United Financial

Q2 2015 Earnings Conference Call

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CORPORATE PARTICIPANTS

Marliese Shaw – *Executive VP of Investor Relations*

William Crawford – *Chief Executive Officer*

Eric Newell – *Chief Financial Officer*

Mark Kucia – *Chief Credit Officer*

PRESENTATION

Operator
Good morning everyone and welcome to the United Financial Bancorp Incorporated Q2 2015 Earnings Conference Call. All participants will be in a listen-only mode. Should you need assistance please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation there will be an opportunity to ask questions. To ask a question, you may press star (*) and then one (1). To withdraw your question, you may press star (*) and two (2). Please also note today's event is being recorded. At this time, I would like to turn the conference call over to Ms. Marliese Shaw, Executive Vice President of Investor Relations. Ma'am, please go ahead.

Marliese Shaw
Thank you, Jamie. Good morning everyone. Welcome to our second quarter conference call. Before we begin, we would like to remind you to read our Safe Harbor advisement on forward-looking statements on our earnings announcement. Forward-looking statements, by their nature, are subject to risks and uncertainties. Certain factors could cause actual results to differ materially from expected results. Our comments today are intended to qualify for the Safe Harbor afforded by that advisement. And now I would like to introduce Bill Crawford, our Chief Executive Officer.

Bill Crawford
Thanks, Marliese. Good morning and thank you for joining us on today's call and for your continued interest in our Company. With me this morning, I have Eric Newell, our CFO, and several other members of our executive teams. Yesterday, United Financial Bancorp released its earnings results for the second quarter of 2015. These results represent United's second consecutive quarter of record revenue, record earnings, positive operating leverage, and increasing pre-provision net revenue. With the merger behind us, we are back to generating solid commercial loan growth along with our fourth consecutive quarter of record mortgage originations and a 73% increase in our non-mortgage consumer loan production.

In November of 2013 at merger announcement, we outlined a few key goals. The first was to achieve a 1.0% return on average assets. For GAAP accounting, we reported 96 basis points this quarter. We set 10% as a return on tangible common equity goal, and achieved 11.12% this quarter. We set an efficiency ratio goal of 57%, and we hit 57% this quarter. By the end of 2015, we expect to be trending towards our 2.0% non-interest expense to average assets ratio goal as we continue our loan growth. We had set high single-digit loan growth as a target and we are now on track year-to-date to achieve this goal, as well. I've heard that some people think we derive a large percentage of our total revenue and earnings in volatile mortgage banking activity. This is not so. Our CFO, Eric Newell, will cover this in a more detail.

Here is what I think is important for our investors to know. United is achieving excellent new commercial client acquisition from our new commercial teams in Worcester, Springfield, and Fairfield along with our legacy Connecticut-based commercial banking teams. We are seeing record commercial loan growth of 19% annualized in the second quarter and it's across all geographies and in each commercial line of business. We also have strong pipelines going into the third quarter. We are near fully staffed in our commercial line of business with an outstanding group of highly experienced bankers. For the fourth quarter of 2015, we expect to have our new cash management system and commercial loan system upgrade in place, which will help drive greater efficiency and growth in low cost core deposits. As one would expect, many of our borrowers desire fixed rates at this point in the interest rate cycle. We use our loan level hedge and secondary mortgage market capabilities to give customers fixed rates, while we produce our desired mix of floating versus fixed rates in our loan portfolios. We also generate fee income.

United is receiving good customer service quality scores in our branch network. While we closed nine branches during the merger, we have four new commercial focus branches in West Hartford, North Haven, Hamden, and Glastonbury, where we expect to drive significant commercial loan and deposit growth. These investments, along with our three new commercial teams, are already in our expense run rates. By year-end 2015, we expect to roll out remote deposit capture, online account opening, a new small business banking suite, and a new mobile banking account. Our mortgage teams continue to take market share from large banks and introduce new clients to our brands.

The Company did not repurchase any shares in the second quarter of 2015 because of tangible common equity at 8.9%. We're focused on leveraging our capital through organic loan and deposit growth, similar to what we did before the merger. Given our previous investments, we believe we are well positioned to drive significant positive operating leverage over the next few years. While we are slightly liability-sensitive, that's based upon a static growth model. The primary risk to United's success in driving strong organic positive operating leverage will be the shape of the yield curve. Management remains focused on managing risks, improving its cost structure, and driving positive operating leverage to create greater earnings per share, tangible book value growth, and a more favorable return on equity and return on assets. As we continue to build performance consistency quarter-after-quarter, we believe a more appropriate valuation will materialize. Through the Rockville United merger, we are essentially a new $5.7 billion bank, and the second quarter of 2015 represents our second clean quarter of earnings results. So we are just getting started.

I want to thank all of my United Bank teammates and directors for their unwavering dedication and hard work in delivering every day for our customers in addition to driving revenue growth and earnings for our shareholders. Now I'll turn the call over to our CFO, Eric Newell.

Eric Newell
Thanks Bill. Yesterday we reported net income of $13.3 million or $0.27 per diluted share for our second quarter of 2015. This is a penny improvement from the $0.26 we reported in the first quarter. Today I will focus on three items. First, our expense management; second our mortgage banking business and its impact on our financial statements; and finally some discussion on our NIM. I will then update you on some expectations for our NIM purchase accounting and our effective tax rate.

Revenue in the quarter increased by $2.1 million to $50.3 million, while expenses declined by $300,000 from the linked quarter, staying flat at $30 million. This is the second consecutive quarter demonstrating United's ability to show positive operating leverage by growing revenues at a pace faster than expenses, all while investing in the future of our Company to ensure continued growth. This positive operating leverage was demonstrated in our efficiency ratio, which decreased to 57.4% in the second quarter from 60.8% in the linked quarter. The ratio of non-interest expense to average assets, a ratio that we have consistently focused on since our merger announcement in 2013, declined to 2.19% in the second quarter from 2.23% in the linked quarter. Importantly though, if you remove the changes in the second quarter pertaining to expense categories that supported our growth, mainly mortgage commissions and expenses related to loan level hedging, our NIE would have been $29.1 million. Using this pro forma NIE number applied to our actual average assets in the first quarter, or apples-to-apples comparison, that pro forma NIE is 2.11%. Looking back to what we promised in the merger announcement relating to a reduction in NIE spending between the two legacy companies on an assets frame of $4.8 billion, the pro forma NIE to average assets promised at that time was to 2.10%. We have been laser focused on the NIE spending, and I'm happy to say that we're on the five yard line and look forward to making more progress in the second half of 2015.

I'd like to provide you an update on our mortgage banking operation, as we believe there may be some misconceptions on the Street about its impact on our financial statements. Our mortgage banking investments made in the last two years are allowing the company to provide a value proposition to its existing and prospective customers, as well as other constituencies in the mortgage space we serve in Connecticut and Massachusetts. Our credit delivery channel is one of the more responsive among our competitors, which is a huge benefit to our constituencies. We have developed a purchase-oriented business model, which has benefited us over the last year due to the reduced refinance volume in the market. We believe we are properly sized for our current footprint and therefore do not anticipate further investments to build out our production capacity. Importantly though is the contribution of our mortgage banking line of business to our overall results. We estimate that mortgage banking pre-tax revenue is approximately 1.5% of our total revenues in the second quarter, as well as year-to-date when including the expenses pertaining to current period production, which supports the majority of the income for mortgage banking activities reported and total non-interest income.

Further, in viewing available regulatory data in the 12-months ending March 31, 2015, United's gain on sale of loans were 18% of total fee income, while the peer mean was 14%, and the top quartile was 18% when compared to publicly traded companies between $2 billion and $10 billion in asset size. We attribute the reporting of United in the top quartile as due to the low level of deposit fees to total fees in the measurement period, an opportunity we intend to take advantage of. When looking at the contribution of United's gain on sale of loans to pre-tax ROA and ROE, our results reflect that 8 basis points are contributed to ROA and 68 basis points are contributed to ROE, while our top quartile peers report contributions of 12 basis points to ROA and 105 basis points to ROE. What this tells us is that United does not have an over-reliance on mortgage banking income since expenses supporting current period production are predominantly variable in nature.

I would like to spend some time discussing our NIM. During the quarter, we experienced a $650,000 increase in loan fees, predominantly prepayment penalties paid to the Company, which are included in the earning asset yield. As discussed in our first earnings call, prepayments have largely been realized from our sophisticated developers in our regional commercial real estate portfolio that are cashing out due to record market cap rates and the low interest rate environment. Further, we experienced approximately $325,000 in additional benefit to our margin due to purchase accounting accretion from loans. Both have the effect of maintaining the yields on our earning assets to be flat at 3.91%. With a large portion of our net loan growth occurring late in the second quarter, average earning assets were largely flat. However, this growth will be reflected in our average assets in the third quarter along with corresponding interest income.

While the success of our loan level hedge program during the second quarter will have an impact on the earning asset yield going forward, we have the production capacity to choose whether to originate floating or fixed-rate loans, depending on our interest rate risk strategy. Our customers are generally seeking a fixed-rate loan in this environment but the Company does not always want to add fixed-rate loan production on the balance sheet. The amount of variable rate loans we originate in a quarter is an asset liability management decision, and we enter the quarter with expectations as to the mix we would like to derive depending on the level and shape of the yield curve, our funding mix behavior, and the market's expectations of interest rates. We expect to have a bias towards fixed-rate deals, given that we have pulled the duration of our commercial portfolio in by nearly 12 months over the last four quarters, as well as our relatively neutral position of the balance sheet for rising interest rates.

On the funding side, as you may recall, last quarter we discussed our promotional pricing for money market accounts, and that pricing has ended on June 30. The expectation is that a subsequent improvement in the cost of interest bearing deposits will occur during the second half of the year. Because of this expectation, the increase in deposit costs recorded in the first half of the year cannot be considered linear.

I would like to provide you with some additional expectations. First, relating to the NIM, in the fourth quarter earnings call, I discussed an expectation for approximately 10 basis points in compression in the GAAP NIM per quarter through 2015 and that expectation is largely intact. As many of you are forecasting your models for 2016 and 2017, it's a little early for me to discuss our expectations on the core NIM, but I did want to update our third quarter 2014 earnings release disclosure on accretion expectations to assist you in that modeling.

For 2016, we expect to have a net benefit in line with what we previously disclosed. However, effects in 2017 and 2018 have been neutralized, meaning that we do not expect any significant impact to our margin from purchase accounting in years beyond 2016. Much of that benefit is being seen this year in 2015 due to higher prepayment speeds in the purchase portfolio than initially expected. Regarding our effective tax rate, for 2015 the full-year tax rate guidance remains intact at between 18% and 20%. At this time I am comfortable communicating a forecasted effective tax rate for 2016 between 25% and 28%, which is driven by the tax planning strategies I've discussed to you on prior calls. In order to assist with your earnings models, I've identified that the forecasted partnership expense for the second half of 2015 is going to be approximately $1.4 million, and for 2016 will be $2.6 million. You can ratably apply those expenses across quarters. This expense supports the lower tax rate.

Thank you for your time this morning, and the management team and I would be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator
Ladies and gentlemen, we will begin the question-and-answer session. To ask a question, you may press star (*) and then one (1). If you are using a speakerphone, we ask that you please pick up the handset before pressing the keys to ensure the best sound quality. To withdraw your question, you may press star (*) and two (2). Once again, it is star (*) and then one (1) to join the question queue. Our first question today will come from Mark Fitzgibbon from Sandler O'Neill. Please go ahead with your question.

Mark Fitzgibbon
Hey, guys. Good morning.

Eric Newell
Hey, Mark.

Mark Fitzgibbon
The first question I have, Eric, on the margin. So you're suggesting that the core margin still has a little bit more compression over the next two quarters remaining in this year?

Eric Newell
Yeah. Core margin, I would expect, is going to compress 5 basis points per quarter.

Mark Fitzgibbon
Okay, 5...

Eric Newell
And so that means I'm not taking into account the benefits that we would get from purchase accounting or any additional prepayment fee income.

Mark Fitzgibbon
Okay. And then in terms of provisioning, obviously you had very strong loan growth in the quarter and so it's understandable the provision was where it was. Will that likely back down a little bit in 3Q assuming more normal loan volumes?

Eric Newell
Yes. I would expect if you take the average loan balance that we would report in the third quarter, the annualized provision is going to be about 35, I think a range I've been giving is like 33 to 38, so split the difference, 35 basis points.

Mark Fitzgibbon
Okay. And then I guess now that you all have really achieved the financial goals that you set forth in the MOE, I wondered if you've raised the bar, if you've established sort of intermediate term financial goals going forward?

Bill Crawford
Hey, Mark, we'll be getting back to you on that, but the way to think about it is driving positive operating leverage next several quarters, growing loans, and we are very focused on ROE and return on tangible common equity.

Mark Fitzgibbon
Okay. And then in terms of mortgage banking, are you pretty; I know you had said you are fully staffed up in the commercial lending side. Are you pretty well done with staffing increases on the mortgage banking side as well?

Eric Newell
Yes.

Mark Fitzgibbon
Okay. And then lastly, I guess, with the strength in the loan level hedging income this quarter, I'm curious, was there a concerted marketing push on that new product or, I know it's not a brand new product for you, but just a bigger push in that area?

Bill Crawford
Eric, you can sort of talk through our choices there?

Eric Newell
Yeah. I mean we have the production capacity to be nimble there. We certainly want to be mindful of core margin. So if we were to have a bias towards fixed rate, that income, corresponding interest income, will come in through the NII line, or if we have focused on loan level hedging, putting variable rate paper on, obviously that's going to impact NII incrementally, but we'll see that income through the fee income line. I would say that right now we are kind of focused on a barbell strategy, where we want to be kind of nimble enough where we can respond to changed expectations in the market when they occur. So I would say that we are not really focused on just one or the other, but you did see a success rate that was higher than what we've normally seen on loan level hedging in the second quarter.

Mark Fitzgibbon
Okay. And then in terms of operating expenses, around $30 million you think is a good run rate for the third quarter?

Eric Newell
Yes sir.

Mark Fitzgibbon
Thank you.

Operator
Once again, if you would like to ask a question, please press star (*) then one (1). Star (*) and then two (2) will remove yourself from the question queue. Our next question comes from Travis Lan from KBW. Please go ahead with your question.

Travis Lan
Yeah, thanks. Good morning everyone.

Eric Newell
Hi, Travis.

Travis Lan
How are you doing?

Eric Newell
Good.

Travis Lan
You mentioned that your sophisticated borrowers, I think, are cashing out of properties because of historically low cap rates and high valuation just kind of led to prepayment bounce this quarter. How does that align with your own appetite for CRE growth given that kind of market background?

Eric Newell
Well I would say, who do you want, you want...?

Bill Crawford
Yeah, I'll take that. Yeah, I mean we do a lot of CRE. We have a lot of large investors and they are taking chips off the table, but we are replacing it with very good product and well underwritten products.

Travis Lan
Okay, all right. Has it changed at all, your kind of what your willingness, say on like the LTV side or has kind of this --in the Northeast we're hearing a lot more about frothy markets in Boston and New York CRE. Has that changed at all the way you kind of underwrite your CRE product or what you are willing to do there?

Bill Crawford
We are pretty consistent on that but Mark Kucia, our Chief Credit Officer is here, you want to talk about…

Mark Kucia
Yeah. I would say through this period we have maintained our discipline, so our underwriting remains conservative and the product we are putting on, the asset quality is very good.

Travis Lan
Gotcha. Okay. How do you guys gauge the result of the deposit promotion? How successful was that versus maybe what you expected?

Bill Crawford
Well, obviously we rose deposits, increase deposits very nicely,   higher cost there. I think in my comments you heard several things we're working on. We have these new branches; they are already in our run rate. We have several new products that are coming online, including an upgrade of our cash management system. So we're very focused on driving stronger, low-cost, higher-quality core deposit growth. But when we do need to run specials and such, we obviously have that capability, particularly in our new branches where we can do that without cannibalizing our existing branches from a deposit rate special perspective.

Eric Newell
And I will just add one more comment there. The special is heavily biased towards new money, and so the success rate for us will be our relationship managers cross-selling those customers, new customers that came into the bank and to stick to your products, that will drive DDA growth.

Travis Lan
Got it. That makes sense. So I mean if you kind of look at what the customer response was to the deposit promotion, and you're paying up for your promotional rates, does that tell you anything, maybe about the way that you think your customers are going to behave when rates rise? Or just kind of how that impacts your own thinking about deposit betas or anything else?

Bill Crawford
I think, Travis, when you talk, there are certain customers that are highly motivated by rate. When you run a special, you are going to get some of that. But that doesn't mean, I think, all customers necessarily are that rate sensitive. Eric, what would you add?

Eric Newell
Well, in our modeling we have been continually and continue going forward, been very aggressive in our betas in a rising rate environment, and that's one of the reasons why you're seeing that. Unlike many of our peers, we're reporting ourselves as moderately liability sensitive because of those assumptions we're making. I do think there will be a certain sleeve of customers that will demand a higher rate immediately when that rate does rise in the market.

And so that's why it will be critical for us to grow that core low cost DDA, which won't have that effect on our rising cost of funds for us.

Travis Lan
Got it. Okay, that makes sense. And then just last one, I don't know if you've published or not, but do you guys, have you published your deposit beta assumptions?

Eric Newell
We have not.

Travis Lan
Okay, all right. Thank you guys very much.

Operator
And our next question comes from Matthew Breese from Piper Jaffray. Please go ahead with your question.

Matthew Breese
Good morning everybody.

Bill Crawford
Hi, Matt.

Eric Newell
Hi, Matt.

Matthew Breese
I was hoping to get some color. I think you talked about it last quarter on the dynamics of the promotional money market deposit product and how that's going to behave in the second half of the year. I think there was somewhat of a snapback in the cost, is that accurate?

Eric Newell
Yes, sir. So the pricing is guaranteed through June 30, and then what we do is we work them back to our rack rates, so if the new customers come in and then we have them, when they do certain behaviors that are considered sticky, they might be able to get some more pricing that's beneficial to our rack rate, but not at the original rate that we brought them in at. But then by the end of the year, you're going to see a great bulk of that money priced back down to the rack rate.

Matthew Breese
Is it enough to move the overall cost of interest bearing deposits meaningfully downwards towards the end of the year? Could you size that up a little bit?

Eric Newell
Yes, it would, because I think if you look at the cost of funds on the press release in the back there's a line that's focused on money market, and now you'll see linked quarter that that's from the year-end quarter into the March quarter into the June quarter. That increase is almost entirely because of the money market special. So I can't tell you to go back to our December quarter and say that that's going to be the prevailing rate moving forward, but a lot of the increase that you've been seeing kind of campaign to-date, is because of the special.

Matthew Breese
Okay. So that 13 basis point increase, the majority of that, we should see come back down in the second half the year? That's accurate?

Eric Newell
All else being equal, yes. Now keep in mind, the environment we're in, or actually in the geography we're in, the structural liquidity ratios, the loan to deposit ratios are probably the least favorable in the country, and so a lot of our peers are starting to show significant loan growth. They are going to need to find some deposits as well, and so you're going to start seeing, and we have been seeing deposit pricing specials in the Connecticut and Massachusetts footprint that we serve.

Matthew Breese
Okay. And does that extend to I mean, a lot of the times we see promotional CD offerings, are you seeing promotional offerings going to the core account savings, checking, and to your point, money market? Is that accurate, too?

Eric Newell
Money market is the biggest special that we see just because you have that flexibility to price it in a promotional fashion for a finite period of time. Whereas with a CD, you buy it for whatever that term is. And so I think we've been starting to see some CD specials in certain parts of the curve, probably beyond 18 months, probably between 18 months and 24 months we are starting to see some specials, but I would say most of them are in money market and we're not seeing much in terms of DDA or savings in terms of pricing.

Matthew Breese
Got it. Okay. And then going back to the income from loan level hedging, can you give us a better sense of how we should be modeling that item? It tends to fluctuate quite a bit from a quarter-over-quarter basis, and it sounds like you have some control over that depending on how you want to manage the balance sheet, but from a modeling perspective can you give us an idea of what we should kind of include in our overall revenue targets?

Eric Newell
Well, I made the point that, yes, you are right in that we can control that just because the bias for our commercial customers is to have a fixed rate, and so we do have a selling effort to sometimes get that customer to do a loan level hedge. I guess in terms of modeling on the second half, given that we want to take a more of a barbell approach in adding fixed rate and variable, I don't think that you could take the second quarter and extrapolate it into the second half.

Bill Crawford
Now what that would mean would be, we would be putting more income on the net interest income line.

Eric Newell
Yeah. I mean, what it really comes down to is, the economics will still be in the P&L, but it will just come in via that NII line versus the fee income line.

Matthew Breese
Right, but that item is not going to go to zero, correct? It's going to be something less than...

Eric Newell
No. The reason that won't go to zero is over the last 3 to 4 quarters, we've really had some opportunities to bring in talent on the whole commercial banking side, talent that has experience in selling that type of product, and there are certain customers, when we go upstream, that want that loan level hedge and so therefore we have the ability to provide that tool to them for their interest rate risk management strategy.

Bill Crawford
Matt, if you believe that that's going to move rates up, the swap holds, you basically can monetize economics that you would've gotten on a fixed rate in our earlier period. If rates go up, you know that obviously a very nice trade, but everything you do has balance to it, and so we're always solving for what's the most optimal mix for us and allowing us to win the business with the customer, and so that's why it's a continuous dialogue as to where is the best place for us to recognize that income, whether we want to do that through the swap, whether we want to sell a mortgage loan, or whether we want to put it on the balance sheet, and we are constantly evaluating that and working with customers really on a deal-by-deal basis in the commercial space.

Eric Newell
I think one last point on that Matt is, I don't see a need for us to pull up a duration on the commercial portfolio in any further than where it is today, and that will allow us to put some more fixed rate in on the portfolio.

Matthew Breese
Right, which would ultimately result in less loan level hedging fees.

Bill Crawford
Yes. But also obviously improve net interest margin and net interest dollars, net interest income dollars.

Matthew Breese
Right. Okay and then just going back to the tax rate for 2016, just so I have the dynamics correct, we should expect $1.6 million of impact on the income statement from a non-interest income standpoint spread throughout the year and then an overall effective tax rate between 25% and 28%, is that accurate?

Eric Newell
No, that $1.6 million was in the second half of this year and then, oh no, $1.4 million in the second half of this year and $2.6 million full year 2016.

Matthew Breese
Got it. Okay, understood. Thank you very much.

Operator
And ladies and gentlemen, we've reached the end of today's question-and-answer session. At this time, I'd like to turn the conference call back over to Bill Crawford for any closing remarks.

CONCLUSION

Bill Crawford
Alright, well, thank you for your interest in our Company, and we look forward to seeing you all soon. Take care.

Operator
Ladies and gentlemen, that does conclude today's conference call. We do thank you for attending. You may now disconnect your telephone lines.