United Financial Bancorp

United Financial Bancorp, Inc. Q2 2017 Earnings Call

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CORPORATE PARTICIPANTS

Marliese Shaw- *Executive Vice President, Corporate Secretary and Investor Relations*

Bill Crawford - *Chief Executive Officer*

Eric Newell - *Executive Vice President and Chief Financial Officer*

David Paulson - *Executive Vice President, Head of Wholesale Banking*

Mark Kucia - *Executive Vice President and Chief Credit Officer*

PRESENTATION

Operator
Good morning and welcome to the United Financial Bancorp Second Quarter 2017 Earnings Conference Call. At this time, all lines are in listen only mode. If you should you need assistance, please signal a conference operator by pressing star (*) 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 telephone keypad; 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. Please go ahead.

Marliese Shaw
Thank you, Kate. Good morning, everyone. Welcome to our second quarter conference call. Before we begin, we would like to remind you to read our Safe Harbor advisement on forward-looking statements on our earnings announcement. Forward-looking statements, by their nature, are subject to risks and uncertainties. Certain factors could cause actual results to differ materially from 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 today's call. In April 2016, United Financial Bancorp announced four key objectives, which you will find on Page 8 of our investor deck. We believe then and we believe now that sound execution against these four key objectives will improve our core earnings and valuation over time. In the second quarter of 2017, the Company continued to make progress towards these objectives. I'll provide an overview, and Eric Newell, our CFO, will provide more detail about the quarter's results.

In the second quarter of 2017, the Company achieved record net interest income through both loan growth and the benefits provided with asset sensitivity to rising rates. Provision expense declined, year-over-year, due to slowing migration from uncovered to covered loan portfolios, combined with lower loan losses. This is an important trend that Eric will discuss further.

Asset quality remains stable and strong, non-performing assets remain low and reflect a gradual declining trend. Over the last several quarters, the Company has posted improved fee income from more predictable sources such as core banking fees, bank-owned life insurance and investment management fees. Given a flatter yield curve, we have a bias towards originating variable rate assets, which has led to an increase in loan-level swap income this quarter from our commercial banking business. All of this combined to drive record fee income in the second quarter of '17.

On Page 16 of our investor deck, you can see that during the second quarter of 2017, our net swap income in mortgage banking fees to total revenue was 6.5% or slightly above our 10-quarter average for that same measurement of 6.2%. By selling interest rate swaps and mortgages not only do we generate fee income, but these are tools that help us build a more asset-sensitive balance sheet while meeting our customers' needs. When the yield curve is flat, like it is now, we tend to generate more fee income. With a positively-sloping yield curve, we would likely drive more net interest income and less swap and mortgage banking fee income. Year-over-year and linked-quarter non-interest expense was well controlled. The annualized non-interest expense to average assets ratio was 2.06% for the second quarter of 2017, evidencing attractive operating cost structure.

On Page 15 of our investor deck, the Company is reporting tangible book value growth plus dividends over the last 10 quarters, which has experienced a 9.8% compound annual growth rate during that time. We believe this is a key long-term driver of shareholder value.

Over the last four consecutive quarters, the Company has generated $59 million in after-tax income, or $1.16 earnings per share, with a 10.6% compound annual growth rate in tangible book value plus dividends. In the last four quarters, the Company's average return on assets of 89 basis points and return on average equity of 8.94% and return on average tangible equity of 11.15%. Year-over-year total loans have increased 7% and deposits have increased by 12%. C&I loans have increased by 18%, year-over-year, and we expect continued strong performance in C&I lending and core deposit growth. Total revenue has increased 16%, year-over-year, with relatively flat non-interest expenses and declining provision providing very strong operating leverage. The Company has made investments in IT and project management, which is helping to improve the customer experience by making banking faster and more efficient and an overall better experience for our customers. We continue to attract, retain and develop top talent, which I believe is our primary competitive advantage. We have an inclusive culture, which encourages constructive debate and dialogue throughout the Company without regard to level. Our executive team employees are focused on winning for our customers, shareholders, and communities. The Company's return on average assets and its return on equity are favorable by comparison to most of our local geographic competitors, but there is a gap between United and some of our regional and national peer banks. We are focused on prudently reducing that ROA and ROE gap over time by executing against our four key objectives. I want to thank my United Bank teammates for staying keenly focused on providing exceptional customer experience for our customers, and now I'll turn the call over to Eric Newell, our CFO.

Eric Newell
Thank you, Bill. Major drivers of our performance this quarter were improved net interest income on a linked-quarter and a comparable period basis, lower provision expense on a comparable period basis, and improved fee income and relatively flat expense growth in both the linked and comparable quarters. Net interest income improved due to average annualized loan growth in the second quarter of 15.1% and resulted in a 3 basis point expansion of net interest margin to 3.04%. Provision expense was flat to the linked-quarter and improved from the comparable period due to slower CPR's in the purchase portfolio and lower charge offs during the quarter. The provision forecast includes assumptions for our loss factor, our growth factor, as well as our CPR factor on the Company's purchase portfolio, since coverage is required for those loans when they move over to what we call the covered portfolio, even though it does not result in net loan growth on the balance sheet. For the first half of 2017, we have been experiencing CPRs in the purchase portfolio at about 50% of our initial estimate, which generates a lower provision cost. Prior to that slowdown of CPRs, the Company's forecasted provision expense to average gross loans was 30 basis points and despite seeing slower prepay speeds for the first two quarters, we’re not quite ready to affirm that the current 18 basis point run rate for provision expense in the first half of the year is the appropriate amount to model going forward. Therefore, we've revised the forecast to 24 basis points annualized in the second half of the year. I would note that we have not changed our initial forecast to losses despite a dramatically improved result in that regard during the second quarter and our provision methodology remains unchanged from previous quarters.

Fee income was improved, in part, due to seasonably increased mortgage banking revenue on a linked-quarter basis, despite an expectation for decline in income from the comparable prior year period due to dynamics driven by higher interest rates. Additionally, wealth management income was improved over the prior year period and flat on a linked-quarter basis. Higher swap fee income was recorded in both the linked-quarter and comparable prior year period due to higher origination volumes, particularly in variable rate products.

The Company has included additional disclosure in the investor deck this quarter to enhance the data available pertaining to both swap and mortgage banking revenue. This disclosure provides the net swap income that is netting from the swap revenue to portion of the quarter's non-interest expense related to originating that swap, then adds mortgage banking revenue and compares that result to total revenue, which is defined as net interest income before provision and total non-interest income. This data is provided over the last 10 quarters and as you can see; our total contribution this quarter is in line within the 10-quarter average. In a period of time when the yield curve is flat, our bias will be toward variable rate asset production, which often results in an increase in swap revenue. Expense management was evident in the linked-quarter with total non-interest expense remaining flat. Non-interest expense was additionally flat, year-over-year, however, the prior year period include elevated expenses due to the recognition of $1.4 million of severance expense. On a pro forma basis, when the severance costs are excluded, total non-interest expense increased by 5.1%, which largely reflects standard year-over-year increases to expenses and, to a lesser degree, the previously disclosed investments in Information Technology. The tax rate is in line with the previously disclosed forecasts.

Looking ahead to the remainder of 2017, we expect more of the same and the forecast slide in the press deck indicates the salient items of interest. While annual periodic loan growth of 6.9% slightly lags the high single-digit growth previously forecasted, this is due to our selective process of booking loans that are accretive to our aspirational ROA and ROE goals, which becomes more challenging when the yield curve is flat, as it has flattened out through the first half of 2017. If the yield curve remains flat or becomes flatter, there is a risk that loan growth falls more in line with what we have shown year-over-year or mid- to high-single-digit growth. We remain focused on originations of assets that are priced off shorter-term indices, such as C&I and consumer loans, and have become more selective of originations of asset types that are more sensitive to a flat yield curve, such as investor commercial real estate.

Our NIM forecast, which includes a 1 basis point increase over the last quarter's forecast, does not include any changes to interest rates in the second half of the year and does not include the impact of the June rate hike due to timing of recognizing that increase to prime and LIBOR, which is generally around the 10th of the month.

We have seen betas for money market accounts rise in our municipal and commercial clients and less so with our retail segment. Wholesale funding is also sensitive to changes in market rates and as a result, we've seen an increase in both the cost of deposits as well as the cost of funds. Given the June FOMC change to short-term rates, we expect a similar result in the third quarter in terms of changes to NIM as we saw in the second quarter.

Provision expense in the second half will likely be around 24 basis points annualized based on my previous commentary. The total fee income forecast increases to a range between $8.25 million and $8.75 million per quarter and non-interest expenses will be approximately $35.5 million per quarter, with the effective tax rate forecasted to remain steady. Thank you for your time this morning, and management team and I will be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question and answer session. To ask a question, you may press star (*) then 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). At this time, we will pause momentarily to assemble our roster. The first question comes from Mark Fitzgibbon of Sandler O'Neill. Please go ahead.

Mark Fitzgibbon
Hey, guys, good morning.

Bill Crawford
Good morning.

Eric Newell
Good morning.

Mark Fitzgibbon
Eric, was the 26% rise you had in service charges this quarter, was that primarily due to higher swap income or were there some other items in there as well?

Eric Newell
Swap income was one of the drivers on a linked-quarter basis, as well as mortgage banking. Generally you would see mortgage banking be higher in the second quarter than first and that happened again this year.

Mark Fitzgibbon
Yeah, but I wasn't talking, per se, about the mortgage banking line, just the service charges and fees, looked like they went up like 26% linked-quarter.

Eric Newell
I apologize. Yes, primarily swaps.

Mark Fitzgibbon
Okay and then, secondly, I've wondered if you'd willing to maybe share with us any guidance on the loss on an LP investments line for the back half of the year? Is that likely to fluctuate much?

Eric Newell
That would be included in the number I gave on total fee income, but I think that what you're seeing in the second quarter is a good indication of the back half, per quarter.

Mark Fitzgibbon
Okay and then could you update us on sort of the Company's headquarters move to Hartford in terms of timing and incremental costs?

Eric Newell
I would say that the incremental cost largely is insignificant to EPS, and that move doesn't happen until the end of this year and the big part of that is there, we have had some good success in subleasing the current space that we're in, in Glastonbury, which actually has a more expensive lease rate than what we have in Hartford.

Mark Fitzgibbon
Okay and then last question. You guys have made some great strides in terms of profitability. Have you recalibrated your sort of profitability targets upward and if so, can you share those with us?

Bill Crawford
Mark, what we want to do is work towards, over time, we're working towards a 1.00% ROA at our current tax rate and so that occurs, we believe, sometime, pick a quarter sometime in late '18, early '19.

Mark Fitzgibbon
Great, thank you.

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

Collyn Gilbert
Great, thanks. Good morning, guys.

Bill Crawford
Good morning.

Collyn Gilbert
Just a quick question. Back to the fees, Eric, I know, I think you guys had said last quarter that you were going to be doing some sort of service charge reassessment in the back half of this year on the fee structure. Did you guys do that and was the increase, I know you said it was primarily swap income, but just trying to understand perhaps the impact of that exercise?

Eric Newell
If you look at, if you annualize the quarterly range I gave you for fee income, it's a little bit higher than what we had put in the forecast page, the last point on our last earnings call. So some of that has to do with the fact that we do think that swap fee income will be a little higher than we initially expected for the year, but we do include the service charge increase that we do annually in those numbers and I believe that occurs in the middle of this quarter. So it hasn't happened yet, just yet.

Collyn Gilbert
Okay, that's helpful and then just on the, your comments on the loan pricing and in relation to the curve, what are you seeing out there in terms of loan pricing? Has the backup in the ten year, has that impacted loan pricing? Or just maybe talk a little bit about the competitive dynamics that you're seeing there and where you're seeing some of the best pricing and then some of the weakest pricing.

Eric Newell
I'll let David Paulson take that.

David Paulson
Good morning. Yeah, we're seeing a continued pressure in virtually every asset class that we bid on. So while we'll see the nominal rate go up slightly, just by virtue of what we're seeing to date in terms of interest rate increases, it's still fiercely competitive out there and so we continue to be very disciplined on using our pricing model to achieve the ROE aspirations and

expectations that we set forth thus far.

Collyn Gilbert
Okay, and then on the funding side, do you, what was the impact this quarter of muni deposits, and then the cost of those deposits, too? Just trying to extrapolate, I mean, that's going to be volatile quarter-to-quarter, I'm just trying to make sure we monetize that impact here as we look out going forward.

Eric Newell
I don't think I want to necessarily quantify muni, specifically, but I would say that I think a good proxy of what's going to happen in the third quarter for cost of funds for deposits is what happened this quarter. Does that make sense?

Collyn Gilbert
Okay, it does and so, and that's inclusive of the muni in and out,

Eric Newell
Correct.

Collyn Gilbert
and the cost of the munis? Okay, okay. So and then maybe a broader question, Eric, just what are you seeing in terms of deposit pricing? Where do you think there's going to be pricing pressure? I know that the betas jumped a bit this quarter. It's still certainly within a normal range, but just trying to get your sense of what you think the impact could be later into this year and into next year on deposit pricing.

Eric Newell
We found when we studied ourselves back in 2004, none of us around the table were actually here, but it was the last time that we could study our own behavior in a rising rate environment and we found that money markets, which are probably the best proxy of betas for, in terms of the deposit class in a rising rate environment. When it’s continued, you have continued fed rates, you find that your beta kind of stabilizes in the year two and we found that that beta was probably between 40% and 50%. Last year, we were at 10%. I wouldn't really characterize last year as year one, because there wasn't a continual drip of FOMC rate changes. So I would say we're in year one now and we're nowhere near 50% at this point. But I think if you continue to see, I think, Collyn, your firm's forecast, you have another rate change later this year and a couple next year. If you continue, if that comes to fruition, you'll probably see the betas for money market widen out a little bit more than what we're seeing now. I would say that retail betas are lower than commercial and municipal. But as that higher rate starts to get closer to a 2%, which seems to be a very big inflection point for the retail customer in terms of short rates, I think you're going to see cost of funds go up more across the industry.

Collyn Gilbert
Okay. Okay, that's very helpful and then just back to the loan growth, I'm sorry, the pipeline. How does the mix stand now? I think last quarter it was like 80% C&I, 20% investor CRE. Is that similar structure this quarter or do you see that moving here as you wrap up the second quarter for the pipeline?

David Paulson
Yeah, Collyn, it's Dave. It's a very similar dynamic. Last quarter, we were looking at probably 80/20. I think the last pipeline report I ran was something closer to 75/25, so right in that

wheelhouse.

Eric Newell
And that just represents the fact that in my prepared commentary that we're focusing on C&I and consumer origination just because it's less sensitive to that flatter yield curve than the investor CRE. Investor CRE can get very attractive on a ROA and ROE basis on a steeper curve and we dabbled more in that when we did see that in the late fourth quarter, early first quarter, but obviously, that's reversed.

Collyn Gilbert
Yeah, that makes sense. Okay and then just one final question. Do you, can you just remind us what type of, if any, do you guys have in terms of SNC exposure?

Eric Newell
We do have SNC exposure and it is about…

Mark Kucia
Just under $300 million.

Eric Newell
Just under $300 million.

Collyn Gilbert
Okay, okay, great, thank you very much.

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

Matthew Breese
Good morning, everybody.

Eric Newell
Hey, Matt.

Matthew Breese
Eric, just on the swap fee income this quarter. I just want to make sure I have numbers right. Was that around $1.8 million, if I look at the deck the right way?

Eric Newell
Yeah, that's a good approximation, that's net.

Matthew Breese
Okay and then you guys, with a flatter yield curve, expect something similar in the quarters to come? Or if you could just kind of color that a little bit, what should we be thinking about?

Bill Crawford
Yes, Matt, I think we showed you on that slide, what we've got a 10-quarter average for swap and mortgage banking and I think that's a good way to think about. Last 10 quarters, we averaged 6.2%. This quarter, we are 6.5%. With a flat yield curve, we'll probably do a little more in swap and so that's sort of where our heads are.

Matthew Breese
Okay and then in the mortgage line, it was, was it pure gain on sale? Was there anything else in there like MSR write ups? Or was it just regular way of business there?

Eric Newell
It's total mortgage revenue. So it would include MSR and hedging and what not. It's not just pure gain on sale.

Matthew Breese
Okay, could you break that out or quantify that for me?

Eric Newell
I don't believe we have broken that out in the last several, actually years. I think we've changed this just to our mortgage banking revenue.

Matthew Breese
Okay.

Eric Newell
But, yeah, and I would go back to Bill's comment on kind of anchoring around that 10-quarter average. I don't expect that you're going to see a significant deviation from that. In terms of banking revenue, I think that if you look at the first half of this year, I think it's a good approximation to what we think is going to happen in the back half of this year.

Matthew Breese
Okay and then hopping to expenses, one item that caught my eye was just in the other expense line. It was, I think, $6.5 million this quarter, up quite a bit from last quarter. What drove that increase? Is anything notable in your eyes?

Eric Newell
Nothing notable. Just because I'm not recalling the answer to that. If it was, I will, you actually asked a question I don't have the answer to, so I will...

Matthew Breese
We can follow up.

Eric Newell
Yeah, we’ll need to follow-up, but I wouldn't, it's nothing that I would say is notable.

Matthew Breese
Okay and then just thinking about the loan pipeline. What was the average yield on the pipeline versus what's on the balance sheet? Is it accretive still at this point or dilutive? Just wanted to get some characterization there.

Bill Crawford
Yes, the loan pipeline, the stuff we're doing, Matt, it is accretive. That's a key focus for us and, obviously, it ties to what our funding looks like. We could make loan growth a lot higher if we wanted, but we want to continue to grow our NIM and so that's really the constraint on loan growth, is really how we fund it and to make sure we're funding it efficiently.

Matthew Breese
Okay and then my last question is, I noted that at several points during the quarter, United would be on Bankrate.com, especially in the money market account, with some fairly good rates and I want to get a sense for how much in deposits came from the online sources and what the balances were there.

Eric Newell
Yeah, we've been experiencing or experimenting in that channel and also doing some digital marketing because we've been learning about how that customer behaves and what we are learning we're also looking to use on our customers, our current customers. But to that end, the deposits gathered there aren't material to the total deposits and the rate that you are seeing, interestingly enough, has a lower incremental cost to us than what we would need to advertise in our brick-and-mortar footprint, because it's due to the competition and we are a little over banked here in New England.

Matthew Breese
Right. Okay, I'm just curious, geographically, where is the money coming from? Is it widespread or concentrated anywhere?

Eric Newell
It's widespread.

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

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

CONCLUSION

Bill Crawford
Great. Well, as you can see, we're very focused on improving profitability. We're working on how do we get to the 1.00% ROA a 10.00% ROE and a 12.00% return on tangible common equity, and you can see that we got pretty close this quarter to those numbers. That's where our focus is. That and we think we do that through our four key objectives and we look forward to seeing you guys next time. Hope you have a great day. Thank you.

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