Univest Financial Corporation

Q4 2018 and Year-End Earnings Conference Call

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CORPORATE PARTICIPANTS

Jeffrey Schweitzer – *President and Chief Executive Officer*

Roger Deacon - *Chief Financial Officer*

Michael Keim – *President of Univest Bank and Trust*

PRESENTATION

Operator
Good day and welcome to the Univest Financial Corporation Fourth Quarter 2018 and Year-End 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 (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 Jeffrey M. Schweitzer, President and Chief Executive Officer. Please go ahead.

Jeffrey Schweitzer
Thank you, Andrew, 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 $18.4 million during the fourth quarter, or $0.63 per share, bringing earnings for the year to $50.5 million or $1.72 per share. Our fourth quarter results include the recovery of $1.8 million, or $0.05 per share after tax related to the loan we previously charged off in the second quarter related to fraudulent activities of employees of the borrower.

We were very pleased with our results for the quarter as we finished the year strong with loan growth during the quarter of $140.4 million, or 14.5% annualized, bringing loan growth for the year to $386.5 million, or 10.7%, which exceeded our previously communicated guidance during the year of 8% to 10% growth as we continue to see solid loan demand due to market disruption and the strength of our local economy.

Additionally, deposit growth was solid for the quarter as deposits grew $65.9 million during the quarter, or 6.9% annualized, primarily due to increases in commercial and consumer deposits offset by seasonal declines in public fund deposits. For the year, deposits grew $331 million, or 9.3%. Finally, we continue to see benefits from our diversified business model as revenues for 2018 in our wealth management, which includes our trust operations, and insurance business lines are up 6.8% and 5.9% compared to the prior year.

I'm going to 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. I'd like to start off by saying, I think the fourth quarter was another very strong quarter for our company. As Jeff mentioned, we reported earnings of $0.63 per fully diluted share for the quarter and $1.72 for the year. In our

press release, we highlighted three unusual and nonrecurring items. First, as Jeff mentioned, we recognized the $1.8 million recovery, or $0.05 per share related to the loan we charged off in the second quarter. The total impact of this loss for the year was $10.9 million, or $8.6 million after-tax, which equates to $0.29 per diluted earnings per share.

We also recognized reduced executive compensation of $496,000 related to vesting of performance-based restricted stock and bonuses as certain performance metrics were not achieved during the measurement period. These two items were offset by a $287,000 reduction of BOLI income as we have approximately $2.7 million invested in nonqualified annuities, which are tied to the equity market volatility.

As it relates to our net interest margin, core margin was 3.70%, or up 3 basis points compared to the third quarter of the year. This increase included a benefit of approximately $327,000, or 3 basis points related to nonrecurring fee income. I would like to point out, as can be seen in the average balance sheets in the press release, our loan growth during the quarter was back ended and that due to our strong deposit growth, we had an average of about $50 million in excess cash during the quarter. The impact of this excess liquidity reduced our core net interest margin by approximately three basis points, which is consistent with the third quarter.

Net interest margin continues to benefit from our slightly asset-sensitive balance sheet and the 25 basis-point rate increase we experienced in September. Since the fourth quarter of 2016, the first quarter with an interest rate increase for the post-merger combined entity, the cumulative loan yield beta is 28.8% compared to a lower cumulative deposit cost of funds beta of 24.6%. Additionally, our core deposit beta, which excludes public funds and broker deposits, is only 9.5% for the same period.

Due to the significant loan growth and modest increase in core margin, we would note that our reported net interest income increased 10.4% for 2018 compared to the same period in 2017. Excluding the benefit of purchase accounting accretion, which declined significantly in 2018, our net interest income for the year increased 12% from 2017. Second, the provision for loan losses of $103,000, which benefited from the $1.9 million in net recoveries for the quarter.

As we look to 2019, we would guide to approximately $2.2 million to $2.4 million per quarter in loan loss provision. Third, as expected, our noninterest expense and efficiency ratio continued to decline this quarter as compared to the first three quarters of the year. Excluding the first quarter restructuring charges, noninterest expense for the year was $136.7 million, representing an increase of 4.6% from 2017. If we were to add back the fourth quarter executive compensation adjustments, that increase would be 4.9% for the year. As it relates to 2019, we would guide to a 5.5% to 6% increase in expenses as we continue to hire additional revenue-producing lenders and wealth management insurance employees as well as invest in technology, including the digital platforms. We have no new financial centers planned for 2019.

Finally, I would like to remind the group that the first quarter of each year tends to be our least profitable quarter, with higher efficiency ratio and lower ROA due to seasonal payroll taxes, merit increases, and occupancy costs. Similar to 2018, this ratio will improve every quarter throughout 2019. I believe the press release was straightforward for the remaining items and accordingly, that's it for our prepared remarks. We will be happy to answer any questions.

Operator, would you please begin the question-and-answer session?

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 Frank Schiraldi of Sandler O'Neill & Partners. Please go ahead.

Frank Schiraldi
Good morning.

Jeffrey Schewitzer
Good morning, Frank.

Roger Deacon
Good morning.

Frank Schiraldi
I wondered if, Roger, you could talk about the--obviously, you mentioned the back-loaded loan growth. I wonder if you could talk a little bit about the NIM, sort of what the NIM looked like maybe later in the year, maybe for the month of December. Or just maybe just give us some color on your expectations for what that does to the NIM and your anticipation of mechanics going forward.

Roger Deacon
Sure. So, going forward in the first couple quarters, we're not going to be in a situation where we have excess liquidity. So that three basis points we saw this quarter would be--of excess liquidity would kind of be an add-back. For the first quarter, we've got this benefit of the December rate increase, so I would anticipate that our margin would be relatively flat this quarter. Again, it's going to depend on deposit pricing and competition. And, then the only other thing I would say going forward is that if the Fed does pause on their rate increases in March, the second quarter forward, we'll probably see a little bit of compression, just the fact that we won't get an increase on the asset side. And, as liabilities tend--will mature on our CDs and borrowings and the like, they'll reprice at a slight--at higher rates. So, I think we're going to be flat for the first quarter and probably a little bit of compression if you believe the Fed is going to pause going forward.

Frank Schiraldi
Okay. And then I just wonder if you can give a little more color on--you mentioned the expectations for increased expense in 2019, which is a bit above what I had. And, so if you could you just maybe talk a little bit about how much of that is incremental tech versus bringing on revenue-facing employees?

Roger Deacon
Yes, it's really, it’s a combination of the both. It's all--our strategy is to continue to invest in the business and revenue-producing investments. So, we will--we plan to be aggressive in trying to hire new lenders this year. And, so that incorporates that aggressiveness and we just wanted to lay that out there in advance that we are going to be investing in the business. Additionally, we've done a lot of investment in infrastructure on the technology side. We're close to the end

of that, but now we're starting to really invest in digital initiatives. That's why we mentioned that we're not going to be investing in financial centers, but more on the digital side.

Michael Keim
Yes, Frank, it's Mike Keim. I would tell you, from a technology perspective, a couple things. One, we will be rolling out a new mobile app for the bank in the first week of February. We continue to make investments in Encino to enhance what we're doing on the commercial loan side as well as we're looking at possibly utilizing Encino from the consumer deposits and personal loan side as well so that we continue to have the digital experience that our customers expect.

Beyond that, from an infrastructure perspective, we're in the process of moving to Office 365 in the cloud. So, that's going well also. So, to Rog's point, we're not--we're never going to stop investing in the business because we think it's critical for us to continue to drive forward, to increase revenue while keeping the expense base relatively consistent so that we can drive down the efficiency ratio.

Frank Schiraldi
And then just finally on buybacks. So you had talked about some repurchases that you made in October back on the 3Q call, and it looked like that sort of trailed off later in the quarter just given where your end-of-period shares were versus the last quarter. So, how are you thinking about buyback activity here given you still, I think, have some under your current program?

Roger Deacon
Yes, we do, Frank. And, I think it's a little bit consistent with what I mentioned last quarter. We did another 50,000 this quarter, so we did another 150,000 total. What we're really focused on is redeeming a good portion of our sub-debt in March of 2020. And, so that's where we want to keep our powder dry. Again, we were--150,000 shares is not that significant relative to what other folks are doing, but we thought that, given pricing, that was appropriate. But, in the long run, we'll really focused on reducing that sub-debt to a level we're more comfortable operating with in 2020.

Frank Schiraldi
Great. Okay, thank you.

Roger Deacon
Sure. Thanks, Frank.

Operator
The next question comes from Michael Perito of KBW. Please go ahead.

Michael Perito
Hi, good morning, guys.

Jeffrey Schweitzer
Good morning, Mike.

Roger Deacon
Morning, Mike.

Michael Perito

I wanted to ask a couple things. I guess, one, Roger, you were just talking about the 3 bps from the liquidity build that should go away. But, I was just curious, can you remind us what you think kind of is a core level of liquidity that you guys are--we should expect you guys to operate with going forward?

Roger Deacon
On an excess liquidity basis, we would operate with none. I mean, you know, we now--if our loan-to-deposit ratio is greater than 100%, my balance sheet -- I'm doing short-term borrowing without excess liquidity. It just so happened that with the nice public fund deposit growth in the third quarter and just continued strong deposits in October and November offset by the loan growth being later in December, we did have excess liquidity in the fourth quarter. But going forward we really…

Michael Perito
Yes, yes. No, I'm sorry. I must have asked that question incorrectly. I mean, what's the normalized liquidity level that we should expect you to operate with going forward? Because if I look at you guys over the course of 2018, the investment portfolio was fairly steady, about $450 million to $460 million, but the cash and cash equivalents position was $50 million to start the year, built a bit over and it's been $110 million, $120 million in the back half of the year. So, I'm just curious, is it closer to $50 million? Is it a little higher than that now given the balance sheet growth? Just curious how you're thinking about that.

Roger Deacon
No, it would still be in that $50 million number we were talking about at the beginning of the year.

Michael Perito
Okay, got it. Thank you. And, then on the noninterest income side. The--it seems like you guys are run rating about $14.5 million to $15 million in the last few quarters. I think obviously, in the first quarter, my expectation would be for you guys have a little bump in the insurance business, like you typically do. But maybe if we back out the contingency income, what are you thinking about a core run rate there, given some of the market volatility we've seen, the mortgage environment. Is there any--can you give us some help there on how you're thinking about that?

Roger Deacon
Yes.

Jeffrey Schweitzer
Well, I'll let Rog get into the numbers. But on the insurance side, the first quarter is always higher because of the contingent income. But backing that out, that's 5% to 7%, which we came in at 5.9% this year. So 5% to 7% type of increase year-over-year that we expect on a yearly basis. Wealth was impacted by the market conditions. We lost $120 million or so in AUM in the fourth quarter just because of the market decline. So, obviously, building on that hurts revenue a little bit.

Now, we got about half of it back already due to some of the recovery as we head into the first quarter, but that will have a little bit of an impact at the beginning of the year. But, overall the RIA is 10% to 12% type of growth and trust is really 3-ish percent type of growth. So, when you average them out, it's really in that 9% to 10% overall growth for the wealth management business. And frankly, mortgage, I don't know if you want to talk about mortgage, Mike.

Michael Keim
Yes, the first quarter is always going to be a slow one just because of the seasonality. We have stabilized, I think, at this point. Our pipeline has been consistent for the last month or two, so that looks good. Margins have come down. I think you've seen this not just at our regional competitors, but also at the money center banks. Margins are down pretty dramatically. Ultimately, as the market kind of settles itself down and mortgage and the excess capacity on the operations side come out of that, I would expect margins to normalize again. We were down 50 basis points or so on the margin side of the equation.

So, we'll see some of that come back, and we also continue to extend our recruiting net, for lack of a better term, so that we can widen the area as we widen the area in totality that we operate in, widen that area that we recruit mortgage bankers--mortgage loan officers to join us as well. So, hopefully, we'll see some come-back, for lack of a better term, on the mortgage side as well.

Roger Deacon
So, at a macro level--at the macro level, we would look for noninterest income, combining all of those factors, to be up about 5% year-over-year.

Michael Perito
Okay. That's helpful. Thank you, all. And, just a couple more if I could squeeze them in. One, just on the interest recovery, can you just give us an update on that credit, I guess, just broadly? I'm sure specifics can be eliminated, but is there room for more to be recovered? Or, do you think that it's kind of played out at this point? Just any update you can provide us there.

Roger Deacon
Yes, we don't know. I mean, it's still being worked. If we were to get something, we couldn't really guess at the current time. If we get it--if we get a little more, that's just gravy from our perspective. It'll still be worth a little bit, but we feel good where we ended up the year with that and getting that $1.8 million.

Michael Perito
Sounds good. And, then on loan growth for next year. I think last call, we--you guys had discussed 8%. But, obviously a strong fourth quarter here. And, then it seems like you're baking in additional hires into--conservatively into your expense run rates. I'm just curious if that 8% is still the case or are we looking more at a range similar to this year? It could be 8%, but could it also be a 10% type of scenario?

Michael Keim
Mike, we're going to stay committed to the 8% at this point in time. We'll continue to be active, as both Jeff and Roger referenced, in recruiting folks. But, at this point in time, given the existing staff that we have in place, 8% is the appropriate number.

Roger Deacon
Yes. One item to note on that, Mike, is we did have significant growth in the mortgage portfolio last year, and our goal would be to sell a higher percentage of that, and that would bring down growth in that portfolio, which is part of the reason we keep bringing down the overall targets.

Michael Perito
Got it. Very helpful, gentlemen. Thank you for taking my questions. I appreciate it.

Roger Deacon

Thanks, Mike.

Operator
Again, if you have a question please press star (*), then one (1) on a touchtone phone.

The next question comes from Brody Preston of Piper Jaffray. Please go ahead.

Brody Preston
Good morning, everyone. How are you?

Jeffrey Schweitzer
Good morning, Brody.

Roger Deacon
Hi Brody, how are you doing?

Brody Preston
I'm doing well, thanks. I think most of my questions have been answered. But, I guess I just wanted to, I guess, add into the tax rate a little bit. I know looking back, some of Fox was based in New Jersey and I wanted to know if you guys were expecting any impact from the change in New Jersey tax rates to your broader tax rate in 2019.

Roger Deacon
Hi Brody, we would--it would not be significant or material. Our overall tax rate we're targeting for next year is 19% to 19.2%.

Brody Preston
Okay. And, then I just wanted to touch on your exposure to ag and farm loans and some leasing exposure. There's been--there's some weakness in, I guess, for instance, for some of your competitors this quarter. And, just broadly speaking, from our--in the Midwest, the tariffs have had a negative impact on ag and farm land. And so, I wanted to gauge sort of what industries you guys are most exposed to there?

Michael Keim
Our number one industry would be dairy, but we have a lot of diversified farms and they're smaller, family-owned farms. They're not, what I would say, conglomerate farms, for lack of better terms. So, our exposure is minimized due to--one, the customer base diversifies themselves and just the nature of them as well.

Brody Preston
Okay. And, you guys haven't noticed any weakness going on within that book?

Michael Keim
No. The book's performed extremely well. I mean, dairy prices have been down, but the book continues to perform and that's largely a testament to how our customers run their businesses.

Brody Preston
Okay, great. Thank you very much, guys.

Roger Deacon
Thanks, Brody.

Jeff Schweitzer
Thanks, Brody.

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

Jeffrey Schweitzer
Thanks, Andrew, and just thank you to everybody for participating this morning. We are excited about how we finished the year and feel like we have some good momentum heading into the first quarter, even given all of the macro items that are out there that could impact the economy. Our local economy continues to be pretty solid. So looking forward to talking to everybody at the end of the first quarter, and have a great day.

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