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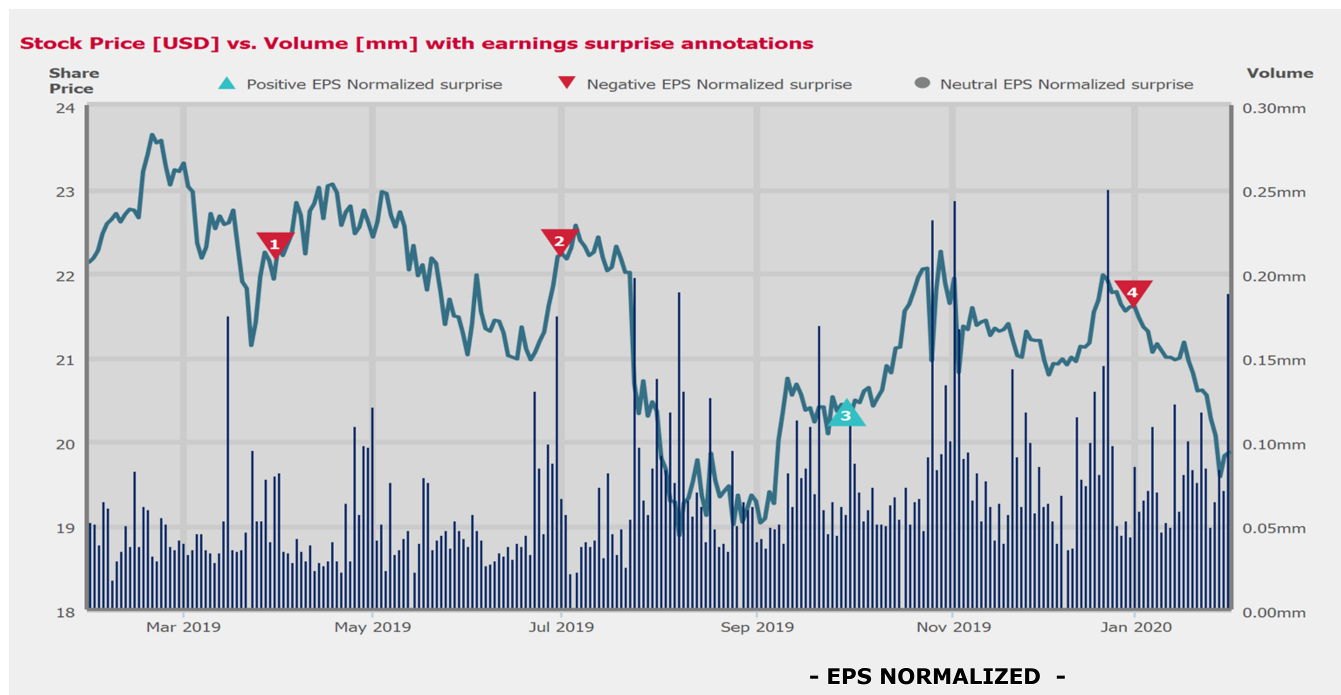
Flushing Financial Corporation NasdaqGS:FFIC FQ4 2019 Earnings Call Transcripts

Friday, January 31, 2020 2:30 PM GMT

S&P Global Market Intelligence Estimates

	-FQ4 2019-			-FQ1 2020-	-FY 2019-	
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	ACTUAL
EPS Normalized	0.43	0.41	▼(4.65 %)	0.32	1.59	1.65
Revenue (mm)	42.80	46.22	▲7.99	42.70	173.40	171.41

Currency: USD
Consensus as of Jan-20-2020 9:31 PM GMT



- EPS NORMALIZED -

	CONSENSUS	ACTUAL	SURPRISE
FQ1 2019	0.39	0.33	▼(15.38 %)
FQ2 2019	0.45	0.42	▼(6.67 %)
FQ3 2019	0.41	0.48	▲17.07 %
FQ4 2019	0.43	0.41	▼(4.65 %)

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Call Participants

EXECUTIVES

John R. Buran
President, CEO & Director

Susan K. Cullen
Senior EVP, Treasurer & CFO

ANALYSTS

Steven Comery
Morgan Group Holding Co.

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Presentation

Operator

Welcome to the Flushing Financial Corporation's Fourth Quarter 2019 Earnings Conference Call.

Hosting the call today are John Buran, President and Chief Executive Officer; and Susan Cullen, Senior Executive Vice President, Treasurer and Chief Financial Officer.

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 the discussion 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. 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 U.S. GAAP.

For information about these non-GAAP measures and for reconciliation to GAAP, please refer to the earnings release and/or the presentation. I'd like to introduce John Buran, President and Chief Executive Officer.

John R. Buran
President, CEO & Director

Thank you. Good morning, everyone, and thank you for joining us for our fourth quarter 2019 earnings call.

On today's call, we hope to provide you with additional insight into our consistent positive earnings power, business strategy and sustainable competitive advantage. I'll begin with our fourth quarter and full year 2019 highlights and then provide an overview of the strategies we are executing to continue to create long-term shareholder value. Then our CFO, Susan Cullen, will review our financial performance in greater detail. Following our prepared remarks, Susan and I will address your questions.

Beginning on Slide 3, we provide our quarterly highlights and are pleased to report fourth quarter '19 GAAP diluted EPS was $0.45, up 22% from the prior quarter while core diluted EPS was $0.41.

Net interest income increased by 6% from the third quarter of 2019 as the net interest margin improved by 11 basis points primarily due to the cost of funds decreasing 11 basis points and the yield on the loan portfolio increasing 4 basis points. As we reported in previous earnings calls, we had an opportunity to reduce funding costs. We were able to capture 11 basis points of opportunity this quarter. There is an additional opportunity to reprice downward as there are $1 billion of retail CDs with an average rate of 2.20% maturing in 2020.

Furthermore, the cost of funds demonstrated continuous improvement throughout the quarter. The swaps we put on in prior periods benefited both our interest and noninterest income as there was a small upward slope in the curve. Credit quality remains pristine and continues to improve with classified assets at the lowest level since 2008.

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Importantly, delinquent loans have decreased to 34 basis points of gross loans at December 31. Loan closings for the fourth quarter of '19 were $270 million, and we remain well positioned for continued loan growth in 2020.

For the year, we originated $1.2 billion of loans, of which over half were C&I originations. At December 31, 2019, the loan pipeline remained a healthy $325 million compared to the pipeline leading into 2019 of $197 million, presaging stronger growth for 2020.

Loan growth for 2019 totaled 4%, which was in line with our expectation of mid-single-digit growth driven primarily by C&I loans growing in excess of 20%. As part of our balance sheet strategy to become less liability sensitive, we have successfully increased our originations of C&I loans, which are predominantly floating rate to approximately 19% of total loans at year-end 2019. Total deposit mix improved as we continued our strategic focus on increasing core deposits, which increased nearly 7% in 2019. Our Asian initiative continues to be an attractive deposit source as these deposits grew 12% in 2019.

Our ongoing focus on developing and maintaining a multilingual branch staff to serve our diverse customers in New York City market area remains a key sustainable competitive advantage. This quarter, we strengthened our Asian market network with the Universal Banker model by opening a new branch in Hicksville, New York and relocating our Bell Boulevard branch to Bayside, Queens, bringing our total retail network to 20 branches.

We continue to remain excited about our pending acquisition of Empire Bancorp, which is expected to close in the second quarter of 2020. All required applications and notifications have been filed with the regulatory agencies.

Our strategic objectives are summarized on Slide 4. Increase core deposits and continue to improve the funding mix. Manage net loan growth and focus on yield and the best risk-adjusted returns. Enhance core earnings power by improving scalability and efficiency. Profitable growth and expansion through new distribution channels and business lines. Manage credit risk and remain well capitalized under all stress test scenarios.

On Slide 5, we summarize why we believe the acquisition of Empire is such a great strategic fit as it meets our priorities by increasing core deposits, managing net loan growth with a focus on the best risk-adjusted returns, enhancing core earnings power with more scale, enhancing profitable growth and expansion while remaining disciplined over credit risk and maximizing shareholder value over the long term.

The Empire deal increases are noninterest-bearing deposits by 44%, creating Long Island's sixth largest bank by deposit share among regional and community financial institutions.

Importantly, on Slide 6, we detailed our assumptions behind our forecast of 19% accretion to our 2021 consensus EPS estimates. As you can see, we're assuming a modest 1% incremental after-tax spread upon moving securities to loans from Empire's excess liquidity to achieve an additional $2 million in income. The most significant earnings impact, however, will come from $9 million in cost reductions.

Next, on Slide 7, we see significant opportunity to improve key performance metrics related to efficiency and profitability. This slide summarizes the key metrics as we move from stand-alone to pro forma Flushing with projected cost savings of approximately 50% of Empire's 2020 noninterest expense base or $9 million.

Cost savings have been identified and will be driven by eliminating redundant systems, consolidating back-office operations and reducing nonclient facing costs. This acquisition is anticipated to increase our balance sheet on a pro forma basis to approximately $8 billion in assets, $6.4 billion in loans and $5.9 billion in deposits while expanding our footprint into Suffolk County.

Importantly, the acquisition is anticipated to improve our ROAA, ROATCE and efficiency ratio. After the acquisition closes, our branch network will increase to 24 branches with enhanced access to the Suffolk County market. The 3 new branches will open the door to a county with approximately 1.5 million people and 75,000 businesses.

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Referring now to Slide 8. We remain focused on these key areas. Exceeding customer expectations, enhancing earnings power, strengthening our commercial balance sheet and maintaining our strong risk management philosophy. As previously announced, to further enhance our existing footprint, we've been executing a digital transformation strategy that's currently in this testing phase, and when complete, will improve our customer experience.

Our digital offerings will be enhanced to state of the art technology, allowing us to modernize the customer experience without adding to our existing infrastructure. We expect to have this transformation completed in the second quarter of 2020. Susan will provide additional details shortly. Overall, we remain well capitalized, and our focus on our strategic objectives enables us to further deliver profitable growth and long-term value to our shareholders.

Now I'll turn the call over to Susan to provide additional color on our performance.

Susan K. Cullen
Senior EVP, Treasurer & CFO

Thank you, John. I'll begin on Slide 9. Net interest income for the fourth quarter of 2019 was $41 million, up nearly 6% quarter-over-quarter due to the net interest margin increasing 11 basis points to 2.48%. The yield on the loan portfolio increased 4 basis points quarter-over-quarter, while the cost of funds decreased 11 basis points. The cost of funds continuously improved throughout the quarter.

The core net interest margin was 2.33%, flat quarter-over-quarter. As a reminder, core net interest margin excludes the prepayment penalties, recovery of interest on nonaccrual loans and the mark-to-market adjustment on the qualifying hedges. The Fed rate decreased in late September and October 2019 affected the rate of our C&I loan portfolio in the beginning of the fourth quarter. With a steady interest rate environment, we believe the yield on these loans will also stabilize. Year-over-year, the net interest margin decreased 9 basis points as the cost of funds increased 6 basis points, while the yield on interest-earning assets decreased 4 basis points.

On Slide 10, we highlight the strategy built into the balance sheet, we are using to reduce funding costs to support NIM stabilization. As a reminder, we have $1 billion of retail CDs scheduled to mature in 2020 at a weighted average cost of 2.2%. As highlighted on the right-hand side, current replacement funding costs are significantly lower than maturing CD rates. And importantly, over the long term, we'll position our balance sheets to be more interest rate neutral which allows us to seize opportunities as we continue to actively manage funding costs and evaluate strategies to further strengthen our balance sheet in all interest rate environments.

On Slide 11, total loans were $5.8 billion up 4% year-over-year as we continue to focus on origination of full banking relationships through the C&I, multifamily and commercial real estate loans. These originations totaled 89% of loan production for the fourth quarter. Approximately 50% of our originations in the quarter were nonbrokered loans. We continue to diversify our loan portfolio as C&I originations for the quarter were 31% of total originations and a record of 52% for 2019.

John mentioned that total C&I loans amount to 19% of the loan portfolio at December 31st, but what differentiates us from our competitors is since 2011, we have originated almost $3 billion of C&I loans while recognizing approximately 40 basis points of loss excluding the taxi medallion portfolio as a percentage of originations over that same period. Our C&I portfolio does not contain any leveraged lending. As we continue to shift our balance sheet into a more interest rate neutral position, we have originated floating rate C&I loans.

In the third quarter and early fourth quarter of '19, the rates on these floating rates loans decreased due to the Federal reserve lowering rates. With the steady interest rate environment, we would expect stability in these floating rates. The mortgage loans should also provide stability as they reprice at a slower pace than the C&I loans. The growth in the C&I portfolio continues to offer advantages to the company primarily continued diversification of the loan portfolio as these are primarily adjustable rate loans, the yield offers more protection in the rising rate environment, and they assist the company in moving to a more interest rate neutral position.

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At December 31st our loan pipeline totaled $325 million at an average rate of 4.18%. The pipeline is $128 million greater than the pipeline at December 31, 2018. The composition of the pipeline is 58% adjustable rate and 42% fixed rate. The loan-to-value on a real estate portfolio at quarter end was a modest 39% and the debt service coverage ratio for the current quarter's originations of multifamily, commercial real estate and 1-4 family mixed-use loans is 184%.

Importantly, we underwrite each loan using a cap rate in excess of 5% and then stress test each loan. We remain committed to our strategy of focusing on C&I, commercial real estate loans and multifamily loans. In the fourth quarter of '19, these loan closings represented 31%, 20% and 39% respectively of all originations while maintaining our conservative loan to value and debt coverage ratios.

On Slide 12, nonperforming loans were approximately $13 million improving nearly 10% quarter-over-quarter as credit quality remains one of our core strengths. In the fourth quarter, we recognized net recoveries and recorded a benefit for loan losses of $300,000 due to changes in the portfolio mix. Importantly, total delinquent loans decreased to 34 basis points of total loans from 49 basis points at September 30th. The loan-to-value on real estate dependent nonperforming loans amounted to 26% as of December 31st.

Moving to Slide 13, as a reminder we 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. As we continue to grow our balance sheet, we remain mindful of maintaining asset quality. As shown here, over 2 decades, Flushing has demonstrated superior credit metrics and at year-end 2019, our total classified assets improved to the lowest level in 2008.

As I previously stated, since 2011, we originated over $3 billion dollars of C&I loans recording less than 40 basis points of losses excluding taxi medallion when losses are compared to the originations over the same time period. Our credit discipline includes limits on concentrations to specific industries and general avoidance of high-risk industries. Further, we believe the loan-to-value and prior loss metrics associated with the real estate portfolio will minimize volatility of future charge-offs.

As highlighted on Slide 14, our strong credit quality metrics have resulted in our coverage ratio increasing from 129% to 164% year-over-year as of December 31, 2019. With the adoption of CECL in 2020, we estimate our Day 1 impact to increase our current allowance between $1 million and $3 million or 5% and 15%. However, we continue to evaluate our assumptions used in creating this estimate.

Continuing to Slide 15, the current portfolio loan to value is less than 40% based upon the value of underlying collateral at origination, and we do not adjust the appraised values for increases. Given the low loan to value associated with the nonperforming real estate loans, we did not foresee an increase in related expenses.

Slide 16 shows 90-day delinquencies as a percentage of loans originated by year. Overall, our credit quality remains pristine, as you can see the results of our strong underwriting discipline with just 11 loans delinquent greater than 90 days for the last 10 vintage years.

Slide 17 highlights the evolution of our funding mix as we increase funding, the percentage of core deposits have increased. When we need to access the wholesale funding markets, we can advantageously ladder out the liabilities for longer terms. Core deposits increased 5% quarter-over-quarter and 7% year-over-year, totaling 72% of all deposits at December 31 compared to 52% at December 31, 2010. The loan-to-deposit ratio for the fourth quarter of 2019 was 114% compared to 116% at September 30. We believe the acquisition of Empire Bancorp will enhance this ratio and improve our funding costs.

On Slide 18, our deposits increased 2% quarter-over-quarter and year-over-year. Growth is primarily driven by money market and noninterest-bearing accounts. We continue to focus on the growth of core deposits with an emphasis on noninterest-bearing deposit accounts, which increased over 5% year-over-year, while transaction accounts increased 7% from December 31, 2018. Noninterest-bearing deposits of $435 million represent 9% of total deposits.

Turning to Slide 19. We continue to strengthen our presence within the Asian market. Our Chinatown branch continues to perform well and achieve targeted levels. In the fourth quarter, we opened a new

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branch in an attractive Asian market in Hicksville, New York to further expand our successful ethnic strategy and enabled us to grow more than 12% deposits within our Asian branches. We continue to have a strong focus on the community where we have over $800 million in deposits at branches that serve the Asian communities and over $650 million in loans.

We continue to capture strategic growth opportunities within this market, aided by our Asian advisory board and our multilingual staff. Also in order to diversify deposit gathering channels, we are improving our digital online mobile offerings as part of our overall digital strategy, which we summarize on Slide 20. As John mentioned, this strategy will improve our customers' overall banking experience without requiring us to add to our physical infrastructure. These technologies reduce the overall cost of gathering deposits.

We expect the new technologies to be fully operational in the second quarter of 2020 and enable us to attract customers outside our footprint and deepen current customer relationships. The new technologies are currently undergoing user acceptance testing.

Moving to Slide 21. Noninterest expense using GAAP increased only $4 million or 3% for the year while expanding our distribution network and negotiating the acquisition of Empire. Core noninterest expense improved even more, increasing less than $2 million or 2%. Continuing to manage expenses and improving the NIM will assist us in achieving our long-term goal of an annual efficiency ratio in the low to mid-50s.

Continuing on Slide 22. The ratio of noninterest expense to average assets improved to 1.66% for the year ended December 31, 2019, compared to 1.72% for '18 and 1.73% for '17. The company has historically maintained a relatively stable ratio of noninterest expense to average assets. As a reminder, the first quarter of 2020's noninterest expenses will contain seasonality, resulting in higher expenses due to the impact of annual grants of employee and director restricted stock unit awards. We continue to look for opportunities in our operations' continuous improvement with efficiency gains and expect to share best practices and further gain efficiencies from our pending acquisition of Empire Bancorp.

Regarding taxes for 2020, we approximate the effective tax rate between 22% and 24%. With that, I'll now turn it back to John for some closing comments.

John R. Buran
President, CEO & Director

Thank you, Susan. On Slide 23, I'd like to conclude by summarizing why we remain well positioned for continued and consistent profitable growth.

The CD repricing available to us will assist in reducing the cost of funds over 2020. Although we will remain a liability-sensitive company, the implementation of our swap strategy and the origination of floating rate loans are in direct response to management's goal of becoming less liability sensitive and continues to be an important component in mitigating NIM compression.

The loan pipeline as of December 31, 2019, totaled $325 million and is greater than the pipeline as of December 31, 2018. Our credit metrics remain strong as nonperforming loans have decreased as have total delinquent loans. We continue to focus on increasing the amount of direct loan business as approximately 50% of fourth quarter '19 loan closings were nonbrokered loans.

We have contained noninterest expenses in this low rate environment. We continue to see positive trends, including growth in the C&I portfolio as we move our balance sheet to a more floating rate business and a continued strong loan pipeline.

With the pending acquisition of Empire Bancorp, the pro forma combination of our banking franchise lowers our overall cost of deposits as well as improves our loan-to-deposit ratio. The merger is expected to enhance our core earnings with significant revenue opportunities and cost synergies and expand our presence into a new market on Long Island.

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The investment in the Universal Banker model continues to pay dividends. Universal bankers are spending more time with customers, and this has resulted in branch sales increasing approximately 20% in total and 35% per branch employee.

Our ongoing focus on developing and maintaining a multilingual branch staff to serve our diverse New York City customers remains a key differentiator.

The New York City market and its strong Asian customer base continues to represent a significant opportunity for us.

The implementation of our technology transformation will expand our footprint and allow for deposit gathering at a total cost less than brick-and-mortar while enhancing the customer experience for business and consumer clients.

Overall, our vision remains consistent, and that is to be the preeminent community financial services company in our multicultural market by exceeding customer expectations and leveraging our strong banking relationships.

In conclusion, our strong culture and track record, attractive markets and customers, consistent financial performance and continued execution of our strategic objectives will position the company to do very well in the future.
We will now open it up to questions. Operator, I'll turn it over to you.

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Question and Answer

Operator

[Operator Instructions]. Our first question today comes from Steve Comery of G. Research.

Steven Comery
Morgan Group Holding Co.

Looking at Slide 10, I kind of appreciate the detail there. Just kind of wondering, would you, just kind of as a base case, expect to replace most of the maturing CDs with new CDs? Or do you think you could kind of get some filter through to other categories?

John R. Buran
President, CEO & Director

We think we're going to get it filtered through the other categories. So the -- we're -- today, we're probably bringing in a little bit more money market than CDs. So I think we'll probably see a little bit more coming out of that. And obviously, we're always focused on our NOW account business and our interest-bearing DDA -- noninterest-bearing.

Steven Comery
Morgan Group Holding Co.

Okay. And then sort of just on the same topic, like this -- the maturing CDs. What's sort of the impact of Empire being integrated? I mean does that change sort of the opportunities there? And like what do you do with their CDs? So kind of how are you thinking about that?

Susan K. Cullen
Senior EVP, Treasurer & CFO

So how we think about that is, their deposits will increase our noninterest-bearing deposits significantly. Looking at their CD portfolio, it's not nearly as great as our, so I wouldn't expect it to have a material impact on our -- on these numbers.

Steven Comery
Morgan Group Holding Co.

Okay. Okay. Fair enough. And then just on -- switching gears, the loan yields in the origination table in the press release. It looked like nonmortgage yields kind of increased a lot. Was there any specific reason for that, just given rates slowing down, in general, during the quarter?

Susan K. Cullen
Senior EVP, Treasurer & CFO

Yes. During the prior quarter, we had a lot of C&I-type mortgage loans that were drawing down that yield. They were longer term.

Steven Comery
Morgan Group Holding Co.

Okay. And would you characterize the mix this quarter as sort of more typical or the previous quarter?

Susan K. Cullen
Senior EVP, Treasurer & CFO

I would think this quarter is probably more typical in this environment, but that's always subject to change.

John R. Buran
President, CEO & Director

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Yes. I think one of the things that is strong in our company is really the ability to diversify that loan portfolio and to focus on the areas that are giving us the best risk-adjusted returns in any particular time period. So I think we try and remain somewhat flexible in dealing with our risk and return as we look at the opportunities out there in the market.

Steven Comery
Morgan Group Holding Co.

Okay. Okay. Makes sense. And then finally for me, no repurchases during Q4. Just given kind of how the stock has done recently, how do you think about that given where the valuation is today? And then also in regard to the deal closing coming up?

John R. Buran
President, CEO & Director

So we -- obviously, the stock has been down recently. We think that there are some opportunities for us looking back at repurchases. Obviously, we had quite a bit of blackout going on in the last quarter or so as we dealt with the changes associated with the merger.

We think that the merger is very, very much on track. The -- all the filings have been done with the regulatory authorities, and we think the prospects for a combined Flushing and Empire combination far, far exceed Empire standing alone or Flushing standing alone for that matter.

Steven Comery
Morgan Group Holding Co.

Okay. And you mentioned blackout periods, have those expired? Or is that still ongoing?

Susan K. Cullen
Senior EVP, Treasurer & CFO

No. The general rule is that it expires 3 days after -- 3 business days after we've released earnings.

Steven Comery
Morgan Group Holding Co.

Okay. So 3 days from now. Is that...

Susan K. Cullen
Senior EVP, Treasurer & CFO

Last night.

Steven Comery
Morgan Group Holding Co.

Oh, okay. 3 days from last night. Okay. Fair enough.

Operator

[Operator Instructions].

John R. Buran
President, CEO & Director

If there are no other questions, then thank you very, very much for attending the call. And if there are any further individual questions, we'll look forward to hearing from you, you know how to contact us. Thank you very much.

Susan K. Cullen
Senior EVP, Treasurer & CFO

Thank you.

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

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