United Financial Bancorp, Inc.

Second Quarter 2018 Earnings Call

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

CORPORATE PARTICIPANTS

William Crawford, *Chief Executive Officer and President*

Eric Newell, *Chief Financial Officer*

Marilese Shaw, *Executive Vice President of Investor Relations*

PRESENTATION

Operator
Good morning and welcome to the United Financial Bancorp, Inc. 2Q 2018 Earnings Call. All participants will be in listen-only mode. Should you 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 1 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

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

Marilese Shaw
Thank you, Debbie. 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 our 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.

William Crawford
Thank you, Marilese, and thank you to all of you for joining us on today's call. Today I'll make a few high level comments and then turn the call over to our CFO, Eric Newell, who will take you through the details of the quarter.

I was pleased with the linked quarter loan, deposit, and checking account growth. Additionally, United Financial Bancorp, Inc. saw its net interest margin expand during the second quarter, and asset quality, liquidity, and capital remain strong and stable. Furthermore, we're seeing robust commercial loan pipelines heading into the third quarter of 2018, which is typically our strongest quarter for loan growth, and tangible book value per share increased to $11.40 after paying out 39 percent of our earnings via a cash dividend to our shareholders.

I want to take the opportunity to thank our United Bank employees for a steadfast focus on serving our customers and communities. I'll now turn the call over to Eric Newell, our CFO.

Eric Newell
Thanks, Bill, and good morning. The Company's performance during the second quarter of 2018 resulted in 31 cents per diluted share of earnings, with the main drivers of this consensus beat provided by a stronger NIM driving linked quarter growth in net interest income, and lower-than-anticipated provision and tax expense, which was somewhat offset by lower-than-expected fee income and higher expenses.

The Company had some one-time items in its expenses in the second quarter. We had more aggressive onboarding costs for mortgage loan officers recruitment that we did not anticipate going into the quarter. We had some true-ups to incentive plans due to stronger loan growth and improved loan management performance in the second quarter than what we realized in the first quarter, and we started to recognize an expense associated with annual carryover of paid time off due to the materiality of that expense as our workforce grows. These items each contributed considerably to the consensus miss on non-interest expenses and my expectations going into the second quarter.

Given the challenging revenue growth environment, our management of expenses has been in the forefront of the Company's attention. Balancing regulatory requirements and investment in areas of the Company that can drive revenue growth in the face of a flat yield curve is challenging at best, and we continue to scrutinize expenses for savings throughout — through seeking ways to better utilize our retail footprint, to drive towards higher vacancy rates in our shared service departments, and taking a more aggressive posture towards negotiation of third-party vendor contract renewals and to employ a higher level of scrutiny over our discretionary expenses, including raising the internal rate of return required for projects that may show elongated periods until breakeven.

The NIM expanded by 7 basis points in the second quarter of 2018 from the linked period. This is primarily attributed — attributable to the intense focus on booking earning assets that support or are accretive to the Company's existing earning asset yields.

We have continued to experience a high level of prepayments in our commercial books due to spreads narrowing, and there are times when we deem it more appropriate to allow the asset to move off of our books, because it is not supportive of our ROA and ROE goals.

Within our commercial portfolio, we're looking at twice as many deals this year over last year to book the same amount of production. Some good news, though, is that our pipeline is the largest it's been this year and, in fact, from third quarter 2016, and we expect that in the second half of 2018, we will grow earning assets that support our 2018 growth forecasts.

The third quarter of the calendar year is generally a seasonally favorable period for commercial bookings. In terms of pricing, we frequently see spreads of 140 to 160 basis points over the index, which is pricing that we would typically not book on our balance sheet without a considerable deposit relationship which would result in an accretive ROE. We are booking spreads of about 180 to 220 basis points over the index at this time.

Deposit costs are continuing to see pressure and, as you would expect in New England, the low growth markets where deposits in this geography are growing around 1 to 2 percent annually. We frequently look at the delta between our pricing, along with our competitors, to wholesale market pricing such as the FHLB, and over the last several quarters, we've seen top-of-market pricing get close to alternative wholesale market pricing, indicating an increased level of competitiveness in the market. There are parts of the curve where top-of-market pricing in a comparable duration is within 50 basis points of FHLB funding. Coming into this period, we are generally observing 100 to 150 basis points below comparable wholesale funding for top-of-market pricing.

As I stated earlier, I attribute our 7 basis points of NIM expansion to the slower and more thoughtful growth on the earning asset side, and I would additionally attribute it to the Company's balance sheet positioning, whereby net interest income is largely neutral to interest rate changes. For the second half of 2018 and into 2019, I believe we will have a flat NIM, without any significant change from where we are now, but we may have a quarter here and there where there is some fluctuations due to timing of Fed interest rate moves. I remind you, our forecast slide does not consider future Fed rate moves.

Fee income did come in lighter than expected and declined from the first quarter, primarily attributed to mortgage banking revenue. Mortgage servicing rates valuation declined by $1.4 million pre-tax between the two periods. Despite a 12 basis point increase in the ten-year Treasury yield, which is a proxy to MSR valuation, our valuation agents have seen industry costs increase for servicing, which is an important input into our MSR valuation. While we do hedge a portion of our mortgaged servicing rights valuation, this hedge cannot protect us from valuation input changes such as servicing costs.

I would like to comment regarding our effective tax rate for the quarter. You'll note that our rate is much lower than anticipated. As we all know, tax modeling is based on annual assumptions, and when those assumptions change, there is an adjustment that must be made to catch up to the last actual period as if the model had the adjusted assumptions the entire year, and this adds some volatility to our forecast.

Three areas that drove our effective tax rate down was lower-than-anticipated pre-tax income for the full year, due to lower loan growth than we had initially forecasted; a higher level of tax credits than what we had originally anticipated; and, finally, a higher level of option exercises, which under the new accounting guidance is treated as a discrete item, which can impact our quarterly tax rate.

On our forecast slide, you'll note that for the remainder of 2018 and 2019, we're not reflecting the Webster branch acquisition and assumed deposits. In 2019, we estimate there is no incremental impact due to the acquisition of the branches and assumed deposits, and this is due to the anticipated deploying of assumed deposits and to higher cost borrowings initially. We believe that as we deploy assumed deposits into earning assets, incrementally above the current loan growth forecast, that will more than cover the incremental expenses of the net three branches we will add to the franchise and associated staff, as well as incrementally improve net interest income. There will be some lease extinguishment expenses in the fourth quarter of 2018 once the deal is closed, which will be one-time in nature, and we're still working through the accounting of that expense, so I have nothing to share with you today.

Thank you for your time this morning. The management team and I will answer your questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. At this time, we will pause momentarily to assemble our roster.

The first question comes from Mark Fitzgibbon of Sandler O'Neill and Partners. Please go ahead.

Mark Fitzgibbon
Hey, guys, good morning.

William Crawford
Hey, Mark.

Mark Fitzgibbon
It looked like you didn't change your fee income guidance, even though mortgage was down a bunch this quarter. Are you assuming a big rebound in mortgage later in the year, or is there going to be an uptick in some other fee income line?

Eric Newell
Typically, you normally ask me about limited partnership expense, and so I actually was looking at that. I think that…

Mark Fitzgibbon
That was actually my next question.

Eric Newell
So if you looked at our year-to-date under the partnership expense, I would estimate about 75 percent of what we expect to recognize for the year has been already recognized in the first half, so you have that benefit for the forecasting in '18. You know, we have been working on onboarding some loan officers that — you know, we had some turnover in the New England market, and so we do expect that as those loan officers come on, that we probably will be showing more gain on sales in the mortgage line, so I wouldn't characterize it as a large pick-up. Certainly, the MSR valuation was a headwind for us this quarter. We generally — on a — annually, we reassess our deposit fee structure, and every summer we come out with generally a, you know, a 2 to 3 to 4 percent increase in fees. So that's an expectation that we have for the back half of '18. And also, we have some — our Wealth Management Group generally does seasonally well in the third quarter, which also would support that unchanged fee, the income forecast for the year.

Mark Fitzgibbon
Okay. And then it looked like there was a pretty big uptick in service charges and fees this quarter. Anything unusual in there?

Eric Newell
I wouldn't characterize it as unusual. I think that there was a lot of — one thing that does pop into my mind immediately is Wealth Management. There was a lot of volatility in the first quarter of the year, market volatility, which I think really dampened their performance, and they were able to rebound in a pretty strong fashion in the second quarter.

Mark Fitzgibbon
Okay, and then, lastly, it looked like C&I business — or business loan yields were up about 45 basis points from the linked quarter. And I know, obviously, you get the benefit of the Fed hikes, but was there any prepayment penalties or loan recoveries or anything in there that moved that number up?

Eric Newell
No.

Mark Fitzgibbon
Okay. Thank you.

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

Collyn Gilbert
Thanks, good morning, guys.

William Crawford
Hi.

Collyn Gilbert
Just a follow-up on the loan discussion. So, you know, loan growth obviously is good, and, Eric, you alluded to a strong pipeline going into the third quarter. Can you just talk about sort of where you're seeing the growth and kind of what's driving that and just kind of your — yeah, what sort of the composition is of the pipeline?

Eric Newell
I think if you look at the growth that we've shown year to date in that category, I know investor CRE is one area that we've been growing more aggressively this year than we had in previous years. I think that's probably an indication of what we would be doing in the back half of the year.

Collyn Gilbert
Okay**.**

Eric Newell
But in terms of — I don't think you're going to see a lot of significant growth in consumer relative to the growth that you would see on the commercial side. You know, the residential portfolio did grow a little bit in the first half of the year. We generally like to kind of keep that portfolio as a percentage of total where we've had it, so there could be some timing there, where we might have it in the portfolio, but then end up selling it, but I think we're — obviously, the C&I is certainly an area that we want to — or will continue to grow, and, you know, there's generally a longer selling process when trying to convince those potential COIs to come over to United, and I think we're going to continue that focus on that, but certainly you've seen that investor CRE has been more of a growth area for us this year.

Collyn Gilbert
Okay. Okay. And have you seen pricing within that segment improve, you know, or relative to where you've seen rates go, but just curious, competitively, what pricing was — in that segment is doing?

Eric Newell
Yeah, you know, back to my prepared commentary, no, we haven't. I think spreads have come in dramatically over the first half of the year, and so there are times where we're competing against others that are willing to offer down to 140 basis points over the index, and if that asset is sitting on our balance sheet, at something that's obviously higher in they're repricing, we oftentimes will let that asset go away from us, or we're seeing a lot of prepayments occur, because they're able to get a lower rate than where they're currently at, not because of the interest rates, it's just because the spreads are have come in a lot. So that's one of the reasons why we're looking at a lot more deals. A lot more flow is coming into our pipeline because we want to ensure that we're booking assets that are supportive or accretive so our NIM and our ROE goals.

Collyn Gilbert
Okay. Okay, that's helpful. And then just tying also to your comments on the funding side and the competitive pressures that you guys are seeing there on the deposit side, are you able to extend duration at all? Like if you are going to maybe start to look at the FHLB as an alternative, can you get a little bit more duration on some of those funding vehicles, or how are you thinking about duration on the funding side?

Eric Newell
Yeah, we — I know I didn't talk about it in my prepared commentary, but on the FHLB portfolio, if you looked at the swap curves in the first half of the year, there was some dislocation between the FHLB and the swap curve, so we were actually able to take — I think it was over $100 million of notional and use — and really put some duration on that was much cheaper in the swap market than it would be in the FHLB market. So incrementally — and we definitely seek ways to add duration to our funding portfolio, so that's one example of what we did in the first half of the year. I believe that was in the second quarter.

And also on the deposit side, you know, we, as a management team, we spend a lot of time looking at what our competitors are doing and what's working in terms of some special pricing, and it seems where there's kind of a sweet spot, at least for now, in our markets. Consumers are willing to go out to about 19, 20 months, and then it kind of erodes, even if you have a pretty high rate out there. You know, if you're top of market at 20 months, the consumer doesn't generally seem to bite, so we are — you know, again, this isn't — it's incrementally, but we are playing in that 15-to-18 month area to try to ever so slowly add some duration to our CD portfolio.

Collyn Gilbert
Okay. That's very helpful. And then just one last question. In the guidance tables that you guys provided in this slide deck, I just was curious. It looks like you've perhaps removed your second half 2019 ROA target — or there's an N/A there — where you had had a 1.00% previously? What's causing that removal?

William Crawford
Hey, Collyn, this is Bill. We remain committed to achieving that. That's just whatever — we didn't have it down, but we remain committed to our 1.00% ROA back half of '19 at the 10 percent effective tax rate.

Collyn Gilbert
Okay. Got it. Okay, that's all I had. Thank you.

William Crawford
Thanks.

Operator
As a reminder, if you do have a question, please press star, then 1. The next question comes from Brody Preston with Piper Jaffray. Please go ahead.

Brody Preston
Good morning, guys, how are you?

William Crawford
Good.

Brody Preston
Eric, just to clarify, so there was no prepay for anything like that in the overall NIM number?

Eric Newell
No. I mean, there — very de minimis. It wasn't something that would impact our NIM.

Brody Preston
Okay. Okay, great. You know, with the loan growth guidance, I guess you touched on investor CRE sort of maybe driving the back half of the year, but I just wanted to get a sense for where you're seeing sort of the best opportunities from a geographic standpoint and, I guess, where you're seeing the most competition.

Eric Newell
I would say in any of the geographies that we play in, we're definitely seeing competition, so obviously our legacy Massachusetts and Connecticut, we're very focused on that, and it's well vetted and known that we participate in our regional commercial real estate portfolio. We'll do deals in Upstate New York, Pennsylvania, down into the Mid Atlantic. We don't have a significant New York City exposure portfolio, and we're not really focused on any specific — you know, it's not like we're doing multifamily in New York City. We don't have a material exposure to that, so I think anywhere that we're really playing we're seeing, you know, competition.

Brody Preston
All right.

Eric Newell
Everyone's going after the same, you know, high quality assets that we're going after.

Brody Preston
All right. So I guess in terms of pricing, could you give us a sense of what's driving, I guess, maybe that spread compression that you noted earlier, specifically within the investor CRE market?

Eric Newell
I think if you look at collateralized loan obligations, CLOs, if you — you know, because there's a lot of visibility into that market because it trades. You know, the AAA tranches there this year, the spreads that were being done were sub-100 basis points for the first time in probably ever. A lot of that's being driven by insurance companies, and I think we're seeing very similar behavior in the whole loan market as well as the commercial real estate market, whereas, you know, insurance companies are willing to — because they have, obviously, a very different duration or liability duration profile than a bank does, they're willing to accept lower spreads for high quality assets. And also, you have some larger bank players that have a deposit profile, that is, the cost of those deposits are much lower than what we could — are currently experiencing, so they're willing to reduce their spreads down to what we're seeing, sometimes down to 140 basis points.

Brody Preston
Okay, great. That's good color. And then, I guess, switching gears a little bit, on the securities portfolio, I just wanted to get a sense of the strategy there, should we be modeling it up, down, flat? Any changes?

Eric Newell
I would say that on a notional basis, it's flat, and so as the balance sheet's growing, we're seeing that that percent — the percentage of the investment portfolio, the total assets is declining.

Brody Preston
Okay.

Eric Newell
Actually, in fact, I would probably say even, you know, if you look at the year-to-date experience, I think you may have seen, it's actually the notional has shrunk. Probably just keep that trend growing.

Brody Preston
Okay. I just want to touch base on Connecticut, the real estate market there and your thoughts on the impacts from SALT so far.

Eric Newell
Yeah, I think it's a little early yet. You know, I don't know if we've really seen anything materially changed in valuation in Connecticut due to the tax reform. I know that some papers have said that Connecticut might see a 1 to 2 percent decline in valuations over ten years, but since we're only in year one, I've not even really — we haven't really seen anything.

Brody Preston
Okay. And I guess on CECL, I just wanted to know if you guys have any updated thoughts there, if you could share anything?

Eric Newell
We have been working on CECL for the last two years, and there's a team of us that are working — or there's a committee of us that meets frequently, and we actually have a couple folks that are working on it full-time, and we expect that we'll probably be offering up some type of disclosure early in 2019.

Brody Preston
Okay. And then on the — you know, you talked about maybe commercial loans sort of carrying the day for the rest of the year. And I know it's such a small portion of your book, but I just want to get a sense for, you know, consumer installment loans, it's the sixth straight quarter that you've seen pretty strong double digit annualized growth, and so I wanted to get a sense for what's driving that.

Eric Newell
Well, I mean, we've been investing in our consumer origination team, you know, you're probably seeing better execution in cross-selling efforts, where we're either trying to — we're talking to customers that have a mortgage but don't have a home equity with us. We also are doing better execution in the utilization, so while utilization in the portfolio, I don't know if it's really gone up tremendously, maybe a little bit. You know, we weren't really ever talking to our home equity customers that we did have, to say, "Hey, why don't you use your home equity?" that we're starting to — you know, market to those customers a little bit more. And we also from time to time augment that portfolio with some other home equity loans from other geographies just to get some exposure outside of Massachusetts and Connecticut.

Brody Preston
All right. Great. Thank you very much, guys.

Eric Newell
Thank you.

CONCLUSION

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

William Crawford
Okay. Well, thank you for your interest in our Company, and we're always available to take questions, so thanks again and have a great day.

Operator
This concludes the conference for today. Thank you for attending the presentation. You may now disconnect.