Univest Corporation of Pennsylvania

Q4 and Yearend 2017 Earnings Conference Call

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CORPORATE PARTICIPANTS

Jeffrey Schweitzer - *President and Chief Executive Officer*

Michael Keim - *President, Univest Bank and Trust*

Roger Deacon - *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the Univest Corporation of Pennsylvania Fourth Quarter and Yearend 2017 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 0. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then 1 on your telephone keypad. To withdraw your question, please press star, then 2. Please note this event is being recorded.

I would now like to turn the conference over to Jeff Schweitzer, President and CEO of Univest Corporation of Pennsylvania. Please go ahead, sir.

Jeffrey Schweitzer
Thank you, Rachel, and good morning and thank you to all of our listeners for joining us. Joining me on the call this morning is Mike Keim, President of Univest Bank and Trust, and Roger Deacon, our Chief Financial Officer.

Before we begin, we remind everyone of the forward-looking statements disclaimer. Please be advised that during the course of this conference call, management may make forward-looking statements that express management's intentions, beliefs, or expectations within the meaning of the federal securities laws. Univest's actual results may differ materially from those contemplated by these forward-looking statements. I will refer you to the forward-looking cautionary statements in our earnings release and in our SEC filings. Hopefully, everyone had a chance to review our earnings release from yesterday. If not, it can be found on our website at univest.net under the Investor Relations tab.

We reported net income of $10.3 million during the fourth quarter, or 37 cents per share. This included a charge related to the revaluation of our net deferred tax asset of $1.1 million, or 4 cents per share, related to the passage of the Tax Cuts and Jobs Act of 2017. During the quarter, we raised a net $70.5 million of capital through a follow-on common stock offering. This capital was used to bring our capital levels more in line with peers and will be used for general corporate purposes and take advantage of strategic opportunities in the future.

The highlight for the quarter was loan growth of $132.9 million, or 15.2% annualized, which resulted in loan growth for the year of $334.2 million, or 10.2%. Much of this growth occurred in December as our ending loan balance of $3.62 billion was $114.8 million higher than the average loan balance for the quarter, which provides us solid momentum heading into 2018.

During the fourth quarter, we opened two new financial centers, one each in the Lehigh Valley and Lancaster as we continue to expand our physical footprint. The opening of these new locations was offset by the announced closing of three of our legacy financial centers as we continue to optimize our financial center footprint by consolidating locations in our historical core market that are in close proximity to other financial center locations and reinvesting the dollars associated with these locations in technology and our expanded footprint. We announced the closing of these locations on January 17, 2018, and will record a charge of between $600,000 and $700,000 related to these closures during the first quarter of 2018.

I will now throw it over to Roger for some additional discussion on our results.

Roger Deacon
Thank you, Jeff, and I would also like to thank everyone for joining us today. I'm going to discuss one item related to the fourth quarter but primarily focus my remarks on 2018 guidance.

As it relates to the net interest margin in the fourth quarter, our core margin was 3.72% for the quarter compared to a 3.69% for the third quarter. This increase included a minor benefit of approximately $225,000, or 2 basis points related to non-recurring fee income. So I would say our core margin was relatively flat on a linked quarter basis. The impact to our reported net interest margin included purchase accounting accretion of 4 basis points for the quarter, which is consistent with our expectations, and 7 basis points for the year. I'd like to remind everybody that we anticipate that this purchase accounting accretion will decrease and will be only 1 to 2 basis points throughout 2018.

As it relates to guidance for 2018, as a result of the reduction in the federal tax rate from 35 to 21%, we anticipate that our effective tax rate for 2018 will be approximately 19%, which includes the anticipated benefit associated with ASU 2016-9 or stock-based compensation. This guidance is down from our prior guidance of 29%. The amount of this benefit is impacted by our sizable tax-free loan and municipal lease businesses as well as our municipal bond and [unintelligible] portfolios. The currently effective tax rate will fluctuate as a result of the timing of vesting and exercise of equity awards.

Jeff referred to the closing of three branches and a related one-time charge of approximately $600,000 to $700,000 for the first quarter of 2018. The annual saves related to this activity are estimated to be $1.3 million. The 2018 benefit of approximately $900,000 has already been incorporated in our prior guidance of 5.5 to 6% expense increase for 2018.

We currently have no other change to our prior guidance for 2018, but just wanted to remind folks we are anticipating loan growth and guiding towards a range of growth between 8 and 10%.

On the core margin perspective, excluding purchase accounting, we are anticipating margin to be relatively flat for the year. We are anticipating that any benefit we see related to the federal rate increases could be offset by an increase in our deposit costs as a result of increased competition, which could result due to high loan-to-deposit ratios within our region and/or other financial institutions competing away some of the tax benefit from the rate cut, with more aggressive pricing.

That said, because we report net interest margin on a tax equivalent basis, our reported margin will decline 6 to 7 basis points for 2018 as compared to our reported margin in 2017. Accordingly, when combining the decrease in the benefit of purchase accounting accretion with the revised reporting related to the tax cut year-over-year, our reported comparative margin will be down 12 to 14 basis points.

Finally, as it relates to guidance and the loan loss provision, we have no change. Obviously, the provision is driven on a quarterly basis by loan growth and credit losses, but we are still guiding to approximately $2 million to $2.2 million per quarter, or approximately 17 to 18 basis points.

Finally, I would like to remind the group that, like many other financial institutions, our first quarter tends to be our least profitable quarter, with higher efficiency ratios and lower ROAs due to higher seasonal compensation and occupancy costs. These ratios should improve every quarter after the first quarter throughout the year.

I believe the press release was straightforward for the remaining items, and, accordingly, that's it for my prepared remarks. We will be happy to answer any questions. Operator, would you please begin the question-and-answer session.

QUESTIONS AND ANSWERS

Operator
Thank you. To ask a question, you may press star, then 1 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 2.

The first question comes from Michael Perito with KBW. Please go ahead.

Michael Perito
Good morning, guys.

Jeffrey Schweitzer
Good morning, Mike.

Roger Deacon
Good morning, Mike.

Michael Perito
I apologize. I got on a couple minutes late, so I'm sorry if I missed this, but any thoughts on kind of the mortgage business as you head into next year? I saw the comment in the release, that, you know, the supply kind of impacted the fourth quarter balances, but just curious how you guys are thinking about that business from a revenue perspective as we move into 2018.

Michael Keim
Yes, Mike, it's Mike Keim. Good morning. With regard to the mortgage business, when we talked in the third quarter earnings call, we talked about what we needed to do was go out and recruit additional people to draw business in for us. And that's exactly what we did. We hired two additional producing sales managers in the fourth quarter. They will also be growing teams underneath them, and, really, these are folks that are going to be able to bring purchase business in, not rely on referrals from the bank network.

So, we're continuing on that strategy on the mortgage side. The market—you know, in this market and where we operate, clearly, January's been cold, and we have snow on the ground, but to the extent that we move through the first quarter here and get into the spring purchase market, we believe that we will be able to continue to grow the mortgage business and regain past profitability levels that we had seen.

Michael Perito
Okay. Has there been any pickup at all, I guess, in the first month or so here, or has it been kind of similar levels or production at this point?

Michael Keim
We have—two things here, Mike. We ended the year and going into January slightly higher than we were at this time last year. A part of what goes on and goes through our P&L, and you can see that in the fourth quarter as well, is what is the mix of our business between saleable and portfolio? And in the fourth quarter, our portfolio mix was higher than it had been previously, so that impacts gain-on-sale levels, but it also does drive net interest income over time. That's basically carried forward into the early part of January. From a purchase perspective, we really see the markets start to pick up mid-February forward, and that is somewhat dependent upon the weather.

Michael Perito
Okay. And then just sticking in the non-interest income line for another question here, just any thoughts—you know, you guys got off to a pretty strong start on the insurance side. I know typically it kind of follows the trajectory that it always does, but just kind of curious if maybe you have any insight yet on kind of the contingency piece in the first quarter and any overall thoughts about how that line could track or any growth opportunities in 2018.

Roger Deacon
Yes. Mike, it's Roger. We anticipate it to be slightly higher than what it was the first quarter of last year. Last year was about a little bit more than a million dollars, and we're within that range, maybe a little bit better, the first quarter but not too significant.

Michael Perito
Okay. And then, finally, Roger, you mentioned—actually, I'm going to ask a different question. Jeff, on capital, the loan growth was solid. It seems like pipelines are good and the 8 to 10% growth is a good number. And it sounds like there's still some stuff you guys are doing on the expense side the early part of this year, but any thoughts on bank M&A? And maybe you can give us some updated thoughts around timing of when you think, you know, it would kind of be appropriate for you guys to get more—maybe aggressive is the wrong word, but be more open to opportunities there and how you guys are thinking about that over the next, call it, six to 18 months.

Jeffrey Schweitzer
Sure. Consistent with what we've said in the past, we are—you know, we're looking at still doing some stuff on the systems side, which will take us through the middle of this year, which will then allow us to be more proactive in looking on the bank M&A side. But I will caution, as I said in the past, that there's been a lot of consolidation in this market over the last few years, that we've participated in as well as others, and the opportunities that are out there aren't as robust as they were in the past. So there just isn't—with the consolidation that's occurred, there just aren't as many solid opportunities to acquire banks when we look out, that would really fit what we're looking to try to do. But from an ability to do it and be more proactive and look at it, you know, once we get into the second half of the year, we would be in that position.

On the other M&A side with mortgage—I mean, with wealth and insurance, we're always looking there, and we'll always continue to look and build a pipeline of potential acquisitions. Not to say that there's anything imminent, but it is something that the heads of those lines of business are focused on as part of their growth strategy.

Michael Perito

Thanks, Jeff, and those imminent bank M&A comments, I mean, is that broad in scope, or is that really just kind of like the Greater Philadelphia region? I mean, as you guys kind of move north and west organically, is that—is there a little bit more in those neck of the woods for you guys to look at, or does that comment that really encompasses all of those opportunities at this point?

Jeffrey Schweitzer
I would say it pretty much encompasses, you know, the markets that we're looking at. We're Southeastern Pennsylvania. As you said, we're going a little north, we're going a little west. But overall what would meet our criteria? You know we're not looking to do a small bank deal. We're going to grow loans 8 to 10% this year, you could do the math, that is a small bank, so for us to acquire a small bank, it's more disruptive than it necessarily is additive, unless we were entering a new market. So overall I would say that we're going to be looking more towards the billion dollar type of institutions, which, when you look at what's out there, that limits the pie that we can go after.

Now, as we expand geographically, obviously that could bring more players into the mix, but we're also looking to acquire stuff that enhances the franchise to the extent that we do acquisitions and not just making us bigger.

Michael Perito
Got it. Great. Thank you very much, guys, appreciate it.

Jeffrey Schweitzer
Thank you, Mike.

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

Matthew Breese
Good morning, guys.

Jeffrey Schweitzer
Good morning, Matt.

Roger Deacon
Hi, Matt.

Michael Keim
Hi, Matt.

Matthew Breese
I just wanted to go to the growth outlook. You know, when we talked about the capital raise, one of the potential outcomes was you were seeing opportunities to hire folks in your market, and I wanted to get an update there. If you actually have accomplished any of that, to what extent?

Michael Keim
Matt, it's Mike Keim. So we continue to be looking to recruit in all three of our primary markets as we run from a commercial perspective, which is the Lancaster market, what we call the Delaware Valley Division, as well as the Lehigh Valley. We did pick up another addition in the Lehigh Valley during the fourth quarter, and we are continuing to talk to people. There is nothing

out there at the present time that would be a whole team lift-out, but there's opportunities for us to cobble together a team and to potentially continue to move forward there, so we are looking at that. It is a tight market in terms of trying to recruit people and get talent, especially at this time of the year, because people are close to getting their bonus payments at most institutions and will stay for that period of time, but we are in deep discussions with several people and we'll continue to move forward.

Matthew Breese
So you picked up one—I totally understand the timing. You know, what is—what do you think is the goal that—you know, in terms of people, that gets you where you want to be by this point next year?

Michael Keim
Matt, typically we don't—I don't focus necessarily on the number of people that we pick up. I look at the quality of people that we can get, so I try not to limit ourselves. Do we budget to a number of people? Yes, but I'm more focused on if there is a team or if there is a group of people that makes sense for us, I'd rather focus on the quality of the book of business that they can help us grow, so I'm not going to commit to a specific number.

I would tell you, similar to what was discussed in the capital raise and what we've discussed on other earnings calls, we continue to look for it. If we could find another Lancaster team, we would certainly do that. We're looking to bolster the Lancaster market as we—as some of the people that we talk to. Can we go into your county a little bit and do some other things there? We would certainly do that, but we're not going to peg to a specific number, because in my past, that's actually caused problems, because you try to drive to hire a specific number of people, and it's not necessarily the quality people that you get and want.

Matthew Breese
Understood, Okay. And then, Roger, just on the NIM outlook, obviously a lot of moving parts as we head into the new year with the tax changes. Maybe frame it another way, you know, what are your expectations for net interest income, you know, growth year-over-year? I'll leave that question there.

Roger Deacon
Sure. Give me one second. The reported is roughly 6.5%, but remember that includes the purchase accounting. When we exclude the purchase accounting, then we're looking for a net interest increase of approximately 8.5%.

Matthew Breese
Great. Okay, that's very helpful.

Roger Deacon
So it's kind of consistent with that growth, kind of consistent with a flat margin.

Matthew Breese
Okay, and then you spoke about some volatility on the tax rate throughout the year. Where do you expect the high and the low points to be?

Roger Deacon

The low will be in the first quarter and somewhat in the third quarter. Most of our restricted stock vests in the first quarter, and we do have some that vests in the third quarter as well, but that's where the biggest benefit will be.

Matthew Breese
Understood, okay.

Roger Deacon
You know, options are a little tougher, because you can't really predict when they get exercised.

Matthew Breese
Right. My last one's really around the shape of the yield curve, obviously the five and ten years backed up quite a bit, and I just want to get a sense from what you're seeing higher yields pass through and, conversely, where you're seeing some of that spread computed away.

Roger Deacon
Yes, so I've released a new commercial loan production. We've seen a modest uptick during the year of maybe 5 to 10 basis points, but that's about it. So we really haven't seen a significant increase in new origination loan pricing.

The benefit we've seen over the course of the year related to increase in yields on our interest bearing assets, primarily relates to just our existing portfolio repricing. So, where we've actually done a great job this year is in increasing our non-interest bearing deposits, and that's really been what's helped us keep our margin, you know, what I would say relatively flat for the last two to three quarters. Our—the value of our—what we call free float is up 6 basis points from the fourth quarter of last year.

So, you know, it's competitive, and that's why I've really guided towards a relatively flat number. In theory, we should get a little bit of a benefit of a rate increase. We just don't know what's going to happen on that deposit pricing side, so I'm hoping I'm conservatively calling it by a flat margin for the year, but it's competitive, and what we don't know—we haven't seen it yet, but we don't know if competitors are going to get more aggressive and compete away the benefit of the tax cut by coming out with more aggressive pricing on loans or on deposits. So it's really a watch-and-see situation right now.

Matthew Breese
Right, understood. And if I could just ask one more.

Roger Deacon
Sure.

Matthew Breese
Obviously, with the change in tax rate, your bottom line should be a bit better, and I just wanted to get a sense for, with the added capital generation power, where will you first look to put that? Will it be in cash to sock it away maybe for something like [unintelligible] or a higher dividend or cash acquisitions? Just curious what your thoughts are there.

Roger Deacon
Well, at the current time, we've kept the capital at the holding company, and we're just using that to reduce our short-term borrowings. I don't really have the intention to put it in investments, and I don't have the intention of really changing my capital management strategy at the current time.

I'd like to put it to use through additional growth, maybe, you know, a folding on acquisition on the wealth or insurance side. And Jeff already discussed kind of the M&A—the bank M&A environment, but I think, obviously, the first place I'd like to spend it is organic growth, and if we had an opportunity to do lift-outs or the like, I would spend it there via an expense and capital usage.

Matthew Breese
Right. Okay. That's all I had. Thank you.

Jeffrey Schweitzer
Yes.

Roger Deacon
Thanks, Matt.

Michael Keim
Thanks, Matt.

Operator
Again, if you have a question, please press star, then 1. At this time, we will pause momentarily to gather any additional questions.

This concludes our question-and-answer session. I would like to turn the conference back over to Jeff Schweitzer for any closing remarks.

CONCLUSION

Jeff Schweitzer
Well, I'd just like to thank everybody for participating today. We're looking forward to a really solid 2018 and looking forward to talking to everybody at the end of the first quarter.

And Go Eagles! Have a good day.

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