Univest Financial Corporation

Fourth Quarter and Year End 2020 Earnings

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CORPORATE PARTICIPANTS

Jeffrey Schweitzer – *President & CEO*

Brian Richardson – *EVP and CFO*

Michael Keim – *President, Univest Bank & Trust*

PRESENTATION

Operator
Good day and welcome to the Univest Financial Corporation Fourth Quarter and Year End 2020 Earnings conference call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing star and then zero. After today's presentation there will be an opportunity to ask questions. To ask a question, you may press star and then one on a touchtone phone. To withdraw your question, please press star and then two. Please note that this event is being recorded.

I would now like to turn the conference over to Jeffrey Schweitzer. Please go ahead.

Jeffrey Schweitzer
Thanks, Tom. 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 Co.; 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 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 $25.9 million during the fourth quarter or $0.88 per share. We were very pleased with our results for the quarter as we experienced another quarter of strong loan growth with loans growing $112.8 million excluding PPP loans forgiven, or 9.6% annualized resulting in growth for the year of $436.2 million or 9.9%. Additionally, our mortgage banking team continues to perform very well, setting internal highs as net gain on mortgage banking activities increased $3.3 million or 316.5% for the quarter and 316.7% for the year compared to the prior year's comparable quarter and prior year as refinance activity continued combined with a robust local housing market which is only muted due to limited supply of homes.

As we have gotten more clarity on the impact of the pandemic on our loan portfolio and with the reduction in deferrals and modifications to 1.4% of our loan portfolio, we were able to release $8.7 million of our allowance for credit losses during the quarter, bringing our coverage ratio down to 1.72% of loans and leases, excluding PPP loans. We continue to be pleased with the performance of our core business as our pre-tax pre-provision income for the year was up $9.1 million or 10.3% compared to the prior year, with an increase of 8.6% from the fourth quarter of the prior year.

Before I throw it over to Brian, I just want to thank the members of the Univest family. They continue to do a wonderful job serving our customers, our communities and each other as we continue to work through the current environment and move Univest forward.

I'll now turn it over to Brian for further discussion on our results. Brian?

Brian Richardson
Thank you, Jeff. I would also like to thank everyone for joining us today. I would like to start by touching

on four specific items from the earnings release. First, our reversal of provision for credit losses was $8.7 million for the quarter, which was driven by an $11.6 million benefit due to changes in economic related assumptions within our CECL model, offset by reserves attributable to the 9.6% annualized loan growth we achieved during the quarter. For the full year of 2020, we recorded a total provision for credit losses of $40.8 million, of which $27.4 million was driven by changes in economic factors. As of December 31st, our allowance for credit losses was 1.27% of total loans, excluding PPP.

Additionally, during the fourth quarter, we continued to see reductions in COVID related deferral activity and stable levels of non-performing assets and net charge offs. We ended the year with $68 million of deferrals, which represented 1.4% of the portfolio. Second, reported margin of 3.02% was flat with the third quarter. Reported NIM was negatively impacted by 13 basis points of excess liquidity, which averaged $256 million for the quarter, compared to $329 million in the third quarter. Additionally, NIM was reduced by 7 basis points due to carrying low yielding PPP loans on the balance sheet.

Core margin, excluding excess liquidity and PPP impact was 3.22%, a decrease of 8 basis points when compared to the third quarter. During the fourth quarter, PPP loans contributed $3.1 million to net interest income, of which $369,000 related to forgiveness activity. For 2020 PPP loans contributed a total of $7.9 million to net interest income. As of December 31st, $7.7 million of net deferred fees remained on the balance sheet, which represents approximately 63% of the initial deferred fee amount. Third, as it relates to non-interest income, our mortgage banking business finished the year with another very strong quarter, as Jeff previously discussed. Additionally, other non-interest income included swap fees of $1.6 million for the fourth quarter, which was an increase of $1 million when compared to the fourth quarter of 2019. For the year swap fees totaled $5.7 million, representing an increase of $4.4 million when compared to 2019.

Fourth, non-interest expense included the following non-recurring items, a $1.4 million restructuring charge related to the Financial Center Optimization Plan, which was announced in the fourth quarter. This plan is expected to result in expense savings of $1.8 million in 2021 and $2.4 million on an annualized basis. A $1.1 million charge related to the termination of $80 million of long-term borrowings, with a weighted average rate of 1.46%. This is expected to result in an interest expense benefit of approximately $800,000 in 2021. A $928,000 benefit related to the modification of performance based equity awards during the fourth quarter. These modifications replaced the original peer based ROAA metric with a peer based pretax pre-provision less net charge off ROAA metric. This was done to address the inherent lack of comparability and peer ROAA metrics due to the variation in CECL implementation timing and approach.

The Compensation Committee of the Board of Directors concluded this replacement metric was a more comparable measure of performance and we plan to include this metric in future performance based grants. We reported a pre-tax pre-provision ROAA of 1.44% for the quarter and 1.62% for the year. Adjusting for the previously mentioned one-time items, our pre-tax pre-provision ROAA was 1.55% for the quarter and 1.65% for the year, which shows that we were able to produce [ph] solid core results despite the inherent challenges faced while operating during a pandemic.

I believe the remainder of the earnings release was straightforward, and I would now like to focus on five items as it relates to 2021 guidance. First, PPP inherently introduces a lot of volatility as it relates to NII and NIM. As previously mentioned, at December 31st, we had $7.7 million of net deferred fees from the first round of PPP that will be accretive to income over the remaining life or accelerated upon forgiveness. It is challenging to determine the exact timing and extent of forgiveness, which is further complicated by the second round of PPP. So I think it is most appropriate to exclude PPP when giving 2021 guidance. Accordingly, NII excluding PPP was $166.5 million for 2020. For 2021, we expect loan growth of approximately 7% to 8%, excluding PPP loans, and we expect this to result in net interest income growth

of 2% to 4%, again excluding PPP. This is reflective of the current interest rate environment.

Second, the provision for credit losses will continue to be driven by changes in economic forecast, potential government stimulus, and the expected timeframe to fully exit the pandemic environment.

Third, we have historically seen non-interest income growth of approximately 5% per year, but we experienced outside growth of 19.7% in 2020 due to mortgage banking activities and swap fees. Accordingly, we expect contraction of 5% to 7% in non-interest income for 2021. This translates to a compound annual growth rate of approximately 6% from 2019 to 2021, which is slightly above historical norms.

Fourth, we reported non-interest expense of $155 million for 2020 and expect non-interest expense growth of approximately 2% to 4% in 2021, which reflects the expected savings from the previously mentioned financial center optimization plan offset by our continued investments in digital offerings and expansion markets, specifically York, Burks and Cumberland counties. These regional centers will serve both business and consumer customers and provide Univest integrated financial solutions.

Lastly, as it relates to income taxes, we expect our effective tax rate to be approximately 18% to 18.5%, assuming the current statutory rate remains unchanged. That concludes my prepared remarks. We'll 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 the 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 star and then two. At this time, we will pause momentarily to assemble our roster.

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

Michael Perito
Good morning, guys. Happy New Year.

Jeffrey Schweitzer
Good morning Mike.

Michael Perito
A couple of questions for me, appreciate the outlook commentary. First, on the loan growth side, 7% to 8% for next year. Obviously, you have been tracking it seems ex-PPP a little stronger than that in the back half of 2020. Just curious what some of the drivers are, how the pipeline looks today, and maybe relative to six months ago and can you talk about the marketplace for additional talent adds right now, it seems like there's quite a bit of talent moving around, especially from Wells Fargo and in your neck of the woods, just curious how that pipeline looks as well?

Mike Keim
Yes Mike, good morning. It is Mike Keim. With regard to how the pipeline looks, it looks strong. As we've talked about in the last couple of quarters, it was important for us to continue to be a lender during the pandemic. We did pull back on our underwriting criteria to make sure we were more conservative,

given the economic outlook at that point in time and as it continues today. But we stayed in the game and we continue to build momentum, and really, I think it's a testament to the strength of our teams and that consistent contact that we have with our customer base.

So we are seeing growth basically across the board. Obviously, we're not growing in the hospitality or accommodation industries at this point in time, but we see strong growth continuing in Central Pennsylvania and we see our diversified loan portfolio continuing to grow in what we call the East Penn and New Jersey marketplace.

As we move forward from a talent perspective, we have picked up a couple of people. We would agree with you that there seems to be some moving around. We haven't necessarily gotten talent from the institution that you referenced, but there are other people out there and we are always actively recruiting and trying to add talent to our teams.

Michael Perito
Understood. Thanks for that. And then just Brian, on the efficiency ratio here, or maybe just [speaker off-mic] you guys are talking about 100 basis points positive operating leverage for the last handful of years now. Now, if I think about the core efficiency ratio is 63% in 2017 down to 60% now. I am wondering, can you talk how much of that is branch optimization and other cost reduction efforts versus technology investments that are reducing costs around back office processes and whatnot. I was wondering if you guys can talk about that dynamic and it seems like you think it's sustainable into 2021 based on the guidance provided Brian, is that a fair assessment?

Brian Richardson
Yes, as we go forward to 2021, there's a lot of noise there in 2020. As we all know 2020 was abnormal in a lot of ways and it's seen in several expense lines. If you look at certain activity based things, they were down year-over-year. For example, we're self-insured on medical and when you're self-insured it's activity based and we saw about $1 million decrease year-over-year in medical. That's displacing mid-single-digit increases and underlying medical costs, again really just a function of the pandemic and folks electing deferral procedures and the like.

You'd almost expect that something like that to start to return back to the normal level. T&E is another example that was down $1.2 million year-over-year and I hope for everybody’s sake that that returns back to a normal level, not just personally but also from the health [ph] of the overall economy, that those activities return back to normal. With those two items alone and incorporated in my guidance there it is $2.2 million worth of benefit in 2020 that you'd expect to start to give some of that back in 2021.

Lots of noise in the expense items, again, achieving semi operating leverage here in 2020 despite the pressures that we've seen on the revenue side.

Michael Perito
And then just to comment, anything in terms of kind of technology efficiency and is that something you think you can start to pull through the numbers or continue to pull through the numbers going forward or any thoughts there?

Mike Keim
From a technology perspective Mike, the way we look at it and the way we continue to drive forward is, what happens is we're not necessarily reducing headcount as a result of these technology expenditures, but as we grow as an organization we are not adding headcount. We're getting operating leverage but it's going, I would say, almost the more positive way, growth without having to add versus having to reduce.

Michael Perito
Alright, great. Well, thank you guys for taking my questions. Appreciate it.

Mike Keim
Thanks, Mike.

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

Frank Schiraldi
Good morning. Just wanted to ask on the changes in the model leading to the reduction or the negative provision in the quarter, is that more Univest centric, is that changes to macroeconomic expectations, and if so, if the latter I just wondered if you could share kind of some of those changes in the model?

Brian Richardson
Sure Frank, this is Brian. We use a third party forecast, economic forecast, Moody's, to just put it out there. We've consistently earlier in the year, we used the baseline scenario. We looked at some downside scenarios that we utilized at the third quarter and continue to utilize that downside scenario in the fourth quarter. But there was improvement of that downside scenario from September 30th to December 31st and that's what kind of led itself through the numbers there as we released the $8.7 million as previously discussed.

Frank Schiraldi
Okay, and in terms of the expense guide, Brian, you mentioned the savings involved with the reduction in branches and it sounded like that ladders [ph] in over 2021 is that right or did you get that all up front?

Brian Richardson
No, that ladders in because we have closures that are occurring at the end of this month and then we have closures that are coming in June, at the end of June. It does ladder in, that's why we expect $1.8 million in savings for 2021 and full annualized savings going forward as we look into 2022 from your kind of original start point would be $2.4 million, all in on the initiative.

Frank Schiraldi
Okay. And then just finally, I wonder if you could talk about thoughts on capital return in 2021 in terms of a buyback? Thanks.

Jeffrey Schweitzer
Frank, this is Jeff. As we've discussed, when it comes to capital our first goal is to pay back our subordinated debt which we've started that process and we'll pay back if everything goes according to plan. We'll pay the rest of the original $95 million in midyear. And then once that happens and we kind of get a little more clarity as we get through the first six months, vaccines and the like, and the economy hopefully reopens again fully, then everything's on the table when it comes to capital deployment, whether it be buybacks, looking at the dividend, things of that nature.

Obviously, the Board will be integrally involved in all of those discussions but our first goal is to pay back that subordinated debt and then get a little more clarity on the year and how everything's going with the pandemic and assuming everything goes according to plan and while we're all hopeful it will be and everything is on the table.

Frank Schiraldi
Okay, alright, great. Thanks.

Jeffrey Schweitzer
Thank you.

Operator
As a reminder, if you have a question please press star and then one to be joined into the queue. Our next question comes from Matthew Breese with Stephens Incorporated. Please go ahead.

Matthew Breese
Good morning. Just going back to loan growth, Mike, as you outlined the pipeline strength, I thought you were describing it from a geographic standpoint, being across the board fairly strong. Could you describe for us what segments, whether it's C&I or CRE or resi that are stronger than you expected to grow, more so than others in 2021?

Mike Keim
Sure, Matt. It is across our footprint. And where you see the most growth at the moment we continue to grow our Ag business. I would then say, CRE certainly is a component of that. C&I, and I'm ranking them. I would go CRE, Ag, C&I, which is a mix there. And also we had ramped up an ABL component. We're going to see some growth from what we're doing on the ABL side in the first quarter as well. So it's kind of across the board.

Matt Breese
And how are new yields, as you look at those categories, what are the blended incremental yield now versus call it six months ago?

Brian Richardson
Hi Matt, this is Brian. If you look at it quarter-over-quarter, we've seen improvement there. We were right below 3% for new commercial production back at the third quarter. That's up 20 basis points to 315 here in the fourth quarter. And it's really a 50/50 split there between fixed and variable. Our fixed look where we saw production levels around 368, which was flat quarter-over-quarter, and our variable book was around 263 for the fourth quarter in production.

Matt Breese
Got it, okay. And then just tying this into the core NIM outlook, I appreciate the NII guide as I think about loan growth, it has been very robust but NII up single-digits. I'm assuming that the core NIM outlook is there's continued pressure there. Could you just give us an idea where you think the stabilization point is and when you think you'll be able to fully deploy the excess liquidity?

Brian Richardson
Yes, the excess liquidity point, that's why I really tried to focus on NII in my guidance there. It was simply excess liquidity is a moving target just with the first round of PPP and the forgiveness that will come along with that, which is now the time frame for that extended just because of round two and a tail that'll come along with that.

I would think core NIM overall though should relatively, that is starting to stabilize. We're seeing that there will be some deterioration. But I really think that started to slow and we're in a point of more stabilization than we've been over the last couple of quarters.

Matt Breese
Okay, great. And then last one, just on fee income. I recognize the strength this year, and you're calling for a little bit of a decline next year. I'm assuming a lot of that's mortgage banking. Could you just walk through the other lines of business wealth, trust, insurance, and how you think the individual lines will perform?

Brian Richardson
Sure. A big component of that is the decrease in the outsized mortgage banking or increased mortgage banking for the year and the swap fees. But if we look on the wealth and investment management side, we see that in the kind of the 10% to 15% growth type range for the year. On the insurance side of things we're in the mid-single-digit growth is what we're expecting there on that side of the business.

Matt Breese
Great. I appreciate it. Thank you for taking my questions.

Jeffrey Schweitzer
Thank you, Matt.

CONCLUSION

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

Jeffrey Schweitzer
Thanks, Tom, and thanks to everyone for joining us today. I think we ended the year on a really strong note with a lot of momentum as we head into 2021. We're excited about what we've been able to continue to accomplish to serve our customers and our communities throughout this pandemic and look forward to continuing to do that as we hopefully will work towards more of a normalized environment, as we get through this year.

So I just want to thank everybody for participating again. And please stay safe. Have a great day.

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