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MRLN - Q3 2017 Marlin Business Services Corp Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2017 / 1:00PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Greetings and welcome to the Marlin Business Services Corporation Third 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, Lasse Glassen. Please go ahead, sir.

Lasse Glassen - *ADDO Investor Relations - MD*

Good morning and thank you for joining us today for Marlin Business Services Corp's 2017 Third Quarter Results Conference Call. On the call today is Jeff Hilzinger, President and Chief Executive 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 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?

Jeffrey A. 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 third quarter results. Before I begin today, I'd like to first acknowledge our colleagues, customers and their communities in Texas and Florida who had been affected by the devastation of hurricanes Harvey and Irma. Of primary importance to us is the wellbeing of our employees and ensuring that we provide as much assistance as possible to our customers who had been impacted.

Turning to Marlin's third quarter results, I will begin with an overview of the highlights from this past quarter, including our recent progress on the Marlin 2.0 strategy that is designed to help transform our company into a provider of credit products and services to small businesses. Lou Maslowe, our Chief Risk Officer, will comment on credit performance. And Taylor Kamp, our Chief Financial Officer, will then wrap up our prepared remarks with details on our financial results and business outlook.

Overall, Marlin's third quarter results were mixed. We continued to benefit from strong growth and origination volume in our core channels, continued strong yields and growth in net interest income from the record size of our portfolio. However, earnings were impacted due to hurricane provisions and weaker portfolio performance, particularly within our transportation channel. While there was a modest increase in net charge-offs, our allowance for credit losses increased significantly as it is very sensitive to recent delinquency trends.

Total third quarter sourced origination volume of $160.4 million was up 21% from the same period last year, but down 4% from the previous quarter driven by the intentional pullback in our transportation channel as we pivot to a new strategy to improve the channel's ROE. The year-over-year growth was due to strong customer demand in our Equipment Finance business. In addition, our working capital loan product funding stream continued to make a meaningful contribution with third quarter origination volume of $13.8 million or nearly 9% of total sourced originations. This is up from $10.3 million or 8% of total sourced originations a year ago.

Our direct origination initiative also continue to gain traction with origination volume increasing to $16.5 million during the quarter, an increase of 7% over last quarter and 61% over the third quarter last year. We expect growth in direct originations to continue to accelerate in the future. Also in the quarter, we referred or sold $22.7 million of volume as part of our ongoing capital markets activities. At quarter end, total investment in leases and loans expanded to a record $883.8 million, up 3% compared to the previous quarter and up 17% from a year ago. While credit quality remains acceptable, we are proactively addressing recent trends to ensure that near-term portfolio performance improves.

Overall, the fundamentals of our business remain very strong and we made good progress during the quarter on our strategic objectives to drive long-term growth and profitability. For the third quarter, we reported GAAP earnings per share of $0.26. Excluding the impact of credit losses and insurance claims related to hurricanes Harvey and Irma, earnings per share on an adjusted basis were $0.31. The increase in the general loss provision from weaker credit performance further impacted earnings per share by approximately $0.05. Taylor Kamp will provide more details on the impact of the hurricanes and the increased loss provisioning on our results in his remarks.

During the quarter, we completed the transformation of Marlin's senior leadership team with the addition of Aswin Rajappa as Senior Vice President and Chief Marketing Officer. Given Aswin's extensive experience, especially with data analytics, digital marketing and digital transformation, he is ideally suited to manage our marketing activities at a more strategic level and to lead Marlin's marketing function into the future. He will undoubtedly play a key role as we move forward with the Marlin 2.0 transformation, particularly as we expand our direct strategy and develop new customer response and credit targeting models.

Subsequent to the end of the quarter, we announced the promotion of Mark Scardigli to the newly created position of Senior Vice President and Chief Sales Officer. Previously, Mark served as Senior Vice President and leader of Marlin's indirect sales team. In his new role, Mark will have responsibility for leading the company's overall origination activities and will report directly to me. At the same time, we announced the departure of our former Chief Operating Officer, Ed Siciliano, who stepped down earlier this month to pursue personal interests. We've began the process of transitioning Ed's responsibilities to members of the company's senior leadership team and we do not intend to refill the COO position. With Aswin's appointment and Mark's promotion, Marlin's senior leadership team is now fully in place and across the board, I couldn't be more pleased with the team that we've assembled.

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

I'd like to share with you the progress we've made in each of these areas since our last call. First, a key 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, our go-to market strategy now includes offering multiple products to small businesses as well as providing additional financing solutions directly to our end user customers. Within this context, during the quarter we completed an extensive analysis of our product and channel-level profitability, and now have a much better understanding of the through-the-cycle return on equity for each of our origination platforms.

This analysis is now being used to help us make more informed choices about where our capital and human resources are best deployed. Within Equipment Finance, this analysis has begun to informed choices we are making to optimize our channel mix and has caused us to revisit the strategies we've been executing in our transportation and franchise channels, both of which were launched in early 2016. In transportation, during the quarter, we made the conscious decision to significantly reduce our volume and pivoted to a new strategy that is focused on financing transportation equipment used by small businesses as opposed to financing equipment used primarily by transportation companies.

This more vocational approach to the transportation space is much more consistent with our direct strategy where we have better insight into our customer's credit histories and should drive much better risk-adjusted returns through the cycle. Franchise 2 is undergoing a significant shift as we adjust our risk appetite and financing products in a way that will generate more attractive risk-adjusted returns through the cycle while also having franchise remain an important part of our direct strategy. These changes have slowed our growth in both channels, but will ultimately cause them to become more relevant to our direct strategy while also improving their own risk-adjusted returns.

In addition to these changes, the results of our channel profitability work also validated the attractiveness of investing in our direct strategy. While equipment dealers, distributors and manufacturers have historically been Marlin's primary customers and will always be a critical importance to the company, an equally important part of Marlin 2.0 is leveraging our approximate 350,000 lifetime end user customers, including approximately 2,500 new small business customers entering the Marlin system every month. The objective under our direct strategy is to identify additional financing opportunities with these existing end user customers, offer multiple products and to create ongoing relationships with these customers.

In addition to creating a proprietary flow of follow-on financing opportunities with these existing end user customers, it is important to note that we do not incur customer acquisition cost beyond the initial transaction. So this follow-on business significantly lowers our weighted average customer acquisition cost.

As I mentioned earlier, this initiative is gaining good traction as is evidenced by the $16.5 million of direct originations volume funded during the quarter, which represents a substantial increase over prior periods. With Aswin Rajappa now on board, I expect this growth to accelerate as we begin better leveraging Marlin's data and low cost access to small business customers.

We also made good progress during the quarter on our second pillar of Marlin 2.0 which focuses on using capital more productively. Our portfolio growth during the quarter allowed us to further reduce our equity to assets ratio to 16.4% this quarter from 16.7% in the prior quarter and 18.3% in the third quarter last year.

Additionally, we continue to improve our ability to manage the size and composition of our balance sheet through our capital markets activities. Investor demand and pricing for Marlin's product remains very strong and execution on the portfolio sales during the third quarter was excellent. We view these transactions as a means to optimize both the economic and credit composition of our portfolio and to enhance ROE over time.

And finally, while we did make progress during the quarter in better leveraging the company's capital through growth, there remains significant room for improvement in the company's operating efficiency. While our process renewal initiative has worked well, we are currently evaluating other areas of the company that could benefit from a similar approach including our sales organization where our sales leaders have embraced the process renewal approach with the view to improving salesforce effectiveness. And now that most of the 2.0 investment is complete, we are focused on controlling cost and operating more efficiently as we continue to grow.

In conclusion, while we are focused in the near term on improving our portfolio performance and on adjusting our channel mix to optimize the company's risk-adjusted returns, strategic momentum continues to build and I am more confident in the value of the Marlin platform today than I was a year ago.

In addition, the company continues to show the strength of its core earnings through continued growth in its net interest and fee income, which provides a strong foundation on which to build. There is much to do and I look forward to continuing to focus on the execution of our strategy, enhancing our financial and operational performance, and driving superior value for all of our stakeholders as we move forward.

With that, I'd like to turn the call over to Lou Maslowe, our Chief Risk Officer, to discuss the performance of our portfolio in more detail. Lou?

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

Thank you, Jeff, and good morning, everyone. My comments today will focus on Marlin's third quarter portfolio performance. I will address specifically the drivers for the increasing trend in delinquency and charge-offs. I will also explain factors leading to the $1.9 million increase in our allowance for credit losses which drove a significant increase in the third quarter provision. Finally and most importantly, I will discuss the actions being taken to ensure that our credit quality and performance remain a strength as we continue to grow Marlin's portfolio.

Consistent with Marlin's overall third quarter results, the portfolio performance in the third quarter was mixed. While delinquency and charge-offs in the Equipment Finance portfolio continue to increase in the third quarter, the Funding Stream portfolio continued to perform very well with steady delinquency and better than target charge-offs. Equipment Finance receivables over 30 days delinquent were 115 basis points, up 21 basis points from the second quarter and 35 basis points year-over-year.

Equipment Finance receivables over 60 days delinquent were 63 basis points, up 9 basis points from the second quarter and 17 basis points above the third quarter of last year. The quarter-over-quarter increase in Equipment Finance 31-day delinquency was observed across our business where the year-over-year increase is largely attributed to updates to collection strategies, portfolio sales and higher delinquency in the transportation channel.

The increase in the 60-plus days delinquency quarter-over-quarter was driven by a significant increase in the transportation channel and to a lesser extent other channels such as office equipment and national accounts.

While an increase in the transportation channel delinquency was anticipated given the maturation of the portfolio, the magnitude of the increase was greater than expected. As Jeff mentioned, we are shifting our strategy in transportation to focus on financing transportation assets for our customer base active in a broad range of industries as opposed to serving companies only in the transportation industry. This change in focus will significantly reduce cycle risk and provide an overall higher risk-adjusted return.

Funding Stream delinquency remained excellent as the 15-day delinquency decreased from 89 basis points to 77 basis points and increased slightly in the 30-day bucket from 35 basis points to 42 basis points.

Aggregate net charge-offs in the third quarter increased to 1.73% of average finance receivables on an annualized basis, as compared to 1.65% in the prior quarter and 1.36% in the third quarter of last year. As mentioned last quarter, we anticipate that net charge-offs will continue to increase modestly over time as our high yield Funding Stream product grows as a percentage of the total portfolio, although the third quarter increase was driven by Equipment Finance.

Net charge-offs in the Equipment Finance portfolio increased by 18 basis points and 32 basis points compared to the prior quarter and prior year period respectively. Third quarter charge-offs in Equipment Finance were higher than expected largely due to a spike in transportation channel charge-offs of $429,000, which was more than double expectations and the primary reason for the quarter-over-quarter increase. It is important to note that charge-offs excluding transportation are performing in line with our channel loss expectations, albeit higher than the strong performance that we experienced in 2016.

Funding Stream charge-offs of $198,000 represented 3.05% on an annualized basis, which is well below the 600 basis points target for this product in the current economic environment and what we view as a very acceptable and profitable level for the product.

The allowance for credit losses increased by $1.9 million in the quarter to $14.5 million, a 15.5% quarter-over-quarter increase. This compares to an $872,000 increase from Q1 to Q2. The increase is due to the hurricane provision of $500,000, approximately $300,000 due to growth in the portfolio, and $1.1 million due to higher delinquencies and charge-offs. Marlin's reserve methodology is highly sensitive to changes in delinquency and charge-offs.

The calculation projects the next 10 months of losses based on delinquency migration and charge-off trends over the prior 6 months. As we expect delinquency and charge-offs to level off, we don't expect further increases of this magnitude in the near future. While the overall role in fourth quarter average portfolio performance is within expectations, we are proactively addressing the increasing trend in delinquency and charge-offs in the Equipment Finance portfolio.

For transportation, we have tightened our underwriting criteria while we make the strategic changes described by Jeff earlier in order to improve the portfolio quality and overall profitability of the business. Over the past month, we have commenced a number of initiatives to assess and address the root causes of the increase in delinquency and charge-offs. These initiatives focus on credit quality, collections effectiveness and operational policies and procedures.

In order to assess credit quality, we recently rescored the entire Marlin portfolio in order to determine if there is evidence of any material degradation in credit quality as compared to the credit scores at origination. We were pleased to find that there were -- has only been a very minor downward migration in the credit scores, which would equate to less than a 10 basis points increase in annualized charge-off expectation.

We are also adding resources to our collections department to ensure adequate coverage on our growing portfolio, which has grown 21% in assets under management year-over-year without any corresponding changes in collections headcount. We are also developing a behavioral model to help our collectors improve the efficiency of their calling efforts.

Having been part of the Marlin team now for 9 months, I can say that I am very pleased with the company's strong risk and credit culture. While the increasing delinquency and charge-offs represent at least in part a return to more historical norms following a period of extraordinary portfolio performance, we will continue to make adjustment to our credit, collections and operational processes in order to optimize portfolio performance.

In the near term, I expect our portfolio performance metrics to stabilize and remain within our targeted range.

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

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

Thank you, Lou and Jeff, and good morning. Third quarter net income was $3.3 million or $0.26 per diluted share compared to $4.3 million or $0.35 per diluted share for the third quarter last year. As Jeff mentioned, on an adjusted basis, our third quarter 2017 earnings per share included a $0.05 per diluted share negative impact due to the provisioning of hurricanes Harvey and Irma.

An additional $0.05 due to credit provisioning previously discussed by Lou and an additional $0.01 due to final senior leadership team recruitment and relocation expenses. As mentioned last quarter, we continue to benefit in the third quarter from the successful pass-through of rate increases within our equipment finance business driving a 3 basis point increase in yield over last quarter.

This was partially offset by an 11 basis point decrease in the yield on Funding Stream originations. For the quarter, total yield on new originations funded of 12.18% was down 3 basis points from the prior quarter and up 49 basis points from the third quarter of 2016. Approximately 72% of Funding Stream's loans were originated with existing Marlin customers as we continue to be focused on maintaining superior credit quality in this product.

Referral volume of $12.8 million was down $0.4 million from the prior quarter but increased over three times from the third quarter of 2016. Most of the referral volume continues to come from Horizon Keystone which was acquired in the first quarter of this year. However, as previously communicated, we're beginning to put more of this volume on balance sheet. In the third quarter, Marlin kept approximately 52% of Horizon Keystone's production on balance sheet, which is up from approximately 13% last quarter. This migration of HKS assets to Marlin's balance sheet will continue through the balance of the year. Entering 2018, we are likely to place all of HKS originations on our balance sheet.

During the quarter, we completed (technical difficulty) portfolio sales totaling $9.6 million. This generated an immediate net pretax gain on sale of $252,000 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 $43 million in assets for our funding partners which allows us to maintain an ongoing relationship with these customers.

Our investment in leases and loans grew approximately 3% from last quarter and 17% year-over-year to $884 million, an all-time record. Total managed assets increased 21% from a year ago. For the quarter, net interest margin was 10.73%, down 14 basis points from the prior quarter and 57 basis points lower than a year ago. The decrease in margin percentage was primarily driven by a decline in late fees and end-of-lease revenue based on certain updated servicing practices, growth in the mix of lower yielding Equipment Finance channels and an increase in the company's cost of funds.

The decrease due to mix and fees was partially offset by an increase of 49 basis points in new origination loan and lease yield over last year. The portfolio continue to perform within acceptable ranges in the third quarter. The allowance for credit loss reserves was just 1.64% of total finance receivables and coverage of total 60-day delinquencies was 235.6%. As we mentioned earlier, it is important to note that our reserved methodology is very sensitive to small short-term changes in delinquency and loss emergence.

Third quarter operating expenses were $15.7 million compared to $12.8 million in the third quarter last year. The increase from the third quarter last year was primarily due to an increase in expense stemming from the Horizon Keystone acquisition including intangibles amortization, expense and higher salaries and benefits. Expenses also increased due to the aforementioned hurricane provisioning, a true-up of uncollectible property tax and FDIC insurance, investments in the company's direct origination initiative and Marlin's senior leadership team.

The increase from the prior quarter was primarily due to investment in the senior leadership team, provisioning for hurricane-related insurance claims and increases in FDIC insurance partially offset by reduction in legal and external consulting fees relating to the regulatory matter. The company's efficiency ratio for the third quarter was 58.7% compared to 55.2% on an adjusted basis for the prior quarter and 54.9% in the third quarter last year. On an adjusted basis for the impact of the extraordinary expense relating to the hurricanes, the efficiency ratio was 57.1%.

The impact of recruiting new senior executives resulted in a decrease in efficiency at 0.8 percentage points. Lastly, sales bonus compensation relating to the overachievement in our recent acquisition also decreased efficiency 0.8 percentage points in the quarter.

Our capital position remains strong in the quarter with an equity-to-assets ratio of 16.42%, 184 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. In addition, I am pleased to report our Board of Directors declared a regular quarterly dividend of $0.14 per share payable on November 16, 2017 to shareholders of record as of November 6, 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. Total sourced origination volume is expected to finish the year approximately 20% above 2016 levels. Portfolio performance is expected to level off and remain within our targeted range. Net interest margin as a percentage is expected to remain relatively constant for the remainder of 2017. And finally, ROE is expected to improve in the fourth quarter of 2017 as the company continues to improve operating scale.

And with that, I will turn the call back to Jeff. Jeff?

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

Thanks, Taylor. To wrap up, I'd like to reiterate my earlier comments that we are focused in the near term on improving our portfolio performance and on adjusting our channel mix to optimize the company's risk-adjusted returns. Strategic momentum however also continues to build and I am more confident in the value of the Marlin platform today than I was a year ago. In addition, the company continues to show the strength of its core earnings through continued growth in its net interest and fee income which provides a strong foundation on which to build. I look forward to continuing to focus on the execution of our strategy, enhancing our financial and operational performance as we go forward.

With that, let's open up the call to questions. Operator?

QUESTIONS AND ANSWERS

Operator

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

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

So I'm still having a little bit of a tough time understanding what specially happened in transport. So can you maybe explain this little bit more? And then when did signs of this issue pop up in the quarter?

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

Then Lou can talk a little bit to just sort of the metrics and when we noticed issues. So the problem with the transportation strategy as it was originally conceptualized this day was essentially a wholesale originated strategy focused on financing Class 7 or Class 8 trucks that are used almost exclusively by transportation companies. That -- the good news about wholesale is it allows you to grow very quickly because you're basically leveraging equipment dealers in a wholesale way. The bad news is that the pricing is very low and Class 7 and Class 8 especially with small fleets and motor operators is a very risky segment. So over the course of the last 6 months or so, we've been proactively shifting it from -- trying to shift it from motor operators to small fleets. One of the pieces of the ROE analysis that Lou did was basically a deep dive on whether we would be able to get to enough small fleet to have it perform the way that we needed it to perform in the ROE analysis. And the issue we faced was that in order -- the definition of small fleet, it gets you to better credit performance would require such large deal sizes that we just weren't comfortable putting those deal sizes on our balance sheet. And because it's a wholesale originated strategy, those assets aren't liquid. So you can't use a capital market strategy to try to mitigate the deal size. So when you put all that together and you put it through an ROE analysis, it become -- it became clear to us that from a pure return standpoint, it didn't make sense. And then again because it's focused on transportation companies as opposed to small businesses, as we've evolved our direct strategy, that original transportation strategy was just becoming obsolete from a strategic perspective. So really from every angle we look at it, whether it was liquidity, whether it was strategic relevance, whatever it was expected return over the course of the cycle, it just became very clear to us that we needed to either exit transportation completely or we needed to pivot to a different strategy which is what we've decided to do which is more vocational, which makes I think a lot more sense certainly for Marlin because transportation assets as a class are in high demand by small businesses. Lots of small businesses need trucks and transportation assets to operate. And we referred to that as more -- a more vocational strategy. And so I think taking this -- making this shift to a vocational strategy allows us to improve the returns. It's completely relevant with our direct strategy. And because it's not going to be originated on a wholesale basis, it'll be originated through direct relationships that we have if liquid is well which means that we can bring capital markets tools to bear on it. So it's -- I think it's the right strategy for Marlin. But it's taken us a few months to figure out exactly how we wanted to pivot and what exactly that pivot was going to look like.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

That's great color. I have a much greater understanding of what's going on there, so that helps. Maybe just diving a little bit more deeper there, maybe the effect on lease volume, so -- from your decision to pull back there. So maybe what did you do in transport in Q3 and then what was that relative in Q2?

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

I have to look at the specific numbers, but the transportation volume in the third quarter, Chris, was 40% less than it was in the second quarter. So I don't have the actual numbers in front of me here, but it's -- it was a pretty significant reduction. And that reduction was primarily as a result of -- we basically significantly constrained the credit box as we were going through the -- in anticipation of the return analysis and in anticipation of a shift in the strategy.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Got it. And thenâ€¦

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

This is Taylor. So TFG from the second quarter to the third quarter went from $13.7 million to $8.5 million.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

That's great. All right. So I guess if we're -- so just annualized at $8.5 million, call it $32-ish million, how -- I mean how should we think about the impact to your origination in '18 from the pullback in transport and then maybe even in franchise as well?

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

Yes. I think we're -- the transportation volume in 2018 is going to be much less than what we had projected when we were originating under the wholesale strategy. I think we've got something between $20 million and $25 million of transportation volume in our 2018 plan. Now that's within a context of total origination volume that we still expect to grow approximately 20% next year. So it's in addition to pivoting transportation and transportation there's also this growing commitment to direct which mitigates the pullback to a great degree. And then I think it's important that we point out that the other indirect channels that we have are growing well and they're growing pursuant to plan and they are working the way that we want them to work, and they all came through the ROE, the deep ROE analytic that we did in a very positive way.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

That's great to hear. Okay. So for '18, you're still thinking roughly a 20% year-over-year growth in loan and lease origination is achievable?

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

Yes. And we're still finalizing our plan, but it's going to be somewhere between 15% and 20%.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Perfect. Okay. And then in your press release and in your prepared remarks, you did note a targeted range for delinquencies. So could you help me understand what that means? I mean, can you quantify the targeted range maybe on the 30-day and the 60-day metrics? And then secondly, what is your outlook for performance, as you mentioned there in the press release too, for charge-offs and then maybe your loan loss reserve ratio?

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

Sure. Let me take this one. Chris, this is Lou. Yes, when we referring to the range, we're -- frankly we're more focused on the charge-off line when we're talking about that. And as you may recall from last quarter, we were talking about that range up to about 1.76 -- 1.76 which came out of our -- the ROE analysis that we've been talking about. The delinquency that we have today I would say is higher than our target, although I don't have an exact number but that's what drove the higher allowance. So our objective is to get the allowance number a bit down moderately we think through a reduction in delinquency. But I would say and then we would -- the allowance would then adjust through next year in accordance with our portfolio growth. So overall, I don't expect a big adjustment in allowance. Like I said, we saw a particular increase in the 31- to 60-day bucket and that's where we're really focusing to get it down. And that should help us level off the allowance that around the 156 basis points where we are today. As far as charge-offs go for next year, we -- as we commented that we expect them to level off in the ballpark of where we are really in the current environment. We're comfortable at this current level. It was up a bit as a result of the transportation group as we mentioned and we expect that to continue to have an impact on our charge-offs really for most of 2018. So I wouldn't expect a significant difference one way or the other from where we are this quarter.

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

Yes. I think, Chris, should do it from a forecast perspective. I think a couple of things to keep in mind here. The weakness in the portfolio performance is real for sure and there are a lot of things that we can do and are doing to address it. But I think the good news is I want to emphasize the fact that we -- we've not materially changed our underwriting standards over the last year. And I think the rescoring of the portfolio and the fact that the rescoring process shows that there's been very little deterioration in the underlying credit worthiness of the portfolio validates that. And I think it helps direct our efforts to really a more tactical approach to how we better collect the portfolio that we have. So I mean when you look at the macro environment, it remains benign. When we -- when we do our outreach to folks that are in the same business as us and try to get an understanding of what's happening with their portfolios, we don't see much change year-over-year. So I think the issues here are Marlin-specific and I think that they are the kinds of things that we can deal with in a relatively straightforward way in the near term by doing the things that Lou talked about in his opening comments.

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

I think on top of that Jeff, it's important to mention that really our under -- our underwriting standards have remained constant. I mean there is always minor tweaks here and there, but for the most part, our underwriting approach and the credit scores, our approval rates are all very much consistent, which is the basis for why we expect a fairly steady results.

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

And so all of the comments exclude the transportation portfolio.

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

Right.

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

So obviously there we really constricted the credit box and really took a much more narrow view with respect to the dealers that we were doing business with. And the rescoring statement that we made, that excludes the transportation portfolio as well.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Great. That color is very helpful. Thanks, Lou. Thanks, Jeff. Switching to maybe yields, so Taylor, I think you said that there was some impact in regards to base rate increases quarter-over-quarter. Now what are your expectations for the -- for that to continue maybe in your ability to price increase in new customers for '18?

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

Yes. Historically, we've proven that we can pass along those rates. There's an inelasticity in the demand. So to the extent that the rates go up in December again, we would try to pass those along and believe that we can pass those along.

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

Yes. I mean they are easier to pass in some segments than in others. And I think the other shift that you'll see in '18, Chris, is as we move into the new transportation strategy, that's going to grow on a lower rate and mitigate that to a great extent with the growth in direct. What's going to happen is that mix shift is going to cause the weighted average yield at the enterprise level to rise. You encounter intuitively, it's also going to cause our target net loss approximately to rise as well because the loss rates in direct are higher than they are in transportation, but the pricing in direct is much, much higher than it is in transportation. So when you take that into account, you will actually have rising ROEs as we make this shift in our channel mix, even though the company's enterprise level target net loss rate will rise as a result of that. Because (inaudible) and yield in the direct business will rise at a faster rate than the loss of gross. It's really the opposite of the wholesale transportation issue which is where you -- because you have very little of any control over the origination process, you actually have underpriced risk as opposed to direct where we think we have overpriced risk. So the shift is a good one. The bad news is that because it's a more retail oriented -- direct is a more retail oriented origination strategy, it takes longer to build it. But we believe strongly that that shift in the strategy is absolutely a significant source for better risk-adjusted returns per ROE and better enterprise value for the business.

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

Yes. And Chris, I would refine my statement a little bit in that we don't need that discrete event of interest rate increases to try to pass things along. We're seeing a little bit of increase in our cost of funds, cost of deposit just simply because they priced outside of the fed rate. So we try to pass that along as it happens.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Got it. And then as a follow up, maybe let's see, in your guide for the NIM to remain relatively constant, does that include or not include any changes in base rates?

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

It currently doesn't include. And I would say that our NIM will remain relatively flat, but there may be some upward tick in that even in the fourth quarter.

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

Yes. We've been able to use the announcement of fed rate hikes, Chris, as an opportunity to be able to raise our pricing because many of our customers expect an increase in price because that's such a public announcement. Where we lag is when the bond market or the fixed income market swap rates in particular are rising gradually over time or in anticipation of an event like that. And they are typically a company like this will have its margin squeezed until it gets -- squeezed modestly until it gets to a point where there is an opportunity to put through a price increase. And then you recapture those margins. And hopefully actually you can put through a price increase that's large enough that you actually more than recover those margins. But the timing -- the sequencing or the timing is staggered typically.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Makes a lot of sense. Last topic for me, so we were pleased to learn that you're spending in Marlin 2.0 as complete which you said in the prepared remarks. But thinking maybe a little bit longer term, how much investment should we expect in your transformation to Marlin 3.0 maybe in tech going forward and then the timing of that potential spend?

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

We're working on our plans as I said before. So nothing is locked at this point. But when we look at our sort of our spend from an IT stand point to keep the lights on as opposed to spend that's dedicated towards evolving the automation of our processes or in the sort of a continue to evolve -- the evolvement of our portals and the customer interfaces, I mean it's significant but it's not something that the company can't afford and can't -- would keep us from being able to ultimately meet the -- our objective of getting to a 15% ROE over the course of the next few years.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Great. And then just for the Q3 and maybe Q4 expense, I mean you had a couple of changes in senior leadership bringing on Aswin and then Ed -- the separation with Ed. So can you quantify if there is any one-time expenses in Q3? And then should we expect any one-time expenses from the separation in Q4?

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

Yes. That's a good question, Chris, and we've given that a lot of thought. So -- and I alluded to it in my comments, but generally in Q3 we did have some Hurricane Irma and Harvey expense related to insurance claims -- projected insurance claims and that was a little over $400,000. We had some additional recruiting expense related to what we talked about sort of finishing out our investment in SLT. That was a couple of $100,000. We had some sort of bonus commissions for -- paid to HKF for their overachievement of their volume targets here in Q3 now and so you sort of kind of take those out, there's a little bit of extra expense that goes the other way in Q4. But the big item in Q4 will be with Mr. Siciliano's exit, there's some one-time expense related to that offset by some recapture. That net-net is probably about $500,000 pretax that we'll have to pay next quarter.

Operator

Our next question comes from Brian Hogan with William Blair.

Brian Hogan

I had a question on kind of follow up to last one, efficiency ratio. Your outlook that I think last quarter to go back to that and you had said at least you had thought that third quarter was going to be the inflection point and improving from there. And obviously, we had the hurricanes and -- but even the exit, absent the hurricanes, efficiency rate -- and the recruiting stuff that you just called out, the efficiency ratio went the wrong direction. I guess can you comment on the outlook for the efficiency ratio and how fast you get to go there? And obviously you changed in your -- the transportation thing, just kind of give us more thoughts there please?

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

Yes. So that's a good question too. I think it's the other side of the coin from what we just talked about. But if you remove in Q3, if you remove the impact, you recalculate efficiency ratio after -- before the impact of the hurricane or Horizon, extraordinary bonus and a recruiting expense, you get back into that range of 55% or so. In the next quarter as that falls off -- as other things fall off, we continue to build scale ignoring the amounts for Mr. Siciliano. I think, we exit the year in -- with an efficiency ratio in the low 50. So I think we're not that far off from the guidance that we gave before with respect to the efficiency ratio. We just had some unexpected items really in the last half of this year.

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

Well, we did gross faster in the quarter as we -- the reasons that we've outlined, Brian.

Brian Hogan

Sure. And then can you comment on the ROE outlook? Not just for the fourth quarter, but longer term? You had given some longer term comments there. I mean I think previously last quarter you said like low teens and this quarter was, call it 9-ish percent thereabout. Do you -- what is increase from -- is it up from 8 or is -- I mean just kind of comment on the fourth quarter. And then what are your longer term outlook? Has that changed given you're going through originations outlook and ROE study?

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

Yes. In the short run, while we gave some guidance last time around a low teen, a very low teen number, I think Q4 this time adjusting for whether it's late charge end of lease along with some other expenses, I think we're going to be in the very low double digits with respect to ROE. When I say double, just over 10 I think for the fourth quarter. The long term outlook I think we do reset a little bit, but we have strategic initiatives that will -- we believe will help replace transportation and other things that we've deemphasized. That shouldn't put us that far behind in the long run from the guidance we've given before.

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

Yes. I think, Brian, I think the result of the channel profitability work that we've done in the repositioning of the channel mix that we've discussed today probably extends getting to the future state ROE by 6 months to 12 months. But I would say that we are replacing a volume and platforms that was primarily wholesale originated with this direct strategy which I think ultimately creates maybe as much more strategic volume and it creates a lot more strategic value in the platform because there are customers we control. We capture all of the margin at that point. We have the ability to leverage our initial origination cost better than we do with the wholesale originations and it's liquid. So I think the tradeoff of what ultimately we're going to look like would be taking us 6 months to 12 months longer to get there is a very fair tradeoff.

Brian Hogan

Sure. Can you comment on the origination demand in a competitive environment please? Obviously you have a pretty strong origination growth outlook for 2018 being 15% to 20% that is going to -- what do you see out there competitively inâ€¦

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

Yes. I mean our -- the competitive environment really hasn't changed much in terms of who we compete against. Yes, again I would say that Marlin is -- within the context of the -- even the small ticket Equipment Finance business, it has really a spec of market share. So it's -- we really don't need to increase our market share by much to have it be -- have a pretty significant impact on the company as we try to achieve our scale objective. And we see that even today. I mean we had -- notwithstanding the conscious decisions we made around transportation and franchise in the third quarter, the other channels all performed very well. And going into the fourth quarter, we continue to really experience record application levels. And we think that October as an example should be close to a record month for the business. So there is a lot of momentum, which I think we really need to highlight here. There's a lot of momentum beyond franchise and transportation that I think bodes well for both the fourth quarter and the continued growth in origination volume next year. And next year's volume is occurring with a channel mix that I think is a lot more attractive, and that ultimately will build a lot more attractive portfolio over time.

Brian Hogan

Sure. And can you comment on the jump in the restructured loans? I mean it's a pretty hefty jump.

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

Yes. We -- it's really -- this is Lou. I have some specific statistics, but the hurricanes is driving the higher restructure activity. In fact, see, I have these numbers are as of October, but just to give you some example some idea that we have booked restructures for hurricane Harvey 39, restructures totaling $1.1 million and for Irma 74 totaling $1.7 million. Yes. This is actually we think is good new story and that these are customers saying -- they're staying in business, they just need a little help while they get back on their feet.

Brian Hogan

All right. And then you commented on this a little bit earlier, just wanted a little more color. Your ability to pass through increases in rates and even more than that. But yes, we see the yields being relatively steady while your cost of funds went up. Can you -- just trying to understand that a little bit better. Can you comment on that please?

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

Yes, sure. I think you've got -- so we've -- I think there have been 75 basis points worth of price increases over the last 9 months or so. So our -- the yield and our origination volume today is 49 basis points higher than it was before. So we haven't passed through everything, Brian, but we've passed through a fair amount of it. And I do think that our price increases are going to lag the increasing base rates or increasing rates from fed price movement. So it's normal to lag going up and it's normal to lag coming down. And -- but I think the good news is that we've shown that we're able to pass through 50 of the 75 basis points. And it's -- again, this is a big difference between retail-oriented channels and wholesale-oriented channels. Wholesale-oriented channels, the basis of competition is much more on price and it's much more difficult to pass through price increases. And so again, I reiterate this shift from wholesale origination primarily in transportation into direct gives us a lot more control over our ability because it's fundamentally less competitive, we are more control over being able to pass through price increases. Plus I think in the direct channel, as we see in our retail business, there is value to the customer to have the process be convenient. So there is an opportunity for convenience pricing as well. And I've said this before and I think a platform like Marlin especially is it -- as we pivot towards this direct strategy, we should always be testing the price elasticity of the demand whether we have rising rates or not. And so that's a discipline that we're working on instilling in the business. We're not there completely yet, but I do think that whether it's in Funding Stream or whether it's in Equipment Finance beyond whether the price is proper for the risk, there is also an opportunity I think here for us to press price on a convenience basis.

Brian Hogan

All right. Last question. I think previously in calls you discussed diversifying your capital structure and maybe a little bond deal or whatever. Can you comment on your progress there?

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

Yes. This is Taylor. You know, right now with the way our capital has been declining with organic growth and the fact that we've been able to very successfully manage capital through our syndications, we've held that had that on hold really. So we haven't really needed it and it's -- it doesn't mean that it isn't in our mind going forward, but over the last few months we haven't needed it. And there is a little additional cost upfront with that and we thought that we can -- everything is pretty much the Ts and Cs are all worked out and we can pull the trigger in a pretty quick fashion. But we've chosen to put that -- push that out a little bit.

Operator

Our next question comes from Bill Dezellem with Tieton Capital Management.

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

A couple a questions. First of all, continuing down the transportation. Is that your lowest yield and maybe I should be asking the lowest ROE category or are there others that are lower yet?

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

This is Jeff. The transportation was the lowest through the cycle ROE by far at least in its wholesale originated form. So there were -- there are others that I need to have some work done on them in terms of positioning and in terms of the way that we work to enhance the ROE. As I said before, there are 6 or 7 levers that impact ROE deal size operational intensity, obviously yield tenure, credit loss expectations. And so what the ROE analytic allowed us to do was basically quantify those levers within each of our platforms and be able to develop strategies in each of the platforms to be able to optimize the ROE by pulling those levers or adjusting those levers in a way that we think optimizes the way that we compete in each of those channels. And that's -- we've identified those. And so even in the channels that made it through the process with a green light, that doesn't mean that the way that the ROE that they're generating today is the ROE that they should be generating or that they ultimately could generate. So that work that we did, it isn't like we just said, well, either you platform pass or you don't pass and we exit, it was every platform has an opportunity to have its ROE improved. In the case of transportation of franchise, they both required significant changes in strategy. And in transportation's case, we felt that we needed to really constrain origination volume and to really tighten the credit box while we were going through that process.

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

And if you overlay the fact that transportation assets are not nearly as liquid as other assets, we couldn't manage that as well with our secondary marketing and syndication strategy.

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

Yes, yes. We can't underestimate that because the more you originate, the more you -- because they are not liquid, the more you are forced to live with the asset for its life. So you feel differently if you had a platform where you were trying to optimize ROE, but you felt that risk reward was fundamentally balanced, so that ultimately it didn't make sense for us to keep it in our balance sheet, we could intermediate it to somebody else's where it might make sense. But in transportation's case, that option wasn't available, which is why we felt we had to move quickly once we reached the conclusions that we did.

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

Thank you. And then if we heard you correctly early in the call, there was also a reference to changing how you addressed the franchise category. Would you talk in some more detail about that if we heard correctly?

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

Yes. That I think our thoughts on how we want to evolve franchise are less evolved than they are in transportation. And so the franchise platform was always conceptualized as being sort of a mini version of what we're trying to do as a company, which is develop relationships with franchisors in order to get access to initial transactions with franchises and then basically follow a direct strategy. That I still think that that approach is valid. But the question becomes how much resource should we apply against it and realistically how much can we rely on that platform under that strategy to provide growth? And the jury is still out on that. And we have a relatively conservative number in our 2018 plan for franchise, but because we are uncertain about exactly what that's going to look like. So we have lots of ideas about it and we're working with the team there to understand what is the ultimate best future state for the franchise platform. I think there is a important role that the franchise business can play in the future of Marlin. But I don't think it's going to be a high -- I know it's not going to be the high growth platform that we had thought it was going to be or that the company had thought it was going to be when it entered in late 2015, early 2016.

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

That's helpful. Thank you. And then finally, I'd like some clarity and this is just my ignorance and lack of understanding on the provision going forward. And so I think we heard you say that the provision is really based off of the last 6 months and assuming then that the December quarter looks similar to the September quarter with the current level of charge-offs and delinquencies, you would be dropping Q2, adding Q4, which Q4 would be higher than Q2. So does that then imply that the provision goes up or because your portfolio performance stays constant, does that actually imply that it stays flat? So can you help me try to put that together a little better, please?

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

It's a very good question and I'll try to do that for you. This is Lou. Yes, so first of all, just to be clear, so in terms of credit loss provision on the P&L, there is really the 2 components, right. There is the charge-offs and then there is the loss allowance that you're referring to that really had the big impact this quarter. And you're right. So when we go back 2 quarters, you have to look at the migration patterns and the ending delinquency in the quarters that you're dealing with to see what the impact is going to be. So in theory, it could be that if with -- if our migration remains constant this quarter, there could be some increase in the allowance, but it really has a heavy dependency on where the delinquency ends because you base your calculations off of the ending delinquency going forward 10 months. So it's very mechanical, but I would summarize it to say that if we're able to keep delinquency where we are or reduce it, then I would expect that there would be no material change in the allowance going forward, except for as I said, growth is always going to have an impact on the allowance, but much more modestly than higher delinquency and charge-offs.

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

Great. And then just --

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

Does that help?

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

It does. And just to make sure that I am totally clear that if delinquencies are flat at the end of December versus the end of September, that the provision should be very similar assuming 0 growth. But since you likely will have growth, it would be higher as it naturally is when there is growth in the portfolio.

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

That would be my expectation. Yes. I think the one caveat that we have here for the fourth quarter, of course, is the impact of the delinquency related to the hurricane. We're hoping to keep that. And again our expectation is that it won't have a material impact, but that's the one I would say unknown that we'll know better over the next 30 days to 60 days.

Operator

We have a follow up question from Chris York with JMP Securities.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Just one follow up here. Lou, what were the reasons for the $1.2 million increase in the non-transport reserves?

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

So the way we broke it down for Q3 is we break it down into how much is portfolio growth, how much is credit and how much was due to the hurricane. So the place to start first of all the allowance went up $500,000. So that was out of -- the total allowance increase was $1.9 million, right. So you take the $500,000 out for the hurricane. And then we calculate portfolio growth was about $344,000, the difference being the $1.1 million, okay. And I think that's the number you're asking for, for the credit fees, right?

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Yes. Yes.

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

Okay. So that is -- so that's really is asking where is the delinquency, what drove the higher delinquency. We've talked about transportation was one of the major segments that grew the delinquency, impacted delinquency. And to some extent, some of that was expected because we started building that portfolio in the beginning of '16. So we have just really seen as that portfolio is maturing, a growth in delinquency in that area. Other than that, we saw a quarter-over-quarter increases really in the major components of our business, retail, OEG, our Office Equipment Group. So I would really say it was across the board as to where we saw the increases in the delinquency and the migration in the portfolio.

Christopher John York - *JMP Securities LLC, Research Division - MD & Senior Research Analyst*

Got it, okay. Retail, office and then migration? Okay.

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

Yes.

Operator

Thank you. I would like to turn the call over to Jeff Hilzinger for closing comments.

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

Thank you for your support and for joining us on today's call. We look forward to speaking with you again when we report our 2017 fourth quarter and full year results in early February. Thank you very much.

Operator

This concludes today's teleconference. Thank you for your participation. You may disconnect your lines at this time.
