Byline Bancorp, Inc.

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Q2 2018 Earnings Conference Call

July 27, 2018 at 9:00 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 morning, and welcome to the Byline Bancorp, Inc. Second Quarter 2018 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 touchtone phone. To withdraw your question, please press star, then two. Please note this event is being recorded.

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

Allyson Pooley
Thank you, Austin, and good morning, everyone. Thank you for joining us today for the Byline Bancorp Second Quarter 2018 Earnings Call. We will be using a slide presentation as part of our discussion this morning. Please visit the events and presentations page of Byline's Investor Relations website for access to the presentation.

Before we begin, I'd like to remind you that this conference call contains forward-looking statements with respect to future performance and financial conditions of Byline Bancorp that involves risks and uncertainties. Various factors could cause actual results to be materially different from 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.

Management may refer to non-GAAP measures, which were intended to supplement, but not substitute, for the 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 non-GAAP measure.

With that, I'd like to turn the call over to Alberto Paracchini, President and CEO.

Alberto Paracchini
Thank you, Allyson. Good morning and welcome to our second quarter call. Joining me this morning is Lindsay Corby, our CFO, and Tim Hadro, our Chief Credit Officer. As is our practice, I'll start by providing you with an overview of our performance and key highlights for the quarter, then pass the call over to Lindsay, who will cover our results in more detail. After that we will open the call for questions.

We're pleased to report to report that we have a very solid quarter characterized by strong growth coming from our diversified lending businesses and improving profitability. We like our position in the market and, after closing the First Evanston transaction, feel that we're well positioned to capitalize on market opportunities.

Turning over to slide 3 of our deck. Net income came in at $2.8 million, or $0.08 per share. There were several non-recurring items impacting results that I'll get into in a minute, but adjusting for those, our earnings came in at $10.6 million, or $0.32 per diluted share.

During the course of our integration planning we had the opportunity to take a hard look at the core systems book Byline and First Evanston, and made the decision to migrate the combined banks through FIS's IBS platform. We feel this platform will enhance our product capabilities, particularly in commercial banking, give us better application integration, and allow us to operate the bank more efficiently. We anticipate the system conversion will take place during the first quarter of 2019. As a result of this decision, we recorded certain non-recurring expenses this quarter related to contract termination and other conversion-related expenses.

Moving over to revenues, we had total revenue of $53.6 million, which was approximately 19% higher than last quarter. The growth was largely the result of increased volumes, higher net interest income, and strong fee income driven by higher gain on sale of government-guaranteed loans.

Profitability continues to improve with adjusted ROA coming in at 110 basis points, up 36 basis points from last quarter, ROE above 8%, and ROTC coming at 10.9%. From a production standpoint, the quarter was strong. Originations came in at $195 million and we saw nice growth in our originated portfolio of approximately $186 million, or 11.5% in the second quarter. Excluding the impact of the acquisition, our portfolio grew by 22% on an annualized basis. Our strong production was truly a team effort, as we saw broad contributions from our diversified commercial lending businesses and lower than anticipated payoff activity. As you know, payoff activity is difficult to predict from quarter to quarter, so it's certainly nice to see it moderate during this quarter.

Our government guaranteed lending business performed very well with originations exceeding $170 million and strong gain on sale revenue. This quarter we saw good product diversification and originations, and we're also recognized by the SBA as the top 7A lender in the state of Illinois, which speaks to the quality of our bankers and team in that business.

Under the faucet front, we ended the quarter with total deposits of $3.6 billion, balances were impacted by the acquisition, but if we exclude that impact, total deposits grew by 3.6% from the prior quarter.

Non-interest bearing DDAs grew by 5% and deposit composition remained excellent with DDAs accounting for almost 33% of total deposit. Average deposits per branch continues to move in the right direction ending the quarter at $61.8 million. This reflects both the lower legacy branch account, the impact of the acquisition, and higher deposit balances.

Moving over to expenses. We continue to gain operating leverage, revenue grew nicely, outpacing expense growth, which if you exclude the impact of the transaction increase by 1.9% and stemmed largely from branch consolidations expenses that we incurred this quarter. On an adjusted basis, our efficiency ratio came in at 63.4%, which improved by 3 percentage points on a year-over-year basis. This ratio can have some volatility quarter-over-quarter, but there's no question we're making progress in getting to our targeted level of below 60% by the end of 2019. Lastly, asset quality improved with NPAs declining from 100 basis points in Q1 to 70 basis points this quarter. Credit costs also declined, while our provision increase was largely driven by new loan growth.

That's all I had, so with that, let me pass the call over to Lindsay, who will give you more detail on our results.

Lindsay Corby
Thanks, Alberto. Good morning, everyone. I will start on slide 4, with the review of our loan and lease portfolio. Our total loans and leases were $3.3 billion at June 30th, an increase of $1.1 billion from the end of the prior quarter. First Evanston contributed approximately $944 million in total loans. Our originated loan portfolio increased approximately $186 million net. During the quarter we saw increases across all of our major lending areas, with the strongest growth coming in our C&I and commercial real estate portfolios.

Moving on to deposits, on slide 5, our total deposits increased to $3.6 billion at June 30th. Excluding the impact of the acquisition, we saw good growth in our deposit portfolio across all categories with total growth of $90.1 million. Our non-interest bearing deposits represented 32.7% of total deposits at the end of the second quarter. As we anticipated, our cost of deposits increased by 11 basis points to 52 basis points, which was primarily driven by promotional CDs and money market campaigns to bring in funding to support our loan growth we had in the quarter.

Moving to slide 6, I'll discuss our net interest income and margin. Our net interest income increased by $5.4 million, primarily due to the one-month contribution of First Evanston. Our reported net interest margin decreased 2 basis points to 4.43%, or 12 basis points when you exclude accretion income. Excluding the impact of the acquisition, our non-interest margin declined 14 basis points to 432. This was attributed to a 6 basis point decline in our average loan and yield leases combined with a 10 basis point increase and our total cost of deposit.

Turning to slide 7, and our non-interest income. Compared to the prior quarter, our non-interest income increased by $3.1 million. Excluding the acquisition, the most significant driver was a $2.2 million increase and our net gains on government guaranteed loan sales. The volume of loans sold exceeded the prior quarter and our average premium on loan sales also trended higher this quarter, due to a more favorable mix of loans sold.

We also had an increase of $668,000 in other non-interest income mainly due to a $946,000 increase in our customer derivative fee income. During the second quarter we added a new line item in non-interest income for our wealth management and trust business as a result of the acquisition. For the month of June, this business generated $192,000 of non-interest income. As a result of our additional fee income and revenue from the acquisition, we expect that our net gain on sale of government-guaranteed loans will trend down as a percentage of our overall revenue mix over time.

Moving to slide 8, let's look at our non-interest expense. Our second quarter, non-interest expense reflects the impact of the one month of First Evanston's operation. It also includes $10 million of expenses related to the significant items from the core conversion and other merger-related expenses. Excluding the acquisition, our non-interest expense grew modestly, increasing by approximately 2%. This was primarily attributed to an increase in expenses of $891,000 related to the branch consolidations during June. These charges had a $0.03 impact on our earnings per share in the second quarter.

As Alberto mentioned, we have planned our system conversion for the first quarter of 2019. After the conversion, the cost savings from the combination with First Evanston will be more apparent in our reported results. We are on track to meet the cost savings expectations associated with the acquisition.

Turning to slide 9, we'll take a look at asset quality. Our non-performing loans decreased to 81 basis points of total loans at the end of the second quarter. On an absolute dollar amount, our NPLs increased $2.5 million, mainly due to inflow from our government-guaranteed lending business. At June 30th, government-guaranteed loans accounted for approximately $7 million of our NPLs, our non-performing assets declined by $1.5 million, driven by a $4.1 million reduction in OREO.

Our net charge-offs were $1.9 million, or 29 basis points of average loans and leases for the quarter. Charge-offs were primarily related to the unguaranteed portion of STA loans. Provision expense for the second quarter was $4 million. The second quarter provision included allocations of $3.7 million for our originated loans and leases, which was offset by a $528,000 credit to the provision for acquired and pared loans. Our provision expense this quarter was primarily driven by growth in the portfolio.

Our allowance for loan and lease losses to total loans was 59 basis points at June 30th, down from the end of the prior quarter due to the loans added from the acquisition. In addition to the traditional allowance of the percentage of loan and lease metrics, we also analyze the allowance in conjunction with the acquisition accounting adjustments impacting our acquired portfolio. At June 30th, the acquisition accounting adjustments, plus the allowance for loan and lease losses represented 214 basis points of total loans and leases.

With that, I would like to pass the call back to Alberto for closing remarks.

Alberto Paracchini
Great, thank you, Lindsay. In summary, we're focused on executing our strategy and have positive momentum going into the second half of the year. We expect to see more of the benefits, as Lindsay mentioned, of the transaction in the coming quarters as we realize projected synergies and continue to grow our business. On the M&A front, we continue to evaluate opportunities in the market and remain interested in acquiring banks that fit well with our culture and can add value to our franchise.

With that, operator, we can open the call for questions.

QUESTIONS AND ANSWERS

Operator
And at this time, if you would like to ask a question, you may press star, then one 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.

Our first question today comes from Nate Race with Piper Jaffray. Please go ahead.

Matthew Clark
Good morning, it's Matthew Clark, pinch hitting for Nate. On the SBA volume, very, very strong this quarter. I wanted to get a sense for the pipeline going to 3Q and whether or not you might think at that level of activity might come down a little bit going forward or not?

Alberto Paracchini
I think overall, the pipeline remains strong. I think one thing, Matt, this quarter that we saw a little bit more of was we had originations that were well diversified, and by that I mean we had very good 7A production. We also had some USDA production. In general, the mix of loans that we had there was more than just the traditional 7A loan. We also had some 504s, those are obviously for us, our balance sheet products. In general, we like what we saw. Obviously, the unit had a very good performance as far as originations. And as we said in the past, it's a business where we take a longer term approach on a quarter-by-quarter basis, not only in originations but also with gain on sale revenue. You can see some volatility, but that said, pipeline remains strong.

Matthew Clark
Great. Within the NPLs, any update on credits you were working through last quarter?

Alberto Paracchini
Still working through particularly those credits. I think if you go through the release, we've added more detail so that you can see really the portions of loans that are in our NPL bucket that have a government guarantee. As you can see there in that schedule, we're still working through—it's roughly about $7.4 million in our NPL line that are related to guaranteed portions of loans. It takes time to work out some of these assets but we continue to plow ahead and expect to ultimately see those reductions as resolutions start to occur.

Matthew Clark
Okay, great. Then last one, I just want to get your broader thoughts on the commercial real estate landscape, good growth there this quarter, just any commentary on where you're seeing opportunities?

Alberto Paracchini
I think we continue to see opportunities in the areas where—in our targeted markets, good competition, pricing is always a consideration, but we're seeing plenty of deal flow. We haven't seen a slowdown. Obviously, you're not going to bat a thousand. We hope to bat somewhere in the 250 or 300 range and the key is being able to see transaction flows so that you can continue to be selective. I don't know that I would say that there's anything unusual there, just continue to focus on getting enough at bat and doing a good job for clients.

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

Michael Perito
Good morning, guys. Thanks for taking my question. I wanted to maybe start on the expense run rate. So the conversion's happening in 1Q '19, obviously the branch closures happened in late Q2, so if we think about everything together here, the full quarter of First Evanston and 3Q, does the run rate kind of drift up towards $37.5 million and then work its way down towards the high $36 million range by the early part of next year. Is that generally range bound consistent with what you guys are thinking at this point?

Lindsay Corby
Mike, I understand your question; it's difficult to really peel this back this quarter, just given that there's only one month in there. And I think the easiest way to look at this is just to do the backwards math. And so the way that I think about it is if you look at our current expense rate of $45 million, you back out the $10 million of the one time. That gets you to $35 million, and if you add on First Evanston's expenses, which on average ran anywhere from $7 million to $9 million, call it. That will get you a pretty good pro forma from there. And then I'd say going forward, we won't start seeing the branch expenses start coming out until later this year. There's always a lag, because we closed them here at the middle of June, call it. So there is a little bit of a lag so you'll start seeing that come out towards the end and then the expense savings in terms of First Evanston are very much back-ended with the conversion. So you'll start seeing a little bit of it here in the next third and fourth quarter coming up, but the bulk of it comes with conversion.

Michael Perito
That's helpful. Thanks. But maybe I'll ask the question slightly differently, I guess. If we exclude any other legacy growth and we just kind of look on a pro forma off of today's number. The $35 million, where does that number go with the full cost saves of both the branch and First Evanston? Is it like $39 million, $40 million or I don't know if that makes sense, but if we just look ahead but assume all else equal, do you have a sense of where that number moves to with all the cost saves-end from both the branch closures and the First Evanston date target of cost saves?

Lindsay Corby
Yes, I think your $40 million number feels pretty good in terms of how I'm looking at it right now.

Michael Perito
Okay. Thank you. Then, on the margin, if I recall correctly, First Evanston, they were pro forma is going to be a little dilutive to your NIM. I'm assuming that was part of the quarter-over-quarter compression and the coordinate. I was curious, Lindsay, if you had any thoughts on where that trends next quarter with both the legacy Byline dynamics you're seeing, but then also a full three months of First Evanston.

Lindsay Corby
Right. So, if you recall, Mike, when we talked last quarter, I brought up a one-time item that contributed about 10 basis points to the NIM, so really we view the NIM on a quarter-over-quarter basis as pretty flat. There was a little bit of compression by a couple basis points, call it, not much, but that was a result of the core deposit pricing, and the pressures that we saw mainly in money market and CDs. The remainder of the core deposit, the betas remained pretty low and within our expectations. On a go forward basis—

Michael Perito
There could be some pressure in the third quarter from the full three months of First Evanston. But all in—I mean the trends are fairly positive on the core and inside?

Lindsay Corby
Correct. I'd say they're pretty flat here. Like we've said in the past, we are asset-sensitive, Mike, so you will see slight expansion in terms of the yields on the loans; however, it will be offset by the deposit pressures. We view it as slightly flat going into Q3 here and then possibly expanding slightly going forward from there.

We will see a little bit of the benefit in the rate increase that occurred in June in the third quarter, so that will help. And then if we get one in September that will come obviously into the fourth quarter.

Michael Perito
Okay, helpful. Thank you. Then, just lastly, Alberto, any updated thoughts—obviously, there's been some volatility in the Fifth Third and [indiscernible] share prices and I'm just curious, has the uncertainty around that transaction changed anything on the ground level or there or just generally speaking in terms of disruption in the market? Are you seeing a higher velocity of opportunity or are you still just mostly kind of people poking around and in the early stages?

Alberto Paracchini
That's a really good question, Mike. I think you guys put out a piece and talking a little bit of uncertainty. All kidding aside, I think it's too early. One thing I'll tell you is, we have seen situations where as a result of that merger, we have been able to pick up some business. I don't get the feeling that this is something that's broad, but we have seen already the benefit of being able to see some transactions where we've been able to win the transaction as a result of clients having concerns over changes or clients feeling that they want to—maybe it's a good time to look at potentially a different banking relationship. So, that's a positive.

As far as opportunities, potentially because with lenders as a result of the transaction, I think that's still too early. I think that's not something that we will see probably until much closer, if not until post transaction.

Michael Perito
Awesome. Thank you for taking my questions, guys. Appreciate it.

Operator
Our next question comes from Terry McEvoy with Stephens. Please go ahead.

Terry McEvoy
Good morning, everyone. Maybe, I'll ask the other side of that question. You're number one in market share in deposits in Evanston. No doubt, competitors have kind of stepped up their game in that market, I think somebody announced they opened a branch and discussed it last week. Have you seen any run off and what are you doing, or do you have to play a little defense here and when does that shift to maybe

more offense and how do you go about doing that?

Alberto Paracchini
Good question, Terry. Competition is a fact of life and we compete with some of our competitors, we compete with them not only in Evanston, but in other markets as well. I think we're more than holding our own. We remain very comfortable with our position in that market and the type of banking that we do and the relationships that have been built in Evanston by formerly First Evanston, over a 25 year period. We are relationship and client focused there to the degree that we have to defend our position, we will do so. But at this point I think we feel pretty good with where we are in Evanston and frankly in the other markets where we compete. Hopefully, Terry that gives you some color on the question.

Terry McEvoy
It does, thanks. Maybe, just Mike's question, looked at a different way. I normally don't ask about monthly margins, but June had the full impact of the transaction. Was there a noticeable change in the margin on a monthly basis that maybe would help us better understand the trend as we start Q3?

Lindsay Corby
No, it was pretty close, Terry. A couple basis points different, nothing material.

Terry McEvoy
Thank you. Then, just lastly, was it customer derivative fee product that was mentioned in the release and I think on the call earlier, is that a sustainable level or was it just a large transaction and how should we think about that revenue line in the back half of the year?

Lindsay Corby
That's a great question, and we had a really great performance here for the first half of the year in terms of that portion of our business. So, we've been really happy. I'd say Q2 was higher than normal, but I do feel that it'll remain pretty strong here going forward.

Alberto Paracchini
Terry, one thing I would add on that is I think during the first half of the year, what we saw is as clients started seeing rates backing up and interest rates, short term rates, going up and the talk of potential additional rate increases to the degree that they had the opportunity to lock in rates. I think some clients took advantage of that. I think one thing to keep in mind going forward is, I think that will be—it's to some degree, even though we don't have a derivative business, this is more customer-related transactions, it has some correlation to movements in interest rates. And the perception by customers that now maybe it's a good time to lock in long term financing. So, to a degree that there's some volatility there, I think that will drive, swap income, which is really largely what we're doing there.

Terry McEvoy
Understood. Thanks and have a nice weekend.

Alberto Paracchini
Thank you, Terry.

Operator
The next question comes from Andrew Liesch with Sandler O'Neill. Please go ahead.

Andrew Liesch
Good morning. First, on the long growth here, especially on the CNI, it was pretty strong. I was just curious, was any of this pulled forward from this quarter, and how's the pipeline look going into the third

quarter?

Alberto Paracchini
I think pipelines, in general, remain solid. I think we had, as I mentioned in my comments, it was just broad contributions. Sometimes you have quarters where one group or one area tends to have a better quarter than another group. Here I think what was interesting was one, it was just broad contribution across the board from our different commercial lending businesses. And two, and this is an important point, is payoff activity, which as you all know has at times on a quarter basis can add some volatility and can certainly have impact on net loan growth. This quarter it was muted. I mean, it was lower certainly than last quarter and certainly lower than what we've seen in the first half of the year. So, that contributed. Obviously, anytime that payoff activity is lower than we anticipate and certainly much lower than what we had been seeing in prior quarters, that it's obviously going to give you some wind at your back to push net loan growth higher.

Andrew Liesch
Then just risk related to some of the CNI loans, some of these commercial businesses that you added. Is there an opportunity for you guys to add some core deposits through them to reduce the reliance on some of the campaigns you're running?

Alberto Paracchini
I would say, yes. We are a relationship lender on the CNI side. So when we are looking to—the CNI business that we do is not about doing a loan transaction with a customer. We want to get the deposit relationship and we expect to get the deposit relationship as part of a transaction. The answer to that question is yes.

One thing, Andrew, to add to give you additional color. One thing that's important to us is we want to remain core deposit funded. It's important to us that on the DDA side, on the relationship side; we continue to build relationships, add DDA accounts on the commercial side, on the small business side through our branches. But it's important to us that, as we grow the portfolio, we want to medium- to long-term we want to make sure that we have the funding for that portfolio coming largely from our deposit base. Just a comment there on strategy.

Andrew Liesch
Great, thank you. You covered the rest of my questions.

Operator
Again, if you'd like to ask a question, please press star, then one.

Our next question comes from Brian Martin with Fig Partners. Please go ahead.

Brian Martin
Good morning. Lindsay, just one question, the breakdown. I think last quarter you talked about a little bit ago, maybe a 10 basis point benefit, the accretion this quarter, can you just give us some color on the breakdown between what was First Evanston and what was Legacy? Just so we have an idea of how to think about it prospectively.

Lindsay Corby
Last quarter, I did talk about the 10 basis points, so happy to answer any questions on that. That showed up in the loan yields and obviously fell down through to the bottom line, but that was not part of accretion, so just to be clear on that piece.

Then in terms of the accretion breakout, the accretion last quarter was about 31 basis points. So when you strip out the First Evanston acquisition, it's held in pretty close there, it fell slightly just called under $100,000 of net accretion impact on the margin there. So it's just a couple basis points there, Brian. Then the rest obviously was related to the First Evanston acquisition.

Brian Martin
That is helpful, thank you. Can you just talk about—you talked about obviously with the funding cost going up, just what trends are you seeing on the pricing on the loan side? Are you getting better pricing? It sounds like you are if you're expectation is to maintain the margin, but just any color on what the rates look like on Kirk Production and how you're thinking about that?

Alberto Paracchini
I'll give you a relative answer on that. On a quarter-to-quarter basis, depending on the business, I think our SBA business, we price the business a certain way. We do a lot of work. There's a lot of work involved in an SBA loan and we want to make sure that we get properly compensated on that business.

We're obviously selective, but it's a business that we tend to be pretty firm in terms of pricing. Some of our other businesses, it's obviously a competitive market. But on a quarter-over-quarter basis I couldn't tell you that we have seen a compression, broadly speaking, in the rest of our commercial lending businesses. I think quarter-over-quarter I would characterize those more just neutral.

Brian Martin
Okay, that's helpful. Just the last thing for me, I think they asked a question about the [indiscernible] pipeline, but just as First Evanston coming into the fold, is there any expectation that there's any runoff from that portfolio that offsets some of the pipeline growth you expect, or just not to think about it that way?

Alberto Paracchini
I think it's natural to expect, I mean there's some natural runoff in the portfolio. And I think we only have one month where we're actually finally just seeing it for one month. I think as we move forward here this quarter, starting this month, and certainly in the month and quarters ahead, I think we'll start to get a much better perspective. First Evanston was very much very similar to us, a relationship lender, building long-term relationships with clients. It's the pipeline, but it's not unreasonable, Brian, to expect some degree of just regular pay down activity.

That said, it's a granular portfolio and that's primarily a CNI portfolio so there's not of lumpiness in that portfolio. Overtime, I think, we'll see how that plays out. We feel pretty good about that aspect going forward.

Brian Martin
Okay and the last one from me was, Lindsay, you talked about the expenses a little bit. Just so I'm clear, next year, I think when you go through the conversion, would you expect the first clean quarter with all of the cost savings realized to be the second quarter, or more of a third quarter event, based on timing?

Lindsay Corby
I would say more of the third quarter, to be honest. I think you'll start seeing it after that first quarter conversion happens. You'll start seeing things come down, but I really think it'll be that latter half of 2019 where it's very clean.

Brian Martin
Alright, thanks for taking the questions.

Alberto Paracchini
Excellent, thank you, Brian.

CONCLUSION

Operator
This will conclude our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

Alberto Paracchini
Thank you. I just want to say thank you for joining us this morning and we look forward to speaking to you again next quarter. Thank you.

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