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Earnings Review

July 27, 2020

OFG Bancorp (OFG - NYSE - Closing Price: $14.09)

OFG: Expecting Stable NIM and Continued Efficiency Drive to Generate EPS Growth.

Overview: OFG reported 2Q20 net income to common shareholders of $20.2 million, up from the $0.2 million net loss posted in 1Q20. On a per share basis, 2Q20 results were $0.39 compared to $0.00 in the prior quarter. 2Q20 results included $6.0 million of one-time interest recoveries on acquired Scotiabank loans and a $3.5 million favorable adjustment to the bargain purchase gain recorded on the Scotiabank de Puerto Rico acquisition, partially offset by $3.0 million of merger and integration expenses and $2.0 million of COVID-19 related expenses. Some of the significant irregular, one-time or nonrecurring items that affected 1Q20 results include $0.3 million in merger & restructuring charges, and a $4.7 million gain on investment securities. Collectively, the nonrecurring items boosted 2Q20 earnings by roughly $4.1 million after-tax or $0.08 per share. Similarly, 1Q20 earnings were boosted by approximately $3.8 million after tax or $0.07 per share. Adjusted 2Q20 EPS was $0.31 compared to adjusted 1Q20 EPS of $(0.07) excluding the impact of these items. Adjusted results exceeded our adjusted estimate of $0.24 and the median Street estimate of $0.26. The outperformance compared to our estimate was due to a combination of a lower loan loss provision and lower noninterest expenses. Highlights from the quarter include:

- Net interest income was essentially unchanged compared to 1Q20. However, without the $6.0 million in interest recoveries mentioned above, we would have seen a $6.0 million sequential decline. Average earning assets advanced 3.4% LQ, while the NIM contracted 16 bps to 4.78% from 4.94% in 1Q20. The interest recoveries accounted for 28 bps of NIM in 2Q20, so the "core" NIM was actually down 44 bps linked-quarter. Average loan yields fell 3 bps sequentially, but PCD loan yields jumped 142 bps due to the interest recoveries. Absent the recoveries, PCD loan yields still rose, but by a more modest 21 bps. Meanwhile, average non-PCD loan yields declined by 69 bps sequentially. The mix of assets at period end included a higher portion of cash (15.7% of interest earning assets in 2Q20 versus 11.0% in 1Q20) as a result of an influx of deposits. The average cost of interest bearing liabilities fell 14 bps to 0.97% from 1.11% in 1Q20. The average cost of interest bearing deposits dipped 9 bps sequentially in 2Q20, while the average cost of borrowings rose 11 bps linked-quarter. Fair value premium amortization and core deposit premium amortization contributed an incremental 12 bps to the cost of interest bearing liabilities, similar to the 12 bps impact in the prior quarter.
- Noninterest income of $27.2 million was down $4.3 million or 13.7% from the prior quarter. However, if we strip out the $3.5 million bargain purchase gain recorded on the Scotiabank transaction recorded in 2Q20 (compared to $0.4 million in 1Q20) and the $0.6

Market Data			Earnings Per Share Data					
				Our Forecast			Consensus	
			2019A	2020E	2021E		2020	2021
Market Value (M)	$723	1Q (Mar.)	$ 0.42	$ (0.02)	$ 0.36		$ (0.02)	$0.46
ADTV (Shs)	369,833	2Q (Jun.)	$ 0.43	$ 0.39	$ 0.38		$ 0.39	$0.50
ADTV (000')	$5,210.9	3Q (Sep.)	$ 0.11	$ 0.43	$ 0.43		$0.38	$0.57
52 Week Range	$8.63-$23.76	4Q (Dec.)	$ (0.05)	$ 0.48	$ 0.46		$0.45	$0.59
Dividend Yield	1.99%	Year	$ 0.92	$ 1.27	$ 1.62		$1.03	$1.90
		P / E	15.4	11.1	8.7		13.7	7.4

Fundamental Metrics (MRQ)	
Balance Sheet	
Total Assets (M)	$9,933
Gross Loans HFI (M)	$6,953
Total Deposits (M)	$8,542
Loans / Deposits	81%
Securities / Assets	5%
Debt / Assets	1%
Profitability	
FTE NIM	4.78%
Nonint. Income / Revenue	18.40%
Efficiency Ratio	62%
Core ROAA	0.97%
Core ROACE	9.0%
Credit Quality	
NPAs / Assets	1.17%
NPLs / Loans	1.21%
NCO Ratio	0.92%
Reserves / Loans	3.35%
Provision / Avg Loans	1.03%
Capital Adequacy	
TCE / TA Ratio	8.3%
Total Capital Ratio	15.0%
Tier 1 Ratio	13.7%
Tier 1 CE Ratio	12.0%
Leverage Ratio	10.2%
Performance	
Core Value	$21.13
3 Yr. Success Ratio	11%
Failure Ratio	6.6%

Source: SNL Financial, Company data

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million gain on MBS sales compared to $4.7 million in 1Q20), “core” noninterest income fell approximately $3.2 million or 12.3%. The decrease was largely due to the COVID-19-related shutdowns, which led to decreased economic activity and lower transaction volumes.

- Noninterest expenses declined $1.8 million or 2.1% linked-quarter. Merger & restructuring expenses grew $2.7 million from the prior period. In addition, OFG incurred $2.0 million in COVID-19-related expenses during the quarter. Excluding these items from the prior period, core noninterest expenses fell $6.5 million or 7.5% sequentially. There was a $1.0 million decline in compensation costs, with the remainder spread among other G&A categories. Much of the sequential decline reflected the reduced economic activity, which resulted in lower transaction-related expenses and reduced commission compensation. Management still expects to achieve most of the anticipated savings from the Scotiabank integration in 2021. OFG’s adjusted efficiency ratio was 65.86% in 2Q20 compared to 66.13% in 1Q20.
- OFG recorded a $17.7 million credit loss provision in 2Q20, down $29.4 million or 62.5% compared to the $47.1 million provision in the prior quarter. The decline primarily stems from a $29.1 million reduction in COVID-1-related adjustments, which fell from $34.1 million in 1Q20 to $5.0 million in 2Q20. The allowance for credit losses grew $1.9 million or 0.8% linked-quarter, slipping to 3.35% of loans held for investment from 3.41% at March 31, 2020.
- Despite the downturn in economic activity related to COVID-19, overall, asset quality has still not suffered significantly. Net charge-offs fell to 0.92% of average loans in 2Q20 from 1.44% in 1Q20. NPLs decreased $8.4 million or 8.5% linked-quarter, falling 26 bps to 1.81% of non-acquired loans from 2.07%, while OREO and other repossessed assets also fell, leading to a decline of 9.8% in NPAs. Early stage delinquencies decreased from 3.16% of loans on March 31, 2020 to 2.64% on June 30, 2020.
- OFG recorded a tax expense of $7.2 million in 2Q20, producing an effective tax rate of 25.0%.
- Gross loans held-for-investment climbed $186.4 million or 2.8% sequentially. The increase was once again entirely in the commercial loan segment, which grew $281.2 million or 12.2% linked-quarter thanks to $286.4 million of PPP loan originations. The consumer, auto and consumer segments all saw decreases. Despite the unfavorable economic environment, OFG recorded solid loan production. We just noted the significant PPP loan production, but other internal loan originations in the commercial segment also held up well, climbing 82.1% from the prior quarter. Meanwhile, consumer and auto loan originations fell 63.7% and 56.7% respectively. Originations through the mainland loan participation channel declined 24.2% sequentially to $35.7 million from $47.1 million in 1Q20. Meanwhile, mortgage loan production decreased 31.3% to $21.1 million. Much of the declines in mortgage, auto, and consumer loans was driven by the COVID-19-related shutdowns. As some of the restrictions were lifted late in the quarter, originations of mortgage and auto loans began to rebound. Total originations were $504.4 million, up 79.4% compared to the $280.6 million posted in 1Q20, and up 54.2% from the $326.6 million originated in the same period a year ago.
- Total deposits climbed $722.7 million or 9.2% sequentially, led by a $658.9 million rise in demand deposits. Also contributing was a $149.1 million jump in savings accounts. Partially offsetting these increases was a $48.0 million decline in time deposits and a $37.3 million drop in brokered deposits. As a result, the deposit mix improved noticeably, as brokered and time deposits decreased to 25.7% of total deposits from 29.1% on March 31, 2020. The increase in deposits during the quarter was larger than the $186.4 million rise in gross loans held for investment. As a result, OFG was able to reduce securities sold

under repurchase agreements by $50.1 million. However, the rest of the deposit funding largely went into cash, which grew $574.1 million sequentially, creating a drag on the NIM.

- Tangible book value per share rose to $16.01 on June 30, 2020 from $15.60 on March 31, 2020, while the tangible common equity ratio declined 41 bps to 8.39%. OFG's regulatory capital ratios increased further during the quarter. The leverage ratio climbed to 10.16% from 10.14%, the CET1 ratio increasing to 12.03% from 11.69%, and the Tier 1 ratio advancing to 13.71% from 13.36%. All of the regulatory capital ratios remain well above the minimums needed to be considered "well capitalized" under regulatory guidelines.

Earnings Estimates: There is greater than usual uncertainty right now due to the COVID-19 pandemic situation. The unknown path of the pandemic makes it difficult to gage the state of the economy over the next three to six months. This makes forecasting loan and deposit levels, as well as the NIM problematic. One thing that seems certain is that we will see credit quality deteriorate as payment moratoriums end. That being the case, we'll start with credit costs. OFG has solid reserve coverage relative to average loans. While we believe net charge-offs will increase noticeably in coming quarters, a significant portion of the charge-offs should reflect loans already reserved for. We are projecting a credit loss provision in the $16 million to $17 million range over the next three quarters. This is similar to the 2Q20 level, though 2Q20 included a $5.0 million COVID-19-related adjustment. This results in total provisioning of $98 million in 2020 and $73 million in 2021, down from our prior projections of $120 million and $98 million.

We are assuming minor balance sheet shrinkage over the next few quarters as PPP loans get repaid or forgiven and deposits stemming from government stimulus programs get drawn down. The reduction in deposits will allow OFG to reduce low-yielding cash and investments at the same time as low yielding PPP loans are paying off should help keep the NIM fairly stable despite the low interest rate environment. We expect noninterest income to rebound modestly as the economy gradually reopens, while noninterest expenses should remain contained due to efficiency efforts and gradual integration of the Scotiabank operations. We still anticipate most of the cost savings from the Scotiabank acquisition in 2021.

After adjusting our model for the above items, we are raising our 2020 EPS estimate from $0.54 to $1.27 (from $0.63 to $1.35 excluding merger & integration expenses). We are also raising our 2021 EPS estimate from $0.90 to $1.62 while initiating a 2022 estimate of $1.86.

Outlook:

Puerto Rico has seen many catastrophes in recent years, from the government debt crisis and Hurricane Maria in 2017 to the earthquakes of early 2020, and now the pandemic. Thought there are still many challenges to overcome from these events, there is also a considerable backlog of disaster relief still due that could help the island respond to the COVID-19 downturn.

We believe that OFG is well positioned to improve profitability as the economy rebounds. With the stock still trading below tangible book value, we believe that OFG remains an attractive investment.

Due to changes in our coprorate structure and a desire to avoid conflicts of interest, we are discontinuing the practice of providing target prices and stock ratings in our reports. However, we still believe we have insights to offer and value to add for the small number of securities that we continue to provide research coverage for.

Exhibit 1:

OFG Financial Corporation: 2Q20 Highlights

	Actual Results			Change	
	2Q19	**1Q20**	**2Q20**	**LQ[1]**	**YOY**
Loans Held for Investment ($000)[2]	4,596,885	6,766,114	6,952,512	11.0%	51.2%
Total Deposits ($000)[2]	4,945,137	7,819,271	8,541,926	37.0%	72.7%
Average Earning Assets ($000)	6,060,819	8,556,553	8,845,744	13.5%	45.9%
Total Revenue ($000)	104,033	136,551	132,212	-12.7%	27.1%
Net Interest Income ($000)	81,085	105,101	105,060	-0.2%	29.6%
NIM (FTE)	5.57%	5.05%	4.88%	-0.17%	-0.69%
Average Securities Yield	2.41%	1.93%	1.83%	-0.10%	-0.58%
Average Loan HFI Yield	7.56%	7.00%	6.97%	-0.03%	-0.59%
Average Cost of Int.-bearing Deposits	1.04%	0.97%	0.88%	-0.09%	-0.16%
Efficiency Ratio	49.5%	63.9%	64.7%	0.71%	15.2%
NCO Ratio	1.15%	1.44%	0.92%	-0.52%	-0.23%

1. Linked quarter changes for the balances are annualized.

2. Loans Held for Investment and Total Deposits balances are end of period balances.

Source: company filings

Exhibit 2:

OFG Bancorp

(Figures in thousands except for per share data)

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2017A	2018A	2019A	2020E	2021E	2022E		1Q20A	2Q20A	3Q20E	4Q20E	1Q21E	2Q21E	3Q21E	4Q21E
304,172	315,894	322,793	424,840	417,124	430,398	Net interest income	105,101	105,060	108,308	106,371	102,070	103,156	105,188	106,710
113,139	56,108	96,792	98,130	72,571	71,915	Provision for loan losses	48,530	17,696	16,154	15,750	17,410	19,590	17,744	17,827
191,033	259,786	226,001	326,710	344,553	358,483	**Net Interest Income after Provision**	56,571	87,364	92,154	90,621	84,659	83,567	87,443	88,884
						Non-interest income:								
39,468	43,638	42,866	56,307	55,225	59,347	Banking Services	15,713	13,668	13,455	13,471	13,641	13,590	13,681	14,313
4,050	4,767	4,275	12,789	13,591	14,699	Mortgage Banking	3,234	3,072	3,226	3,258	3,225	3,354	3,488	3,523
1,403	-	-	-	-	-	Accretion of FDIC indemnification asset	-	-	-	-	-	-	-	-
25,790	25,934	26,224	27,128	26,802	27,333	Fin'l Svc (Brokerage & Insurance Fees & Other)	7,286	6,366	6,302	7,173	6,437	6,630	6,431	7,304
-	-	-	-	-	-	Investment banking fees	-	-	-	-	-	-	-	-
-	-	-	-	-	-	Gains (losses) on trading acct & securities	-	-	-	-	-	-	-	-
-	-	-	-	-	-	Gains (losses) on derivatives	-	-	-	-	-	-	-	-
7,976	5,756	9,128	9,531	557	579	Other non interest income	5,217	4,046	135	133	139	139	141	138
78,687	80,095	82,493	105,755	96,175	101,958	**Total non-interest income**	31,450	27,152	23,118	24,034	23,442	23,714	23,742	25,278
						Total Non-interest expense								
79,751	76,524	82,533	140,101	141,572	143,286	Compensation and Benefit	35,544	34,506	34,851	35,200	36,608	34,411	34,927	35,626
32,711	33,084	30,052	45,607	43,880	44,319	Occupany & Equipment	11,439	11,837	11,415	10,915	10,915	10,915	11,025	11,025
5,616	5,084	5,208	6,548	6,813	7,160	Advertising & Promotion	1,629	1,645	1,629	1,645	1,678	1,695	1,712	1,729
12,406	12,442	14,629	23,447	24,216	25,194	Professional Fees	5,789	5,847	5,847	5,964	5,964	5,964	6,083	6,205
3,415	3,447	3,315	3,992	4,237	4,496	Communications	971	990	1,010	1,020	1,031	1,051	1,072	1,083
4,634	4,662	2,426	787	1,371	1,426	Net costs of assets acquired through foreclosure	(193)	316	332	332	338	342	345	345
63,098	71,838	71,027	110,733	102,647	107,431	Other Expenses	31,839	27,333	26,680	24,880	25,302	25,555	25,766	26,024
201,631	207,081	209,190	331,213	324,735	333,313	**Total non-interest expense**	87,018	82,475	81,764	79,956	81,836	79,933	80,930	82,036
52,646	84,410	53,841	71,538	86,458	94,757	**Net Income**	402	21,787	23,485	25,864	19,578	20,384	22,551	23,945
						Per Share Data:								
0.90	1.52	0.92	1.27	1.62	1.86	Earnings Per Share	(0.02)	0.39	0.43	0.48	0.36	0.38	0.43	0.46
0.24	0.25	0.28	0.34	0.38	0.38	Dividend	0.07	0.07	0.10	0.10	0.08	0.10	0.10	0.10
26.59%	16.48%	30.60%	26.81%	23.52%	20.44%	Dividend Payout Ratio	-295.26%	17.87%	23.44%	20.93%	22.38%	26.51%	23.53%	21.83%
17.73	17.90	18.75	19.84	21.89	24.32	Book Value	18.33	18.69	19.23	19.84	20.19	20.70	21.28	21.89
15.67	16.15	15.96	17.15	19.18	21.58	Tangible Book Value	15.60	16.01	16.55	17.15	17.49	18.01	18.57	19.18
43,947	45,400	51,335	50,963	49,092	47,092	Average Shares Outstanding (MM)	51,404	51,336	51,092	50,592	50,092	49,592	49,092	48,592
						Profitability Measures:								
52.66%	52.29%	57.55%	63.42%	63.26%	62.61%	Efficiency Ratio	63.95%	64.65%	63.73%	61.31%	65.20%	63.00%	62.77%	62.15%
0.85%	1.31%	0.83%	0.74%	0.91%	0.99%	Return on average assets	0.02%	0.92%	0.88%	1.06%	0.83%	0.86%	0.88%	1.00%
5.61%	8.73%	5.15%	6.82%	7.87%	8.16%	Return on average equity	0.15%	8.45%	8.29%	9.67%	7.38%	7.50%	7.51%	8.46%
5.23%	5.28%	5.37%	4.83%	4.86%	4.92%	Net Interest Margin	4.94%	4.78%	4.80%	4.81%	4.82%	4.85%	4.87%	4.90%
24.77%	19.42%	22.06%	20.54%	18.69%	19.07%	Fee Income % Revenues	23.03%	20.54%	17.59%	18.43%	18.68%	18.69%	18.41%	19.15%
						Average Balances:								
4,125,804	4,348,135	4,511,190	6,725,841	6,600,315	6,833,044	Loans	6,687,987	6,840,650	6,723,499	6,651,228	6,552,433	6,546,146	6,619,248	6,683,434
3,826,000	3,811,406	3,781,006	6,241,818	6,307,835	6,339,190	Interest Bearing Deposits	6,053,482	6,105,014	6,403,901	6,404,877	6,341,307	6,293,828	6,288,827	6,307,377
860,287	1,078,178	1,100,599	1,823,333	1,707,222	1,713,174	Non-interest Bearing Deposits	1,698,964	1,983,092	1,844,540	1,766,734	1,723,609	1,702,887	1,700,516	1,701,878
5,818,598	5,985,524	6,009,521	8,794,089	8,584,149	8,743,650	Earning Assets	8,556,553	8,845,744	8,980,606	8,793,454	8,594,570	8,531,969	8,570,523	8,639,536
4,366,367	4,277,457	4,196,718	6,527,969	6,409,345	6,462,921	Interest Bearing Liabilities	6,325,282	6,262,683	6,865,169	6,658,744	6,494,510	6,364,347	6,369,028	6,409,496
						Asset Quality Ratios:								
1.30%	1.38%	1.09%	0.79%	1.25%	1.19%	Net Charge-offs / Loans	0.98%	0.79%	0.95%	1.01%	1.16%	1.25%	1.21%	1.21%
3.87%	3.65%	1.78%	2.20%	2.44%	2.12%	Nonperforming Assets / Loans	1.97%	1.73%	1.92%	2.20%	2.36%	2.43%	2.44%	2.44%
2.21%	2.08%	1.24%	2.09%	1.88%	1.73%	Reserves / Loans	2.21%	2.17%	2.14%	2.12%	2.19%	2.11%	2.00%	1.90%
1.91%	1.14%	0.92%	1.24%	0.90%	0.89%	Provision /Loans	2.50%	0.88%	0.79%	0.77%	0.87%	0.99%	0.87%	0.89%
						Capital & Leverage Ratios:								
15.06%	14.73%	16.16%	10.48%	11.74%	12.15%	Equity / Assets	11.07%	10.48%	10.79%	11.34%	11.57%	11.74%	11.83%	11.94%
13.59%	13.35%	14.79%	9.10%	10.32%	10.81%	Tangible Equity / Assets	9.55%	9.10%	9.40%	9.92%	10.15%	10.32%	10.43%	10.56%

Disclosure Appendix

Analyst Certification:

I, Joseph Gladue, the primary analyst covering this issuer, certify that: 1) all of the views expressed in this report accurately reflect my personal views about the subject security or issuer, and 2) no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this report.

Risk Factors:

The realization of any or all of the following risk factors, among others, may adversely affect the company's stock price and prevent it from reaching our target price, if one is established:

- a weakening of the United States economy and the regional and local economies in which the company conducts operations
- unanticipated loan losses or securities-related losses
- a weakening of local real estate markets or the soundness and liquidity of the securities market for real-estate backed assets
- failure to maintain sufficient excess capital or liquidity to conduct operations
- the effects of trade, monetary, and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System
- the effects of increased inflation, a flatter yield curve, or increased volatility in financial markets
- inability to attract core deposits or continue to obtain third party financing on favorable terms
- adverse legal action against the company or litigation initiated by the company
- inability to successfully integrate acquired operations or to maintain sufficient excess capital post the close of a transaction

Investment Rating Definitions:

Investment ratings reflect the analyst's assessment of the subject stock's return potential relative to the NASDAQ Bank Index. There are three investment rating tiers:

- **Outperform/Buy:** The subject stock's total return is expected to exceed the return of the NASDAQ Bank Index by 10% or more over the next 12-month period.
- **Neutral/Hold:** The subject stock's total return is expected to be comparable with the return of the NASDAQ Bank Index over the next 12-month period.
- **Underperform/Sell:** The subject stock's total return is expected to be less than the return of the NASDAQ Bank Index by 10% or more over the next 12-month period.

Investment Rating Distributions (as of June 30, 2020)

	All Covered Companies		**Investment Banking Services** Provided in the Last 12 Months	
Rating Categories	**Count**	**% of Total**	**Count**	**% of Category**
Outperform/Buy	6	100%	0	0%
Neutral/Hold	NA	0%	0	0%
Underperform/Sell	NA	0%	0	0%
Total	6	100%		

Other Important Disclosures:

J. Alden Associates, Inc. (DBA Alden Securities) is a FINRA-registered broker-dealer.

Alden Securities expects to receive compensation for investment banking services from the subject company in the next three months and/or seeks to receive such compensation.

Analyst compensation is based, in part, on Alden Securities' profitability, which includes revenues from investment banking.

Target prices, if applicable, are derived from our 12 Month Valuation Assessment. Our 12 Month Valuation Assessment is based on a blend of several relative value methodologies.

Alden Securities shares in the commissions for trades that are executed through Tourmaline Partners, LLC.