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PFBC - Q2 2018 Preferred Bank Earnings Call

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PRESENTATION

Operator

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

I would now like to turn the conference over to Kristen Papke, Investor Relations for Preferred Bank. Please go ahead.

Kristen Papke

Hello, everyone, and thank you for joining us to discuss Preferred Bank's financial results for the second quarter ended June 30, 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 statements. 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 & Corporate Secretary*

Thank you. Good morning. I'm pleased to report that our second quarter net income was $17.4 million or $1.14 per share. Net income was 48.5% better than the year before. Earnings per share was 41% better than the year before. Of course, these numbers include the positive tax effect resulting from the tax cut, but on a pretax earnings basis, this year is 27.5% better than the same quarter last year.

This quarter, we had a reversal of our interest about $800,000 related to the New York loans and -- which has reduced our net interest income.

Deposits seem have -- seem to have resumed its growth pattern. For the quarter, deposit increased 4.6% on a linked quarter basis. We updated our interest-paying rate of our deposit product this quarter, and this is part of the reason for the increase of deposit totals.

Loan increased roughly $90 million, or 2.9%, on a linked quarter basis, okay? The loan pipeline still looks reasonably steady. We still are subject to heavy payoff pressure as the earlier quarters. We still find many of our fellow banks are financing long-term loans under fixed-rate basis, and the latest being a loan that was paid off in July. A hotel loan was paid off by another bank at the rate of mid-4% for a 10-year fixed rate. We've decided we're not competitive and didn't try to retain the credit.

During the quarter, like some previous quarters, we have been working pretty hard on converting our core processing system. As such, there are some deconversion costs, as you will call it, right, that related deconversion to the old system that was expensed throughout the first 3 quarters. We expect the conversion effort will be completed in this quarter. In fact, we're pretty close to conversion -- our completion right now, okay. And the expense will not be repeating in the fourth quarter. But as such, we're able to maintain our efficiency ratio at the 35% basis.

Our net interest margin is 4.07%, although there seems to be a little compression from the 4.14% reported in last quarter. But I'd like to remind you that I reported to you in the last year -- last quarter's earnings phone call that last quarter was -- have a -- it is pretty extraordinary as deposit didn't grow and resulted in the leverage effect change, which may have affected over $0.10 of the net interest margin. So actually, we're quite pleased with net interest margin that represent, in our mind, a small growth from last quarter, even without increasing the deposit to the market rate, [EBITDA], the cost of the market rate.

We have, for this quarter, delivered ROA of 1.83% and ROE of 18.8%. We're having -- we have been delivering this kind of a top tier of the peer group earnings during the past number of quarters. We hope to -- we'll continue to dedicate it to do the same thing.

Thank you very much. Ready for your question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question today comes from Aaron Deer with Sandler O'Neill.

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

I guess, if -- could -- let's start with the non-accruals removed to held-for-sale. I'm just curious, there was no write-down required on that transfer, and I understand that the credits themselves have no real loss for us from a -- given where the LTVs were at -- with the underwriting. But it -- in -- if you're looking to sell the loan, is it reasonable to expect that you're going to be able to get face value or better, and what kind of leads you to that conclusion?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

Number one, if we are selling it, it is pretty hard to predict now what the sales value it is, would be -- will end up, okay? And while in the current economy will requires to value these assets based on whether the most recent valuation report that we have received. And we have done -- and other people have done many different valuation report. We took the lowest possible use of the property and the lowest possible valuation from all these report and still did not come up with any impairment on write-down necessary. And we cannot, under the current economy rules, [to make any] provision or write-down to that, not that we don't want to.

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

Okay, I understand. Okay, and then on the -- Ed, as you're kind of looking at your expected CDs that are maturing over the next -- this month and next or this quarter and next along with your anticipated funding needs and where current market rates are on deposit prices, is it your expectation that we should see the margin in -- I should maybe clarify, the core margin, if you back out the interest reversal that you had in the prior quarter, but is it your expectation that the margin should now continue an upward trajectory?

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

It's -- well, first off, Aaron, it probably would've been around 4.22%, 4.23% this quarter, excluding the reversal of interest. Going forward, we did have a pretty significant increase in cost of funds over the quarter. But we had a good increase in our loan yields as well. So as you know and as we've talked about, deposit betas in the first part of this cycle were very, very, very low. And those have continued to increase as we go forward. So we're going to walk the line of continuing to be competitive and to grow deposits, but at the same time, not getting too crazy because we're still sitting on nearly $500 million in cash. And so we can afford to be a little more selective in terms of our deposit growth. The other thing I wanted to point out also with respect to deposit growth, even though we went up [147] for the quarter, our net amount of rate listings service deposit and broker deposits, net-net, went down $19 million for this quarter. So we actually shed some of those while we were growing more of the core deposits. But going forward on the margin, Aaron, I would venture to say from 4.07%, it will probably tick up a little bit from here for sure.

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

From 4.07% or from the 4.22%, 4.23% that you mentioned?

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

On the 4.07%.

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

Okay. So I guess, why not the 4.22%, 4.23% if that's where the -- where it was ex the interest reversal?

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

Well, because we still have a lot of headwinds. As Mr. Yu has talked about on prior calls and perhaps on this one as well, the new loan production that we're putting on is not going on at the higher yields one would expect, given the increasing rate environment. So there's a headwind. Rising deposit costs are also a headwind. We still have a number of CDs still on the books, Aaron, as I'm sure you can imagine, set to mature in the next few months that are far below market rates. Those will renew at market rates. And so we'll have that pressure as well.

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

Okay. No, that's exactly what was I trying to get at. It was just kind of what your anticipated funding needs were and the impact that would have. So there's going to be some more pull-through and just the higher cost of funds?

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

Yes.

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

Okay. Just -- and just any sense of the -- it sounds like the pipeline is still -- you said reasonably steady. So should we expect loan growth for the back half of the year to be something similar to what we saw in the first half? Is that a reasonable conclusion?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

I can only tell you that from what I can see, unless [Wellington next] has seen differently, I can only tell you that we can only see 3 months, okay? A long pipeline because what we're seeing is a reasonably steady as compared to the second quarter. Wellington, do you have any other information?

Wellington Chen - *Preferred Bank - President & COO*

No, I totally agree.

Operator

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

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

I was wondering if we could drill down little bit on expenses here? In particular, I know you mentioned the deconversion expense in the release. I was wondering, did that include consulting? Or how much additional expenses are tied to consulting fees?

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

We'll have at least a few hundred thousand more, Steve. But in the context, in the grand scheme of things, it's not going to be felt. We're already -- there's a few things related to the conversion. The capitalized cost of the new system, that gets capitalized in and that gets amortized over the life of the contract. We know that. The interesting part about this, as Mr. Yu alluded to, deconversion fees from your old system have to be expensed. And so that's what we have been expensing throughout first, second and partially in the third quarter. Those deconversion fees were slated to be about $1.1 million to date. Through Q2, we've expensed $900,000 of that. So we'll only have a little bit left in Q3 as well as a little bit left in consulting costs.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And then, I guess, in terms of -- drilling down on the margin perhaps a little bit further. Where are your CD rates these days that are bringing in the new deposits?

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

Well, they're -- it depends on, obviously, the maturity buckets. I think for 1 year, we're right around 2%. I think for 3 year, we're around 2.50%. And then, obviously, you extrapolate in between those. But those are -- the 1 year and the 2 year are really more special rates, if you will.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And I guess my last question here in terms of the problem New York loans. Do you have any expectations around the possible timing of the sale of those loans?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

No. But it has been stated as one of the top priority item for us. But in the meantime, there's -- you can always sell it under huge discount in there. A lot of vouchers flying around, trying to pick on this thing. And we have many, many offer that coming to us at a lower than we want to sell level. Okay? But obviously, we have to walk the fine line about -- between the price and the timing.

Operator

The next question comes from Tyler Stafford with Stephens.

Gordon Reilly McGuire - *Stephens Inc., Research Division - Research Associate*

This is actually Gordon McGuire on for Tyler today. I'd like to just piggyback on the problem loan discussion. I'm wondering if you could just go into a little bit more detail on the borrower and the properties and just provide a little bit clarity that gets us a little bit more comfortable on the underwriting, just a -- like LTVs, debt service coverage, what kind of occupancy you're seeing out of those properties?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

Gordon, I'd like you to -- refer you to a press release that was issued earlier this quarter. It has all that information contained, including the address of the property, the type of the property, the original valuation, the loan-to-value ratio of the property. And then with all that information over there. So -- and probably no need to repeat over here, okay? But I do like to go over the underwriting procedure. And -- because when this thing happens, since our loan process require -- loan of this type require board approval, should the board, including myself, are highly concerned about whether we are falling off any other underwriting practices that was in the bank, whether we're sticking to our guideline and have all the informations [factual]. So we have run through the heavy review and gone through every step of the document to see whether this document, pertinent document, is a bona fide document, true document. It was being done on the basis. It should be underwritten and so on. Is there any misrepresentation? I mean, [other] thing. So after all the review, our board has concluded that they didn't see anything that was why -- I mean, to further criticize on these things. Then, internally, we went through another matter. Is this a single event or isolated event relating to one borrower or is it across the board? Preferred Bank has a lot of other credits that needs to be concerned with. In fact, in the second quarter, we've seen improving credit trend overall in terms of the quality of our -- most of our loans, okay? And [30] to 290 days has been reduced. Then a nonaccrual has reduced. So we have concluded it's probably an isolated event. Then, not including you, I have to answer at least 3 or 4 very senior shareholder of ours as they hour-long, hour-and-a-half-long go through every step of the way, okay? Including why and who and how and what and where, all the -- and the philosophical things that go over the -- go over this transaction, okay? And so far, I don't think that there's any follow-up questions from these people again. Name these people you would know, okay?

Gordon Reilly McGuire - *Stephens Inc., Research Division - Research Associate*

All right. Just I guess, moving to the deposits. So you moved the rates in March. I was wondering if you could discuss your relative positioning as far as your marketed rates versus the competitors, and how long or how much time you think that move -- the move up in March might give you before you might have to see another bump?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

Okay. It seems to be -- my feeling is that what I can see is that, first of all, in late -- in the February -- in January and February, we start to see people making moves on the interest rate. And this time, the moves are like a staircase type of move. Seems to be people moving are moving $0.50 or more on each of the product in one shop type of situation. So some banks started to move. And then gradually, everybody started [too]. So we are one of the last one to do it in a manner of community banking group in the Los Angeles area, okay? And follow up on that, as few other people then, we moved their rates again. So all I can tell you right now, we're probably sitting right in the middle of the range of interest rate compared to our peer group, our competitors. We cannot [compare] with the major bank that still does not want to pay any (inaudible) but they are getting the deposits anyway there. Next move, when it's going to come? Don't know. It's a staircase situation, but likely to stay associated with another rate change as there may be another next move at this quarter-end, which -- it's just a guess.

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

With all that cash.

Gordon Reilly McGuire - *Stephens Inc., Research Division - Research Associate*

Okay. I guess, as far as how we're thinking about deposit growth. I know, Ed, I think you mentioned liquidity levels you have on the balance sheet. Do you think those will [sink] deposit growth, maybe slows from this 2Q number, and you have to move those cash balances down from here?

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

Well, I think, Gordon, it's -- as Mr. Yu alluded to regarding the loan pipeline, he's got 3 months of visibility. We pretty much have 0 months of visibility with respect to any kind of deposit pipelines. But suffice to say, our goal has always been to grow deposits first. Philosophically, we believe that's where the value of the franchise truly lies. And so that will always be our #1 goal. However, as you mentioned, we do have a lot of cash. As we talked about in Q1, we had a lot of cash, so we didn't have to do a lot of chasing with respect to deposits. But I think you can expect deposit growth rate similar or maybe a little less than what you saw in Q2 going forward for the next few quarters. That would be my best educated guess at this point.

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*

Ed, I was hoping you could give us the interest-bearing deposit rate for the second quarter as well as your average loan yield for second quarter? I don't think you've included that in your release.

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

Yes, average loan yield, Gary, was [5.57%] for Q2. Average rates on interest-bearing deposits, including money market, were about 1.02%.

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

Okay. And that 5.57% is after the interest reversal, correct?

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

Correct. Add another approximately 9 basis points to that to get the -- a better, more accurate read.

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

Okay, great. And then on the loan growth this quarter in terms of the C&I growth, was that general C&I? Or was that more weighted towards trade finance in the quarter?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

You want to answer that?

Wellington Chen - *Preferred Bank - President & COO*

Sure. Gary, this is Wellington. It's general C&I. We don't have that much trade finance transaction. And so it's really a working -- local working capital to various local institutions.

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

So were you guys seeing increased new production in that C&I bucket? Or was it increased utilization of your existing commitments?

Wellington Chen - *Preferred Bank - President & COO*

It's in both. But we did have some quite a bit of new relationship that we brought in that we've been working on since earlier this year. So -- and then that, coupled with a few existing customer that they haven't been drawing much on their line of credit and the seasonal situation, so they start to [wind] down.

Operator

The next question comes from Tim Coffey with FIG Partners.

Timothy Norton Coffey - *FIG Partners, LLC, Research Division - VP & Research Analyst*

Ed, as you get into looking at kind of the growth in deposits, any -- I mean, is it likely that you'll start drawing that cash because that load is -- it's more than you've had in a while? So then could we see that create somewhat of a slowdown on the growth in deposit costs?

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

Well, actually, Tim, to correct you, our cash levels have actually been close to $500 million for about the last 5 quarters now. It was really only kind of Q1 where we drew down a little bit. But again, like I said, we'll -- cost of deposits will keep going up simply because of how the CDs will be maturing and rolling over. That's just a given. What we need to do is control and weigh the costs versus the growth given the backdrop of almost $500 million in cash and wanting to maximize EPS. So it's -- that's really kind of -- the balancing act we have to do here is managing all those components.

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

Gary, I guess that the -- this is Li Yu, okay? I guess I have to answer you from operating point of view, not really a mathematical point of view, okay? We want to continue to operate and continue to grow. One of the situations we do is that whenever you can have the stable, long-term deposit at a reasonable cost, you take it, irregardless you're currently medium or not, okay? If somebody walks in that says, "Li, here's about $0.5 million, $1 billion dollar deposit. I'm going to stay with you a year, 2 year." We'll take it right away. It will hurt our NIM to no end. It will hurt the ROA. It'll hurt many different things, but it'll probably help the ROE and net income. But regardless where is the deposit, we can continue to book loans. This is -- I guess this is survival of the institution. So with that, as long as we have that big -- I mean, even though we have the big cash on hand, if I can, I'd like to maintain even more cash on hand.

Timothy Norton Coffey - *FIG Partners, LLC, Research Division - VP & Research Analyst*

I guess, with the visibility you see on your loan portfolio, there is no reason to get cute on the funding. So that makes sense. And then I still had a couple of other cleanup questions. Beyond the deconversion on -- I'm switching courses, do you have any other big IT projects planned, or back-office projects planned?

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

Not big, Tim. But we do have what we call Day 2 projects post conversion. There's going to be some new products and services, the biggest of which we'll be implementing will be online account openings. Actually be able to go our website and open a new deposit account. So you can imagine the processes around that and implementing that are considerable. So those are what we call Day 2 projects. Those will be rolled out overs Q -- over Qs 3 and 4 of this year.

Timothy Norton Coffey - *FIG Partners, LLC, Research Division - VP & Research Analyst*

Okay. Are those things we should start looking to budget for in noninterest expenses?

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

Well, a lot of that stuff is already baked in. So what you're really going to be seeing will be the consulting and the people costs surrounding that. But it won't be considerable.

Timothy Norton Coffey - *FIG Partners, LLC, Research Division - VP & Research Analyst*

Okay. And then just sort of a clarification. The discussions that we've had about loans in the pipeline for 3Q, is that inclusive of this hotel loan paying down?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

Sure. It is all -- we -- when we look at the pipeline, we also look at payoffs, loan payoffs. The net number is what we're talking about.

Operator

(Operator Instructions) The next question comes from Don Worthington with Raymond James.

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

Any outlook for the tax rate in the second half? I know it was up a bit this quarter versus last.

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

Yes, that's a great question, Don. I'm glad you brought that up. I think it will be consistent with this most recent quarter. That's my best visibility, and I think that's right around 28%.

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

Okay, great. And then what was the nature -- or what generated the securities gain in the quarter? Was this some restructuring or anything along that line?

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

It was actually a couple of things. Believe it or not, it was a little bit of a blessing in disguise. We owned a corporate note, which was a former subsidiary of Bank of America, which actually had a low investment-grade rating on it, if you can believe that. That was called at par. We owned it at a discount. So that was the gain. Offsetting that $130,000 gain was a loss of about $18,000 on the sale of a pool of MBS, which, under the new accounting standards in Q1, required us to mark that pool-to-market through the P&L on a quarterly basis. I think you saw one of our two big brothers have a challenge with that this quarter. And so in order for us not to have to mark that to market on a quarterly basis to the P&L, we sold it, took about $18,000 loss.

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

Okay, great. And then you mentioned at least that 1 competitive deal where you had a payoff. Where is the competition coming from primarily? Is it other community banks or large banks? Or all of the above?

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

It's other community banks. Also that foreign banks is really one of the (inaudible) seems to be their funding structure is way different than ours. And also, that -- I mean, banks larger, not necessarily the so-called mega bank, but banks that are in the $100 billion range.

Operator

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

Li Yu - *Preferred Bank - Chairman, CEO & Corporate Secretary*

Well, so thank you so much for your joining us in the -- in earnings phone call. As we said, we hope we can continue to deliver favorable financial results to our shareholders. Thank you.

Operator

This conference has now concluded. Thank you for attending today's presentation. You may now disconnect.