Byline Bancorp, Inc.

2Q 2017 Earnings Conference Call

July 28, 2017 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Allyson Pooley - *Financial Profiles*

Alberto Paracchini - *President and Chief Executive Officer*

Lindsay Corby - *Chief Financial Officer*

Tim Hadro - *Chief Credit Officer*

PRESENTATION

Operator
Good day, and welcome to the Byline Bancorp, Inc. Second Quarter 2017 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.

After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your telephone keypad. To withdraw your question, please press start then two, and please note, this event is being recorded.

I would now like to turn the conference over to Allyson Pooley of Financial Profiles. Please go ahead.

Allyson Pooley
Thank you, Nicole. Good morning, everyone, and thank you for joining us today for Byline Bancorp's Second Quarter 2017 Earnings Call. Joining us from Byline's management team are Alberto Paracchini, President and Chief Executive Officer; Lindsay Corby, Chief Financial Officer; and Tim Hadro, Chief Credit Officer is also with us and will be available for the Q&A session.

We will be using a slide presentation as part of our discussion this morning. If you haven't done so already, please visit the Events and Presentations page of Byline's Investor Relations website to download a copy of the presentation. Alberto and Lindsay will discuss the second quarter results, and then we will open the call for questions.

Before we begin, I'd like to remind you that this conference call contains forward-looking statements with respect to the future performance and financial condition of Byline Bancorp that involve risks and uncertainties. Various factors could cause actual results to be materially different from any future results expressed or implied by such forward-looking statements. These factors are discussed in the company's SEC filings which are available on the company's website. The company disclaims any obligation to update any forward-looking statements made during the call.

Additionally, management may refer to non-GAAP measures which are intended to supplement, but not substitute, for those most directly comparable GAAP measures. The press release available on the website contains the financial and other quantitative information to be discussed today as well as the reconciliation of the GAAP to the non-GAAP measures.

With that, I'd like to turn the call over to Alberto.

Alberto Paracchini
Great. Thank you, Allyson, and welcome to our second quarter earnings call, the first one for us as a public company. Before I get into the slide deck, I'd like to start by thanking you for participating in the call today. We've had the opportunity to meet and get to know many of you during the IPO process, and we look forward to working for you and our stockholders in the quarters and years ahead.

I would also like to take a moment to thank our customers for allowing us to earn their business on a daily basis and also thank our employees for their hard work and dedication to the company. We would not be at this point in our journey without their commitment to our company.

Now moving on to Page 3 of the deck. Since this is our first call as a public company, I'm going to begin by providing a brief overview of Byline. We are a commercial bank with over a 100-year history. The current management and our board assumed control of the company after recapitalizing it in 2013 in what was at the time the largest recap of a bank in Chicago in over 25 years.

With $3.4 billion in assets, today we are the largest community bank by deposits and branches in the city of Chicago. We're a new public company having successfully launched and priced our IPO at the end of the second quarter.

We have a diversified loan portfolio with a commercial orientation, as you can see in the lower left-hand side of this slide, and have a very attractive deposit base that has a significant proportion of non-interest bearing deposits, a high concentration of core accounts, and an attractive funding cost. Our capital levels are very strong, and our profitability continues to improve as shown by our return on average assets of 75 basis points and an efficiency ratio that stands at 66% as of the end of the quarter.

Moving over to Slide 4, our franchise consists of four distinct business lines. Our retail banking business provides funding to all of our lending activities and has 57 branch locations serving the needs of small businesses and consumers within our footprint. Next, our commercial banking business serves business owners, middle market clients, and well-capitalized sponsors. The business consists of commercial banking, commercial real estate, sponsor finance, and treasury management.

Our small business capital unit originates and services government guaranteed loans throughout the Midwest and other selected states in the country. It is the sixth most active SBA lender in the US and the number one lender in the states of Illinois and Wisconsin. This is a highly specialized business focused solely on government guaranteed lending. Lastly, our small ticket leasing business provides vendor financing programs and solutions in industry verticals such as healthcare, manufacturing, and energy efficiency.

Moving over to the next slide, our growth strategy is fairly simple. First, we want to continue to grow our business organically and expand our product capabilities. We have room to further increase share and are not constrained by over concentrations in any particular loan category.

Second, we feel our culture, platform, and the opportunity we offer will allow us to continue to attract talented bankers and teams to our platform that will drive incremental growth. Third, we'd like to deploy more of our liquidity into loans via selective acquisitions of portfolios or niche businesses. Lastly, we want to be in a position to participate in what we believe will be additional consolidation in the marketplace.

Now, turning over to the highlights for the second quarter. As far as earnings were concerned, we had net income of $6.1 million, which represents an increase of 136% from the prior year. As previously disclosed at the time of our IPO and our subsequent 8-K, we completed an early repurchase of our series A preferred stock. EPS for the quarter, excluding the impact of the series A preferred repurchase, came in at $0.24 a share including the one-time impact of the preferred repurchase EPS for the quarter was a loss of $0.18 a share.

ROA was 75 basis points for the quarter compared to 80 basis points last quarter, reflecting a slightly higher provision expense. Our pre-tax pre-provision ROA came in at 168 basis points, which was 9 basis points higher than the previous quarter.

In terms of revenue, our net interest margin was steady for the quarter at 4.02%, and non-interest income was up 7.2% from last quarter driven by strong gain on sale income from our small business capital unit. Loan production for the quarter was strong and came in at $155 million. Loan pipelines remained healthy, and we continue to add talented bankers to the company. During the second quarter, we added one CNI team and one banker in our commercial real estate group.

From a balance sheet perspective, loans increased by $5.5 million and were impacted by a higher level of unexpected runoff during the quarter. Deposits and deposit costs remain stable, and we saw a favorable shift in mix with non-interest bearing DDA replacing runoff in our CD portfolio. We've worked hard on becoming more efficient over the last year, and that's reflected in our efficiency ratio of 66% for the quarter.

From a credit quality perspective, we had provision expense of $3.5 million and net charge-offs of 26 basis points for the quarter. Our allowance to loans at the end of the quarter increased to 65 basis points.

For a more detailed review of our performance for the quarter, I'd like to pass the call over to Lindsay.

Lindsay Corby
Thank you, Alberto. Good morning, everyone. We are excited about the progress we have made and the trends we are seeing in our financials as outlined on Page 7. I'd like to highlight a few metrics in addition to what Alberto has previously covered.

The loans and leases as a percent of deposits continues to be an area of focus for us showing a small increase this quarter to 84.87% versus 74% a year ago. Our tangible common equity ratio was 11.16% as of the second quarter providing ample capital to support our growth strategies as outlined by Alberto. We continue to show improvements in our key performance ratios which we will expand upon in the upcoming pages.

Turning to our balance sheet. We'll start with our diversified loan and lease portfolio on Slide 8. Our total loans and leases were $2.15 billion at June 30th, an increase of approximately $6 million from the end of the prior quarter.

As Alberto mentioned, the new production was largely offset by a higher level of runoff in the portfolio as the result of several commercial real estate construction projects that stabilized and prepaid prior to final maturity, the refinancing of syndicated credits that we opted not to participate in renewing, and a single commercial loan. The growth in our originated portfolio and lease portfolio was primarily driven by increases in commercial, government guaranteed lending, and small ticket equipment leases.

Looking at our total deposits on Slide 9, they were down during the quarter. Although, we saw an improvement in our overall mix. Total deposits were $2.5 billion at June 30th compared with $2.6 billion at the end of the prior quarter. We experienced a favorable shift in mix with non-interest bearing demand deposits increasing by $49.4 million primarily due to an increase in business accounts, which included a commercial relationship of $28.3 million that was later utilized to finance the transaction.

This was partially offset by a decline in interest-bearing deposits due to the seasonal decrease of a municipal deposit relationship and the runoff of time deposits added through the Ridgestone acquisition. Overall, deposit composition remained stable with core deposits at 84.9% of total deposits.

I'll start on Slide 10 with a discussion of our net interest income and margin. Our net interest income increased $300,000 from the prior quarter to $29.8 million and $9.4 million or 46% compared to the prior year.

Compared to the prior quarter, the second quarter benefited from a higher level of accretion income and the impact of rising rates. Compared to the prior year, the increase was driven by higher balances and accretion resulting from the Ridgestone acquisition as well as the positive impact of rates.

Our net interest margin for the second quarter of 2017 was 4.02%, a 2 basis point increase from the first quarter of 2017. The second quarter margin benefited from the higher earning asset yields resulting from the increase in accretion income and higher rates offset by an increase in the cost of interest-bearing liabilities.

Within the various assets and liabilities, we had an increase of 33 basis points on cash at other financial institutions due to the increase in the Fed Funds rates. This was partially offset by an increase in Federal Home Loan Bank advances of 48 basis points due to increased expense related to swap transactions. We also had a decrease in other borrowings of 43 basis points.

The loan accretion income contributed 23 basis points in the first quarter and 33 basis points in the second quarter. As our interest-earning asset mix continues to change, the yield on the earning assets will continue to expand. Our overall cost of deposits was 30 basis points in the second quarter, up 6 basis points from the prior quarter.

The increase in deposit cost is attributed to the time deposit category. As our CDs mature and renew at higher rates with the stronger loan production we anticipate for the second half of the year, we have chosen to get in front of rate increases for our CD balances as part of our liquidity and interest rate risk management strategies.

As the CDs acquired from Ridgestone mature, we are also seeing a decline in the purchase accounting benefit to our cost of deposits. Excluding the impact of fair value adjustments, our cost of time deposits increased 7 basis points during the quarter. We anticipate another drop in the fair value accounting adjustment benefit on our time deposits in the third quarter, although not to the same degree as we experienced in the second quarter.

Turning to Slide 11 and our non-interest income. Compared to the prior quarter, our non-interest income was up 7.2% to $13.2 million. We saw increases across our major fee generating areas consistent with the seasonal pickup that we typically see during the second quarter. Gains on sale of loans continues to be stable and increased by $363,000 since the previous quarter primarily due to higher net premiums.

Moving to Slide 12, let’s look at our non-interest expense. At $29.2 million, our non-interest expense increased by 1% from the last quarter. Within our specific expense items, the most notable variance was an increase in salaries and benefits expense, which was partially related to the addition of the new commercial banking professionals Alberto discussed.

This was partially offset by a decrease in professional fees which was related to our IPO preparation. On a year-over-year basis, you can see the results of our efforts to better leverage our infrastructure. Compared to the second quarter of 2016, our total revenues increased by more than 60% while our non-interest expenses increased just 28%. As a result, we continue to see a steady improvement in our efficiency ratio which improved to 66.2% from 67.1% last quarter and 83% in the same period last year.

Turning to Slide 13, we’ll take a look at asset quality. Provision expense for the second quarter was $3.5 million, which was $1.6 million higher than the first quarter. The increase in the provision for this quarter was impacted by the periodic re-evaluation of cash flows done on our acquired credit impaired portfolios.

We recognized deteriorations and expected cash flows on the acquired credit impaired loans immediately through provision expense while improvement to cash flows are recognized prospectively over the life of the loan. During the second quarter, $1.6 million of our provision expense represented net deterioration in our acquired impaired portfolio while we were able to reclassify $11.8 million from non-accretable to accretable yield that could be recognized over the life of the portfolio.

Our net charge-offs were $1.4 million or 26 basis points of average loans and leases for the quarter or 22 basis points year to date. The allowance for loan and lease losses was 65 basis points at June 30th, up 10 basis points from last quarter.

In addition to the traditional allowance as a percent of loan and lease metrics, we also analyze the allowance in conjunction with the acquisition accounting adjustments impacting the acquired portfolios. That balance was $37.7 million as of the quarter-end.

NPLs remain low at 76 basis points, but increased by $7.4 million during the quarter. The increase was primarily due to a government guaranteed loan carrying an 80% guaranty and a well-secured commercial loan.

With that, I will turn it back to Alberto for closing remarks.

Alberto Paracchini
Thank you, Lindsay. In closing, we believe it's an exciting time for us at Byline. Our franchise is characterized by a strong position in our primary market, a seasoned team and board of directors, a high quality deposit base, a diversified and growing commercial business, a disciplined credit culture, and a simple growth strategy.

With that, I would like to thank you for your time this morning, and now I will open up the line 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 on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star then two.

Our first question comes from Ebrahim Poonawala of Bank of America Merrill Lynch. Please go ahead.

Ebrahim Poonawala
Good morning, guys.

Alberto Paracchini
Good morning, EB.

Ebrahim Poonawala
Just wanted to first sort of get a better sense of the loan payoffs during the quarter, one in terms of what drove these payoffs. Obviously, it feels like it was a little bit of a surprise in terms of the magnitude of the payoffs, so would love to get your thoughts around what drove this, what is the impact from the interest rates or something else going on in the market, and how you see payoffs trending as we think about the back half of the year.

Alberto Paracchini
Sure. I would say, EB, we were a bit surprised in a way in the sense that I think the part that was more surprising is just the confluence of factors that kind of aggregated a lot of activity. It seems like throughout the first—after January, we saw activity pick up in February, March, and certainly continued a bit further more in the second quarter.

But I'll give you a couple of examples. For example, we had some in our real estate portfolio, and this is simply just a function of good loans, good construction loans that reached stabilization, and essentially the client opted to secure longer term financing a little bit earlier than we anticipated. And that happened on two projects that were very much along similar timelines in terms of construction. They both stabilized.

These were two student housing projects. They both stabilized right around at the same time, and I think with the dip in rates, the client opted to secure financing on a long-term basis. And therefore, we got paid off a bit earlier.

Other activity that we saw, for example, on our syndicated loan book, there was a fair amount of refinancing activity, and in some cases, we were fine with it in the sense that we decided to stay in the transaction. And others the levels at which the transactions priced were just simply not attractive, so we opted to pass.

Lastly, we had a loan that we had done approximately three years ago as part of a trade that we did on our legacy portfolio to dispose of assets. That loan had been paying off steadily and essentially paid off in full just a bit earlier than we anticipated early on in the second quarter.

There's one thing to note here, and sometimes when you make good loans, good loans eventually paid off as we saw on those two construction projects. But I think the biggest surprise was just everything kind of happening at once. I can tell you that starting off in the third quarter we've seen payoff activity drop off considerably, so we certainly are not expecting the same level of runoff that we saw in the first and second quarter.

Hopefully that answered your question, EB.

Ebrahim Poonawala
No, that was good color. I guess if you think about it, and I know it's difficult to predict what payoffs will be, but assuming they are originating somewhere around what we did in the second quarter, what's the reasonable net loan growth that we should think about as we think about this year? And generally, as you think about what Byline should be growing given the team that you just brought on board, and if you have any plans to hire additional bankers through the next few months.

Alberto Paracchini
I'll take the latter part of your question, EB, and then Lindsay will take the early part of the question. But as far as bankers and teams and pipelines, we continue to actively look for talented bankers to join our company.

We had additional success this quarter. We attracted a team of three bankers in our traditional commercial banking business. We also did a hire of one banker that joined our commercial real estate group.

In terms of new teams, it usually takes a little bit of time for that team to build a pipeline and start contributing in terms of outstandings to the portfolio, but they've hit the ground running. And certainly, we're starting to see the pipeline build; we're pretty excited about that.

We continue to talk to people in the marketplace, and as I said earlier in my remarks, we think we have a very attractive platform, a great culture, and we offer opportunities for people to be able to grow. We think that we'll continue to see that going forward.

Lindsay.

Lindsay Corby
Sure. Thank you. EB, it's pretty consistent with the guidance that we've previously given. We really want to stick to those estimates in terms of where we think we're going to end up. I don't think it's going to be really any different from the previous guidance, we see it as very robust right now for the second half of the year. And the payoffs obviously will be muted; I think it's pretty consistent with what we've previously disclosed.

Ebrahim Poonawala
Understood, and one last question, and then I'll hop off. But now that we're done with the IPO, you've got the cash and the capital in house, would love to get your around outlook for M&A and in terms of where you see the market around further expectations. Is it realistic to assume that there might be an opportunity over the coming months, I know it's always hard to predict, but to deploy some of that capital towards a whole bank deal?

Alberto Paracchini
EB, let me just comment on that. There's certainly a lot of conversations taking place in the market. I think that's been consistent now for some time. As you pointed out, the gestation period of these things, sometimes it can be shorter; sometimes it can be longer.

I think what I would say on there is we continue to talk to people. We think that again, now having a public currency, it certainly makes us a very competitive potential acquirer for other institutions, we feel good about where we are with respect to M&A. But first and foremost, we kind of focus on the things that we can control which is let's execute our organic strategies primarily and certainly be in a good position to participate and take advantage of opportunities as they surface in the market.

Ebrahim Poonawala
Alright. Thanks for taking my questions.

Alberto Paracchini
Thank you.

Operator
Our next question comes from Nathan Race of Piper Jaffray. Please go ahead.

Nathan Race
Good morning, everyone.

Lindsay Corby
Good morning, Nate.

Alberto Paracchini
Hi, Nate.

Nathan Race
Just wanted to start on the uptick in NPLs this quarter. It sounds like one of the credits was tied to an SBA deal, and can you just kind of provide any additional color on the other credit maybe in terms of geography, industry type, and if this was a credit that was previously on substandard or watch?

Alberto Paracchini

You want to take it, Tim?

Tim Hadro
Sure. To answer your first question, there's no common theme in terms of industry or geography. In terms of the individual credits, there were five credits which essentially account for the increase in NPL. Of the approximately $7.6 million total, $5.8 million is either covered by a government guarantee or in fact cash collateral for the principle, it's a high quality non-performing position.

We have as part of identifying; these were previously identified as concerning credits. During the quarter, we sat down and did the review. We determined that the deterioration had taken to the point where we need to carry them as non-performing loans. We also as part of our review set up the appropriate reserves, and in fact, subsequent to the quarter, one of the loans we expect it will return to performing status shortly.

Alberto Paracchini
Nate, does that answer the question?

Nathan Race
Yes, that's great color; I appreciate that, Tim. And then just kind of changing gears on the NIM looking forward, Lindsay, can you kind of just help us in terms of thinking about core loan yields and just the reported loan yields going forward? It sounds like purchase accounting accretion contributed to the uptick we saw in loan yields this quarter, so any commentary you can provide in terms of thinking about both loan yields and the margin particularly given that it sounds like you guys kind of increased your deposit price and score to try to get ahead of some competitive factors within your footprint.

Lindsay Corby
Sure. Loan yields, we expect that they'll continue to expand, Nate, in terms of the go forward, pretty consistent in terms of what we previously disclosed. Again, we haven't seen any real change there. The only difference as we talked about earlier was the accretion; we did have a slight uptick in terms of accretion just due to the fact that the portfolios were improving.

In terms of the NIM, we see it expanding, but it'll be offset by rising rates and cost of liabilities obviously. Again, consistent with previous disclosures that we've provided, and it's going to slowly expand through the cycle. We do have expectations of rising rates, and you can see an expansion of another 10 basis points approximately.

Alberto Paracchini
Yes, Nate. Just to add there in terms of how we think about interest rates going forward, we have just one 25 basis point increase in '17, 1 in '18, and 1 in '19. In aggregate, 75 basis points all the way through to '19 is kind of how we're modeling rates at this point.

Nathan Race
Understood, and then if I could just sneak one last one on SBA gain on sale revenue. Nice uptick this quarter in the 4% to 5% range, and it looks like gain on sale margins ticked up a little bit as well. Is it fair to expect this kind of build to persist near term or how should we be thinking about the pace of growth within the fee income as it relates to SBA revenue?

Alberto Paracchini
I think that's a good assumption, Nate. I think we saw, I mean so far as you saw in the results, I think it's fair to say that things are pretty stable in this space right now. Obviously, that can change, but we're not seeing anything that would jump out at us to change that view.

Nathan Race
Got it. I appreciate all the color, guys. Thank you.

Alberto Paracchini
Thank you very much, Nate.

Operator
Our next question comes from Michael Perito of KBW. Please go ahead.

Michael Perito
Hi. Good morning. Thanks for taking my question.

Alberto Paracchini
Good morning, Mike.

Lindsay Corby
Good morning, Mike.

Michael Perito
A few from me. Maybe just following up on the SBA question, I understand there's obviously the gain on sale and there's the piece that kind of I think is evenly split between CNI and CRE balances, but just maybe taking it from a broader perspective, I guess what do you guys think is kind of an overall realistic growth range annually for the small business capital unit at this point?

Alberto Paracchini
Sure. Mike, I think for the way we kind of think about that at this point is if you think about gross originations for that business and the current run rate right now, we did about $110 million in gross originations for the quarter. If you roughly speaking annualize that, take about 75% of that being the guaranteed portion, and then you have the remainder being the unguaranteed portion that we keep on the balance sheet today that should give you a pretty good sense in terms of growth and kind of where the business is at, at this point.

Michael Perito
Okay, I don't know if seasonality is the right word, but I mean is there any kind of choppiness or volatility on a quarter-to-quarter basis that we could anticipate in the gain on sale SBA business or historically at Ridgestone was it fairly consistent on a quarter-to-quarter basis?

Lindsay Corby
They're fairly consistent. I'd say the beginning of the year you see a little bit of a dip, but nothing drastic. It's a pretty stable outlook for the gain on sale.

Michael Perito
Okay.

Alberto Paracchini
One thing to add there, Mike, and we're not seeing anything in the horizon. But a couple of things to keep in mind, fiscal year for the SBA ends as of September 30th, and then from time to time the SBA program like many other government programs there's political noise around it. But at this point, there's nothing in the horizon that would seem to be in play right now, but those are two things to just keep in mind.

Michael Perito
Helpful. Thanks, Alberto. Maybe switching over to the expenses in the quarter, I mean it sounds like the new team of three lenders kind of came on mid-quarter. I mean any sense on kind where the quarterly expense run rate could trend? I mean is it fair to assume that there could be some pickup in the third and fourth quarter with the full quarter from that team and maybe the other hire as well?

Lindsay Corby
Yes, that's a fair assumption, and as Alberto mentioned, we're continuing to look for additional teams and professionals throughout the industry. That's a consistent assumption.

Michael Perito
Okay. I just have one more quick clarification question. I think last quarter the accretion recognized was about $5.8 million or so in that ballpark. Lindsay, do you happen to have the number for the second quarter as well?

Lindsay Corby
For the second quarter for accretion?

Michael Perito
Yes.

Lindsay Corby
It's about $7 million for second quarter.

Michael Perito
Perfect. Thank you very much, guys. I appreciate it.

Alberto Paracchini
Thank you, Mike.

Operator
Again, if you have a question, please press star then one. Our next question comes from Terry McEvoy of Stephens. Please go ahead.

Terry McEvoy
Thanks. Good morning, everyone.

Alberto Paracchini
Good morning, Terry.

Terry McEvoy
Just trying to put the $149 million of loan runoff or payoffs in perspective. Do you have that figure for call it the first quarter of this year and the fourth quarter of last year just to put some context behind that?

Alberto Paracchini
Terry, we don't have that in front of us. We can certainly provide it. Happy to get you those estimates. If we can do it offline, and if anybody else would like to get it, we're happy to send it to you. If you could just send us an email, we're happy to provide it.

Terry McEvoy

Okay. Great. And then if I look at the margin ex-accretion, it was down about 8 basis points, and it looks like deposit costs were up about 7. How much of that came from just acquisition accounting and the impact on deposit costs versus just the core deposit pricing and being proactive and raising rates a bit?

Lindsay Corby
You're spot on with the deposit costs, 6 basis points was just the cost of time deposits. That was the increase there. Really, there was little to no impact from what we deem as our more core deposits. There was also an impact from the accretion that was related to the timed deposits on Ridgestone, that accounted for a good portion of it. And then as well, we had an uptick in the Federal Home Loan Bank advance expenses, that was the other component.

Terry McEvoy
Okay. That was it on my list. Thank you.

Alberto Paracchini
Great. Thank you, Terry.

Operator
Again, if you have a question, please press star then one. We'll pause momentarily. As we have no further questions, I would like to turn the conference back over to Mr. Paracchini for any closing remarks.

CONCLUSION

Alberto Paracchini
Well, thank you. I think I'll just end the call by thanking you all for your interest in Byline. We look forward to working with you in the quarters and years ahead and look forward to seeing you at some point in the fall and at our next call later on this year, so thank you.

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