People's Utah Bancorp

Q3 2019 Earnings Call

Thursday, October 24, 2019, 12:00 P.M. Eastern

CORPORATE PARTICIPANTS

Mark K. Olson – *Executive Vice President and Chief Financial Officer*

Len E. Williams – *President and Chief Executive Officer*

PRESENTATION

Operator

Good afternoon and welcome to People's Utah Bancorp's Third Quarter 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 (0). After today's presentation, there will be an opportunity to ask questions. To ask a question you may press star (*) and one (1) on your telephone keypad. To withdraw your question, please press star (*), then two (2). Please note that the event is being recorded.

I would like now to turn the conference over to Mark Olson, Executive Vice President and Chief Financial Officer. Please go ahead.

Mark K. Olson

Good morning. Thank you for joining us today to review our third quarter 2019 financial results. Joining me this morning on the call is Len Williams, President and Chief Executive Officer for People's Utah Bancorp. Our comments today will refer to the financial results included in our earnings announcement released last night. To obtain a copy of our earnings release, please visit our website at www.peoplesutah.com.

Our earnings release contains forward-looking statements. All statements other than statements of historical fact are forward-looking statements. Such statements involve inherent risks and uncertainties, many of which are difficult to predict and beyond the control of the company. We caution readers that a number of important factors could cause actual results to differ materially from those expressed in or implied or projected by such forward-looking statements. These forward-looking statements are intended to be covered by the Safe Harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. Forward-looking statements speak only as of the date they are made, and we assume no duty to update such statements.

I will now turn the call over to Len Williams, Len?

Len E. Williams

Thank you, Mark. Good morning and thank you for joining us on the call today. People's Utah Bancorp achieved another quarter of strong financial performance even as we continue to position, strengthen and fortify our balance sheet. We realized the return on assets of 1.9% and a return on equity of 13.8% for the third quarter after building our average equity to average assets from 12.8% a year ago to 13.7% for the third quarter of 2019, while increasing our allowance for loan losses from 1.4% a year ago to 1.8% at the end of the quarter.

Our total assets grew 10.5% from a year ago. This was primarily the result of strong low-cost core deposit growth. Total deposits grew $230 million or 12.3% year-over-year as our retail branches and commercial treasury management team focused on raising commercial deposits from existing clients as well as the acquisition of new client relationships. We recently signed a contract for new treasury management platform that we believe will help us continue to grow our commercial deposit base and improve our fee income. We anticipate rolling this new platform out at the beginning of 2020.

Our cost of interest-bearing deposits increased 14 basis points to 0.70% for the third quarter 2019, compared to 0.56% for the same period a year ago. Our total cost of deposits increased only 9 basis points, or 0.45% for the third quarter of 2019, compared with 0.36% for the same period a year earlier. We continue to experience significant competition for deposits. As a result, we anticipate that the downward deposit betas will be lower than in previous interest rate reduction cycles. Loans held for investment were relatively flat for the first nine months of this year, decreasing $3.8 million, or 0.2% to $1.68 billion at September 30, 2019 compared with September or December 31, 2018, and decreased $43.2 million or 2.5% compared with September 30, 2018.

The decline is primarily the result of reduction in the acquisition, development, and construction loan portfolio of $38.7 million, or 11.9% from December 31, 2018 to September 30, 2019 and $96.4 million, or 25.2% from a year ago, as we have managed loan concentration levels and have become more selective with the type and size of construction projects that we are willing to finance giving our perspective on a potential slowing economy.

We've reduced our acquisition, development, construction portfolio to total capital concentration from a high of 149% at the end of the first quarter 2018 to 90% at the end of the third quarter 2019. We continue to focus on diversifying our loan portfolio. In particular, we are focused on growing our C&I book. Currently, we operate two commercial banking centers that are located in Salt Lake County and we are in the process of building out a commercial banking team to open in Utah County this quarter.

We are continuing our efforts to automate and digitize our commercial loan origination process through the implementation of an online commercial lending application and have begun the building, testing, and uploading phases of nCino, which is an industry leader in the commercial banking loan operating systems space. The goal of this project is to ensure that we continue to provide our historical high touch and unparalleled responsiveness to our client and to be able to offer the same client service as we continue to grow in size and complexity and expand our geographical footprint. We expect to have the first phase of this project completed this quarter.

On the retail banking front, we mentioned on our last call, our plan to open a new business-oriented branch in the fast-growing Pleasant Grove area, where a number of technology firms have recently built new corporate offices. The branch has been open, and we have experienced positive results as we work to build additional business relationships in the area. We have completed the demolition of our Alpine branch and have made significant progress on rebuilding the branch. We expect to complete the rebuild sometime in the fourth quarter of 2019. The Alpine branch is one of our oldest branches with over $120 million in deposits.

As I mentioned on our last couple of conference calls, we have decided to simplify our branding strategy to a single unified name for our bank. A new logo and a more contemporary look. We have identified the new name, logo and overall style. We are currently communicating the new brand with our existing clients through one-on-one discussions and other forms of communication. We plan to make a public announcement on November 12th, 2019 regarding our new branding strategy. We expect this new branding strategy will provide us with the opportunity to increase market penetration as potential clients better understand our size, scale, and product offering as a unified Bank.

Ultimately, we anticipate these efforts will result in greater growth in our loan and deposit portfolios and higher overall revenues. While the economy in Utah continues to be strong, we believe that there are beginning to be signs of a general economic slowdown, including flattening of the treasury yield curve and the Federal Reserve lowering interest rates by 25 basis points twice so far this year.

We believe it is prudent for us to be prepared for an economic slowdown so that we can take advantage of market conditions to expand our market share either organically or through acquisitions. We continue to actively evaluate potential acquisition opportunities, both in Utah and in states contiguous to Utah, particularly along the I-15 corridor.

I am also pleased to announce that the Board of Directors declared a quarterly dividend payment of $0.13 per common share, the dividend will be payable on November 12th, 2019 to shareholders of record on November 4, 2019.

I will now turn the call back over to Mark to discuss our financial performance. Mark?

Mark K. Olson
Thank you, Len. Net income was $11.1 million, or $0.59 per diluted common share for the third quarter of 2019, compared to $11 million, or $0.58 per diluted common share for the second quarter of 2019 and $10.5 million, or $0.55 per diluted common share for the third quarter a year ago.

For the third quarter 2019, net interest income grew 3.7%, or $1 million to $28.2 million compared with $27.2 million for the same period a year earlier. The increase is primarily the result of average interest-earning assets growing 8.3%, or $170 million, while yields on interest-earning assets declined 18 basis points to 5.44% for the same comparable period. Lower yields on interest-earning assets was primarily the result of a $207 million, or 62.5% increase in the average amount of lower yielding cash and investment securities held by us stemming from average core deposits, increasing $172 million, or 9.4% for the same respective period.

Yield on total loans increased 16 basis points to 6.49% for the third quarter 2019 compared with the same period a year ago, while average loans declined $35.5 million, or 2.1% for the same comparable period. The percent of loans to total interest earning assets decreased to 75.7% for the third quarter of 2019, compared with 83.7% for the third quarter of 2018. Acquisition accounting adjustments, including the accretion of loan discounts and amortization of core deposit intangibles added 10 basis points to the net interest margin for the third quarter of 2019.

For the third quarter of 2019, provision for loan losses were $2.1 million compared with $1.9 million for the same period a year earlier. The increase in provision for loan losses in the third quarter is due primarily to a $1 million increase in specific reserves set aside with the remainder, the result of increased general reserves. We recorded annualized net recoveries of 0.08% for the third quarter of 2019, compared with net charge-offs of 0.21% for the same period a year earlier. For the nine months ended September 30, 2019 annualized asset net charge-offs were 0.05% compared with 0.03% for the same period a year ago.

Non-performing assets were $4.3 million, or 0.17% of total assets at September 30, 2019, compared with $8.8 million, or 0.40% a year earlier. The percentage of allowance to loans held for investment increased to 1.82% at the end of September compared with 1.36% a year earlier.

In addition to our allowance for loan losses, we have $6.4 million in both non-accretable and accretable credit discounts remaining on our acquired loan portfolio. The allowance for loan losses plus credit discounts to loans held for investment was 2.2% at September 30, 2019. We believe that it is prudent for us to continue to build our overall allowance for credit losses, given that we believe we are nearing the end of an overall economic cycle. For the third quarter of 2019, non-interest income increased $0.7 million, or 17.7% to $4.5 million compared to $3.8 million for the same period a year ago. The increase was primarily the result of mortgage banking income, increasing due to higher loan sales in the third quarter of 2019 compared to the same period a year earlier, as we experienced an increase in refinance volumes as overall interest rates declined.

For the third quarter of 2019, non-interest expense was $16.1 million compared with $15.3 million for the same period a year earlier and is primarily the result of $0.5 million in higher salary and employee benefits, $0.5 million in higher marketing and advertising expense related to the rebranding of the company. We expect higher marketing and advertising expenses as we roll out our new brand strategy, both in the fourth quarter 2019 and into 2020. Higher costs were offset by lower FDIC premiums as we applied the small Bank FDIC assessment credits to our overall premium assessment. We expect to benefit from these assessment credits for an additional two quarters.

Our efficiency ratio was 49.2% for the third quarter of 2019, compared to 49.3% for the same period a year ago. Non-interest expense to average assets was 2.7% for the third quarter of 2019, compared with 2.8% for the same period a year earlier. For the third quarter of 2019, income tax expense was $3.4 million compared with $3.3 million for the same period a year ago. The effective tax rate was 22.2% compared with 23.9% for the same respective period.

In June 2016, the financial accounting standard Board, or FASB, issued an accounting standard update or ASU related to the measurement of credit losses on financial instruments. The ASU significantly changes the accounting for credit loss measurement on loans and debt securities. Loans and held-to-maturity debt securities, the ASU requires a current expected credit loss or CECL measurement to establish the allowance for credit loss or ACL for the remaining estimated life of the financial assets, including off balance sheet credit exposures, using historical experience, current conditions, and reasonable and supportable forecast.

The ASU eliminates the existing guidance for purchase credit impaired or PCI loans, but requires an allowance for purchase financial assets with more than an insignificant deterioration since origination, otherwise known as purchase credit deteriorated or PCD assets. This ASU is effective beginning after December 15, 2019. On October 16, 2019, the FASB voted to delay the adoption of this ASU by two years to January 2023 for private companies, not-for-profit companies and certain small public companies that meet the definition of a smaller reporting company, or SRC as defined by the Securities and Exchange Commission. To meet the requirements of an SRC, an entity must be an issuer and have public float of less than $250 million or public float of less than $700 million in annual revenues of less than $100 million.

As of June 30, 2019, our public float was $466 million and our annual revenues for 2018 were $130 million. Therefore, we do not meet the requirements of an SRC and will be required to adopt ASU effective January 1, 2020. The implementation process includes the evaluation of technical accounting topics; developing, validating, and implementing models and methodologies used to calculate CECL; updating ACL documentation; validating the internal controls and overall operational readiness for the adoption of this ASU. We are currently reviewing new models and processes in parallel with the existing model and processes under current accounting guidance in advance of the January 1, 2020 effective date.

These parallel runs will focus on technical functionality of the CECL calculation, operational execution at the end -- of the end-to-end processes as well as disclosure requirements. We have established a project team and a steering committee to provide cross-functional governance over and make key decisions related to the project plan and the parallel runs. We expect to use the weighted average remaining maturity or WARM approach adjusted for prepayment to calculate CECL. As described in the FASB staff questions and answers, we intend to use the qualitative approach to adjust historical loss information for current conditions and for reasonable and supportable forecast and then immediately revert to historical credit losses.

As noted in the ASU, an entity can or shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and forecast to differ from the conditions that existed for the period over which historical information will be evaluated. The adjustments to historical loss information may be qualitative in nature and should reflect changes related to relevant data. We are currently in the process of evaluating the impact of the ASU on our earnings, financial position, and regulatory capital amounts and ratios. We expect our ACL to increase upon adoption because the ACL will be required to cover the full remaining expected life of the portfolio, rather than the incurred loss models under current US GAAP.

In addition, a portion of the increase will be due to PCI loans that will be reclassified as PCD loans with the credit related non-accretable discount increasing both the ACL and loan balances, but not retained earnings. However, accretable discounts held on non-PCD loans are not allowed to be moved to ACL as part of the adoption. As a result, we will be required to set additional -- set aside additional ACL for non-PCD loans through retained earnings upon adoption. As a result, we will continue to hold accretable discounts that will be recorded into interest income over the remaining life of non-PCD loans as well as a similar amount in our ACL. We expect greater volatility in our earnings, and those of other banks after adoption due to the nature and time horizon used to evaluate CECL. In addition, we expect the potential negative impact of credit availability and reduced loan terms to borrower as the ACU is adopted by financial institutions.

Lastly, we expect a lack of comparability with financial performance to many of our peers as we adopt this ASU due to the delayed adoption for public companies similar in size to us, but that meet the requirements of an SRC. The ultimate effect of CECL on our ACL will depend on the size and composition of the loan portfolio. The loan portfolio's credit quality and economic conditions at the time of adoption, as well as any refinements to the model methodologies and other key assumptions used.

At adoption we will have a cumulative effect adjustment to retained earnings for the change in the ACL, which we expect to negatively impact our regulatory capital amounts and ratios. Bank credit for agencies have provided regulatory accounting relief for an initial capital decrease from the adoption of this ASU by allowing a phased adoption over three years on a straight-line basis, which we expect to utilize.

I will now turn the call back over to Len.

Len E. Williams
Thank you, Mark. We are pleased with the strong financial performance and positioning we achieved in the third quarter of 2019 and year-to-date. In particularly, we are pleased with the momentum we have experienced in our treasury, cash management, commercial program and the resulting growth in deposits. We continue to focus on taking advantage of the strong economic prospects in the markets we serve. We are passionate and enthusiastic about our prospects to expand our commercial and industrial lending to small and medium-sized businesses through our branches in commercial banking center.

Also, we continue to actively pursue potential acquisition opportunities throughout the Intermountain West, which we believe is crucial component to our business strategy and shareholder value creation model going forward. Thank you for joining us today. At this point. I would now like to open the lines for questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, please press star (*) and one (1) on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press star (*), then two (2). At this time, we will pause momentarily to assemble our roster.

First question comes from Jeff Rulis, D.A. Davidson. Go ahead.

Jeffrey Allen Rulis
Thanks.

Len E. Williams
Good morning, Jeff.

Jeffrey Allen Rulis
Good morning.

Mark K. Olson
Hi Jeff.

Jeffrey Allen Rulis
Len, I was hoping to kind of range bound the economic slowdown that you have sort of referenced for several quarters and I want to -- well, I think certainly prudent at this point in the cycle, just wanted to check in and see that level of caution. I suppose, I think you are speaking more of a downshift than a reverse and, knowing the Utah economy is in great relative shape, just wanted to kind of sharpen what I think is your view of how the economic landscape is progressing?

Len E. Williams
Yes, Jeff, probably the easiest way for me to explain it is going from almost unbelievably well to very good. You know, I mean that is an odd slowdown, but we have seen inventories in residential new construction lengthen. We are seeing a little bit more availability to where there has been such excess demand and no supply. We are starting to see a little bit of supply. We have, as we have stated, had a pretty high concentration in the real estate arena that we have backed down. And we are starting to see some extensions and things carried out a hair longer. So, it is typical stuff you see in a normal economy that we have not seen for a while and that is what we are talking about.

Jeffrey Allen Rulis
Got it. Okay and I guess given sort of that backdrop and you spoke on the M&A approach, I guess given that cautious stance, does that slow that effort some in lieu of sort of buying someone else's problems, do you get the sense that the Bank's health or targets that you are looking at or have you gauged or changed your interest given your view of the landscape?

Len E. Williams
You know I think a lot of this last year, year-and-a-half has been positioning for us to be opportunistic in any climate. We feel we've fortified the balance sheet. We have identified our credits well enough to where even in a downturn we do not feel we are going to be 100% internally focused like sometimes happens. So we want to be able to play offense and acquire and grow market share even if things reverse, let alone slow down. So that is the intent. We feel we are pretty well there at this point.

Jeffrey Allen Rulis
You get the sense, there is more inbound, I mean, when do you see the turn in the economy, some of the smaller players may look out to reach to a partner and say, wow, this is a tough row ahead. I guess, are you getting any sense that there is more people coming to the table and say, all right, I am willing to be a little more reasonable with my valuation given -- do you think that that is impacting the targets as well and their reasoning?

Len E. Williams
Yes, we are not seeing reasonable valuations yet. Jeff. We are -– we have conversations out there, there are plenty of people talking, but this has been a pretty long upswing and most privately held community banks have done quite well through this cycle. I think we are going to actually have to wait until either this interest rate cycle or a business slowdown impacts earnings. At that point I think we will have some opportunities.

Jeffrey Allen Rulis
Got you. Okay and then maybe one last one maybe for Mark as well. I am just looking at that reserve build, you guys are on a pretty steady clip upward, all while you are diminishing the construction land development. I guess is the reserve build above 2% in the future, is that reasonable to think you would climb to that or is that not really a number that you are actively watching. It is just the underlying risk in the portfolio? Thanks.

Mark K. Olson
Yes. No, I do not think we would get to 2% under current accounting guidance, that is certainly under CECL. There will be an increase in reserves and that would increase that number overall. So, yes, I do believe we will go over 2% potentially after the adoption of CECL.

Jeffrey Allen Rulis
Okay. I will step back. Thank you.

Len E. Williams
Thank you.

Operator
Our next question comes from Andrew Liesch, Sandler O'Neill. Go ahead.

Andrew Brian Liesch
Good morning guys.

Len E. Williams
Hi Andrew.

Andrew Brian Liesch

You continue to have really good deposit growth without much in the way of grown loan portfolio and I understand why. But what -- how should we be looking at this liquidity here. Cash is increasing without necessarily a big increase in the securities book. Are you looking to apply this in to securities, what is the thought with the deposits that have come on over the last few months?

Len E. Williams
Yes, we have purchased some securities. I mean, not a great time to be buying securities, quite honestly. Particularly, if you are going out longer in duration, that you just do not get paid for the risk. So, we continue to watch that and to the extent that we can see good pricing on certain securities we are buying. We would obviously like to invest the cash in lending and anticipate that we will have opportunities to grow the loan book a little bit more and put that to use.

Andrew Brian Liesch
So, how should we be looking at the size of the securities portfolio relative to the overall asset base and I know it is not the best time to be buying securities in this rate environment, but what is -- I mean is there a certain percentage that you would like to keep it at?

Mark K. Olson
Yes, we would like to keep it at around $300 million to $350 million, that is where we would be careful.

Andrew Brian Liesch
Okay, got you and then just with fewer loan growth opportunities, given some of the caution and the liquidity coming on, I mean is it unreasonable to think that we are still going to see the margin come in. Maybe still be able to grow net interest income, but margin be under pressure?

Len E. Williams
You are right on, Andrew. We do feel we are going to be able to grow the net interest income, but we are impacted by these rate reductions in a pretty big way. We have got our short duration of our portfolio. That said, we talked about earlier about our concentration and bringing the loans, the capital down. We are now under a number where we are comfortable actually rebuilding some of that back up with the right clients and the pipelines, we think, will allow us to do some of that. So, we will probably see some longer-term larger real estate deals go on here in the next quarter to two quarters.

Andrew Brian Liesch
Great. That is good to hear. You have covered all my other questions. I will step back.

Len E. Williams
Thank you.

Mark K. Olson
Thanks, Andrew.

Operator
Again, if you have a question, please press star (*), one (1).

Our next question comes from Don Worthington, Raymond James, go ahead.

Donald Allen Worthington

Thank you, good morning guys.

Len E. Williams
Hi Don.

Donald Allen Worthington
Mark, you talked about the FDIC credit going another quarter or two. Is it at the same rate in this quarter or would it be a diminishing credit?

Mark K. Olson
It would be about the same effect as we have right now for the next couple of quarters. I mean it's not a huge dollar amount, but we do get the benefit. So --

Donald Allen Worthington
Every little bit helps. Right. Yes.

Mark K. Olson
Quite a bit, exactly.

Donald Allen Worthington
And then mortgage banking revenue, that was strong. Do you expect that to continue, particularly if rates declined further?

Mark K. Olson
We do, we have actually hired a new gentleman to run our mortgage division and we are increasing the size of it as far as producers as we speak. So, we are looking at non-interest income growth, both in the mortgage area, if rates continue to decline, and then also by some of the strategies we have regarding treasury management, fee income.

Donald Allen Worthington
Okay, great. Thank you.

Mark K. Olson
Thank you.

Len E. Williams
Thanks Don.

Operator
This concludes our question-and-answer session. I would like to turn the conference back over to Len Williams for any closing remarks.

CONCLUSION

Len E. Williams
Great. Thank you all for joining us and your interest in the company. We appreciate you are being with us and look forward to these as we -- in the coming quarter. So, thank you all and have a wonderful Thursday.

Operator

Conference is now concluded. Thank you for attending today's presentation. You may now disconnect.