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MRLN - Q1 2016 Marlin Business Services Corp Earnings Call

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CORPORATE PARTICIPANTS

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Taylor Kamp *Marlin Business Services Corp. - CFO*

CONFERENCE CALL PARTICIPANTS

Brian Hogan *William Blair - Analyst*

Andy Ellner *JMP Securities - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Marlin Business Services Corporation's First Quarter 2016 Earnings Conference call. At this time, all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. As a reminder, this conference is being recorded and is being webcast simultaneously on the Investor Relations section of Marlin's website at www.marlinfinance.com. The recording of the call will be archived on the website for approximately 45 days.

I would like to remind you that this conference call may contain statements that are forward-looking within the meaning of the applicable federal securities laws and are based on Marlin Business Services Corporation's current expectations and assumptions, which are subject to a number of risks and uncertainties that could cause actual results to differ materially from those anticipated.

Factors that could cause actual results to differ from those anticipated are detailed in the Company's Securities and Exchange Commission filings. Listeners are cautioned not to place undue reliance on these forward-looking statements. Such forward-looking statements speak only as of the date of which they are made, and the Company does not undertake any obligation to update any forward-looking statements to reflect events or circumstances after the date of this call.

Speaking to you today will be Ed Siciliano, Chief Sales Officer and Interim Chief Executive Officer. Also on the call is Taylor Kamp, Chief Financial Officer. The Company will begin the call with prepared comments and follow up with a question-and-answer session.

It is now my pleasure to introduce your host, Mr. Ed Siciliano of Marlin Business Services Corporation. Thank you, Ed. You may begin.

Ed Siciliano - *Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer*

Thank you, [Liz]. Good morning everyone and welcome to today's call. Let me begin by providing some highlights of our progress we have made in executing our new business plan in the first quarter.

As you recall, in 2015, we set out to make deliberate investments in our business to accelerate originations, better serve our customers and position ourselves to consistently drive higher shareholder returns. We invested in our sales force to take advantage of a large market opportunity and in support of our new equipment leasing channels; franchise and transportation. We also entered the small business loan market by developing our funding stream product. I am pleased to report that we saw significant progress toward our goals in the first quarter. Total originations were \$108.4 million, a record and up 33% year-over-year and even slightly higher than fourth quarter 2015 originations. Higher application levels, increased dealer contribution, and momentum in our new channels drove this increase.

We are taking market share. Importantly, our volume momentum was not the result of approving lesser quality credits. In fact, our credit approval rates declined year-over-year. Our new loan product funding stream continues to gain traction with better-than-expected credit results, further demonstrating the value of cross-selling to known credit within our customer base and the efficiency of well-designed web-based technology. A few highlights from our business results.



We ended the quarter with net income of \$3.7 million, net earnings were impacted by higher yielding asset run-off within our portfolio and by higher expenses carrying over from last year's investment spending. Total loan originations more than doubled to \$7.9 million and represented approximately 7% of our total originations. Credit results, given the seasonality we expected in Q1, were well within our desired range with quarter-ending delinquencies and losses declining year-over-year. Early loan credit results are exceeding expectations as we cautiously increased originations and refine our underwriting models. Yield on new leased business declined by 31 basis points from the fourth quarter due to channel mix but was offset by higher loan yield in the quarter. Overall, net interest and fee margin increased over the previous quarter to 11.58%.

Finally, I want to provide you with an update in regard to our CEO search. Marlin's Board has recently completed a comprehensive talent search process which uncovered some exceptional individuals. An offer has been made to a highly qualified industry executive and we are finalizing terms. We anticipate a formal announcement out in the early May. We are truly excited about this development. We feel that it will help accelerate our momentum.

In closing, the Company is energized and looking forward to achieving many new milestones in the quarters to come. I want to thank every Marlin employee for their contributions so far this year. Looking ahead, our priorities continue to be prudent originations growth as we seek to maximize the return on our sales force and new product investments, sensible credit underwriting and expense management and optimal capital deployment. We look forward to presenting future results and demonstrating unique potential of the Marlin's small business lending platform.

With that, I will turn the call over to Taylor. Taylor?

Taylor Kamp - Marlin Business Services Corp. - CFO

Thank you, Ed and good morning. As Ed mentioned, Marlin had another strong quarter and we continued to build substantial momentum in our core business and in our new initiatives. This is in spite of the fact our historical first quarter results are generally our lowest quarter from a seasonal standpoint. We had very encouraging operating results with net income of \$3.7 million and EPS of \$0.29 per diluted share. Total origination volume, including leased loan and syndicated volume, as Ed noted, was the second consecutive record quarter at \$108.4 million, up 33% a year ago.

Total volume was up about 1% from last quarter, even though first quarter production has historically been well below fourth quarter. Our net investment in leases and loans grew approximately 3% from last quarter, and 12% year-over-year to \$702.1 million. ROE for the quarter was 9.74%, up from 9.33% a year ago. We expect ROE to continue to increase as our new initiatives gained traction and scale up. For the quarter, net interest margin was 11.58%, 6 basis points higher than the fourth quarter of last year. As a result of the increasing impact of our funding stream loan product, we continue to see improvement in the average new business yield and some remediation of the decline in NIM. Even so, we will continue to see our NIM levels move slightly down and laterally as older higher rate business rolls off. We expect the trend to continue for two more quarters or so depending on any subsequent increase in market rates.

Cost of funds increased slightly from last quarter, from 98 basis points to 100 basis points. Fee income increased 11 basis points from last quarter, but was down 39 basis points from a year ago. This decrease from last year was due mostly to lower late charge generation resulting from better front-end portfolio delinquency performance. As Ed emphasized, credit quality continued to perform well in the first quarter. Total 30-plus and 60-plus delinquency were up somewhat from the fourth quarter to 0.85% and 0.52% respectively. However, 30-plus delinquencies were down 2 basis points from year ago and 60-plus delinquencies were down 5 basis points. Total charge-offs decreased to 1.35% of average finance receivables as compared to 1.60% last quarter and 1.70% last year. It is still early in the second quarter, but we are seeing a continuation of the positive credit performance. The allowance for credit loss reserves was 1.31% of total finance receivables, and 223.4% coverage of 60-day delinquencies. Additional information on static pool losses and delinquencies is available on our Investor Relations website.

First quarter 2016 operating expense was \$12.7 million as compared to \$11.2 million a year ago. The increase in expense from last year was primarily due to an increase in average headcount of approximately 25 full-time equivalent employees and our new product channels, partially offset by decrease in headcount in other areas of the Company. Variable expense was also up from last year due to higher application levels and higher loan and lease originations. Yesterday, we declared a regular dividend of \$0.14 per share.

Our capital position remained strong with an equity to assets ratio of 19.03%, 0.39 percentage points below last quarter and 3.73 percentage points below last year. The large decrease from a year ago reflects the impact of our \$2 per share of special dividend declared in September of 2015. We will continue to closely monitor our capital account, weigh investment alternatives, and adjust capital trajectory as needed by deploying capital with the best interest of our shareholders in mind.

As Ed and I have both highlighted, Marlin's first quarter performance, especially in the areas of volume production and credit quality, serves as strong evidence that our investments in our strategic initiatives are starting to bear fruit, but not at the expense of increased credit risk.



And with that, I will turn the call over to the operator for Q&A.

QUESTION AND ANSWER

Operator

(Operator Instructions) Brian Hogan, William Blair.

Brian Hogan - William Blair - Analyst

Good morning. Lots of questions here. I will start with the efficiency ratio. 58% in the quarter and you kind of highlighted some elevated investment spend. I guess what is the investment spend by how much? And how long do you expect it to continue for these new growth initiatives? What is the normal ordinary course operating expenses? And then what are the returns on those investments that you expect to get? What's the target ROEs on those?

Taylor Kamp - Marlin Business Services Corp. - CFO

Brian, I'll take that one. Thank you. This is Taylor. We don't -- we are not going to give specific guidance on this but let me give you some elements of that. As I noted, I'll start with sort of the investment spend. We added 25 new sales, credit and support resources in our new initiatives since a year ago, and about seven of those resources were added in the first quarter. We would expect to add a few more resources through the second quarter but pretty much be done with that process of investing in new initiatives. That increase is a little shy of \$2 million in staffing and infrastructure investment since last year. I would say that the good news is that our staffing and administrative expense have been pretty flat since that period of time.

As far as the efficiency ratio goes, there's been a lot of noise in that number certainly over the last couple of quarters and in this quarter and also the first quarter generally has some other seasonal things that happen. We have some FICA expense and things like that that increased that number a little bit. But we would expect in the last half of the year to start to see our initiatives mitigate the erosion in the efficiency ratio. In particular, our funding stream product will be, we believe, positive contribution to the number. And so as revenues -- so if expenses tend to be flat through the end of the year from a quarterly basis, as our revenues increase, we would see that efficiency ratio begin to drop. Now whether we get back to our historically low levels remains to be seen as we're focused primarily on additional incremental income contribution and growth in assets.

Brian Hogan - William Blair - Analyst

All right. So, do you have a target efficiency ratio or is it just seeing how the growth and returns kind of plays out?

Taylor Kamp - Marlin Business Services Corp. - CFO

I think as we scale up, we would see those historical ratios return, but again we're focused on generating incremental income, superior ROE performance and asset growth. As far as the return -- our targeted return for all channels should be in the mid-teens once they are scaled up, some above that, maybe some on the lower-end of that range. But in general, we're a mid-teen -- we have a mid-teen target for return on equity.



Brian Hogan - William Blair - Analyst

All right. That's helpful, thanks. Like credit trends, delinquencies up from quarter-over-quarter, kind of relatively flat year-over-year. The charges were down on the quarter. What are you seeing broadly from a credit perspective? You look at the Equipment Leasing & Finance Association, they saw their charge-offs spike in the quarter. Just kind of seeing what are you seeing broadly from a credit and then what are you doing you're your underwriting perspective? And with that, the approval rate dropped. Obviously, it can be a function of the number of applications you get in and same number of -- approving the same number, but what is the quality of the applications coming into?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

Brian, this is Ed, I can comment a little bit on that. We are pleased with the credit results. We look at it on the first quarter over first quarter basis and the key categories, 30-day, 60-day and losses are down. So, we're pleased with that. In terms of credit quality through the door, you commented on approved rates, they are declining based on credit quality through the door, but we trust our models and we're really not tweaking our models, these are 18-year credits history models, which are highly calibrated, and we're not really changing those.

If you look at our core markets, approval rates were more like 64%, but they blend it down to the 62% that you might see in the supplemental information as a result of our new channels, which we have some lesser quality coming through the door, which we're just not accepting. So, guidance on that is we're probably be running in the low 60s as opposed to a year plus ago, where we're 67%, but I want to reemphasize that we trust our models, and we feel like it's optimized right now.

Brian Hogan - William Blair - Analyst

What are your views on the economy? Are you seeing) Cant understand region? Obviously, oil and gas industries are tough, what are your thoughts there?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

So, we recently completed a state -- we do a state scorecard analysis and as it turns out, we have very limited exposure to what's happening on the petroleum industry just on your comment there. The economy is, it's not hurting us and it's not helping us. It's been in the doldrums for quite some time, which is why we're trying to just kind of out run that macroeconomic condition by investing in new channels; loan, franchise, transportation, and that's working for us. With applications up 37% and volume up the way it is, we think we've got the right plan.

In terms of small business stress, our 30-day number really doesn't indicate within our portfolio, but there is a lot of small business stress. We're being extremely cautious on the loan size in the lending area where we do see a frothy market developing. But yes, we're pleased. We're taking market share is how we're growing the business, not necessarily buying any deeper on the credit side.

Taylor Kamp - Marlin Business Services Corp. - CFO

Now if I would add to that, Ed, we're seeing some disruption among our competition. You have CIT and DLL and GE all in some state of flux. And so, we believe that that can give us an opportunity to fill gaps. But in general, I think that our volume is a testament to the fact that we're hitting on all cylinders.

Brian Hogan - William Blair - Analyst



And then a follow-up to that comment, I was going to ask about the competitive environment and obviously you just mentioned, GE and the likes. What are you seeing from the bank side, just comment on the competitive environments even more broadly please?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

I can start Brian. It's hard to quantify, but we are in a period of some competitive disruption. So, GE is the big one out there, added the business except for their core businesses where they're selling products and financing that. That's caused some disruptions. Some of the other big banks, specifically DLL and CIT seem to be pulling back in the leasing space, I think that might have something to do with Basel III and capital requirements increasing. And then the independents seem to be suffering through some transition as well. [Direct capital] was recently sold and there's some other noise around some of the smaller leasing companies we compete with. And I think we're really benefiting from that. Our business is strong. We're growing, we're taking market share, we just won a meaningful program from a large kind of recognizable technology manufacturer in a highly competitive situation. So, we're grabbing share. Also happy that our loan product is adding real value to our customers. So, I feel like we've never been better positioned.

Brian Hogan - William Blair - Analyst

Why did you win that contract, was it just a quality of service or was it price?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

It's flexibility to offer a price and exchange for value in service level that we provide. The ticket size was 25,000 which nobody -- we just don't think anybody does that ticket size better in the United States. We are flexible in terms of the terms around the contract and we're really excited about that. Hopefully, we are going to do many more this year, but that was a big one, which will start to implement that program in Q2 and see the results in the second half.

Brian Hogan - William Blair - Analyst

Sure. I have more questions, but I'll jump back in queue.

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

That's fine, Brian. Thank you.

Operator

(Operator Instructions) Andy Ellner, JMP Securities.



Andy Ellner - JMP Securities - Analyst

Good morning. Thank you for taking my question. I'm filling in for Chris York this morning. We appreciate the update on the CEO search, which is good to hear. Could you also update us on the CCO search?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

Yes, sure. So we have that position open. We're actively working with Heidrick & Struggles and help us fill that position where we're actively interviewing as an organization right now, but we're also tying Andy, the CCO search to the CEO on boarding. So, we'll have more information on that in the next quarter.

Andy Ellner - JMP Securities - Analyst

Great, that's helpful. My other questions have been asked and answered. Thank you.

Operator

Brian Hogan, William Blair.

Brian Hogan - William Blair - Analyst

I am back. So, are there any one-time costs in the quarter related to the CEO search or CCO search or any other items?

Taylor Kamp - Marlin Business Services Corp. - CFO

Yes. There is, we expensed -- this is Taylor, we expensed the CEO search expense in the fourth quarter. So, there is no sort of incremental or transitional expense related to that in the first quarter. We do have some minor trailing expense related to the consultancy arrangement with the former CEO. But we're pretty clean in the quarter. There is seasonal expense but unrelated to the CEO or CCO search. I will note that the CEO expense, there was no salary and comp expense in the first quarter. We have planned for that, so we'll see some increase in the second quarter due to that, but there will be some offsets as well.

Brian Hogan - William Blair - Analyst

Sure, thanks. The averaged lease size had jumped up a decent amount, but the implicit yield came down. Is this due to business mix more from a national account channel, which obviously would explain maybe some lower credit losses and maybe hopefully some efficiency savings. But can you explain that please?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer



Yes. So for many years, Brian, our average ticket was [\$13,000, \$14,000]. We are consciously trying to bring ticket up a little bit. And so, we've taken a more open posture with our vendor base. We have 5,000 active vendors letting them know that we're more willing to look at some of the larger credits. Also looking for higher credit quality, as we move up ticket. So yes, in the first quarter, our average ticket booked with 16,000. So, really a slight increase from the 14,000 historic, but it helps overall volume and originations. Commensurate with that, you've got our new channels, transportation of franchise, which do have lower yields, which gives you a lower yield -- new origination yield blend and you saw that at 10.35%. But that's offset by some really rich yields on the loan products, a loan product that we're really just addressing our existing customer base, so kind of high credit quality, but enjoyable yields for the time being within that.

And then the other key thing that we're doing, I mentioned that applications were up 37%, we're really leveraging the size and growth of our sales force right now and kind of over-originating on applications with the intent of syndicating some of that business. We're looking for fee income associated with that, which we're going to layer on top of lower origination yields and come out with the NIM that's highly respectable in the slow interest rate environment.

So, there's really three components to the plan. We're over-originating, growing the balance sheet, we're looking for more syndication fee income and we are putting some loan yields on top of that. We feel the result is going to be earnings growth, while we grow ROE and ultimately some good things for the shareholders over time. And that's the plan and I will say after two quarters of executing on that, we're really delighted with the results.

Brian Hogan - William Blair - Analyst

And there is no syndication in the quarter, is that just because it's coming or is that the thoughts there?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

Yes. So, syndication is in kind of two flavors, Brian. One is where we just get a fee and we don't list it on the supplemental data and the other is where we're retaining servicing and you'll see that net syndication number. We did plenty of fee income, but we weren't necessarily retaining service on that business but look for that to grow over the next couple of quarters. What we did accomplish in the first quarter as we added three or four new syndication sources, we're trying to find a home for everything we're originating now. So, we can really get syndication, a referral income up substantially over the next couple of quarters.

Taylor Kamp - Marlin Business Services Corp. - CFO

I would say that there is some staging involved with that product and with that service and that as we build up volume and as we build up access or reach into assets, you'll see more activity on that front. But it takes -- it is a little bit of lead time as we stage assets for sale.

Brian Hogan - William Blair - Analyst

On the business loan product, what do you -- how fast do you expect it to ramp? What are the -- do you have target originations for the year? Obviously, there is [seven and change] in the quarter. Up from here, I assume but how we're thinking about the ramp?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer



It's going to be approximately, Brian, \$40 million in the year. If you run rate loan results from the first quarter, we're already at \$32 million, roughly \$8 million times four quarters if you annualize that. Each quarter will grow although you won't see the same growth in the next few quarters. That loan product is fully staffed, all our technology is working although we're refining it. And I want to reemphasize that our model focuses primarily on pre-qualified model on customers. So, we're using internal referrals, direct mail, digital marketing to reach our known customer base. So, as a result of that, credit quality has been very, very good. We can count loan charge-offs on one hand at the present time. So, we're slowly throttling that product, paying attention to our credit models. But as it relates to loan, Marlin is in a unique and enviable position [to off] a working capital and we have a lot of headroom within our customer base.

Brian Hogan - William Blair - Analyst

And that last comment was actually one of my questions like how much more room do you have, but also with that the implicit yield on those has bounced around the decent amount as you are probably testing the product and as you may be alluded to earlier that your -- maybe your lost forecast for the product as maybe lower than initially thought, but what are the returns on that product, I mean it was yield of 28% in the quarter and charge-offs of 3% in the quarter, just kind of what are your thoughts on the returns?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

I am glad you asked the question, Brian. I will handle yields and let me turn it over to Taylor for the returns, but our daily ACH working capital product, yields on that product were 34% in the quarter. The reason you see the lower yields on that line, Brian, is that we have a couple of -- we have some traditional loans for our franchise market that have much lower yields, which blended that down to 28%. So, we did \$6 million plus on the daily ACH kind of high-yield product at 34%, and we did some 7% to 8% loans within our franchise channel, which is why you see the 28%. So, it actually hasn't bounced around. We've been in that 34% range on our high-yield products since its inception, but we're doing a little bit of the other traditional business. And in regard to returns, Taylor, maybe you can share some color on that.

Taylor Kamp - Marlin Business Services Corp. - CFO

That product limbs itself well at 34% topline, limbs itself well to generating a very good sort of NIM. The overall income is right now about neutral to the total P&L, but as I noted earlier, that business in the latter half of the year really will start to ramp up as the expense growth slows and the volume increases and so you can do some simple math around 34% yield and [one in a quarter cost of funds -- 100 basis points cost of funds] and it's a little more expensive to generate that volume than some of our leasing products and then losses even if you use sort of fully loaded 4.5% loss proxy on that if you average between broker and direct, it generates very nice returns once it's scaled.

And we also internally look at that product from a risk-based capital standpoint. But in general, you'd expect those returns to be superior to our lease returns.

Brian Hogan - William Blair - Analyst

Okay. Thanks. Do you have origination target for the leases for the year? I mean, you mentioned earlier you're going to originate as much as possible until you use the syndication market, I guess, but where are your costs and how much you can do especially with the competitive disruption?

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

We don't have forward guidance on that, Brian. The only thing I would say is, it's our expectation that quarter-in quarter-out we'll be increasing originations.



Brian Hogan - William Blair - Analyst

All right. Your capital, why didn't you buyback any stock in the quarter, your stock price was down and especially mid-February time frame and any thoughts on why you didn't repurchase shares?

Taylor Kamp - Marlin Business Services Corp. - CFO

Brian, that's true we didn't buy back stock in the quarter, but on the other hand, we continue to significantly expand our funding of new loans and leases over prior-year and you should take that to mean that we believe that investing in that growth in those assets will provide superior returns over the mid and long-term. That being said, we'll continue to monitor the capital account and weigh those opportunities and those opportunities obviously organic growth, they are inorganic growth, they are returning capital to shareholders and try to use that capital in most efficient manner. It's just simply a trade-off. Right now, we believe that we have an opportunity to invest in the business, invest in earning assets and that will contribute to expansion in the value of the Company.

Brian Hogan - William Blair - Analyst

I think that's it from me for now. Thanks for your time.

Ed Siciliano - Marlin Business Services Corp. - Interim CEO, EVP, and Chief Sales Officer

We appreciate the questions, Brian. Thank you.

Operator

That concludes today's question-and-answer session. Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program and you may now disconnect. Everyone have a great day.



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