S&P Global
Market Intelligence

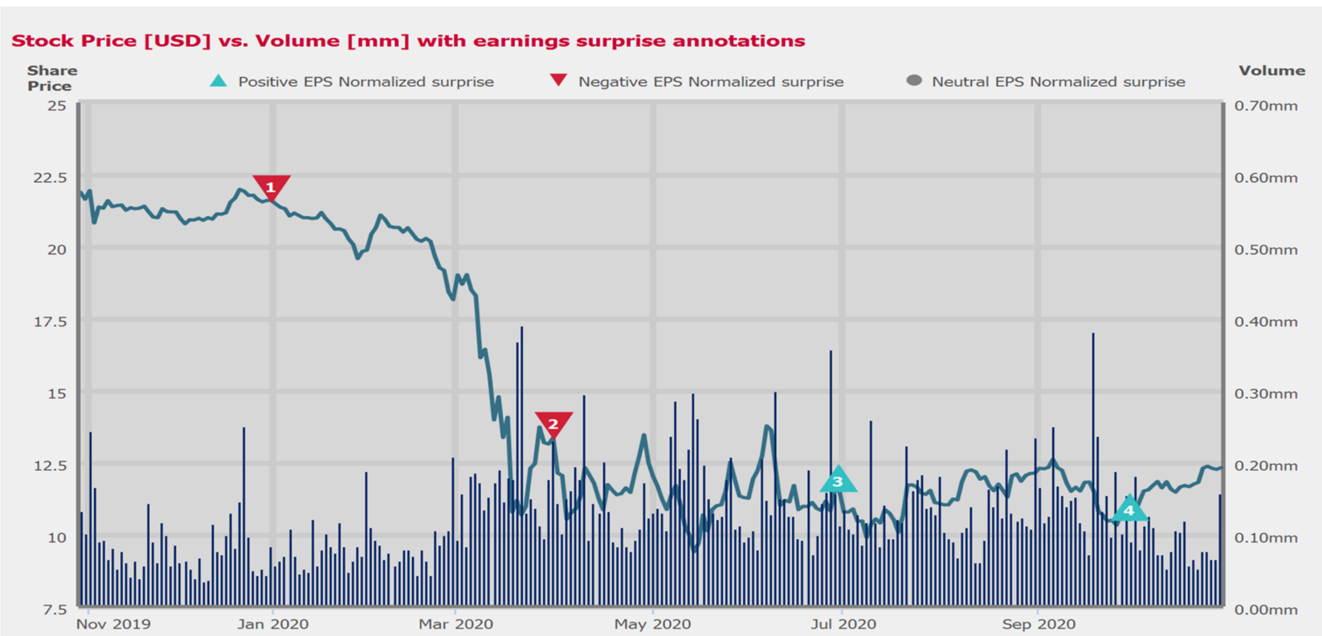
Flushing Financial Corporation NasdaqGS:FFIC FQ3 2020 Earnings Call Transcripts

Wednesday, October 28, 2020 1:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2020-			-FQ4 2020-	-FY 2020-	-FY 2021-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.38	0.56	▲47.37	0.40	1.48	NA
Revenue (mm)	52.12	51.28	▼(1.61 %)	55.17	206.24	NA

Currency: USD
Consensus as of Oct-29-2020 12:10 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2019	0.43	0.41	▼1 (4.65 %)
FQ1 2020	0.20	0.19	▼2 (5.00 %)
FQ2 2020	0.34	0.36	▲3 5.88 %
FQ3 2020	0.38	0.56	▲4 47.37 %

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Call Participants

EXECUTIVES

Francis W. Korzekwinski
Senior EVP & Chief of Real Estate Lending

John R. Buran
President, CEO & Director

Susan K. Cullen
Senior EVP, Treasurer & CFO

ANALYSTS

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Steven Comery
G. Research, LLC

Presentation

Operator

Good day and welcome to Flushing Financial Corporation's Third Quarter 2020 Earnings Conference Call. Hosting the call today are John Buran, President and Chief Executive Officer; Susan Cullen, Senior Executive Vice President, Treasurer and Chief Financial Officer; and Frank Korzekwinski, Senior Executive Vice President and Chief of Real Estate Lending. Today's call is being recorded. [Operator Instructions] A copy of the earnings press release and slide presentation that the company will be referencing today are available on its Investor Relations website at flushingbank.com.

Before we begin, the company would like to remind you that discussions during this call contains forward-looking statements made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. Such statements are subject to risk, uncertainties and other factors that may cause actual results to differ materially from those contained in any such statements. Such factors are included in the company's filings with the U.S. Securities and Exchange Commission. Flushing Financial Corporation does not undertake any obligation to update any forward-looking statements, except as required under applicable law.

During this call, references will be made to non-GAAP financial measures as supplemental measures to review and assess operating performance. These non-GAAP financial measures are not intended to be considered in isolation or as a substitute for the financial information prepared and presented in accordance with the U.S. GAAP. For information about these non-GAAP measures and for a reconciliation to GAAP, please refer to the earnings release and/or the presentation.

I'd now like to introduce Mr. John Buran, President and Chief Executive Officer, who'll provide an overview of the strategy and results. Mr. Buran, the floor is yours, sir.

John R. Buran
President, CEO & Director

Thank you. Good morning, everyone, and thank you for joining us for our third quarter 2020 earnings call. I want to start out by thanking our employees for their tireless work in assisting our customers and communities as we continue to navigate these unprecedented times due to the COVID-19 pandemic. The safety and the health of our employees and customers remains our highest priority.

On today's call, I will discuss our third quarter highlights as well as provide an update on the merger with Empire Bancorp, which has been approved by all parties and is scheduled to close on or about October 31. Then our CFO Susan Cullen will provide greater detail on our financial performance, credit quality, capital and liquidity profile. Following our prepared remarks, we will address your questions along with our Chief Real Estate Lending Officer Frank Korzekwinski.

Beginning on Slide 3. We realized a strong quarter of operating results. Our third quarter GAAP earnings totaled $0.50 per share and we achieved record core earnings, up 56% from the prior quarter. We achieved record net interest income for the second consecutive quarter as the company capitalized on a low interest rate environment resulting in cost of funds decreasing 10 basis points. At the same time, the yield on interest-earning assets increased. As a result, net interest margin expanded 13 basis points from the previous quarter.

We anticipate that our cost of funds will further decline during the fourth quarter as $315 million of retail certificates of deposit are scheduled to mature at an average rate of 110 basis points compared to a current 1-year CD rate of 60 basis points. We expect asset yields to see limited reductions. Credit quality continues to be one of our key strengths and a competitive differentiator. Forbearances granted to our customers during these tumultuous times have decreased from a peak of $1.5 billion to approximately $846 million.

Over 97% of the forbearances are secured by mortgages with a loan-to-value of approximately 46%. This collateral protection is better than the total real estate portfolio of 88% collateralized more mortgages. As the economic concerns escalated in the second quarter, we generally granted forbearances for a term of 6 months. Therefore, we expect a significant reduction in forbearances during the fourth quarter. Through September 30, approximately 80% of loans we expected to return to full payment status have done so. With the remaining 20%, we generally granted a new forbearance for terms that are to the company's advantage.

For example, if a forbearance was for a full P&I, the new forbearance would be a deferral of the principal with the customer making interest payments. The provision for credit losses was reduced by 74% compared to the provision for the previous quarter and totaled $2.5 million. The allowance for credit losses stands at 65 basis points of gross loans and 155% of nonperforming loans. As a reminder, our maximum charge-offs were only 64 basis points in the midst of the Great Recession, while the industry peak charge-offs were nearly 5x our experience.

I'm excited to share that Empire Bancorp shareholders approved the merger yesterday. As stated earlier, the merger is expected to close on or about October 31. The credit quality of Empire remains strong with no loans greater than 90 days past due and less than $1 million in loans greater than 30 days past due. As of September 30, Empire has $120 million in active forbearance agreements outstanding. The system conversion is scheduled for the middle of November. We're excited about this combined bank, which will be a leading bank franchise on Long Island.

Overall, we made good progress in the third quarter to achieve our strategic objectives, which include managing our cost of funds and continuing to improve the funding mix, increasing net interest income by leveraging loan pricing opportunities and portfolio mix, enhancing core earnings power by improving scalability and efficiency, managing credit risk and remaining well capitalized under all stress test scenarios.

Slide 4 shows the trend resulting in record net interest income this quarter. The net interest margin increased 13 basis points quarter-over-quarter and 63 basis points year-over-year. The increase in net interest income was primarily due to the decrease in the cost of funds of 10 basis points quarter-over-quarter and a 105 basis points year-over-year. Additionally, the yield on interest-earning assets increased 3 basis points from the second quarter.

On Slide 5, I detail management's focus during the third quarter. With loan activity somewhat muted for much of the quarter, we focus on maintaining yield on interest-earning assets. Gross loans decreased 1%, while net average interest-earning assets decreased approximately 2%. We took advantage of the opportunity discussed on previous calls to reduce our cost of funds. We decreased funding cost 10 basis points from the second quarter and a 105 basis points versus the same quarter in 2019. During the quarter, we further reduced forbearances and continued site inspections for a cross-section of our retail properties noting the stores were open, well stocked and the surrounding area was active.

On Slide 6 and 7, we provide details on outstanding forbearances. As I mentioned earlier, I'm pleased to highlight that total forbearances have decreased to $846 million from a peak of $1.5 billion. As of the end of September, these amounted approximately 14% of the portfolio. 97% of these loans are secured by real estate with an average loan-to-value of 46%. Less than half of our forbearances are in more stressed industries like retail or hotels that have been shut down during the onset of the pandemic, but began to open during the third quarter. The remainder of our forbearances include multifamily, medical offices and other general commercial real estate that we judge more prone to a speedier recovery.

On Slide 8, we show that over $749 million of forbearances are scheduled to expire in the fourth quarter. Total projected expirations are 98% secured by mortgages. For this reason, we believe there is minimal loss content in the portfolio.

With that, let me now turn the call over to Susan to provide additional details on our financial performance and asset quality.

Susan K. Cullen
Senior EVP, Treasurer & CFO

Thank you, John. I'll begin on Slide 9. Non-performing loans totaled $25 million, which is 42 basis points of gross loans and net charge-offs totaled $837,000 or 6 basis points of average loans for the quarter. Loan-to-value on real estate dependent loans amounted to 38% as of September 30, and the average loan-to-value for nonperforming loans collateralized by real estate was 31%.

Slide 10 shows 90-day delinquencies as a percentage of loans originated by year. Our credit discipline has remained consistent for the past 10 years as we tightened underwriting criteria back in 2009. As a result, in the last 10 vintage years, we have only 24 90-days plus delinquencies.

Turning to Slide 11, we provide an update on our third quarter allowance for loan losses. In the third quarter, we recorded a provision of $2.5 million, a reduction of 74% compared to the provision for -- of nearly $10 million in the second quarter. For the allowance evaluation as of September 30, the forecast showed a tough economy with elevated unemployment and subdued GDP. We continue to use the Oxford Economic Forecast Model. This model assumes it will take 4 quarters for our losses to return to our historical norms. Our credit discipline continues to serve us well in the current environment, and we'll continue to stay close to our customers and manage that carefully.

As highlighted on Slide 12, our coverage ratio has improved significantly since the financial crisis in 2008. Our solid credit quality metrics have resulted in our coverage ratio increasing to 155% as of September 30, 2020 from 28% at December 31, 2008. The coverage ratio decreased from the second quarter is due to a slight uptick in the amount of nonperforming loans. We remain confident that there is a minimal loss content in the loan portfolio. Importantly, we continue to underwrite each loan using a cap rate in the mid-5s and stress test each loan.

Continuing on Slide 13, we note our charge-offs during the Great Recession were significantly better than the industry, and that performance continued through the second quarter of 2020. We continue to actively manage our loan portfolios to identify and resolve problem loans recording charge-offs early in the delinquency process. As a reminder, we are a historical seller of nonperforming loans. Since the Great Recession, our construction loans have decreased by approximately 38% and mixed use by 21%, while the loan-to-values on loans have improved from -- improved to 38% from 48% heading into the Great Recession.

As we continue to strengthen our balance sheet, we are mindful of maintaining asset quality. Based on the most current data, over 2 decades, we have demonstrated superior quality of metrics. Our maximum charge-offs were 64 basis points in the midst of the Great Recession, while industry peak was nearly 5x that.

As detailed on Slide 14, we believe the credit outlook for the company remains positive. The company has a strong credit history and an active forbearance program. Our loan portfolio has retained its historical conservative nature and remains 88% collateralized by real estate with an average LTV of 38%. Loans liquid greater than 90 days amount to only 38 basis points of gross loans. Our forbearances declined 44% to $846 million as of September 30, and the pace of forbearance request has steadily declined. We remain cautiously optimistic as the New York metro area has entered into Phase IV with positive results thus far, which is important as over 90% of loan portfolio is situated in the metropolitan New York area.

On Slide 15, we detail the opportunity to further reduce funding cost in support of our NIM. We have approximately $780 million of retail CDs scheduled to mature through the third quarter of 2021 at a weighted average cost of 124 basis points. At the end of the third quarter, retail CDs currently represent 16% of total deposits. As shown on the right hand side, current replacement funding costs are significantly lower than maturing CD rates. And we're using wholesale market to strategically reduce cost of funds. Importantly, we believe there is protection to limit the downward pressure on asset yields.

As described on Slide 16, we expect reduced movement in asset yields. Barring movement in the macro interest rate environment, we believe the floating rate portfolio of $599 million will not further reprice. Additionally, approximately 21% of the real estate portfolio reprices annually, and there are floors associated with individual loans.

Moving to Slide 17. Non-interest expense increased $1 million or 4% quarter-over-quarter. The efficiency ratio was 55.4% compared to 54.9% the last quarter and 58.9% a year ago. The ratio of non-interest expense to average assets increased 1.69% for the third quarter of 2020 compared to 1.49% for the third quarter of 2019 due to the growing business and the realization of an FDIC assessment credit in the third quarter of 2019. The company has historically maintained a relatively stable ratio of non-interest expense to average assets.

Included in non-interest expense for the third quarter is $400,000 of legal expense related to the Empire merger. The focus on managing expenses and improving the NIM assisted us in achieving a lower efficiency ratio. We will continue to focus on these items in order to further improve that ratio. As always, we are focused on continuous improvement and look for more opportunities with efficiency gains, especially with the addition of Empire branches and given our enhanced ability to serve our customers and work remotely. Regarding taxes for 2020, we approximate the effective tax rate between 23% and 25%.

With that, I'll now turn it back to John.

John R. Buran
President, CEO & Director

Thank you, Susan. As we previously remarked, the Empire shareholders approved the merger yesterday. We're very excited about the combination with Slide 18 summarizing the transaction highlights. The merger is planned to close on or about October 31. This transaction expands our footprint into Suffolk County and lowers our cost of funds while improving the loan-to-deposit ratio. The merger will be approximately 20% accretive to earnings in 2021 with an earn back of 3.4 years.

On Slide 19, the expected cost savings of $7 million along with incremental earnings from Empire drive the approximate 20% earnings accretion for 2021. There's been an acceleration of the projected expense saves as Empire's experience employee turnover. The majority of the cost saves will be recognized in 2021 with salaries and benefit expense representing approximately 60% of the cost saves.

On Slide 20, the pro forma company will have assets of $8 billion, gross loans of approximately $7 billion and deposits of $6 billion. The larger balance sheet allows us to penetrate the bigger companies in the Suffolk County market, which is over 76,000 businesses. Our loan-to-deposit ratio will improve to a 115%. We look forward to updating everyone on our integration progress in future quarters.

Turning to Slide 21. We recognize there are opportunities and learnings from operating during the COVID-19 environment. There's an opportunity for employees to work remotely, which could reduce occupancy costs. And if we can move functions outside of Metro New York, additional savings are possible. Further, our enhanced digital platform has proven powerful. We are attracting a younger demographic. For the quarter, 23% of account openings were completed digitally and online banking enrollment increased 4%. We have noticed improved employee productivity as we are able to streamline processes through technology. Additionally, with the ability to work remotely, there will be less lost work time for a inclement weather or sick days.

On Slide 22, we detail that the third quarter results give us a good start heading into 2021. Record core diluted EPS increased 56%. NIM improved 13 basis points with an opportunity to further reduce the cost of funds, a reduction in the provision for credit losses of 74% from the second quarter. Efficiency ratio in the mid-50s. Credit remains strong. And finally, the Empire merger provides additional opportunities.

Concluding on Slide 23, I summarize how we plan to continue to execute our strategic objectives to come out of this pandemic in an even stronger position. I continue to be proud and impressed with the hard work and dedication of our employees. We continue to play an essential role in supporting our communities and customers' financial need. The addition of Empire to the Flushing family will only strengthen our reach and capabilities. Our balance sheet capital and liquidity going into this environment was strong, and our positive core earnings power provides a good base to absorb future credit losses.

Stress testing confirms our ability to sustain material credit loss of necessary over a multiyear horizon. Our competitive advantage and consistent credit discipline have served us well during this challenging economic environment, and we continue to stay close to our clients and manage our loan portfolio prudently. Our ongoing focus on developing and maintaining a multilingual branch staff to serve our New York City diverse population remains a key differentiator. The New York City market and its strong Asian customer base continue to represent a significant opportunity for us over the long term.

We'll continue to provide a safe and inclusive environment for all employees and customers. Importantly, our investment in the universal banker model has been critical to our ability to serve our customers in this environment along with our enhanced digital capabilities. Our online and digital capabilities continue to be a key differentiator for our customers. We remain focused on supporting our communities and executing against our strategic priorities. I'm excited to welcome the Empire team to Flushing Financial as I believe that the combined entity will unlock further stakeholder value.

I'll conclude by thanking our employees once again for their dedication and commitment as we continue to execute our strategy. We remain focused on maintaining strong capital, liquidity and asset quality, while also managing expenses in our net interest margin to continue to improve and become an even stronger, more resilient company.
Now we'll open it up to questions. Operator, I'll turn it over to you.

Question and Answer

Operator

[Operator Instructions] And the first question we have will come from Steve Comery of G. Research.

Steven Comery
G. Research, LLC

If I could just go straight to the forbearance, obviously down substantially to $846 million. I'm wondering if you guys could tell us how much of that is second request and sort of what the term on the second request typically was? I'm assuming it wasn't 6 months again?

John R. Buran
President, CEO & Director

I think limited amount is second request. When we went into this, we put a lot of our forbearances on a 6-month deferment. So that is the reason why we're carrying more into the fourth quarter.

Steven Comery
G. Research, LLC

Okay. And then the loan pipeline, obviously still pretty strong, $394 million. It was like $311 million at the end of Q2 though. Are customers just hesitant to close on loans? And is that like becoming less prevalent now? Like do you think you'll see a lot of these loans closed in Q4? Or is it kind of further out?

Francis W. Korzekwinski
Senior EVP & Chief of Real Estate Lending

This is Frank Korzekwinski, Steve. The slowdown in the closing occurred primarily due to the fact that as the economy began to open, we were becoming a bit more judicious in establishing what the actual cash flow that the borrowers had on hand in preparation for a long closings. Rent rolls appeared to be strong. Obviously, 2018 - '19 income and expenses were in good shape. It was taking us a little bit longer to verify what the current rent collections were prior to loan closings. That seemed to improve considerably over the last several months as businesses began to open at a quicker pace. So we would expect that bottleneck to begin to move aside and closings would begin to accelerate.

Steven Comery
G. Research, LLC

Okay. Very helpful. Obviously, the merger with Empire expected to close very soon. Maybe some updated thoughts on the margin impacts from Empire. I know just like based on the Q2 results, the Empire kind of had what looked like should be an accretive margin for you guys. But just any updated thoughts there as things have changed over the third quarter.

Susan K. Cullen
Senior EVP, Treasurer & CFO

So Steve, this is Susan. During this quarter, yes, their NIM should be accretive to our NIM. The other metrics have stayed pretty stable. We still have the dilution as we have reported it, the 3.4 earn back period. We spent a lot of time this quarter looking at their credit quality to make sure that we were all in agreement and understood what we were actually purchasing, and we are very, very comfortable with their credit.

Steven Comery
G. Research, LLC

Okay, thank you. And maybe one more for me on the merger. I guess, so expected to close basically this week and then systems integration in November. Maybe just in general terms, I guess, what's like the road map after systems conversion? And kind of what opportunities are you excited about that merger?

John R. Buran
President, CEO & Director

So we're in the process of putting together a pretty strong marketing approach that will begin in mid-November and we will accelerate that as we turn the corner into the new year. We don't have a great deal of presence in the Long Island market at this point in time, but we do have a number of people on our staff who have been in the past working on Long Island. In addition, we expect to leverage the talent that is in the Empire group as well to provide us with a significant uptick, particularly in the business area.

In addition, we will be introducing Empire customers to our enhanced digital capabilities that we just rolled out for the Flushing bank customers at the end of the first quarter. So that should be an increase in service that they will see. And we have some new products coming online like a new escrow account and also some enhancements to our cash management products. So we expect that we're going to have a very, very strong suite of products to introduce to both our business customers and our consumer customers.

Operator

[Operator Instructions] The next question we have is from Collyn Gilbert of KBW.

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Just to follow up on Steve's question on the discussion around Empire, and Susan, your comment or your all comment about being very comfortable with credit. Can you just frame that for us in how we should be thinking about the reserve in the fourth quarter with having folded Empire in?

Susan K. Cullen
Senior EVP, Treasurer & CFO

I would think the reserve would be pretty consistent, but we would have to take into capital loan growth. So I would expect there would be a slight uptick in the quarter, given adding another couple -- $900 million or so worth of loans.

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And are you -- and if you could just remind us the credit mark that you were assuming on Empire, did that change at all now?

Susan K. Cullen
Senior EVP, Treasurer & CFO

No, the percentage has stayed consistent.

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. And then in terms of the accretion numbers that you guys gave, can you just kind of clarify what those base assumptions were when you say 20% accretive to 2021, what you were using for kind of a base assumption just given all the moving parts that we've seen since this deal was announced and those metrics were initially offered?

Susan K. Cullen
Senior EVP, Treasurer & CFO

Those metrics really haven't changed much, Collyn, but I think the initial announcement was 19%. So using our base income, then layering in $7 million worth of cost saves from Empire and then the $7 million of incremental earnings from their interest-earning assets, that's how we're coming up with that number in broad strokes.

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So I'm sorry, so that -- so $7 million of incremental net interest income and then $7 million of cost saves. So on the total numbers?

Susan K. Cullen
Senior EVP, Treasurer & CFO

That's $7 million of income, not just net interest income, but $7 million of income and then stripping out $7 million worth of cost saves.

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. So $14 million of whatever, pretax income growth or about the 10% -- cost effects to tax or the expense savings. Okay. Okay. Got it. And then just in terms of the OpEx outlook, John, you mentioned kind of efficiency continues to be a target and all of the potential changes that you're seeing within the workforce and operations, given that the kind of work-from-home dynamic. Are there any other -- I mean, is there any initiatives -- kind of broad initiatives that you think could come into the fold in 2021 in terms of cost -- further cost cutting?

John R. Buran
President, CEO & Director

I think our concentration in 2021 is going to be to actualize the Empire-related cost saves as we look to develop our specific programs associated with remote work. But I don't think that those will come in until later on in the year. But I think the concentration will be on securing that $7 million of cost saves on the Empire transaction.

Collyn Bement Gilbert
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. That's helpful. And then just -- sorry, one last thing on closing the loop on credit. So given kind of where you sit and your commentary around deferrals, I mean, is the expectation that you do not -- or you're not going to -- you don't expect kind of much of an increase in net charge-offs from here? Or just trying to think, kind of, of the broader loss content within -- that's within your book as we look to 2021?

Susan K. Cullen
Senior EVP, Treasurer & CFO

Sure, Collyn. The loan deferrals are 98% or something. The preponderance sum is backed by mortgages. And they have an average LTV somewhere in the mid-40 range. So given that amount of run room before we would actually hit a 100% or even an 85% loss assuming a 15% discount for selling costs, we have a lot of room in that portfolio before we would experience any material losses is the view that we have taken and believe in.

Operator

I'm showing no further questions in queue. This will conclude our question-and-answer session. I would now like to turn the conference call back over to Mr. John Buran for his closing remarks. Sir?

John R. Buran
President, CEO & Director

I want to thank you all for listening in and we look forward to updating you on our successes associated with our upcoming Empire transaction. Until then, stay safe. Thank you.

Susan K. Cullen
Senior EVP, Treasurer & CFO

Thank you.

Operator
I will thank you, sir. I will thank you also, ma'am, and so for your time today. Again, the conference call has concluded. Again, at this time, you may disconnect your lines. Thank you, everyone. Take care and have a wonderful day.