Univest Corporation of Pennsylvania

Third Quarter 2018 Earnings

October 25, 2018 at 9:00 a.m. Eastern

CORPORATE PARTICIPANTS

Jeff Schweitzer - *President and Chief Executive Officer*

Roger Deacon – *Chief Financial Officer*

Mike Keim - *President of Univest Bank and Trust*

PRESENTATION

Operator
Good morning, and welcome to the Univest Corporation of Pennsylvania's Third Quarter 2018 Earnings Conference Call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. 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 Jeff Schweitzer, President and CEO of Univest Corporation of Pennsylvania. Please go ahead.

Jeff Schweitzer
Thank you, Brandon, 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 statement 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 $15 million during the third quarter, or $0.51 per share. The third quarter is historically one of our slowest growth quarters for loans, however, we did report solid loan growth of $47.8 million, or 5% annualized, bringing our year-to-date loan growth to $246 million, or 9.1% annualized. We believe we will come in at the higher end of our previously communicated guidance of 8% to 10% growth in loans for the year.

Additionally, deposit growth was strong for the quarter, as deposits grew $199 million during the quarter, or 22% annualized, primarily due to seasonal increases in public fund deposits. As a result, we ended the quarter with a loan to deposit ratio of 101.2%.

Finally, we continue to see benefits from our diversified business model, as revenues for the first nine months of 2018 in our wealth management, which includes our trust operations and insurance business lines, are up 9% and 6.2%, respectively, compared to the same period in the prior year.

I'll 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'd like to start off by saying I think we had a very good quarter. For the quarter, we were happy to report return on average assets increased to 1.23% and return on tangible equity increased to 13.7%, respectively. As it relates to our net interest margin, core net interest margin was 3.68%, which was down 2 basis points compared to 3.70% in the second quarter.

I would like to point out, as can be seen in the average balance sheets in the press release, that due to our strong deposit growth we had on average about $40 million in excess cash during the quarter. The impact of this excess liquidity was to reduce our core net interest margin by approximately 3 basis points.

We continue to see the benefits of a slightly asset-sensitive balance sheet, with 33% of the loan portfolios variable, 16% adjustable and only 51% fixed rate. Since the fourth quarter of 2016, which was the first quarter with an interest rate increase after the combined merger with Fox Chase, our core net interest margin has increased 15 basis points, from 3.53% to 3.68%.

Additionally, during the same period of time, our cumulative loan yield beta is 26.2%, compared to a lower cumulative deposit cost of funds beta of 21.5%. Due to the significant loan growth and stabilization of our margin, we would note that our reported net interest income increased 9.6% for the nine months of 2018 as compared to the same period in 2017. Excluding the purchase accounting benefit, which declined significantly in 2018, our net interest income for the same period has increased a solid 11.5% from the first nine months of 2017.

The provision for loan losses was $2.7 million for the quarter, or slightly higher than our prior guidance of $2 million to $2.2 million. The primary reason for this variance versus guidance is an incremental general reserve of $800,000 required for one large shared national credit loan, which was downgraded from special mention to substandard. As everyone is aware, the provision for loan losses and credit losses is event-driven. I continue to believe our run rate provision is $2 million to $2.2 million, rising modestly with the size of the balance sheet in 2019.

Fourth, as expected, our noninterest expense and our efficiency ratio continued to decline this quarter as compared to the first two quarters of the year. We have no change to our prior guidance of $138 million of noninterest expense for 2018, excluding restructuring charges. This would represent an increase of 5.5% for the year.

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

QUESTIONS AND ANSWERS

Operator
Absolutely. 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 our roster.

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

Michael Perito
Good morning, guys. Thanks for taking my questions.

All
Good morning, Mike.

Michael Perito
I have a few I want to hit on. I want to start maybe on loan growth. I apologize, I got on the call a couple of minutes late, so I apologize if I missed anything at the beginning of the prepared remarks. On the loan

growth outlook, obviously the growth was decent this quarter. I know the second and fourth quarter typically are strongest for you guys, but curious how you guys are thinking about the outlook here. Some of your regional peers have been talking up competitive environment and the ability to close on quality deals in the pipeline at good rate and structure. Obviously you guys have been moving west a little bit and seemingly, again, some good growth there, so I'm just curious what your updated outlook on loan growth is and what you guys think is achievable with the environment you're seeing today.

Mike Keim
Mike, it's Mike Keim. I would tell you, with Jeff's comments, that we had previously stated a range of 8% to 10%, and we believe that for the year we'll be at the higher end of that range. You are correct, and we've looked at a lot of our local competitors as well, there is a lot of competition, primarily on price, but a little bit on structure as well in some of our core markets. A good portion of our growth is coming from the Lancaster team that's growing and will continue to do such. When we look forward to next year, we're going to be looking at more of a budget of an 8% growth.

Michael Perito
Thanks, Mike. That was helpful. Is that reflective of stable pipelines, but an assumption around a lower closing rate, or do you think overall pipeline levels will be down year-on-year?

Mike Keim
Pipelines year-over-year, right now we still have a good pipeline and we will close through on the fourth quarter. For us looking forward we're just absorbing the market commentary that we're getting, and we just think it's more realistic to go into that 8% range.

Roger Deacon
I would just add, Mike, if you think about it on a dollar basis, 8% next year is approximately the same as a 9% to 10% in 2018. Yes, the notional dollar. So from our perspective it's not a significant reduction in what we believe we can produce as a company. It's more about the size of the balance sheet.

Michael Perito
No, that's fair. Obviously it's not; it's 100 basis points. Just curious what you guys are seeing, because of some of the commentary, so that was helpful. Thank you.

Secondly, any thoughts, Roger, on that same point especially with the pricing competition. How much room is there in terms of pricing and the yields you're getting on incremental loan production in the market and where you guys might start walking away from credits? I understand it can vary from credit to credit, but more broadly. Then secondly, how does that play into the margin as we move past next quarter? Any initial thoughts on that?

Roger Deacon
Sure. Our team has done a really good job of attaining new credits at good rates. During the quarter the average rate on our new commercial loans was approximately 5.1%. We're north of 5% on our new credits, and we've seen nice increases over the last three quarters in that metric.

Yes, it is getting competitive. What I'll tell you is, a little bit as it relates to the whole P&L, we're going through the budget process right now, but our goal for next year is just to continue to improve our marginal operating leverage. That's more at the macro level, if I can improve that 200 to 300 basis points and grow revenues at a 7.5% to 8% and grow my expenses at 4.5% to 5%, I've won in that equation. That's really what we're targeting to do as a business.

Do I think there's going be a little bit of pressure on margin? I do think there's a little bit. We had a little bit higher cost of funds on our deposits this quarter because of the public funds. That said, we were able to keep pace with our slightly asset sensitive balance sheet. So I think we can work through it, we're focused on working through it. We're seeing continued growth in our variable rate loans. There might be a little bit of compression on margin next year, but I don't see, from our perspective, what other institutions are seeing.

Michael Perito
Okay. A couple more I'll actually sneak in here. One just on credit, the Shared National Credit in the quarter, obviously it's been a strange year from a credit perspective because all the metrics and obviously the outlook seems stable, but there has been a couple episodic events in 2018. How are you feeling about the overall credit of the loan portfolio at this point as we move towards the end of the year and into next year?

Mike Keim
Mike, I think your depiction is accurate. Overall, our metrics are strong and we feel generally good about the credit quality of the portfolio. Obviously, we had the charge-off in the second quarter and the shared national credit that got downgraded in the third quarter here. You see a couple, and when they're a larger credit size, obviously they influence the provision in any given quarter. Generally speaking, we believe that the credit quality of our portfolio is strong, and we see no trends that would take us away from that.

Michael Perito
Then lastly, Jeff, on the capital deployment side, it's a unique situation because obviously you guys raised the capital not too long ago at the end of last year, and the growth's been solid this year at 10%, again, second consecutive year, more or less, and obviously there is one quarter left to go here. It does feel like, especially if growth's at 8%, that you're not really going be able to make a dent in that capital ratio just via your organic growth and current dividend.

I'm just curious, how are you guys thinking about capital deployment as you start to budget for 2019? Do you have to broaden maybe the toolbox a little bit here, especially with some of the recent weakness in the marketplace and look at maybe share repurchases, or go back to increasing the dividend? I was just curious. Any updated thoughts would be helpful.

Jeff Schweitzer
Overall on capital, the reason we raised the capital was multi-fold. We do see good organic growth, but as you said, it's not necessarily at a level that will eat into the capital that we raised. We do continue to look at opportunities on insurance and wealth for acquisitions and we work a pipeline of that on a continuous basis, not that we've closed anything this year, but it is something that we are actively doing, as we continue to look to build out our diversified model. We did buy back about 100,000 shares this quarter.

Roger Deacon
In the month of October.

Jeff Schweitzer
In the month of October—sorry, in the month of October to take advantage of what seems to us to be a ridiculous drop in share price. It's a good investment for our organization to buy back some shares.

On the dividend front, we hold firm with what we've always said there, that we need to get more back to peer level before we will start to increase that dividend, which should be low 30% payout ratio type of numbers. I do think there's still opportunities to continue to look at lift outs and continue to look at non-bank acquisitions. These all take time. But I do think that that is a use of capital that could happen in

2019 as we continue to move forward and continue to work on things that we have in the pipelines.

Michael Perito
Jeff or Roger, if you'd just remind me, the buyback, what's the size of the current authorization that you guys have outstanding still after the 100,000 in October?

Roger Deacon
It's slightly more than 900,000.

Michael Perito
Okay. All right, great. Thanks for taking all my questions, guys. I appreciate the color.

All
Thanks, Mike.

Operator
As a reminder, if you would like to ask a question, please press star then one.

Our next question comes from Matthew Breese with Piper Jaffray. Please go ahead.

Matthew Breese
Good morning, everybody.

Jeff Schweitzer
Good morning, Matt.

Matthew Breese
Just going back to the buyback a little bit, at current levels do you feel like you want to use the entire authorization?

Roger Deacon
No. One of the things, quite frankly is, we're looking out to 2020, where we have some sub-debt that will convert from its current fixed rate to a LIBOR based rate that's right around 8% or so. I do want to keep powder dry to pay down some of that sub-debt. It's a little bit of what do you do in a scenario where, look, stocks have been hit hard, right? And so I think we would all believe that buying our own stock would be a good investment at these levels, but it's also the concept that I do want to be able to pay down a decent portion of that sub-debt in 2020. We're looking at it both ways.

Matthew Breese
Understood. Okay. Could you give us a little bit of an outlook for the tax rate for 4Q in 2019? I know Fox Chase has some locations in South Jersey, and the tax situation there has changed. So is there any impact there?

Roger Deacon
Not really. We would say we're around 18.5% for the fourth quarter. When we look out to 2019, we would guide to a range of 19% to 19.5%. A little bit of it is just a function of the increased pre-tax income less benefit from your term differences, and we do have less municipal loans that are tax free now than we did a year ago. That would bring it up just a little bit. We're looking at 19% to 19.5% for next year.

Matthew Breese
Okay. Then maybe going back to the margin, I think you noted in your comments that you had some

excess cash and liquidity for the quarter that impacted the margin by 3 basis points. I was just curious, if we could see that used and maybe for 4Q should we get some of that back, should we see margin expansion in 4Q?

Roger Deacon
One of the things that we're anticipating is that the loan growth is going to be back-ended this quarter. So today I have some excess cash. The goal is over the next two months to utilize that. So by the end of the year you'll see it utilized for the quarter and on averages we'll still have a little bit excess liquidity like we did in the third quarter.

We don't mind that. That's just a function of developing really good relationships on the deposit front that are going to be of value for a long time to come. We know in the public funds arena, that there is a seasonal decline in the fourth quarter. It's just timing within the quarter on loan growth versus the deposit run-off.

Matthew Breese
Okay. Then just staying on the margins, as we go deeper into this cycle, one thing I'm observing in the Northeast is that the number of banks able to defend the NIM and retain an asset-sensitive position, the population just gets smaller and smaller every quarter. I was curious, as you look at your current pricing metrics for deposits, do you feel like there's any sort of shortfall versus where you are versus competition, and where we might see that tipping point of margin compression versus stability?

Roger Deacon
I think we feel good about our deposit pricing. As we communicated last quarter, we are operating a CD promotion that's 59-month at 3%, 23-month at 2.50% and a 13-month at 2.25%. We feel good about that pricing relative to if I had to go out and borrow term borrowings, these pricings are 25 to 50 basis points lower.

So I think where there's a possibility of getting squeezed a little bit is on the lending side, where we've been able to do 50% variable, 50% fixed, and I think that's going to switch a little bit to where borrowers are starting to lock in and may not be able to swap that. It just depends on the individual borrower. You may see a decline in new originations of the variable nature and more fixed rate there. It would be a slower grind on margin, I would say. I do think that's where you would see some pressure.

Matthew Breese
Right, okay. Your guide, if we're looking out over the next five or six quarters, is some slight margin compression on a core basis. Is that accurate?

Roger Deacon
Yes, that is correct.

Matthew Breese
Okay. Then my last one is just on the muni deposits for fourth quarter and into the first quarter of next year. What is the estimated outflow?

Roger Deacon
In the fourth quarter I believe it was about $70 million of outflow. Then next year it just becomes cyclical within their respective cycles. In Pennsylvania, the third quarter is big for school districts, that's when the school districts raise their taxes for the next year, so they get all their funds in basically August, early September. There's a liquidation throughout the rest of the year on that, where the low point is June 30th and then it recycles again. We will plan accordingly for that, but I can tell you, the second quarter of

every year will be our highest loan to deposit ratio.

Matthew Breese
Understood. Okay, that's all I had. I appreciate it. Thank you.

Operator
Our next question comes from Chris Reynolds with Neuberger Berman. Please go ahead.

Chris Reynolds
Good morning, gentlemen.

Jeff Schweitzer
Good morning, Chris.

Chris Reynolds
I have two questions. The first relates to just the general housing market in your operating footprint. It's well documented that housing activity and prices in the Northeast, whether it's Connecticut or New Jersey, has been soft over the last couple of quarters. I'm wondering what you're seeing in your operating footprint. Then also, can you provide an update on just your expansion in and around the Philadelphia market, which is important for you for growth?

Mike Keim
So on the first Chris—it's Mike Keim. With regard to the housing market, on the residential side it's just simply the available supply that's out there in the markets, and our footprint is down. Turnover is quick, and there wasn't a lot that was added quarter-over-quarter. Actually, home appreciation is up a little bit, but the supply is down, so that clearly hurts us on the mortgage side, and we go from there.

With regard to the next question, with Philadelphia expansion, we've laid out, we have six financial centers and an LPO that sits in Center City Philadelphia. We continue to add people and look to add talent as we go, but we have not added additional physical infrastructure. And at this point in time, we're not looking to add additional physical infrastructure. We're putting a lot of focus more on the digital side of the equation for our growth.

Chris Reynolds
Okay. Thanks a lot.

Operator
Our next question comes from Frank Schiraldi with Sandler O'Neill. Please go ahead.

Frank Schiraldi
Good morning. Most of my questions have been answered, but I just wanted to ask, Roger, just following up on the promotions you talked about, just wondering what traction you're getting there? Then given liquidity on the balance sheet, are you looking to shut off the taps there at all? Then finally just how that compares in pricing to brokered CDs these days.

Roger Deacon
Sure. To answer your question, I'm not worried about having a little bit of excess liquidity. To me I'm about a wash in the P&L on that, and so if it's a little bit of a ding to the margin, I don't really care, because I really care about net interest income.

I don't really have any intention of turning off the spigot on the CD programs, primarily because they've been successful. I have borrowings that are maturing longer term that I'm not going to replace. I'm just going to continue to use the CD programs. The only time you would change that, quite frankly, is if you thought rates were going to turn the other way, and I think it's a little too early for us to really get a sense of what's going on. If the Fed does increase three to four more times in the next five quarters, then these decisions on the CDs I think are going to be the correct decisions.

As it relates to our comparative rates, for example, on a five year brokered CD is a 3.38% five year overnight with the Fed all-in cost is about a 3.40%. I'm 40 basis points better and I'm doing it with customer CDs, which are obviously much more attractive.

One thing I would say this quarter, for example, we track our CD programs by new dollars that come into the bank. Last quarter we had $51 million new deposit dollars, and that related to 298 new customers. This quarter it was 173 new customers, with new dollars of $35 million. That's a nice way to make traction within our market area as well of attracting new customers and the opportunity to cross-sell. I'm really winning two birds with one stone relative to just going out to the wholesale market.

Frank Schiraldi
Great. Okay. Thank you for all the color.

Roger Deacon
Sure.

CONCLUSION

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

Jeff Schweitzer
Thanks, Brandon, and thanks to everybody for joining us on the call today. We appreciate you participating, and look forward to talking to everybody again in January after we report fourth quarter earnings. Have a great day.

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