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WSFS - Q2 2018 WSFS Financial Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the WSFS Financial Corporation Second Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I'd now like to turn the conference over to Chief Financial Officer, Dominic Canuso. Sir, you may begin.

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

Thank you, Shelby, and thanks to all of you for taking the time to participate on our call today. With me on this call are Rodger Levenson, Chief Operating Officer; Art Bacci, Chief Wealth Officer; Steve Clark, Chief Commercial Banking Officer; and Rick Wright, Chief Retail Banking Officer. Mark Turner, our President, Chairman and CEO is unable to join us on the call today as he is traveling internationally. Before Rodger begins with his remarks, I would like to read our Safe Harbor statement. Our discussions today will include information about our management's view of our 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 Rodger Levenson.

Rodger Levenson - *WSFS Financial Corporation - Executive VP & COO*

Thank you, Dominic, and thank you to everyone for your time and attention today. We are pleased to announce a very strong quarter for WSFS with reported earnings of $28.7 million or $0.89 per share. Earnings per share grew 39% when compared to the second quarter of 2017. These results represent an ROA of 1.65% and a return on average tangible common equity of 20.61%.

Our performance this quarter was a reflection of significant organic revenue growth which was balanced between our fee and spread businesses; good loan and deposit growth, and solid credit metrics.

Core results excluding securities gains and corporate development costs in both quarters were modestly stronger than the reported results.

Core net interest income growth of 12% versus the same quarter in 2017 was directly related to a 4.10% net interest margin combined with a 7% annualized growth in both total loans and total customer deposits for the quarter when compared to the first quarter of 2018.

As detailed in the earnings release, the reported net interest margin increased 17 basis points and on an organic basis increased 13 basis points compared to the second quarter of 2017. 11 basis points of this increase was a result of being well positioned for the higher short term rate environment. While we are pleased with the growth in our margin, we expect to see the already competitive deposit pricing environment intensify in the coming quarters. Combined with ongoing commercial loan pricing pressure, likely higher deposit betas should offset the full quarter impact of the June Fed Funds target increase of 25 basis points as well as potential additional 2018 rate hikes. As a result, we see a net interest margin that will likely be in a range plus or minus around 4.05% for the second half of 2018.

Loan growth for the quarter was driven by a 7% annualized increase in C&I loans which is our largest commercial loan portfolio. We also experienced an increase in consumer loans primarily as a result of our relationship with Spring EQ, a Philadelphia based digital home equity lender. Our commercial loan pipeline remained strong with a 90-day weighted average of $150 million, which should translate into mid to high single digit loan growth consistent with our previously communicated full year expectations.

7% annualized deposit growth for the quarter was driven by a very healthy 18% annualized increase in non-interest-bearing accounts and a 30% annualized purposeful growth in CDs. This performance once again demonstrates our ability to fund loan growth via customer-generated deposits.

Core fee income growth of 13% versus the second quarter of 2017 continues to be very balanced across all 4 of our major fee-based businesses especially Wealth Management and Cash Connect.

Core non-interest expenses grew 10% versus the second quarter of 2017and was largely attributed to increased incentive and earnout accruals in conjunction with our strong operating performance. This translated into a core efficiency ratio of 59.6% consistent with our full year expectation of slightly below 60% and reflected 3 full percentage points of positive core operating leverage.

Credit quality remained strong with stable or slightly improved levels across all key metrics. Total credit cost for the quarter was $3.2 million and keeps us on track for our full year 2018 expectations of $13 million to $15 million.

While the Tax Reform Act has helped year over year comparisons, we are tracking above where we thought we would be on pre-tax income and given the stock price and planned exercise activity, we now expect our 2018 effective tax rate to be, with some volatility, more in the range of 20% to 21% versus the earlier outlook of 23%.

In summary, our results for the second quarter of 2018 reflect the continued momentum of WSFS as we gain market share, optimize prior acquisitions and investments, and continue to increase our profile and strategic advantage of being the largest locally-managed bank in Delaware and the greater Delaware Valley area.

We look forward to continuing this momentum during the second half of 2018 and achieving or exceeding our goal of 1.50% core and sustainable ROA for the full year. Thank you, again. At this time, we would be happy to answer your questions.

QUESTIONS AND ANSWERS

Operator

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

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

Thanks, good morning on a great quarter and congratulations Rodger on your new job. So maybe first, starting with just the loan growth. Can you talk a little bit more about the relationship with Spring EQ, in Phili, and would you expect to continue to purchase more home equity loans through this partnership or how should we kind of think about that pace of growth in the back half of the year?

Richard M. Wright - *WSFS Financial Corporation - Executive VP & Chief Retail Banking Officer*

Catherine, this is Rick Wright. Spring EQ is a Philadelphia-based company that sources home equity loans digitally across the country. We have a 20-year relationship with one of the principles involved there. And we have a forward agreement with them, as well as a small warehouse line that we participate. And we also agreed to provide them wherewithal to get started. So we did -- the underwriting standards are principally the same as we use for our core generated business here. And we would expect that we're going to continue over the next 12 to 18 months to take in about as much as we're doing now from them.

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

Okay. And what you are buying from them, are they also national credits or you concentrating more of what you're purchasing in your end markets?

Richard M. Wright - *WSFS Financial Corporation - Executive VP & Chief Retail Banking Officer*

At the moment, they're pretty much national. They come from 30 different states. We are looking to perhaps revise that a bit and try to focus a little more in our footprint. But at the moment, we are taking them pretty much across the country.

Rodger Levenson - *WSFS Financial Corporation - Executive VP & COO*

Yes, and Catherine, this is Rodger I would just reiterate what Rick said. It's all done to our underwriting standards. And the profile of the loans geographically would be what you would expect from a company that's in the early stages of a startup. And it's worked out to be very consistent with the original plan. And we're really pleased with how that relationship has progressed.

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

Okay, great. So -- and would you say how much -- so how much of the -- would all of the consumer growth tied to this?

Richard M. Wright - *WSFS Financial Corporation - Executive VP & Chief Retail Banking Officer*

A lot of it. I think, we grew about $36 million for the quarter. About $24-ish million was from Spring EQ, $2.5 million was what I would call core footprint growth. And then we have another thing that we're doing with a company called LendKey that sources us student loans in sort of an expanded footprint of ours and that grew about $5.8 million.

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

Okay. So you're saying about $20 million, $24 million a quarter coming from the Spring EQ relationship?

Richard M. Wright - *WSFS Financial Corporation - Executive VP & Chief Retail Banking Officer*

I would say $10-ish million a month, is about what we're getting from them, growth.

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

Okay, sounds great. And then separately on the commercial side. What is your outlook for commercial growth in the back half of the year given more competitive pricing and the outlooks for CRE pay down that continues to be headwind? It seems like the origination growth was still really strong this quarter.

Stephen P. Clark - *WSFS Financial Corporation - Chief Commercial Banking Officer & Executive VP*

Catherine, Steve Clark here. Our expectations for the second half of the year kind of remain consistent with what we previously communicated, kind of mid to high single-digit growth in commercial loans. And we're feeling very good about our pipeline, as Rodger indicated, and about 90-day weighted average of $150 million. And that's the highest it's been since this time last year. So we're optimistic about the second half of the year.

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

Okay. And then one just small follow-up, the other noninterest income was up a little bit more than last quarter, I think, about $1 million. Anything in there that we should know about that's driving that increase?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

Catherine, this is Dominic. A good portion of that increase is coming from non-bailment fee income from Cash Connect, so their Total Cash Management services, which is the repackage armored car carrier services, insurance, and other logistics and software offerings.

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

Got it. So that's a good run rate to grow from here then?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

Correct.

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

Ok great and congrats again on a great quarter.

Operator

And our next question comes from Russell Gunther from Davidson.

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

Good afternoon guys, just wanted to circle back to the margin guidance that was provided, caught some of this. But if you could just kind of flush out your assumptions in the back half for Fed fund increases, which are kind of modeling internally for deposit betas to step-up? And then the purchase accounting accretion there? A lot of moving parts, but just some help on the assumptions would be great?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

Sure, this is Dominic. And first I'll level-set the second quarter performance, as Rodger mentioned, the 4.10% net interest margin included about 6 basis points of outsized purchased loan accretion. So what we would see is a normalized NIM for the quarter around 4.04%. And what we've observed through the cycle-to-date is a deposit beta of about 20%. And again, as Rodger mentioned, we anticipate that to increase back towards the historical average of 50% over the next few rate increases. So we actually see that 4.04% to maintain. While we see potential benefits from the rising rate environment, primarily one more increase this year in September, that is likely offset by the continued runoff of the purchased loan accretion, runoff of the reverse mortgage portfolio and the rising betas that we anticipate.

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

Very helpful, thank you. And then on the expense side of things, up a little bit relative to what I was looking for appreciate performance on continued operating leverage and recommitment to the sub-60% efficiency. But is there anything in that, call it, $57.4 million core that is either seasonal in nature or may not run rate going forward?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

This is Dominic, again. We actually do see the second quarter as a healthy run rate for the business. We are pleased with the high 50s and would expect us to maintain through that. As we mentioned in both the release and Rodger's comments, a good portion of the growth that we saw in noninterest expense was from performance-based variable comp and earn-out that is associated with the strong revenues generated. So we expect both to continue and us to deliver our guidance of below 60 efficiency ratio for the full year.

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

All right, great. Thanks, Dominic. And then just last one for me is on growth in both CDs and brokerage CDs. Assuming that it's kind of captured in the margin guide. But sort of what's the trajectory for those deposit buckets, and just remind us of your strategy on the funding side there?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

Sure. The first thing I would note is, we're very pleased with the growth in the deposit -- core customer deposits in the second quarter. Which were -- evidence of our strong brand and presence in our market, we were able to grow our non-interest-bearing deposits very helpfully given the rising rate environment along with the first purposeful increase in our CD portfolio. We foresee both continuing to grow. We look to remain competitive with both our money market pricing and our CD promotions to ensure our customers have competitive rates with us. And so we would anticipate that to continue and to deliver the mid-to-high single-digit growth that we offer.

Rodger Levenson - *WSFS Financial Corporation - Executive VP & COO*

And I would add just, Russell, broker deposit is just another vehicle that we use to fund the balance sheet growth, including Cash Connect. So I think what you see there is what you should expect to see for the remainder of the year.

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

Very helpful thanks.

Operator

(Operator Instructions) And our next question comes from Frank Schiraldi from Sandler O'Neill.

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

Just a couple of questions I had left. In terms of, you think about this -- I don't know if you'd call it credit sponsorship. But when you think about Spring EQ and LendKey, those relationships, where do you see this -- those balances potentially grow into in the near term as a percentage of loans or of consumer? And what is -- what's the appetite for growth there?

Rodger Levenson - *WSFS Financial Corporation - Executive VP & COO*

So I'll kick it off, and then I'll let Rick add some color. First, on the Spring EQ relationship. As Rick mentioned, we had a long-term relationship with the key principle of this entity. And so we've always viewed this as an opportunity to partner with them at the early stage of their growth, hopefully learn some things about how to offer home equity products digitally, making equity investment, as Rick discussed. But then at some point, as they got bigger and more traction, we would expect that relationship to change as they got more access to capital and warehouse lines and other things. So for the foreseeable future, certainly through the next year or so, the numbers that Rick outlined to you would be our continued expectation. Some point beyond that, would probably go down a little bit depending upon their success rate and kind of where we are positioned in the marketplace. And that was always been our expectation, kind of help them get started for a period of time and then they would move on, and we would then hopefully at some point monetize our equity investment in the company and also gain some learnings from that relationship. LendKey has been a partnership, which we've had for a number of years. It's really our primary student lending product. As Rick described, it's basically input print, although that's a little bit expanded from where our physical footprint is. And we would expect that to continue to grow at the rate that it's been growing over the last couple of years. We're pleased with that partnership. We look at student lending as an important part of our consumer lending offering and would expect that to continue longer term.

Richard M. Wright - *WSFS Financial Corporation - Executive VP & Chief Retail Banking Officer*

This is Rick Wright, again. The only color I would add is Spring and LendKey much like SoFi and Zenbanx are things that we try really hard to learn from, because as the digital changes are happening in the marketplace we just want to make sure that we are agile enough to do what we need to do. And so I think the learning part of this is probably almost equally important to us as the balance sheet activity.

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

Sorry. It sounds like you guys covered some of that before. I might have missed it. And then I -- just the other question was on Cash Connect. Is there -- as we think about kind of returning that business to where it has been maybe on a legacy ROA, legacy return levels, should we think about -- is there the ability to pass on some of the higher funding costs to customers in the legacy business? Or is it really more now just about retooling away from that cash heavy business? And if so, either way, I guess, can you just share with us the kind of startup expense that might be running through that pretax income level at this point that might -- as you build out that new business may dissipate to a certain degree?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

Sure, Frank. This is Dominic. First off, I'll start off by saying Cash Connect, in its 20 years, history has evolved at various points as the market has shifted, and this is another time which we believe we will successfully position ourselves for the future. With bailment as the primary revenue source, most of that is already passed on through the bailment pricing structure to our customers. What we saw in the second quarter year-over-year was 17% fee income growth primarily driven by bailment along with improvement in our TCM penetration in our existing customer base, along with the very healthy growth of Smart Safe. That resulted in a 10% net revenue growth, and that reduction was really a result of some pricing pressure and pricing concessions on some customers in the quarter as a result of the rising rate environment. We still believe that there is still upside and strong growth from the bailment business, but as you mentioned we are focused on diversifying through the TCM product or the bundling of armored carrier services, insurance, and optimization and reconciliation software with our customers, growing that penetration by 40% year-over-year, along with the 68% growth in our Smart Safe revenues versus the second quarter of last year. In fact, year-to-date, we've grown the number of Smart Safes in the market by over 20%. So we are in the midst of reinvesting in that diversification within the business, and we expect that to pay off over the next year as we return the margins back towards the historical average of 130 to 150 ROA.

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

Ok great, thank you.

Operator

And our next question comes from Austin Nicholas from Stephens.

Austin Lincoln Nicholas - *Stephens Inc., Research Division - VP and Research Analyst*

Most of my questions have been answered. But may be just on the Corporate Development costs. Can you remind us what costs are included in there? And any expectations for those in the back half of the year?

Rodger Levenson - *WSFS Financial Corporation - Executive VP & COO*

So Austin, it's Rodger. So as we've said previously, 2017 was a year of optimizing prior acquisition and investments, and we would begin the process in 2018 of doing more prospecting. So the cost that you see there are the costs of prospecting for some potential Corporate Development activities. And as a reminder, on the traditional bank side, we said that's -- our focus continues to be on continued investments in South Eastern PA, and we are also looking on our fee-based side to supplement those businesses with some smaller bolt-on acquisitions, primarily in the wealth space where we think we have a tremendous amount of opportunity. So the costing that you would see in there would be kind of a normal cost of that prospecting in talking to potential interesting parties.

Austin Lincoln Nicholas - *Stephens Inc., Research Division - VP and Research Analyst*

Understood, thanks. And then, I guess, is the efficiency guidance, does that include the Corporate Development costs or does that exclude them?

Dominic C. Canuso - *WSFS Financial Corporation - Executive VP & CFO*

So that efficiency ratio that we offer below 60% is on a core basis. So it excludes securities gains and Corporate Development costs.

Austin Lincoln Nicholas - *Stephens Inc., Research Division - VP and Research Analyst*

Understood. Okay, great. And then maybe just one last one on the relationship with SoFi. Could you give us some color on how that's performed or any kind of color on the financial impact that you have seen so far and any developments beyond the cash management account that was announced, I think, at the end of last year, would be really helpful?

Richard M. Wright - *WSFS Financial Corporation - Executive VP & Chief Retail Banking Officer*

This is Rick Wright, again. There really hasn't been anything significantly new on that. We are still trying to help them launch their money market product. It is still in beta. They're expecting to launch it later this year. We have a situation with them or an agreement with them that we receive a small amount of expense reimbursement for this at this point. But there is really nothing material that's happening with SoFi to us.

Austin Lincoln Nicholas - *Stephens Inc., Research Division - VP and Research Analyst*

Understood, thanks that is all the questions I have.

Operator

I would now like to turn the call back to Rodger Levenson for any further remarks.

Rodger Levenson - *WSFS Financial Corporation - Executive VP & COO*

Thank you, again, everybody for joining us today. Mark, Dominic and I will be on the road in the coming months. And we look forward to seeing many of you at that time. Thank you, and good day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.