Univest Corporation of Pennsylvania

2Q 2017 Earnings

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CORPORATE PARTICIPANTS

Jeff Schweitzer –*President and CEO*

Michael Keim – *President of Univest Bank and Trust*

Roger Deacon – *Chief Financial Officer*

PRESENTATION

Operator
Good morning, and welcome to the Univest Corporation of Pennsylvania Second Quarter 2017 Earnings conference call. All participants will be in a 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, Brian. 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's 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 found on our website at univest.net under the Investor Relations tab.

We reported net income of $11.8 million during the first quarter or $0.44 per share, which included a BOLI death benefit of $889,000. Excluding this benefit, net income was $10.9 million or $0.41 per share. A couple of highlights for the quarter was strong 20.1% annualized loan growth, as we experienced strong commercial loan growth across all of our markets.

As we discussed last quarter, our second and fourth quarters tend to be our strongest quarters for loan growth. When combined with the first quarter, our year-to-date annualized loan growth is 13.7%, and we remain comfortable with our previous guidance for the year of 10% to 12% as we anticipate slower growth in the third quarter as seasonally the first and third quarters are typically lighter quarters for us. Additionally, our efficiency ratio was 60.74% during the quarter, 61.8% excluding the BOLI gain, as we continue to focus on driving down our efficiency ratio.

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 a couple of items from the earnings release.

First, our net interest margin, as disclosed core net interest income, which excludes the impact of purchase accounting adjustments was $34.5 million for the second quarter and represented a $1 million or 3.1% increased as compared to core net interest income of $33.5 million for the first quarter. Our quarter margin, again excluding purchase accounting adjustments, was at 3.68% compared to 3.72% for the first quarter, but up from 3.61% in the fourth quarter of 2016. The decrease in the current quarter of 4 basis points is primarily due to an increase of cost of funds due to increased competition on public funds and commercial deposit rates and increased borrowing costs as during the first half of the year we opportunistically termed out $125 million in longer return borrowings at an average life of 3.5 years at a rate of 1.84%.

I believe from the margin perspective it's better to analyze where we are in the second quarter compared to the fourth quarter. This comparison includes the 50 basis point impact of the two 25 basis point increases in December and March. From the fourth quarter of 2016 to the second quarter of 2017, excluding purchase accounting adjustments, our margin increased 7 basis points from $361 to $368. This increase is due to an increase in yield on our interest-earning assets of 14 basis points offset by an increase in our cost of interest-bearing liabilities of 8 basis points. Again, I believe this increase in net interest margin better demonstrates the asset sensitivity of our balance sheet.

Second, I would like to discuss is the provision for loan losses. During the quarter we reported a provision of $2.8 million. As we know, the provision is comprised of an increase in general reserves, which relates to the growth of our loan portfolio and specific reserves and charge-offs is the other component. Half the provision for this quarter, or $1.4 million, solely relates to the significant growth that Jeff previously explained. And the other $1.4 million relates to specific reserves and charge-offs. I believe the press release was pretty straightforward as it relates to non-interest income and expense.

Accordingly that's it for my prepared remarks. We'll be happy to answer any questions. Operator, would be please begin the question-and-answer session.

QUESTIONS AND ANSWERS

Operator
Sure. We will now begin the question and answer session. To ask a question, you may press star, then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then two.

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

Michael Perito
Hi good morning, guys.

Jeff Schweitzer
Good morning, Mike.

Roger Deacon
Good morning, Mike

Michael Perito
Two questions from me maybe starting on the deposits. I know the second quarter you had some seasonal impact. It sounds like from the outflows and municipal deposits, but the loan-to-deposit ratio crept up a bit to 104 and 105. Just curious, it sounds like it could rebound a bit next quarter and with the seasonally slower growth quarter, but any outlook, commentary around where you expect that ratio to trend over the next year or so and what range you guys are comfortable operating the bank in?

Roger Deacon
Sure, Mike. So, one of the things we like to look at is not spot, but average and our average loan-to-deposit ratio for the quarter was a 101.6 versus the higher 104 and change at the end of the quarter.

The loan growth was primarily in the month of June and the seasonal run-off of our public funds, which is primarily our county money runs off and before the school district money comes in Pennsylvania in the third quarter. So, we're more focused on the averages here rather than points. We think we're going to around a 102 to 102.5 at the end of the third quarter and the averages will be somewhere around that as well for the quarter. As we operate the bank we really would be prefer to be in that 100 to 105 range. I'm comfortable being at 105, particularly if you know it's just timing with some future events, but we really would like to operate in that 100 to 105 range.

Michael Perito
Okay, thanks, Roger. Maybe on the [audio disruption], out here maybe just near term we had the raise in June. It sounds like you guys will have some funding rebound in the third quarter at least on a relative basis. Is there is room for some mention of those longer-term termed borrowings behind you or how are you guys thinking about that?

Roger Deacon
You were breaking up a little bit, Mike, is your question related to our thoughts on margin?

Michael Perito
[Audio disruption]

Roger Deacon
The margin quite frankly is really going to be driven by what we're seeing on the deposit front. We did see an increase in competition in the second quarter. I think that was—after the second rate increase in March. I think some folks woke particularly in the public funds world where it had been relatively quiet. I think our customers are starting to think that the rate should be passed onto them and also on larger commercial customers. So, it will be interesting to see how the third quarter plays itself out, but the margins are really going to be driven by the beta on the deposits.

I'm really looking at what I would say a flat margin for the quarter, which means the benefit of the rate increase will be offset by incremental deposit costs. If I win a little bit, I'll take it, but we are also trying to operate in that 100 to 105 range as well.

Michael Perito
Okay and then one last one maybe for Mike. Loan growth was really strong in the quarter. I'm curious if you can give us any color about kind of the geographic breakdown and also looking for an update. I've heard from some of your peers at Lancaster [audio disruption] has picked up quite a bit the last six months, just curious any thoughts around that.

Michael Keim
So overall, Mike, loan growth is really across all of our footprint. All three of our divisions contributed solidly in the quarter. We continue to see significant growth coming from the Lancaster market. If your comment—and again you broke up a little bit—was relative to increasing competition in the Lancaster market.

Michael Perito
Yes, it was.

Michael Keim
So, competition continues to play there. I will tell you what we really see is in the niche market that the team that we brought on board, we can continue to grow and will. To the extent that we look to a larger size credit, some of the larger players in the marketplace are being very aggressive from a pricing

perspective. So, that is where we would see the most competition and where we need to stay disciplined to protect our margin where others can step in with and do what they need to do. But to the extent that we stay where we are very good at and our niche in that marketplace, we continue to see good growth at solid margins. Lehigh Valley, as we talked about on other calls, continues to be an area for growth there, so we saw fairly significant uptick in Lehigh Valley. And across our core market, which we call the Delaware Valley Division, we also had solid performance.

Michael Perito
Okay, great thanks, guys. I appreciate all the color.

Michael Keim
Thank you, Mike.

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

Frank Schiraldi
Hi guys, good morning.

Roger Deacon
Good morning, Frank.

Frank Schiraldi
Just a couple of questions. Just following-up on deposit costs. So Roger, from your comments, it sounded like it's primarily the institutional side. Are you seeing anything on the retail side yet in terms of pressure to increase?

Roger Deacon
Our core rack rate, we're not seeing it across the board, but we're seeing a lot more promotions in the marketplace on the money market and CD side. You're seeing a lot more of that than we were three months ago.

Frank Schiraldi
Okay, and are you prepared to allow—given, it seems like the pressure is coming mostly on the institutional side maybe not all of that is a good relationship and you might let some of that roll off. I know given your loan-to-deposit ratio that makes it tougher. Are you allowing any of this to roll off as opposed to increasing rates and then maybe looking at the wholesale market, which might even be a little cheaper or no?

Roger Deacon
Quite frankly no. We have rates that we're targeting internally as it relates to the public funds and larger commercial customers. And from my perspective there is a value to the institution of these relationships as opposed to being wholesale. So, similar to this 100 to 105 loan-to-deposit ratio, I really don't want to significantly increase my wholesale borrowings and brokered CDs to my total assets either. So, quite frankly—

Jeff Schweitzer
We'll defend our turf.

Roger Deacon
We'll defend our turf, well said, Jeff.

Frank Schiraldi
And then, I just wondered if you could maybe give a little color on credit and just how you're feeling about the previous guidance on credit costs.

Roger Deacon
I'm still comfortable with the previous guidance. Quite frankly, this quarter was solely due to the sizable loan growth, which was larger than I had quite frankly predicted on a quarterly basis. So, if you had a slowdown in the third quarter, you would see some decline in the provision in third quarter.

Michael Keim
Yes, overall on the book of business, Frank, we see credit quality continuing to improve. So, that goes hand in hand with what Roger just said. So, to the extent that our provisions go up and down, it is really tied to our loan growth.

Frank Schiraldi
Okay, great and then just finally, I'm sorry if I missed it, but in terms of the expense base kind of right in line with the guidance for the full year and I would guess you're reiterating that and then we should expect sort of flatness going forward. Is that reasonable?

Roger Deacon
Well, I think I'm still at 130 for the year, which is roughly a 32.7 the next two quarters and that's how I'm thinking about it. We continue to invest when we have the opportunities to invest in technology and in people. We're not going to sit with a pause. So, for right now, I'm going with that 32.7 per quarter and 130 for the year.

Frank Schiraldi
Got you, alright thanks, guys.

Roger Deacon
Thank you.

Operator
Next question comes from Matthew Breese with Piper Jaffray. Please go ahead.

Matthew Breese
Good morning, everybody.

Roger Deacon
Hi, Matt.

Matthew Breese
Just going back to the deposit growth strategy. I mean just thinking about maintaining that loan-to-deposit ratio of 105 or even moving it a little bit lower, your loan growth projections are 10%, implying you have to at least keep that on the deposits front, so $350 million more in deposits. Where do you see the majority of that $350 million coming from? Is it the muni and commercial side? Explain to me what the incremental cost there is today versus what it was six months ago.

Jeff Schweitzer
I'll cover some of this, Matt, and then I'll let Roger chime in on some of the cost side of the equation.

But if you look at where our growth will come from over time, it will continue to come from the public fund side. In the Lancaster market and Lehigh Valley we really haven't penetrated those markets from a public fund market perspective like we can. Our commercial customers, and really tie that to our cash management activities, and continue to build out and focus on cash management operation and run that like a standalone business that also complements the commercial lending business. And then we have some other opportunities and initiatives that we're working on as well.

And the other part of this and the last part of this I would say is we've opened up several locations on the consumer side. We need to continue to work on those to reap the benefits of the investments that we've made. So, we're very cognizant of the fact that loan growth at 10%, you can't keep doing that and growing deposits of 5%. So, we are working on those initiatives to narrow that gap and keep ourselves from a loan-to-deposit ratio in the range that Roger referenced earlier.

Roger Deacon
And so from a cost perspective, we've had three rate increases since December, March, and June. On those folks, I would say on average we're 50 to 75 basis points higher than where we were in December.

Matthew Breese
Okay, and where were you in December just for reference sake?

Roger Deacon
I would say on average you were at the 25 to 50 basis points.

Matthew Breese
Okay, and then maybe turning to capital levels, tangible common equity is at 7.8% this quarter. You've been here before, but certainly on the lower end. Could you give us some color on your comfort level and where capital needs to be?

Roger Deacon
Sure, so I've communicated this at different conferences and the like, but we're down a little bit for this quarter just because of the loan growth. We're really looking at that 8%-type number of managing to, but we're comfortable being a little bit below from point-to-point. But from a management perspective, we've communicated the intention is to not increase the dividend and to retain all the extra earnings that we have to support our loan growth going forward. Our projections indicate that that's adequate even though it's not excessive, but it's adequate for us in terms of managing our capital ratios.

Matthew Breese
Okay, and then last from me is really given where we are in the year, we're about a year after the Fox Chase closing. We're about a year after the bulk of the Lancaster team hires. Just give us a sense of where we are in terms of what's actually occurred versus expectations and is it better or worse than what you guys originally outlined?

Jeff Schweitzer
I would say that it's going according to the plan. The loan growth numbers that we had anticipated are happening, with the Lancaster lift out that really provided some extra juice to our loan growth. But across the board from all the conversions, the consolidation of locations, integration of people, and just the overall growth of the company it's really gone according to plan.

Lancaster is actually a little bit ahead of schedule as far as their loan growth. They're probably a good $40 million higher than we would've predicted at this time. And I would say from the Fox Chase side, that's gone pretty much as we designed it. So, we're really pleased.

Roger Deacon
And I would add that from a financial perspective the same. Our goal here is really to achieve operating leverage and right now we're starting to show that, and as you look forward going forward to third and fourth quarter having revenues grow at a much greater rate than our expenses is the key. And from my perspective we're really executing rate along with our thought process on that.

Matthew Breese
Right, and then I know for when this all happened you guys were in the mindset of "Let's maintain culture and keep things cohesive and be out of the M&A game for a little while." Has that changed all now that everything is on track?

Jeff Schweitzer
No, we're still probably a year out from looking at any bank M&A. There is some stuff that we're still working on putting in Salesforce. We just put in a new mortgage system. There are some foundational things that we're doing on the tech side that we want to get in place before we would do another bank transaction. We had talked about 18 to 24 months when we did the Fox Chase deal when we closed it and we're 12 months into that. So, I would say we're sticking to what we had provided guidance on back then.

We want to make sure that as we're prepared for the next level of growth whatever that maybe, whether it's lift outs or M&A, that we have some foundational things buttoned down.

Matthew Breese
Very good. That's all I have for questions. Thank you, guys.

Roger Deacon
Thank you.

Operator
Again, if you have a question, please press star, then one. 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
Thank you, Brian, and thank you to everybody for joining us today. As we've noted we're pleased with the quarter and we look forward to talking to everybody again after the third quarter. Have a great day.

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