WSFS Financial Corporation - Fourth Quarter 2018 Earnings Conference Call
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Officers:
Rodger Levenson, President & CEO
Mark Turner, Executive Chairman
Dominic Canuso, Chief Financial Officer
Art Bacci, Chief Wealth Officer
Steve Clark, Chief Commercial Banking Officer
Rick Wright, Chief Retail Banking Officer

Analysts:
Michael Perito; KBW
Austin Nicholas; Stephens
Russell Gunther; Davidson
Joe Gladue; Merion Capital Group

Presentation

Operator: Good day, ladies and gentlemen, and welcome to the WSFS Financial Corporations Fourth Quarter 2018 Earnings Conference Call. (Operator Instructions)

As a reminder, this conference is being recorded.

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

Dominic Canuso: Thank you, Imani. And thanks to all of you for taking the time to participate on our call today. With me on this call are Rodger Levenson, President and CEO, Mark Turner, Executive Chairman, Art Bacci, Chief Wealth Officer, Steve Clark, Chief Commercial Banking Officer, and Rick Wright, Chief Retail Banking Officer.

Before Rodger 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 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 report on Form 10-Q, as well as other documents we periodically file with the Securities and Exchange Commission. All comments made during today's call are subject to the safe harbor statement.

With that read, I'll turn the discussion over to Rodger Levenson.

Rodger Levenson: Thank you, Dominic. And thank you to everyone for joining us on the call today.

We are pleased to announce that in the final year of our 2016-to-2018 strategic plan, we recorded record operating results with Net Income of $134.7 million, Earnings Per Share of $4.19, an ROA of 1.92%, and an ROTCE of 23.72%. Our fundamental performance combined with our transformational acquisition of Beneficial Bank, provides WSFS with significant momentum and long term opportunity as we move into our 2019-to-2021 Strategic Plan.

Our comments today are a bit longer than normal and will be divided into three primary sections. Dominic will begin with a recap of 2018, and then I will provide an update on Beneficial and the 2019 outlook including our three-year ROA targets. At the conclusion of our prepared remarks, the team will be happy to answer any questions.

I will now hand it back to Dominic.

Dominic Canuso: Good afternoon, everyone. Our reported results for the full year 2018 included two positive non-core items: gains related to our investment in Visa Class B Shares which increased non-interest income and insurance recoveries from two legacy legal matters which reduced our noninterest expenses. In discussing our core performance for the year, I will be excluding these two items as well as our normal practice of excluding securities gains, which were minimal for the year, along with Corporate Development expenses which were entirely related to Beneficial and consistent with deal expectations.

Highlights for the full year 2018 included:

First, Core Net Revenue growth of 12% compared to 2017, balanced between an 11% increase in Net Interest Income and 13% growth in Core Fee income.

Second, Loan growth of 2% for the year. This was below our expectations as strong growth in consumer loans was offset by commercial loans which were flat for the year. As mentioned in previous quarters, we maintained our pricing and structure discipline in a very competitive market which led to lower than anticipated fundings. In addition, we experienced a high level of pay-offs due to liquidity in permanent and non-bank markets. However, this discipline significantly contributed to our strong growth in our Net Interest Margin and Net Interest Income and more than made up for the lower than expected loan growth.

Third, Strong deposit growth with total customer deposits growing 8% for the year when compared to 2017 and on the high end of our expected range of mid-to high single digits. This growth, in conjunction with moderate deposit betas, continue to demonstrate the strength of our core deposit franchise.

Fourth, Full year reported Net Interest Margin was 4.09% which represents a 14 basis point improvement over 2017. Going into the year, we expected a Net Interest Margin in the low 3.90s for the year. Our outperformance was driven by the previously mentioned disciplined loan and deposit pricing and a balance sheet structured to be well-positioned for rising rates.

Fifth, Well diversified Core Fee Income growth of 13% driven by our Wealth and Cash Connect businesses and consistent with our outlook of low double-digit growth.

Sixth, Expenses were well managed with a Core-Efficiency ratio for the year of 59.1% inclusive of higher variable performance-based compensation. As discussed in our earnings release, this is in line with our 2018 expectations of slightly under 60%. Core non-interest expense growth of 9% supported the 12% Core Net Revenue growth resulting in three full percentage points of positive core operating leverage for full year 2018.

Seventh, Total credit costs were $14.6 million in 2018 within our range of expectations of $13 million to $15 million for the year. Overall, our credit quality metrics remain stable and at very favorable levels.

Finally, As a result of our performance, we achieved a full year Core ROA of 1.63% and Core ROTCE of 20.18%. As a reminder, this performance came entirely from organic growth and significantly exceeded our full year financial and strategic plan target of 1.50% core and sustainable ROA.

Rodger Levenson: Thanks, Dominic. Turning to Beneficial, we are pleased to report that shareholders from both companies overwhelmingly approved the merger in December. In addition, the regulatory approval process is moving along as expected and we remain on track for a closing on March 1st.

As outlined previously, our systems and brand conversion is scheduled for the last weekend in August which is also when the majority of the branch consolidations will occur. This six month period post closing will provide ample time for integration planning and training to ensure a smooth conversion for both customers and associates.

Teams from both companies have been working diligently and collaboratively on the integration plan. 35 key business teams with representatives from both organizations are working very closely with our Integration Management Office, with weekly updates with our Executive Management Steering Committee that are also reviewed monthly with a Special Integration Committee of the board. Overall, we are very pleased with our progress to date and look forward to becoming one combined company in the near future.

Finally, I will provide a high level outlook for 2019.

In many respects, the development of our 2019 Plan began last summer when teams from both companies worked together to establish the baseline for the financial modeling supporting the Beneficial combination. During the five months since our announcement, our original assumptions for combined operating results, cost and revenue synergies, and corporate development expenses have been affirmed, providing the template for the 2019 plan.

As a reminder, the Plan assumes a March 1st close of Beneficial resulting in 10 months of combined results and a systems and brand conversion at the end of August.

Highlights of the plan include:

First, Loan growth in the low single digits as low to mid-single digit organic growth is offset by normal merger attrition in the consumer, mortgage, and commercial real estate portfolios.

Second, Deposits to remain flat to slightly decreasing as low single digit organic growth is offset by attrition related primarily to our branch optimization plan as part of our Delivery Transformation.

Both loan and deposit attrition levels are expected and consistent with our original modeling.

Third, A Net Interest Margin just under 4.10%. This includes model purchase loan accretion and balance sheet optimization. This also incorporates increasing deposit betas and the expectation of one interest rate hike in June in line with Fed Fund futures when the plan was completed in December. The NIM impact of no rate increases as indicated by the recent futures market could be in the range of a couple of basis points.

Fourth, Core Fee Income Growth in the high single digits after normalizing for the sale of Beneficial's insurance business in late 2018.

Fifth, Excluding Corporate Development and other one-time merger related expenses, a Core Efficiency Ratio of around 58%.

Sixth, Total credit costs of around 25 basis points on average loans or $18 million to $22 million for the year. As a reminder, these costs can be uneven from quarter to quarter and reflect anticipation of a continued stable economy.

Seventh, A full year core effective tax rate of approximately 23% to 24%. Please note that our reported effective tax rate will be closer to 30% to 31% due to transaction related tax treatments.

Finally, A note on Capital Management. As stated in the Release, we intend to continue our longstanding policy of returning at least 25% of annual net income to shareholders through a combination of dividends and share repurchases. The Board approved a new share repurchase authorization in December, and at current pricing levels, we have a bias towards repurchases. We will evaluate the amount and pace of repurchases when we come out of the blackout period after the merger closes.

Overall, we expect to achieve a full year Core ROA of 1.50% in 2019. The first half of the year results will be impacted by the typically slower first quarter driven by seasonality and the transaction closing. We would anticipate ROA increasing during the second half of the year.

Looking beyond 2019, our new three year Strategic Plan reflects a fully integrated Beneficial including realization of 100% of cost savings and planned revenue synergies. Consistent with prior modeling, we target a Core ROA of 1.65% in 2020 and 1.75% in 2021. This obviously assumes a stable economy and rate environment.

In summary, 2018 saw successful completion of our last three Strategic Plans which took us from a zero ROA in 2009 to 70 basis points in the first quarter of 2013, to a full year Core ROA of 1.63% and a Core ROTCE over 20% in 2018.

Our upcoming transformational combination with Beneficial gives us the opportunity to deliver continued very high levels of quality performance through our new Strategic Plan and for many years to come.

At this time, we would be happy to take your questions.

Questions and Answers

Operator: (Operator Instructions) Michael Perito with KBW.

Michael Perito: A few questions for me. I wanted to start, all the outlook commentary on 2019 and the Beneficial transaction is really helpful. The one area I was just kind of curious on as the deal close is getting closer here is just can you give a little bit more guidance on how the balance sheet size will shake out after the deal closes and any of those adjustments that we've talked about in the past on the investment portfolio and borrowings, et cetera, are made and where you kind of think the total assets will trend post all those adjustments and the deal closed?

Dominic Canuso: Sure, Mike, this is Dominic. So first, as we've discussed before, we see an opportunity to restructure the combined balance sheet at and just after the close of the transaction, to optimize the significant liquidity and cash at Beneficial. They are sitting on $1.3 million of cash short-term -- $1.3 billion of cash and short-term investments, investment portfolio. And we will be leveraging $300 million of that cash to pay for day one transaction consideration, along with restructuring the balance sheet, half of which will go to pay down overnight funding that is higher cost and then restructuring their investment portfolio to increase the yield from the low two percentage points it is today to the mid-three's. That will result in about $0.5 billion net reduction in the pro forma balance sheet shortly after the transaction, and then we'll grow throughout the year. We do see loan growth on a consolidated basis of about 2%. We'll increase the balance sheet from day one throughout the remainder of the year.

Michael Perito: Helpful, Dominic. Thanks. And then so on the loan growth side, I mean, obviously 2% relative to where you guys were on a percentage basis is not seemingly that huge of a number. But obviously, on a dollar basis it's a much larger number and it does seem like there's some market dynamics that are making things a bit challenging right now, including some increased competition from non-bank lenders.

So I'm curious how do you guys view that 2% number in the light of all those things that you've discussed and I just mentioned? And I guess, where do you see the growth coming from? Is it from these new lenders you brought on and [your] expectation that you'll bring more on over the course of 2019? Or is it that's just really baked in from the current team and the production you expect to rebound over the course of the year?

Rodger Levenson: So this is Rodger. I'll start, and then Steve can add some color commentary. So obviously, just to reiterate, that 2% is net growth. So that would include the attrition that I referenced to in my comments, which is normal and expected for transitions like this and also includes the runoff of some legacy consumer portfolios at Beneficial.

So we feel organic growth in the low to mid-single digits for us going forward is appropriate considering the amount of momentum that we feel in the marketplace, which includes not only the hiring of those new lenders, we're talking to other new lenders, we're getting a lot of very positive feedback in the market as we go out and talk to new customers, and we're hearing positive things from our existing customers because of our larger balance sheet. So we feel very good about the opportunity for organic growth in 2019.

Michael Perito: Lastly, Rodger, I didn't hear you mention the number specifically. But what was the size of the new repurchase authorization that the Board approved?

Rodger Levenson: So as I said on the call and we referenced in the release, we have approval to go back in after the deal closes and we come out of blackout, to resume our longstanding policy of returning 25% of annual earnings in a combination of the purposely low dividend and share repurchases. And so that's where we will start. And then as our earnings trajectory grows and our capital levels build, we will look to do, certainly look to do increasing amounts of share repurchases, especially at these price levels. So we have ample authorization to continue the program of 25% return to shareholders.

Michael Perito: Okay. So is there no specific authorization amount that's been disclosed? Is it just generally to complete the 25% payout target?

Rodger Levenson: Yes, I'd say that's accurate. If you look at our earnings, [it's] the current authorization that we have. And again remember, this is in conjunction with capital levels and other things, and we're in the middle of an application process, is a little bit under 500,000 shares. But we would expect to revisit that when we come out of blackout, as I said.

Michael Perito: Okay. That was all I had. Appreciate the color, guys. Thank you.

Operator: Austin Nicholas with Stephens.

Austin Nicholas: Maybe just back on the NIM guidance, could you remind us what the expectation for accretion is within the slightly under 410 NIM guidance?

Dominic Canuso: Sure, Austin, this is Dominic. Included in that is a net accretion which includes purchase loan accretion and then the marks on the CDs and borrowings around 30 basis points on a full year basis.

Austin Nicholas: Understood. That's helpful. And then maybe just switching gears to the fee income part of the business. Could you maybe give us some outlook on the profitability and maybe kind of Net Revenue growth outlook in the Cash Connect side of the business? It looked like fee income was strong this quarter, but I know funding changes have resulted in kind of net revenue being a little bit flat over the course of the year. So any thoughts on that business in 2019 would be helpful.

Dominic Canuso: Sure, and just to quickly follow up on your previous question when we talked about purchase loan accretion, I think it's important to note, and we've reiterated this before, that given the longer duration of the assets from Beneficial and the lower pricing, we expect that purchase loan accretion to continue for about 4.5 years. So I wanted to just follow up on that point.

Austin Nicholas: Got it.

Dominic Canuso: Within Cash Connect, we do continue to see the opportunity for double-digit fee income growth as they continue to invest and expand their SmartSafe business, along with leveraging their other fee services across their full bailment customer base.

And we also have been discussing over the last few quarters the repositioning of the funding of that business to transition it from where it has been this year in the 80 basis point range of ROA, back towards its historical average of north of 130 ROA and towards north of 150, which we expect to do in 2019 and beyond. In fact, the fourth quarter included a one-time true-up adjustment in costs that we shifted from a legacy cash basis to accrual basis on one of their funding line items that reduced their income. So in fact, they would have had net income growth year-over-year by about 5% and an ROA in the quarter in the 120s. So we are seeing positive trajectory from their repositioning the balancing sheet. We expect that continue into 2019. We do anticipate a slightly smaller balance sheet from that business in 2019, as one of their larger customers that is a significant bailment customer, will shift and reduce their bailment volume but maintain their other fee services, and that will also improve ROA.

So net net, net income will be relatively flat year-over-year, but the ROA will considerably improve into the 130s and then we expect bottom-line growth from there on.

Austin Nicholas: Got it. Thanks, Dominic. That was very helpful. Those were the only two questions I had. Thanks.

Operator: (Operator Instructions) Russell Gunther with Davidson.

Russell Gunther: Just quick one for me to get things started on the insurance business that Beneficial's selling. Could you guys just quantify the revenue that will be at risk or that's accompanied with that business, please?

Rodger Levenson: Yes, I have it here. Hold on a second. So their insurance agency had a little under $5 million of annual revenue that will not be there in the run rate number going forward.

Russell Gunther: Okay. Got it. Thank you. And then just switching gears to the loan growth, on the consumer side, been a nice source of growth for you guys, as you talked about. Maybe just a little bit more color in terms of the growth outlook going forward within consumer. You guys can touch upon the partnership you have with Spring EQ and LendKey as well as type of yield you'd expect to be able to continue to get on that portfolio?

Rick Wright: This is Rick. In terms of volumes between LendKey and Spring EQ, we would probably expect something in excess of $100 million for 2019. I don't have in front of me the yields on those, but they've grown a little bit with the rate changes. I will tell you that the credit metrics are solid on both of those. We have -- let me grab my paper, the LendKey, we've got a 768 average FICO on the student loans, of which that's about 5% of the portfolio, and then consolidation loans about 760. We're seeing nothing in the way of credit deterioration there.

And on the Spring EQ side, the underwriting is exactly the same as ours. So again we've got a very low delinquency on that as well.

The traditional home equity business, we're sort of at a push. We might have a little bit of growth next year. We're putting on a lot of volume, but we're having a lot of it run off, and we're having the line not extended as much as they had been in the past, we were up over 50% utilization, now we're closer to the lower 40s.

Russell Gunther: I appreciate the color there. Thank you. Last one for me. I appreciate you guys sharing your thoughts on the ROA within the three-year plan. Obviously, a lot of wood to chop with the integration. But are there other kind of bigger picture strategic initiatives you would hope to accomplish in there, that you could share with us beyond the Beneficial integration, that's going to help drive that ROA?

Rodger Levenson: So, no. Yeah, Russell, really, if you look at our three-year strategic plan, kind of the two major components of that are the full and successful integration of Beneficial and starting, obviously, to harvest all the long-term growth opportunities we see with that, and then the delivery transformation that is being done in conjunction with that combination. And so the combination of those two items are really the thing that's driving the numbers in the three-year strategic plan.

Russell Gunther: Makes sense. Okay, guys. Thanks so much. That's it for me.

Operator: Joe Gladue with Merion Capital Group.

Joe Gladue: Yes. I'm sorry. My question's been answered. Thanks.

Operator: Thank you. And with no further questions in queue, I would now like to turn the conference back over to Mr. Rodger Levenson for closing remarks.

Rodger Levenson: Thank you. And thanks again for your time and attention. Dominic and I will be on the road. We'll be joining Mark at Investor Conference in the next few weeks, and then we will be on the road over the next couple of months and we look forward to seeing many of you then. Thank you very much, and have a good day.

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