United Financial Bancorp, Inc.

Q1 2018 Earnings Call

April 18, 2018 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Marliese Shaw – *Executive Vice President, IR*

Bill Crawford – *Chief Executive Officer & President*

Eric Newell – *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the United Financial Bancorp, Inc. Q1 2018 Earnings Conference Call. All participants will be in a listen-only mode. If you do need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star then one on your telephone keypad. Please note, this event is being recorded.

I would now like to turn the conference over to Marliese Shaw, Executive Vice President, Investor Relations Officer. Please go ahead.

Marliese Shaw
Thank you, Chad. Good morning everyone. Welcome to our first 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 and President.

Bill Crawford
Thank you, Marliese and thanks to all of you for joining us on today's call.

Today I'll make few high level comments and then turn the call over to our CFO, Eric Newell. As we discussed, management is focused on responsibly achieving a 1.00% return on average assets, assuming a 10% effective tax rate, in the second half of 2019 on a run-rate basis.

In the first quarter of 2018 United Financial Bancorp, Inc. achieved earnings of $0.31 per diluted share, 89 basis points for return on average assets and 11.25% return on tangible common equity. That's with a 2.08% NIE to average assets ratio, and those results are driven primarily by fee income and expense control.

On a year-over-year basis, these earnings results produced 15% earnings per share growth, 10% growth in total deposits, 9% growth in non-interest bearing deposits, total loans and tangible book value plus dividends. The net interest margin has declined and Eric Newell our CFO, will cover this in detail.

As we were building our 2018 and 2019 earnings plan in late 2017, the company was coming off three consecutive quarters of double digit loan growth with a gradually improving net interest margin.

Since the Tax Reform Act was passed in late December, we've seen a flattening of the yield curve, credit spreads are compressing a bit and we've seen more deposit and loan pricing competition.

In the first quarter of 2018 the company experienced higher loan payoffs anticipated from customers selling commercial real estate and C&I credits improving upon their existing pricing grids.

Historically, the first quarter loan growth is seasonally slower, but we are seeing strong momentum in our loan and deposit pipelines. However, given the current environment we are pulling back on previously planned investment and expense growth.

We stated on our last earnings call that we would tie expense and investment growth in the company to revenue growth. If you annualize our first quarter 2018 expense growth, you can see we're following through on that statement. Our financial improvement targets remain the same. We're just planning on getting there somewhat differently and that's basically with somewhat lower loan growth, lower margin and lower expenses.

Overall, we think this is a more conservative path to our financial improvement targets. We are being disciplined around asset quality and margin, instead of chasing dilutive asset growth in this highly competitive environment.

We are pleased with the 6% annualized deposit growth achieved in the first quarter of 2018. We are seeing strong production in checking unit sales in our retail bank and commercial cash management teams have strong pipelines with larger commercial core deposit opportunities.

Our IT investment is helping us drive new commercial deposit wins and we recently negotiated significant cost savings on our core provider contract. Asset quality, capital and liquidity remains strong and stable.

I will now turn the call over to Eric Newell, our CFO.

Eric Newell
Thank you Bill and good morning. This morning I'll discuss the results of the quarter and why they differed from the company’s initial expectations, as well as add some color around what we're seeing for the remainder of the year. Importantly though, our goal of achieving high single digit earnings per share in 2018 and attaining a 1.00% ROA in the back half of 2019 remains unchanged.

The NIM declined to 2.90% from 2.98% in the linked quarter, or by 8 basis points. We estimate that 6 basis points of this compression is due to the tax equivalent yield impact, resulting from the lower statutory tax rate applied in the first quarter of 2018 in comparison to the linked period due to tax reform. Without that adjustment our pro forma NIM would have been 2 basis points lower than the linked period.

As you likely are aware, the reported NIM of 2.90% is lower than what the company's forecasts reflected for the full year in 2018. Several factors have contributed to this difference. First, we experienced a high level of prepayments and escalation of CPRs across our investment portfolio and loan products in the first quarter, which had the effect of realizing deferred costs during the quarter that normally would have been recognized over a longer period of time.

This contributed to about 5 basis points of NIM compression from my original expectation. We’re seeing our CLO portfolio called away from us due to meaningfully lower spreads in the AAA tranches in the market, a phenomenon that we're also seeing in our loan portfolios. Customers are able to reduce their rates at competitor institutions due to compressed spreads compared to several months ago. We frequently see competitors offering rates at a 150 to 160 basis points over the index rate. Given our funding mix and cost of funds, our risk adjusted return models show the aforementioned spread as dilutive to NIM, ROA and ROE.

Secondly, we attribute the remainder of the NIM miss to a cost of deposits that was higher than expected due to a shorter than expected deposit product repricing trend after FOMC rate increases as well as unfavorable mix variance compared to our initial expectation.

While one may deduce that some of the first quarter loan customer behavior may be idiosyncratic to the period, we continue to see customers taking advantage of lower spreads which contributes to higher prepayment speeds and recognition of deferred costs, resulting in our view of NIM stability at the level we show in the first quarter for 2018. We're also taking advantage of the swap markets on our wholesale funding portfolio to add some duration which will assist in adding asset sensitivity to the balance sheet in a rising interest rate environment.

In looking at profitability, we have five levers we can utilize, maximizing yields on earning assets in a way that is responsible through risk and return, strategically responding to our markets to minimize increases in the cost of funds, selling deposits effectively, fee income growth and finally expense management.

The first two levers are largely driven by what the market is giving us. Marginally, it is a difficult operating environment since spread drives 85% of our revenue, and the yield curve flattening that has occurred over the last year is causing the company to closely evaluate asset growth that we are willing to consider for origination since it is important to drive incremental asset growth that is supportive or accretive to our NIM and aspirational ROA and ROE goals.

We have found great success in our efforts to sell deposits more effectively over the last few years as demonstrated by the 10% deposit growth the company has achieved year-over-year for the past two consecutive years in a low growth deposit market, where United generally already has top market share.

The company opened its Hartford branch location this past Monday and announced a Greenwich, Connecticut location earlier in the quarter, both of which should support our deposit gathering efforts. We have another de novo branch in the pipeline that should support our efforts here as well.

Finally, expense management efforts have also been successful. In the last earnings call, I mentioned that if revenue did not come in as expected, expenses would be contained and the flat linked quarter non-interest expense results are reflective of that prior statement.

Taking all of this under consideration and management's responsibility to maximize profit in this challenging operating environment and in light of our continued expectation to achieve high single-digit EPS growth in 2018 and 2019 as well as achieve a 1.00% ROA in the back half of ’19, we are reducing our NIM forecast to be flat to first quarter results, decreasing our loan growth goals in response to market dynamics and reducing our non-interest expense forecast.

The results of these actions will keep our earnings picture for 2018 and 2019 intact. The slower loan growth allows the company to more efficiently fund its loan growth as well as allowing for us to be more selective in the assets we do originate for our books to find those opportunities that are accretive to NIM, ROA and ROE.

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

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question and answer session. To ask a question, you may press

star one on your telephone keypad. If you are using a speakerphone please pick up your handset before pressing the keys. To withdraw your question, please press star then two. At this time, we will pause momentarily to assemble our roster. The first question will come from Mark Fitzgibbon with Sandler O'Neill & Partners. Please go ahead.

Mark Fitzgibbon
Hey guys. Good morning. First, Eric, I wonder if you could help us think about what the net loss on LP Investments is likely to look like for the remainder of this year.

Eric Newell
Well, I don't specifically comment on that. I would say it's in the—I mean it's incorporated in the forecast for the fee income. But I would say that first quarter, as you saw last year on LP losses was a little muted, so I think you could use that concept this year as well.

Mark Fitzgibbon
Okay. And then secondly, do your net interest margin assumptions assume any rate hikes or changes in the yield curve?

Eric Newell
No changes in the interest rates or the yield curve are contemplated in our forecast.

Mark Fitzgibbon
So if the Fed were to hike say, a couple more times this year, would your margin assumption then be a little bit lower?

Eric Newell
Well, when we look at the positioning of our interest rate risk, I would say that we are neutral to minimally liability sensitive. I feel confident that our NIM would be fairly close to where we're currently forecasting with changes to a market rates due to some of the actions we're taking on the liability side to get some duration there.

Mark Fitzgibbon
Okay. And then on loan pipelines, I think Bill in your comments you mentioned that the pipelines were real strong. Can you share with us the size of those and maybe the mix, as well as the mortgage pipeline also Bill, if that's possible?

Bill Crawford
What I would say is we typically see this where first quarter our numbers are slower, in fact we budget around 15% of our total production to happen in Q1. We are seeing the normal strengthening we would expect, in our commercial pipelines. So we don't really put a number out there.

What I would say is, you've seen us grow loans at pretty good rates over the last several years and usually second quarter is a strong one for us and so is third quarter. And so we feel good about what we see there. Eric I'll let you talk about the mortgage business.

Eric Newell
Yeah, I mean mortgage, is certainly—we're seeing an improvement from the pipeline that we saw in the first quarter. Although I would note that as a market because we're in a rising interest rate environment, you are seeing lower production levels this year, I think it's the expectation, than last year. However, we're a purchase shop, so I think you are going to see more purchase as a percentage of total production than REFI.

Bill Crawford
And Mark, back to the commercial business, we're less worried about production. Probably what surprised us a little bit last quarter were just pay offs. We had customers selling commercial real estate and people moving down their pricing grid, so that was probably more of our issue than production.

Mark Fitzgibbon
Thank you.

Operator
The next question comes from Collyn Gilbert with KBW. Please go ahead.

Collyn Gilbert
Thanks. Good morning, gentlemen.

Bill Crawford
Good morning.

Collyn Gilbert
Eric, just to touch on the NIM first and just some of the interest rate commentary that you just said, so that you kind of see the balance sheet now neutral to minimally liability sensitive, but I think in your most recent IRR disclosures, with a 200 basis point increase in rates, I thought it showed like NII going up about 5%, which would suggest modest asset sensitivity, so just trying to sort of reconcile those disclosures with where you're seeing the balance sheet now going from here.

Eric Newell
I don't have that disclosure right in front of me, but if I recall correctly, I believe that is a shock, that 200 basis points is, you know, that would be an instantaneous shock whereas, when I think of interest rate risk positioning, I look at it from more of a ramp perspective.

Collyn Gilbert
Okay.

Eric Newell
Like what we think would generally happen, 25—I think the market expectation, we're going to have 25 basis point movements, maybe two or three more this year. So I looked at it from that perspective.

Collyn Gilbert
Okay. So I guess, then in—because I think that the—and I don't have it right in front of me, but in terms of the, there's a very short duration nature of your assets, right? I think, what was it, like 40 some odd percent reprices?

Eric Newell
Yes, about 40, I think we’re approximately 45% of our loans are tied to LIBOR and Prime.

Collyn Gilbert
Okay. So I'm just trying to structurally get the liability sensitivity here, just seems like you’d be more asset sensitive than what, how to balance sheet’s playing out. I'm just trying to understand that a little bit better.

Eric Newell

As a percentage of our total funding, you have our wholesale funding book, which is also extremely short. And we're, I would say the majority of that book reprices in under three months. So we are taking actions there to extend the duration on our wholesale funding book to get some asset sensitivity. The way that we are doing that is, we can go into the swap market and get better funding through swaps than just going straight to the FHLB, and we're also taking advantage of that very, very flat yield curve.

Collyn Gilbert
Okay, that's helpful. And just tying back to mortgage banking, so just understanding, you kind of, you've given the guidance and the color for fee income for the year, I mean, does that assume, I presume, that the mortgage banking kind of stays at these robust levels?

Eric Newell
Yes. I think what we're trying to do is defend our mortgage banking revenue contribution in a way that gets us closer to that 10-quarter average that we have on the investor deck. We have kind of fallen behind there in the last couple quarters, and that was largely due to just a lower level of producers. And so, we've been having some success in building or finding those producers, bringing them online and then you can also see that as a percentage of our loans sold year-over-year is almost double than it was the year prior.

So I think you're going see, I'm not going to say that you're going to see a doubling, but you know, I just think that we are trying to keep robust mortgage banking revenue and that certainly is contemplated in our fee income line.

Collyn Gilbert
Okay. That's helpful. And then—so great commentary on expenses, I mean, I know you guys had indicated last quarter that if you weren't going to see the revenue growth that you could pull back on expenses. I'm impressed with how quickly you've done that. I mean in a quarter's time, to change course here is pretty impressive and surprising also. So what, can you just talk a little bit more about kind of what's going into the reduction in your expense outlook?

Eric Newell
Yes, certainly. When we built the plan, our two year plan in the fourth quarter of last year, we had contemplated a lot more revenue growth and that was supported by people that were producing that revenue, and since that revenue became more challenging to come by that was accretive to NIM, ROA and ROE, we decided to slow the anticipated build of people and also the associated compensation with those people to reward their production.

We also took a look at some of the contemplated projects in the shared service areas and made some decisions on what can we do to defer some of these projects that don't put at risk our goal of the EPS, high single-digit EPS growth in '18 and '19 as well as our 1.00% ROA goal. So, a lot of that expense build that we talked about in the last earnings call was all anticipated and it wasn't bought and that's why I was very confident in telling you on the last call that, if the revenue didn't come the way we expected it that the expenses wouldn't come in, and you saw that actually happen this quarter.

Collyn Gilbert
Okay, that's helpful. And then just one final question, I think you're now guiding to an 8% tax rate in 2019 and I think you guys had said maybe a 10% rate before, so just curious as to why the drop. Are you anticipating more investments coming on?

Eric Newell

I think it's that we reported an 8% ETR and our forecast is 10%. To that, I would say that, because we had the tax reform that came in very late last year, and annualized ETR is an estimate and there's a lot of inputs that go into that, and our team spent 30 days trying to get to hone our estimates as much as we can. Admittedly this year, I think you're just going to see some volatility on our ETR. I know that's sometimes frustrating for your models, but there's just—we don't actually have to file a tax return until September and that's where it just kind of becomes final, but right now based on our estimates, our best guestimate is a 10% ETR for 2018.

Collyn Gilbert
Okay. All right. I will leave it there. Thanks, guys.

Bill Crawford
Thanks, Collyn.

Operator
Again, if you have a question, please press star then one. The next question comes from Matthew Breese with Piper Jaffray. Please go ahead.

Matthew Breese
Good morning, everybody. Just to follow up on Collyn's expense question, I just wanted to get a sense for the breakdown where those reductions are going to happen. How much do you think will be tied to salaries and compensation revenues and how much from the contemplated projects?

Eric Newell
Well, it's not that it's going to happen. It won't happen. So keep in mind that, that number I was giving you was expected spend. So it's not like I've already bought it or we've already bought it. We're just not going to buy it or we're going to defer it. I would say that the great majority of it is people and compensation.

Matthew Breese
And is that from variable rate compensation or just slowing down pace of new hires?

Eric Newell
Both. Correct.

Matthew Breese
Okay. Got it. Okay. And then hoping you guys could just go back to your commentary around loan competition and what you're seeing for spread compression and just give us a better sense for the extent of which we've seen those spreads comprise.

So I know you said, I think it was 150 to 160 basis points. What was that six months ago? And if you could touch on some other asset classes like commercial real estate and to what extent spreads have compressed there as well? That would be helpful.

Eric Newell
I think the commercial real estate, is certainly where you see the most compression. And that's, when I think about the 150, 160 over, that's the asset class that we're thinking of in terms of investor CRE. I would say that six months ago, we could probably more easily do 200 over. Maybe 190 to 200 over or maybe even 180 to 200 over. So you're seeing about 20 or 30 basis points compression.

But interestingly enough, I think we saw kind of a step down in spreads right in January, like right in the

New Year where we saw it in our CLO portfolio. Insurance companies are accepting AAA tranches at sub 100 spreads. And so that causes the CLO managers, to basically called the whole deal and reprice it. So we're not participating in that just because it's not accretive to our return metrics and I think you're seeing a similar phenomenon happened within the CRE portfolio, whereas a sponsor could actually reduce their interest rate, even though we're in a higher interest rate environment because spreads have come in so much.

And so, we frequently are presented with an opportunity to keep an asset, but we have to take a 150, 160 over and it really tears up our NIM, ROA and ROE, and so sometimes we make a choice to let that asset go off our books and go elsewhere.

Bill Crawford
Matt, one thing I'll share with you is we have something called a look-to-book ratio, and that's really how many deals are we looking at and how many are we booking and essentially we've seen that ratio extend out, and so Dave Paulson and his team, Dave runs our commercial bank, they just have to look at a lot more deals to find the ones that we're going to put on the balance sheet that where we like the credit and it's supportive of our NIM and ROA goals. And so, essentially our team's just having to work harder to get to those wins that make sense for us and we're passing on more deals as a result.

Matthew Breese
Got it. Okay. And are you seeing the increased competition from insurance companies or banks or both?

Bill Crawford
It's really all over the place.

Matthew Breese
And does that mean to get more looks at deals you have to extend geography or the size of loans that you would look at?

Bill Crawford
It's really just, we continue to work harder on our networks, and just start to source deals. We're not planning on significantly expanding headcounts. It's probably just working a little smarter and a little harder as we go forward in time.

I think on the loan side, our team does a very good job of coming through there. The other piece to it is with a lower loan growth, we can fund that loan growth more efficiently. If we're going to drive loan growth into the low double digits, we also have to have funding that make sense for that.

And so, when you think about what's happening with funding in the banking world, what's happening with the two-ten spread, we could grow high double or low double digits, but it just wouldn't be attractive to us. So we think our current plan is a better plan, given the environment we're seeing currently.

Matthew Breese
Got it. Okay. That leads to my last question, which is does the slowdown in loan growth prospects allow you to show a little bit less deposit beta? For instance, I noticed that the online money market rate dipped this week and I was just curious if the guidance and action like that are tied to each other?

Eric Newell
Absolutely Matt. If we have - because of the growth that we have in our core markets in terms of deposit growth, I mean, if you look at the FDIC summary of deposits, I think over the last five years, the

markets that we sit in generally grow 1% to 2%. And in the markets in the towns that we're in, we generally have top market share. So, in order for us to fund a much higher loan growth, we need to either pay up for it or we need to go find it elsewhere, and you know, obviously if we're finding it elsewhere or paying up for it, you're going to have higher betas. So that certainly helps us reduce the reliance that we could have on higher beta deposit sources.

Bill Crawford
And Matt, like I said in my comments, our commercial team is, with what we've been able to do with the cash management in our IT area, is looking at larger commercial deposit opportunities, deposit wins now, so that's one of the benefits of our IT investment is being able to chase bigger, more complex commercial deposits, and so I'm looking forward to our results there.

Matthew Breese
Okay. That's all I had. Thank you.

Operator
Next question is a follow-up from Collyn Gilbert with KBW. Please go ahead.

Collyn Gilbert
Hi guys, sorry. I stepped off for one second. And I don't know if, Matt, if you guys covered this with Matt and I apologize if you did. But, just the expansion, did I hear you say correctly that you're, you're moving, you're going to open a branch in Greenwich. Is that right?

Eric Newell
Correct. Yes, we announced that in first quarter.

Collyn Gilbert
If you could kind of talk about or just remind us of what the initiative is there and why Greenwich?

Bill Crawford
We have a commercial team, we’ve have in Fairfield County for a while. They’ve been doing very well. We like the results we're seeing there. Obviously, it's a terrific market, and so our customers essentially want us to start to have physical presence there. So we're in Greenwich and we’re looking at one other location right now in Fairfield County, but really it's just an extension of what we've been doing on the commercial side there for the last couple years. It's not, we're not planning a significant retail presence there, those branches are designed to support commercial, private banking and business banking.

Collyn Gilbert
Okay. And you’re expecting that to come online when?

Eric Newell
Fourth quarter.

Collyn Gilbert
And the second location, when do you think that'll come online?

Eric Newell
For expense planning purposes which is included in our forecast, it's also in the fourth quarter.

Collyn Gilbert

Okay. That was it. Thanks, guys.

CONCLUSION

Operator
Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Bill Crawford for any closing remarks.

Bill Crawford
Okay. Well thank you for your continued interest in our company and we'll look forward to talking to you next quarter. Take care.

Operator
The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.