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PFBC - Q1 2018 Preferred Bank Earnings Call

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Zach Weiss

PRESENTATION

Operator

Okay. Good day, and welcome to the Preferred Bank First Quarter 2018 Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to Ms. Kristen Papke, Financial Profiles. Please go ahead.

Kristen Papke

Hello, everyone, and thank you for joining us to discuss Preferred Bank's financial results for the first quarter ended March 31, 2018.

With me today from Management are Chairman and CEO, Li Yu; President and Chief Operating Officer, Wellington Chen; Chief Financial Officer, Edward Czajka; and Chief Credit Officer, Nick Pi. Management will provide a brief summary of the results and then we will open up the call to your questions.

During the course of this conference call, statements made by Management may include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are based upon specific assumptions that may or may not prove correct. Forward-looking statements are also subject to known and unknown risks, uncertainties and other factors relating to Preferred Bank's operations and business environment, all of which are difficult to predict and many of which are beyond the control of Preferred Bank. For a detailed description of these risks and uncertainties, please refer to the SEC required documents, the Bank files with the Federal Deposit Insurance Corporation or FDIC. If any of these uncertainties materialize or any of these assumptions prove incorrect, Preferred Bank's results could differ materially from its expectations as set forth in these documents. Preferred Bank assumes no obligation to update such forward-looking statements.

At this time, I'd like to turn the call over to Mr. Li Yu. Please go ahead.

Li Yu - *Preferred Bank - Chairman & CEO*

Good morning. I'm very pleased to report that the first quarter 2018 net income of $16.6 million or $1.09 a share, was a record for our bank. This quarter, we benefited by lower tax rate, current interest rate environment and also increased loan portfolio.

Loan growth for the quarter was $155 million, of which there's a $36 million of home mortgage pool that we purchased. So the internally generated loan growth was $118 million plus.

The quarter's deposits did not grow. In fact, it decreased by $1 million for the quarter. At the beginning of the year, we have decided to deploy some of our excess cash on our balance sheet to fund the loan growth, and we did not react to the market interest rate changes until the third month of the quarter, but then a steepness of the rate changes also amazed us. The non-growth of the deposits and the larger growth of the loan portfolio has resulted in further expansion to our net interest margin due to the change of leverage. We have estimated, hypothetically, assuming that we have had a $100 million deposit increase also, the net interest margin would have been $0.11 lower -- 11 basis points lower or standing at 4.03% as if it is a 28 basis point improvement from prior quarter.

This quarter, we have witnessed a very intensified rate competition on deposits in the marketplace. We're also seeing the rate competition loans is also quite intensive in this quarter and as is, so therefore, we decided to add a number of deposit and loan personnel to our staff. We'll continue to adding these relationship officers throughout the years.

As always, we will continue to make further improvement to our technology. At present, we're right in the middle of converting of our core processing system. Last year, we have announced that we're going to raise $50 million in new capital through the ATM asset. In January, at the level of $36 million, we decided to terminate the new capital raising. We believe the lower tax rate and the current rate environment that the Bank will be earning sufficient return on equity to meet our loan growth -- our company growth.

Thank you so very much, and I'm ready for your question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question comes from Aaron Deer with Sandler O'Neill Partners (sic) [Sandler O'Neill + Partners].

Aaron James Deer - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research and Equity Research Analyst*

I -- Li, I appreciate the -- I guess, the added color behind where the margin would've been had you continued to grow deposits. Just kind of drilling into that idea a little further and given the kind of pricing competition that you've described, both on the deposit side as well as it sounds like on the loan side, can you give us a sense of where the current spread is between newly added incremental deposits and incremental loans? So we can kind of get a sense of -- can we still expect to see further widening from the benefit of rate hikes, which I would expect in the existing portfolio? But to what extent there might be spread compression on new loans and deposits added to the balance sheet that would curb that?

Li Yu - *Preferred Bank - Chairman & CEO*

There will be -- perhaps, I will add to -- add some color later on, but from my point of view, it will be something that we have not able to really quantify in the real world yet. Now, to my mind and looking at the movement of different segment of the deposit, the different segment of the loans, okay, I will say that further expansion is possible but is not going to be sufficient for the next quarter, consider the deposit activity as is, okay? But over the long term, a lot of people have been booking up deposits by anticipating other loan increases, so they jump to the deposit rates. So whether this thing will continue and how far it will continue during the remainder of the year is something that we're watching every day, but I'm hoping that we will have some expansion in the next quarter. Ed, you have anything to add on that?

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

Yes. I -- the one thing I can say and talking this morning with the rest of our team, Aaron, is that, on the loan side, we still do see a spread between what's getting paid off and new loan bookings, although it seems to me that spread is narrowing, which I think is positive news. However, conversely, on the other side, on the deposit side, the spread between what we currently have in portfolio relative to our different portfolios versus the new business that's coming out there can be anywhere from 30 to 60 basis points difference on any given particular product. So to Mr. Yu's point, in his comments earlier, the increase in market deposit rates has been pretty dramatic.

Aaron James Deer - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research and Equity Research Analyst*

Yes. Sounds like it. The -- okay, and then switching to the expenses, just curious, I guess, first on the systems conversion. It sound like that costs related -- that are actually pretty modest at this point. If I read the release correctly, maybe $200,000 or $300,000 per quarter, and that seems light given to what I've seen with other institutions as they go through that process. What -- is that correct in terms of what the run rate of those expenses are? And are there any other kind of onetime items or ongoing costs that we should be thinking about with respect to the systems conversion?

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

Sure. So in the first quarter, Aaron, we recorded about $0.5 million of what I will turn de-conversion fees. So under accounting rules, any data that you receive from your current provider that you are going to de-convert from -- and this are -- these are data files that are going to go to your new vendor. Basically, your own information, right, all of your customers' information, that expense for those files must be expensed. You cannot capitalize that towards the cost of the new system. So the fees we're talking about are de-conversion fees and consultant fees as we've hired a project manager to lead us through the process. So we incurred about $0.5 million in Q1. We'll incur roughly the same in Q2, maybe a little bit less and then a little bit more in Q3 as the conversion is actually slated for Q3.

Aaron James Deer - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research and Equity Research Analyst*

Okay. And then all of that is expected to go away by the fourth quarter?

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

Yes. Yes, the rest of the costs relative to the new system. and all of our investment in that system obviously gets to be capitalized along with the system over the life of the contracts.

Aaron James Deer - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research and Equity Research Analyst*

Okay. And there's no existing software or anything like that, that's -- whether it's going to be written down?

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

No, because these contracts expired right at the time we're converting. So that was the -- ideal from a timing standpoint for us.

Aaron James Deer - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research and Equity Research Analyst*

Sure. Okay. And then -- you also -- Li had mentioned bringing on more loan or deposit professionals. Can you talk about what we're talking about in terms of the number of personnel and what kind of impact that might have on the sellers and benefits line?

Li Yu - *Preferred Bank - Chairman & CEO*

Well, we have added about 6 new personnel in the first quarter, mid-level, okay? And then these things -- as you know, these things is very opportunistic, okay, and depend on whether you can find talent, and you have to attract them and whether they will -- they want to join you. And as you may suspect, these talents are competed by everybody. So if we have the same luck of hiring 6 more in each and every quarter, okay, I'll be very pleased, but I doubt there will be same results. In other word, I cannot tell you from numbers how each quarter will be adding up, but I have made allowance for maybe as much as 20 people over the year.

Aaron James Deer - *Sandler O'Neill + Partners, L.P., Research Division - MD, Equity Research and Equity Research Analyst*

Okay, maybe looking at it from another direction, your -- the efficiency ratio in the first quarter was right around 36%. Obviously elevated from the project costs but -- presumably, those go -- as we said, that goes off by the end of the year or so, maybe as we look out to the fourth quarter, once those costs are gone, might we still be in kind of the mid-30s, or could we be back down into the low 30s by the end of the year?

Li Yu - *Preferred Bank - Chairman & CEO*

We certainly hope it will be lower, but efficiency ratio is a function of the net interest income and the growth of net interest income, if we're planning at the current situation as a growth, yes, it will reduce, okay? But that is dependent on whole lot of hard work, whole lot of competition that ahead of us.

Operator

The next question comes from Tyler Stafford with Stephens.

Tyler Stafford - *Stephens Inc., Research Division - MD*

Maybe just to start on the dynamics between the deposit growth this quarter and the liquidity that you used to fund the growth. I guess, just -- how much more willingness is there to let those deposit balances to not compete as much there, let those deposit balances decline and use your liquidity to fund the growth going forward?

Li Yu - *Preferred Bank - Chairman & CEO*

We are fully in competition right now. We're in the battle mode, okay? The reason is that we have also to be defensive, not only we need to increase, we -- the most importantly, we cannot let anything go, okay? So if the current situation is that we will work as hard as trying to get a new deposit, how much more we can get and then after we get it, then we will decide -- I mean, the movement afterwards. So right now, at this point in time, we'll keep ourself up to be very competitive in next 6 months at least, okay?

Tyler Stafford - *Stephens Inc., Research Division - MD*

So we should think about maybe just the loan-to-deposit ratio moved up to 95%, would that be kind of a maximum you think about where your comfort level is?

Li Yu - *Preferred Bank - Chairman & CEO*

Highly possible, yes. We will be -- we'll be comfortable with that, yes.

Tyler Stafford - *Stephens Inc., Research Division - MD*

Okay. And so I hear you loud and clear on the deposit competition. What is the rate that's kind of offered out there in the market that would make you competitive right now?

Li Yu - *Preferred Bank - Chairman & CEO*

Well, there is all over the place that to be competitive. For instance, the 3 submarket that we operating on, each has a different rate, the Los Angeles, San Francisco and then in New York, okay? New York being the most highest because where we are, it's a very retail operation, and on the same streets, there's about 70 banks around on the same street, anybody is posting a interest rate on a window, okay? So they are basically in the past of 25 to 30 basis points ahead of California. Right now, Los Angeles is really getting heat up right now. It's -- I cannot even keep up with the rate of posting because after we post, somebody post higher, okay? And if you look at the Los Angeles Times, okay, which I look at it, there is a couple of bank, it was posting above, right? The most recent [up] 2.25% for 13 months, okay? So it's all over the place, okay? And thank heaven our PCB portfolio is not maturing all at the same time. So they give us everyone -- every of my banking colleagues in other banks have a breathing room. And -- But we've tried to working on, of course, put our effort in getting more transactional deposits and trying to hold to -- hold on to our relationship deposits.

Tyler Stafford - *Stephens Inc., Research Division - MD*

And did I hear you correctly in your prepared remarks that that acceleration of the competition really heated up or really accelerated in March?

Li Yu - *Preferred Bank - Chairman & CEO*

We don't need to go over to 2.25%, okay? What I told you -- what I'm trying to tell you is there's a lot of people doing different things there. We think, in the market, we operate with a service level that we've given to our customers with a relationship, we're highly one-touch service type of bank. So our people did not depend on posting on the window to get the money. We go out and get our deposits. So we like to think that we can be much lower than a 2.25% level.

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

Tyler, to your earlier question, we saw -- we really saw it start to accelerate, actually, in Q4 and on into Q1. What Mr. Yu was alluding to earlier is we started our own fight in this war, if you will, in March of this year. So we chose to stay out of the high rate competition for a while, but we have slowly started entering that in March in order, as he said, to protect what we have and to continue to start growing again.

Tyler Stafford - *Stephens Inc., Research Division - MD*

Okay, got it. And then just last one from me. What were the yields that that home mortgage portfolio that you guys purchased came on the books at, roughly?

Li Yu - *Preferred Bank - Chairman & CEO*

I think 3 point...

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

3.95%.

Tyler Stafford - *Stephens Inc., Research Division - MD*

3.95%?

Li Yu - *Preferred Bank - Chairman & CEO*

Yes, I think, 3.96%, to be exact amount.

Operator

The next question comes from Gary Tenner with D.A. Davidson.

Gary Peter Tenner - *D.A. Davidson & Co., Research Division - Senior VP & Senior Research Analyst*

My question's largely been answered. I just wanted to make certain that the margin expansion purely a function of the rate hike and the earning asset mix, nothing in terms of a sequential change in prepayment penalties or interest recoveries or anything along those lines?

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

There -- I think we had one small prepayment penalty in there that was like less than $100,000, Gary, that made up of small component of the interest income, but in terms of the margin expansion, yes, it is pretty much 100%, those 2 items.

Li Yu - *Preferred Bank - Chairman & CEO*

Gary, as you know, that most of our loan is shorter duration, is a floating-rate loan. As such, the market behavior of floating-rate loan is fully floating and floating was prime daily floating, is that they don't attach with a prepayment penalty, okay? So very few of our loans have a prepayment penalty clause attached to it.

Operator

The next question comes from Steve Moss with B. Riley FBR.

Zach Weiss

This is Zach Weiss, filling in for Steve today. Just a quick question in terms of capital allocation, how do you all prioritize that? I know you're looking to grow the balance sheet but given the windfall from recently enacted tax legislation, was just curious if you were looking to return that back to shareholders or just using that capital to continue to focus on growth?

Li Yu - *Preferred Bank - Chairman & CEO*

Well, I think our first priority is using the capital to fund the growth, okay? And then we just raise some capital, if you just remember, okay? In other words, to meet the previously -- that designed growth need. And the new tax rate clause help us out in term of our capital situation. So if we cannot grow then, obviously, we want to benefit the shareholder, but as long as we can grow, shareholder will get better rewarded with our growth. That is our belief, okay?

Zach Weiss

Great. That's helpful. And then one last question. So given the investment within the quarter of adding some compliance administrative personnel and adding some office space, was just curious -- the capacity there in terms of how much more you could continue to grow before investing further in more of those back-office type of expenses, just get an idea of like an incremental margin.

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

Well, I think the way we're set up now -- and we're currently looking to be moving our corporate downtown headquarters to larger space as well, that will allow us further growth. The administrative offices we took in El Monte, were actually in the fourth quarter of the prior year. I was using those for comparative purposes on a year-over-year basis under occupancy expense. But right now, we still have some room there for further expansion. And so -- and then, of course, in our branch network, we always have further room for expansion there, simply because our business model allows that. So I think, from a overall occupancy and geography and real estate standpoint, we're in good shape to continue to expand.

Operator

(Operator Instructions) Our next question comes from Dan -- Don Worthington with Raymond James.

Donald Allen Worthington - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Wanted to get back to the loan purchase for a second. You talked about the yield. What are the terms or types of credit that those are?

Li Yu - *Preferred Bank - Chairman & CEO*

Wellington, you want to answer that?

Wellington Chen - *Preferred Bank - President & COO*

Yes, generally, like a 3 and a 5 ARMs.

Donald Allen Worthington - *Raymond James & Associates, Inc., Research Division - Research Analyst*

3 and 5 ARMs, okay. And then I assume this was a pool of loans. Where is the collateral located?

Wellington Chen - *Preferred Bank - President & COO*

They all local, California, Southern California, maybe a few up in Northern California. That's it.

Donald Allen Worthington - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. And then I noticed Letter of Credit fee income was up in the quarter. Anything behind that? Is that seasonal? Or where might you expect that to settle out over the next couple of quarters?

Li Yu - *Preferred Bank - Chairman & CEO*

Probably, going forward, it's reasonably steady. The variation will not be too big.

Donald Allen Worthington - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. And then any guidance on the tax rate going forward for the rest of this year?

Edward J. Czajka - *Preferred Bank - Executive VP & CFO*

Well, we came in it, I believe, it was 26.1% ETR for the quarter, and I think we would expect the very, very similar ETR going forward, Don.

Operator

Okay. This concludes our question-and-answer session. I would like to turn the conference back over to Mr. Yu for any closing remarks.

Li Yu - *Preferred Bank - Chairman & CEO*

Thank you very much for your attention. And, obviously, that we continue to inform you with any major events that happen in the Bank, okay? Thank you very much.

Operator

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