United Financial Bancorp, Inc.

Q4 2018 Earnings Conference Call

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CORPORATE PARTICIPANTS

Marliese Shaw – *Executive Vice President, Investor Relations*

Bill Crawford – *President, Chief Executive Officer*

Eric Newell – *Executive Vice President, Chief Financial Officer*

Mark Kucia – *Executive Vice President, Chief Credit Officer*

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PRESENTATION

Operator
Good morning and welcome to the United Financial Bancorp Incorporated Fourth 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 (0). After today's presentation there will be an opportunity to ask questions. To ask a question, you may press star (*), then one (1) on your touchtone phone. To withdraw your question, please press star (*), then two (2). 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, Kate, and good morning, everyone. Welcome to our fourth 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 the 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 a few high-level comments and then turn the call over to our CFO, Eric Newell, for more detail on the quarter's results. Our United Bank team delivered strong loan and deposit growth this quarter, which included the company's fourth quarter acquisition of three net new branches from Webster Bank. Additionally, during the fourth quarter of 2018, the company restructured its mortgage banking division. The goal here is to serve mortgage customers more cost effectively with our direct mortgage banking model. This is a much lower cost delivery system, and using technology we can still deliver the exceptional customer experience demanded by today's marketplace.

United Financial Bancorp's balance sheet remains solid. Asset quality, liquidity, capital, and interest rate risk remains strong and well managed. Over the last few years, we've expanded our branch network and we've also invested in information technology, business banking, the commercial lending, and our cash management capabilities. As we look forward, our primary objective will be to curtail non-interest expense growth and fully capitalize upon the company's past investments in order to drive improved operating leverage.

Given a near flat yield curve, limiting future expense growth and further infrastructure investments will be critical to driving earnings growth. We'll also be focused on continuing to protect and grow franchise value as a top priority. In the current operating environment, we will not over-push earnings growth through credit or duration risk. Competition for loans and deposits remains brisk throughout New England, and we continue to win our fair share.

We believe we're now in the part of the economic cycle where sticking to sound fundamentals versus short-term gain is also critical. So, our focus remains centered upon delivering on our four key objectives which we set forth a few years ago. I want to take this opportunity to thank our United Bank employees for their steadfast focus on serving our customers and communities.

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

Eric Newell
Thank you, Bill, and good morning. Yesterday, the company reported earnings for the fourth quarter of 2018 of $0.24 per diluted share, which compares to the linked quarter earnings of $0.32 per diluted share and $0.19 per diluted share reported in the fourth quarter of 2017.

Before I address some of the noise in the quarter, I want to address our fundamentals, which remain unchanged during the most recent quarter and year. During the fourth quarter, the NIM declined by 2 basis points to 2.90%. The fourth quarter increases in the earning asset yields reflect the September 26th FOMC rate move. And, while the December 19th FOMC rate hike will have an impact on our earning assets, those assets tied to prime were not re-priced until the latter half of December and those assets tied to LIBOR were not re-priced until early January, thus providing minimal benefit to the quarter.

In looking at the year-over-year change in NIM, the company experienced a nine basis-point compression, of which we estimate one of those basis points being related to the lower statutory tax rate from tax reform. Over that period of time, the FOMC increased rates in March, June, and December of 2017 and in March, June, September, and December of 2018, or 150 to 175 basis points, depending on how you look at it. The company's cost of total interest-bearing deposits increased by 46 basis points to 1.49% year-over-year. Anecdotally, I believe the beta on our interest-bearing deposits will decline in 2019. There is some psychology at work here. Depositors react more quickly when seeing prevailing rates moving above 2.00% versus moving above 3.00%, especially if the move above 2.00% is when the depositor was previously earnings less than 100 basis points.

Deposit gathering in Connecticut and Western Massachusetts remains quite competitive. In reviewing the competitive landscape, I evaluate the midpoint of the competitor rates in the top quartile of each maturity term and compare that to the similar duration borrowing rate at the FHLB Boston. Most recently, we have seen that spread narrow to 50 basis points and in some maturity terms there is no spread at all. About 18 to 24 months ago that spread was 150 basis points across the curve.

In our 2019 forecast as it pertains to NIM, the company is expecting a range of 2.80% to 2.85%. I note that approximately five basis points of compression is expected to be due to the adoption of ASU-2017-08 relating to the amortization of premiums to investment call dates rather than their maturity date, which will have the effect of reducing the yield on our municipal investment portfolio. The company budgets with flat rates as management does not attempt to forecast forward rate movements. So therefore, the forecast does not anticipate any further rate movement from the FOMC. Given the current shape of the yield curve, however, we do expect additional compression due to the flatness of the curve.

Loan growth came in at 6% for 2018. We expect more of the same in 2019. The composition of the loan growth in 2019 will be more commercially focused versus the consumer growth observed in 2018. We anticipate some improvement in C&I and CRE growth in 2019 versus what we experienced in 2018. Residential mortgages will remain flat. Loans held for sale will decline in the first half of 2019 for reasons I will soon discuss. The investment portfolio will remain flat on a notional basis, so it will continue to decline on a relative basis in terms of a percentage of earning assets.

Fee income in the most recent quarter had the benefit of our acquired Webster Bank branches, a transaction that closed in early October. We anticipate that fee income in 2019 will be largely in line with 2018 results, though income will be less driven by mortgage banking revenue. Late in the fourth quarter after a thoughtful and deep analysis of the company's residential mortgage business, management realigned the business to respond to how our customers have increasingly interacted with United Bank when seeking a mortgage.

Increasingly, our customers apply online or call into our mortgage loan sales team. These direct acquisition channels have a distinct and meaningful cost benefit for the company versus the traditional retail channel. Coupled with tightening economics in mortgage banking in terms of the gain on sale we could achieve when selling our production into the secondary market and the competitive nature of rate offerings, an opportunity to dramatically improve the cost structure of our mortgage unit presented itself and we capitalized on it.

Consequently, late in the fourth quarter the company reduced its staffing in the mortgage unit by largely eliminating the Retail Loan Officer position as well as back office origination staff that supported that acquisition channel and can currently recognize $2.2 million of severance expense. The payback of this severance is well under one year.

United Bank continues to originate residential mortgages. Customers can come into a branch, go to our website and apply, or call us directly. We expect mortgage banking revenue will fall by about 30% from 2018 actual results as we continue to realize servicing income from our servicing portfolio. As I stated earlier, over time mortgage banking will contribute less to total fee income. That said, I want to emphasize that we expect that total fee income in 2019 will be in line with 2018 as increased service charges are anticipated to offset some of the reduced mortgage banking income.

Non-interest expense in the fourth quarter was $43.7 million. There were $4.6 million of expenses recognized in the fourth quarter that largely did not occur in the linked period and will not occur again in the first quarter of 2019. First and foremost is the aforementioned pretax $2.2 million of severance expense associated with the mortgage banking division. Second, related to the Webster Bank branch acquisitions, management closed three united branches, resulting a lease impairment charge as required by GAAP when operations cease in a leased property, which totaled $466,000 pretax, as well as other expenses related to the Webster Bank branch closing, which totaled $371,000.

During 2018, due to a policy change related to the paid time off accrual for our employees, the company recorded an accrual for time earned but not in the calendar year that carried over into 2019, and there was a true-up totaling $439,000 in the fourth quarter related to that accrual. While these items still add the total of the $4.6 million I mentioned earlier, the remainder of the expense was in salaries and occupancy lines.

For the full-year 2019, we forecast NIE to be between $154 million and $156 million. This forecast reflects the increased expenses related to the net three additional branches following the Webster Branch acquisition, including the associated staff expense, the reduced expense from the a repositioning action taken in the mortgage division late in 2018, as well as some natural expense increases we expect in salaries and benefits. Expense management continues to be an essential tenet of the company, especially in the operating environment we have been experiencing and we expect will continue throughout 2019.
The company is maintaining its loan loss provision forecast in 2019 at the same level experienced over the last several years, which is a range of 16 to 18 basis points of average loans. Nonperforming assets in the fourth quarter remained low and all portfolios are performing as expected. The allowance coverage to nonperforming loans remains strong. While we are not providing any forecast or disclosure on CECL at this time, I can tell you that the company is well-positioned for a January 1, 2020 adoption. The company began running its CECL allowance model parallel to its existing model of record as of year-end and it anticipates

disclosing the impact of that model adoption in the fall of this year. Our tax rate in 2018 was influenced by continued investment in alternative energy tax credits, tax planning, and also tax reform impacts. We expect a more normalized tax rate in 2019 of 10%.

And with that, the management team and I will be happy to answer any questions you have.

QUESTIONS AND ANSWERS

Operator
We will now being the question-and-answer session. To ask a question, you may press star (*), then one (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 two (2).

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

Mark Fitzgibbon
Hi, guys. Good morning.

Bill Crawford
Good morning, Mark.

Eric Newell
Good morning.

Mark Fitzgibbon
A couple questions. First, it looks like you've seen some pretty strong C&I growth. Is there any particular geography or type of business that's coming from?

Eric Newell
I would say that our investments in C&I teams in Fairfield County, Western Massachusetts, Worcester, and also Metro Hartford area. Investments we made in late 2014 are continuing to augment growth there.

Mark Fitzgibbon
Okay. And then secondly, Eric, I know you mentioned in the press release you had a couple of deposit campaigns this quarter, CD deposit campaigns. What's the plan for the first quarter, given your comments about pricing out there and spreads?

Eric Newell
Well, we've noticed--late in fourth quarter, we did some testing in certain buckets relative to being very competitive to that FHLB curve and we had some success there. So, we will obviously look at our competitive landscape and react as we normally would to grow deposits. I think some of the recent change in sentiment in the market relative to FOMC rate movement in 2019 has caused us to back off some of our pricing specials. So, I'm hopeful that we continue to be able to experience having to post up lower rates to get new customer acquisition.

Mark Fitzgibbon
Okay. And then, I know you're hesitant to guide to what the loss on LP investments might be, but can you give a sense of what the pipeline for new tax credit investments looks like?

Eric Newell
I believe 2018 is–how about this, we would not make a larger investment in ‘19 than we did in

'18. In fact, I think the bias might be a little bit smaller. So, on the LP investment, I think, if you pull that in by 10% to 20% versus what we experienced in '18 that might be a good starting point.

Mark Fitzgibbon
Okay. Thank you.

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

Collyn Gilbert
Thanks. Good morning, guys.

Bill Crawford
Hi, Collyn.

Eric Newell
Hello.

Collyn Gilbert
Just wanted to talk a little bit about the loan growth that you put on this quarter and I think it was quite a variance from what I think you were expecting perhaps going into the quarter. And, just kind of talking about what you're seeing there, maybe what the new loan origination yields are as well, and just kind of the difference that–Eric, you made the point obviously that consumer was a big driver in '18 but commercial's going to be a big driver in 2019. Just talk about some of the yield dynamics maybe within some of those portfolios as we think about the margin going forward?

Eric Newell
Yes, I think if you looked at yield for the three months ending sort of quarter-to-date year end, if you look at those yields in our yield table in the press release, I would say that for commercial real estate where we recorded 4.43%, I think that we're probably doing, what do you think, David, do you think that we're doing 25 to 50 basis points better than that or?

David Paulson
It depends on how far out on the curve we're going, but yes, we're probably in the mid to three-quarters, 4.75%-ish to 4.50% is the Investor CRE.

Eric Newell
And then on the C&I, Collyn, you know, we're reporting 4.76%, and a lot of that's variable. So, I think that we've been able to be fairly successful in holding the line on spread for C&I. So, you'll likely see some benefit early in the year on the C&I spread just because--or not the spread, the yield, because of the late December FOMC rate movement. So, you'll probably see an equal difference or equal change that you saw from the linked quarter from 4.43% to 4.76%. I don't expect that you would see anything that dramatically different. Residential, that's going to be a little probably flat to maybe some modest growth in 2019, and we're definitely booking assets at higher than 3.70% there. I would say, Brandon, we're doing like 4.50% to 5.00%.

Brandon Lorey
Yes.

Eric Newell
In terms of the composition, you called out other consumer. You did see that we grew that fairly

nicely this year, and a lot of that is our retail marine. I think that that is representing some of the execution or growth that we've had in our floor plan. So, we don't believe that that portfolio is going to grow much more materially from where it stands today just because I think we're coming into year four of having that on our balance sheet and originating it and the average life of those loans is about four years. So, we believe that we're going to see the CPRs or sort of the prepayments pick up there and essentially keep that portfolio flat. Hence, my commentary on focusing more on where we believe that more of our growth is going to come from commercial in 2019. Does that answer your question?

Collyn Gilbert
Yes, that's super helpful. Okay. And, then just thinking about the funding side and you sort of touched on this, Eric. But, the--just kind of your customer acquisition strategy and your pricing strategy, I mean you guys are carrying deposit rates higher than other banks in your markets with a similar asset mix profile. So, can you just--and I know you sort of explained where your pricing is now and you explained consumer behavior relative to the rate environment and curve and stuff. But, just thinking about it more kind of from an organizational standpoint, if you see--is there ways are sort of change that funding mix to really start to optimally structurally improve that NIM?

Eric Newell
Well, first I look back at some of the successes we've had over the last couple years. We've been able to grow transaction accounts, before 2018 we've been able to grow DDA transaction accounts about 10% year-over-year. This year, I think it slowed to more like 6% to 8% growth, more 8%. So, if we can continue that arc, I think that that is certainly--trajectory, I meant, that is certainly beneficial in improving the structural aspects of NIM. C&I, which is growth that is very slow to come to us. You know, we made investments in those teams in late '14 and have been able to continue to augment our growth in '16, '17, and now '18 and we expect that to continue in 2019. As we build our capabilities up in our cash management solutions where we can be very competitive with our local peers, we're starting to see a lot more success, successes and wins in getting operating accounts from the C&I business. So, as C&I continues to represent more of our loans and mix, that composition will look closer to our local peers. I think you're also going to see more transaction account growth from that line of business, which will help as well.

Bill Crawford
Collyn, to continue on that, it's Bill Crawford. We also have a fair number of branches that we've built over the last couple years that are already in our run rate that will help us, and some of the things we're working on in our business banking area around technology, we think will help grow transaction accounts. But, clearly, what our focus is, is growing the consumer checking and then really growing commercial and business banking DDA. That's how we're going to create more valuable deposit franchise and ultimately, bend down our funding costs relative to peers.

Eric Newell
If you looked at--just to build on Bill's point a little bit, unfortunately, you don't get visibility to this data. But, if you looked at our West Hartford, Connecticut branch, which has been open now for three to, or four-to-five years. Obviously, when you open up a new branch in a new market where you don't have that market share, price is one of those value propositions that you need to use, so you're going to have a higher cost of funds. But, as that branch has matured, that cost of funds has improved dramatically. And, so as Bill mentioned, we opened up Greenwich, Connecticut last year, and we opened up Westport, Connecticut a couple of weeks ago, and we also have some other de novo branches that have been opened up in the New Haven County in the last several years that are making that transition to what West Hartford has done. And, so

when we look at the contribution that those new branches are giving us in terms of deposit growth, we model a higher cost of funds because we know that that's going to be one of the ways that we get the customer in the door. And then they get to know us and we can get more of a relationship, which obviously bends that cost of funds down.

Collyn Gilbert
Okay, okay, that's very helpful. Thank you for that. And, then just on the expense side, what--you've indicated, Eric, that there's going to be--the remainder, I think you said of the savings–or of the $4.6 million, that's not going to occur, is in salary and occupancy line. Can you just give a little bit more color as to what--where you see the drop off coming in those two segments?

Eric Newell
Yes, $1 million of what I didn't explain is in salaries, pre-tax; $0.5 million is in occupancy, and $371,000 is in Other.

Collyn Gilbert
Okay. And the $1 million in salaries that's coming off, is that a reduction of FTEs? Is that--I'm just curious what's driving that?

Eric Newell
A little of it is some severance that wasn't related to mortgage repositioning and just a couple touch-up items or year-end items that we don't expect to occur in ‘19.

Collyn Gilbert
Okay. Okay, that's helpful. I'll leave it there. Thank you.

Operator
Again, if you have a question please press star (*), then one (1). Our next question is from Matthew Breese of Piper Jaffray. Please go ahead.

Matthew Breese
Good morning, everybody.

Eric Newell
Hi, Matt.

Matthew Breese
I just want to talk about the NIM. I had a couple of follow-up questions. So, I just wanted to make sure I had the first quarter of 2019; I know there's some changes to how the amortization of the premium, especially in the muni book, will change, so, is that initial five basis-point knockdown and then if we think about the guidance, should it be from there basically flat to two basis points of organic compression without any Fed hikes? Is that the way to think about it?

Eric Newell
I agree with you.

Matthew Breese
Okay. And, then just thinking about the balance sheet interest rate position, if we do get a hike or two hikes; one, can you comment on where the balance sheet stands in terms of interest rate sensitivity and how would that impact the margin?

Eric Newell
Well, in my prepared commentary, I guess I didn’t marry the two, but if you look at our NIM

compression year-over-year, we lost nine basis points. And then if you just look at the quarter-to-date fourth quarter ‘17 to quarter-to-date fourth quarter ‘18, we lost eight basis points. And in the first scenario, there was about 150 basis points--yes, 150 to 175 basis points of FOMC rate movement. So, looking at that--and in the second scenario, I think there were about 100 to 125 basis points of rate movement between those two periods.

So, when I look at what the market has done relative to our NIM compression, I believe that we're showing that we're pretty much balanced, maybe minimally liability sensitive, but I don't think we're--I'm not posturing us to be significantly liability-sensitive or asset-sensitive, obviously. So, to me, obviously, some of the structural items that I was talking about in answering Collyn's question are certainly helpful on the margin to--if we, for example, had another 100 to 125 basis-point rate movement in the market for whatever reason, if that would occur, I believe that you probably would see similar behavior there as what we saw in the last 12 months.

Matthew Breese
Understood, okay. And, then as going to fee income, as mortgage-related revenue comes down, I think you mentioned by 30% this year versus 2018, I think you mentioned you'll make up some of that through increased service fees and I was just hoping you could give us a little bit more color on the specific areas to make that up. Is that on the commercial fees or consumer fees or could you tell us a little bit more?

Eric Newell
Yes. Well, so the service fees, a lot of the benefit you see linked quarter is because we're--we have the six branches that we acquired from Webster. Those customers, the activity, or deposit fee and MSF fee or activity are pretty much fully in the fourth quarter number. So, you're going to continue–I mean there might be some seasonality that you see with that, just because generally we see debit card interchange and MSF fee income higher in the fourth quarter than in the first quarter, but that number will be higher. And, we're also continuing to build upon our wealth management group and their contribution to fee income. So, I think between the two of those items, they make up for that mortgage banking reduction that I'm expecting in 2019. So, that total non-interest income line for, that we--that total that we experienced in 2018 I think will largely be in line in 2019.

Matthew Breese
Okay. And then along the same lines, removing some of the noise, where do you think first quarter organic expense run rate will shake out so that we can build upon that for the year?

Eric Newell
I would point you to just the--our forecast of the 154 to 156, our annualized basis with a little seasonality because we do have some higher expenses in the first quarter because the tax withholding is higher, but once that fizzles out, I think that will be--I would look--I would just kind of gear your model on that forecast number.

Matthew Breese
Okay. I guess, my last one is I just wanted to hone in on commercial real estate. It sounds like it's an area you might grow a little bit more in 2019. Has anything changed worse or better from a competitive standpoint? Are spreads wider or slimmer than they were for 2018? And, then I just wanted to get your thoughts from a health and credit quality or valuation perspective of that asset class for 2019 and 2020 really?

Eric Newell
Well, in terms of spread, I think in our calls throughout ‘18 we talked about the spread

compression that we have been experiencing, which is an asset class were we held off on growing for much of the year. I think some of the, late in the second half of the year, I think if you look at some of the swap curve relative to the FHLB curve, it became more advantageous for us. And, I think that's still--this asset is more advantageous for us to swap, just because of the flatness of the curve where we do get some more spread there relative to what we would do if we were to try to do a fixed rate. So, I don't believe that there is really any significant change in the competitive landscape in terms of spread. We do have a lot of life insurance companies that are in the space and given their willingness to go out long with little amortization because of their liability structure, they definitely are much more competitive than we ever could be on spread.

Bill Crawford
In terms of asset quality, I'll let Mark Kucia to talk about that. Mark?

Mark Kucia
Sure. The portfolios are performing well. Commercial real estate across all the major food buckets, if you will: office, retail, apartment, industrial. We're mindful in underwriting new deals in the go-forward of changes in the market and also the possibility of increased interest rates and include that in our underwriting. So, we believe we'll be able to continue to successfully originate commercial real estate in the go-forward.

Matthew Breese
Understood. And, just on the apartment front maybe, can you give us an idea of where you're underwriting these loan from a cap rate basis and if there's any pressure to move those higher?

Mark Kucia
You know, it really depends on the market that you're in. So, it becomes somewhat market-specific. But, you're seeing caps anywhere from--depending on the markets that we're looking at, you know, in the 6.00% to 7.50%-ish, somewhere in that range. But, one thing we're always mindful of is debt yield and making sure that in the overall context of interest rates that the loans are properly sized. Now, there are markets that have much lower cap rates, and we have not been originating, generally speaking, in those markets.

Matthew Breese
Understood. Okay, that's all I had. Thanks for taking my questions.

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

CONCLUSION

Bill Crawford
Okay. Well, thank you everyone for your interest in our company and we'll look forward to catching up with you next time.

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