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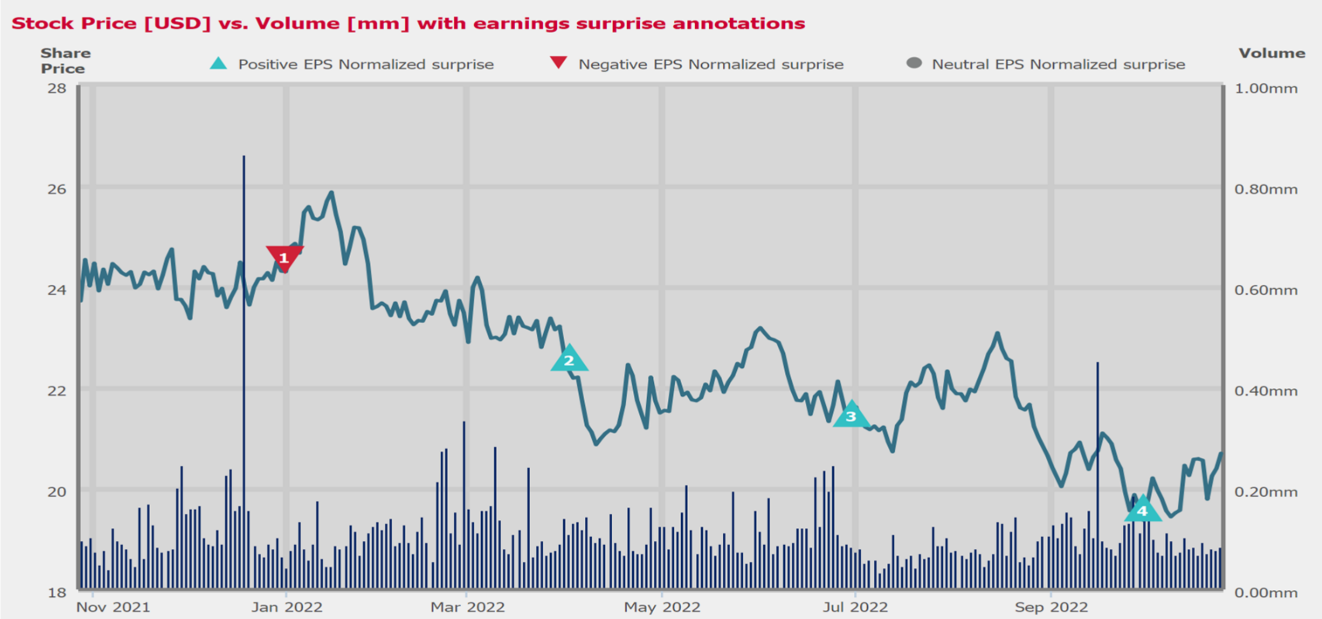
Flushing Financial Corporation NasdaqGS:FFIC FQ3 2022 Earnings Call Transcripts

Wednesday, October 26, 2022 1:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2022-			-FQ4 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	0.60	0.62	▲3.33	0.53	2.46	NA
Revenue (mm)	64.87	64.68	▼(0.29 %)	61.26	262.34	NA

Currency: USD
Consensus as of Oct-26-2022 4:00 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ4 2021	0.68	0.67	▼1 (1.47 %)
FQ1 2022	0.54	0.61	▲2 12.96 %
FQ2 2022	0.69	0.70	▲3 1.45 %
FQ3 2022	0.60	0.62	▲4 3.33 %

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Susan K. Cullen
Senior EVP, Treasurer & CFO

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Keefe, Bruyette, & Woods, Inc., Research Division

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D.A. Davidson & Co., Research Division

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

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Presentation

Operator

Welcome to the Flushing Financial Corporation's Third Quarter 2022 Earnings Conference Call. Hosting the call today are John Buran, President and Chief Executive Officer; and Susan Cullen, Senior Executive Vice President, Chief Financial Officer and Treasurer. [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 contain 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 risks, uncertainties, and other factors that may cause actual results to differ materially from those contained in any such statements, including as set forth in the company's filings with the U.S. Securities and Exchange Commission to which we refer you.

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 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 would now like to introduce John Buran, President and Chief Executive Officer, who will provide an overview of the strategy and results.

John R. Buran
President, CEO & Director

Thank you, operator. Good morning, everyone, and thank you for joining us for our third-quarter 2022 earnings call. Following my prepared remarks, Susan will review the financial trends, and we will then answer any questions. The local economy was generally positive in the third quarter as New York City continued to recover from the pandemic, which led to solid loan growth. On the other hand, the Fed aggressively raised rates, which pressured funding costs while also increasing loan origination yields. Given this environment, we remain focused on executing on our strategic objectives. We reported GAAP earnings per share of $0.76 and core EPS of $0.62. This translated to a return on assets of 1.11% and a return on equity of nearly 14%. Core return on assets was 90 basis points, and core return on equity was over 11%. These returns are within range of our stated through-the-cycle goals of 1% and 10%, respectively. Core loan yields increased 20 basis points quarter-over-quarter, while core deposit yields expanded 47 basis points, resulting in net interest margin compression of 28 basis points on a reported basis and 30 basis points on a core basis. In a period of rate rises, the general trend in our net interest margin is expected to be shaped like a V.

When the Fed is raising rates, funding costs reprice faster than assets. When the Fed stops raising rates, then assets are expected to increase faster than funding costs over a period of time and then the NIM begins to recover. In the near term, the net interest margin should have pressure and then over time, expand once loan repricing accelerates. Average non-interest-bearing deposits reached a new record at $1.1 billion for the quarter and increased 13% year-over-year. Loan closings were a strong $464 million in the quarter. The loan pipeline declined to $309 million as we've become more selective in terms of rates and collateral type as borrowers adjusted to the higher rate environment.

We continue to focus on total relationships versus transactional business. Asset quality is a hallmark of this company. During the quarter, our non-performing assets, which have a loan-to-value of less than 51% were stable at 58 basis points. We continue to invest in the future as we hired 46 people from institutions within our markets that are involved in a merger, 20 of those being revenue producers. Overall, we're managing the balance sheet to deal with the rising rate environment while maintaining our focus on credit quality.

Slide 4 outlines the merger disruption that continues in our markets. During the quarter, we hired additional 4 people, including 2 revenue producers from banks participating in mergers. The M&A activity in our market is in various stages of integration, and we expect to add more people and profitable banking relationships as conversions occur and strategies change. Given this environment, we expect to remain focused on organic growth opportunities. The merger activity is having a positive impact on our business. On Slide 5 depicts the strong loan closings for the quarter. Pull-through rates increased after bottoming out in the third quarter of 2021. The loan pipeline has declined after record levels the prior 2 quarters, by the decisions we're making on rates, collateral type and full relationship focus. Additionally, borrowers are adjusting to a higher-rate environment. Given the significant move in rates, loan closings could slow. However, satisfaction should also decline.

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Slide 6 depicts the growth in our low-cost delivery channel, our digital banking platforms. We continue to see high growth rates in monthly mobile active users, users with active status and digital banking enrollment. The numerated platform, which digitally originates small-dollar loans as quickly as 48 hours continues to grow. We originated approximately $60 million of commitments in the first 9 months of the year. Most of these commitments have a weighted average rate that is greater than the overall loan portfolio yield. We continue to explore other fintech product offerings and partnerships.

The third quarter had several important events to highlight, as you can see on Slide 7. We signed a lease for Brooklyn branch, which will expand our Asian banking footprint. As a reminder, last quarter, we signed a lease in Hauppauge, which is expected to open by year-end. We successfully issued $65 million of subordinated debt. This additional capital provides flexibility to lower our CRE concentration ratio, and we timed it well as subsequent offerings have had higher rates. On the product side last month, we launched contactless-enabled ATM debit cards. We participated in many community events this quarter, including supporting the Dragon Boat Race festivals in Flushing and Port Jefferson. We also hosted a harvest moon reception for our Asian banking customers. These events are examples of how Flushing Bank supports our communities. I'll now turn it over to Susan to provide more detail on our key financial metrics. Susan?

Susan K. Cullen
Senior EVP, Treasurer & CFO

Thank you, John. I'll begin on Slide 8. Growing non-interest-bearing deposits is a priority for us. Average non-interest-bearing deposits increased 13% year-over-year and comprised nearly 17% of average deposits compared to approximately 15% a year ago. Our teams continued to open new checking accounts, which were up 26% year-over-year. The growth in non-interest-bearing deposits helps mitigate the overall rise in deposit rates. Our incentive plans are focused on increasing non-interest-bearing deposits. We are also growing CDs to lengthen our duration.

Slide 9 shows how our deposit rates move compared to Fed funds. Our ability to control deposit rate increases is a key factor in the net interest margin outlook due to our liability-sensitive balance sheet. We have done a good job of eliminating deposit rate increases so far in 2022. From the fourth quarter of 2021 through the third quarter of 2022, interest-bearing deposit yields increased 63 basis points compared to the 211 basis point rise in average Fed funds rates, implying a deposit beta of 30% compared to 43% in the prior cycle. We expect the cumulative deposit betas to continue to rise as rates increase.

Slide 10 outlines loan portfolio yields. Net loans, excluding the PPP loans, increased nearly 7% year-over-year. With the exception of the PPP loans, loan growth occurred both in mortgage loans, which increased nearly 4% year-over-year, and commercial business loans, which rose over 18%. Loan portfolio yields increased 23 basis points during the quarter. Notably, yields on the loan pipeline increased 117 basis points during the quarter. Prepayment penalty income declined to $1.3 million in the third quarter compared to $2.3 million in the prior quarter and $1.8 million a year ago.

Slide 11 provides more detail on the repricing of the loan portfolio. While a portion of the loan portfolio reprices with each Fed move, the majority reprices over time. We have approximately $1 billion or 15% of loans that should largely reprice with the Fed moves. An additional $1.9 billion or 27% of loans were repriced through 2024. As of September 30th, these loans are expected to reprice 200 basis points higher. This does not take into account any future Fed moves, which could push repricing rates up further. Importantly, once the real estate loan reprices, our prepayment structure resets to the original terms.

Slide 12 outlines the net interest income and margin trends. The GAAP net interest margin was 3.07% and decreased 28 basis points during the quarter. Net interest income decreased 5% quarter-over-quarter to $61 million. Core net interest income, which removes the impact of net gains from fair value adjustments and purchase accounting accretion decreased 6% quarter-over-quarter as the core net interest margin declined 30 basis points to 3.03%. This rate cycle has been different from the past cycles, given the pace and magnitude of rate moves. However, our deposit beta has been lower this cycle. As John said previously, in a rising rate environment, the path of net interest income is expected to look like a V with compression from rising funding costs from the Fed increases rates followed by expansion over time as loans reprice.

Moving on to asset quality on Slide 13. We have a long history of strong credit quality, primarily due to our low-risk credit profile and conservative underwriting. For the quarter, net charge-offs were only 2 basis points. Our low-risk credit profile and conservative underwriting has served us well through many cycles. As you can see, our losses have been well below the industry. We remain comfortable with the credit quality and allowance for credit losses. We believe there is limited loss content in the loan portfolio if there's an economic downturn due to greater than 88% loan portfolio secured by real estate with an average LTV less than 37%. Plus the 1% of our loans have a loan-to-value of 75% or more. And the weighted average debt service coverage is 1.8x and over 1.15x in stress scenarios for our multifamily and investor commercial real estate portfolios, which comprised 65% of total loans. These factors contribute to our expectation of low-loss content within the portfolio.

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Additionally, on Slide 14, our allowance for credit loss is presented by loan segment. Our allowance is different from peers, largely due to loan mix as we have a higher percentage of real estate collateral at low average loan to values. Overall, the allowance for credit losses to loans increased 1 basis points to 59 basis points during the quarter. Non-performing assets were stable at 58 basis points and the loan-to-value on these assets is less than 51%. Criticized and classified loans increased slightly to 89 basis points of loans compared to 85 basis points in the prior quarter. The coverage ratio is 142%, meaning we have approximately $1.40 reserve for each dollar of nonperforming assets. We remain very comfortable with our credit risk profile and continue to expect minimal loss content.

Our capital position is shown on Slide 15. Book value and tangible book value per share increased during the quarter despite the $15 million increase in accumulated other comprehensive loss. We took advantage of the attractive stock price and repurchased nearly 131,000 shares during the quarter and returned 40% of earnings through dividends and share repurchases. The tangible common equity ratio declined to 7.62% driven mostly by the incremental 18 basis points of accumulated other comprehensive loss. In the short and the medium term, the company will maintain its targeted 8% tangible capital ratio while balancing the attractiveness of share repurchases.

Before I turn the call back to John, let me provide some additional color on the outlook. With the liability-sensitive balance sheet, controlling the cost of fund is paramount. The passage time should allow for the accumulation of loan repricing to exceed the cumulative effect of the increase on the funding. In addition, we have $592 million of swaps on funding that will be priced to our benefit in 2023. The net interest margin will remain under pressure over the short term and then should expand in the medium term and beyond from loan repricing. Non-interest expenses are now expected to increase low single digits in 2022 from the core base of $144 million as year-to-date expenses were better than expected. Finally, the effective tax rate should approximate 28% for 2022.

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

John R. Buran
President, CEO & Director

Thank you, Susan. On Slide 16, we wrap up our key messages. We continue to benefit from merger disruption as we continue to recruit and add people and business. While we had strong loan growth during the quarter, we're becoming more selective in terms of rates and collateral type. Borrowers are adjusting to higher rates. Flushing Bank has a long history of superior credit quality, driven by our conservative credit culture. We have a low-risk loan portfolio as proven by the high percentage secured by real estate, low loan-to-values, and high debt service coverage ratios. We are well prepared to handle any potential economic downturn affecting the credit markets. We're managing through rate increases. We're controlling deposit rates in the context of a challenging market. In the near term, we expect some NIM pressure, but loans will reprice in coming quarters and help the net interest margin. Capital return was 40% this quarter and book and tangible book value per share increased. Going forward, the company will balance the capital return with the desire to increase the tangible common equity ratio to 8%. Overall, the company performed in a range of through-the-cycle return on average assets and return on equity goals in the third quarter.
Operator, I'll turn it over to you to open up the lines for questions.

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Question and Answer

Operator

[Operator Instructions] Today's first question comes from Mark Fitzgibbon of Piper Sandler.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

I'm wondering if Susan, maybe you could share with us what spot deposit rates look like today?

Susan K. Cullen
Senior EVP, Treasurer & CFO

Spot deposit rates are pretty stable. We are running some, obviously, some CD specials out there as we're trying to lengthen the duration of our liability portfolio. But we've kept them pretty stable.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

Okay. From where they were for the quarter or at the end of the quarter?

Susan K. Cullen
Senior EVP, Treasurer & CFO

At the end of the quarter.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

Okay. And then secondly, I wondered if you could kind of update us on what iGO balances are and maybe what the rough spread difference between traditional bank deposits and iGO deposit rates are, say, on average?

Susan K. Cullen
Senior EVP, Treasurer & CFO

The iGO banking deposit bases are a little bit higher, but not out of line. We are competing with the other Internet banking banks if you will. So we look at that market a little bit differently to compete in those markets versus our brick-and-mortar.

John R. Buran
President, CEO & Director

And the balances are less than $200 million.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

Okay. Great. And then John, I heard what you said about the NIM outlook. And Susan, can you help us think about the magnitude of the near-term pressure on the margin?

John R. Buran
President, CEO & Director

So I think that we've seen interest-bearing deposit betas at around 30% for the year. We expect that to move up somewhat. And then of course, we're being very successful in terms of our repricing on loans. For example, the repricing loan beta for the third quarter was about 90%. So there are about $151 million of loans that repriced at a weighted average of $5.69 compared to our contractual expectation of $5.85. So we're being very successful in that repricing. So I think that the -- obviously, there's a difference in magnitudes there. But we will continue to see some pressure on the NIM over the next quarter and certainly until the Fed starts to reduce, let's say, its increases going forward.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

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And I get it probably isn't 30 basis points again this quarter, but is it half that roughly?

John R. Buran
President, CEO & Director

I think we're still in the same category, I would guess. I think that we'll have to see whether this 75 and the 25 come on board in the next 2 months that the Fed is projecting at this point in time. But I think that -- we do have about 15% of the loan portfolio repricing with those Fed moves. So we'll certainly see pretty much a one-for-one those particular loans or close to it, let's say, we'll see multiple price increases on those loans as time goes on. So I think that the deposit beta, I think we'll continue to see some pressure. And it's a matter of how quickly loans continue â€“ rates continue to rise that will determine how quickly the loan portfolio catches up.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

Okay. Changing gears a little bit. I guess I'm curious, John, with the loan-to-deposit ratio somewhat elevated. Would it make sense to slow loan growth a little bit and maybe be a little more aggressive with the buyback program given that you're trading below tangible book value?

John R. Buran
President, CEO & Director

So I think that we're cognizant of a number of different factors going on in the market today. First off, I think there's going to be, at least for the next quarter or so a natural muting of the loan growth due to the borrowers getting used to a new rate level, and we'll see whether or not that resettles itself going forward. And then frankly, we are being more selective in terms of what we're accepting in terms of both rate and credit risk as we potentially look at the possibility of a recession down the road. So we're being, I guess, what you would call our typical cautiousness with respect to the growth of the loan portfolio. So certainly in the next quarter or so, we're expecting a somewhat muted loan growth. Our pipeline is down to $3.09, which isn't a terribly low, but certainly significantly lower than the last couple of quarters. So I think there's some natural factors going on there that are going to somewhat mute loan growth in the next couple of quarters.

Mark Thomas Fitzgibbon
Piper Sandler & Co., Research Division

Okay. And then lastly, Susan, can you help us think about expense growth in the fourth quarter given that you've got some new locations coming online and people just help us think about what $36-ish million a good run rate for expenses in fourth quarter?

Susan K. Cullen
Senior EVP, Treasurer & CFO

The people for the branch is set to open at the end of the year are already baked into the numbers of those employees have already been hired and the branch that we signed the lease for those people are in process and it would not be a material change. But I would think that the mid-30 number would be a reasonable number for your run rate on expenses.

Operator

The next question comes from Chris O'Connell with KBW.

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

I wanted to start off on the deposit side. One, from that first question on the spot rate and deposits. So where were -- I guess where were they at the end of the quarter? Or what were they unchanged from?

Susan K. Cullen
Senior EVP, Treasurer & CFO

At the end of the quarter, they were about $115.

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

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Okay. Got it. And on the flows and an overall outlook on deposit growth going forward, there are some declines in the checking and non-interest lines. What are you guys hearing from your customers? And what are you guys seeing on flows? And how do you think the overall outlook on deposit growth is going forward?

Susan K. Cullen
Senior EVP, Treasurer & CFO

So our average non-interest-bearing was up quarter-over-quarter. We had some customers that unfortunately for them, or fortunately, for them, they had to pay, they had to take some money out to pay their taxes. But our account openings has also been very strong during the quarter. So we think that bodes well for our noninterest-bearing deposit growth going forward.

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. Got it. And there's a part of the deck that was put in, that's talking about NII generally rising in year 3. Does that imply NII goes down until then?

Susan K. Cullen
Senior EVP, Treasurer & CFO

No. I think what we're saying there is thatâ€¦ Sorry, we're having phone issues. Sorry, Chris. Can you repeat your question?

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

Yes. Just like color around the outlook side, I think it says NII generally rising in year 3, just exactly what that entails?

Susan K. Cullen
Senior EVP, Treasurer & CFO

So we would expect that the -- as the rates continue to rise, we'll continue to see pressure. And then our V shape and the length of that will be dependent on, obviously, the Fed. And then we expect, as we get the stabilization of the liability funding then the asset side will start taking off. So I don't expect 3 years of compression followed by the up, if that's what you're asking. I would expect it's all going to be dependent on Fed movements.

John R. Buran
President, CEO & Director

So you're also talking about NII, Chris, and I think that the question for us also is going to be how we perceive the credit markets going forward and whether we're going to continue to be more and more selective in credits if we start to proceed toward a more recessionary environment. So at this point in time, it's a little bit difficult to see because I think that with this rate increase, we've seen a natural pullback in terms of certainly our loan pipeline as we wait for customers to potentially adjust. That said, very, very often in times like these customers, the customer base that we have tend to be able to find some bargains that are out there, so to speak. And I think that could regenerate loan growth for us at some point in time. But certainly for the next quarter or so, we're being somewhat selective and cautious and our borrowers are certainly waiting to see what's happening with the rate environment before they jump in.

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. That's helpful. And I think last quarter, you provided where the NIM was versus at the end of the quarter versus during the quarter. Do you have that for this quarter?

Susan K. Cullen
Senior EVP, Treasurer & CFO

It's down. I would expect compression as great or if not a little bit greater than what we saw in this quarter.

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

Okay. That's helpful. And for the $500 million of swaps in something, I think repricing down to 70 bps. Can you just give a little color around that and the timing and whether those are against deposits or the borrowing side?

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Susan K. Cullen
Senior EVP, Treasurer & CFO

They're on the funding side of the balance sheet. So they could be -- they're on wholesale funding. So whether that's borrowings or we've stepped into a broker market wherever we can get the best, obviously, liability rate, those swaps are against that type of funding. They primarily reset in 2023, a big chunk of them that will mature. And then during the height of the pandemic, we took the opportunity to match the funding -- not the funding, excuse me, the swap market at that time against what we had so that we would -- we're getting a longer protection and the swap market when we did that naturally brought the price down during the pandemic from 125 basis points roughly down to the 72.

Christopher Thomas O'Connell
Keefe, Bruyette, & Woods, Inc., Research Division

Got it. And what's the timing on those in 2023?

Susan K. Cullen
Senior EVP, Treasurer & CFO

Big chunk of them is in the first quarter, and then they are pro rata throughout '23 and a little hangover into 2024.

Operator

We have time for one more question. The next question will come from Manuel Navas of D.A. Davidson.

Manuel Antonio Navas
D.A. Davidson & Co., Research Division

Just circling back on the NII commentary, does that mean that you probably will see that downward slope of the V until the Fed stops raising rates?

Susan K. Cullen
Senior EVP, Treasurer & CFO

That's correct. But it will also be offset somewhat by our loan repricing that we talked about.

Manuel Antonio Navas
D.A. Davidson & Co., Research Division

So it could get a little bit better, maybe the slope declines a little bit as we get towards the end, as I said, gets towards terminal.

Susan K. Cullen
Senior EVP, Treasurer & CFO

Yes.

John R. Buran
President, CEO & Director

Yes.

Manuel Antonio Navas
D.A. Davidson & Co., Research Division

Okay. Is there a level that you're uncomfortable in terms of the loan-to-deposit ratio?

John R. Buran
President, CEO & Director

No, we've been up in size of 120 or so. A little higher at some point in time.

Manuel Antonio Navas
D.A. Davidson & Co., Research Division

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That helps. Yes. I've seen it in the past, but just wondering if that changed anything going forward. In terms of loan growth, I understand it's going to be muted, but with paydowns coming down, the worst-case scenario is flat. You should still have a little bit, but likely no declines.

John R. Buran
President, CEO & Director

I think we're going to see -- I think it's going to be dependent upon whether or not in the short term in the next couple of quarters or so, borrowers begin to accept the higher rate environment. And I think that's critical. And then, of course, we're being very selective, dependent upon the situation with respect to the possibility of a recession. Paydowns will slow. We're certain of that, and we've already seen that begin to occur. So we're expecting that going forward. But I think the dynamic of the slowdown in paydowns versus the, let's say, acceptance of higher rates on the part of customers is going to determine the ultimate growth there. But as I said, we expect to see some muted loan growth in at least the next couple of quarters.

Operator

There no more questions in the queue. At this time, I would like to turn the conference back over to John Buran for any closing remarks.

John R. Buran
President, CEO & Director

I just want to thank everybody for attending this session and look forward to speaking with many of you individually in the next a couple of meetings that come up. Thank you very much.

Susan K. Cullen
Senior EVP, Treasurer & CFO

Thank you, have a good day.

Operator
This concludes today's teleconference. You may now disconnect your lines, and we thank you for your participation.

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