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MRLN - Q4 2016 Marlin Business Services Corp Earnings Call

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Brian Hogan *William Blair & Company - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the Marlin Business Services Corporation's 2016 fourth-quarter and full-year results conference call.

(Operator Instructions)

As reminder, today's conference call is being recorded.

I would now like to introduce your first speaker for today, Lasse Glassen, ADDO Investor Relations. You have the floor.

Lasse Glassen - *ADDO Investor Relations - Managing Director*

Good morning, and thank you for joining us today for Marlin Business Services Corp's 2016 fourth-quarter and full-year results conference call. On the call today is Jeff Hilzinger, President and Chief Executive Officer; Ed Siciliano, Executive Vice President and Chief Operating Officer; and Taylor Kamp, Senior Vice President and Chief Financial Officer.

Before beginning today's call, let me remind you some of the statements made today will be forward-looking and are made under the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those projected or implied due to a variety of factors. We refer you to Marlin's recent filings with the SEC for a more detailed discussion of the risks that could impact the Company's future operating results and financial condition.

With that, is now my pleasure to turn the call over to Marlin's President and CEO, Jeff Hilzinger. Jeff?

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Thank you, Lasse. Good morning, and thank you everyone for joining us to discuss our 2016 fourth-quarter and full-year results. I will begin my remarks today with an overview of the key highlights from the past quarter, including an update on our Marlin 2.0 initiative that we expect will help take Marlin to the next level of growth and profitability. Ed Siciliano, our Chief Operating Officer, will provide additional comments on our fourth-quarter and full-year operational performance, and Taylor Kamp, our Chief Financial Officer, will then discuss details about our financial results and provide 2017 full-year guidance.

We concluded 2016 with an outstanding fourth quarter, driven by robust origination volume and strong credit quality, which helped deliver solid earnings growth. Total origination volume of $146.1 million was a record for a single quarter, and increased nearly 14% compared to the previous quarter and more than 35% from the fourth quarter last year.

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While strong customer demand in our equipment finance business continues to drive overall growth, we also benefited from our strategy to transform Marlin from primarily a micro-ticket equipment lessor into a broader provider of credit products and services to small businesses. Funding Stream, our working capital loan business, also performed well and contributed $11.3 million, or 8% of total originations in the quarter, and our franchise finance business, which caters to the unique financing needs of franchisees, contributed $5.1 million, or 4% of total fourth-quarter originations.

As a result, our investment in leases and loans grew to a record $793.3 million, up almost 5% compared to the previous quarter and up 17% from a year ago with continued strong credit quality. Fourth-quarter net income also increased on both a sequential quarter and year-over-year basis to $4.8 million, or $0.38 per share.

Overall, 2016 was a very productive and transformative year for our Company, and I want to thank everybody at Marlin for their hard work and dedication during a year of significant change. We're all looking forward to building on this success in 2017. Along with our strong business performance we also announced an important promotion and a key new hire to the Marlin senior leadership team.

During the quarter we promoted Karen Shields to the newly created position of Deputy General Counsel. Karen is a 14-year veteran at Marlin, and in her new role she will have responsibility for managing a number of the Company's legal functions, including vendor and customer contract negotiations, litigation and the creation and management of the Company's transactional documents. Karen has made significant contributions to Marlin's success over the past decade, and we're very pleased to recognize her with this well-deserved promotion.

Subsequent to the end of the quarter we were very pleased to announce the appointment of Louis Maslowe as Marlin's new Chief Credit Officer. Lou has an extensive background in commercial finance with over 30 years of credit experience. Before joining Marlin Lou was Senior Vice President and Chief Risk Officer of the Americas for DLL, a global provider of asset-based financial solutions and a wholly owned subsidiary of Rabobank Group.

In this role his responsibilities included all credit adjudication, enterprise risk management and credit scorecard management for the Americas. In addition he served as Co-Chairman of the Global Model Risk Committee and was a member of DLL's Global Risk, Credit and Audit Committees. Prior to this he held senior leadership positions in credit and risk management with other leading bank-owned, independent and captive leasing companies.

As Marlin's Chief Credit Officer, Lou will be responsible for managing all underwriting practices, policies, procedures and Marlin's overall risk appetite across all of our businesses. Given his significant experience across a wide range of commercial finance products, Lou is ideally suited to lead our credit function as we look to expand Marlin's product and service offerings beyond equipment finance. I am delighted to have Lou join our senior leadership team.

In building out our management team over the past several quarters, I have been mindful of the need to leverage new ideas and perspectives while at the same time preserving what has helped make Marlin such a great Company. I feel that the Marlin team today definitely embodies this concept, and that we are well positioned to now pivot from defining Marlin's new strategy toward an increasing focus on the execution of our strategic plan.

At this point I'd like to switch gears and provide an update on our business transformation process, which we refer to as our Marlin 2.0 initiative. Through Marlin 2.0 we expect to drive sustainable growth and improve returns by first, strategically expanding our target market; second, better leveraging the Company's capital base and fixed costs through origination and portfolio growth; and third, improving our operating efficiency by better leveraging fixed costs through scale and through operational improvements to reduce unit processing costs.

I'd like to share with you the progress we've made in each of these areas since our last call. First, with respect to our strategic market expansion, while Marlin has historically operated primarily as a micro-ticket equipment lessor, in recent quarters we've begun to see meaningful contributions from credit products and services that reach beyond our equipment finance business.

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This is most clearly evident with the ongoing success we're seeing with our Funding Stream working capital loan business, which increased sequentially in each quarter during the year. We expect Funding Stream origination volume to continue to accelerate in 2017, and believe more than ever that Marlin is uniquely positioned to offer this product, given its large base of existing customers, which is our primary target market.

In addition our franchise finance business, which was formed in late 2015 and also offers credit products beyond equipment finance, continued to grain traction during the quarter. While franchise origination volume was relatively modest in 2016, we expect activity to pick up significantly as we more aggressively target this unique and attractive market in the future.

Also consistent with our stated strategy of augmenting organic growth with strategic corporate development activities, we announced the acquisition of Horizon Keystone Financial. Horizon has a 20-year track record as an originator of equipment finance credit products focused on the office furniture, HVAC and automotive markets, including a team of originators and sales support staff who we welcome to Marlin as our newest employees.

Exact terms of the transaction were not disclosed, but included an initial payment with a commission-based compensation structure going forward. We expect the transaction to be accretive to Marlin's earnings per share in 2017.

This transaction represents an important milestone for Marlin and extends our existing equipment finance business into new and attractive markets. By providing Marlin with the opportunity to enter these new equipment markets, Horizon is an ideal complement to our existing equipment finance business and further leverages our existing infrastructure.

In addition, by providing the Horizon team with access to our technology, marketing resources and low-cost funding platform we believe that there is an opportunity to significantly accelerate Horizon's future growth. Because origination and portfolio growth is a key component of the Marlin 2.0 initiative, we expect to identify additional growth engines in the future, both organically and through acquisitions like Horizon, with the goal of doubling our origination volume by 2020.

We also made good progress during the quarter on our second key priority, which aims to better leverage the Company's capital and fixed costs through growth. With respect to leveraging capital, our record origination volume and portfolio size during the quarter allowed us to reduce our equity to assets ratio from 19.42% to 18.19% on a year-over-year basis.

During the quarter we also made significant headway with a large financial institution to establish a wholesale credit facility at the holding company level. In addition to diversifying our funding sources, the credit facility will also better leverage our capital base and allow us to further increase Marlin's return on equity in the future. We are close to completing our negotiations on the facility's terms and conditions, and we expect to have the new facility in place later in the first quarter or early in the second quarter of 2017.

We're also continuing to refine our strategy with respect to secondary capital markets activities, and I'm pleased to report that we completed another portfolio sale during the fourth quarter. In addition to providing Marlin with another source of funding, we view these transactions as a means to optimize both the economic and credit composition of our portfolio. These activities will be particularly beneficial in the future by allowing us to more precisely manage the size of our portfolio without interrupting the flow of our origination activities as we more fully leverage our capital base.

Future sales will continue to be focused on assets that Marlin originates that may reside more efficiently on other investors' balance sheets or that Marlin elects to sell because of other economic or risk factors. As we have stated previously, over the next two to three years our goal is to use this more diversified set of funding sources to improve Marlin's overall portfolio leverage to approximately 90%.

And finally, we also continue to make progress better leveraging the Company's fixed costs during the quarter, as evidenced by our improving operating efficiency despite certain nonrecurring expenses that were associated with our Marlin 2.0 initiative. During the quarter we remained highly focused on evaluating, renewing and optimizing our business processes in order to enhance overall operating efficiencies, while also creating an improved customer experience.

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Internal Marlin teams continue to actively work on process renewal initiatives with the overarching objective of achieving significant improvements in cycle times, quality and overall productivity. We estimate that we are currently about halfway through the 9- to 12-month design portion of the project, and overall I am quite pleased with what we're seeing in terms of the potential gains in throughput while maintaining current operational headcount levels. As I've stated previously, through all of these activities we expect to improve Marlin's operating efficiency ratio in the coming years to approximately 45%.

In summary, 2016 was the beginning of a truly transformative period for Marlin. During this past year we saw significant changes to Marlin's leadership team. We also launched the Company in a new strategic direction with a larger market opportunity that we believe will better leverage Marlin's strengths to drive sustainable, profitable growth.

In attacking a larger opportunity, we do expect overall yields to decline somewhat as we reach into new segments of the market, but we expect that the financial impact from reduced yields will be more than offset by efficiencies from scale, improved credit quality, larger transaction sizes, improved productivity and a more efficient use of capital. Taken together, these changes will result in a substantial increase in return on equity, which is our primary focus. With Marlin's new strategic course set, 2017 will be very much focused on executing against our strategic plan as we continue to work to unlock Marlin's significant value for all of our stakeholders.

With that, I'd like to now turn the call over to Ed Siciliano, our Chief Operating Officer, to discuss our fourth-quarter operational performance in more detail. Ed?

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

Thank you Jeff, and good morning everyone. My comments today will focus on fourth-quarter and full-year origination activities and overall credit quality.

Total origination volume in the fourth quarter was $146.1 million, breaking the previous record established last quarter by 14% and up 35% compared to the fourth quarter of last year. In addition, full-year 2016 total origination volume exceeded the $500 million milestone for the first time in Marlin's 19-year history and came in at $504.3 million, up 31% from 2015. We're pleased to have reached these record origination volumes while maintaining our stable credit underwriting standards.

Our equipment finance origination volume, independent of Funding Stream, also reached a historic quarterly high of $134.9 million, about 14% higher than the previous record. In addition, our investment in leases and loans grew to $793 million, also a record high, up 5% from the prior quarter and up 17% from the fourth quarter last year. The origination volume growth on both a year-over-year and sequential quarter basis was driven by a number of factors, including increased application levels and dealer contribution within our core channels, higher average ticket and increasing contributions from our new channels, franchise, transportation and Funding Stream.

To expand on Jeff's comments earlier, Marlin's process renewal initiative is beginning to produce early results, as demonstrated by a fantastic final month of 2016. In December the Company processed $54 million worth of equipment finance transactions, an increase of 23% over Marlin's previous best month ever, without any increase in production headcount or support staff.

Going forward, we believe process renewal will have a dramatic positive impact on our processing capacity as a result of significant improvements in productivity and streamlining. As added benefits we expect to see improvements in cycle times, service levels and quality.

Overall Marlin's disciplined credit underwriting continues, as evidenced by our strong credit quality and portfolio performance. For the quarter 30-plus and 60-plus day delinquencies were 80 basis points and 46 basis points respectively.

This is up slightly from the prior quarter but well within our desired range. Net charge-offs during the quarter were $2.7 million, or 1.4% of average finance receivables, as compared to $2.5 million, or 1.36% of AFR in the prior quarter, and $2.6 million, or 1.6% of AFR in the fourth quarter last year.

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We also continue to see momentum from our working capital loan product, Funding Stream, which was launched in 2015. Total fourth-quarter Funding Stream origination volume increased to $11.3 million, up 9% from the prior quarter and 3 times higher than the year-ago period.

This past quarter Funding Stream represented 7.7% of total origination, up from 3.4% of total originations in the fourth quarter last year. In line with previous quarters we were able to increase total Funding Stream origination volume, while also maintaining better than expected credit results.

This is in large part due to our ability to offer this product to existing customers and target those customers that have demonstrated to Marlin to be good credit risks. During the quarter approximately 80% of Funding Stream loans were originated with existing Marlin customers, many of whom were prequalified.

As expected, equipment finance yields continued to decline due to channel mix, but were partially offset by growth in our Funding Stream product, which has yields that are nearly 3.5 times higher than our average yields in the equipment finance business. Going forward we anticipate growth in Funding Stream will continue to offset declines in our equipment finance yields.

Our franchise financing business, which caters to the unique needs of franchisees, saw origination volume of $5.1 million, or 4% of fourth-quarter originations, as compared to 3% in the prior quarter and less than 1% in the fourth quarter of 2015. Building this business takes time, but it is worth the effort given the customer diversity and strength of credit.

During the quarter we completed our largest sale to date of equipment leases previously held on our balance sheet, totaling $11 million. This transaction in the fourth quarter generated an immediate gain on sale of $270,000 that was recorded in other income. Once again, we continue to service the leases that were sold and will recognize servicing fees over the life of the leases.

In closing, we are very pleased with our results in the fourth quarter and full year 2016. We believe we are in a very strong position entering 2017 and are very encouraged by our 2016 results, particularly around our Funding Stream and franchise products, additions to our management team and recent acquisition of Horizon Keystone Financial.

We continue to reach new milestones, and I look forward to continue to execute our well-defined strategy in 2017. With that, I'll turn the call over to our CFO, Taylor Kamp, for a more detailed discussion of our fourth-quarter and full-year financial results.

Taylor?

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

Thank you Ed and Jeff, and good morning everyone.

Marlin continued to demonstrate exceptional performance, led by record growth and originations and record portfolio levels while maintaining stable credit performance. In the fourth quarter we generated net income of $4.8 million and EPS of $0.38 per diluted share, which was ahead of expectations. This compares favorably with $4.3 million, or $0.35 per diluted share in the prior quarter, and $3 million, or $0.24 per diluted share a year ago.

For the full year 2016 the Company generated net income of $17.3 million with an EPS of a $1.38 share, up from net income of $16 million with an EPS of $1.25 in the prior-year period. Our net investment in leases and loans grew approximately 5% from last quarter and 17% year over year to $796.7 million. This was an all-time record for net investment.

Return on equity for the quarter was 12.06%, up 96 basis points from the prior quarter and up 410 basis points from a year ago. The lower ROE last year was due to one-time charges associated with the retirement of the previous CEO. We expect ROE to improve going forward as the business grows and we better leverage fixed costs through increasing scale via benefits from process renewal.

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For the quarter, net interest margin was 11.44%, 14 basis points higher than the prior quarter and 8 basis points lower than a year ago. The decrease in margin percentage from a year ago was primarily driven by the roll off of higher-yielding assets, growth in lower yielding equipment finance channels, a decline in late fees, and an increase in the Company's cost of funds.

The Company experienced an increase of 16 basis points in cost of funds from the fourth quarter of last year to 1.14%. This reflects the continuing impact of the December 2015 Fed rate hike and the recent December 2016 rate hike. This increase is in line with our expectations for continued NIM compression in the equipment finance business.

The portfolio continued to perform within acceptable ranges in the fourth quarter. Total charge-offs increased slightly to 1.40% of average financed receivables as compared to 1.36% last quarter, but down from 1.60% last year. For the quarter the allowance for credit loss reserves was 1.38% of total finance receivables and 264.4% coverage of 60-day delinquencies.

So far in the first quarter of 2017 we are continuing to see acceptable credit performance. Additional information on static pool losses and delinquencies is available on our investor relations website. Please note with the arrival of Lou Maslowe, our new CCO, and as we transition toward Marlin 2.0 we expect we will modify or replace these schedules in our core earnings and supplemental reporting with more relevant information.

Fourth-quarter other expenses were $13.5 million, compared to $12.8 million in the prior quarter and $14.6 million in the fourth quarter last year. The decrease in other expenses compared to the fourth quarter last year was mainly a result of one-time costs in the fourth quarter last year relating to the retirement of the Company's previous CEO. The increase in other expenses compared to the prior quarter was partially related to an increase in compensation expense associated with higher volume.

Despite an increase in other expenses from the third quarter, increased levels of earnings assets from the growth in our equipment finance and Funding Stream portfolios more than offset higher sequential quarter expenses. As a result, the Company's efficiency ratio improved 29 basis points to 54.6% in the fourth quarter.

Our capital position remained strong in the quarter with an equity to assets ratio of 18.19%, 7 basis points below last quarter and 123 basis points below last year. The continuing decrease in the capital ratio quarter to quarter was by design and resulted from strong asset growth.

I am pleased to report that our Board of Directors declared a regular quarterly dividend of $0.14 per share payable on February 16, 2017 to shareholders of record as of February 6, 2017. We continue to be committed to prudently balancing our growth strategy while continuing to provide value to shareholders.

We will weigh capital investment alternatives and adjust our capital trajectory as needed with the best interests of our shareholders in mind. The build-out of our syndication capability and closer and more frequent monitoring of our capital account allows us to very precisely manage capital.

Now, turning to our business outlook for the full year ending December 31, 2017. Full-year origination volume is expected to finish at least 20% above 2016 levels, which includes the impact of the Horizon Keystone acquisition.

Credit quality is anticipated to continue to remain stable and within our acceptable ranges. Net interest margin is expected to move slightly lower in 2017 with the roll-off of higher-yielding legacy leases and continued growth in lower yielding equipment finance channels, partially offset by expected growth in the Company's higher yielding Funding Stream loan business. And finally, we expect ROE to grow to the low teens by the end of 2017 as strategic initiatives gain traction and the Company continues to improve operating scale.

In conclusion, Marlin's strong fourth quarter was a capstone on a well-executed and record-setting year and represented an earnest but aggressive step toward Marlin 2.0. We look forward to continuing this success in 2017 and beyond.

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

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Brian Hogan, William Blair.

Brian Hogan - *William Blair & Company - Analyst*

Good morning. Question on the credit first. The reserve ratio up 5 basis points from the prior quarter, 1.38%. You talk about stable credit environment outlook.

And then looking at the pools by vintage and considering the lease rates and whatnot by implicit yield basis. I guess what I'm getting to is, what explains the increase in the reserve ratio? And then going further, you look at 2016 the delinquency for that vintage is 0.56%. If you look at a year ago for the 2015 vintage, it was 0.4%. I'm just trying to reconcile, considering the lower yields that you're putting on.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Yes, good morning Brian. This is Jeff. Thanks for the question.

Our view on this is, is that the performance of the portfolio as a whole and of any particular vintage is going to occur within a band, and is going to bounce around in that band as just a normal course of kind of statistical noise. We don't see any trend, negative or positive, actually, in the performance of the portfolio.

Not just the statistical data, but also the qualitative feedback we get from our collectors as they're talking to people that are delinquent are that there's not -- it's still a very benign environment and we don't believe that there's really any trending going on here. So having said that, I will say that we've got -- now we've got Lou onboard and we're really grateful that he's here because I think he's going to bring, I think, a very sophisticated focus to exactly how we're adjudicating credit, both today and as we continue to expand the business going forward.

We're -- I think as Lou gets his legs under him we're going to be in a position where we're going to report more robustly in terms of these calls. And it may be differently, but it's going to be more robustly on the credit performance of the portfolio. Ed, I don't know if you have any additional comments to that. But it's -- my perspective is, is that we're operating with a band. The band is consistent with the assumptions in the business model, which is totally consistent with the ROE objectives that we're trying to get from each business.

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

The only thing I would add -- how you doing, Brian?

Brian Hogan - *William Blair & Company - Analyst*

Good.

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

Is that, as you would expect, we have loss proxies by channel, and within bands within each one of those channels. And we're operating clearly within that band that Jeff talks about. If anything, we might've been a little low in 2015 in terms of maybe a tiny bit tight on credit. So we'll be refining these loss proxies by channel with Lou's help, but from a planning standpoint, even as we plan losses, we're doing better than we expected.

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Brian Hogan - *William Blair & Company - Analyst*

All right. I guess moving onto the origination activities. You said the demand was really strong, particularly in leveraging your platform particularly in December. Do you see the strong demand environment continuing through January?

And then just talk about the demand broadly from outlook? Obviously you expect originations to be up more than 20%. Any particular areas? Is it broad-based?

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

Yes. As you can tell, we're quite pleased with the results in the fourth quarter. Buying was very, very strong, and what we're most happy about, it was across all channels. All channels contributed and had year-over-year growth.

Our two newest channels, transportation and franchise, accounted for about half of the quarter-over-quarter growth. It was about $30 million higher in the fourth quarter of this past year versus the year-ago period.

About $15 million of that came from the new channels, but the other $15 million came from our core channels. So it's pretty across the board. We're seeing small business demand in terms of upgrading equipment or acquiring new equipment is very strong right now. We're hoping that continues.

But we're feeling really good about the business. And so far in 2017, although the first quarter will not be at the same level as the fourth quarter because that peaks due to seasonality, but we're expecting each quarter this year to be higher than the previous year quarter. And we're already seen that out of the gate.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Yes. I think I would just add, Brian, that I think small business optimism in terms of the economy these days is really strong. And regardless of what you think about the current administration's social policies, I don't think there's any question that there's been a surge of optimism, especially on small business -- from a small business perspective in terms of what they expect the macro environment to be over the course of the next year or two. And again, it's validated by sort of the qualitative feedback that we get just in touching almost 70,000 small businesses that are in our portfolio.

Brian Hogan - *William Blair & Company - Analyst*

Sure. And I guess with the stronger origination volume that you're seeing, and obviously syndication volume can be lumpy and I understand that, but what are your expectations for syndication volume going forward? And obviously you are working on the relationship with the bank?

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Yes. So syndication, it's a strategic capability for Marlin 2.0. I think the fourth quarter was a larger pool. It had better execution, it was with different partners. And I think it continues to show the progress that the Company is making in terms of its comfort with how to actually engage in a sophisticated way in its capital markets.

And I think that that's going to continue. I think we have $40 million or $45 million in the plan next year for syndication on a quarterly basis. But we're looking at other capital markets capabilities as well, because fundamentally the objective here is to try to disconnect the origination capability of the business from any kind of funding or credit or economic limitations that it has.

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So we want to originate as much as we can to leverage the origination infrastructure costs here, recognizing that that doesn't necessarily mean that all those best reside on Marlin's balance sheet for their duration. So I think you're going to continue to see us add additional capital markets avenues over the course of the next year or two as we continue to try to increase Marlin's origination footprint within the context of being a small business lender.

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

I would just say, Brian, it's really helping on the sale side because we're not saying no to our customers anymore. At this point, given the partners that we've secured and the agreements that we have in place, we're able to place a lot more of the business that's coming in from our vendors today in the way of flow.

So our capabilities have expanded, we've got our models built in terms of the economics and the credit aspects of when do we syndicate. And as Jeff said, I think we'll be running at this rate, about $10 million or $11 million a quarter this year.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Brian, I'm getting notes passed to me here that I misspoke by saying $40 million per quarter. I meant $12 million, $10 million to $12 million per quarter. So it's $40 million, $45 million for the year.

Brian Hogan - *William Blair & Company - Analyst*

Okay. I was going to say, that's a pretty big number.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Yes, that was my mistake.

Brian Hogan - *William Blair & Company - Analyst*

With that, you said you had $270,000 in gain on sale. Is that obviously a consistent level then, considering your range per quarter going forward?

And then with that, the servicing fees, other income was obviously up 0.8% year over year, $270,000, of which was the gain on sale. So 0.5%, is that the servicing fees, or what is the other driver there? Obviously several questions there.

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

Hi, Brian. It's Taylor. How are you?

The gain in the quarter was pretty consistent as a percent of the assets we're selling. And as you know, there's two pieces to that. There's the whole cash gain that we get on the deal and then there's the piece that report for GAAP purposes on the gain on sale line, and that deferred piece related to servicing.

So there is that other piece is mostly servicing. And we accrete that into income -- or into fees over the remaining life of those deals. And it's about a one-quarter to one-third ratio. So the servicing amortized -- capitalized servicing fee is about one-quarter to one-third of the overall cash gain.

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Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

I think the split between period gain on sale and servicing fee income, Brian, is going to continue because it's important strategically for us to be the servicer of the asset going forward, both because that's what the vendor bargained for when they gave us the opportunity. But it lets us continue to keep in touch with the end user and hopefully do a second, third or fourth deal.

The notion of sort of selling servicing released, I wouldn't say we would never do it. But it's not -- that would be inconsistent with sort of the broad strategy of using capital markets to help us continue to be able to service our portfolio and increase the number of repeat transactions we can do with small businesses.

Brian Hogan - *William Blair & Company - Analyst*

On the Funding Stream, the loan product, you said, I think I heard you right, 80% was with existing customers. How far penetrated are you in on your existing customer base? And then how much do expect that to grow in 2017?

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

Yes, on the penetration, we're slightly penetrated. We have a lot of headroom there. So in the quarter we did several hundred loans.

But we're marketing to a prequalified existing customer base of about 100,000. So you can get an idea about how much headroom we have there.

We did $35 million in Funding Stream. We're steadfast in focusing on our existing customer base because we believe with that particular product that's where the safety is in terms of credit. So we're absolutely going to continue to do that.

The other smaller piece comes from a very small pool, about a dozen brokers that we have very good relationships with. So same plan for 2017. Funding Stream loans will be in the range of $50 million to $55 million.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

The other thing I would say, too, is in addition to the -- we should get 100,000 customers that are -- we're sort of saying is our target market, of which about 68,000 are active current customers. But I think the other thing that's important to recognize is that there's between 2,300 and 2,500 new small business borrowers that are coming into our portfolio every month.

There were almost 2,500 in December. So, that in it and of itself is a substantial population of potential follow-on financing opportunities, whether it's Funding Stream or whether it's another equipment finance deal, or over the course of the future other products or services that we might be able to provide to them.

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

Just a couple of other points on Funding Stream, Brian, might be helpful. One is the -- we have less than $20 million on the balance sheet, so it does roll off pretty quick because of the short term. But we are starting to see some renewal business, which has a compounding effect to originations.

In the past couple of quarters we also saw a couple of competitors drop out of the market. And we saw increased applications, particularly on the broker side, but it really highlights our discipline. We just didn't go after that business. We stayed focused on serving our customer base. And that's why it didn't increase more than it could have.

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Brian Hogan - *William Blair & Company - Analyst*

All right. Operating efficiency, you obviously laid out targets to get to 45% on a run rate basis exiting 2019. What are your thoughts on progression in 2017? Obviously improving that efficiency ratio has big implications. But obviously you brought on the Horizon staff, you have a Chief Credit Officer now. What are your -- how fast does it trend to 45%.

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

Hi, Brian. Taylor again. That's actually correct, we're targeting 45% by 2019.

We would expect the first quarter of 2017 to be sort of flat to maybe down slightly from the prior quarter. That's because of some seasonal payments that we have in the first quarter relating to comp.

But we would expect the total year on average to be a couple, 3 points below where the fourth quarter ended up for 2017. And the progression to 45% accelerates as we continue to grow.

Brian Hogan - *William Blair & Company - Analyst*

So you're talking in the 52% to 53% range for 2017?

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

Yes, that's a good target. It maybe a little below that, but 52%-ish.

Brian Hogan - *William Blair & Company - Analyst*

Moving onto the asset yield. The implicit yield was down quarter over quarter, but there was a spike in the total yield from the prior quarter. What are the drivers there, trying to understand what's going on there? What level should we forecast going forward, given the declines in the implicit yield?

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

Clearly we have a lot of moving parts in the yield. Now, you're talking about the yield on the portfolio or the yield on new business?

Brian Hogan - *William Blair & Company - Analyst*

The yield on the portfolio as a whole, but then trying to understand the implicit yield on new business, the implications there.

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

So we have a change in mix that is progressing in the equipment finance business as we go to better credit, larger ticket kinds of deals. We did have, just note that we did have a small portfolio purchase in the fourth quarter which had a lower rate to it. It was a clean portfolio and we bought that. It shows up in the volume. So that probably depressed the number a little bit in the fourth quarter.

We would expect the leasing book, new business yields in the leasing book to really kind of remain flat through 2017. You've got the rate increase in December 2016 that will influence that a little bit but it's on a delayed basis. And then obviously in the Funding Stream product, that we're pretty

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explicit about what the rates are on that. That portfolio will stay, or that volume will stay as a relative constant percentage to the overall volume. So I don't know if that helps or not.

Brian Hogan - *William Blair & Company - Analyst*

Yes. That's fine.

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

Hey, Brian, I can add on new originations. Again, Taylor mentioned mix, so that's going to put some pressure on new origination yields. However, there are two offsets to that.

One is we have just started to implement price increases and we're seeing our competitors do that as well based on Fed funds rates going up. So that's approximately 25 basis points in certain channels, not all channels.

And the second has to do with syndication. Some of that lower priced business that we're putting on we're holding for sale and then selling. So that actually exits the portfolio. There are two offsets to the mix issue which has yields coming down a bit.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

And I'll just end those comments by saying, you know Brian, we've talked about this in the course of a couple of different calls, yield and NIM are not accurate proxies for return on equity.

They're certainly important contributors to it, but you know every one of these channels has a very different loss proxy, they have different transaction size and tenor characteristics, they have different degrees of operational complexity or processing complexity.

So there are five or six levers, and NIM is certainly an important one of them, but there are a lot of other levers that go into determining exactly how attractive these flows are on a ROE basis. Again, I will say I've seen many flows that have yields less than 10% that have ROEs that are well in excess of 15% when you take into account the other attributes of the flows.

Brian Hogan - *William Blair & Company - Analyst*

Sure. And just to be clear, the implicit yield on new business that you reported in the quarter includes the low yielding business that you ended up selling, is that --?

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

No, not necessarily. We didn't sell necessarily just what we originated in that quarter.

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

Right, right. That was business that was a little bit seasoned on the books that had a yield of mid-5%, high-5% on it.

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Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

The process basically is at the middle of every quarter we take a snapshot of the portfolio, we determine whether there's credit concentrations we are uncomfortable with or are there pools of assets that we originated that -- ultimately we will be using ROE if they are sub-10% or sub-12% ROE. We're still working on our channel ROE models at this point so we're using yield at the moment, which by my own definition is imperfect but is all we have at the moment.

So we take a look at what the eligible pool is based upon those criteria. And we put together a pool for sale and we take it to market and try to create a competitive dynamic, which we were successful in doing in the fourth quarter.

I think that you can't necessarily just look at the yields in the quarter and say, well, they were impacted during the quarter 100% by the sales, because it's the -- the assets become fungible once they go on the balance sheet. Then we're optimizing the whole balance sheet, not just trying to optimize the flow of incoming business that was done in that quarter.

Taylor Kamp - *Marlin Business Services Corporation - SVP & CFO*

And I would add that, really, as we've built up and ramped up this syndication capability, we've used the seasoned portfolio a little bit to prime the pump and rebalance our portfolio. But I think as you see us get more efficient at that process, there'll be more and more same-period kind of transactions that take place.

So we can talk more about that as we get into it. The other thing is, and I'm not sure it was caught, is that we did have this portfolio purchase in the quarter which had some low rates in it but fit our strategic goals.

Brian Hogan - *William Blair & Company - Analyst*

All right. Thanks for your time.

Ed Siciliano - *Marlin Business Services Corporation - EVP & COO*

You're welcome.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Thanks, Brian.

Operator

(Operator Instructions)

Ladies and gentlemen, this now concludes our question-and-answer session for today. So I would like to turn the call back over to management for closing comments.

Jeff Hilzinger - *Marlin Business Services Corporation - President & CEO*

Thank you for your support and for joining us on today's call, everybody. We look forward to speaking with you again when we report our 2017 first-quarter results at the end of April. Thank you.

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Operator

Ladies and gentlemen, thank you again for your participation in today's conference call. This now concludes the program, and you may now disconnect at this time. Everyone have a good day.

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