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Earnings Review

October 26, 2020

OFG Bancorp (OFG - NYSE - Closing Price: $15.02)

OFG: Reports Strong Loan Originations and Noninterest Income; Expecting Continued Efficiency Improvements. Discontinuing Coverage.

Overview: OFG reported 3Q20 net income to common shareholders of $25.8 million, up from the $20.2 million posted in 2Q20. On a per share basis, 3Q20 results were $0.50 compared to $0.39 in the prior quarter. 3Q20 results included $0.5 million of one-time interest recoveries on acquired Scotiabank loans and an additional $3.5 million favorable adjustment to the bargain purchase gain recorded on the Scotiabank de Puerto Rico acquisition, partially offset by $2.7 million of merger and integration expenses and $2.1 million of COVID-19 related expenses. 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. Collectively, the nonrecurring items boosted 3Q20 earnings by roughly $0.8 million after-tax or $0.02 per share. Similarly, 2Q20 earnings were boosted by approximately $4.1 million after tax or $0.08 per share. Adjusted 3Q20 EPS was $0.48 compared to adjusted 2Q20 EPS of $0.31 excluding the impact of these items. Adjusted results fell $0.06 short of our adjusted estimate of $0.54 but well above the median Street estimate of $0.38. The shortfall compared to our estimate was primarily due to greater NIM compression than we anticipated, largely because we had assumed some accelerated fee accretion from PPP loan forgiveness during the quarter. Highlights from the quarter include:

- Net interest income declined $5.5 million or 5.3% compared to 2Q20. However, without the previously mentioned $5.5 million sequential decline in interest recoveries from $6.0 million in 2Q20 to just $0.5 million in 3Q20, net interest income would have been essentially flat. Average earning assets advanced 4.2% LQ, while the NIM contracted 48 bps to 4.30% from 4.78% in 2Q20. The interest recoveries accounted for just 2 bps of the NIM in 3Q20 compared to 28 bps of NIM in 2Q20, so the “core” NIM was actually down 22 bps linked-quarter. Average loan yields fell 40 bps sequentially, while PCD loan yields slumped 94 bps due to the decline in interest recoveries. Absent the recoveries, PCD loan yields rose 9 bps. Meanwhile, average non-PCD loan yields declined by 16 bps sequentially. The problem of excess liquidity continued in 3Q20, as cash constituted 20.9% of average interest earning assets in 3Q20 versus 15.7% in 2Q20. The average cost of interest bearing liabilities fell 10 bps to 0.97% from 1.07% in 2Q20. The average cost of interest bearing deposits dipped 8 bps sequentially in 3Q20, while the average cost of borrowings was unchanged linked-quarter.

Market Data		Earnings Per Share Data					
				Our Forecast		Consensus	
			2019A	2020E	2021E	2020	2021
Market Value (M)	$771	1Q (Mar.)	$ 0.42	$ (0.02)	$ 0.35	$ (0.02)	$0.36
ADTV (Shs)	349,204	2Q (Jun.)	$ 0.43	$ 0.39	$ 0.31	$ 0.39	$0.41
ADTV (000')	$5,245.0	3Q (Sep.)	$ 0.11	$ 0.50	$ 0.35	$0.36	$0.46
52 Week Range	$8.63-$23.76	4Q (Dec.)	$ (0.05)	$ 0.43	$ 0.37	$0.40	$0.51
Dividend Yield	1.86%	Year	$ 0.92	$ 1.30	$ 1.39	$1.05	$1.73
		P / E	16.4	11.6	10.8	14.4	8.7

Fundamental Metrics (MRQ)	
Balance Sheet	
Total Assets (M)	$10,016
Gross Loans HFI (M)	$6,760
Total Deposits (M)	$8,632
Loans / Deposits	78%
Securities / Assets	5%
Debt / Assets	1%
Profitability	
FTE NIM	4.30%
Nonint. Income / Revenue	21.87%
Efficiency Ratio	60%
Core ROAA	1.24%
Core ROACE	10.9%
Credit Quality	
NPAs / Assets	2.55%
NPLs / Loans	1.92%
NCO Ratio	0.61%
Reserves / Loans	3.48%
Provision / Avg Loans	0.79%
Capital Adequacy	
TCE / TA Ratio	8.5%
Total Capital Ratio	15.5%
Tier 1 Ratio	14.3%
Tier 1 CE Ratio	12.6%
Leverage Ratio	10.0%
Performance	
Core Value	$21.13
3 Yr. Success Ratio	11%
Failure Ratio	6.6%

Source: SNL Financial, Company data

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- Noninterest income of $31.3 million was up $4.2 million or 15.4% from the prior quarter. This includes a $3.5 million bargain purchase gain recorded on the Scotiabank transaction. However, this was unchanged from a similar amount posted in 2Q20. The increase was largely due to increased economic activity, which drove a $2.6 million or 19.2% sequential rise in banking services revenues. Increased mortgage loan production and the resulting sales of this production generated a $0.8 million or 27.5% advance in mortgage banking revenues, while financial services revenues jumped $0.9 million or 14.2%.
- Noninterest expenses declined $2.0 million or 2.4% linked-quarter. Merger & restructuring expenses fell $0.3 million from the prior period. In addition, OFG incurred $2.1 million in COVID-19-related expenses during the quarter, up a modest $0.1 million from the prior quarter. Excluding these items from both periods, core noninterest expenses fell $1.8 million or 2.2% sequentially. There was a $2.6 million decline in compensation costs and a $1.2 million drop in OREO expenses, offset partially by a $1.9 million rise in "other" noninterest expenses due largely to increased banking activity. The sequential decline in core noninterest expenses occurred despite the rebound in economic activity that drove rising loan originations and noninterest income. Management still expects to achieve most of the anticipated savings from the Scotiabank integration in 2021. OFG's adjusted efficiency ratio was 62.17% in 3Q20 compared to 65.86% in 2Q20.
- OFG recorded a $13.7 million credit loss provision in 3Q20, down $4.0 million or 22.8% compared to the $17.7 million provision in the prior quarter. The decline primarily stems from a $4.2 million reduction in COVID-19-related adjustments, which fell from $5.0 million in 2Q20 to $0.8 million in 3Q20. The allowance for credit losses grew $3.1 million or 1.3% linked-quarter, rising to 3.48% of loans held for investment from 3.35% at June 30, 2020.
- Lower economic activity related to COVID-19 has still not shown up noticeably in asset quality figures, even as loan deferral periods have largely ended. Net charge-offs fell to 0.62% of average loans in 3Q20 from 0.92% in 2Q20. Non-PCD NPLs increased $23.1 million or 25.6% linked-quarter, rising 52 bps to 2.33% of non-acquired loans from 1.81% at June 30, 2020. Meanwhile, PCD NPLs dipped $1.8 million or 2.2% sequentially and OREO and other repossessed assets fell $3.4 million or 13.8%, leading to a 9.3% advance in NPAs and an increase in NPAs/Assets to 2.17% from 2.00% at the prior quarter-end. Early stage delinquencies decreased from 2.64% of loans on June 30, 2020 to 2.50% on September 30, 2020.
- OFG recorded a tax expense of $6.3 million in 3Q20, producing an effective tax rate of 18.7%. Management expects the effective tax rate in 2021 and 2022 to be in the 30%-32% range.
- Gross loans held-for-investment declined $192.2 million or 2.8% sequentially. The decrease was once again primarily in the commercial loan segment, which fell $155,7 million or 6.0% linked-quarter, while residential mortgage loans decreased $63.4 million or 2.6% and consumer loans shrank $24.8 million or 5.4%. The driver of these declines was payoffs and paydowns, as low economic activity, low interest rates, and cash from government relief programs all contributed to payoff activity. Still, OFG recorded very strong loan production in 3Q20. The best performing segment was residential mortgages, which saw originations jump 294.4% linked-quarter t0 $93.7 million. This is greater than originations for all of 2019, which totaled $92.8 million. Not far behind was the auto segment, which generated growth of 229.0% in loan originations to $155.9 million. Also contributing to the strong production were consumer loan originations, which grew 65.4%, while originations through the mainland loan participation channel advanced 154.5% sequentially to $90.9 million from $35.7 million in 2Q20. Meanwhile, commercial loan production decreased 15.3% to $83.5 million and PPP loan originations dropped 96.4% to

$10.3million. Low interest rates, pent-up demand, and easing of some of the COVID-19-related restrictions all helped fuel the increase in loan originations. Total originations were $457.8 million, down 9.5% compared to the $506.0 million posted in 2Q20, but up 57.1% from the $291.4 million originated in the same period a year ago. If we exclude PPP loans, originations grew 103.7% sequentially from 2Q20 to 3Q20.

- Total deposits climbed $90.5 million or 1.1% sequentially, led by a $312.6 million rise in demand deposits. Also contributing. Partially offsetting these increases was a $58.3 million drop in savings accounts, a $41.7 million decline in time deposits and a $122.1 million decrease in brokered deposits. As a result, the deposit mix improved noticeably, as brokered and time deposits decreased to 23.5% of total deposits from 25.7% on June 30, 2020. The increase in deposits during the quarter, occurring while gross loans held for investment decreased $192.2 million led to another increase in on-balance sheet liquidity. This additional deposit funding went into cash, which grew $383.0 million sequentially, creating a further drag on the NIM.
- Tangible book value per share rose to $16.51 on September 30, 2020 from $16.01 on June 30, 2020, while the tangible common equity ratio advanced 19 bps to 8.58%. Most of OFG's regulatory capital ratios increased further during the quarter. The leverage ratio dipped to 10.00% from 10.16%, but the CET1 ratio increased to 12.55% from 12.03%, and the Tier 1 ratio advanced to 14.25% from 13.71%. All of the regulatory capital ratios remain well above the minimums needed to be considered "well capitalized" under regulatory guidelines.

Earnings Estimates: We were impressed by OFG's 3Q20 results. Though loan balances declined due to high payoff activity, the company generated much higher loan production than we anticipated. We believe that this is partly due to federal disaster relief finally making its way to the island, along with some loosening of COVID-19 restrictions that together helped boost economic activity. However, part of the loan origination growth likely also stems from the larger platform created by the Scotia transaction and good execution. We believe these factors should carry forward into future quarters. Likewise, better-than-expected noninterest revenues were probably helped by the same set of circumstances. The bank continues to reduce operating expenses and we expect continued efficiency improvements as the systems conversion from the Scotia transaction takes place in 4Q20. Our prior forecast anticipated that the PPP loan forgiveness would begin in 3Q20 and that the bank would start to see some accelerated fees included in net interest income during the quarter. Our faith in the government was misplaced. In the absence of these fees in 3Q20, the NIM contracted sharply due in some measure to the significant excess liquidity on the balance sheet. We still expect to see some of the accelerated fee income from PPP loan forgiveness in 4Q20, leading to roughly 8 bps of NIM expansion, though the core NIM is likely to suffer at least a few basis points of compression as overall interest rates remain low and cash balances remain high. We still expect that asset quality will start to show the impact of the COVID-19 lockdowns and reduced economic activity in 4Q20, leading to growth in net charge-offs, but we have reduced our provision projection modestly to reflect the significant build-up of the allowance for credit losses over the last three quarters.

After adjusting our model for the above items, we are raising our 2020 EPS estimate from $1.27 to $1.30 ($1.35 excluding merger & integration expenses). We are reducing our 2021 EPS estimate from $1.62 to $1.39, and our 2022 estimate from $1.86 to $1.50.

Outlook:

OFG's 3Q20 results were encouraging. We have noted the strong loan originations reported for the quarter, but we should also comment on Management's outlook. We found the overall tone of management's comments on the conference call to be more optimistic than usual. That being said, we still expect an extended period of low interest rates, combined with the fallout from many months of economic shutdowns to create significant headwinds for banks. OFG has the opportunity to gain efficiencies from the integration of the Scotia transaction over the next few quarters, while reducing some of the NIM impact of extra liquidity, but the overall economic environment will still be difficult. Though we are reducing our forward EPS estimates, we still think OFG is in a good position, and that Federal disaster relief will soften the economic impact of some of the issues we've just noted.

While we have enjoyed covering OFG for close to twenty years, shifting corporate responsibilities do not allow us time to provide the same level of diligence to our equity research as we would like. Consequently, we are discontinuing coverage of OFG Bancorp.

Exhibit 1:

OFG Financial Corporation: 3Q20 Highlights

	Actual Results			Change	
	3Q19	**2Q20**	**3Q20**	**LQ[1]**	**YOY**
Loans Held for Investment ($000)[2]	4,503,617	6,952,512	6,760,331	-11.1%	50.1%
Total Deposits ($000)[2]	4,878,058	8,541,926	8,632,457	4.2%	77.0%
Average Earning Assets ($000)	5,981,757	8,845,744	9,218,717	16.9%	54.1%
Total Revenue ($000)	102,888	132,212	130,859	-4.1%	27.2%
Net Interest Income ($000)	80,710	105,060	99,533	-21.0%	23.3%
NIM (FTE)	5.53%	4.88%	4.40%	-0.49%	-1.13%
Average Securities Yield	2.14%	1.83%	1.81%	-0.02%	-0.33%
Average Loan HFI Yield	7.50%	6.97%	6.57%	-0.40%	-0.93%
Average Cost of Int.-bearing Deposits	1.07%	0.88%	0.80%	-0.08%	-0.27%
Efficiency Ratio	49.3%	64.7%	63.8%	-0.89%	14.5%
NCO Ratio	3.04%	0.92%	0.62%	-0.30%	-2.42%

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	3Q20A	4Q20E	1Q21E	2Q21E	3Q21E	4Q21E
304,172	315,894	322,793	407,849	378,992	386,385	Net interest income	105,101	105,060	99,533	98,155	96,484	92,500	94,264	95,744
113,139	56,108	96,792	94,352	60,135	61,170	Provision for loan losses	48,530	17,696	13,669	14,457	15,048	15,884	14,047	15,156
191,033	259,786	226,001	313,497	318,857	325,215	**Net Interest Income after Provision**	56,571	87,364	85,864	83,698	81,437	76,616	80,217	80,587
						Non-interest income:								
39,468	43,638	42,866	61,781	65,857	70,615	Banking Services	15,713	13,668	16,297	16,103	16,296	16,194	16,306	17,061
4,050	4,767	4,275	14,179	15,298	16,311	Mortgage Banking	3,234	3,072	3,917	3,956	3,758	3,758	3,871	3,910
1,403	-	-	-	-	-	Accretion of FDIC indemnification asset	-	-	-	-	-	-	-	-
25,790	25,934	26,224	28,835	29,522	30,105	Fin'l Svc (Brokerage & Insurance Fees & Other)	7,286	6,366	7,272	7,911	7,111	7,324	7,104	7,983
-	-	-	-	-	-	Investment banking fees	-	-	-	-	-	-	-	-
-	-	-	-	-	-	Gains (losses) on trading acct & securities	-	-	-	-	-	-	-	-
-	-	-	-	-	-	Gains (losses) on derivatives	-	-	-	-	-	-	-	-
7,976	5,756	9,128	13,153	210	218	Other non interest income	5,217	4,046	3,840	50	53	53	53	52
78,687	80,095	82,493	117,948	110,886	117,250	**Total non-interest income**	31,450	27,152	31,326	28,020	27,218	27,329	27,334	29,006
						Total Non-interest expense								
79,751	76,524	82,533	134,280	127,311	128,853	Compensation and Benefit	35,544	34,506	31,955	32,275	32,920	30,945	31,409	32,037
32,711	33,084	30,052	46,662	46,001	46,461	Occupany & Equipment	11,439	11,837	11,943	11,443	11,443	11,443	11,557	11,557
5,616	5,084	5,208	6,228	6,411	6,738	Advertising & Promotion	1,629	1,533	1,518	1,548	1,579	1,595	1,611	1,627
12,406	12,442	14,629	16,284	14,392	14,974	Professional Fees	5,789	3,475	3,475	3,545	3,545	3,545	3,615	3,688
3,415	3,447	3,315	3,731	3,871	4,109	Communications	971	905	923	932	942	960	980	989
4,634	4,662	2,426	(310)	1,789	1,861	Net costs of assets acquired through foreclosure	(193)	316	(866)	433	442	446	451	451
63,098	71,838	71,027	122,936	119,666	125,583	Other Expenses	31,839	29,903	31,815	29,379	29,473	29,767	30,063	30,363
201,631	207,081	209,190	329,810	319,442	328,577	**Total non-interest expense**	87,018	82,475	80,763	79,554	80,343	78,701	79,686	80,713
52,646	84,410	53,841	73,375	76,108	78,583	**Net Income**	402	21,787	27,438	23,748	19,535	17,418	19,227	19,928
						Per Share Data:								
0.90	1.52	0.92	1.30	1.39	1.50	Earnings Per Share	(0.02)	0.39	0.50	0.43	0.35	0.31	0.35	0.37
0.24	0.25	0.28	0.28	0.38	0.38	Dividend	0.07	0.07	0.07	0.07	0.08	0.10	0.10	0.10
26.59%	16.48%	30.60%	21.57%	27.32%	25.32%	Dividend Payout Ratio	-295.26%	17.87%	13.97%	16.23%	22.69%	31.84%	28.29%	26.93%
17.73	17.90	18.75	19.72	21.53	23.57	Book Value	18.33	18.69	19.13	19.72	20.06	20.51	21.01	21.53
15.67	16.15	15.96	17.09	18.88	20.89	Tangible Book Value	15.60	16.01	16.51	17.09	17.43	17.87	18.37	18.88
43,947	45,400	51,335	51,215	49,595	47,595	Average Shares Outstanding (MM)	51,404	51,336	51,342	51,095	50,595	50,095	49,595	49,095
						Profitability Measures:								
52.66%	52.29%	57.55%	63.96%	65.21%	65.24%	Efficiency Ratio	63.95%	64.65%	63.77%	63.45%	64.95%	65.68%	65.53%	64.70%
0.85%	1.31%	0.83%	0.76%	0.79%	0.81%	Return on average assets	0.02%	0.92%	1.04%	0.96%	0.82%	0.73%	0.73%	0.82%
5.61%	8.73%	5.15%	6.96%	6.92%	6.84%	Return on average equity	0.15%	8.45%	9.66%	8.80%	7.32%	6.39%	6.31%	7.06%
5.23%	5.28%	5.37%	4.59%	4.36%	4.37%	Net Interest Margin	4.94%	4.78%	4.30%	4.38%	4.50%	4.30%	4.32%	4.35%
24.77%	19.42%	22.06%	20.54%	22.81%	23.20%	Fee Income % Revenues	23.03%	20.54%	23.94%	22.21%	22.00%	22.81%	22.48%	23.25%
						Average Balances:								
4,125,804	4,348,135	4,511,190	6,691,115	6,344,846	6,613,234	Loans	6,687,987	6,840,650	6,787,022	6,448,800	6,284,437	6,288,141	6,367,895	6,438,912
3,826,000	3,811,406	3,781,006	6,149,001	6,069,424	6,089,718	Interest Bearing Deposits	6,053,482	6,105,014	6,240,639	6,196,868	6,113,451	6,056,668	6,046,276	6,061,300
860,287	1,078,178	1,100,599	2,040,204	2,125,183	2,114,537	Non-interest Bearing Deposits	1,698,964	1,983,092	2,276,400	2,202,359	2,154,485	2,120,014	2,112,685	2,113,547
5,818,598	5,985,524	6,009,521	8,886,588	8,684,315	8,842,709	Earning Assets	8,556,553	8,845,744	9,218,717	8,925,339	8,702,897	8,632,858	8,664,171	8,737,333
4,366,367	4,277,457	4,196,718	6,332,522	6,159,821	6,213,583	Interest Bearing Liabilities	6,325,282	6,262,683	6,343,555	6,398,569	6,242,760	6,115,754	6,120,277	6,160,493
						Asset Quality Ratios:								
1.30%	1.38%	1.09%	0.79%	1.47%	1.40%	Net Charge-offs / Loans	0.98%	0.79%	0.50%	1.31%	1.37%	1.47%	1.43%	1.43%
3.87%	3.65%	1.78%	3.94%	4.43%	3.77%	Nonperforming Assets / Loans	1.97%	2.96%	3.33%	3.94%	4.27%	4.41%	4.43%	4.43%
2.21%	2.08%	1.24%	2.23%	1.58%	1.02%	Reserves / Loans	2.21%	2.17%	2.30%	2.26%	2.15%	1.98%	1.78%	1.60%
1.91%	1.14%	0.92%	1.29%	0.79%	0.78%	Provision /Loans	2.50%	0.88%	0.82%	0.76%	0.82%	0.85%	0.73%	0.79%
						Capital & Leverage Ratios:								
15.06%	14.73%	16.16%	10.48%	11.58%	11.85%	Equity / Assets	11.07%	10.48%	10.63%	11.19%	11.42%	11.58%	11.63%	11.69%
13.59%	13.35%	14.79%	9.10%	10.20%	10.54%	Tangible Equity / Assets	9.55%	9.10%	9.28%	9.81%	10.03%	10.20%	10.27%	10.36%

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 September 30, 2020)

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

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.