Univest Financial Corporation

Q1 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Jeffrey Schweitzer - *Chief Executive Officer*

Michael Keim - *President, Univest Bank and Trust*

Brian Richardson - *Chief Financial Officer*

PRESENTATION

Operator
Good morning and welcome to the Univest Financial Corp. First Quarter 2020 Earnings Conference Call. All participants will be in listen-only mode. If you need assistance, please signal a conference specialist by pressing the star key, followed by 0. After today's presentation, there will be an opportunity to ask questions. Please note the event is being recorded.

Now, I'd like to turn the conference over to CEO, Mr. Jeff Schweitzer. Please go ahead.

Jeffrey Schweitzer
Thank you, Nick. 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 Brian Richardson, our Chief Financial Officer.

Before we begin, I'd like to start by saying I hope everyone listening is staying safe and you and your families are healthy. I also need to 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 $838,000 during the fourth quarter—first quarter, or $0.03 per share. Earnings for the quarter were significantly impacted by $20.3 million, or $0.55 per share, of expense related to COVID-19, which was the result of economic assumptions within our CECL model.

Before we get into further discussions on earnings, I would like to briefly discuss our response to the COVID-19 pandemic. Let me first say that our approach to this pandemic has been to focus first and foremost on the safety of our employees and customers in the decisions we have made, as their safety is our highest priority. We are following the current guidance and recommendations from the government and regulatory agencies to protect the health and safety of our employees, customers, and communities. We were the first financial institution in our market to institute drive-thru-only banking at our financial service centers, and 95% of our non-branch personnel are working remotely, at least part time, with the vast majority working remotely full time.

As the situation continues to evolve and the financial impact remains unknown, we continue to provide the service that Univest customers expect. We implemented new operating procedures at all of our financial centers and have reminded customers of the digital solutions available to them. We are offering assistance to our business and consumer customers who have been negatively impacted by the pandemic in the form of deferrals and waived fees.

As noted in our earnings release, we have modified, or are in the process of modifying, over 1100 loans with principal or principal and interest deferrals, with an aggregate principal balance of $540 million. Additionally, we were one of the first banks in the market taking applications and approving loans through the SBA's $349 billion paycheck protection program. We received over

2,850 applications for funding through this program, and before the initial funding was fully utilized, we got 1,051 applications approved by the SBA for $415.7 million. Interestingly, we have not seen notable usage of lines of credit, as total line usage is consistent with where it was in January and February.

Excluding the provision and expense we recorded in the first quarter related to COVID-19, we are pleased with our financial results for the first quarter. Prior to the stay-at-home orders going into effect in our markets, we had generated solid loan growth and ended the quarter with $62 million of loan growth, or 5.7% annualized, and deposits grew $47.2 million, or 4.3% annualized, for the quarter.

Another bright spot for the quarter was the growth in mortgage banking revenue, which increased 468.1%, or $2.3 million, compared to the first quarter in the prior year, as refinances picked up due to the low interest rate environment.

Additionally, we took aggressive action with respect to deposit pricing during the quarter, reacting to the Federal Reserve's interest rate cuts. Brian will discuss our margin further in his comments. However, as everyone knows, the world changed in March, which calls into question many things for the duration of the year. We still do not know when stay-at-home orders will be relaxed in our markets or when businesses will be allowed to re-open. As a result, we are rescinding our original guidance for 2020 and will not be giving guidance for the remainder of the year at this time, as the impact of the pandemic on our local business communities and the timing of the return to more normal operations for local businesses is unknown.

Before I throw it over to Brian, I just want to thank the members of the Univest family. I could not be more impressed or proud of the way our employees have handled the current environment. Their attitude, compassion, flexibility, and willingness to jump in wherever needed over the past six weeks, says a lot about them as individuals and about the culture at Univest. I thank them for all their amazing efforts and service to our customers, communities, and each other.

I will now turn it over to Brian for some additional discussion on our results.

Brian Richardson
Thank you, Jeff, and I would also like to thank everyone for joining us today. I hope each of you, your families, and your friends are safe during this challenging time.

As Jeff mentioned, we reported earnings of $0.03 per share for the quarter, which was impacted by $0.55 of COVID-19-related credit calls.

We adopted CECL effective January 1, 2020. In conjunction with this adoption, our reserve for loan and lease losses—loans and leases increased by $12.9 million, our reserve for investments increased by $300,000, and our reserve for unfunded commitments increased by $1.1 million. This was a total increase in reserves of $14.3 million, which resulted in an after-tax, retained-earning adjustment of $11.3 million. Total CECL-related charges for the quarter were $21.8 million. This included expense of $20.3 million, or $0.55 per share, related to COVID-19 and the resulting impact on the economic forecasts used within our model.

Excluding the COVID-19 impact, our CECL credit costs for the quarter would have been $1.5 million. Through the adoption of CECL and the first quarter provisioning, our reserves for credit losses and unfunded commitments have increased by $35.7 million, or 100% since December 31, 2019. As of March 31st, our allowance for credit losses is 1.53% of total loans and leases.

I would now like to touch on two items related to the earnings release. First, despite the Federal Reserve's emergency rate cuts in early March, net interest margin, excluding purchase accounting and excess liquidity, increased 1 basis point compared to the fourth quarter of 2019. This was the result of certain liabilities repricing faster than a portion of our LIBOR-based variable rate loans. However, this was a short-term benefit, and we expect continued pressure on NIM and NII as our variable-rate loans continue to reprice in the second quarter.

During the quarter, we opportunistically sold $58 million of lower-yielding investments at a gain of $652,000 and extinguished a $35 million borrowing with a one-time cost of $656,000. Subsequently, we were able to purchase replacement investments with a slightly higher yield, which were partially funded with a four-year borrowing at a rate approximately 125 basis points less than the extinguished borrowing.

Second, our mortgage banking business had a very strong quarter. Net gain on mortgage banking activities totaled $2.7 million, which represented an increase of $2.3 million, when compared to the first quarter of 2019. This was driven by strong refi activity, which accounted for approximately 60% of the origination volume for the quarter.

On previous calls, we had expressed our intention to redeem approximately $50 million of sub-debt on March 30, 2020, when it hit its five-year anniversary. Based on the current economic conditions, we elected not to redeem the sub-debt. We now have the ability to redeem it on a quarterly basis and will evaluate those options as economic conditions normalize.

Lastly, as Jeff mentioned, due to COVID-19 uncertainty and the related impact on—from stay-at-home orders and social distancing directives—could have on our customers and our businesses, we are rescinding the 2020 guidance that I provided on last quarter's call. While we are operating in uncertain times, our strong capital and liquidity positions us well to navigate this challenging environment.

That is it for my 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'll now begin the question-and-answer session. To ask a question, you may press star, then 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 2. At this time, we will pause momentarily to assemble our roster.

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

Michael Perito
Hi, good morning, everyone. Glad to hear everyone's doing, you know, reasonably well under the circumstances.

Jeffrey Schweitzer
Hi, Mike.

Brian Richardson
Good morning, Mike.

Michael Keim
Good morning, Mike.

Michael Perito
Thanks for taking the questions. I wanted to start on the credit side of the house. It seems like a lot of your local peers that adopted CECL are using kind of the baseline Moody's forecast to drive some of your, you know, GDP, and unemployment assumptions, I guess. Is that similar to what you guys utilize? And can you maybe lay out in a bit more detail what—some of the underlying macro assumptions that you're using to drive kind of the reserve level that you put up in the first quarter?

Brian Richardson
Sure, Mike, this is Brian. We use various economic factors across our loan segments, including unemployment, housing price index, GDP, retail sales, et cetera. We do use Moody's, and for purposes of the March 31st calculation, we used Moody's baseline forecast from March 27th.

Michael Perito
Okay. So is—I mean, it's reasonable—you know, obviously, what you guys did in the first quarter, I think, you know, it's fair to classify as kind of—was conservative and proactive, but having said that, obviously there's still a lot of unknowns out there, right? So as you see it now, four weeks later, after that March 27th consensus that you used, I mean, there's probably room for a little bit more provision in the second quarter. I know, it's hard to see even that far, so I'm not going to really ask you to go beyond that, but is that a fair kind of sentiment, do you think, at this point, given what you know?

Brian Richardson
Yes, I mean, our practice is to use the most recent forecast as of the balance sheet date. That said, we don't really focus on forecasts that come out subsequent to the quarter, and as it relates to the second quarter, what's really going to matter is where the forecasts end at the end of June, and it's certainly too early to tell exactly where those will land.

Michael Perito
Okay. Okay. So, all right, that makes sense. But as you guys look at the—you know, I guess, how do you balance the reserve today against kind of stimulus and deferrals and things of that nature? It seems like it's a little bit of a tightrope. You guys have an idea of how many clients are deferring, and my guess is those clients could be at risk of coming out on the other side not quite as strong, but there is a lot of stimulus going around. How did you guys kind of factor that in when trying to decide kind of ultimate loss rates and the reserve level?

Brian Richardson
Well, at the early part in the cycle, where we are here, I mean, using the baseline forecast, we presume includes a little bit of contemplation of that as we didn't go to a more Draconian-type forecast. That said, a 90-day deferral or a 180-day type deferral, it will shift cash flows, but under a life of loan loss perspective, there isn't an overwhelmingly large assumption of what that will do over the life of the loans, baked in currently.

Michael Perito

Okay. A couple more things I wanted to hit quickly on the margin. I apologize if I've missed it, but I was listening to your comments, and I was just wondering if you had an idea of what the impact from the debt extinguishment would be on the second quarter NAM, and do you think it's enough to kind of hold NIM to, you know, down only a few basis points, or do you think with the full quarter's impact of all those cuts, it will be a decent amount of pressure on the margin in the second quarter?

Brian Richardson
There's a lot of moving parts, when you look at NIM and NII in the second, and even in the third, quarter. Obviously, PPP and the…

Michael Perito
I should clarify, yes, sorry, Brian, excluding PPP. I know obviously PPP could end up at the end of the quarter…

Brian Richardson
Yes. That's going to bring a lot of volatility.

Michael Perito
[Inaudible]

Brian Richardson
The fact is the pricing of LIBOR loans is also going to bring inherently some volatility. There's a slight benefit that will come from the extinguishment of debt, but, conversely, by holding onto the sub-debt, there's an expense that goes along with that. So, I would think it kind of—just assuming that there will be downward pressure going forward due to LIBOR loans resetting. Just as a reminder, during the first quarter, one-month LIBOR averaged 141 basis points. As of yesterday, it was at 57 basis points. So, there is—there will be pressure resulting from that.

Michael Perito
Yes. Okay. And then just, lastly for me, and then I'll just step back, Jeff, just on capital, what are you guys thinking at this point? Obviously, the first quarter was a little onerous from a capital perspective. You had CECL in there, you had the big provision in there, and growth was still pretty robust. You know, I imagine the capital levels will be a little bit higher going forward, when you take some of those one-time items out, and the balance sheet growth probably a bit slower in the second quarter, but can you comment any just on how you feel capital levels are today and just general thoughts around the dividend and whether you're comfortable kind of keeping that at this point, with the uncertainty?

Jeffrey Schweitzer
Sure, Mike. You know, we feel good about where our capital is. We obviously stress our capital levels and feel good about where we are from a capital and liquidity perspective. Given the—all the uncertainties that everybody's aware of, going forward we're comfortable that we have a good solid capital position and where we are. We aren't going to be doing any buybacks, you know, consistent with pretty much everybody else in the industry. And at this point, the dividend is obviously something the Board looks at on a quarterly basis, but, given our capital levels and where we are, we feel comfortable from a dividend perspective, at least for the—you know, the near term as we go forward.

Michael Perito

Great. Well, thank you, guys for the added color and for taking the questions this morning. I hope everyone stays well and talk more soon.

Jeffrey Schweitzer
Thanks, Mike.

Brian Richardson
Thanks, Mike.

Operator
The next question comes from Frank Schiraldi of Piper Sandler. Please go ahead.

Frank Schiraldi
Good morning, guys.

Jeffrey Schweitzer
Good morning, Frank.

Brian Richardson
Good morning, Frank.

Frank Schiraldi
I just wondered if, Brian, maybe you could talk a little bit about your concentrations in some of the more sensitive areas like energy, restaurant, hotel as, you know, a percentage of the total loan book and then to the extent you have it, the amount of each that is in deferral currently.

Brian Richardson
Sure, Frank. So, from a hospitality—if we look at hotels, motels, and the like, we're around $170 million—is our exposure there, from an outstanding perspective. Food service and the like were around $60 million. So that kind of gives you a sense on that side. On the CRE retail side, outstandings are roughly $250 million. So, that's really the higher, quote, unquote. Right now everything is—can be deemed higher risk when we have these stay-at-home and shutdown orders, but the ones I know that are commonly talked about kind of tend to be in that retail- and hospitality-type space, and that's the exposures that we have in the current book right now. On the energy side, we don't have significant exposures at all.

Frank Schiraldi
Okay. And do all of those areas have elevated deferrals at this point, I would imagine?

Brian Richardson
Yes. I mean, on the hospitality side, we're around—60% is our deferral rate, so 60% of our book has some level of deferrals, and then on the remaining CRE retail, we're in that 10 to 15% range.

Frank Schiraldi
And could you—food service, did you mention? Do you have that?

Brain Richardson
That is in that 10 to 15—sorry, no, that's included in my 60% for total aggregate hospitality, between hotel and food service.

Frank Schiraldi
Gotcha. Okay. And just following up on that, another sector, just curious how you guys are feeling about the ag book in this environment. Any color you can offer there?

Mike Keim
Yes, Frank, it's Mike. Generally speaking, our ag book continues to perform, and, quite frankly, continues to grow, because we largely serve those family-type farms that are well diversified, and there continues to be a need for their product, be it eggs, be it poultry, be it milk, et cetera. And even though milk is at a declining level, because of schools being closed and some other factors, there's the alternative uses for milk that can be used, such as cheese, ice cream, et cetera. So we continue to feel good about what we're doing on the ag side.

Frank Schiraldi
Okay, great. And then just finally, just thinking about Phase 2 of PPP, it sounded like you guys had plenty in the hopper that, you know, when the government ran out of the $350. So, I would imagine—do you think there's plenty of good opportunity there? How large do you see that opportunity for Univest?

Mike Keim
Yes, right now, Frank, we continue to get as many loans approved or [unintelligible] approved at this point. We believe that we'll have about 900 ready to go when Congress formally allocates the money, when the House acts later today, and we have a large team ready to hit Go and work through the SBA process. So that 900 equates to somewhere in the neighborhood of $85 million of additional funding, which would bring us very close to 2,000 loans and $500 million.

Frank Schiraldi
Gotcha. Okay, great. Thank you.

Jeffrey Schweitzer
You're welcome, Frank.

Brian Richardson
Thank you, Frank.

Michael Keim
Thank you.

Operator
Again, if you have a question, please press star, then 1. This concludes our question-and-answer session. I'd like to turn the conference over to Mr. Jeff Schweitzer for any closing remarks. Please go ahead.

CONCLUSION

Jeff Schweitzer
Thank you, Nick, and thank you, everyone for joining us today. These are obviously very uncertain times, challenging times, and, most of all, I just hope that everybody listening is staying safe, social distancing, and taking care of yourself and your families and that everybody's healthy. We look forward to talking to everybody again at the end of the second

quarter, and hopefully we'll have a little more clarity on what's going on in the world, but until then, as I said, stay safe and appreciate your participating today. Have a great day.

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