Univest Financial Corporation

Q2 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Jeff Schweitzer - *President & Chief Executive Officer*

Brian Richardson - *Chief Financial Officer*

Mike Keim - *President of Univest Bank & Trust*

PRESENTATION

Operator
Good day, and welcome to the Univest Financial Corporation Second Quarter 2020 Earnings Conference Call. All participants will be in 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 a touchtone phone. To withdraw your question, please press star, then two. Please note that this event is being recorded.

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

Jeff Schweitzer
Thank you, Sabrina. 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 would 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 could be found on our website at univest.net under the Investor Relations' tab.

We reported net income of $2.1 million during the second quarter, or $0.07 per share. Earnings for the quarter were significantly impacted by $19.9 million, or $0.54 per share of expense related to COVID-19, which was the result of changes in economic assumptions within our CECL model. As the economy continues to reopen, combined with spikes in cases in certain parts of the country, there continues to be great uncertainty surrounding the pace of the economic recovery in our markets. This uncertainty isn't reflected in our CECL provisioning during the quarter.

In spite of the current economic environment, we continue to be pleased with the performance of our core business as our pre-tax pre-provision income during the quarter increased $3.3 million, or 15.1% compared to the second quarter of the prior year with our pre-tax pre-provision return on average assets for the quarter being 1.71%.

Our diversified business model continues to perform well in spite of the uncertain economic environment. In accordance with the orders from the governors of Pennsylvania and New Jersey, we continue to encourage our employees to work from home to the extent that they can. We reopened all of our branch lobbies on June 29, and our customers have adapted to the safety protocols in our branches and our employees continue to provide the great service Univest customers have been accustomed to.

While loans were relatively flat during the quarter, excluding PPP loans, this is net of a decrease of $94.5 million in commercial line utilization during the quarter. We continue to see lending opportunities as the economy has reopened and customers and prospects have become more open to meetings across all of our lines of business, whether virtually or in person with masks and social distancing in place.

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 continue to handle the current environment. While we continue to focus on the safety of our customers and employees, as the economy has reopened our employees continue to figure out ways to serve our customers and communities, ensuring we are part of moving our local economies forward.

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

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

As Jeff mentioned, we reported earnings of $0.07 per share for the quarter. The total provision for credit losses was $23.7 million. This included expense of $19.9 million, or $0.54 per share related to COVID-19, which was the result of changes in economic assumptions within our CECL model. The core business continues to perform well with pretax, pre-provision return on average assets of 1.71% for the quarter.

I would now like to touch on four specific items related to the earnings release. First, excluding the COVID-19 impact, our provision for the quarter would have been $3.8 million. This includes, $1.3 million related to a previously acquired loan, which was transferred to REO during the second quarter. Upon transfer, a charge-off of $2.7 million was recorded, of which $1.4 million was previously reserved. The property is currently under an agreement of sale and is expected to close during the third quarter. It is important to note, this charge-off was not COVID-19 related and the loan had been placed on non-accrual in the first quarter of 2018.

Through the adoption of CECL and our year-to-date provisioning, our allowance for credit losses on loans and leases has increased $50.9 million, or 144% since December 31, 2019. As of June 30, our allowance for credit losses is 1.94% of total loans and leases, when excluding PPP loans. Second, as expected, we experienced net interest margin compression during the second quarter. Reported NIM of 3.18% decreased 30 basis points, when compared to the first quarter.

Reported NIM was negatively impacted by 16 basis points of excess liquidity, which averaged $271 million during the quarter and nine basis points due to carrying low-yielding PPP loans on the balance sheet. Core margin, excluding excess liquidity and the PPP impact was 3.43%, a decrease of 11 basis points, when compared to the first quarter.

Third, as it relates to noninterest income our mortgage banking business continues to have a great year. For the quarter, our net gain on mortgage banking totaled $3.5 million, which represented a year-over-year increase of $2.7 million. For the six months ended June 30, 2020, our net gain on mortgage banking totaled $6.3 million, an increase of $5 million, when compared to the same period in 2019. This was driven by a 185% increase in revenue-generating volume and a 48% increase in margins.

Additionally, noninterest income included swap fees of $1.7 million for the second quarter, which was an increase of $1.3 million compared to the second quarter of 2019. This illustrates customers' desire for longer-term fixed rates, which are achieved via interest rate swaps.

Fourth, included as the last page of the earnings release is a table, which shows our portfolio concentrations and PPP and modification activity as of June 30. We originated $510 million of PPP loans. As of June 30, we had $11 million of net deferred fees on our balance sheet related to these loans. Additionally, as of June 30, we had modified 1,420 loans and leases with a combined principal balance of approximately $720 million.

These modifications included principal and/or interest payment deferrals with the majority having an initial deferral period of 90 days with a potential extension for an additional 90 days. These modifications were completed in accordance with the Cares Act and the interagency statement on loan modifications and as such are not categorized as troubled debt restructuring. It is important to note that new modification requests have slowed considerably with only $8 million of new deferrals occurring so far in July.

In closing, strong performance of the core business and our strong capital and liquidity continue to position us well to navigate this uncertain 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 will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you would like to withdraw your question, please press the star, then two. At this time, we will pause momentarily to assemble our roster.

The first question is from Frank Schiraldi from Piper Sandler. Please go ahead.

Justin Crowley
Hi, good morning guys. It's actually Justin Crowley on for Frank this morning. So, just starting with—and I know it's really kind of the wildcard for the back half of the year and really depends on a number of moving parts. But I just wondered, if you could maybe provide us with your thinking on provisioning for the back half of the year. I realize it's kind of tough to give a forward guide here in a pretty fluid environment. So, maybe just any color you could give on your thoughts in a CECL world of provisioning in the third quarter. And looking ahead here obviously the reserve stands at close to 2% now, so just thoughts on that front.

Brian Richardson
Sure, Justin. This is Brian Richardson. As you know, there's varying economic scenarios and assumptions that can be used in the CECL methodology overall. Since our implementation of CECL back on January 1, we have consistently used the baseline economic forecast provided by Moody's. So—and our policy is to use the last economic forecast as of the balance sheet date. So, for the second quarter that would have been as of June 9th.

So, we consistently applied that throughout as of the initial implementation through the first quarter and the second quarter we've consistently used that baseline forecast. That said, it really depends on where that lands at the end of September of what third quarter provisioning would look like, as well as the fourth quarter would be dependent on the last forecast in December.

I would note that the July 7th forecast will not use in our model because again, we use the last one as of the balance sheet date. We did see some signs of stabilization there. However, it is certainly too early to tell where things will land and a lot can change between now and the end of the third quarter.

Justin Crowley
Okay. That's helpful. And then just on deferrals. So, you gave the detail, it looks like they were up slightly from this time last quarter. I was just wondering so, you grant the 90-day deferral. I'd imagine a portion of those have come up for—have expired since. I was wondering if you could provide any detail on sort of customers returning current. I don't know if you're granting second 90-day deferral periods, just any detail there that you're seeing so far, if you can provide that?

Brian Richardson
Yes. So far, approximately $400 million, or 57% of the total deferrals have reached the end of their initial 90-day deferral, of which approximately 45%, or $180 million, have been extended. Of the remaining $220 million, $118 million, or approximately 55%, have begun making post-deferral payments. For that remaining population, the next 30 days or so will be very telling, to see if those relationships are able to resume payments on a normalized basis, or if further extensions are required.

Justin Crowley
Okay. Perfect. I appreciate that. And then just one last—one quick one for me. Just on capital. Obviously, on a reported basis, the TCE was down, just given PPP. But it looks like, if I'm doing my math right, just even controlling for that capital is still down a little bit, pairing that with two quarters of depressed earnings, obviously, just given the reserve builds. What sort of commentary can you sort of provide on the safety of the dividends here at this level?

Jeff Schweitzer
Justin, this is Jeff. Right now, we feel comfortable about the capital position that we have. The Board, obviously, will look at that every quarter. We know the dividend is important to our shareholders, especially, our retail shareholders. So they don't take it lightly, but it is something that they will review on a quarterly basis. But, at this point, we feel comfortable about our capital position.

Justin Crowley
Okay, great. Thank you for taking my questions, guys.

Jeff Schweitzer
Thank you.

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

Michael Perito
Hi. Good morning, gentlemen.

Jeff Schweitzer
Good morning, Mike.

Brian Richardson
Good morning, Mike.

Michael Perito
Thanks for taking the questions. I wanted to piggyback on the provision question a little bit. As I think about kind of where you're at today, obviously, a very healthy reserve. I think at this point most of your peers are using somewhat similar economic data. I know there's probably some variability.

But I don't really view you guys as having a risky loan portfolio. And I guess you guys seem to be a little bit ahead of the game. I was wondering if you can maybe just kind of dissect that gap a little bit for us further. I understand, you really can't tell us where forward provision is, but as you try to understand kind of your methodology more, I mean, it seems to be more conservative. I was wondering if you could expand on what some of the drivers of that are a little bit.

Brian Richardson
Sure, Mike. This is Brian. As I said, I mean, we've used a consistent approach with literally just using the baseline forecast from Moody's, with no overlays currently from a positive or negative perspective. So, as I would try to reconcile that to what other folks may be doing. I don't have insight into exactly what overlays they're doing or not. But we are applying a consistent approach, like I said, of using the baseline forecast from Moody's.

Michael Perito
Okay. And so, in terms of kind of what—I mean, I assume you guys use some type of stress testing or loss rate modeling, based on those assumptions that kind of drive the CECL model output. Is that correct?

Brian Richardson
Correct. We developed historical correlations to these various economic forecasts or economic factors. And then, based on the forecast of those factors is how our provisioning is driven from a discounted cash flow perspective.

Michael Perito
And any sense on kind of how those loss rates or assumptions compare to kind of the bank's historic performance during periods of stress?

Brian Richardson
They were highly correlated in the past when we set it up. And to the extent that unemployment was the driver in the past, for example, we also utilized housing price index, GDP, retail sales for all various loan segments. So those were highly correlated in the past. Again, we're in unprecedented times here, so that correlation—we'll see how that plays out, as we navigate through the pandemic.

Michael Perito
Okay. That's helpful, Brian. Thanks. And, I guess, just kind of related, but I was wondering, if Jeff or Mike, maybe you guys could provide a little bit more color, kind of, on the local economic conditions, maybe especially kind of out in Lancaster, where, I know that was a big driver of your growth, leading into the pandemic. What's happening? How is the reopening trending? Is business—I'm sorry, commercial customer confidence picking up? Any insights there would be great.

Mike Keim
Yes, Mike. So it's Mike Keim here. I would tell you the local economy, all things being equal, was starting to open up. If you look about our business lines, some customers are doing very well. The governor shut down bars and put limitations on restaurants again. But if you go market-by-market, to be more specific to your question, the Lancaster market's doing really well.

I mean, we have—as you well know, we have an agricultural base there. That base continues to perform well. And it's in early innings, in terms of how things are going to be going here. We're in frequent discussions with our customers across our footprint. Overall, knock on wood, at this point in time, things seem to be going well. But we have to also be honest with the fact that we have a lot of people that got PPP funds.

Brian and Jeff had a pretty extensive discussion on our deferrals. So, we're helping customers along at the same point in time. So, as long as the economy doesn't shut down dramatically again, I think we'll continue to progress. And that's the big wildcard, obviously, with COVID cases ramping up across the country.

Michael Perito
Yes. Helpful. Thanks Mike. And then, just lastly, kind of a quick two-parter for me. But Brian, or Jeff, can you just provide some—there were a couple up and down pieces with the non-interest income and non-interest expense. Any kind of quick hit or thoughts you can provide us on the near-term outlook for both of those? Mortgage pipelines, are they still strong? Is some of the lower expense items in the quarter sustainable? Any thoughts there would be great. Thank you.

Jeff Schweitzer
Sure. Yes. This is Jeff. On the non-interest income side obviously, wealth got hit with the downturn in the market in the—towards the end of the first quarter. With the recovery that happened in the market in the second quarter, we expect that we'll start—we'll pick up some of that lost revenue as we start to bill on end-of-quarter balances and the monthly billings that we do, we do a combination of monthly and quarterly billings.

So—and we're starting to see customers be more willing to have discussions. So April was a low point on new business, May was better, June was even better. And we're off to a good start in July on the wealth side. So we are starting to see a recovery there. And obviously the market recovery helps.

Insurance, we got impacted by people—customers laying off employees. When you look at our employee benefit plan practice and you look at workers' comp insurance, premiums got hit there. As things have reopened and businesses are starting to bring back their employees, we're getting those premiums back. So we took a little hit in the second quarter on the revenue side but we're starting to see that that's starting to recover a little bit.

So, mortgage continues to do extremely well. The housing market is booming. The refi market is booming. So locally our mortgage operation, we don't see that slowing down right now. It is still continuing to do real well and we continue to add really high-performing home loan consultants to our sales staff, which are proving—providing results real quickly. So we're excited about that. The expense side I'll throw it over to Brian.

Brian Richardson
Yes. And also on the income side, there are certain activity-based service charges and the like. We did waive overdraft fees and the like through the pandemic. Those were turned back on at the beginning of the third quarter. So that's activity-based and put some pressure on non-interest income with regards to those.

On the expense side, again there's a fair bit of activity-based savings that occurred there with folks being at-home, not conducting business meetings and the like with the stay-at-home orders. We are self-insured on medical insurance. So that's inherently activity-based as well.

So we'll see some of those things start to tick up but partially offset by that activity-based income that was depressed as well for the second quarter. So I think as we start to return to a state of normal, which clearly we are not exactly sure when that will be, those would start to normalize as well but you have it on both sides of the P&L. So there should be an offsetting occurring there.

Michael Perito
Great. Thank you, guys. Appreciate. Stay well.

Brian Richardson
Thank you. You too, Mike.

CONCLUSION

Operator
Again, if you have question, please press 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.

Jeff Schweitzer
Thank you, Sabrina and thank you to everyone for listening today. While there's obviously a ton of uncertainty in the economy and with the COVID-19 virus, we continue our core business does continue to perform very well, especially through the current environment.

Our employees are continuing to do a great job serving our customers. And we're excited about the—what our core business has been able to throw off from an earnings standpoint during this environment. The uncertainty will continue for some time, unfortunately but we have the strong business to continue to manage through this and the team to manage through this. So, we look forward to talking to everybody next quarter. And all I would ask is that you wear your masks and you stay safe. Have a good day.

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