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WSFS - Q2 2017 WSFS Financial Corp Earnings Call

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## CORPORATE PARTICIPANTS

**Dominic C. Canuso** *WSFS Financial Corporation - CFO and EVP*

**Mark A. Turner** *WSFS Financial Corporation - CEO, President & Director*

**Stephen P. Clark** *WSFS Financial Corporation - Chief Commercial Banking Officer and EVP*

## CONFERENCE CALL PARTICIPANTS

**Catherine Fitzhugh Summerson Mealor** *Keefe, Bruyette, & Woods, Inc., Research Division - MD and SVP*

**Frank Joseph Schiraldi** *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

**Russell Elliott Teasdale Gunther** *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

## PRESENTATION

**Operator**

Good day, ladies and gentlemen, and welcome to the WSFS Financial Corporation Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would like to introduce your host for today's conference, Dominic Canuso, Chief Financial Officer. You may begin.

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**Dominic C. Canuso** - *WSFS Financial Corporation - CFO and EVP*

Thank you, Glenda, and thanks to all of you for taking the time to participate on our call today. With me on this call are Mark Turner, President and CEO; Rodger Levenson, Chief Corporate Development Officer; Paul Geraghty, Chief Wealth Officer; Steve Clark, Chief Commercial Banking Officer; and Rick Wright, Chief Retail Banking Officer.

Before Mark begins with his remarks, I would like to read our Safe Harbor statement. Our discussion today will include information about our management's view of future expectations, plans and prospects that constitute forward-looking statements. Actual results may differ materially from historical results or those indicated by these forward-looking statements due to risks and uncertainties, including but not limited to, the risk factors included in our annual report on Form 10-K and our most recent quarterly reports on Form 10-Q as well as other documents we periodically file with the Securities and Exchange Commission.

With that read, I'll turn the discussion over to Mark Turner.

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Thanks, Dominic, and thanks to everyone on the call for your time and attention. We are pleased to report another very solid quarter of earnings, with net income of $20.6 million and Earnings Per Share of $0.64. Excluding a small net amount of securities gains and merger-related costs, core earnings per share were $0.63; core Return on Assets was 1.22%; and core Return on Tangible Common Equity was just a hair under 16%--all very strong results.

In addition, core net revenues grew by $13.9 million or 19% from the same quarter last year, including a robust 17% growth in net interest income and a very robust 24% growth in fee income, both coming from a combination of healthy organic growth and our late-2016 successful acquisition growth.

The net interest margin improved nicely by 3 basis points (in both the quarter and over last year) to 3.93%, despite a decline in normally-volatile acquisition-related accretion and reverse mortgage interest income. We see several basis points of further upside in the margin in the second half of the year, given the mid-June Fed Funds rate increase; our significant core finding composition, (which represents 88% of total customer deposits); as well as the planned payoff of $55 million in higher-cost senior debt on September 1.

Importantly, core fee income grew nicely across almost all business units, resulting in that previously-mentioned total growth of 24% over this time last-year and more importantly, that included more than half, or 13 percentage points, coming from organic growth. Fee income now also represents a robust 36.5% of total revenue, and is very well-diversified among traditional banking, mortgage banking, Wealth Management and Cash Connect services.

Core expense growth of $8.2 million over that same time was far less than core revenue growth, resulting in much improved profit, one point of operating leverage and a better core efficiency ratio, which was 60.9% for the second quarter 2017. Legal expenses were higher in the quarter from an on-going legacy trust matter that is in the cost-heavy arbitration hearing stage. Putting that aside, we expect our core efficiency ratio to trend down meaningfully -- under 60% by the end of the year, delivering a full--year efficiency ratio of approximately 60% -- as a result of our continued good growth, franchise optimization and traditional seasonality.

Credit metrics and credit costs improved in the quarter, almost across the board, and are -- at healthy historical levels, with the opportunity for some further improvement in non-performing assets with the expected positive restructuring in the near term at a large syndicated energy credit, discussed in detail last quarter. We note again that this loan continues to be both fully-paying and well-secured.

Loan growth and deposit growth were muted during this quarter, coming off a very strong first quarter 2017, and with the expected payoffs of some commercial loans; and with the traditional second quarter seasonality in public funding and mortgage balance activity. We have grown total loans and deposits organically in the mid-to-high single digit range since this quarter last year; and with our aggregate first--half 2017 growth and healthy pipelines, we continue to expect mid-to-high single-digit organic growth rate in loans and deposits for all of 2017 as well.

Reported Return on Assets for this quarter was a very healthy 1.23%, the same as the reported Return on Assets for 2Q'16. However, and to oversimplify things, 2Q16 benefited from about $1 million in lower total credit costs from abnormally low charge-offs that quarter; and 2Q'16 also benefited from about $500,000 in pretax equivalent benefits from the initial, catch-up adoption of the new tax stock compensation accounting rule. In addition, the 2Q17 was burdened with about $900,000 in temporary senior debt cost until we pay that older debt off on September 1. All-in-all, that's an additional $2.5 million rounded in pretax earnings momentum year-over-year, which equates to 10 basis points in improved ROA year-over-year--giving us more evidence and confidence that we are on a good path to achieve our Strategic Plan Return on Asset goals.

In conclusion, it has been a very successful quarter and year-to-date. And, as mentioned, one that provides a very good foundation and momentum for us to meet our full year 2017 target of a core and sustainable Return on Assets of at least 1.24%; and also to meet our Strategic Plan target of at least 1.30% in core and sustainable Return on Assets by no later than the fourth quarter of 2018.

Thank you. And at this time, we'd be happy to take your questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) And our first question comes from the line of Catherine Mealor from KBW.

**Catherine Fitzhugh Summerson Mealor** - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and SVP*

First, on the fees, really strong growth in fee income this quarter. Thanks, good afternoon. Is there anything that you saw in the growth that feels temporary or one-time that may normalize as we get into the back half of the year? Or do you feel like this higher level of fee income is a good run rate to grow from for the rest of the year?

**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Yes, so thanks, Catherine. Each of our businesses, the 4 that generate fee income, traditional banking, mortgage banking, Wealth and Cash Connect ATM services have some seasonality in them. And each of their seasonality differs a little bit. So for example, in the second quarter, we benefit in Wealth by some tax preparation services, and things like bankruptcy cases and the income we earn off them can come and go depending on the bankruptcy cases. Having said that, all of them are continuing to grow on a nice fundamental growth trend, so I would expect some seasonality around this base, but continued strong growth year-over-year.

**Catherine Fitzhugh Summerson Mealor** - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and SVP*

Okay. And are you still targeting the 20% year-over-year growth for fees?

**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

For this year in total, yes. Obviously, that has benefited by the fact that we added 2 small acquisitions in Powdermill and West Capital late at the end of last year, so when we look to '18 growth over '17, that number will obviously change and will depend on the dynamics at that time.

**Catherine Fitzhugh Summerson Mealor** - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and SVP*

Okay. That's great. And then, one follow-up on the margin. Can you talk a little bit about what you've seen in your portfolio since now you've got, with WSFS prime in line with Wall Street general prime, and now you've got the June hike on top of that, and so what you're seeing in terms of repricing on your loan book so far this quarter, and as we move into next quarter as we get a full impact of the June hike? Thanks.

**Dominic C. Canuso** - *WSFS Financial Corporation - CFO and EVP*

Sure, Catherine. This is Dominic. As you mentioned, with the March rate increase, WSFS prime was aligned with Wall Street prime. We have continued to see positive benefit, as we've mentioned in previous quarters, from the asset-sensitive position we have in our balance sheet and the high variable rate mix on our loans. In fact, year-over-year, we've seen about 5 basis points improvement from the positive rate environment. With the most recent rate increase in June, we expect that to continue at a higher pace and expect that improvement to continue, especially in the third quarter and beyond.

**Catherine Fitzhugh Summerson Mealor** - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and SVP*

And any impact that you're seeing from the flatter curve that's taken a little bit of that benefit out? Or the short end is really what's driving your higher margins?

**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

The short end is really what most of our assets are priced off of, the loan book, the longer and obviously effects on the large securities book, but it's a much smaller part of the book and a lot slower to reprice. Steve, did you want to comment on competitive environment and loans?

**Stephen P. Clark** - *WSFS Financial Corporation - Chief Commercial Banking Officer and EVP*

Only to add, this is Steve Clark, Chief Commercial Banking Officer, only to add that it remains very, very competitive. But to reinforce Dominic's comments, looking back over the last year on our yield, the yield in the commercial book for the full year last year was 4.19%. First quarter this year, 4.34%; second quarter this year, 4.52%, so we see continued benefit from the short-term rate environment going up.

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

For new loans booked.

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**Stephen P. Clark** - *WSFS Financial Corporation - Chief Commercial Banking Officer and EVP*

For new loans booked, yes, for new loans booked, correct.

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**Catherine Fitzhugh Summerson Mealor** - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and SVP*

Those are new -- those are the average rate on new loans booked that you just gave? Thank you for the color.

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**Stephen P. Clark** - *WSFS Financial Corporation - Chief Commercial Banking Officer and EVP*

New loans booked, that is correct.

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**Operator**

And our next question comes from the line of Frank Schiraldi from Sandler O'Neill.

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**Frank Joseph Schiraldi** - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Hi guys. Just on the -- just a follow-up on the NIM, I'm sorry, did you guys talk about a specific guidance for NIM expectations on the back half of the year given the June hike and the debt payoff?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

We did, and Dominic can correct me if I'm wrong, or augment this, but high 3.90s.

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**Dominic C. Canuso** - *WSFS Financial Corporation - CFO and EVP*

Yes, that's correct. And that assumption includes no additional rate increases for the second half of the year and includes the continued benefit of the most recent June rate hike and the paydown of the older, higher-cost senior debt.

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**Frank Joseph Schiraldi** - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

And the senior debt comes in September, you said?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

September 1 is the planned payoff of that, and that would be $55 million and 6.25% debt coming off the books. We had about a $700,000 noncash write-off of old debt costs to take at that time.

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**Frank Joseph Schiraldi** - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

And then I'm just trying to think through the 1.3% ROA. I believe you had -- correct me if I'm wrong, but you did not have the June hike in your assumptions for that guidance, so I'm just wondering if -- what that might mean for hitting that target, and if you might perhaps expect to hit that a little bit earlier than the 4Q?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Yes, so you listened very closely because I did adjust my wording slightly from prior to say that we would hope to get to 1.30% core and sustainable by no later than the fourth quarter of 2018, so on the current path, obviously nothing significant happening that we don't expect, we would hope to get there a little bit earlier than that.

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**Frank Joseph Schiraldi** - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Okay. And then finally, just on Cash Connect, I wondered if you could just remind us or if anything's changed in terms of expected growth trajectory there year-over-year?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Yes. Sure. So we had been traveling at about a 15% revenue growth compounded for the last 5 years, as we -- you saw and we called out in the first quarter. First quarter slowed down quite a bit. We had some -- besides normal seasonality, we had some large customers that were consolidated up and we lost some business out of that and there's been some margin pressure just due to consolidation of our customers and there are bigger customers demanding better pricing. But offsetting that, we've had growth in managed services, so related to the cash we put in the ATMs as well as the smart safe. So we saw a nice rebound in the second quarter, where growth year-over-year expanded from that 5% to 9%, and we're hoping -- our goal was to get that again up to double-digit growth by the end of the year.

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**Frank Joseph Schiraldi** - *Sandler O'Neill + Partners, L.P., Research Division - MD of Equity Research*

Thank you.

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**Operator**

And our next question comes from the line of Russell Gunther from D.A. Davidson.

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**Russell Elliott Teasdale Gunther** - *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

Good afternoon. Maybe just a quick follow-up on the fee income guidance and commentary. That other income line has kind of steadily marched higher over the past few quarters. Could you just remind us what's in there, what's driving that and what the outlook might be there?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

So a big component of that is the managed services fee income from Cash Connect, so -- that's where that shows up, but Dominic has some other details in front of him.

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**Dominic C. Canuso** - *WSFS Financial Corporation - CFO and EVP*

Yes, so that's correct. And we do expect, since that's associated with the fee income and the Cash Connect business, that would continue to grow in that high single digit or low double digits for the remainder of the year, contributing to delivering the overall fee growth for 20% for the full year basis.

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**Russell Elliott Teasdale Gunther** - *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

Got it. And then your commentary as to expectations for the efficiency ratio for the back half of this year, could you just give us a sense for where you expect to see -- if you do expect to see just the absolute expense level kind of come down to help hit that? Or is this more revenue-driven?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Yes, so I think it's operating leverage-driven, if you will. So let -- maybe just set some context here. Our path for a full -- delivering a full year 60% starts out with kind of in a 62% in the first quarter and then trending down to the 58-plus percent range by the fourth quarter, averaging over the course of the year, ex any big one-timers, one way or the other, 60%. So that's kind of the natural path based on seasonality and growth of the business. So obviously, we're tracking that path for the first 2 quarters of the year and with what we see, we expect to track for the second 2 quarters of the year. And I'm sorry, what was the question again?

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**Russell Elliott Teasdale Gunther** - *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

No, you hit it. I was just trying to get a sense for whether there's anything within the P&L that may experience a more meaningful step-down in the expense line items or is it more kind of revenue-driven?

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**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Yes. It's -- we're -- since we're growing strongly, it is more operating leverage-driven. So just to point one thing out, our -- if you look at our growth in revenue and our growth in expenses year-over-year, so the efficiency ratio on the growth, that was under 59%, which obviously helps the overall efficiency ratio. If you take out some of those legal expenses, this actually would have been kind of under 55%. So as we're growing the efficiency ratio on that growth is improving into the mid-50s, helping to drive the overall efficiency ratio down to under 60%.

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**Russell Elliott Teasdale Gunther** - *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

I appreciate that. Great. And then, you guys, asset quality has been great, a really, really solid quarter there, first half of the year kind of tracking below the low end of that kind of $12 million to $14 million all-in credit cost. Is that still a good guidepost? Or based on your kind of forward look on asset quality, you think you could outperform there?

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**Stephen P. Clark** - *WSFS Financial Corporation - Chief Commercial Banking Officer and EVP*

This is Steve again. We think that original guidance of $12 million to $14 million for the full year, $3 million to $3.5 million per quarter is still kind of a good guide. Credit costs can be uneven, and we just feel that this guidance, this range is still appropriate for the full year.

**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

You've seen in past years, we typically have 3 quarters that are kind of under guidance and one quarter that's well over guidance for the whole year coming at about as guidance, so I would -- it's just the nature of credit and I wouldn't be surprised if those type of things happen in the future.

**Russell Elliott Teasdale Gunther** - *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

Sure. And then last question for me, you mentioned the commercial paydowns in the quarter expected but were a bit pronounced. Just give us a little bit of color about what transpired there and what your expectations for payoffs might be?

**Stephen P. Clark** - *WSFS Financial Corporation - Chief Commercial Banking Officer and EVP*

Yes, so Steve again. In the quarter, we really had some strong production in the commercial bank. We did have some headwinds, about $32 million of unanticipated payoffs in the C&I book. And that was through company sales and a refinance of some owner-occupied real estate. On the CRE side, same story, about $50 million of unanticipated payoffs, plus some anticipated. We had some construction loans move into the permanent market and that was planned. So $82 million in total of payoffs that came at us, still grew a little bit incrementally and as we said earlier, the first half of the year growth of -- in commercial about 5.5% year-to-date annualized. We're feeling pretty good. Our pipeline is strong, remains strong, a 90-day weighted average of over $150 million, and we feel that mid to high single-digit growth for the full year is still forecasted.

**Russell Elliott Teasdale Gunther** - *D.A. Davidson & Co., Research Division - VP & Senior Research Analyst*

Appreciate the help, thanks very much.

**Operator**

(Operator Instructions) And our next question comes from the line of Matt Schultheis from Boenning -- I apologize, I'm showing no further questions over the phone line. I'd like to turn the call back over to Mark Turner, Chief Executive Officer, for closing remarks.

**Mark A. Turner** - *WSFS Financial Corporation - CEO, President & Director*

Okay. Well, thank you. Rodger, Dominic, and I will be on the road a bit in the coming months, and we look forward to catching up with as many of you as possible then and dialoguing further. Have a great weekend.

**Operator**

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program and you may now disconnect. Everyone, have a great day.