United Financial Bancorp, Inc.

Q3 2018 Earnings Call

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CORPORATE PARTICIPANTS

Elizabeth (Betsy) Wynnick – *Executive Vice President*

William Crawford – *Chief Executive Officer & President*

Eric Newell – *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the United Financial Bancorp, Incorporated third quarter 2018 Earnings Conference 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 one on your touchtone phone. To withdraw your question, please press star, then two. Please note this event is being recorded.

I would now like to turn the conference over to Betsy Wynnick, Executive Vice President. Please go ahead.

Betsy Wynnick
Thank you Gary. Good morning, everyone. Welcome to our third 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, Betsy and thanks to all of you for joining us on today's call. In the third quarter of 2018, we generated 91 basis point return-on-assets and 11.30 return on tangible common equity. We continue to grow revenue, core deposits and tangible book value.

In terms of risk management, credit's strong and stable, and we're positioned to handle rising rates with a flat yield curve. Liquidity remains strong. Loan growth is slower than we would like but now is the time to maintain credit and duration discipline. Our banking teams are focused on initiating and growing relationships which add value.

We're seeing growth opportunities in some of our core markets due to some market dislocation. Last week, and not in our Q3 2018 numbers, we added about $110 million in core retail deposits on three net new branches we acquired from Webster Bank. We also have new branches coming online a little later in the year in Greenwich and Fairfield, Connecticut. We're seeing very nice deposit growth in our Hartford office with a relocation of our corporate headquarters last year.

Management will continue to focus on growing revenue responsibly while improving expense control and operating efficiency, continuing to grow net new checking relationship lending, core deposits and tangible book value. All of this will create value overtime. We're also working to balance growing earning assets, growing net interest income and preserving margins in this difficult operating environment.

I'll now turn the call over to our CFO, Eric Newell, for some more details on the quarter.

Eric Newell
Thanks, Bill and good morning. Yesterday we announced third quarter earnings at $0.32 per diluted share, which is a penny better than our linked quarter of $0.31 per diluted share and two pennies better than our third quarter last year.

Compared to the linked quarter, net interest income before and after provision expense moderately improved due to average asset growth despite net interest margin compression. Fee income improved due to lower loss on partnerships, and an increase in mortgage banking and our non-interest expense increased moderately due in part to salaries and employee benefits increasing over the linked quarter.

Our net interest margin declined 5 basis points during the quarter, with our cost of interest-bearing liabilities increasing 17 basis points and our cost of interest-bearing deposits increasing 19 basis points in the quarter.

Our deposit pricing approach has largely been a defensive strategy to date this year, responding to competitive pricing in our markets through proactive and reactive approaches. We've tested some offensive strategies during the third quarter in our time deposits with maturities that customer behavior has tended to accept, and the competition has generally responded in kind.

We're pleased to have successfully integrated the six branches we purchased from Webster Bank over Columbus Day weekend, as this adds to our franchise value as building core deposit funding with incrementally lower betas.

Interest earning asset yields increased 9 basis points during the quarter with most earning asset segments contributing to that increase. Contributors to our improved fee income from the second quarter are higher fees from service charges and fees due to our annual fee increase that went into place on August 1st, higher mortgage banking revenue due largely to a higher mortgage servicing rights valuation, and a lower loss on limited partnerships.

Contributors to our higher non-interest expense from the second quarter, are higher health insurance expenses as more of our plan participants meet their deductibles that costs shifts to the company in the back half of the year, some increased temporary help that was seasonal in nature and some production based true ups for commissions and incentives.

Our actual salaries line declined in the third quarter from the second quarter, and there were no other meaningful contributors to the linked quarter change. As we normally do, we provide our forecast for our fourth quarter. You'll note that we've taken 2019 off the slide as we're in the middle of the budgeting process for that period.

For the fourth quarter I'd look to results in the third quarter as a guide. You will note that our loan growth forecast is lower than we've talked about earlier in the year. We've been quite principled about our approach to the market pricing that we've been seeing, and that has consequently caused a slower level of growth.

Loan pricing is generally well below our hurdle rates for our aspirational ROA and ROEs. However, we have to defend our absolute net interest income dollars, so we've recently taken a more defensive approach to our pricing which will better position us for defending against loss of absolute net interest income dollars.

I wouldn't interpret this as a signal that our NIM will decline notably in the future; however, it's an adjustment to book production that maintains our margin versus improving it. I know our Street coverage will be looking at our 2019 estimates and in the interim until we discuss it more fully on the next earnings call, I would direct them to our second half 2018 as an indication of what to expect in 2019 as it pertains to NIM and loan growth.

And now we'll take your questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question and answer session. To ask a question you may press star, then one 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 two. At this time we will pause momentarily to assemble our roster.

Our first question comes from Collyn Gilbert with KBW. Please go ahead.

Collyn Gilbert
Thanks, good morning guys. Maybe if we could start with just the NIM discussion Eric, and I understand the comments obviously on the competitiveness on the loan side and the asset side, but switching to the funding side, because it seemed like that's where a lot of the pressure came on the NIM this quarter. A couple of things, one is, can you just talk about what you're seeing there, it looks like you also may be replaced a slug of borrowings this quarter with deposits, kind of where you're seeing the repricing dynamic happening within each of those funding buckets. Secondly then to just talk about what sort of support in your comment that you're anticipating the betas to be lower on the Webster deposits that you acquired versus what you are seeing within the organic organization, and maybe we'll stop there and I'll follow up.

Eric Newell
Sure. I'll take the last one first. You know some of the branches that we acquired are in less competitive areas in Connecticut and we've modeled and looked at that and we just feel that we are not going to have to necessarily respond as aggressively or quickly to our pricing strategy down there. And so that's kind of the basis of the sign of the lower betas, as well as the fact that the composition of those deposits are a little more transaction oriented than what you would see kind of at the top of the house at United, so incrementally there's just more transaction related to deposits in that branch acquisition.

In terms of the pricing on the funding side, I think we certainly have—obviously we're showing lower loan growth than what we normally have been used to in the third quarter. Third quarter generally is a season where we see our municipal deposits come back to us in the third quarter, and we did see again so that's why you are seeing deposits increase and the wholesale borrowings decline on a linked basis. But I would note that our municipal deposits have much higher betas than our other sleeves so therefore if you look at the composition of the deposits and how municipal contributed in the quarter, you're seeing a higher cost there and that's one of the reasons why you saw an increase in the cost of funds linked period.

Collyn Gilbert
Got it. Okay, and then just you said in terms of your outlook for NIM, strategically the objective is to try to keep the NIM stable is that right? So are we to assume then that this 2.92% was kind of the new stable run rate that you're going to hope to preserve?

Eric Newell
Yes, when I look at our forecast and all the modeling we do for interest rate risk, and the balance sheet positioning that we have, everything really indicates that we're fairly neutral to interest rates. So as the rates do move up, there is some timing impact, so last quarter we obviously were 5 basis points higher

and I said we'd be stable. And then, I think I've been kind of using that mantra for several years now and we've kind of bounced back and forth so I don't want to necessarily call on that I think that our NIM will go up next quarter, but I think you know there is some phenomena that were occurring in the third quarter, particularly on the wholesale funding side where we noticed the FHLB curve priced in early in the quarter, the rate hike in September as well as the December rate hike, because of the market expectation that the Fed was going to move those two rates up, so we start paying for that in our FHLB borrowings at the beginning of the third quarter.

So that obviously puts some pressure on our funding cost, but we don't really necessarily enjoy that on the asset side. So I think that we'll have more, we'll get the benefit of the September rate hike on the asset side in the fourth quarter, so my expectation is when everything settles out I think that will be fairly stable. We might see basis points up and down from quarter to quarter but the way our balance sheet is structured, it's fairly neutral to our interest rates.

Bill Crawford
Yes, Collyn, I think the last four quarters sort of proved that out. If you look at us over the last four quarters, we're between 3.00% and 2.90% and we bounced around in there so, fairly stable considering all the short term increases in funding.

Collyn Gilbert
Okay, that's helpful. And then just on the loan side, so obviously third quarter came in lower than what you were expecting. You talked again about the pricing pressure, but just curious about sort of pay down activity and any other dynamics that might be playing into the slower loan growth or is it really all just a pricing, a phenomena pricing and you're just stepping away from it, versus demand falling off?

Eric Newell
No, demand is not falling off, actually we've looked at a lot more this year than we had last year, so it's not getting a look, we're definitely getting a look. It's just that we're walking away. I think it's probably 75% to 85% of the time we're walking away because of the pricing.

And we have a—and I think I've talked about this in the past—we've institutionalized many years ago a RAROC model that the producers look at and our hurdle rates there were driving towards the aspirational ROA, ROE that we were looking at and we've noticed that we were often times, sometimes 50 to 75 basis points out of the market.

And so we are looking at that now to say okay rather than look at our aspirational ROA, ROE why don't we look at just defending the NIM, or NII dollars, that we're seeing now, so while we have paydowns—so the second part of your question—our paydown activity particularly in commercial real estate is significantly higher this year than it was last year, so we have that headwind as well.

So we frequently are looking at what's the yield of the paper that's paying off on the book. If we actually took that yield and we put it in our RAROC model it wouldn't hurdle, but what's happening is if we just don't originate, then all of sudden NII dollars will start declining and that's not good either.

So, what I charged the production folks on wholesale banking with, as well as consumer groups, is to let's make sure that we are trying to defend the NII dollars that we have on the balance sheet and try to maintain our NIM versus growing it.

Collyn Gilbert
Okay. Okay, that's very helpful. And then lastly and then I'll just hop in later in the queue. Just discussion around the tax maybe what you're thinking from the tax rate and how you see some of the

dynamics within that business going forward?

Eric Newell
Well, I'm not ready to talk about the tax rate too much on 2019. We'll talk about that in the next earnings call. But I think that the tax rate that you're seeing for the third quarter will repeat in the fourth quarter.

Collyn Gilbert
Okay. And just curious, just kind of the big variances I guess in your tax rate from what you anticipated when you started the year versus kind of now where you're shaking out ending the year. It's just been volatile and obviously difficult to model. So just trying to understand that a little bit more.

Eric Newell
Yes. I mean, I think this year was a little bit more of a challenge because when we talked to you in January we were still flushing out some of the impacts of tax reform. And I think that we still haven't actually or we're just recently or this week filing our tax return for '17. So I think having that happen as well as some of the assumptions that we were under or using in January kind of more validated as the year went on, is driving the lower tax rate. But I think once we get beyond this initial 2018 year we'll have more stability in 2019.

Collyn Gilbert
Okay. And just strategically though the intention is to still be as aggressively utilizing these tax savings businesses as much as you have in the past?

Eric Newell
Well, we constantly assess that business, line of business, and we'll look at the returns on that relative to where we can put capital in other parts of our balance sheet and we might make a decision that we'd rather put our capital somewhere else that's more efficient for us to drive return. So, I don't necessary want you say, yes, that I'm committed to it, but we're constantly looking at the returns in that business.

Collyn Gilbert
Okay. That's helpful. I'll leave it there. Thanks guys.

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

Brody Preston
Good morning everyone. How are you?

Bill Crawford
Good.

Brody Preston
Eric, I just want to go back real quick, I know you've not given explicit 2019 guidance, but did you say you would point people towards what you've done in the back half of 2018 so far as sort of a rough guide?

Eric Newell
Correct.

Brody Preston
All right. Thank you. And I guess just going back to your earlier comments about demand hasn't fallen off on the loan side and 70% to 80% of the time you're walking away due to pricing and you've experienced higher paydown activity this year relative to last year. I just want to know what's driving that. Who? I guess who or what is making you walk away? I'm assuming there's some competitive pressures, but I'm trying to better understand who's the competition.

Eric Newell
Yes. I mean, there's a lot of banks right here in New England and we also in some of the bigger deals, we're competing with folks in the Metro New York or Mid-Atlantic. Many of them have better funding cost structures than we do on a relative basis. So therefore they are able to put up a narrower spread in terms of a price quote to our customer or our perspective customer. And for us it's just really looking at how do we drive improved returns whether its pretax, pre-provision, ROA, ROE and we want to again look at how do we deploy our finite amount of capital in a way that is going to enhance our returns as much as possible.

The other thing, Dave was just waving at me, the other thing—that phenomenon that we're seeing particularly in the commercial real estate space is the life companies are coming in and competing with us and they obviously have a much longer liability structure than a bank does, so therefore they are able to be much more competitive on the pricing side.

Brody Preston
Okay. That's great color. Thank you. I guess sort of sticking with that deployment of capital being here in the face of slower loan growth and margin compression. What do you folks see as your other options that you're considering in driving EPS growth and PPNR growth, is there any expense initiatives in place or could you do share repurchase or changes to the securities portfolio?

Eric Newell
Sure. The investment portfolio is certainly an area that we've leaned on in the past for earning asset growth. I mean you've seen that decline over the years. And I think that on an absolute basis we're probably going to maintain that portfolio in the future, but I don't see it being a significant increase in the percentage of our earning assets. On the expense side, certainly our NII to average asset has increased over the years, so we're going to be looking at that to improve that metric.

And then share repurchases, we constantly are looking at where is the acceptable, I mean that's a risk-free purchase of our shares. So we're constantly looking at the payback of that and comparing it to other initiatives that we might be looking at and determine whether or not it makes sense to maybe step in and buy some of our shares. So we're kind of looking at all three of those levers to assist in PPPT revenue growth.

Brody Preston
Okay. All right. Great. Then I guess maybe just sticking with the margin. Want to get a sense for how much your loan portfolio is tied to LIBOR? And I think you mentioned earlier that FHLB started pricing both rate hikes in ahead of time, but LIBOR had sort of a run up ahead of the third quarter as well. So I want to get a sense, does that impact your margin at all this quarter?

Eric Newell
So, I've been working at one-month LIBOR. I think its three-month LIBOR, but it's not—one month is more prevalent than three-month and prime when you add those three, I believe we're at close to 47%. I don't actually have the breakdown of what LIBOR is, so I'd have to get back to you on that.

Brody Preston
All right. Great. And then, I guess I wanted to go back to Collyn's question about the deposit beta. I know that 3Q is a seasonal high point for you guys for municipal deposits and that those deposits are pricier. But you know when I look at your quarter-over-quarter deposit beta in 3Q ‘18 relative to 3Q ‘17, you see a sizable sort of pickup in it. And I wanted to I guess maybe better understand, if the year-over-year trend is still increasing, I just wanted to get a better sense for why that would change moving forward?

Eric Newell
Well, I think on the consumer side there's a couple of psychological things that have started to occur definitely in the last quarter. I don't know, maybe the last two quarters. And that would be that there's a lot of our competition has a three handle on their offerings and actually we have a couple people that have some, I mean it's very limited, but they have some four handles on their offerings. And I think that really piques the customer’s interest and they are more willing to move their money for that. And so that's just something that we have to make a decision. Are we going to match that, are we going to react to that, or are we going to be defensive or offensive on it? To date, we've been defensive on it.

So, I think when it comes to the consumer I think they're starting to wake up a little bit more in our footprint. Obviously Muni is pretty, 100% beta and a couple of our relationships will call us up in anticipation of a rate hike, or the next day, asking what we're going to do for them. So I mean theres not even a lag there. And then I think you’re also starting to see in the corporate or what we call wholesale banking but the commercial space, some of the treasurers of our customers are starting to look at what they can put their funds in that overnight and it has a two handle on it. So I just think that that's one of the reasons why we're having—the cost of our funds increasing is that there is a lot more attractive rates out there, at least in our footprint.

Brody Preston
Okay. And then I guess circling back to the maybe overall economy, just wanted to get a sense if you're seeing any impact for Connecticut from changes to salt [ph] deductions so far?

Eric Newell
No. We have not. I mean, I think that the one thing that we probably have seen is lower home-equity originations this year over last year because of the inability, or the unfavorable change on the tax deduction of that interest on home equity. But we’ve also, to mitigate that, we were not really driving customers to use the lines they had through direct mail in previous years, and we’ve started to actually do that. I think we've seen some early indications that when we actually ping our customers that hey, you have a home equity, why don’t you try to use it, they do.

Brody Preston
Okay, great. Thank you very much.

Operator
The next question comes from Kevin Swanson with the Hovde Group. Please go ahead.

Eric Newell
Hey, Kevin.

Kevin Swanson
Good morning. How are you?

Eric Newell
Good.

Kevin Swanson
So, I appreciate the comments and competition, but could you talk a little bit about the dynamics in terms of competition from non-banks on mortgage lending? Maybe in terms of structure, and if some of these rate hikes do slow in mortgage lending, how that competition changes in the near term?

Eric Newell
Mortgage lending in terms of commercial mortgage?

Kevin Swanson
In terms of just kind of talking specifically about kind of fee income from mortgage banking services.

Eric Newell
So just so I'm clear, your question, it's asking about mortgage banking revenue forecast or competition of structure on mortgages?

Kevin Swanson
Just kind of how you see the competition evolving in the near term from non-banks and other banks in the market, given a potential slowing from increase in rates?

Eric Newell
That's an interesting question. I think that obviously we're primarily a purchase shop. So with higher rates and in the pace of the rates, how they've increased, have certainly slowed our production numbers this year. I think we're about 15% to 20% lower this year than we were last year. I think that that's pretty close to what we're seeing nationally. So there's no surprise there. I wouldn't necessarily say that we're seeing any impactful competition from non-bank lenders on that space, at least from what we're seeing.

Kevin Swanson
Okay. Thanks. All my other questions are answered. Thank you.

Eric Newell
Thank you.

CONCLUSION

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

Bill Crawford
Okay. Well, thanks everyone for joining us on today's call and we'll look forward to speaking with you again soon. Take care.

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