United Financial Bancorp, Inc.

Q4 2016 Earnings Call

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CORPORATE PARTICIPANTS

Marliese Shaw - *EVP, Investor Relations*

Bill Crawford - *Chief Executive Officer*

Eric Newell - *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the United Financial Quarter Four 2016 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 that this event is being recorded.

I would now like to turn the conference over to Ms. Marliese Shaw. Please go ahead.

Marliese Shaw
Thank you, Andrea, 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 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.

Bill Crawford
Thank you, Marliese, and thanks to all of you for joining us on the call today. I will begin with some high- level comments about United Financial Bancorp's progress, and Eric Newell, our CFO will go into more detail about the fourth quarter results.

We are pleased to announce the company's second consecutive quarter of record earnings per share driven by record revenue, an attractive cost structure, and excellent asset quality. While we're encouraged by the potential for higher interest rates, a steeper yield curve, improving economic growth, and maybe tax reform, like all banks, United is still operating in challenging conditions today.

The company remains focused on our previously disclosed four key objectives. As a result, for the year of 2016, United grew loans by 6%, deposits by 6% and capital by 5%. The company achieved a 78 basis point return on average assets and a 7.8% return on equity for the year 2016.

The second half of 2016 demonstrated improving financial performance. The company's tangible common equity-to-assets ratio remained strong at 8.24%. In the fourth quarter of 2016, the company ended the year with a 90 basis point return-on-assets and 8.95% return-on- equity, and an 11.19% return on tangible common equity, all of which should compare favorably to most banks in Connecticut and Western Massachusetts.

GAAP earnings growth for the year 2016 in comparison to 2015 was flat; however, in 2016 the company was faced with significant declines in purchase accounting accretion. In 2017, this is not expected to be a headwind to GAAP earnings growth, which should result in United growing earnings more in line with industry peers. Seasonally, the second half of the calendar year is typically stronger for the company than the first half.

In the fourth quarter of 2016, the company saw strong loan growth from the commercial banking, C&I lending teams in Hartford, Springfield, and Worcester as well as our consumer banking teams.

Much of the company's loan growth for the fourth quarter came in December. The residential mortgage team had another solid quarter despite slowing refinance volumes. United's lending teams remained very focused on booking new loan relationships with an acceptable risk adjusted return-on-capital.

With regard to deposits, the company continued to drive strong checking account growth. For the year 2016, average non-interest-bearing deposits increased by 9% and average commercial DDA increased by 12%. The company is realizing improved growth in both retail and commercial deposits in terms of units and dollars.

United continues to upgrade its consumer and commercial product offerings, including a cash management product upgrade. Banker incentive compensation is largely tied to low-cost deposit growth and relationship return-on-equity. The company's customer service quality net promoter score has continued to improve upon already strong levels. The United Financial Advisory Team also has impressive momentum.

The company is making significant human capital and systems investments in information technology and project management, which will offer the capacity to evolve with customer preferences and keep up with our toughest competitors in terms of product and service capability. This investment will further allow the company to build more efficient, scalable, paperless, customer-friendly processes and self-service options, which over time will provide the company with the ability to further bend down its cost structure.

The company achieved a non-interest expense-to-average-assets ratio of 2.05% for the fourth quarter of 2016. As we think about 2018 and 2019, this is a ratio we want to drive down along with our funding costs relative to peers'. Improved technology capacity is crucial to achieving this goal. Providing an improving customer experience at a lower cost is usually a winning combination.

In 2017, United expects to see continued strong C&I, owner occupied commercial real estate, and consumer loan growth with modest-to-flat residential mortgage growth. Slowing residential mortgage refinance activity typically leads to improved home equity lending. Overall, we expect high single-digit loan and deposit growth and improved earnings growth to augment the company's capital base net of dividends to shareholders. Given higher interest rates, the company expects a softer mortgage banking income in 2017.

United will remain focused in 2017 on driving improved operating leverage while maintaining strong liquidity and capital ratios. Eventually, higher interest rates should provide an opportunity to begin improving the net interest margin. However, the company's forecast is prepared assuming flat rates. The company is mindful of the pressure on deposit pricing, so the banking teams are very focused on growing low-cost deposits by doing more business with existing and new customers.

While our interest rate positioning is slightly asset sensitive, this is based upon a static or no growth model. Therefore, over time the company's loan growth, assuming increasing rates should support continued improvement in profitability and growth and returns on common tangible equity in 2018 and 2019.

As I stated earlier, United's focus remains to be improving operating leverage, growing revenue, and earnings per share, building tangible book value, and increasing franchise value. The last six years, the company has had to contend with the lowest rates in decades. If a more normalized interest rate and economic environment is presented, the franchise should be able to deliver improved profitability over time. We will have to see how things play out in Washington. In the meantime, the United team will be focused on driving incremental improvement in a safe and sound manner.

As a significant shareholder, I am personally pleased to see our total shareholder return for UBNK has improved. Total shareholder return over various time periods remains a significant focus for our management team and the board of directors.

I will now turn the call over to our CFO, Eric Newell, for more detail on the quarter results, and then we'll take some questions.

Eric Newell
Thanks, Bill. Yesterday the company announced earnings per diluted share of $0.29, beating our comparable 2015 quarter earnings per diluted share of $0.20. I will focus most of my commentary on 2017 expectations and briefly talk about fourth quarter results that may differ from the company's 2017 plan.

First, the company's expenses came in a little more than I had modeled for the fourth quarter, the majority of which are in the salaries' and benefits' line. This reflects a more robust investment in our information technology staffing composition than anticipated due to talent availability. The investment in a technology organization is a strategic incremental investment, which started in the third quarter of 2016 and will be fully recognized in the company's run rate in the first quarter of 2017. This investment will eventually provide positive operating leverage by reducing expenses through improved efficiencies and by increasing revenues through enhanced and new products and services that will maintain and improve United's value proposition to its customers.

The company's expectation for quarterly salaries and benefits expense in 2017 is approximately $20 million. This forecast reflects both the IT investments we discussed as well as the normal increases expected year over year. All inclusive, this reflects a 6.5% anticipated increase in salaries and benefits expense over 2016, slightly elevated from the 3% to 4% increase one would expect in this line.

Total non-interest expenses are forecast to be about $34.5 million per quarter in the first half of 2017, and then around $35 million per quarter in the second half of the year, resulting in a little over 4% of NIE growth year over year. I would note that our ratio of non-interest expense-to-average-assets is expected to be close to 2.00% for the full year, but higher than that for the first half the year while asset growth is seasonally slower. As asset growth accelerates in the second half of the year, the pace of that growth will be greater than the rate of non-interest expense growth.

The company is forecasting a high single-digit asset growth rate, slightly more elevated growth than what the company experienced in 2016. I'd like to point out a couple items of note here. First off, prospective ROEs have improved. Previously the company had indicated that it was less inclined to book on balance sheet growth of commercial real estate and residential mortgages because of their subpar ROEs. We've observed some improved profitability in this area and are more willing to originate these assets for our portfolio than at the time of our last earnings call.

United continues to seek achieving more success with the third objective of remixing cash flows into more favorable risk-adjusted returns which will include C&I, owner-occupied CRE and consumer loans. Investor CRE and residential real estate loans may additionally contribute towards that goal in 2017 given the recent changes experienced in the steepness of the yield curve.

This leads into the discussion on how the company anticipates funding our balance sheet loan growth. As Bill mentioned, for 2016 we reported 6% deposit growth, funding 6% loan growth, and that deposit growth included 8% DDA growth. Thematically, we believe 2017 will be similar to 2016 in that regard.

Commercial and consumer banking teams have multiple deposit initiatives and as a result, much of their incentive plans are aligned with growing low-cost core deposits and generating improved ROEs.

Next, I will discuss our NIM expectation for 2017. First, I'm pleased to say that the company's GAAP NIM and non-GAAP NIM have largely converged. The difference between the two measurements has been purchase accounting adjustments related to our 2014 merger. The non-GAAP NIM was significantly impacted by purchase accounting in 2015. There was less impact in 2016, and we're forecasting even smaller impact in 2017. We will still disclose non-GAAP NIM in the earnings release tables, and from time to time we may see a basis point difference here and there between the GAAP and non-GAAP NIM in that disclosure.

With regard to the fourth quarter 2016, while the company's NIM experienced a decline from the linked period, this was driven by lower prepayment fee income and a modest unfavorable impact from purchase accounting. For the first quarter of 2017, we expect NIM to benefit from the repricing of nearly $850 million of our loan book tied to one month LIBOR. This rate does not tend to rise far ahead of interest rate increases, unlike what the market observed in the three month LIBOR rates during the third quarter of 2016. One month LIBOR increased 7 basis points in the third quarter while the three month LIBOR increased by 20 basis points.

Additionally, during the majority of the fourth quarter, one month LIBOR was relatively stable until the market gained a strong conviction surrounding the December interest rate hike. For example, the one month LIBOR rate sets for adjustable portion of our CRE portfolio were 53 basis points in October, 54 basis points in November, and that compares to 66 basis points in December, ahead of the FOMC announcement. This indicates that the portfolio received a minimal benefit for the fourth quarter yields on the FOMC action taken in December and will receive a more full benefit in the first quarter 2017.

We model our budget based on flat interest rates. If FOMC takes actions to tighten two to three times this year, we will have some benefit over our forecasted net interest income revenue as a result. To elaborate, the recent January one month LIBOR rate set for the commercial real estate portion of our portfolio based off that rate was 76 basis points, and that's 19 basis points over the average rate set in the fourth quarter of 2016 and will reflect improved yield performance during the first quarter 2017 for that segment of the loan book.

In addition to the $850 million of one month LIBOR loans, the company also has another $800 million of loans priced off prime and $350 million of loans priced off one year LIBOR. In total, these variable rate loans represent 41% of our total loan portfolio.

At September 30, 2016, when the company assumed a 150 basis point ramp-up in interest rates, within one year on a no growth balance sheet, net interest income increased by 4.6%, indicating the company's asset-sensitive position.

When looking at the company's improved consistency of core banking fee income, the company's continued commitment to diligent expense management, its high single-digit loan growth expectation for 2017, and the potential benefit of higher short term interest rates, we expect to demonstrate two to one operating leverage in 2017, meaning for every percent of incremental expense in 2017 we're expecting to have double that in revenue growth.

Given that United has some seasonality in its business, we expect 2017 earnings per share to grow more in line with industry standards over 2016 with the back half performing better than the first half, similar to the seasonality reflected in the 2016 results.

Finally, we expect some stability in our effective tax rate in 2017, and we're anticipating a full year effective tax rate of around 13%. Thanks for your time this morning, and the management team and I will be happy to 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 telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two. At this time, we will pause momentarily to assemble the roster. Our first question comes from Kevin Fitzsimmons of Hovde Group. Please go ahead.

Kevin Fitzsimmons
Hi, good morning guys. Eric, I understand your comments about the margin outlook assuming a flat rate environment. I guess I'm just a little surprised that that outlook wouldn't be a little bit higher even in a flat rate environment given all the initiatives you're working on to improve the funding base and to remix the loan book into higher yielding loans. I'm just surprised there's not more incremental benefit baked in there, or are you guys being just more on the conservative side? Or is it just more of a slow moving initiative?

Eric Newell
I would say it's a slow-moving initiative. I do think that there might be a misconception that rates up, steeper yield curve, banks immediately get the benefit in NIM right away, and obviously that doesn't happen. It's been a low-rate environment for eight years, and we're still seeing NIMs grind down quarter after quarter. I would note that we are trying to be realistic. We have seen some increased cost of funds in our markets. You saw that our cost of funds increased by one basis point quarter-over-quarter. So it has been fairly aggressive in our backyard and we're trying to take that into account in our expectation for NIM in 2017.

Kevin Fitzsimmons
Let me just ask, it's a bit of a follow-up, but I know ever since the MOE, I don't think M&A has been a big focus for you guys, and you've been focused more on integrating and getting the core earnings up. But given the need or what you guys would want to beef up core deposits and get that cost of funding down sooner rather than later, would it be a possibility that smaller bank M&A might be possible for you guys, especially if they're deposit rich or is it just too competitive in your backyard, and maybe you might not have the multiple strength to go in there and pay what it would take?

Bill Crawford
Kevin, it's Bill. I would never categorically rule out M&A, but when you look at our opportunity set, I think it's not a likely path for us currently.

Kevin Fitzsimmons
Got it. Okay, thanks, guys.

Operator
Our next question comes from Mark Fitzgibbon of Sandler O'Neill. Please go ahead.

Nick Cucharale
Good morning guys, this is Nick Cucharale filling in for Mark. First, on the loan side, really nice C&I and

owner occupied CRE growth this quarter. You had mentioned that these are kind of the drivers of the strong loan growth forecast in ’17. Just wondered if you could share with us what you're seeing on that side.

Eric Newell
In terms of continued C&I growth?

Nick Cucharale
Yes, especially C&I but owner occupied CRE as well, just what you’re kind of seeing in your lending environment.

Eric Newell
Yes. On the C&I side we've made some investments in teams going back to I believe it was the end of 2014. So, those teams have been on the ground for now over about 24 months, and we’re really starting to see some nice contributions to their ability to contribute towards originations and profitability. So, we do expect that to continue. As you anticipate, moving a C&I relationship from one bank to another is a fairly complicated and a long process, so I think we're going to continue to see some benefits there.

I would say that would probably be, that theme for C&I would follow with owner-occupied CRE. And on the investor CRE side, we had slowed that growth down in 2016 largely a function of the ROEs that we’re seeing in the market just were not meeting our hurdle rates. We would put out an offer, pass through our preliminary credit process, and then the prospect would come back to us with a lower rate because they were getting something across the street. We would just pass on it, and I believe we had almost three quarters of a billion dollars of that paper that we pretty much passed in 2016 on that, just in CRE.

So in terms of what we're seeing now, I think a lot of it is coming down to the steepness of the yield curve has improved. We're seeing higher interest rates. So if that were to continue, or if that's maintained, we’re prospectively seeing our ROEs exceed our hurdle rates, which will allow us to have investor CRE contribute more to our growth strategy in 2017 than what it did in 2016. Furthermore, investor CRE is also a tool for us to help us bring in the duration of the asset side of our balance sheet a little bit more. With short-term interest rates expected to potentially move up two to three times this year, even if you consider the fact that we might have the forward curve is expected to flatten a little bit, because the short-term interest rates are expected to rise, putting on a little more asset sensitivity through a swap will benefit our NII over 2017 and into 2018.

Nick Cucharale
Great. And then you had really nice growth in non-interest income, and I was hoping you could share with us your 2017 initiatives and how wealth management is progressing.

Bill Crawford
Nick, I would say they're doing very well. It's a high-growth rate, but it's off a slow base. But we took a lot of actions in 2016 to build more stability in our non-interest income line. So I think you'll see more consistency there.

Nick Cucharale
Great. Thanks for taking my questions.

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

Collyn Gilbert
Thanks, good morning, guys. Just going back to the loan discussion, and I just want to make sure I heard you guys correctly. So Eric, I think you said in terms of your loan growth appetite that you're seeing, I know you're indicating obviously better ROEs across the board. But how is it that resi mortgage is fitting into your strategy now? Because I know you were steering away from that, it seemed like last year, and now are you suggesting that maybe you'll get back into it with more earnest? If you could just talk a little bit about your appetite there.

Eric Newell
I think it was more of a relative comment. So last year you saw residential generally was falling as a percentage of our balance sheet as well as dollars. So we might be a little more flat this year. You might see some moderate growth in a quarter, but then that might be just because it's in the held for sale. So it was more of a relative comment. So I wouldn't expect to see residential real estate start to grow as a percentage of our total loan book.

Collyn Gilbert
Okay, that's helpful. And then, just back to the more optimistic outlook on growth and the returns you're seeing in some of your CRE and C&I. How are you seeing the pricing of your new originations compared to some of the portfolio yields that are rolling off?

Eric Newell
How about this? I can tell you that the coupons that we're booking are currently at, or maybe even slightly little bit better, than our portfolio yields in that sleeve.

Collyn Gilbert
Is that in most of the loan classes?

Eric Newell
Yes. So there still might be a small differentiation between what is coming off and what's coming on, which was more to your question. But, I wouldn't think it's material because the duration of most of our portfolios is fairly short because of our asset sensitivity. Particularly in CRE I believe we're probably between three and four years of duration there. So obviously, that's a portfolio basis, so you could have some stuff paying off that was originated ten years ago. But all in all, I mean that portfolio has been originated in the current rate environment.

Collyn Gilbert
Okay, that's helpful. And then just shifting gears to the deposit side, seeing a little bit of funding pressure. And you had indicated that you're sort of maybe anticipating more of that going into your NIM outlook. Can you sort of quantify that a little bit more, maybe either through what your assumed deposit betas are or just how you see those cost of deposits trending over the next year or two?

Eric Newell
So in terms of deposit betas, I would characterize ours as conservative, which means high. We did put a disclosure out on this I believe in our—I want to say it's 2015. I'll have to get a specific on that, but it was in one of our investor decks in the last four-to-six quarters. We actually put out our deposit betas, not so much what we modeled, but we showed, I think it was 40%, 60%, 80% betas, to show that—at that point we were showing ourselves as liability sensitive. If we brought the betas down to something like 40%, which is I would say probably not conservative enough, we would've shown ourselves as being wildly asset sensitive at that point. So I would say our deposit betas, our assumptions there continue to be conservative, which if we can perform better than our assumption, that means that

change, that 150 basis point change that I was talking about in terms of asset sensitivity, we would perform better there.

In terms of pricing and the competition, I think that you're looking at a geography, through New England, that has I believe the least favorable structural liquidity ratios in the nation. So our loan-to-deposit ratios are the least favorable. So when folks across the street are looking to grow more aggressively because they're trying to meet their objectives, they're trying to beat NII, they potentially could have a loan-to-deposit ratio that is or exceeds 100%. And if they have a high market share, then that incremental cost of that deposit is going to be expensive, and that's one of the factors that we're competing against ourselves.

Collyn Gilbert
Okay, that makes sense. And then just finally I know you had provided kind of some provision to average loan guidance in your slide deck. But just more on kind of a bigger picture qualitative point of view, how are you seeing the outlook for credit trending here, and do you see any potential weakening should interest rates continue to rise?

Eric Newell
I would say we are not seeing any issues with credit quality. I do know that when we underwrite in commercial real estate, we use a metric that is more normalized. What is it, Mark?

Eric Newell
Debt yield. So we do use debt yields when we are underwriting, which essentially makes sure that when rates do rise, we're not underwriting something that is too euphoric or in a utopian environment. So we're not concerned about our borrowers in terms of a higher interest rate risk environment. I also would note that I believe it's quarterly we go through a stress-testing exercise on our portfolio, and we do shock interest rates in various severities. And if there's any concerns with whether it's valuations or cash flows, it goes into a process where the credit administration team spends a lot of time looking at it and understanding whether there's anything that needs to be done to mitigate our risks. So we're fairly comfortable there, and we're not seeing any themes or anything pop out in the rest of our portfolio.

Collyn Gilbert
Okay. That's helpful. Thank you.

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

Matthew Breese
Good morning, everybody. I do appreciate the detail on the margin guidance for the full year, and there's lot of good detail on the variable rate loan side. But I was hoping for a little bit more specific guidance on, given the rate hike in December, what the impact to the margin would be in the first quarter and then for a full year if we do get those two more hikes or three more hikes, what the impact versus guidance is on the margin.

Eric Newell
You know, Matt, I don't have the math in front of me. But in our budgeting process, we use flat rates, and so I have not budgeted that. But I do think that I probably gave you more information than I've ever given on variable rate, so I think you probably could develop that number independently.

Matthew Breese

Okay. And then has there been any change in the behavior of your C&I borrowers in terms of line utilization pre and post the election and on hopes of the better economic environment?

Eric Newell
At this point we are not seeing any change in our line utilization. It's probably down just a little bit. I think it's probably a little early. If there was a higher level of confidence in the economy or job hiring, that might cause our borrowers to want to make investments, it would probably be a little early to see that at this point, but something that we'll definitely continue to comment on and look at, and hopefully see some nice progress there in 2017 and 2018.

Matthew Breese
Okay. And then on the tax rate, I know you talked about a little bit more stability. The last couple years it's been a bit more volatile. Is there still going to be quarterly variations in that tax rate but ultimately we get to that 13% level, is that how to think about it?

Eric Newell
I would look at around the 13% level as a good effective tax rate for the year. Yes, I admit there has been some volatility, and we've looked at that internally. Our hope is that we will essentially reduce that volatility. I can't promise that it's going to be even every quarter, but that's my goal.

Matthew Breese
And then the related tax item in the non-interest income, what is that expected to be for the full year?

Eric Newell
I haven't been giving any forecast on that, but that number is included in the non-interest income forecast range, so the partnership expense is included in that number.

Matthew Breese
Understood. Okay. That's all I had. Thank you very much, guys.

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.

Bill Crawford
Okay. Well, thank you for joining us on today's call. And if there are any follow-up questions, we're glad to take those. Hope you all have a great day.

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