Univest Corporation of Pennsylvania

Q3 2017 Earnings

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CORPORATE PARTICIPANTS

Jeff Schweitzer – *President and Chief Executive Officer*

Michael Keim – *President, Univest Bank and Trust Co.*

Roger Deacon – *Senior Vice President and Chief Financial Officer*

PRESENTATION

Operator
Good morning, and welcome to the Univest Corporation of Pennsylvania Third 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. 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.

Jeff Schweitzer
Thank you, Chad. Good morning, and thank you to all of our listeners for joining us this morning. Joining me on the call 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 would 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 $11.2 million during the third quarter, or $0.42 per share. During the quarter, we recorded a $2.8 million charge-off related to $5 million of software leases under a vendor referral program. The provision during the quarter related to this program was $1.9 million, as we had already established an allowance of $886,000 related to these leases as of June 30, 2017. We have written the receivables related to this program down to $2.3 million, and do not anticipate any material write-downs to this amount in the future. Additionally, we do not have any similar leases on our balance sheet at September 30, 2017. The impact to the provision related to these leases was $0.05 during the quarter.

As we discussed on previous calls, the first and third quarters are historically lower loan growth quarters for us. Total loans declined $23 million during the quarter primarily due to significant line of credit pay downs and payoffs during the quarter. Loan production during the quarter was relatively solid as we booked $159 million of new loan commitments as we continue to see solid activity, and expect a solid fourth quarter. However, as a result of the decline in loans during the quarter, we anticipate loan growth for the year coming in closer to 9% compared to our previously discussed range of 10% to 12%.

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

Roger Deacon
Thank you, Jeff, and I would like to also thank everyone for joining us today. I'm going to discuss a couple of other items related to our earnings release.

First, as it relates to earnings. As Jeff mentioned, we reported earnings of $0.42 per fully diluted share, which includes the negative impact of the incremental provision related to the leasing programs of $1.9 million, or $0.05, for the quarter, which we do not view to be part of our normal provision run rate. Earnings also includes purchase accounting benefit related to the disposition of a $4.8 million credit impaired loan, and resulted in a $493,000 gain, or $0.01 per share for the quarter, and that's included in our purchase accounting accretion.

Second, as it relates to credit. Our internal credit metrics have continued to improve as our total criticized and classified commercial loans have been reduced by 39% during the year to approximately $86 million from $142 million at the beginning of the year. Additionally, our purchase credit impaired loans have been reduced to only $1.6 million, and our REO balance is $1.8 million. And then finally, our provision for loan losses, excluding the provision related to the leasing program, was only $781,000, and net credit losses was only $292,000 for the quarter.

Given these improvements in our credit metrics, I am estimating our quarterly provision for loan losses will range between $2 million and $2.2 million per quarter on a go-forward basis. As always, that will be event-driven by loan growth and charge-offs, but that is a reduction from prior guidance.

Finally, as it relates to the net interest margin, as disclosed in the earnings release, core net interest income, which excludes the impact of purchase accounting adjustments, was $35.8 million for the quarter, and represents a $1.2 million increase as compared to core net interest income of $34.6 million for the second quarter. This increase was primarily driven by an increase in average loans of $66 million during the quarter as our core net interest margin, again excluding purchase accounting adjustments, was relatively flat at 369 compared to a 368 for the second quarter of this year.

The increase we received in the yield on the loan portfolio of 5 basis points was almost totally offset by an increase in the cost of funds on our deposits and borrowings. The impact to net interest margin of purchase accounting accretion has averaged 9 basis points for the nine months of 2017. We anticipate that this will decrease to 4 basis points in the fourth quarter of this year, and will be only 1 to 2 basis points in 2018.

I believe the press release was pretty straightforward as it relates to non-interest income and expense, and accordingly, that's it for our prepared remarks. We would be happy to answer any questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone 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 will come from Michael Perito with KBW. Please go ahead.

Michael Perito
Hi, good morning, guys. Thanks for taking my questions.

Jeff Schweitzer
Morning, Mike.

Michael Perito
I have a couple of questions. I want to start on loan growth. I think the quarter-to-quarter seasonality

here was well telegraphed by you guys, but as we move into next year, I'm just curious how the pipelines are starting to look today, and maybe some any high-level thoughts you could provide on how you think some—the overall loan portfolio could grow. I imagine there's probably going to be a little bit more churn in the some of the newer stuff next year, but just curious if you have any like initial thoughts as we're only a couple of months out from the start of 2018.

Michael Keim
Hi, Mike, I would tell you—it's Mike Keim, and good morning—I would tell you—

Michael Perito
Hi, Mike.

Michael Keim
That we continue to bullish in terms of what we're doing from a loan growth perspective. The Lancaster market continues to be strong for us, and overall we're strong. As Jeff referenced earlier on the call, loan commitments themselves in the third quarter were strong, and we see, and we are projecting a pickup in loan commitments in the fourth quarter as well.

We think that'll continue to carry forward into next year. We don't think we'll have 10% to 12% loan growth next year, but we are looking at in that 8% to 10% range, so we are ratcheting it down a little bit. But, we feel very good. The teams continue to perform exceptionally well, as well as the Lancaster market, which is a new market for us.

Michael Perito
Awesome, very helpful, thanks, Mike. I also wanted to ask a couple of questions on non-interest income. Curious, the mortgage activity seemed like it slowed a bit, just curious if that pipeline has kind of stayed low into the fourth quarter here, and any other thoughts you can provide on the production there.

Michael Keim
Yes, so production is—first off, the pipeline has stayed relatively consistent from the second quarter forward, so we didn't really get the typical seasonal pickup in the third quarter. That's really a function of housing supply in the key markets that we serve.

We have been successful in recruiting additional loan officers, so we've actually maintained the pipeline going into the fourth quarter here, which is actually very strong, and that's a good sign for us and we're going to continue to recruit. During the second quarter we implemented a new production system in Compass, and now we feel that we've worked through any of the impediments that any system conversations occurs with or has with it. So now adding and recruiting people, and continuing to grow that book of business.

The other thing that hurt us from it, if you just look at the core income statement and the gain on sale line item is besides production being down about 23% year-over-year on the quarter, the mix of our business held for sale versus portfolio, we had an increase in our mix go into our portfolio. So, while that is a short-term tradeoff in terms of an annuity stream versus gain on sale, it will benefit us as we move forward.

Michael Perito
Got it. It's interesting; I've heard that from a couple of your peers on the housing supply issue. Is that something you guys see? Is there some pent-up supply that could hit the market later this year that could maybe make some of the typically slower quarters a little stronger? I mean, it's more of a short-

term phenomenon, but is that something that's possible?

Michael Keim
Look, that's certainly possible, and I think what you're seeing is, is that as that supply tightens, obviously home prices increase, and therefore, people that might not have otherwise been in the market to sell their home rotate into that. So, it's something we'll watch carefully. But like I said, our focus is really getting after and hiring additional folks, loan officers that can bring business to us, and do not rely solely on a refinance environment. For us to be successful in the mortgage banking side we need to continue to grow our business focused on purchase, and when refinance activity occurs we need to take advantage of that and reap the additional benefits.

Michael Perito
Helpful. And then, just my second one on non-interest income just related to the trust business. As I look at overall non-interest income, you've seen some nice growth this year. It looks like trust is tracking to be relatively flat. I'm just curious if there are any organic or inorganic growth opportunities on the horizon that you guys are looking at in that business at this point that we should thinking about.

Jeff Schweitzer
Trust is—we've always said that it would be our lowest growth area in the wealth management platform. It does ebb and flow a little bit during the year, depending on estate settlements and things of that nature, and typically the fourth quarter's a little stronger.

But, I'll tell you the truth, overall it's tracking right on budget for the year for us on the trust income. We've gotten into some specialty needs trust areas, which we see opportunities to grow, but even there a trust is a slower growth market. We'll see our growth in wealth really coming from the RIA-type of wealth management functions versus trust. It's a nice complement to what we have; it's a differentiator as we go after customers and try to win new business on the RIA side to have trust powers. But, overall trust as a business by itself, it's more of a 3%-type of growth line of business.

Michael Perito
Helpful. Thank you, guys, I appreciate all the color.

Jeff Schweitzer
Yes.

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

Frank Schiraldi
Morning, just a couple of questions. First, I'd just be interested to get your guys' commentary, just color on deposit pricing pressures, deposit betas, and thoughts on the core NIM from here, aside from the purchase accounting.

Roger Deacon
Sure. Frank, it's Roger. We did see an uptick in deposit betas during the quarter, and I think that's pretty consistent with what was seen across the industry. Our deposit beta pickup this quarter is a little bit magnified because of the growth in our public funds deposits. And in that space, for public funds the beta, we're about 50 basis points higher today than where we were a year ago on our public funds dollars, which would tell you that beta is about 67%.

And so, there's a little of that spike in the seasonal related to our overall interest rates. But we are seeing an uptick in what we'll say exception pricing for our retail customers, and more folks asking for the higher rate on commercial and public funds. I think, when I look back and looked at our beta relative to where we were last—the fourth quarter of last year, our beta is 16%. But it's grown with each of the rate increases. Again, I think that's consistent with what we've seen across the industry.

As it relates to core margin, we have seen a little bit of an increase in our loan pricing this quarter, so what we don't really—what we don't know what's going to happen is in the fourth quarter. If we get a rate increase—and this is consistent with what I've said before—words like slightly asset sensitive, because we now we're going to get an uptick on a yields on our loans. It's just how much do you have to re-price on the borrowing side and the deposit side.

So, this quarter we were relatively flat. I think going forward we might see a little bit of compression in the core margin, but it's not that significant, and if we get a 25 basis point rate increase, I think that's probably a wash as well.

Frank Schiraldi
Got you. Okay, and then just on loan growth, Mike, you mentioned ratcheting down expectations a bit for next year. Is that more so in the legacy or expansion markets? And then, if you could just talk to whether that's driven more so by greater competition or just maybe a little bit less market activity expectation. Thanks.

Michael Keim
Sure, Frank. I would look at it, and basically say, as we grow the Lancaster book of business, effectively you become a numbers game in terms of what is the accelerated pace. So, if you grow Lancaster from zero and then you're getting ratcheted up, and now we're well over $200 million, it's simply that as that book of business gets larger in the overall book that's slowing us down. So, the legacy markets still continue to grow in that 8% range, and so the incremental impetus, for lack of a better term, coming from Lancaster is slowing down on a percentage basis.

Roger Deacon
Yes, so along we've talked about Univest and the prior/chase is being 8%-type growth businesses. That increase this year on the Lancaster side is going to be less of an impact on the growth year-over-year—

Michael Keim
Percentages-

Roger Deacon
—on a percentage basis, which brings you to 8% to 10%.

Frank Schiraldi
Okay, so I guess not really a big change in thinking, just a bigger balance sheet.

Michael Keim
Correct.

Roger Deacon
Correct.

Frank Schiraldi
Okay. All right, thank you.

Michael Keim
Yes.

Operator
Again, if you'd like to ask a question please press star, then one.

The next question will be from Matthew Breese with Piper Jaffray. Please go ahead.

Matthew Breese
Good morning, everybody.

Jeff Schweitzer
Morning, Matt.

Matthew Breese
Just a couple of quick follow ups, on the loan growth side I'm just curious to hear, what are the incremental new loan yields coming in at, especially on the C&I side and then the CRE side, and how does that compare to your average rates right now?

Roger Deacon
Sure. So Matt, our average yields today are about 430 to 435. A lot depends on the mix of the new production of fixed versus variable. The fix is we're able to see in that 435 to 450 on average, so it's been—that was fairly good this past quarter. On the variable, obviously we're probably about 40 to 50 basis points below that. But all in all, we're pretty close to where our yield is today.

Matthew Breese
Close. And then how would you size up the same question on the deposit side? What is the incremental cost of funds relative to your current costs?

Roger Deacon
In terms of—are you talking in terms of new production?

Matthew Breese
New deposits. If the incremental retail or the incremental commercial customer comes in, what's typically the deposit rate you have to give them to get in the door?

Roger Deacon
Yes, that's a really, really wide range based on the type of customer. If you have a good commercial customer that you have the C&I loan with, you get the operating account with zero rate. So, it's really relationship-driven from that perspective. If I'm just out looking for money, somebody might come in on a 125, which is my overnight cost of funds. And that's why it's so important that we continue to foster the relationships with the commercial lending team and those commercial customers to really keep our overall loan deposit rate low. But it is really a wide range.

We have not changed our consumer pricing. Like I said, we've had more exceptions on that basis. We like to target, if it's a higher-dollar customer, we would like to target between 75 and 100 basis points.

Matthew Breese
Got it, okay. And then, on the expense side things look like they're coming in right where you thought at about $130 million for the year. How would you size up expense growth into 2018, and what we

should be expecting there?

Roger Deacon
Sure. So, I think in—if any—in any normal business model you're looking at, let's say a 4% to 4.5% growth. I would guide a little bit to the higher of that, because we do intend to continue to invest in our IT/Technology as well as e-commerce and mobile banking next year. So I would say that we're looking at that 5%, 5.5% next year-type number. We really want to continue to reinvest in certain aspects of the business to take advantage, to make that be—as the whole platform for banking changes, we want to be right there with that.

Matthew Breese
Okay, so like $136 million, $138 million, something like that is probably a good ballpark?

Roger Deacon
Yes, I think that's fine.

Matthew Breese
Okay. And my last question is really on the tax rate. I think this quarter was a tad higher than what we've seen in the last couple of quarters, and just wanted to get a sense for is that going to come back down, or is 28% the new level?

Roger Deacon
Here's what I would say, I think as we go into '18, we get this whole dynamic around the discreet events, and I'm going to try to go forward and almost ignore that, because that becomes part of your run rate; it's just lumpy by quarter. Next year we would guide to a 29% effective tax rate.

Matthew Breese
Okay. Okay, that's all I had. Thank you very much.

Jeff Schweitzer
Thanks, Matt.

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

CONCLUSION

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

Jeff Schweitzer
I'd just like to thank everybody for participating on the call today. We look forward to a good fourth quarter to end the year, and I look forward to talking to everybody in January. Have a great day.

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