Univest Corporation of Pennsylvania

First Quarter 2017 Earnings Call

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CORPORATE PARTICIPANTS

Jeff Schweitzer – *President and CEO*

Mike Keim – *President of Univest Bank & Trust*

Roger Deacon – *Chief Financial Officer*

PRESENTATION

Operator
Good day. Welcome to the Univest Corporation of Pennsylvania First 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 * key followed by 0. After today's presentation there will be an opportunity to ask questions. To ask a question, you may press * then 1 on a touchtone phone. To withdraw your question, please press * then 2. Please note, this event is being recorded.

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

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

Before we begin, we remind everyone in 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 $10.9 million during the first quarter or $0.41 per share. A couple highlights for the quarter was solid 6.8% annualized loan growth and 13.3% annualized deposit growth. While our loan growth in the quarter was below our expectations for the year of 10% to 12%, we are still comfortable with these amounts for the year as the loan pipeline is strong. The first quarter is typically a lighter quarter for us and we expect loan growth to accelerate in the second quarter.

Additionally, our efficiency ratio was 62.7% during the quarter as we fully realized the cost savings and other strategic initiatives from the third and fourth quarters of last year. We opened two financial centers during the quarter in our expansion markets; one in the University City District of Philadelphia and one in Strasburg in Lancaster, as we continue to reposition our branch footprint and fill out these markets.

Before we get to questions, I would now like to ask Roger to spend a few minutes discussing some other financial highlights. Roger.

Roger Deacon
Thank you, Jeff. And I would also like to thank everyone for joining today's call.

I'm going to take a couple of minutes discussing a few items in our earnings release. First, I will discuss net interest margin. Core net interest income, which excludes the impact of purchase accounting adjustments, was $33.5 million for the first quarter of 2017, which represents a $1.2 million or 3.6% increase as compared to core net interest income of $32.3 million for the fourth quarter of

2016.

Core net interest margin, again, excluding purchase accounting adjustments, was 3.72% compared to 3.61% in the fourth quarter of last year. This increase in net interest margin was primarily driven by the increase in interest rates in December 2016, which increased loan yields at a greater pace than the rates on deposits. We also saw a benefit in our mortgage backed securities portfolio yield due to a slowdown in payment rates on the related premium amortizations.

One item I would note is the increase in mortgage backed security yields acts as a natural hedge to lower mortgage banking revenue in a rising rate environment.

As it relates to the provision for loan losses, we reported a provision of $2.4 million for the first quarter. The provision is primarily due to an increase in non-covered loans during the quarter as strong new loan production, which requires a full reserve, was offset by pay downs and reduced line utilization on existing covered loans which had no loan loss reserve.

For the remainder of 2017, as always the provision is event driven and will depend on loan growth, particularly that of non-covered loans which require the full reserve, plus any specific credit issues. That said, we are increasing our quarterly estimate of the provision to a range between $2.2 million and $2.5 million per quarter.

As it relates to noninterest income, consistent with prior years this quarter's noninterest income included $964,000 of insurance contingency income, which compared to $1.3 million in the first quarter of 2016. Excluding the impact of this contingency income insurance income would have increased $192,000 or 5.9% from the prior year. Also, wealth income increased 19.1% from the same quarter last year due to increased new customers and tailwinds from the fourth quarter market conditions. Mortgage banking decreased 8.6% from the same period due to lower mortgage volumes as a result of increased interest rates.

Finally, as noted in the release, we did have $114,000 of gains on sale of REO during the quarter.

As it relates to noninterest expense, as previously communicated, our goal was to have no acquisition or integration expense in 2017 and the first quarter was clean from that perspective. We reported noninterest expense of $32.0 million for the quarter. We have previously communicated our goal of $32.5 million per quarter or $130 million for the year. The quarter benefitted from timing of certain activity-based expenses such as marketing and professional services that we anticipate will increase in future quarters. We continue to believe we are on track for $130 million of noninterest expense for the year.

Finally, as noted in the press release and consistent with other public companies, we did receive a discreet tax [ph] of $288,000 in the quarter related to the new accounting rules for equity-based compensation. Excluding these types of discreet events, we believe our effective tax rate will range between 28% and 28.5%.

That's it for my prepared remarks. I'd be happy to answer any further 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 *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 *2.

The first question comes from Frank Schiraldi of Sandler O'Neill. Please go ahead.

Frank Schiraldi
Good morning. Just a couple of questions. I wondered if you could talk a little more about loan growth expectations. In terms of where the pipeline stands now, are we already at a level 10% to 12% higher than where we stood last year or are you assuming that pipelines build here and into the back half of the year?

Mike Keim
Good Morning, Frank. It's Mike Keim. Our pipeline has built to that point. As Jeff referenced previously, our first quarter has been historically our lowest point, so we do see pipelines at a point and anticipate strong funding in the second quarter and beyond, which will lead us back to that 10% to 12% annualized loan growth rate.

Frank Schiraldi
Then on the NIM, Roger, if you could just a talk a little bit about in the past I think you've said off of 25 basis point move. Maybe it was just the December rate move, but I think you talked about $1 million to $2 million in potential NII benefit. Is that still a number you'd use for future rate hikes? And at this point, would you say that core margin pressures have subsided?

Roger Deacon
Well, I'll answer that a couple different ways. From a core margin perspective, we do believe those numbers are still appropriate, the $1 million to $2.5 million. From a core margin perspective of the 372, what I would say is we are starting to see some pressure on deposit pricing as a result of this last rate increase. We did not see much at all on the December rate increase. So we're a little bit hesitant, we think we're at the lower end of that range right now; maybe it's a little conservative. But if we think about this second rate increase, you're really probably at the $1 million to $1.5 million range.

I think we beat consensus during the quarter by about one million dollars across the board because of that rate increase. I don't really think we get much of an increase in margin from here on out. So the 372 core is probably a good number to use, but we do anticipate the nice loan growth of $80 million to $100 million per quarter. So that will drive your net interest income really more than the margin.

Frank Schiraldi
So the 25 basis points we got in March, you're saying that you're seeing some offsetting deposit pressure to kind of keep that NIM where it is currently?

Roger Deacon
That's correct.

Frank Schiraldi
Okay. And then just finally, I wondered if you could remind us on growth plans in your expansion markets. Is there any further build out you anticipate in terms of branch openings from here and maybe timing on that? Thanks.

Mike Keim
We're going to continue to build out in the Lancaster market. We did open a new center, as Jeff referenced, in April in Strasburg. We have another center that will open in June, early June in

Brownstown, then one that's in Christiana on Georgetown Road that will open late summer/early fall. That will round out what we're doing in Lancaster for 2017.

We are also looking at opening another center in Bethlehem in the Lehigh Valley, but that will be late in the fourth quarter with negligible income statement impact to our results in 2017.

Frank Schiraldi
Okay. I might have missed it, but in terms of the commentary on the expectation of still being in that 130 level on the expense base, is that more because this staffing has been built out in a lot of these branches already or is it more you just get cost saves elsewhere to offset these incremental costs?

Roger Deacon
We targeted the 130 for the year, Frank. There are obviously a lot of timing things that occur in marketing and professional services and the like, and the overall costs of building out a couple of branches really isn't going to drive that materially different.

Mike Keim
We also announced, and we'll be closing one of our centers in Bucks County in the Solebury market and that will close May 31st. So, it's consistent with our branch optimization project that we've been working on the last couple of years, which is how do we continue to expand in the expansion markets, yet be really thoughtful with regard to where we put centers in our existing markets and take the savings there to offset the increased expenses in the expansion markets.

Frank Schiraldi
Great. Thank you.

Roger Deacon
Thanks, Frank.

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

Michael Perito
Good morning, guys.

Jeff Schweitzer
Good morning, Mike.

Michael Perito
Thanks for the time and for the updates on the outlook commentary. It was helpful. A couple of questions for me.

On the noninterest income side, any updates on how the momentum there is looking? I mean, ex the contingency [ph], it sounds like insurance was still kind of trucking higher, trust was pretty flat quarter-over-quarter. What are you guys seeing? Has there been any pickup in some of the newer areas or just any comments there would be helpful.

Jeff Schweitzer
I would say that insurance ex contingency still is in that 5% to 7% growth is what we saw. Taking out the contingency year-over-year of about 5.9%, so I'd say we still continue to go at that growth rate.

I would say wealth, we've seen some nice opportunities from the expansion markets, especially in Lancaster, we've gotten some good new business. They're having a very good year and I think we'll have a good year going in that higher single digit type of growth rate on the revenue side, which is what we've talked about in the past. So I would say each line of business is still pretty much operating into those levels that we've discussed previously.

Michael Perito
On the deposit growth in the quarter, which is pretty solid, can you talk a little bit where you saw some of that growth? Is it money that you expect [ph] or was it seasonal money? Any more color there you guys can provide?

Roger Deacon
Mike. We really grew in a couple of key places we identify are commercial relationships and also municipal businesses. With a consolidating industry, we do have an opportunity on the municipality side. When I say that I mean counties, school districts, authorities and the likes who like to bank local. So there are opportunities there and we have identified that as an opportunity and are aggressively pursuing those types of deposits.

Obviously, with our loan growth as planned, we do need to be also aggressive on the deposit front, identifying opportunities and working those.

Michael Perito
Is it fair to assume that when you think about those opportunities that the hope for the year is to match the 10% to 12% loan growth with similar dollar deposit growth and keep the loan to deposit ratio in this kind of current range that you're in?

Roger Deacon
Sure. We would like to obviously keep it at around 100%. My sense would be that we're probably going to tweak up to 102%, 103%, 104% from time to time as there is some seasonality in those deposits, and that's okay. We don't mind managing the business that way, but over the long haul we would like to stay between 100% and 105%. That's the way, quite honestly, we used to do things at Fox Chase in that 100% to 105% range where you don't prefund loan growth, you kind of fund it on the backend and that would be the strategy here.

Michael Perito
Okay. And then just one more follow up for me on the margin, maybe I misheard or got a little confused, but it sounded like there were a couple of contradictory comments. So from the March hike you expect $1 million to $1.5 million pickup in NII related just to the hike, but there's no additional increase in the core NIM. Did I hear that correctly?

Roger Deacon
No, what I said was we received the benefit in the first quarter of December. There might be over the course of the year a million dollars, so call it $250,000 a quarter. What I'm really guiding you guys to is that benefit we saw in the first quarter, to keep it around that benefit because we're getting pressure on the REIT side and there is some significant growth planned, so the combination of the two, I would just keep the margin flat for the year and incorporate the growth that we have planned.

Michael Perito
Okay. So the flat core NIM for the year, though, that assumes no additional rate hikes in 2017, correct?

Roger Deacon

That is correct.

Michael Perito
Alright, great. Thanks, guys, I appreciate it.

Jeff Schweitzer
Thank you.

Operator
The next question comes from Matthew Breese of Piper Jaffray.

Matthew Breese
Good morning, everybody.

Jeff Schweitzer
Good morning.

Matthew Breese
Jeff, I just wanted to maybe touch on the wealth management business. I know you gave some good color on organically what that business is capable of, but in the past you've also talked about potential wealth acquisitions and I wanted to know how conversations were there and if there is any pipeline or anything you might call on the cusp of occurring this year?

Jeff Schweitzer
Right now, honestly, the organic growth opportunities are pretty significant for us in wealth. Trust is still a low growth business, but the RIA business is growing very strongly.

We're always out looking for wealth opportunities, but there's nothing imminent at this time. We're really focused internally on, frankly, the organic side, which is obviously the best bang for the buck for our shareholders in return and we're going to continue to focus on that. But we always are always out there talking to people, seeing what opportunities might exist. Because as we expand our markets, if there is an opportunity in some of the expansion markets, it's something we need to look at.

Matthew Breese
Understood. Okay. Then going back to the balance sheet, the deposit side of the balance sheet in terms of strategy, Roger, I know you pointed out that there's been some increasing competition, although quarter-over-quarter we haven't seen much of any deposit beta, but if competition is heating up and the backend of the curve is coming down a little bit, are there alternative strategies you might take including maybe putting on some lower cost borrowings for longer periods of time? Is that an option?

Roger Deacon
Actually, Matt, during the quarter we did extend out, we did $85 million worth of longer term borrowings in that three to five year type range. So yes, we are being opportunistic in that regard. The difference between overnight and five year money is not that significant, so we pick our moments but we are doing some extension.

Matthew Breese
Understood. And if you had to characterize the competition in the deposit beta that we might see in the quarters ahead, how would you size that up?

Roger Deacon
As I said, we'd like to stay at 100% loan to deposit ratio, so where we're being more aggressive is what I'll say on the margin where we have opportunities to attract new customers and new customers with significant dollars. Those customers we're pricing pretty aggressively to get the relationship. You get that relationship in the door, you have them really for a longer period of time. So that makes a lot of sense to us to be aggressive, get the relationship and lock in that funding for an extended period of time.

We haven't really had to do much on the core base yet. But, quite frankly, it's going to come at some point because we can see it with some other competition, including, quite frankly, credit unions.

Matthew Breese
Is that more on the retail side or the commercial side?

Roger Deacon
That would be retail.

Matthew Breese
Okay. And what are you seeing on the commercial front? How competitive is that, the deposit pricing there?

Mike Keim
I would tell you it's competitive, but those deposits are tied to lending relationships and cash management services that we provide, so it's all, to Roger's point, what he was alluding to, it's a total relationship so there's not as much what I would call headline rate pressure. But to the extent that we look to and can get on a larger block of deposits, and somebody might have those parked somewhere else, perhaps even in a mutual fund type of entity, we would pay up and we're looking at that strategically relative to what is the cost for us to borrow overnight vis-à-vis what we would pay on those.

Matthew Breese
Okay. My last question is, I thought you guys had a nice quarter delivering on a number of different things you talked about in prior quarters. From here, I was just looking to get a sense for, we talked about longer term profitability targets – ROA, ROTCE – are all those targets still intact and can you remind us of what those are?

Roger Deacon
Yes, they are intact. I know we were talking around in the range of the 110+ on the ROA, it was really the key item. We'd like to be at 60% on the efficiency ratio. They're really the two key ones that we would look to in terms of how we would drive the business forward. We really haven't changed our thoughts on the long run.

Quite frankly, you're right, from an efficiency perspective and a revenue driven perspective, it was a nice quarter and we feel comfortable that we have the capabilities to continue to achieve operating leverage and grow revenues at a pace faster than our expenses.

Matthew Breese
That's great. That's all I had, guys. Thank you.

Jeff Schweitzer
Thanks, Matt.

Operator
Again, if you have a question, please press *1.

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
Thank you, Francesca, and thank you for everybody joining us this morning. We feel good that we were able to report a clean quarter, which is what our goal was for the first quarter and we look forward to talking to everybody again in the second quarter. Have a great day.

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