United Financial Bancorp, Inc.

Third Quarter 2014 Earnings Conference Call

October 23, 2014 at 10:00 a.m. Eastern

CORPORATE PARTICIPANTS

Marliese Shaw – *Senior Vice President, Investor Relations*

William Crawford – *Chief Executive Officer*

Eric Newell – *Chief Financial Officer*

PRESENTATION

Operator
Good morning, and welcome to the United Financial Bancorp Third Quarter 2014 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 telephone keypad. 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 Marliese Shaw, Executive Vice President of Investor Relations. Please go ahead.

Marliese Shaw
Thank you Laura, and 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'd like to introduce Bill Crawford, our Chief Executive Officer.

William Crawford
Thanks, Marliese. Good morning, and thank you for joining us on today's call and for your continued interest in our company. With me this morning I have Eric Newell, our CFO; Marino Santarelli, our Chief Operating Officer; Scott Bechtle, Chief Risk Officer; Mark Kucia, who heads up our Credit for us; Dave Paulson, Head of Wholesale Banking; and Brandon Lorey, who Heads up Consumer Lending for us.

Yesterday United Financial Bancorp released its first full quarter earnings results as a combined company. The merger provides the company with an opportunity to develop a favorable cost structure in comparison to our peers. Consequently, United will be in better position to deal with the tough operating environment that all banks face as a result of low interest rates and a flattened yield curve.

United will continue to exercise discipline, with regards to both credit and duration risk. We continue to attract and upgrade talent as we simultaneously reduce overall headcount. We view this as United's primary strategic advantage. We continue to evaluate opportunities to lift out high performing commercial, mortgage and financial advisory teams. United is driving to become highly efficient, both from an operational and a capital perspective.

We believe this efficiency is what will drive our valuation. With regard to operational efficiency, on October 14th, United successfully completed its system conversion and is now able to fully execute on its plans for achieving its targeted cost savings. I'd like to thank my United Bank teammates for their continued dedication and hard work.

Our employees work tirelessly to achieve a successful data conversion and I couldn't be prouder of my team. With this team in place and our cost saves on the near horizon I am very bullish for our prospects in years ahead.

Now I would like to turn the call over to Eric Newell, our CFO, to provide further detail on the quarter's results.

Eric Newell
Thank you, Bill, and good morning. United continues to make progress with its merger. As Bill mentioned, we completed our systems conversion a couple of weeks ago. With those conversion related activities coming to a close, we have started to realize some of the planned reductions in headcount and associated benefit expense. We will continue to reduce spending on headcount throughout the quarter as well as eliminate systems redundancy that the company has been carrying in operating two banks since the merger closed.

While we expect expense improvement in the fourth quarter relative to the third quarter, we continue to focus on first quarter 2015 to be more indicative of our expense run rate. Headcount reductions that we have experienced or are planning to realize is focused in our retail banking, wholesale banking and operations areas including deposit operations and finance.

In 2013 the legacy organization in Connecticut went through an exercise whereby our staffing models and our retail branches became more positively correlated to how our branch system is utilized by our customers. Throughout the rollout we reduced the incidence of full time positions in the branches, which allows the company to be more responsive to customer traffic, provide better customer service at high demand times and reduce unneeded expense at times when traffic is slower.

We also implemented a universal banker role in many of our locations. This role added flexibility by allowing key members in our branches to take on multiple duties, thereby making our staffing model more efficient while limiting the impact to our customers. This same process is now being applied to our Massachusetts franchise and is expected to save several million dollars a year.

As you likely saw in the quarter we experienced some turnover in our wholesale banking business. Despite this to-date we have experienced limited impact from the departures and our commercial loan growth during the quarter remained strong.

We are committed to our previous guidance that the company expects to continue high single-digit loan growth on an annualized basis. That loan growth, however, is not expected to have as much impact on our net interest income line as we expected earlier this year. In many of our meetings with analysts and investors I have often been asked at what level do rates benefit the NIM. While the level of rate certainly is a consideration and the answer to that question I believe the shape of the yield curve is more telling.

The spread between the 2 year and 10 year rates on the yield curve better conveys the expected direction of Bank margins. At the beginning of this year that spread was 265 points and today it's approximately 185 basis points. I contend that the shape of the curve is indicative of marginal profitability of new originations depending on the level of interest rate risk the company's willing to bring on to its balance sheet. While we do have a lot more compression required in the 2 and the 10 year to get down to levels seen in 2012, my concern is that we may experience that compression due to a rise in short-term rates which will have a notable impact on our spread income.

On an operating basis in the third quarter of 2014 our NIM appears to compress by 11 basis points; however, when the loan prepayment income is excluded from both periods the linked quarter compression is closer to 5 basis points. The most impactful catalyst to the linked quarter NIM compression is the yield of new originations in our wholesale banking business, but by origination yield in the period as well as in the current portfolio yield.

We have commented previously Bank has excess liquidity at this time, thereby when a high quality commercial sponsor enters the market a high number of funding providers present extremely competitive offers, particularly when insurance companies become involved driving coupon rates down even further.

United continues to use its risk adjusted return on capital or rate lock model as a governor for pricing. The company prefers competing against larger institutions that are typically more rational and disciplined in their loan pricing. The company does not match less disciplined pricing whether in rate or structure. We are honing our focus on developing the tools to allocate and measure return on capital allocations to assist in our goal to be efficient users of capital and the rate lock model is one example of a tool that assists us in succeeding in that endeavor.

Notwithstanding our efforts to be disappointed on pricing and mindful of interest rate risk, I expect the NIM to continue to compress, which will reduce the impact of loan growth on our net interest income. Before I move on I do want to note the additional purchase accounting disclosure we provide in our earnings release this quarter. We identified the impact from accretion of loan, deposit and borrowing marks for each of the past two quarters and annually going forward. This disclosure does not include our nonaccretable marks and is adjusted for management expectations on prepayment speeds.

During the third quarter the company issued $75 million of 10 year term subordinated debt at 5.75%. The offering price spread of 314 basis points over the 10 year treasury, a level showing great execution relative to comparable offerings. This tier two capital will allow the holding company the augmented its liquidity profile and the funds will be used for general corporate purposes including the repurchase of common stock. For much of the third quarter we were not in the market purchasing shares of the company stock as we pursue the issuance of the subordinated debt, which is reflected in our buyback activity.

Last week we announced the third share repurchase program as authorized by the Board of Directors, reflecting 5% of outstanding shares once the existing authorization is completed. Assuming a 30% tax rate the after tax cost of the debt is $3 million, or $0.057 per share annualized. We do not expect the debt offering will reduce our guidance of 2015 expected results.

I wanted to speak a little to our provision in the quarter as well as expectations for those expenses going forward. The provision in the quarter started to trend up largely due to the expected reduction of our purchase loan portfolio as a percentage of our total loan portfolio. We estimate the purchase loan portfolio have an average life nearing five years, which would mean we would have approximately $350 million of loans coming out of the purchase portfolio each year; loans that have no associated provision in the allowance. If we assume the current coverage ratio 106 basis points, this would add nearly $4 million of provision expense annually. This $4 million of provision expense does not consider any changes in the allowance coverage nor any incremental loan growth or charge off activity.

Our non-performing loans increased $10 million during the quarter to $32 million. However, virtually all of the increases attributed to purchased loan portfolio. On May 1 all purchase loans that were not impaired were considered performing even though a portion of loans were on non-accrual at the time that they were purchased. Per our policy these loans remained in that stash for 90 days and without any improvement in payment expectations moved into non-performing at the completion of the 90 days.

The coverage of the allowance to covered loans declined this period because a portion of the purchase loans that are considered non-accrual at September 30th entered the covered portfolio for our internal accounting policy without any additional incremental provision, having the effect of increasing the denominator without impacting the numerator in a charge-off activity which I will discuss further. But to be clear, increase of non-performing loans in the quarter is not a degradation of asset quality and virtually entirely driven by the effects of the merger and purchase accounting.

Last quarter we spoke of a purchase loan that experienced deterioration and upon further review management determined that facts and circumstances existed at April 30th that would have caused it to be impaired. Under the accounting rules we move this loan into the purchased impaired portfolio and applied a $1.5 million credit mark. Subsequent to the measurement date of April 30th the borrower experienced a business disruption and management provided allowance, a dollar amount that represented an estimated loss larger than the credit mark could cover.

Furthermore, as we discussed in the second quarter, there was a second loan originated by legacy Rockville that had been under review for several quarters and estimated loss was provided for that allowance in the second quarter as well. In the third quarter, following historical practices, we charged down a portion of both loans, which increased the net charge-off ratio to 18 basis points in the quarter when annualized. Our annualized year-to-date net charge-off ratio is 10 basis points reflecting continued strong credit metrics.

Next, I wanted to spend some time on our non-interest income for the quarter, which included two noteworthy items. First, you'll see that the gains on our sale of loans declined from the previous quarter. Under our accounting policy we recognize gains on sale on a realized and unrealized basis. Unrealized gains are recognized on the income statement are driven by derivatives from a secondary marketing desk including locks, mandatory and best efforts forward contracts as well as the loans held for sale. If the realized gain on the sale of the underlying loan differs from the unrealized gain once we deliver it into the market the incremental difference is recognized in the period that the loan is delivered.

During the quarter we had a lower level of loans held for sale and mandatory forwards in place than we did in the second quarter. Actions taken by the secondary marketing desk are driven by level and trend of rates, the types of products in our pipeline as well as management decision making on a structure of the balance sheet. As we noted in our earnings release during the third quarter, the company reported record quarterly residential mortgage originations. And it is important to note that the decline in our net gain from the sale of loans does not indicate a reduction of the profit margin on those loans. As management decision making is the largest catalyst to the income we recognize on a quarterly basis relating to those gains.

Additionally of note, is the recent interest rate activity in how the changes in the yield curve may impact the business line. Since September 30th the 10 year rate has declined approximately 27 basis points. Lower interest rates will have an impact on the value of our mortgage servicing portfolio, because all else being equal lower interest rates reduce the duration of the mortgage servicing portfolio, which totals approximately \$540 million at September 30th.

Our stress testing on the MSR indicates the reduction in value of nearing \$500,000 when rates fall 50 basis points. This estimate does not include any additions to the servicing portfolio through the sale of loans, which would mitigate the impact. Furthermore, with the reduction in interest rates the company generally experiences an increase in refinanced business, which also reduces the negative impact of lower rates on the MSR.

The second item in non-interest income I want to discuss further is the net loss on limited partnership investments. During the quarter the company made a limited partnership investment in an LLC, whereby the company provided equity to a fund, which in turn used the proceeds to purchase solar panels. Using that equity as well as other funding the LLC acquired the panels and placed them in service. These units once placed in service are eligible for tax credit from the Federal Government. The economic return to that company is primary based on tax benefits from the Federal Government. Because of the company's ownership in the funds the tax credit rate and depreciation on the panel flows through to the company and reduces our tax liability.

While we see a \$2.2 million loss above the line, there is also a \$2.6 million benefit in tax expense related to this new investment in limited partnership investments, resulting in a net benefit to the company's earnings results in the third quarter and augmenting other limited partnership investments benefits on the tax line. The additional expense and tax benefit recorded in the third quarter is expected to recur in the fourth quarter of 2014.

I'll quickly address tax provision, as it was a benefit to net income for the period driven primarily by this limited partnership tax credit. Previously we had stated the effective tax rate for the year was anticipated to be 10%. When considering this tax credit we now expect the effective tax rate for the year to be negative 20%, which means that management is estimating a negative 30% tax rate in the fourth quarter.

In 2015 barring any additional tax claim, we're anticipating an effective tax rate a more normalized level of 30%. Non-interest expenses in the quarter reflect a full three months of combined entity results, which makes the linked period comparison less meaningful since the second quarter only included two months of combined performance. The ratio of operating NIE to average assets for the quarter was 2.32%, illustrating a further effort ahead of the company to achieve the earlier communicated goal of decreasing that ratio to a sub 2% level by the second half of 2015.

Including the ratio of NIE to average assets, we remain committed to the goals we have previously communicated and acknowledge the commentary relating to our spread income adds some complexity to achieving those goals. However, we believe there are sizable opportunities to reduce expenses due to operating efficiencies in our business.

To that end, we have pulled together a dedicated team that will be led by myself and will focus on expense management across all business lines. For example, we have begun development of staffing models across the company to ensure that we are appropriately allocating our human resources. We are formalizing the methodology of significant business projects in ensuring business cases are well vetted before laying resources against it to ensure we carefully choose projects that are most impactful to the company's return on capital metrics.

Thank you for your time this morning. And now the management team and I would be happy to answer any questions you have.

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 telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press star, then two. At this time, we will pause momentarily to assemble our roster.

And our first question will come from Mark Fitzgibbon of Sandler O'Neill.

Matt
This is actually Matt filling in for Mark.

William Crawford
Hello, Matt.

Matt
Good morning. Just the residential loans you booked this quarter, can you give us the sense of the term and structure, fixed or floating, term to maturity pricing?

Eric Newell
Brandon, do you want to take that? Or, I know it. So I would say about 40% of our production is adjustable at this point and the bulk of the fixed rate would be in the 30 year.

Matt
Okay.

Eric Newell
[Indiscernible]. Just a reminder, we generally sell all of our 15 and 30 year fixed rate, and right now we're portfolioing our adjustable.

Matt
Okay. So that's to say that quarter-to-quarter build everything that's reflected in there is adjustable rate.

Eric Newell
I wouldn't say that. I mean sometimes we put things on the shelf so to speak whereby it might sit there over quarter end and then as the market gives us an opportunity we'll sell the 30 and the 15 fixed rate.

Matt
Okay. And in terms of the core margin I think ex-prepays you said it declined 5 basis points quarter-to-quarter, do you think that it's reasonable to project another 5 basis points of sequential decline heading into fourth quarter just in light of the flattening of the curve.

Eric Newell
The flattening of the curve definitely is going to place pressure on the core NIM. I don't think that the number that threw out there is really too far away from what we're expecting. We are

seeing some pressure on the funding, the cost of the funding and we're going to see some impact from the subordinated debt issuance because that was pretty de minimis in the quarter, third quarter, but it will come in in the fourth quarter. So I do expect that we'll see more compression.

Matt
Okay. And then can you just give us a sense of your outlook for rates and kind of your interest rate positioning at this point?

Eric Newell
Well, Bill likes to talk about the level of the 10 year rate and obviously when we were looking at our projections for '14 and the end of '13 we had a 10 year that was in a totally different zip code than where we are now. I contend that that's the shape of the curve, it is more indicative of that marginal profitability and so since we've seen that flattening of the curve we're going to continue to see some pressure on the NIM and we are modeling for our budgeting purposes what happens to our NII if we do happen to see the Fed move up in the middle of next year 25 or 50 basis points. Because unless all else being equal my view personally is that we're going to see anything out beyond five years on the curve probably stay relatively anchored, and if the Fed moves then you're going to see short rates move up so you're going to see more flattening.

In terms of interest rate risk positioning we are relatively balanced and we reported a fairly significant improvement from our liability sensitivity position that we reported at Rockville only at 331 to the combined entity results in June 30th. We haven't disclosed the September 30th results yet, but I don't expect that we're going to see a significant change there. So we're minimally liability sensitive at this point and I'm comfortable with that.

Matt
Okay. And then lastly and then I will hop out. I just I lost you a little bit with your provisioning comments. I think you were guiding to about $4 million or so of incremental provision expense. Did I hear you correctly?

Eric Newell
Yes, I think frankly I believe the Street is a little light on the provision in the 2015 and so here is how I would frame it out. We have $1.7 billion or $1.6 billion purchase loans that don't have a provision and so when you look at total loan growth, which we are committed to be high single-digit growth at the top of the house. The percentage of that purchase portfolio with no provision is going to come down and management's expectations on that portfolio is a five year life, on average.

And so what I was trying to do is frame it up and say, alright, listen, $350 million of purchase loans are going to kind of drop out of that bucket every year and without taking into account any charge-off activity, without taking into account any change in the allowance coverage, so right now it's 106 basis points on the covered loans, and without taking into account that high single-digit loan growth, I'm expecting $4 million of provision. So I think when you're looking at your models for 2015 you could take that phenomenon if you agree with it and then add in the expected loan growth in the provisioning as well as your expectations on charge-offs. In terms of charge-off expectations I think our year-to-date annualized NCO number of 10 basis points is indicative of what we will see in 2015.

Matt
Thank you very much.

Operator
And our next question comes from Travis Lan of KBW.

Travis Lan
Yeah, thanks. Eric, excluding the purchase accounting impacts and given obviously your core NIM commentary, do you think that the earnings asset growth that you guys can achieve is going to be sufficient to either stabilize or kind of slowly grow net interest income going forward?

Eric Newell
With the shape of the curve as it is today, yes. I think it's too soon to tell, if the Fed move rates up 50 basis points or 25 basis points in the middle of next year. That's why we're looking at it now so we can make changes in our business strategy to continue to grow that line.

Travis Lan
Okay. In terms of the purchase accounting estimates that you laid out in the release for '15 and '16 and beyond, are those impacted at all, would those be impacted at all by changes in interest rates going forward?

Eric Newell
Yes, so we have an in-house model for interest rate risk modeling and we use some consultancy that helps us develop what our prepayment fees are by product type. And so what we did is we levered that to develop what our prepaid adjusted life is on that loan portfolio was, which is what's informing the five years. So if there was a significant change in rates that would kind of potentially drive how that portfolio prepays for sure.

Travis Lan
So could you expand on that? If rates say and it sounds like it's related more to absolute rates as opposed to the shape, but if say the 10 year came down further would that mean that the potential accretion impact in say '15 and '16 would be higher or lower?

Eric Newell
If rates came down—well, so a lot of the pricing in the commercial portfolio, which is kind of a large part of what you're seeing that loan accretion is coming from a commercial portfolio. So a lot of their pricing, particularly in the real estate segment is between the 5, 7 and 10. So if you saw some, if we saw the 5 year, the 7 year, the 10 year come down significantly for whatever reason I do believe that there would be a higher level of prepayment so the average life would fall, which means that the accretion would come in quicker. And then obviously the opposite; as rates went up, that average life of the portfolio would increase so therefore it would slow the accretion coming in.

Travis Lan
Got you, okay, that's helpful. And then zeroing out purchase accounting impacts, it looks like core CRE yields were down 23 basis points in the quarter. Could you just talk a little bit about that and the pace of the decline there?

Eric Newell
Can you repeat that, Travis? I'm sorry.

Travis Lan
No, no just excluding the purchase accounting stuff it looks like core CRE yields were down

about 23 basis points in the quarter and that just seems a little bit dramatic, so I just wanted to see if there was commentary on that?

Eric Newell
Well, it's actually driven by the originations in the quarter. So some of the products that were making up a lot of these originations were either LIBOR based or had narrower margins than what we were expecting. Hence why when I guided last quarter I didn't guide as much compression as actually occurred.

Travis Lan
Okay, alright. And then I think last quarter, if you read through everything, you guys were around maybe $110 million for core operating expenses in 2015. As you kind of talk about trying to find other ways to reduce that, are you still comfortable with the $110 million number? Or is there a little bit more downside there than we would maybe have expected?

Eric Newell
We would like to see some more improvement on that number. So I think a goal of ours would be to maybe find another $2 million to $3 million. Bring that core run rate down to $107 million or $108 million.

Travis Lan
Got you. Okay, thank you very much.

Operator
Again, if you would like to ask a question, please press star then one at this time. And our next question will come from Matthew Breese of Sterne Agee.

Matthew Breese
Good morning, guys.

William Crawford
Hey, Matt.

Eric Newell
Hey, Matt.

Matthew Breese
With the conversion completed, I was just hoping you could quantify the exact amount of cost stage that you are expecting to come out between now and the first quarter of '15 when it's fully baked in?

Eric Newell
Man, you're putting me on the spot here. Let me talk to you conceptually, and I might have to follow up with you on this specifically, but conceptually we had a lot of focus from retail depart. We closed four of our branches, and this is all post September 30th. We closed four of our branches that we'd previously announced.

We are going to only have one core provider. So we had redundancy there, and we had some consultancy spend that may not be in M&A line that will fall off. And then with the reduced head count we're also going to see some reduced benefit spend. So it's tough that, I don't think the fourth quarter NIE is going to be indicative of our run rate and it's going to be more first quarter because there's going to be some noise because not everyone left like October 1.

Matthew Breese
Right, right. I guess that's what I mean by the time it is fully baked in, come the first quarter of 2015, what's the difference between operating expenses now and then?

Eric Newell
Let's see, I think we report NIE annualized. I'm just looking, I have to find our operating NIE for the quarter in our release. Let's see, the total operating expenses 32…45, so right now if you take the 30.4 million, so this is on page F8 of our press release in the back. If you take the 30.4, which is just the quarter, the total operating expenses for the quarter and annualize that you're at 121 billion (million). So I think that you're going to probably see us closer and our first quarter 2015 annualized NIE is probably going to be maybe 111-112 as we get closer to that 110 and my previous comment of 108 in the second half of the year.

Matthew Breese
Right.

William Crawford
Yeah, Q4, Matt, will be continued noisy, though, because the timing of when we're able to implement those cost saves.

Matthew Breese
Right. And by the time the first quarter of '15 rolls around will there be any remaining merger related costs or consultancy expenses flowing through the P&L as well?

Eric Newell
There will be a little, but I would say we're going to be on the ten yard line there.

Matthew Breese
Right. Okay. And then given the changes in the shape of yield curve and then volatility in the 10 year. Looking out from your projections at the onset of the MOE, does anything change in terms of reaching your stated goals of a 10% return on tangible common equity ratio? I know you had mentioned reaching the 1.9 expense ratio, but what about the overall, the other profitability measures?

William Crawford
Yes, Matt; it's Bill Crawford. I think the thesis remains intact, obviously we don't love where the 10 year is and the shape of the yield curve and so given that, we would focus on probably cutting a little deeper and growing a little faster, which we have the opportunity to do. Obviously, we want to be very smart in managing duration risk and credit risk, but we feel like we're well positioned to continue our path towards the financial targets we laid out. And so that's what we are focused on.

Matthew Breese
Okay. And then my last question is really around the debt offering, the $75 million, Eric you had mentioned that part of that was going to be used for share repurchases and I guess I was just curious, are you intending really to use the full $75 million solely for share repurchases, or is there going to be mix of uses on the proceeds?

Eric Newell

There will be a mix of uses on the proceeds.

Matthew Breese
Understood. Okay, thank you very much.

Eric Newell
Thanks.

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

CONCLUSION

William Crawford
Okay, well thank you for your interest in our company and we hope you have a great day.

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