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PRESENTATION

Operator

Greetings, and welcome to the Marlin Business Services Corp.'s Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Lasse Glassen, Addo Investor Relations. Please go ahead.

Lasse Glassen - *ADDO Investor Relations - MD*

Good morning, and thank you for joining us today for Marlin Business Services Corp.'s 2017 Second Quarter Results Conference Call. On the call today is Jeff Hilzinger, President and Chief Executive Officer; Ed Siciliano, Executive Vice President and Chief Operating Officer; Lou Maslowe, Senior Vice President and Chief Risk Officer; and Taylor Kamp, Senior Vice President and Chief Financial Officer. Before beginning today's call, let me remind you that 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, it's now my pleasure to turn the call over to Marlin's President and CEO, Jeff Hilzinger. Jeff?

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Thank you, Lasse. Good morning, and thank you, everyone, for joining us to discuss our 2017 second quarter results. I'll begin my comments this morning with an overview of the key highlights from this past quarter, including an update on our Marlin 2.0 strategy that is designed to transform our company from primarily a micro-ticket equipment lessor into a broader provider of credit products and services to small businesses. Ed Siciliano, our Chief Operating Officer, will provide additional remarks on our second quarter operational performance; Lou Maslowe, our Chief Risk Officer, will discuss portfolio performance; and Taylor Kamp, our Chief Financial Officer, will then wrap up our prepared remarks with details on our financial results and business outlook.

Marlin delivered another strong performance in the second quarter. In addition to benefiting from robust customer demand, our results reflect solid execution of our Marlin 2.0 strategy that is leading to improvements in scale, enhanced operational efficiencies, sustained profitable growth and a more attractive return on equity. Total second quarter sourced origination volume of $167.8 million was up more than 34% from a year ago.

This growth was broad-based and driven by the strength of our Equipment Finance business, including Horizon Keystone Financial, which we acquired earlier in the year and which continues to exceed our expectations.

In addition, origination volume for Funding Stream, our working capital loan business, increased to $14.8 million or 9% of total sourced originations in the quarter, up from $7.8 million or 6% of total originations a year ago. Thanks to this strong origination activity, investment in leases and loans increased to $858.7 million, up over 4% compared to the previous quarter and up 18% from a year ago. This origination activity also allowed us to sell or refer $24.8 million of volume during the quarter to third parties as part of the continued growth and development of our Capital Markets activities. Furthermore, we achieved this strong growth while adhering to our strict underwriting standards, with portfolio performance remaining within an acceptable range during the quarter.

Over my last 14 months as Marlin's CEO, I'm very happy with the success we've had in assembling a world-class leadership team to take the company into the future, and I'm pleased to report that our efforts over the past year to round out the team are nearly complete. During the quarter, we announced Dan Castellini's promotion to Senior Vice President, with responsibility for leading the development of new products to support the 2.0 strategy. We also announced the appointment of Laura Anger as Senior Vice President and Chief Human Resources Officer. In addition to guiding Marlin's overall human resources activities, Laura will be responsible for developing Marlin's HR function to a more strategic level so that we can continue to recruit and retain the most talented people in our industry. With Laura's appointment, the only remaining open position on the Marlin senior leadership team is the position of Chief Marketing Officer. I am pleased to report that we have identified 2 strong finalists, each of whom are exceptionally qualified. So we expect to reach a decision on the new CMO soon. This position is particularly important as we expand our direct strategy and develop customer response and credit targeting models. Without a doubt, we continue to assemble an extremely talented leadership team with tremendous industry experience, and I believe this group is ideally suited to continue executing our plan to take Marlin to the next level of growth and profitability.

Next, I'd like to provide an update on our Marlin 2.0 business transformation initiative. As you may recall, through Marlin 2.0, we expect to drive sustainable growth and improved returns on equity 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, the primary objective of the Marlin 2.0 strategy is to transform the company from primarily a micro-ticket lessor into a broader provider of credit products and services to small businesses. As a result, we are now focusing on providing multiple products to a wider array of small businesses. In support of this, we are quite pleased with the ongoing success of Funding Stream, our working capital loan product. While origination volumes have increased each sequential quarter since we began offering this product just over 2 years ago, we continue to carefully manage its growth as we fine-tune our underwriting and credit models. Within Equipment Finance, our Franchise and Transportation businesses also continue to gain traction as we continue to evaluate and evolve these new channels to maximize their profitability and relevance to the 2.0 strategy.

In addition to organically developed products, we are also actively looking at other corporate development opportunities and initiatives to enter new markets. A good example of this was our first quarter acquisition of Horizon Keystone Financial, which extended our existing Equipment Finance business into the office furniture HVAC and automotive aftermarket verticals.

Along with these current Marlin offerings, Dan Castellini and his team are busy evaluating potential additional new products to further meet the financing needs of our small business customers. We expect to have more to report on our ongoing new product and corporate development efforts on future calls.

In addition to expanding our product offerings we are also making progress in broadening our go-to-market strategy. Historically, Marlin has viewed its equipment dealers, distributors and manufacturers as its primary customers. However, an important component of Marlin 2.0 is acknowledging that our addressable customer base also includes our end-user customers. As I noted on our call last quarter, earlier this year, we realigned most of our origination resources into 2 teams, with one team focused on our traditional indirect or intermediary customers and a new team focused on serving our direct or end user customers. The end user team's objectives are to identify additional financing opportunities with existing end user customers and to create ongoing relationships with these customers. With more than 350,000 lifetime end user customers, including over 70,000 active contracts and approaching 2,000 new end user customers originated per month, this is a large and in many ways untapped market opportunity for the company. In addition to creating a proprietary flow of follow-on financing opportunities, it is important to highlight that we do not incur customer acquisition costs beyond the initial transaction, so this follow-on business significantly lowers our weighted average customer acquisition cost.

During the quarter, we continued to fine-tune the reorganization of our origination resources into indirect and direct teams and focused on how the 2 teams can work best together to maximize our end user penetration. In addition, we also continued to expand the size of the direct team. Although, the end user initiative is still in its early days, we're seeing positive trends in cross-selling multiple products, including Equipment Finance, Franchise Finance and Funding Stream. I expect that our efforts to reach these customers more effectively will be further enhanced once the Chief Marketing Officer is on board.

We also made good progress, during the quarter, on our second key priority, which focuses on using capital more productively. Our strong origination volume and portfolio growth during the quarter allowed us to further reduce our equity to assets ratio to 16.7% this quarter from 17.2% in the prior quarter and 18.5% in the second quarter last year. To further leverage our capital, we continue our efforts to establish a wholesale credit facility at the holding company level and continue to expect to have this facility in place in the near future. Additionally, we continue to improve our ability to manage the size and composition of our balance sheet through our evolving Capital Markets activities. During the quarter, we sold 2 portfolios totaling $12.4 million and referred $12.3 million of volume to various third parties. Investor demand and pricing for Marlin's product was strong, and execution on the 2 transactions in the second quarter was the best since we started our Capital Markets program last year. The majority of the referral volume was originated by Horizon Keystone Financial and we do expect that this volume will shift from being funded on a referral basis to being predominantly booked on balance sheet by the end of the year.

And finally, we also continued to make progress during the quarter in better leveraging the company's fixed costs through growth and by improving operational efficiencies through our process renewal initiative. As evidence of process renewal's growing success, during the first half of 2017, the company was able to process an additional $20.6 million of volume as compared to the second half of 2016 without adding any net new origination credit or operations headcount. On a per headcount basis, application volume increased 13% and booked volume increased 9% in the first half of 2017 as compared to the second half of 2016.

Our ability to further improve efficiencies and ultimately achieve our efficiency ratio goal of 45% by 2020 centers on the success of this initiative. Internal Marlin teams continue to work toward additional significant improvements in cycle times, quality and overall productivity in our origination, production and servicing processes.

Another key element of process renewal are the investments we are making to upgrade our information technology resources across the company. We recently completed a 3-year IT strategic plan that focuses on automating processes that have been optimized by the process renewal initiative, improve the effectiveness of our IT infrastructure and support our direct origination strategy. At the center of the IT strategic plan is adding additional functionality to our salesforce.com platform, including sophisticated data warehouse and back-end analytics capabilities. We are also adding tools from Marketo to enhance our use of digital marketing to support our direct origination strategy. I look forward to updating you on our continued progress on future calls.

In summary, we've had a very productive first half of 2017 and I want to thank everybody at Marlin for their strong execution which is delivering excellent results. Our origination volume and portfolio growth are at record levels, portfolio performance remains within our targeted range, we're making excellent progress on our key Marlin 2.0 business initiatives and we're enjoying strong momentum as we look ahead to continued strong execution during the second half of the year.

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

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Thank you, Jeff. Good morning, everyone. My comments today will focus on our second quarter originations and Capital Markets activities. New originations funded in the second quarter of $155.5 million was up 28% compared to the second quarter last year, while total sourced origination volume of $167.8 million increased 34% from the prior year period.

Looking at new originations funded during the quarter in more detail, Equipment Finance origination volume of $140.7 million increased 6% from the prior quarter and 24% from the second quarter of 2016. These increases were in large part the result of a more productive sales force, driving increased activity levels and dealer contribution. In addition, we are seeing a return on investment spend made in the past 2 years. Funding Stream, our working capital loan product, produced another strong quarter with origination volume of $14.8 million, this was up 7% from the prior quarter and nearly 2x higher than a year ago. This past quarter, Funding Stream represented 8.8% of total sourced originations, up from 8.2% of total sourced originations funded in the first quarter and 6.3% in the prior year period. Due to the short Funding Stream tenors, the portfolio increased by only $6.1 million from the fourth quarter and now represents approximately 3% of the total portfolio. Similar to previous quarters, the continued growth in Funding Stream again helped increase overall total yield on new originations funded. However, we successfully passed on rate increases within our Equipment Finance business, driving a 29 basis point increase over last quarter. For the quarter, total yield on new originations funded of 12.21% was up 35 basis points from the prior quarter and 43 basis points from the second quarter of 2016. Over 70% of Funding Stream loans were originated with existing Marlin customers, as we remain focused on marketing to our known customers, primarily to maintain strong credit quality associated with this product.

Referral volume of $12.3 million was down $10 million from the prior quarter but increased 3.5x from the second quarter of 2016. First quarter referral volume was elevated due to a particularly large transaction that took place in the first quarter. Contributing to the strong year-over-year growth was our acquisition of Horizon Keystone as well as some larger transactions best suited for a partner's portfolio. The integration of Horizon Keystone has been seamless. And during the quarter, we began moving more of its originations volume onto our balance sheet. This migration of assets to Marlin's balance sheet will likely continue through the balance of the year. Entering 2018, we are likely to place the majority of Horizon's originations on balance sheet.

Marlin's process renewal initiative continues to produce promising results that have exceeded our expectations. During the quarter, the company processed over 7,700 finance transactions, an increase of 15% over the same period a year ago, without adding additional headcount. This improvement in efficiency already demonstrates the positive impact of process renewal. Perhaps more powerful, we expect to hold processing headcount flat in 2018, further driving our overall efficiency. During the quarter, we completed portfolio sales totaling $12.4 million. These transactions in the second quarter generated an immediate gain on sales of $477,000 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. We are currently servicing over $36 million in assets for our valued funding partners, while allowing us to maintain an ongoing relationship with these customers.

In closing, we are pleased with the second quarter, and we firmly believe that we are executing on a plan that will deliver meaningful shareholder value over time.

With that, I'll turn the call over to our Chief Risk Officer, Lou Maslowe. Lou?

Lou Maslowe - *Marlin Business Services Corp. - Chief Credit Officer and SVP*

Thank you, Ed, and good morning, everyone. Today, I will provide you with an update on Marlin's portfolio's performance as well as steps we've taken over the past quarter to further strengthen Marlin's risk management governance. Equipment Finance receivables over 30 days delinquent we're 94 basis points, up 4 basis points from the first quarter and 22 basis points above June 30 of 2016. Equipment Finance receivables over 60 days delinquent were 54 basis points, up only 2 basis points from the first quarter and 10 basis points above Q2 of last year. These slight delinquency increases quarter-over-quarter were primarily due to the quarter's higher syndication volume and some adjustments made to past collection practices, whereas year-over-year increases are primarily attributed to movement of portfolio performance toward more historical norms.

Funding Stream delinquency also increased in both the 15-day and 30-day buckets to 89 and 35 basis points respectively. While the increases in basis points from the prior quarter appears material, in terms of dollars and number of contracts it is small. In this case, 15-plus and 30-plus day delinquency is only $230,000 and $91,000, consisting of 8 and 4 past-due accounts respectively. Aggregate net charge-offs in the second quarter increased to 1.65% of average finance receivables on an annualized basis as compared to 1.57% in the first quarter and 1.38% in Q2 of last year. As mentioned last quarter, we anticipate net charge-offs will continue to increase modestly over time as our high-yielding Funding Stream product grows as a percentage of the total portfolio. Net charge-offs in the leasing portfolio increased by 5 basis points and 17 basis points compared to Q1 of 2017 and Q2 of 2016 respectively. Leasing net charge-offs of 1.51% is very close to the quarterly average of 1.47% since Q1 of 2013. It is worth noting that if the year-to-date 2017 portfolio sales of $21 million were still in the portfolio, net leasing charge-offs would've been approximately 1.43% or about 8 basis points lower than reported for Q2.

Syndications are utilized strategically to manage concentration risk in the portfolio and to optimize our return on equity. Funding Stream charge-offs of $380,000 represented 6.19% on an annualized basis, which is in line with the 600 basis points target for this product in the current economic environment and what we view as an acceptable and profitable level for the product. Keep in mind that given the nature of the Funding Stream product and size of the portfolio, results are subject to volatility from 1 quarter to the next, as evidenced by the range of charge-offs over the past 5 quarters, from a low of 1.11% to a high of 6.19%. Although results remain satisfactory, we analyze all transactions that default and make adjustments to our underwriting as deemed appropriate. For example, we recently made some adjustments to our underwriting approach on loan renewals to ensure that the approval requirements are as stringent as the original advance. Notwithstanding the clear upward trend in both delinquency and net charge-offs over the past year, our portfolio analysis of key risk indicators, including delinquency and charge-offs by channel, transaction, size, vintage and credit scores, affirm the fact that our portfolio quality remains solid. We also benchmark our credit metrics to the Equipment Finance industry, which is also experiencing a return to more historical performance levels, following an extended period of low delinquency and credit losses. For example, the Thomson Reuters PayNet small business delinquency index has increased 13 basis points from 1.56% at June 30 of 2016, to 1.69% as of May 30, 2017, which is the latest information available. Over the same period, the Thomson Reuters PayNet default index has increased by 17 basis points from 1.7% to 1.87%.

During Q2, we performed an extensive analysis of our historical through-the-cycle credit losses. This was done to ensure that our credit underwriting and expected losses are aligned with the pricing and profitability of each of our sales channels and Marlin as a whole. We analyzed our portfolio performance dating back to 2007 and divided the past 10 years into recession and nonrecession periods. We determined that our target average portfolio performance during nonrecession periods, based on our current portfolio mix, is 1.76%. Our rolling 4-quarter average of 1.5% remains well below the targeted threshold.

In addition to our ongoing close attention to credit risk, we are strengthening our overall enterprise risk management as we prepare to exceed $1 billion in assets in the near future. This entails increasing attention and focus on Marlin's ability to identify, assess, aggregate, control, monitor and report on a range of risk types, including, most importantly, operational risk as well as regulatory and compliance risk. As part of this effort, we have separated the internal audit and regulatory compliance functions and dedicated a full-time resource to the ERM function.

In conclusion, we will continue to monitor the driving forces behind our enterprise risk profile and portfolio performance. But based on a market and historical perspective as well as our through-the-cycle analysis, we are comfortable with our portfolio quality and performance at this time.

With that, I'll turn the call over to our CFO, Taylor Kamp, for a more detailed discussion of our second quarter financial performance. Taylor?

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

Thank you, Lou, and good morning. Marlin generated strong second quarter results, led by robust growth in originations and record portfolio size, while maintaining credit performance consistent with our expectations. Excluding the expenses related to the previously announced regulatory matter, second quarter net income on an adjusted basis was $4.8 million or $0.38 per diluted share compared with $4.5 million or $0.36 per diluted share for the second quarter last year. Our investment in leases and loans grew approximately 4% from last quarter and 18% year-over-year to $859 million, an all-time record. Through June 2017, Marlin has originated close to $5.3 billion in loans and leases since its inception. Excluding the charge, return on equity on an adjusted basis was 11.80%, up 14 basis points from a year ago. The increase in adjusted base's ROE was primarily due to higher net income as a result of the record portfolio size, efficiency improvements from the growth and scale, the added contribution of

Horizon Keystone and higher syndication fees. We expect ROE to continue to increase throughout 2017 as the business grows and we better leverage fixed costs through increasing scale and benefits from process renewal.

For the quarter, net interest margin was 10.87%, relatively flat from the prior quarter, but 63 basis points lower than a year ago. The decrease in margin percentage from a year ago was primarily driven by a decline in late fees and end-of-lease revenue resulting from changes in certain servicing practices, growth in lower-yielding Equipment Finance and Franchise channels and an increase in the company's cost of funds. This was partially offset by an increase of 43 basis points in new origination loan and lease yield over the second quarter last year. The portfolio continued to perform within acceptable ranges in the second quarter. The allowance for credit loss reserves was 1.46% of total finance receivables, and coverage of total 60-day delinquencies was 245.9%. As we've mentioned on previous calls, it is important to note that our reserve methodology is very sensitive to small, short-term changes in delinquency and loss emergence.

Second quarter operating expenses were $15.1 million compared to $12.5 million in the second quarter last year. In addition to the second quarter $300,000 charge, related to the previously announced regulatory matter, the increase in other expenses from the second quarter last year was primarily due to timing differences in executive salaries and benefits, the addition of Horizon Keystone, increases to the direct team and the timing of new equity plans.

The company's efficiency ratio for the second quarter was 56.69% compared to 55.63% in the second quarter last year. Excluding the impact of the previously announced regulatory matter, the efficiency ratio in the second quarter of 2017 was 55.17% or 46 basis point improvement from a year ago.

Our capital position remained strong in the quarter with an equity to assets ratio of 16.67%, 182 basis points below last year. The ongoing decrease in the capital ratio quarter-to-quarter was by design and resulted from continued strong asset growth and share repurchases.

During the second quarter, the company's Board of Directors authorized a stock repurchase program of up to 10 million of its outstanding shares of common stock, replacing the stock repurchase program announced in July of 2014. In the quarter, under the new and old authorizations, the company repurchased approximately 82,000 shares at an average price of $25.22 per share. Note that the impact of the repurchase will not be fully reflected in the average share count until the third quarter. $9.4 million remains available to repurchase shares under the new authorization. The manner, timing and amount of any purchase will be governed by Marlin's capital plan, which is based on an evaluation of market conditions, stock price and the availability of other attractive investment opportunities.

In addition, I am pleased to report that our Board of Directors declared a regular quarterly dividend of $0.14 per share payable on August 17, 2017, to shareholders of record as of August 7, 2017. We remain focused on the precise execution of our growth strategy and maintaining our commitment to deliver strong returns, increasing net income and value to our shareholders.

Now turning to our business outlook. Full year 2017 total new originations funded is expected to finish at least 20% above 2016 levels. Portfolio performance is anticipated to continue to remain within our targeted and historical range. Net interest margin as a percentage is expected to remain relatively constant for the remainder of 2017 with the continued growth in lower yielding Equipment Finance channels and Franchise Finance and updates to our historical servicing practices, offset by expected growth in the company's higher-yielding Funding Stream loan business and increasing new business yields in certain Equipment Finance channels. And finally, we expect ROE to grow to the low teens on an adjusted basis by the end of the fourth quarter of 2017 as strategic initiatives gain traction and the company continues to improve operating scale.

In conclusion, Marlin's second quarter results reflect continued robust progress toward our strategic objectives, led by strong origination volume and new business yields, a growing portfolio, improving EPS and a higher ROE. We expect to continue this operating momentum into the second half of the year and beyond.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Chris York of JMP Securities.

Chris York - *JMP Securities - Analyst*

So I wanted to begin a little bit by drilling down on your origination guidance, which appears conservative. So if I calculate it correctly, I have on-balance-sheet originations up 31% year-over-year in the first half of the year. And then if I look out, 3Q appears to be a relatively easy comp. So I'm trying to reconcile these 2 items with the guidance, which appears low, otherwise it may imply some meaningful deceleration. So how should we be thinking about origination growth in the second half of this year?

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Chris, it's Jeff. Thanks for the question. I think the reason for our cautiousness on origination guidance relative to the first half performance is because, as Lou mentioned in his comments, we not only went through -- the through-the-cycle analysis we did was part of a broader sort of a channel profitability return on equity process in anticipation of this year's business planning process. And from that, I think there is going to be some shifts in emphasis between the different channels that we have. And it may mean -- obviously all designed to improve the weighted average return on equity for the company and to make sure that we're allocating capital and resources to the places that are the most promising. But it may mean that we have to pull back a little bit on some of the underperforming channels while we're continuing to invest in moving those resources to the well-performing channels. So I -- we don't know yet because we haven't been through the business planning process to know exactly what that's going to look like, but we just -- we thought through the guidance, it might be good if we signaled that we're going to be going through that process. So we'll be in a position, I think, to talk about that process we went through, the ROE process, in a little more detail on next quarter's call. I don't know, Ed, if you had anything specifically that you want to add as well?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Yes, Chris, the only thing I would add is, it's a good problem to have. It isn't -- it's possible that we exceed the guidance that we offered up in the beginning of last year. However, saying that, it looks like Q3 with the summer seasonality is probably going to be flat to Q2. And the other thing is, and I'm sure you've noticed, that we've implemented a series of price increases. So far, we have not had an impact on volume as a result of doing that, but as we turn that screw a little more and look for profitability and enhance ROE we may see some friction on volume growth as a result of getting more price out of the business. So I would expect to see that in Q3 and Q4 as we continue to look for a little more price and test that edge of elasticity on pricing.

Chris York - *JMP Securities - Analyst*

Helpful. And then just to clarify on the guidance, so it's now -- I mean, you have a couple of metrics. So are we thinking about sourced originations or on-balance-sheet originations?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

I would look at on-balance-sheet for the guidance that we gave. Sourced is going to be a bigger number because we're just originating more now in a wider box to sell.

Chris York - *JMP Securities - Analyst*

Got it. So then just to clarify a little bit further, so the Q2 $155 million, Ed, if you're thinking it's maybe flattish in Q3. So then we should be thinking about on-balance-sheet of $155-ish million, if you will, in Q3?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Yes. Early in the quarter, but yes, that's correct.

Chris York - *JMP Securities - Analyst*

Okay. And then switching to pricing which you brought up when you talked about in your prepared remarks, I'm curious to learn how much of the move in base rates have you been able to pass on to customers?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Yes, so we -- our target for the quarter was 25 basis points as our cost of funds is increasing. Fed is moving slowly. So we achieved that. We actually got 29 basis points on our Equipment Finance business. We're going to look to do that again in the third quarter because even though the Fed did not move over the past couple of days here, our cost of funds continues to rise. So we're going to try to implement another price increase, surgically again, not all channels, some of our major account channels, we don't have that latitude because the banks haven't moved yet. But in our micro-ticket business we do have the latitude and we're taking advantage of that.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

I think too, Chris, that as -- I mean, one of the benefits we've talked about with process renewal is not just improving operating efficiency but it improves the customer experience because value and -- or speed and convenience is the value proposition in small balance lending and it always has been and I think it always will be. So to the extent that we can deliver a customer experience that is better on those dimensions then it allows us, then, I think to test the price elasticity of a convenience-priced model. And so I think we need to continue to try to really press the boundaries. I think Ed's term of sort of trying to discover where the edge is, I think that edge is going to move as process renewal continues to have its impact on the business and customers feel a better experience. So yes. So I think it'd be not -- I think the Fed price increase sort of gives us an opportunity because people kind of - the market kind of expects that prices are going to go up. But even in the absence of that, I think because of the things that are unique to Marlin that are going on, there is also an opportunity for us to raise pricing.

Chris York - *JMP Securities - Analyst*

Interesting. So yes, and then maybe switching to the other side, right? To speak about the change in deposits and should -- maybe how should we think about the elasticity there, given the changes in base rates? And which was less than the increase that you just said of 29 basis points on the -- on your assets or your yields on your loans?

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

Yes, yes. So quite frankly, you need to compare the increases on our new business yields to the cost of our incremental deposits. And the increase in yield is, as Ed said, actually increased a little bit more than the deposits we bought last quarter and the quarter before from quarter 1 to quarter 2. So we more than covered the increase in the deposits. But one thing to note is that the deposits reprice a little faster than our yields in new business. They also tend to bake in anticipated rates a little bit more so. So it's not just that the Fed raised rates in March, that was already partially baked into the CD deposit rate. So right now, we're doing a good job not only passing it on but exceeding the increase in cost of funds.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

It's an unusual dynamic, Chris, that we're able to grow origination volume and also increase price. That's a very -- in my experience, that's an unusual dynamic. And I think it's primarily because the most of Marlin's origination volume is coming from segments where the competition is very fragmented. So if -- in the more traditional vendor channels that we have like National Accounts and office equipment, we find that the -- passing through price increases is a lot more difficult than in those segments that are more retail-like and have more fragmented competition. So I don't think that dynamic is probably being felt by all vendor finance companies. I would expect that, that's probably not the case. But again, that's -- I continue to say that I think Marlin really is a unique vendor finance model. I don't even really - I talked about it with a capital V for vendor versus a small V for vendor, and this is definitely a small V business, and you see it. This is another manifestation of the fact that we've got, at least in the historical part of the business, it's very -- the competition is very fragmented.

Chris York - *JMP Securities - Analyst*

Great. And then maybe pulling it all together. So for guidance, your NIM guidance is -- it's essentially -- well, help me clarify it. So you expect your margin maybe of 10.87% for second quarter, you say it's expected to be flat for the remainder of the year, so is that 10.87% where we should be pinning down that flat comment?

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

Yes, I would say, barring some other additional increase in market rates, we would expect our NIM to be relatively flat in Q3 and Q4. As you know there is a -- there are lots of ins and outs, as I commented on in my script, but I do believe that's the right guidance.

Chris York - *JMP Securities - Analyst*

Got it. Last one here, and then help us think about the expectation for the use of your buyback, which you noted that you did use some repurchases here -- or in the second quarter. Because it does seem like you have a lot of uses for your capital, especially with the perspective high marginal ROEs and then potential new products that Jeff you mentioned and -- like the businesses of Horizon Keystone that you purchased in Q1. And then the other thing to think about is the relatively tight amount of authority to comply with your capital agreement with the FDIC. So could you help us kind of pull that all together?

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Yes, the -- I can speak to the purpose of it and Taylor can talk to the impact of it. So that -- really the purpose of that -- of the shares that were bought back in the quarter, Chris, was try to maintain flat share count. From the beginning of the quarter to the end of the quarter. And that's just an ongoing objective that we have. So it's -- obviously, we wouldn't have done that if we didn't think that there was value at $25 a share, which we do. But -- so I think that perspective, coupled with the fact that we targeted a particular number of shares and you'll see -- as it rolls through the next quarter, you'll see that it -- the impact is going to be, that on an average basis we're trying to keep share count flat.

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

Yes. I would say we take a long view of this. And we do believe our strategy and believe our stock's a bargain. And so we took advantage of the fact that we had a little bit of capital, and so it just made sense to us at the time.

Operator

Our next question comes from Brian Hogan of William Blair.

Brian Hogan - *William Blair - Analyst*

So I'm going back to the originations and the outlook and the changes there. Would you say it was totally credit-driven or was it the competitive environment as well or kind of the combination of the 2? And then, talk about the comp -- competitive environment as well, please?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Brian, it's Ed. Completely not credit driven. Approval rates, as you've seen, have gone down consistently over the past 8 quarters. Really what's driving this is a number of factors, volumes up broad-based, along the lines of our core channels, certainly, our investment channels, transportation franchise products, Funding Stream. On the competitive front, I think we are enjoying a period where our primary competitors over the years, the independents have been acquired. There is some disruption as a result of that, I think, we're gaining a little bit of business there. Small business confidence being up, maybe predicated on some of the things that they're hoping for in Washington around healthcare and tax, but demand is strong. And capital investments are being made and working capital product -- our Funding Stream products is being taken for expansion. So it's really -- it not a -- it has nothing really to do with credit, it has everything to do with the investment we've made in new channels and some other tailwinds we have relative to competition and small-business confidence.

Brian Hogan - *William Blair - Analyst*

Sure, and that's obviously driven the strong growth. And, I guess, maybe my question was a little bit more around the slowdown, going back to the previous questions about, like, going from 30% growth in the first half down to -- closer to 20%. And you're talking about, like, changing the credit boxes and this and that, whatever else. I guess, that was the more of the question. Is that...

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Yes. I think it's not just the credit box, Brian. It's -- we said since the first call I was on that yield is not a proxy for ROE. And so we built a model that allows us to isolate the 7 or 8 drivers or levers that go into determining channel profitability, and we've been working through a process of optimizing, resetting those levers so that we optimize the profitability within each channel and then we'll use the business planning process to revisit the allocation of capital to those channels that are -- that have good chance of being the most optimized. And so, certainly, credit boxes is one of those levers and it's an important one as is yield, but there are others as well. So we're not necessarily adjusting our credit box to try to reduce risk in an absolute sense, we're trying to adjust the credit box so that it contributes to the optimization of ROE at -- within each channel and then changing the channel mix so that it optimizes the enterprise ROE. That's the general approach.

Brian Hogan - *William Blair - Analyst*

All right. And then going to the credit quality. I mean, you said through a nonrecession period the average over -- during the past 10 years was like 1.76% and you're below that today. But you have a different mix of business. I mean, did that 1.76% does that adjust for business mix and -- because obviously you have a lower-yielding stuff, which is hopefully lower risk. I just kind of -- because over the last year, we've seen the NIM come down, yields come down and you're starting to reverse a little bit here, I mean. But just trying to reconcile some of the changes in the NIM and the rise in charge-offs?

Lou Maslowe - *Marlin Business Services Corp. - Chief Credit Officer and SVP*

Sure, Brian, this is Lou. Thanks for the question. The 1.76% is a prospective through-the-cycle number based on our current and expected mix. So through the analysis, we made adjustments for each channel based on where we see each channel going. So if you would actually do a calculation and -- the 1.76%, by the way, is post-recession. So the total through-the-cycle would include the recessionary period. 1.76% is just what we've seen since really beginning in the January of 2011, which is what we viewed as the beginning of the post-recession period. So this is the number that we're using based on our current approach and strategy to the business.

Brian Hogan - *William Blair - Analyst*

All right. Moving to operating efficiency, you made a number of hires of one more to go and operating efficiency essentially flat year-over-year. Sounds like it's going to start to show but we haven't seen it yet. What gives you the confidence that it's going to start to come through?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Yes. I mean, Brian, if you look at overall headcount in the business from the end of last year, we're up 12 -- what is it 11 people, and keeping in mind that 12 additions came from Horizon Keystone. So we're actually down some operational heads, we're down a couple of sales heads and we've added to the senior management team, as Jeff has highlighted. And that number is basically going to be flat for the foreseeable future, certainly for the next 4 quarters. So holding that flat, which is being driven by process renewal and higher productivity as a sales force, we think that the outcome is inevitable that you're going to see efficiency gains. It's really -- it really revolves around that. Some of the cost, the expense increases year-over-year were driven by Horizon Keystone and additional senior staff and that's basically done. So with that finished, from here on in it should just be slow gains on the efficiency ratio.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Yea, I think there may be additional heads Brian that we add to the direct lending initiative but they may be supplied by movement away from some of the other platforms that aren't as attractive strategically or financially as direct. Like I said before, we need to kind of go through our business planning process to see exactly what the specifics of that look like. But generally speaking, there is -- given where process renewal is going, there is no reason for us to have to add additional production headcount through next year. We ought to be able to handle the increased origination volume that's in our guidance without adding headcount. So I think the combination of continuing to use -- to leverage our capital and then being able to reduce unit processing cost is going to have a big impact on operating efficiency.

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

From our perspective, Brian, this quarter is the pivot point. Appreciate the skepticism, but the second quarter is the pivot point where things start to turn and we start to see the improvement because the investments have now been made.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

There's -- I mean, there's been a fair amount of investment in 2.0, Brian, over the last year really, over the last 3 quarters. And most of that's done at this point and we're pretty much -- this quarter we were, but for the second half of this year and 2018, it's heads down, focused on execution.

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

Yea, and Brian, before you ask the question, I would say we still stand behind our guidance that the efficiency ratio will exit the year in the low 50s.

Brian Hogan - *William Blair - Analyst*

All right. That -- was going to be my next question, about target, still stand by it and how fast do you expect to go from there? So looking into 2018 then, you expect further improvement from the low 50s? Is that...

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

Yes, definitely. So I think we'd given some guidance that we'd be in the mid- 40s within the next 2 years. So that's still the guidance.

Brian Hogan - *William Blair - Analyst*

All right. And then the last one. You said low teens ROE, exiting the year. So just using a 13%, ROE calculates out to be about $0.54 in 4Q. Is that a reasonable number?

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

That's a little high. Q4? Yes, that's a little high.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

I don't think -- that operating efficiency ratio isn't the average for the fourth quarter, Brian. That's coming out of the fourth quarter.

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

That's coming out of the fourth quarter.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

The average would probably get you a little higher on the EPS estimate for the fourth quarter.

Operator

(Operator Instructions) Our next question comes from Bill Dezellem of Tieton Capital Management.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

I have a couple of questions. First of all, Jeff, you had alluded to this in response to one of the questions but I'd like to dive into it further and that's the improvements that you've made in the approval denial speed -- speed of approval or denials -- really since you joined. Can -- would you talk through that, please?

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Well that's a subset of the process renewal effort. So the operational side of credit adjudication is in scope for that team. The primary form of improving operating efficiency and credit is going to be increasing concentration in credit scoring. So that's -- we've got in -- that's obviously something that Lou and our data folks are really focused on. So getting the no touch scoring up, both in terms of the average transaction size and then in terms of industries that have been previously excluded that we'll begin including in that, we expect to see significant improvements in that. And then -- but having said that, there'll always be a segment of the flow that needs some sort of manual intervention. But there's a lot that you can do even in if -- even in a manually accredited adjudicated flow. Improving access to Internet data, presenting the data to the credit person in a way that's already -- that's sort of already -- it's attracted by the machine, it's presented in a way that the decision can be made very quickly. I mean, it's very tactical stuff but when you compound all these things together, they can have a really significant impact on reducing credit adjudication cycle times. And I don't know, Lou, if you -- Lou may have something -- may have a perspective as well.

Lou Maslowe - *Marlin Business Services Corp. - Chief Credit Officer and SVP*

Just to -- just as an example, so this year, we've put in 2 enhancements to our credit scoring model that have moved us from the low 40s in auto decision, now up to around 50%. So, I mean, 7% on a lot of applications means a lot of efficiency. And we'll continue to -- and we'll have at least 1 or 2 further iterations this year. And it's not about taking more risk or less risk with the credit models, it's about just becoming more efficient by letting the decision engine make the decisions rather than having to go to individuals.

Taylor Kamp - *Marlin Business Services Corp. - CFO and SVP*

The only thing I would add is, more of our business these days is being entered through a portal, MarlinNet, being auto scored, as Jeff and Lou covered, being documented using eDOCS, so signatures are done electronically. And the first call the customer gets is a welcome call. Very, very fast and efficient.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And the things you have described, are those ones that have already been implemented? Or those are things still to come?

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Many of those have already been implemented. But we don't -- I mean, none of this stuff is really done on a big-bang basis because you'd really want to be -- we have a tendency to approach these things through a pilot, and then as the -- and then we iterate through what we learn in the pilot, and then we eventually roll that -- roll those learnings out into other flows or into other channels. So all of these things, salesforce, eDOCS, CMS, the implementation of credit scoring, it's all in the process of being rolled through the company. And they're at different points of penetration, depending on which one we're talking about.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

That's helpful. And I do have one additional question. Your sources of Equipment Finance increased, I think, to a little over 1200. That's the highest for some time, would you talk about the implications of that increase in number of sources?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Yes, that -- so those are basically vendor/manufacturer relationships. And it really just has to do with the traction of the expanded sales channels. We have more relationships to draw from for daily flow of small business applications. So it's a very healthy sign, overall, for the business.

William J. Dezellem - *Tieton Capital Management, LLC - President, CIO, and Chief Compliance Officer*

And do you anticipate that number continues to grow?

Ed Siciliano - *Marlin Business Services Corp. - COO and EVP*

Over time, yes. But there's also a real emphasis on penetration of those sources and maximizing wallet share within those sources. So it'll grow slowly but I think our penetration will increase at the same time.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Yes, I wouldn't -- it's -- generally speaking, more sources is better, but the quality of the source is equally important. Because you can have a subset of your sources that are submitting low approval, low conversion flows and the operating burden on the system or on the economics implicit in those flows may result in a very low ROE. On the other hand, you can -- you have some dealers that are completely in-tune with what Marlin's about, they submit stuff that they know that Marlin is going to approve and that we know will convert, and those are very high quality dealer programs. So we surveil -- we're always trying to add dealers because there is natural attrition, but we have our own surveillance process that we use, both in terms of trying to figure out whether we're getting the credit quality that we want in the flows from the dealers, but increasingly, looking at how attractive those flows are with respect to their overall economics. Not just credit.

Operator

Ladies and gentlemen, we have reached the end of our question-and-answer session. I would like to turn the call back over to Mr. Jeff Hilzinger, President and CEO, for closing comments.

Jeff Hilzinger - *Marlin Business Services Corp. - CEO, President and Director*

Well, I'd like to thank everybody for your support for joining us on the call today. We look forward to speaking with you again when we report our 2017 third quarter results at the end of October. Thank you.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation, and have a wonderful day.
