Flushing Financial

2Q 2021 Earnings Conference Call

Wednesday, July 28, 2021, 09:30 A.M. Eastern

CORPORATE PARTICIPANTS

John Buran – *President and Chief Executive Officer*

Susan Cullen – *Senior Executive Vice President, Treasurer & Chief Financial Officer*

Frank Korzekwinski – *Senior Executive Vice President and Chief of Real Estate Lending*

PRESENTATION

Operator
Welcome to Flushing Financial Corporation second quarter 2021 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. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star (*) key followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, please press star (*) then one (1) on your touchtone phone. To withdraw your question, please press star (*) then two (2). 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 the 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 and 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 reconciliation to GAAP, please refer to the earnings release and/or the presentation. I'd now like to introduce John Buran, President and Chief Executive Officer, who will provide an overview of the strategy and results. Please go ahead.

John Buran
Thank you, operator. Good morning everyone and thank you for joining us for our second quarter 2021 earnings call. On today's call, I will discuss the second quarter highlights and strategic objectives before turning the call over to our CFO, Susan Cullen to provide greater detail on our financial performance. Following our prepared remarks, we will address your questions along with our Chief Real Estate Lending Officer, Frank Korzekwinski.

It goes without saying that the pandemic has affected our personal and work lives. It has brought us masks, social distancing, vaccines and stay-at-home entertainment. In the banking business, it has brought forth challenges, but it has also brought forth opportunities. In the case of Flushing Financial, it has brought forth the opportunity to once again show how strong our management team is and how well we respond to adversity and challenge.

We emerged from the dark days of the pandemic a much stronger company than we were at the end of 2019, the last pre-pandemic year. We have a bigger balance sheet, as we completed our acquisition of Empire National Bank during the height of the pandemic making us $1 billion larger in assets. We have more earnings power, earnings per share for all of 2019 were $1.44. Earnings per share for the first half of this year are already $1.21. We have a better net interest margin today than at the end of 2019, as throughout our history, credit has remained strong with minimal charge-offs. We have a better efficiency ratio, a better loan to deposit ratio, a higher tangible book value and with New York recently opening up, better economic prospects than just a few months ago. Recognizing this opportunity and the improving strength of the company, the board has authorized an increase in share re-purchase to take advantage of our attractive low price and strong dividend.

Turning to slide #4, the second quarter 2021 was an important period as we executed well on our strategic objectives and the New York City economic region started it'srecovery. We reported GAAP EPS of $0.61 and record core EPS of $0.73. GAAP return on average assets and return on average equity totaled 93 basis points and 12% respectively.

On a core basis, these ratios were 111 basis points and 14%, both of which exceeded through the cycle targets of 1% and 10% respectively. The strong results for the second quarter helped boost the tangible common equity ratio to 7.8%. This slide outlines our strategic objectives and how we performed against them. The first objective is to ensure appropriate risk-adjusted returns for loans while optimizing the cost of funds.

Second quarter was our 5th consecutive quarter of record net interest income. While GAAP NIM declined 4 basis points quarter-over-quarter, core NIM rose 8 basis points. Average non-interest-bearing deposits continue to rise and improved 65% year-over-year and now represent 14% of average deposits.

With the announcement in August 2020 of our acquisition of Empire National Bank, we had estimated that it would take 3.4 years to recover the tangible book value dilution. We improved upon that significantly, recovering full tangible book value in less than 9 months as cost saves accelerated and net interest income improved despite operating in the pandemic environment.

The second objective is to maintain strong historical loan growth. Period end loans excluding PPP increased approximately 11% year-over-year and approximately 2% annualized from the first quarter. Our loan pipeline increased 39% year-over-year to $433 million. We expect loan growth excluding PPP to accelerate in the second half of 2021. We assisted customers in the PPP forgiveness process and expect this to continue over the next couple of quarters.

The third objective is to enhance core earnings power by improving scalability and efficiency. As I just mentioned, we had record core earnings per share of $0.73, which more than doubled year-over-year. The improvement in core earnings was due to lower credit related cost and realizing the benefits of the Empire merger. We recognize scale is important in the banking industry and we expect growth in the intermediate term will be largely organic. There have been several M&A transactions announced in our market and given the quality and size of our company, we believe we are in a position of strength to capitalize on any merger disruption. We also continue to make strides in digital banking that Susan will detail shortly.

Our final strategic objective is to manage asset quality with consistent and disciplined underwriting. Strong credit quality has always been a hallmark of the company. Net charge-offs were only 5 basis points this quarter. Non-performing assets declined 17% linked quarter and were only 26 basis points of loans and real estate owned. Despite the reduction in the allowance for loan losses this quarter, the coverage ratio increased while remaining over 200% of non-performing loans. The average loan to value in our real estate collateralized portfolio is 38%. We remain very comfortable with a low level of credit risk in our portfolio.

Overall performance against the strategic objectives was strong, as evidenced by the improvement in both core return on average assets and return on average equity for the quarter.

Even without the release of provision for credit losses this quarter, core return on average assets and the equity exceeded the through the cycle targets of 1% and 10% respectively.

I'll now ask Susan to provide more details. Susan?

Susan Cullen
Thank you, John. I'll begin on Slide 5. The first strategic objective is to ensure appropriate risk-adjusted returns for loans while optimizing cost of funds. Average deposits grew 29% year-over-year and excluding Empire, growth approximated 13%. Average non-interest-bearing deposits increased 65% from a year ago, and average core deposits comprised 84% of average deposits, an improvement from 77% in the second quarter of 2020. Total cost of deposits continued to move lower falling 5 basis points in the quarter and 45 basis points over the past year.

Slide 6 outlines the net interest income and margin trends. Our net interest margin has moving parts including fair value adjustment and net amortization of purchase accounting adjustment.

To make the analysis clear, these items plus the effects of prepayment penalties and net reversals and interest recoveries from nonaccrual loans are removed in the base net interest margin. We encourage you to start with base net interest margin for modeling purposes and then add in your own assumptions for the items previously mentioned. Base net interest income includes PPP loans and fees, which I will detail shortly.

Overall net interest income was a record for the 5th consecutive quarter despite slight decline in average loan and the net interest margin when compared to the first quarter. However, core net interest margin was 3.14%, an improvement of 8 basis points during the quarter but included net prepayment penalty income and PPP fees of 16 basis points compared to 8 basis points in the first quarter.

Base net interest margin rose by 3 basis points sequentially. This was achieved despite a 34% increase in average short-term funds. We expect the $242 million of average interest-earning deposits in Fed funds in the second quarter, which yielded only 8 basis points to decline as the loan growth improves.

As a reminder, we have $592 million of effective swaps that cost 203 basis points to pull down the net interest margin, the majority of which matured by the end of 2023. These swaps will largely be replaced $405 million of swaps that cost 71 basis points. Re-pricing of the swaps absent any other interest changes should provide a benefit to the net interest margin.

Slide 7 discusses the strategic objective of maintaining strong historical loan growth. As previously mentioned, loan growth was challenging in the second quarter due to PPP forgiveness. Period end loans declined less than 2% annualized quarter-over-quarter that grew 13% year-over-year. We chose to stick to our disciplined underwriting and pricing standards. Loan pipelines and line utilization improved during the quarter, and this bolsters our confidence that non-PPP loan growth should accelerate in the second half of 2021. Base loan yields increased 1 basis point in the second quarter and decreased 11 basis points from a year ago. The spread between the yield on loan originations and loan satisfactions excluding the PPP loans narrowed during the quarter but remains negative.

Slide 8 details the PPP portfolio. PPP loans total $197 million at the end of the second quarter with associated fees of $4 million. The yield on PPP loans increased to approximately 3% in the second quarter from nearly 2% the previous quarter. As we disclosed on July 8, total net deferred

PPP fees recognized in the second quarter of $1.2 million up from $0.5 million in the first quarter. Total PPP income did not impact the net interest margin in the second quarter but there was a drag of 4 basis points in the first.

PPP loan forgiveness totaled $69 million in the second quarter with another $22 million in process at quarter end. We expect forgiveness to continue through the remainder of 2021 and possibly into 2022 as the SBA can take up to 90 days to approve such loans.

Slide 9 shows the strategic objective of enhancing core earnings power by improving scalability and efficiency. Digital banking metrics continue to improve with a 38% increase in monthly active mobile users and a 21% rise in digital banking enrollment year-over-year. We are planning additional technology enhancement as we invest in the franchise.

The Empire acquisition is meeting our objectives and we remain confident in achieving the cost savings and 20% earnings accretion from the transaction in 2021.

Tangible book value earn-back has been achieved in 9 months, significantly better than 3.4 years model when the deal was finalized. While timing of M&A is unpredictable, we would not enter any transaction that did not meet our financial hurdles. Additionally, there has been several M&A announcements in our markets for which we are poised to take advantage of disruption. We foresee growth will largely be organic.

Slide 10 has our fourth strategic objective, which is to manage asset quality with consistently disciplined underwriting. As New York City reopens, the local economy is gaining strength as workers are returning to the office. The unemployment rate has improved slightly during quarter, but it is still above national levels. With this improvement, economic factors and our reserving methodology improved, and this partially drove the reserve release for the quarter.

Future loan loss provisions are expected to be driven by loan growth mix and economic factors. Our consistent track record of strong underwriting was on display again this quarter as net charge-offs were only 5 basis points of average loans. The weighted average loan to value on the real estate portfolio is 38% and there is minimal exposure to loans with the loan to value of 75% or more.

Slide 11 outlines some of our strong credit quality statistics. The coverage ratio remains over 200% of non-performing loans and improved during the quarter. Non-performing assets declined both quarter-over-quarter and year-over-year. The average loan to value on the real estate non-performing assets is in low 30%. Forbearances are now approximately 4% loans, but only 1% excluding those making interest-only payments. We remain very comfortable with our credit risk profile and continue to expect minimal loss content.

On slide 12, we talked about our capital ratios, which strengthened during the quarter. Only 9 months after closing the Empire deal, the leverage ratio was nearly at the level at June 30, 2020, and the tangible common equity ratio exceeds the year ago level.

As John mentioned earlier, the board of directors have authorized an increase of 1 million shares to the existing repurchase program. This authorization has no dollar or time limit. The strategy surrounding buybacks has not changed. We will consider using the stock repurchase authorization opportunistically. We view the stock as attractively priced giving approximately 4% dividend yield. Book and tangible book value per share increased to $21.16 and $20.51 respectively at the end of the second quarter.

Before I turn the call back to John, let me remind you of some items that could impact the third quarter. Core net interest margin will be impacted by the timing and level of PPP forgiveness, overall loan growth and deployment of excess liquidity. Assuming no changes in the pandemic response, we expect loan growth excluding the PPP loans to accelerate in the second half of 2021. Purchase accounting accretion is expected to remain below $1 million per quarter. Nonrecurring expenses are expected to increase in third quarter as we closed our branch and unused office space. We intend to be opportunistic on share repurchases while keeping in mind other business considerations. Similar to last quarter, we suggest $35 million as a starting point for quarterly operating expenses before adding normal growth. Our effective tax rate for the full year of 2021 should approximate 26 to 26.5%.

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

John Buran
Thank you, Susan. On slide 13, we provide our outlook. We expect loan growth excluding PPP to accelerate in the second half of 2021 as the local economy fully reopens and we fund our loan pipeline. PPP forgiveness will be a headwind. Core net interest income will benefit from loan growth and the redeployment of the PPP forgiveness and short-term liquidity. Tangible common equity continues to rise and is near our 8% target. We will remain opportunistic with our increased share repurchase authorization. We have a low-risk business model and I have demonstrated over many credit cycles that our losses are well below the industry.

In our view, we are a stronger company than we were pre-pandemic, and our low-risk business model is not properly reflected in our stock valuation. We believe our stock is attractively priced especially with the approximate 4% dividend yield. Through the cycle goals of 1% plus return on average assets and a 10% plus return on average equity remain and we exceeded these goals in the second quarter both with and without the reserve release.

With that, we will now open it up to questions. Operator, I'll turn it over to you.

QUESTIONS AND ANSWERS

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

Our first question come from Mark Fitzgibbon of Piper Sandler. Please go ahead.

Mark Fitzgibbon
Hi, guys. Good morning.

Susan Cullen
Good morning, Mark.

John Buran
Good morning, Mark.

Mark Fitzgibbon
Susan, just a real quick clarification question. Banking services fees were down a bit from pre -- the last couple of quarters. I am curious is that because swap fees were lowers or swap fees in that line?

Susan Cullen
Yes, they are and that is driving that, yes.

Mark Fitzgibbon
That was what driving. Okay great, and then secondly how much of the $246 million of loan deferrals that you guys have out there to mature this year? Will most of them?

Susan Cullen
Most of them do -- the vast majority of them will mature within this coming quarter --coming year.

Mark Fitzgibbon
Okay, great, and then Susan, you gave a lot of detail on the things that are likely to affect the NIM in coming quarters. Can you help us kind of distill that all down to sort of a bottom-line margin impact in say 3Q?

Susan Cullen
Well, I would if I could Mark, but I don't have a crystal ball to spin out what the marks will be our swaps that flows through there or how our prepay penalties are going to come through. So, I think our core NIM – if we talk about that, that is probably a better spot to start or even our baseline NIM that is net of all of those items.

Mark Fitzgibbon
Okay and so the core NIM you think will be under a little bit of pressure?

Susan Cullen
Yes, yes, we do. As we talked about in the past that we had greater opportunity to re-price liability and as you saw we only had a 5 basis points decrease in the cost this quarter and we are -- the assets are holding their own, but we are not going to have as much opportunity to re-price liabilities as we have had.

Mark Fitzgibbon
Okay and then lastly, you say on slide 3 of the slide deck that you are in the early stages of tech enhancements, I guess I am curious what that means? What kind of timing we are looking at? What kinds of maybe products or services you are looking to add in, is this a major cost initiative?

John Buran
So, I think where we will focus, and clearly we did a very good job in working with our vendor on PPP loans. We are looking to possibly expand that relationship in order to provide some additional efficiencies in terms of lending. We of course have -- in the past year have totally revamped our mobile and online banking offerings and we expect to continue to see growth in terms of the utilization of those services by our customer base and then lastly, we were part of the group of a number of banks that have been working with that JAM FINTOP in order to get some insights into some of the emerging technologies that are out there, emerging companies that are doing some smart things with respect to efficiency and friction reduction let's say with respect to our customer base. So, we expect to gain some benefit out of that as well. So, there's

a lot of different things going on at various stages and we expect to – we expect to reap some benefits out of that over time.

Mark Fitzgibbon
Thank you.

Susan Cullen
Thanks Mark.

Operator
Once again, if you would like to ask a question, please press star (*) then one (1). Our next question will come from Chris O'Connell of KBW. Please go ahead.

Chris O'Connell
Hi, good morning.

Susan Cullen
Good morning Chris.

John Buran
Good morning Chris.

Chris O'Connell
Just hoping for one quick clarification question on the PPP NIM impact. I think a couple of times you guys said there was no impact on the NIM this quarter, but then at one point in the earnings release, it might have said there was 6 basis point NIM impact for 2Q 2021, just a little bit of clarification on that?

Susan Cullen
It is the -- I think there is some confusion between the yield on the PPP loans versus the NIM impact. So, the yield did increase versus the first quarter of 2021, but because those numbers are so small in our overall interest income, they did not have material effect on the NIM. There is no effect on our NIM.

Chris O'Connell
Got it, I appreciate the color, great, and then as far as the loan growth, I mean the pipeline is up quite a bit quarter-over-quarter and year-over-year, the outlook seems to be robust for the second half of the year. I am just hoping to get a little bit of color as to where you are seeing that growth coming from. And it sounds like you from the presentation that line utilizations rebounded in the second quarter, but I did see C&I loans were kind of down on an end-of-period basis, so just maybe what the change in line utilizations were or if that was coming post 2Q?

Susan Cullen
So, the line utilizations are mostly post Q2, but they are where they are. The loan growth we expect to be very strong given our strong pipeline, historical average pull-through of those loans, remember we are taking ex-PPP loans, the PPP forgiveness will be a headwind that we will have to fight against, but every dollar we replace with PPP loans with a -- loan yielding 3.5% or so is a much better impact on our NIM going forward.

Chris O'Connell

Got it and it looks like there is a pretty solid makeshift out of cash into the securities book, this past quarter -- this past quarter and maybe you just quantify in kind of what the level of that makeshift will be going forward and what the new yields are on the securities that you are putting on the book?

Susan Cullen
So, we don't expect given our optimism over the second half of the year loan growth that we would need to redeploy the excess liquidity into the securities book. We are very comfortable with our securities book where it is from liquidity and other reasons, so that is where we would stay with the liquidity.

Chris O'Connell
Okay, got it, and I guess lastly just on the overall reserve income, credit quality, trends overall seem headed in the positive direction this quarter and with the understanding that you guys run very clean book all around, how much like where do you guys think the bottom can be on the reserve loans or how much room you have to run that down any more from where it is today?

Susan Cullen
Chris that will all depend on our loan mix, the economic environment whether we have another tail -- headwind excuse me from the delta COVID variant, if we're going to have to factor that into our considerations, all those items will come into play. We continue to underwrite very conservatively. We are very comfortable with where we are. I wouldn't want to make a prediction as to what the lowest number we could go to would be.

Chris O'Connell
Okay, got it and just I guess one final one if I could as far as the buyback authorization increase in the appetite for that going forward, just talk a little bit about maybe what the drivers are of that appetite and as far as the pricing dynamics where you get more aggressive or less aggressive versus tangible book value or with regard to capital levels?

John Buran
Well, look I think by any stretch of the imagination given our performance recently the stock has been trading at a very, very low level just slightly above tangible book and with a strong dividend yield, we felt very confident throughout this time period that we would see and we did have some very, very nice growth in terms of the stock price over the past year or so, but we also feel that given all of the economic factors getting better, the fact that the company is performing much better than it did pre-pandemic that all of the stars are aligned quite well for us to go out and to grab some additional shares of stock particularly if the market is not grabbing them. We certainly see a strong return coming out of that.

Chris O'Connell
Understood. Thank you.

Operator
There are no further questions at this time, and I would like to turn the conference back over to John Buran for closing remarks

CONCLUSION

John Buran

Thank you, thank you very much operator. Well, thank you all for your attention. As I said earlier, I think that we are very, very pleased with the quarter and pleased with the prospects for the future for the company. So, thank you again for your attention and everyone stay safe.

Susan Cullen
Thank you

John Buran
Bye.

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