Univest Financial Corporation

Third Quarter 2022 Earnings Conference Call

October 27, 2022

CORPORATE PARTICIPANTS

Jeff Schweitzer, *President and Chief Executive Officer*

Brian Richardson, *Chief Financial Officer*

Mike Keim, *Chief Operating Officer; President, Univest Bank and Trust*

CONFERENCE CALL PARTICIPANTS

Tim Switzer, *KBW*

Matthew Breese, *Stephens, Inc.*

Justin Crowley, *Piper Sandler*

PRESENTATION

Operator

Good morning. Thank you for attending today's Univest Financial Corporation Third Quarter 2022 Earnings Conference Call.

I would now like to pass the conference over to Jeff Schweitzer, President and CEO of Univest. You may proceed, sir.

Jeff Schweitzer

Thank you, Alexis.

Good morning and thank you to all of our listeners for joining us.

Joining me on the call this morning is Mike Keim, our Chief Operating Officer and President of Univest Bank and Trust, and Brian Richardson, our Chief Financial Officer.

Before we begin, I would like 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 $20.8 million during the third quarter or $0.71 per share. Our net interest income increased 13.2% from the second quarter of the year, as we continued to benefit from rising interest rates. Additionally, we continue to have very strong loan growth, as loans grew $190.6 million or 13.5% annualized, excluding PPP loans during the quarter. Year-to-date loan growth has been $568.8 million or 14.4% annualized, excluding PPP loans.

We were very happy with our results for the quarter, as our pre-tax pre-provision income continues to be solid and increased 27.9% from the second quarter. Additionally, while non-interest income has been negatively impacted by increasing rates and decreasing margins for mortgage banking, along with the declining financial markets impacting assets under management and supervision for wealth management, new business production across our lines of businesses continues to be solid, setting us up for continued future growth.

Finally, while there's definitely recession risk as the Federal Reserve continues to raise rates, our credit quality continues to be solid as non-performing assets to total assets declined four basis points during the quarter with minimal net charge offs of eight basis points.

Before I pass it over to Brian, I'd like to thank the entire Univest family for the great work they do every day, and for their continued efforts serving our customers, communities, and each other.

I'll 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.

As Jeff indicated, we continue to be very pleased with our performance during the first nine months of the year. I would like to touch on five items from the earnings release. First, our strong loan growth in recent years, coupled with the benefit of the rising rate environment continued to provide momentum for our net interest income and net interest margin. Reported margin of 3.67% increased 48 basis points compared to last quarter. Core margin, which excludes the impact of excess liquidity and PPP, was 3.68%, an increase of 27 basis points when compared to last quarter. Net interest income increased $6.8 million or 13.2% compared to last quarter.

Second, during the quarter, we recorded a provision for credit losses of $3.6 million. Our coverage ratio was 1.28% on September 30 compared to 1.27% at June 30. For the first nine months of the year, we've had net charge-offs of $3 million or seven basis points annualized. Despite general economic concerns, we are not seeing signs of pervasive credit quality deterioration in our portfolio. During the first quarter, we actually saw a slight reduction in non-performing assets and delinquencies, and a $59 million or 35% reduction in criticized and classified loans.

Third, non-interest income decreased $2.6 million or 12.6% compared to the third quarter of 2021, which was primarily driven by a $2.4 million decrease in net gains on mortgage banking due to a decrease in saleable volume.

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Fourth, non-interest expense increased $3.4 million or 7.9% compared to the third quarter of 2021. This includes $1.2 million related to our digital transformation initiative, $504,000 resulting from the inclusion of the Paul I. Sheaffer Insurance Agency, which was acquired on December 1 of last year, and $227,000 related to our expansion into Western Pennsylvania and Maryland. Excluding these items, non-interest expense increased $1.5 million or 3.4%.

Fifth, on October 26, the Board of Directors authorized an additional 1 million shares for repurchase. Including this authorization, there are a total of 1.23 million shares authorized for repurchase. During the first nine months of the year, we purchased 450,000 shares at an average price of $25.29. Going forward, we will opportunistically repurchase shares, with no predefined quarterly volume targets.

I believe the remainder of the earnings release was straightforward, and I would now like to provide two updates to our 2022 guidance. First, on last quarter's call I had guided to loan growth of 10% to 11% for 2022. Based on our continued strong growth during the quarter and our current pipelines, we are increasing this guidance to 13% to 15%. Second, we expect the increased loan growth, coupled with a rising rate environment, to result in net interest income growth of approximately 23% to 25% off the base of $173.4 million in 2021. This assumes a 75 basis point rate increase next week, and another 75 basis points in December.

I'd also like to note, the guidance provided last quarter for the provision for credit losses, non-interest income, non-interest expense and income taxes 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.

Operator

The first question comes from the line of Tim Switzer with KBW. You may proceed.

Tim Switzer

Hi, good morning. I'm on for Mike Perito. Thanks for taking my question.

Jeff Schweitzer

Good morning, Tim.

Brian Richardson

Good morning, Tim.

Mike Keim

Good morning, Tim.

Tim Switzer

I wanted to ask about the upgraded loan guidance. It's kind of an acceleration, I guess from what you guys were expecting. Last quarter sort of implied like a high-single digit rate in the back half of the year. Now I'm looking at it real quick. But looks you're in the double digits, like, low double digits now.

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I want to hear kind of what are the trends you're seeing, which markets are you seeing the growth? Then what are your expectations for at least the first half of next year?

Mike Keim

Yes, Tim. This is Mike Keim.

When we talked in the last quarter's call there, we still had strong pipelines and we were moving forward. We had an element of caution with regard to what would have to happen to activity as the Fed continues to move interest rates up. At this point in time, our pipelines are full for the fourth quarter. We expect a very similar quarter to what we had this quarter in the fourth quarter, therefore Brian's guidance.

As we move into next year, I still am cautionary, and we are still cautionary as an organization, with regard to how loan demand will hold up as the Fed continues to raise rates. So that was really why we were a little bit more cautious and conservative last quarter. We're kind of staring it in the face with regard to the fourth quarter right now. But we are still cautious to some degree as we move into 2023.

Tim Switzer

Okay, yes, I understand that 2023 outlook. That's fair with the Fed rate.

Then can you talk about which markets and categories you are seeing the strongest growth in demand from?

Mike Keim

We're actually have a very well diversified book, and we are seeing growth across the footprint. At this point in time our customers continue to see strong economic activity. There is some level of caution that's going on with regard to hiring new people. But other than that, everybody kind of thinks that, at the very least, we're going to have a slowdown, if not some type of recession. But individually, each company is kind of thinking their business is doing fine.

It's kind of an odd kind of situation at this point in time from our prospective perspective. But other than that, we're seeing that growth and strong activity across the board. So there's no specific market or no specific asset class that is stronger than another, or at least memorable.

Tim Switzer

Okay, thanks. That's good color.

The last question from me is on the margin. Really good core expansion this quarter with another 150 basis points baked in your guide. Could you talk about where you see the margin going from here in to like first half of '23?

Brian Richardson

Sure, Tim. This is Brian.

For Q4, we expect kind of in that five to 10 basis point expansion range on NIM. While we're not positioned to give full guidance for 2023, as we're in the middle of our budget process, I think as you kind of just think about our asset sensitivity, and the reduced benefit of that asset sensitivity, the further we get into this raising rate cycle, I would think it'd be fair to conclude that NIM would kind of peak out in the

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fourth quarter, maybe into the first quarter. Then you'd start to see it pull back into that 3.55% to 3.65% type range going forward, on a more normalized basis.

Tim Switzer

Okay, that's understood. Did you guys take any more actions to limit the asset sensitivity, like the swap you guys did last quarter? Or is it more just you're expecting some rising deposit betas?

Brian Richardson

It's really the asset size continuing to behave, as we originally modelled, and as we've seen on the first handful of raises, the first 300 basis points of raises. Where the change is coming in is on the liability side as the positive betas catch up. Through this point, our cumulative beta on interest-bearing deposits is in that 12% range. Historically, in a rising rate environment, we see that in the 45% range. So we expect that to catch up here as things continue to go in the upward-rate environment.

Tim Switzer

Okay, great. That's all for me. Thank you.

Operator

Thank you, Mr. Switzer.

The next question comes from the line of Matthew Breese with Stephens, Inc. You may proceed.

Matthew Breese

Good morning.

Jeff Schweitzer

Good morning.

Matthew Breese

Just curious on the loan growth guidance, is there anything else that's driving that beyond just good kind of core economic activity in your local markets? Maybe talk about the hiring efforts and whether or not it's bearing fruit.

The other thing I'm curious about is whether or not there's been any change in the competitive landscape. Like, have you seen some of the insurance companies or non-banks pull back and become less competitive?

Mike Keim

Hi, Matt, it's Mike.

In terms of hiring, we've consistently looked for and brought on strong producers. So that continued to benefit us over time. There's nobody specifically that we brought on that all of a sudden has produced some outsized growth in the last quarter or so. It's really the cumulative efforts that we've had.

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With regard to the expanded markets in Western Pennsylvania and Maryland, we're still building up pipelines there. That's contributed a little less than $10 million to the loan growth in the third quarter. So it's helping, but it's not a big driver at this point in time. But we will continue to make investments as we grow out those regions.

Beyond that, from a competition perspective, we met with a couple people that seem to indicate perhaps there is some back-off on multi-family from an insurance company perspective. But we haven't seen anything that dramatic at this point in time.

Matthew Breese

Got it, okay. Then maybe just talk a little bit about the funding strategy supporting what seems to be, at least in the near term, continued strong loan growth. What areas do you expect to rely on? Is it going to be CDs and kind of money market?

Then maybe just touch on expectations for non-interest-bearing deposits, which have been down the last couple of quarters.

Brian Richardson

Matt, this is Brian.

We've always historically managed in kind of that 100 to 105 range from a loan to deposit ratio. We were now targeting kind of in that 95 to 100 range. We're a little bit north of that as we ended here. But, of course, growing deposits to continue to fund our growth would be a core initiative. It's kind of an across the board approach, being CDs are certainly a place to be going. We have some promos that are out in the marketplace currently, as well as money markets where we've done some adjustments on our RAC rates, as well, to both retain and drive some incremental deposits there.

On the non-interest-bearing side, we've had a pretty good track record in the last rising rate cycle. For 2016 and 2019 we saw a 12% average increase per year in non-interest-bearing, really sits there in kind of that roughly 33% to 35% of our deposit base on a normalized basis. We'd expect that to continue to grow in conjunction with our C&I growth and our treasury management and commercial offerings.

Matthew Breese

Okay, so you expect that range to hold?

Brian Richardson

Correct.

Matthew Breese

Okay. Then I think you had mentioned it, I don't know if I caught it correctly, historically, a 45% deposit beta for interest-bearing. Is that what you're assuming, kind of full cycle, this cycle as well? Or kind of any change to that?

Brian Richardson
Correct. Yes, we'd expect to resort back to those historical norms. So 40% to 45% on interest-bearing in the low 30s, when you look at it on a total deposit basis, assuming our mix stays the same, where it's two-thirds, one-third between interest-bearing and non-interest-bearing.

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Matthew Breese

Okay. Then, last one for me, just I'd love some commentary on the overall size of the securities portfolio and how we should be thinking that as a percentage of the total balance sheet.

Brian Richardson

Where that is today is certainly in line with where we'd expect – roughly 7% of assets. Historically, we've averaged, or targeted 8% to 9% of total assets. Of course, with our strong loan growth, that's a balancing act and kind of where we sit today it seems like an appropriate level, and we'll continue to manage that moving forward.

Matthew Breese

Okay. Perfect. That's all I had. Thanks for taking my questions.

Mike Keim

Thank you, Matt.

Brian Richardson

Thanks, Matt.

Operator

Thank you, Mr. Breese.

The next question comes from the line of Frank Schiraldi with ABC. You may proceed.

Justin Crowley

Hi, it's actually Justin Crowley on for Frank from Piper Sandler. Morning, guys.

I had a quick question on expenses. There wasn't necessarily anything specific to the quarter, but you've had this digital initiative going for some time now. That's been flown through the base. I was wondering if we could just spent some time just talking about what the benefits there are. Then specifically, on that digital side, how that could potentially help on the funding side, if at all, just as you look at it farther into next year, and sort of what that does for the franchise.

Mike Keim

Yes, this is Mike Keim.

The investments that we have made on the digital side, and what we expect out of them, you kind of tick through these. One, we think that the investments we're making are necessary to keep us from a competitive posture there. Two, we are looking at them and the tools that we have so that we can deepen existing relationships with customers. So we can sell all of our products and services. So that is a revenue side of the equation. The third component of it is what you're getting at is ultimately we believe those digital investments will allow us to be, A, across the board we will be more efficient with regard to processing loans, processing deposits, etc., but also gives us an ability to enter into new markets without

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making heavy investments in fixed infrastructure, i.e., physical space. As we expand into Western Pennsylvania and into the Maryland markets, we can do that with a lot less — couple of regional headquarters in each of the counties that we serve, and go forward from that perspective. So ultimately, that's how it'll benefit us from an expense posture.

But we will also see benefits across the board with regard to just being more efficient as an organization, from the front end to the back end of our operation as we add more tightly integrate workflow and use systems to drive data through.

Beyond that, from a funding perspective, components of what we're doing on the digital side are mobile tools with regard to consumer deposit account opening, as well as we subsequently will add a stronger small business depository tool.

Remember, we are much more a commercial bank than a consumer bank. So new customer acquisition that would be driven by kind of a marketing spent would be the fourth pillar of our digital strategy. We will not embark on that until we get the first three nailed.

Justin Crowley

Okay, got it. Appreciate that.

Then just on the initiative, and sort of the related costs, is that something that is—and forgive me, if you guys have talked about this before, but just how that trends into next year and kind of how spend has shaken out compared to what you originally budgeted for, versus where you see that as we head into 2023.

Brian Richardson

Yes, this is Brian Richardson.

For 2022, we had guided towards $3.5 million to $4 million of spend. We expect to come in on the higher end of that range, but still in that $4 million range. Expect it to be roughly half of that next year. That's really a function of some costs we incurred this year that are deferrable due to the long-term nature of the solution that we're building. So it's really an amortization of that largely coming through in future periods, a lot of our heavy consulting spend, and the upfront work that needed to be expensed was expensed this year, and we had some items that are capitalized will carry into next year.

Justin Crowley

Got it. Then sort of shifting gears, just on uses of capital. I hear you on the buybacks being a little more opportunistic. I guess, as far as other uses, you guys have traditionally leaned more on the team lift out strategy. Nothing that I've heard seems to suggest that that might change going forward.

But just on M&A, could you sort of frame what conversations you're having, if any? Granted, I know, deals right now, it seems like they're a little tougher to get done, just given some of these marks and some other industry headwinds. But just any updated thoughts on M&A would be appreciated.

Jeff Schweitzer

Sure, Justin, this is Jeff.

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Bank M&A is really not a priority of ours at this point. So, while we always want to be attuned to what's going on in the market, and what's out there, it's not something that we're overly focused on. We've entered Pittsburgh and Baltimore by hiring Market Presidents. They're going to be building teams out organically. That's been our strategy now, since we did the Fox Chase transaction, the Lancaster lift outs, over a $ 1 billion bank now out there basically. So that's really our focus is the organic strategy as opposed to bank M&A.

Given where pricing is right now, on stock prices combined with if we are headed to a recession, buying somebody else's loan book just makes it even less attractive from our perspective right now. So, we're going to continue with our organic strategy for the time being, and really focus on that.

Justin Crowley

Understood. Then if I could just sneak one last in, just quickly on credit, obviously metrics look great. I think that's sort of what you're seeing across the industry, no real issues, despite some of the headlines and the macro backdrop.

Are there any areas where you're getting a little more cautious, maybe not specific to this core, but just as you look over the past year or so; or just any areas where you're maybe tightening up asking for lower LTVs or just more stringent standards more broadly?

Mike Keim

Yes. So Justin, it's Mike again.

For the last year, at the very least, we've looked at the office space, with a level of caution. While we may do a deal or two, it's really reflective of who the underlying tenant is, and what business that they're in, that would drive that. Otherwise, we don't have a huge appetite for that space.

Beyond that, when you look at retail, we will still do certain retail deals, but it's again who are the underlying tenants? Who are the organizations? So we want to go into a strip mall, which is local vendors or local companies that were once supporting a strip mall. If there was a larger Home Depot/Lowe's type of underlying tenant, that is something we would look at, move forward that. But we would also be a little bit more cautious with regard to the LTVs on that side of the equation as well.

Those are the two that come to mind the most. We're very careful to be absolutists, saying we will or won't do anything, because a lot of times it is the facts and circumstances of the deal. But on a general basis that's the color I can give you.

Justin Crowley

Okay, awesome. That's super helpful. That is all I have. Thank you so much for taking my questions, guys.

Mike Keim

Thank you.

Operator

Thank you for your question.

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There are currently no further questions registered in queue.

I will now turn the conference back over to Jeff Schweitzer for any closing remarks.

Jeff Schweitzer

Thank you, Alexis.

And thank you, everyone, for participating on our call today. We had a very strong third quarter, and we look forward to finishing the year equally as strong. I hope everybody has a great day. And, go Phillies!

Operator

The conference is now concluded. Thank you for attending today's presentation.

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