary Small
No. I would say generally, this is Gary, and I'll have Matt provide color as well. It feels like 2019 with the addition of some commodity and the normal noise that you're hearing about distribution blockage, labor is the biggest constraint on activity going forward. There are full books of business and it's very, very active really across the industries, and the constraint is labor, and then if you're in a particular industry, like early in the year when construction costs were really spiked up for materials and so forth, there were some moderation there, but that's passed for the most part.

Feddie Strickland
Okay.

Matt Garrity
Yes, I would concur. This is Matt. I would say the labor and supply chain issues have impacted activity more in the first half of the year or the first quarter. I would say 2019 is a fair comparison. I think there's a lot of bottled-up demand over the past 12 to 18 months that we're starting to see come onto the plate now and our customers having conversations with our bankers about active expansion and a lot of deal activity. There's a lot of M&A activity going on as well. So, we're certainly encouraged for the second half of the year and really heading into next year.

Feddie Strickland
Got it; and then kind of along those same lines, do you expect that you could maybe see better core fees just like service charges and whatnot, just kind of as a natural outcropping of some of the improving economic activity?

Gary Small
Absolutely, and we've seen that trend now very steadily over the first six months, and while we might not be back to the starting point, we've certainly have every expectation that we're heading in that direction, and it's material. The difference between prior year and current year in that consumer fees, but they're activity-based fees and folks are out and about. Anything that goes on with this newest variation on COVID could have an impact on that; it’s a little too early to tell.

Feddie Strickland
Got it, all right, thanks so much for taking my questions.

Gary Small
Thank you.

Operator
Again, if you have a question, please press star (*) then one (1). Our next question comes from Tim Switzer from KBW. Please go ahead.

Tim Switzer
Hey good morning. This is Tim Switzer on for Mike Perito. I had one quick follow-up on mortgage if we go back to that real quick. If we kind of saw another increase in interest rates sometime in the second half of this year, would you expect mortgage fees to kind of go back towards these Q2 levels? Would you exclude anything like MSR changes? Or were there some other factors this quarter that won't repeat like the saleable volume?

Matt Garrity
Hi, good morning. This is Matt. I'll answer that by saying, no. Even with an increase in rates, we really feel like 2Q from a, call it, salable mix perspective and real gain on sale activity, is probably more of a low point for us this year. We've made some adjustments in our mix. We've been very disciplined on the pricing side of this because again, we've seen this story play out before, and we've made the strategic decision earlier in the quarter to put a little bit more in the portfolio. We like the outcome for us over a longer term there, but with some stabilization in the pricing in our adjustments, our salable mix is back to more to our expectations. To the extent where if there is a bump in price, I think we're still well positioned overall to deliver a better salable mix outcome and gain on sale outcome for the balance of the year. It would be an impact, certainly, but you shouldn't expect it to retreat back to Q2 levels.

Gary Small
Our business, in general, is a little bit more construction perm as a percentage of total business than our peers would be as much at times as 50%. That product is a great value to the client, and we price meaningfully differently higher than if you were out just doing purchase activity, but the value is there. So perhaps it's a little bit less of a price-sensitive position to be in because of the overall product that we offer. I think that helps support us with our pricing discipline.

Tim Switzer
Okay. Yes. That makes sense, and I mean what is kind of your typical salable percentage if you were under 60% this quarter, what is it normally?

Matt Garrity
Our expectation is to really break that 70% barrier. That's how we want our business model to be adjusted. So as Gary mentioned, Q2 we were south of that 60% number. So that was -- again, there was a lot of strategic decision around our choices, and we thought that putting in the portfolio was a better value for us long term; but with that said, we see our mix here again it's we're only about 30 days into the quarter, but with the adjustments we've made, we're running at our targets now and our expectations at salable. So, it's a fluid situation, but we're -- we feel like we're kind of dialed in where we want to be right now.

Tim Switzer
OK. Great, and I got one more on your buyback. You guys stepped up buyback a little bit in Q2 and talked about continuing the program. With your strong capital levels, is there room for an acceleration in the back half of the year? I'm trying to determine how hard you guys are going to push on this? And then is there kind of a target capital level you guys want to achieve?

Gary Small
I'll start with the latter question first. If you adjust it for PPP, we're running on our most key ratios close to if not over 10%, and if we were in the 9.25% or 9.1% to 9.25%, we'd be just fine. So, you can do the math on tangible capital as to how much we might be inclined to take off the top; but we've got substantial room relative to our authorization in what might be a second authorization if we run through this in due time. Paul?

Paul Nungester
Yes, in terms of the acceleration, certainly, obviously, market conditions permitting at current levels, it's attractive, but if things were to take off for whatever reason, then we've got our bumpers in place to manage accordingly.

Tim Switzer
Great. Thanks for the color.

Operator
The next question is a follow-up with Scott Siefers from Piper Sandler. Please go ahead.

Scott Siefers
Hey guys. Thanks. Gary, just curious to hear your thoughts on M&A sort of following on the capital discussion, a lot more activity nationwide and then some activity in your guys' backyard as well. So just curious to hear your updated thoughts?

Gary Small
Scott, through the first quarter, I would have said everybody is talking except the Midwest, and then in the second quarter, that cured itself. I think it's the normal discussion flow that we would have been expecting in a normal 2018, 2019 environment. It feels like it's a lot more because last year, there was zero; but it's your normal discussions. I think the prompts are banks that are looking at a flattish revenue book even adjusted for PPP because of margin compression and so forth, some of the same old bugaboos, and we've got two years' worth of pent-up activity relative to that. So, there is more discussion than we were seeing in the first quarter, but it's a rational discussion. I think folks are doing what they should be doing as they do the strategic planning going forward.

Scott Siefers
Okay. All right, I think that officially covers it, so. Okay, good. Thank you.

Paul Nungester
Hey, Scott, welcome back to the call, this is Paul. I got your PPP numbers.

Scott Siefers
Terrific. Thank you very much.

Paul Nungester
Sure. At the end of June, we had a total of $9 million of unrecognized fees, but most of that's from round two. So, $1.750 million of that relates to round one, which is going through forgiveness right now. So, that's the potential that could still come in this year. Of that $400-ish million is related to those $2 million in over loans and that they're a little bit of a question mark.

Scott Siefers
Yes. Okay. Terrific. That's exactly what I need. So, thank you for following up on that.

Paul Nungester
No problem.

Operator
There are no more questions in the queue. This concludes our question-and-answer session. I would like to turn the conference back over to Tera Murphy for any closing remarks.

CONCLUSION

Tera Murphy
Thank you and thank you for joining us today as we discussed our quarterly results. We appreciate your time and interest in Premier Financial Corp. Have a great day.

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