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OPB - Q3 2019 Opus Bank Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Opus Bank Third Quarter 2019 Earnings Conference Call. My name is Tiffany, and I'll be your conference call coordinator today. (Operator Instructions)

Speaking on today's call will be Paul Taylor, President and Chief Executive Officer; Kevin Thompson, Executive Vice President and Chief Financial Officer; and Brian Fitzmaurice, Vice Chairman and Senior Credit Officer.

Today's discussion will cover the company's performance during the third quarter of 2019 and information contained in the earnings press release issued earlier this morning. A slide show presentation that accompanies today's call is available on the Opus Bank investor web page at investor.opusbank.com/Presentations. The call will be recorded and made available for replay after 2:00 Eastern Time on October 28, 2019, through November 28, 2019, at 11:59 p.m. Eastern Time by dialing 1 (855) 859-2056, passcode 2222128.

The discussion during the call today may entail forward-looking statements, which are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. You'll find a discussion of these forward-looking statements in our recent FDIC filings and in the earnings press release issued earlier this morning.

Today's call will include a question-and-answer session following management's prepared remarks.

Now I will turn the call over to Paul Taylor, President and CEO, for opening remarks. Sir, you may begin.

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Thank you, Tiffany. Good morning to everybody listening to our third quarter earnings call. I am Paul Taylor. I'm CEO of Opus Bank.

Today, I will provide a brief overview of our performance in the third quarter of 2019. I will then hand it over to Kevin Thompson, EVP and Chief Financial Officer; and Brian Fitzmaurice, Vice Chairman and Senior Chief Credit Officer, who will go through the details of our financial and credit performance.

We had a strong third quarter including improvements in credit quality, which led to a $7.7 million negative provision for loan losses, higher levels of noninterest income from both PENSCO and our Escrow and Exchange division and lower operating expenses. These accomplishments were the direct result of the efforts and determination of Opus team members who worked very hard to improve our profitability and strengthen our balance sheet.

As you recall, we undertook an expense reduction initiative in the second quarter and we saw an immediate benefit in our overhead expense run rate. Our efficiency ratio for the third quarter was 61.8%, which was compared to 71.3% -- 71.32% in the second quarter. We also began to see the trend in our cost of deposits moderate in the third quarter, which helped cushion the decline in our net interest margin.

For the third quarter of 2019, Opus recorded net income of $22 million or $0.57 per diluted share compared to net income of $8.7 million or $0.23 per diluted share in the second quarter. Return on average assets was 1.13% and return on average tangible common equity was 12.88%, helped by the negative provision expense. Credit quality improved with nonperforming assets dropping 65% in the third quarter to only 10 basis points of total assets. And enterprise value loans decreased 44% from the prior quarter to $35.9 million. At this point in time, we're done reporting on enterprise value loans. That $35.9 million should continue to decline every quarter and will decline in the fourth quarter of this year also.

Our Commercial Banking division had a very nice quarter. They originated $99.1 million of loans during the quarter and is continuing to gain traction. It is important to note that the intentional runoff of enterprise value loans has clouded the progress we are making in remixing our loan portfolio towards a greater percentage of commercial loans, but we expect this headwind will lessen in 2020.

The current interest rate environment remains a challenge for the banking industry in general and we are no exception. Yet I am confident that our profitability will continue to improve in the coming quarters.

With that, I will now hand over the discussion to Kevin Thompson, our CFO.

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Thank you, Paul. Turning to Slide 4. Average loans increased $72 million from the prior quarter, driven by new loan fundings of $406 million, offset by loan payoffs of $300 million. Loan fundings decreased primarily due to lower multifamily loan originations as we previously guided, and we originated $99 million of loans in our Commercial Banking division. Loan payoff rates were historically low for the first half of the year, but returned to normal levels this quarter. Total loan yield decreased 6 basis points to 4.24%, primarily due to lower market rates offset by higher prepayment fees.

As you can see on Slide 5, the lower interest rate environment, which led to elevated prepayment activity on securities in the quarter, resulted in a decrease of 3% in average balances and 26 basis points in yield. We continued to optimize our securities portfolio by selling some lower-yielding, shorter-duration securities and swapping them with a mix of longer-duration, mortgage-backed and corporate securities yielding 3.81%.

Turning to Slide 6. Average deposits increased $79.8 million in the quarter driven by growth in interest-bearing demand, money market and savings deposits generated by our Retail, Commercial and PENSCO divisions. Our cost of deposits increased 3 basis points to 1.09% as competition remained high in our markets. We have found opportunities to lower pricing in certain deposit categories and we anticipate making further progress should the Fed continue to lower rates. Our loan-to-deposit ratio remained at approximately 93%.

Turning to Slide 7. Net interest income decreased $937,000, or 1.9%, during the quarter. Interest income from loans increased $0.5 million but was offset by a decrease in interest income from cash and securities of $1.4 million, driven primarily by lower average balances and higher premium amortization. Net interest margin decreased 6 basis points from the prior quarter to 2.82%, primarily due to this decrease in yield and balances of cash and securities. Our cost of funds was unchanged from the prior quarter at 1.23%. As the cost of deposits increased 3 basis points to 1.09%, our cost of borrowings decreased due to lower average balances of FHLB borrowings.

Proceeding to Slide 8. Noninterest income increased 9% to $13.1 million in the quarter after we increased customer fees across various divisions within Opus and PENSCO last quarter. Trust administrative fees from PENSCO increased 6% to $7.2 million and fee income from our Escrow and Exchange divisions increased 8% to $1.6 million. We also recognized sale gains totaling $220,000 primarily on the sales loans in the quarter. Our noninterest income equaled 21% of total revenues.

Turning to Slide 9. Noninterest expense decreased 13% from the prior quarter to $40.1 million. Excluding the second quarter cost reduction expenses of $4.9 million, the decrease was 4% mostly in lower compensation and benefits expense due to reduced headcount, offset by fewer deferred loan origination fees from lower fundings. Professional services expense increased due to additional legal and consulting fees and we benefited from a small bank assessment credit to our FDIC insurance expense.

On Slide 10, we show capital ratio at the quarter end. Our tangible common equity ratio increased 41 basis points to 9.28% and our total risk-based capital increased 49 basis points to 15.26%. Tangible book value per common share increased to $18.94. The Board has approved an $0.11 dividend per common share payable in the fourth quarter, which is unchanged from the prior quarter.

On Slide 11, we display some of our asset liability metrics, which includes durations and our simulation of net interest income, assuming instantaneous parallel shifts. The anticipated duration of our assets has increased as a result of the slight mix shift in loans. We continue to closely assess our position as we navigate this difficult interest rate environment.

I will now turn the discussion over to Brian Fitzmaurice to go into more detail on our loan portfolio and credit metrics.

Brian Fitzmaurice - *Opus Bank - Vice Chairman & Senior Chief Credit Officer*

Thank you, Kevin. This morning, I will review our third quarter credit performance, which depicts continued and significant progress towards a normalized credit environment. This progress is highlighted by a reduction in enterprise value loans of 44% or $28.6 million, leaving a $35.9 million portfolio; a reduction in classified loans of $40.1 million or 37%; and a $13.7 million or 65% reduction in nonperforming assets. Nonperforming assets measured 10 -- 0.10% of total assets as of September 30, 2019. We recorded a negative provision for loan losses of $7.7 million for the third quarter, driven by the improvements in credit. Net charge-offs totaled $4.9 million or 33 basis points of average loans and there were $5.7 million in specific reserves established for the charged-off loans.

We continued to expect our enterprise value loan portfolio reduce through the rest of 2019 through 2020. As a result of the EV portfolio reducing to $35.9 million, we will no longer single out this portfolio for discussion in our quarterly earnings communications. Please note that during the quarter, we did not have any new special mentioned substandard or nonaccrual EV loans and in fact, there are no nonperforming EV loans as of the end of the third quarter.

As I previously mentioned, we recorded a negative provision for loan losses of $7.7 million compared with $3.3 million provision expense last quarter. We previously recorded negative provisions in the second and third quarters of 2017 due to similar circumstances where improvements in our credit quality drove the release of previously allocated reserves. The material factors driving the negative provision this quarter were loan exits, which drove $7 million of the reserve release, a decrease in specific reserves of $5.7 million and a positive risk-rating migration of $1.2 million, offset by net charge-offs of $4.9 million and changes in portfolio mix and loan fundings of $2.3 million.

As of September 30, 2019, our allowance for loan losses totaled $45.2 million or 0.78% of total loans held for investment, a reduction of $12.6 million and 22 basis points for the -- from the prior quarter. And specific reserves decreased to $1 million compared to $6.7 million in the second quarter of 2019.

At the beginning of the year, I indicated that I was optimistic that our credit performance for 2019 would be favorable to both 2017 and 2018 and that our credit metrics would continue, over time, to align with peer bank performance. I'm happy to report we are well along that path. Additionally, as a result of the improvement in the loan portfolio, I don't believe it's necessary for me to make a separate presentation on credit performance on future earnings calls. Therefore, in the future, Kevin and Paul will incorporate credit performance within their comments.

Thank you, and I will now hand the discussion back over to Kevin.

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Thank you, Brian. On Slide 14, we present a summary of our outlook through the end of 2019. We assume a continuation of the current economic environment and one interest rate cut at the end of October.

Despite the difficult interest rate environment, we are optimistic and we continue to see slow, steady economic expansion in our markets. We expand -- we expect loan growth to continue to moderate through the end of the year, with prepayments and competitive pressure at levels we have experienced over the past few years. The overall loan growth for the year should be in the low double digits. We believe with the Federal Reserve potentially lowering rates that deposit cost could moderate through the year while still subject to competitive pressure. We estimate our net interest margin for the full year will be approximately 2.9% due to the impact of the rate environment on loan and deposit pricing and the lack of repricing benefit on variable-rate loans we would experience in an increasing rate environment.

We continue to anticipate a flattening yield curve and elevated prepayments in coming quarters. We continue to maintain our prudent expense discipline and we are very focused on increasing operating leverage. We expect our core efficiency ratio for the full year to be in the range of 64% to 65% with coming quarters driving further down into the low 60s. We expect our credit metrics to be aligned with peer bank performance by the end of 2019. We remain focused on maintaining a strong risk management infrastructure and we are prepared for the implementation of CECL.

We feel this quarter has provided a foundation to drive profitable growth and enhance long-term shareholder value. Our diverse, fast-growing markets are focused on relationship banking and our expense discipline are expected to result in continued improvement over time.

This concludes our prepared remarks. Operator, would you please open the line for questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Matthew Clark with Piper Jaffray.

Matthew Timothy Clark - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

First question just on expenses and the run rate here this quarter. A little better than expected even adjusting for that FDIC credit. But want to get a sense for how we should think about additional cost saves, if there are any, and the plans for ongoing hiring on the commercial lending side of things?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

So as we look forward, there will be -- expenses will be flat to down every quarter that we post. And then as far as the commercial lending teams, we have hired a bunch, but we will continue to be opportunist in looking for people that can produce loans. If we can find good, quality commercial lenders that can produce loans, we will continue to hire and find offsets.

Matthew Timothy Clark - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Okay. And then on the reserve-to-loan ratio, 78 basis points, just thinking about the mix of multifamily, the coverage there at 36 basis points, and I guess how do you think about the pro forma loan mix so we can get a sense for where reserves might fiddle out between commercial in C&I, CRE and multifamily?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Well, as we look at that, multifamily is about 60% of our loan portfolio as we stand here today. We're having great success in our commercial lending division. We expect that to continue and hopefully, the commercial loan growth will continue to be very positive and eventually -- and time would outpace the percent of loan growth in the multifamily. We will always be a multifamily lender. We just move -- need to move up the percent of actual commercial loans on our balance sheet. And as we all know, there are more reserves required on commercial lending than there are on multifamily lending. So in time, the reserve would grow along with the respective loan growth.

Matthew Timothy Clark - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Okay. And then just on the multifamily lending segment this quarter, you mentioned you guys raised rates in that category. Can you give us a sense for what your rates are being offered at this quarter relative to last?

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Yes. And I -- we've maintained rates this quarter. So last quarter, our average funding rate was in the low 4.20s. We're about 4.20 for this quarter. So we kind of maintained that despite the quite large decrease in LIBOR over the quarter.

Matthew Timothy Clark - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Okay. And then just last one on the tax rate coming in close to 26% for the year. Is 26% the right number to use going forward?

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Well, it's dependent on a lot of factors, growth and income, et cetera. So I would say somewhere in the range of 24% to 26% going forward.

Operator

Your next question comes from the line of Tim O'Brien with Sandler O'Neill + Partners.

Timothy O'Brien - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

First question, you guys said that you've kind of got your CECL analysis wrapped up. Can you provide any color at this point in terms of kind of out of the gate where that might be headed? And that would be great.

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Yes. We've -- we're very proud of the progress we've made on CECL. We've done a lot of work internally and we're parallel-testing right now. We're documenting the process, doing model validation, and we do have preliminary results and have had for a while. Until we are complete with our process, we are not prepared to disclose too much and -- because we want to make sure that we have everything buttoned down and our controls in place. But I wouldn't say we're too different from what we're seeing in the industry and we expect this to settle down this first quarter. We'll provide more detail in our 10-K.

Timothy O'Brien - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Great. And then as far as cost to deposits are concerned, do you feel like -- are you ready to say -- or could you say that they might have topped out here for -- on a cyclical basis and we could see some move down here going forward?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Tim, that's the way it feels. It's hard to predict, but the upward pressure has definitely abated at this point in time. We are now looking at lowering the cost of our deposits and have already taken some of those actions. So we're in hopes that this trend continues.

Timothy O'Brien - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

And then just two quickly kind of cleanup questions around credit. The -- when you guys are reserving for commercial loans and obviously, they -- there is some variance in the kinds of commercial loans that you're putting on the books. But can you give a ballpark of how much in initial provision you put towards those loans to support them kind of on a go-forward basis. Is it like 1% to 1.5%, something like that? Or can you give a little color there?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Sure. It changes every quarter but this quarter, it's 1.46% for a past C&I loan.

Timothy O'Brien - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

And then last question. I mean I know enterprise value loans, there is not much left there. Are you pretty much done with planned exit loans? Or is there a balance left there?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

No, there's still a balance. So we have classified loans of $68 million and so there is opportunity for us to still exit those if, in fact, they can't be rehabilitated. But I think generally, those would be exits and that takes time. So...

Operator

Your next question comes from the line of Jackie Bohlen with KBW.

Jacquelynne Chimera Bohlen - *Keefe, Bruyette, & Woods, Inc., Research Division - MD, Equity Research*

Brian, just a question for you before you got put on the back burner going forward. And -- if I look at the breakdown that you provide in terms of the provision expense and I strip out loan exits, specific reserves and net charge-offs just under the assumption that this is related to a book that has now diminished significantly and I look at what the go-forward is. The provision in and of itself is pretty low. Is that a good way to look at how it will be going forward outside of whatever changes are going to be implemented with CECL?

Brian Fitzmaurice - *Opus Bank - Vice Chairman & Senior Chief Credit Officer*

I don't know if it's low. It just depends on the -- it's relative to the asset class, right? So because so much of the book is what we consider a low risk with a very -- with no charge-off history, multifamily, that's why it's where -- that's where it is. And as it grows, in the -- the C&I space, it will grow as Paul was saying just -- and we book a multifamily loan, we book 35 basis points of provision on a new loan. So there is a 111 basis points required every time we book a delta, every time we book a new C&I loan. So -- and I think -- yes, against peer we wouldn't be -- I think if you look at peer, for somebody that has a lot of multifamily, we're not low.

Jacquelynne Chimera Bohlen - *Keefe, Bruyette, & Woods, Inc., Research Division - MD, Equity Research*

Okay. And when you -- when I think about that 1.46%, is that a function of some of the past charge-off history? And so as we go forward and look back further in the past, that would go down? Or is that a function of where you see credit today?

Brian Fitzmaurice - *Opus Bank - Vice Chairman & Senior Chief Credit Officer*

That's a look back -- that includes look back. So it should -- assuming -- it should go down. Yes, the factor should go down each quarter. Yes.

Jacquelynne Chimera Bohlen - *Keefe, Bruyette, & Woods, Inc., Research Division - MD, Equity Research*

Okay. Okay. And then as I think about -- looking more broadly to just the loan portfolio and understanding that you want to get your point where new fundings are coming more from commercial than multifamily, what does an ideal portfolio mix look like? And how long do you think it takes to get there, just generally?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Well, it's hard to state what an ideal portfolio mix is. Clearly, there needs to be more commercial. We have to keep in mind that commercial is much more of a relationship business. We hope to garner deposits and treasury management fees and business. So it's a more holistic business. Right now, we're going for as much as we can. Clearly, as you look into the markets that we're in, I think every bank in the market is trying to grow commercial loans. I believe we have a really great trade team and the team is improving every day and we'll continue to get our fair share where in the past we were not. So I think you'll see commercial loans grow nicely and hopefully, it will become a much greater percent of the balance sheet as we look forward.

Jacquelynne Chimera Bohlen - *Keefe, Bruyette, & Woods, Inc., Research Division - MD, Equity Research*

Okay. So just kind of a gradual mix shift over time?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Yes.

Operator

(Operator Instructions) Your next question comes from the line of Tim Coffey with Janney.

Timothy Norton Coffey - *Janney Montgomery Scott LLC, Research Division - Director of Banks and Thrifts*

As we started looking at a lower rate environment in the next couple of quarters, would you -- and we're thinking about what loan growth could look like for next year. Is $300 million in payoffs a reasonable expectation for the quarter?

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

It's a little hard to forecast that. It is very dependent on the markets, dependent on cap rates, dependent on interest rates. We, definitely, the first half of the year, saw, for us, historically, low paydown rates. And I think that was people maybe on the sideline waiting to see what happened with interest rates. We've gone right back up to our historical rates, so I anticipate that probably will continue into the future. But it's dependent on many factors.

Timothy Norton Coffey - *Janney Montgomery Scott LLC, Research Division - Director of Banks and Thrifts*

Of course, of course. Earlier, you mentioned that you had a feeling about deposit rates and I'm just kind of wondering if you had a feeling about the expected payoff levels the next couple of quarters?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Well, clearly, the trend looks like it's going to continue. Rates are falling and LIBOR seems to be staying in line with that. So one would think that paydowns would continue and increase potentially.

Timothy Norton Coffey - *Janney Montgomery Scott LLC, Research Division - Director of Banks and Thrifts*

Okay. And I apologize if I missed this in your earlier comments, but did the payoffs in the quarter have any positive impact on margin?

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Yes. Our prepayment fees came in higher quarter-over-quarter, so we did get some benefit from that. But of course, our paid -- the loans that are paying down are coming off at a higher rate than those loans coming on so it increases our asset sensitivity in a down rate environment.

Timothy Norton Coffey - *Janney Montgomery Scott LLC, Research Division - Director of Banks and Thrifts*

Okay. And then a question for Brian. With the introduction of caps on rent increases for multifamily every year, does that have any impact on the current portfolio in terms of cap rates?

Brian Fitzmaurice - *Opus Bank - Vice Chairman & Senior Chief Credit Officer*

I wouldn't -- I don't know what's going to happen in the cap rates, but if your question is what's going to happen -- we don't think there is a negative effect to the performance of the portfolio. So because we underwrite to rents in place. So we don't think it will impact the performance.

Operator

Your next question comes from the line of Kevin Swanson with Hovde Group.

Kevin William Swanson - *Hovde Group, LLC, Research Division - Director & VP*

Just one kind of follow-up. Most of my questions have been answered. But last quarter, PENSCO was called out as a strategic focus going forward, can you provide any color on what that might be or any progress made on PENSCO so far?

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Yes. We recently installed a new president at PENSCO. A very experienced gentleman, has spent most of -- has spent all his career in the wealth management arena. As I've always said, I believe PENSCO is an incredible opportunity for this company, and I think there is a lot more we can do with PENSCO and better sell our products at PENSCO. So I believe PENSCO will be a shining star as we move forward. But we are still putting flesh on the skeleton right now to see what that's going to look like.

Operator

Your next question comes from the line of Tim O'Brien from Sandler O'Neill + Partners.

Timothy O'Brien - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

One quick other follow-up. The professional services expense, increased legal and consulting fees. Can you give a little more color on that one on what that was?

Kevin L. Thompson - *Opus Bank - Executive VP & CFO*

Tim, I would call that a more normalized level. It was abnormally low in the prior quarter.

Operator

There are no further questions in queue at this time. I will now turn the conference back over to our presenters.

Paul W. Taylor - *Opus Bank - President, CEO & Director*

Yes. We just want to thank you for calling in to our conference call and your interest in Opus Bank, and we'll talk to you next quarter. Thank you.

Operator

This concludes today's conference call. Thank you for your participation. You may now disconnect.