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WSFS - Q3 2017 WSFS Financial Corp Earnings Call

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PRESENTATION

Operator

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

I would now like to introduce your host for today's conference, Mr. Dominic Canuso, Chief Financial Officer. Please go ahead, sir.

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

Thank you, Christy, 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; Steve Clark, Chief Commercial Banking Officer; and Rick Wright, Chief Retail Banking Officer. Both Rodger Levenson, Chief Operating Officer; and Paul Geraghty, Chief Wealth Officer, who usually participate, are out on other banking business and are unable to join us on the call today.

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 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 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.

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

Thanks, Dominic and thanks to all, for your time and attention today.

We are pleased to have reported another quarter of very solid performance on both a reported and a core basis. The quarter was also very clean, with approximately $700,000 of non-cash debt issuance costs, and $700,000 of realized securities gains; such that the reported and core results were nearly equivalent, with core results being slightly better than our reported earnings because of minimal merger-related expenses in the quarter. The strength and clarity of our results reflects WSFS' delivering on our goal that 2017 would be a year to focus on and optimize prior investments, including recent years' acquisitions.

Highlights for the quarter include: a core Return On Assets of 1.21% ---or 17% better than core results for the same quarter last year; a core Earnings Per Share of $0.64 and a Core Return On Tangible Common Equity of over 15% both core EPS and Core Return On Tangible Common Equity were 25% better than the same quarter last year.

These results were driven by strong core net revenue growth, which was up $12.3 million or 16% year-over-year, including good improvements in both organic and acquisition growth coming in the forms of both net interest income, up a robust 14%, and fee income, up a very robust 19% over this quarter last year.

Consistent with the ongoing strength and improvement of our earnings, the Board increased our per share dividend by 29%, from $0.07 per quarter to $0.09 per quarter, which keeps us well within our desired policy of returning, over the cycle, between 10% and 15% of our earnings through cash dividends; in addition to that, we continue to repurchase shares in the open market in a methodical way to further enhance our returns of capital to shareholders, consistent with our often-discussed philosophy and policy.

Loan growth was 6% in each the quarter, the year-to-date and the year-over-year period and was not only good and consistent, but also in line with our communicated expectations of mid- to- high single-digit growth. Despite modest local economic growth and intense competition for loans, our mid-single-digit organic growth demonstrates the combination of our continuing ability to take good market share, balanced with our disciplined approach to pricing and underwriting.

Credit quality remains strong, with problem loans, non-performing loans and total Non-performing Assets all at low historical levels and improving modestly over the prior quarter. As a result, total credit costs in the quarter at $3.5 million were very consistent with our annualized expectations; and at $8.6 million through September 30, year-to-date total credit costs, annualized, are slightly better than the favorable-end of our full-year 2017 expectations. Likewise, charge-offs for the year-to-date stood at 19 basis points of loans, very consistent with our longer-term, sustainable expectations, and also very consistent with the 20 basis points for the same 9-month period last year.

Deposit growth essentially matched loan growth over the last year, which was and is our goal, and allowed us to stay at a healthy and near optimal loan-to-deposit ratio of 96%. Importantly, 89% of our deposits are core deposits, and 50% are low and no-cost demand deposits, which evidence the strength of our customer relationships, and these deposits are also very valuable in the current rising-rate environment.

Pricing on deposits was also disciplined and consistent with our strong relationships and our high-service model, with recent rack rate-deposited betas at about 15%, and still well below longer-term modeled expectations. As a result, combined with rising yields on loans and investments, the repayment of our higher-cost senior debt late in the quarter and other small factors that can move from period to period, our margin improved 2 basis points in the quarter, and a healthy 11 basis points over the same quarter last year.

Core fee income performance was again a standout in the quarter, growing 19% over the same quarter last year including 13 percentage points coming from organic growth. Some business lines, like Wealth, grew strongly and covered the softness in other fee areas; and the diversity of sources demonstrates the strength of our fee-heavy business model. Fee income now represents a very desirable 36.3% of our total revenue.

Core expense growth to support the franchise was $8 million or well less than the $12.3 million in core net revenue growth, demonstrating improved efficiency, and this dynamic was one major factor in helping propel the strong 25% core EPS growth over last year.

We did face some challenges in the quarter, and our results were a couple pennies short of even our own expectations. Expenses were a bit elevated due to the acquisition earn-out accruals and legal costs from some legacy trust matters. And we are starting to see deposit competition increasing through local promotional rates and promotional account acquisition practices, so core deposit growth was not as robust as we would have liked, and pricing pressure is starting to build on funding costs as we expected it would.

Further, Cash Connect's bailment business and specifically the retention of one large bailment account, funded internally, put slight pressure on our margins as that revenue shows up in fee income, but the internal funding costs shows up in interest expense, until we can either fund it through external sources, and/or improve overall profitability in other ways through cross-selling additional services to bailment customers, which is fundamental to Cash Connect's business model and is our current focus.

While all of these items just mentioned were small individual challenges in the quarter, we expect these are altogether manageable in the medium term and over the course of our strategic planning period.

Most importantly, the fundamental and leading indicators of our success continue to be very healthy and enviable, as we were, for the 12th year in a row, highly ranked in a local market independent survey as a "Top Workplace"; for the second year eligible, we were internationally recognized as a "Gallup Great Workplace;" and for the seventh consecutive year, we remained the "#1 Bank" in our home market in another independent survey. These leading indicators; the strengths of our markets, team and brand; our continuing market share growth and momentum in fee income and net interest margin; and our opportunities to improve economies of scale even further all give us high confidence, that while lofty, we still expect to achieve our Strategic Plan goal of a core and sustainable 1.30% Return On Assets by no later than the fourth quarter of 2018.

Thank you, and at this time we would be glad to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from the line of Catherine Mealor of KBW.

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

Thanks and good afternoon. So Mark, on your comments on the expenses and this couple, what kind of feels like onetime-ish items, could we actually expect for the expense rate to decline next quarter as those pieces come out?

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

So let me give you a little color on that, and Dominic, please augment it to the extent you see necessary. So the two items we mentioned were: Some legacy trust legal matters--We're still in the arbitration stage there, so I would not expect them to run off next quarter and not even maybe the quarter after that. But after that, they should conclude as we -- as the arbitration ends and there's a decision rendered. You asked about -- they were about $0.5 million or so in the quarter. And the other we mentioned were earn-out accruals. Some of those were due to the higher performance of some of the recent acquisitions, and some were due to a restructuring of one of the earn-outs to account for the fact that in the mortgage banking business, there has been increased regulations there. And so those we would expect to be more like onetime, and that's about another $0.5 million.

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

Okay. That's helpful. Okay. And then on the margin, what's your outlook for the margin going into next year? It feels like you're getting some -- a nice tailwind on loan yields moving higher, your deposit betas are lower, and they'll naturally increase from 15%. But do you still feel like once we get a full quarter impact from the borrowing being paid off and you continue to benefit from loan yields moving higher, there's still an upward bias to your net interest margin?

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

So I would think a slight upward bias. The headwinds we're facing -- or excuse me, let me start with the other end. The tailwinds we're facing, you mentioned, are a full quarter rather than just one month of the payoff of the higher debt costs; our asset sensitivity, especially coupled with lower-than-modeled deposit betas; and overall, just growth and improvement in the mix of the balance sheet. On the headwind side, we have the runoff of some accretion, we do have deposit pressures building, so to the extent our loan growth stays robust and we want to keep that deposit growth, we may have to pay up a little bit for deposits. And then we have our reverse mortgage portfolio, which is a high-yielding portfolio, although small, continues just to run off. So the combination of those headwinds and tailwinds in any quarter, usually would, at this point, result in some modest improvement.

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

Okay. And then would you say on the deposit side, is it more pressure on the cost of the incremental deposits that you're adding to your balance sheet? Or are you seeing pressure on your current core basis funding?

Richard M. Wright - *WSFS Financial Corporation - Chief Retail Banking Officer for WSFS Bank and EVP of WSFS Bank*

This is Rick. I'll talk about the deposit side and the beta thing. We have, thus far, as we've said, experienced a very low beta, around 15%. And we've said all along that at some point after enough Fed increases, the beta is going to go up pretty meaningfully. And with the next projected increase, which people are saying are likely in December, we expect the beta to increase to around the historical average of 50%. And so this is due to a lot of increase in competitive activity. We're especially seeing that from banks that have a loan-to-deposit ratio over 100%. And we're continuing to develop strategies around which products are the right ones to feature and worry about in this environment and which ones we're going to leave alone, and we're going to be using targeted promotions as well as exceptions and focus on strategies to grow our no-cost deposits so that we have a little more flexibility in our pricing. Dominic, you want to talk about the other side of that?

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

Yes. So and just rounding that off, so I think we are seeing it both from existing customers through exception pricing and growing the deposit base. But we do see a slight pickup in the deposit cost as deposit betas typically lag the rate increases, so we expect that in the near term. But all in all, shape into Mark's comments around the headwinds and tailwinds, that net's to a slight growth in the net interest margin over the near term.

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

Thank you for your comments.

Operator

Our next question is from Austin Nicholas of Stephens.

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

Good afternoon, I think Catherine asked most of my questions. But maybe just touching on fee income, it was nice to see the strength there that you mentioned. And maybe just taking a look at Cash Connect, can you maybe talk about what drove the upside there? And then maybe your outlook for, call it, overall pretax income in that business, just given that it was flat quarter-over-quarter due to those pricing pressures and some funding costs that, that built in that business line.

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

Yes. Some historical and maybe some current context would be helpful here in answering that question before I get to a specific answer, and again, Dominic, jump in as you feel necessary. So this business is only 20 years old, 20 years old for us, and frankly, as an industry it's only 20 years old. And over that 20 years, as you might expect, that there's been some change in the industry, some consolidation, some change in the dynamics. And over -- it's actually happened several times before, where there's been kind of creative destruction change through consolidation, through changes in technology, etc. And our folks in that business -- and we have weathered those pretty well, to still be one of the dominant, most profitable players in that industry. But we're going through another one of those changes right now over the last couple quarters, probably into the next couple quarters, as with rising rates, some of the smaller mom-and-pops are getting -- their costs are getting pressured as funding their machines is one of their most significant costs. And the big guys and gals are consolidating the small guys, which puts pressure overall on those of us in the industries that are suppliers to that industry as the dominant players get bigger and have more pricing power. We've been and continue to try and offset that by the bailment business, that business that I just spoke of, being the backbone business and still doing that, but trying to fund a large percentage of that not with our funds but with other people's Reg D reserves, which is both healthy and legal and which improves our ROA and reduces that funding pressure, but mostly by selling managed services. So not the backbone, low margin bailment product, but other value-add services like the reaggregating of armored car services, insurance services and other kind of processes and systems that help them run more efficiently. So that kind of rejiggering of the business model is going on right now. So typically, over the last 5 years, we've seen a growth rate in their revenues of about 15% a year. Because of that, it's slowed down to about 9% over the last 2 quarters. But we would expect, with our funding optimization as well as the cross-sell of services and new services like deposit safe, that could tick back up again into the low teens after we get past the next couple of quarters. And that profitability with -- that's been flat for the last couple of quarters, that we've had to invest in those new services, would tick up as well.

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

Understood. That's helpful. So I guess the quarter-over-quarter, I guess, flat profitability, is -- there was still some, call it, build of expense for those new products in the -- in that business line?

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

Correct. And then I mentioned this in my comments, but I would point out that I think it's that nice strength and diversity of our fee-based business model. We really have four sources of fee income: Wealth, Cash Connect or cash logistics, mortgage banking and traditional banking. In any quarter, two or three of those will probably be performing pretty well, but one or two will hit some softness. But we still managed to show nice, healthy, 13% organic growth and total growth of 19% year-over-year.

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

Great. That's helpful. And then maybe just touching back onto loan growth. Loan growth came in within your mid- to high single-digit guidance around that 6% rate. Were there any moving pieces in there in terms of pay offs? And any way we should be thinking about those as we go into the fourth quarter?

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

Yes, so this is Steve Clark speaking. Certainly, during the quarter, loan growth was hindered somewhat by a decline in our residential mortgage book of about $27 million. That's part of our plan to sell -- to originate and sell residential mortgages into the secondary market. So our 6% annualized growth for the quarter of about $74.5 million was negatively impacted by that $26.9 million of sale into the secondary market on the resi side.

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

So the other components, especially C&I and construction and commercial real estate and other consumer loans, grew nicely in the high single digits, in some cases, higher than that.

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

Thank you all no more questions.

Operator

Our next question is from Joe Gladue of Merion Capital Group.

Joseph Gladue - *Merion Capital Group LLC, Research Division - Research Analyst*

Just a couple of mine left. I don't think I heard you mention, I just wondered if there's any update on that C&I participation loan that was downgraded in the first quarter and just where that stands.

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

Yes, Joe. Steve again. So at the end of the third quarter, that shared national credit remained in our NPA totals. So as you recall, it was downgraded as part of a targeted review back in the first quarter. It has been in our numbers through the third quarter. The credit continues to pay current, and we do continue to expect a resolution of that situation sometime in the near term.

Joseph Gladue - *Merion Capital Group LLC, Research Division - Research Analyst*

Okay. And I guess just one other one. I guess in the press release, it mentioned what the, I guess, the change in purchase accretion on acquired loans was from the year-ago quarter. Just could you -- I guess, I could back into it, but could you tell me what that change was from second quarter?

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

Yes, this is Dominic. It's actually up slightly to about 14 basis points but below the year-to-date average. And we do, as we've mentioned before, expect that to continue to tick down, and that's part of the headwinds that Mark had mentioned earlier. And that would continue to decrease in the next year into the high single digits.

Joseph Gladue - *Merion Capital Group LLC, Research Division - Research Analyst*

Thank you.

Operator

Our next question is from Russell Gunther of D.A. Davidson.

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

Good afternoon guys, just a follow-up on the loan growth commentary. Could you give us a sense for where the pipeline sits today versus coming into the beginning of the quarter? And based on what you're looking at for 4Q, is there an opportunity for that mid-single digit to migrate to the high single digits?

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

Yes, Russell. Steve again. So our pipeline in the commercial side remains strong. The 90-day weighted average kind of forecast for us is about $150 million. And going back to the end of the second quarter, that 90-day weighted average forecast of pipeline was essentially the same, about $153 million. So we had a strong quarter of closings, commercial loan closings, of -- or about $73 million for the quarter, and we build that pipeline back up. So we continue to expect, for the full year, kind of mid- to high single-digit commercial loan growth.

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

Okay. That's helpful. And then any kind of commentary in terms of both loan, I mentioned the commercial side, but maybe parse CRE and C&I for me? And then, I guess, the plans would be the same for the residential real estate portfolio to continue that gain-on-sale action there.

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

Yes, so for the commercial side during the quarter, approximately 68% of our growth was C&I, and the balance was CRE.

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

Got it. I appreciate that. As you guys look out in terms of geographically your different markets, what -- where the sort of source of strength is and where you'd expect it to be. Where do you think that those kind of loan growth drivers from the geographic perspective are?

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

So again, consistent with our strategy, I think for commercial, during the quarter, about 55% of our fundings were in Pennsylvania, with the balance primarily in Delaware, a little bit in Maryland. And looking at the pipeline that I referenced a minute ago, about 60% of that pipeline are opportunities in Pennsylvania.

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

Got it. Okay. That's great color thank you. And then maybe just circling back to the asset quality, I think you guys mentioned in the release a couple of NPLs that were resolved this quarter. Just any kind of color there in terms of resolution and types of credits.

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

I don't think anything special. Steve or Dominic, please jump in. I don't think anything special. I just think the normal working of problem loans to resolution, either paydown or payoff. So positive, generally positive resolution. Steve, Dominic?

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

Yes, I just would add, NPAs declined, as you saw. Problem loans also decreased over the prior 2 quarters. In the charge-off number, there was one C&I resolution of about $1.2 million, but other than that, it was just a lot of smaller kind of granular items coming to a close.

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

Very good, thank you guys, my other questions were answered.

Operator

Our next question is from Frank Schiraldi of Sandler O'Neill.

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

Good afternoon. I guess the only thing left for me is M&A then. I just wonder, I guess given the focus and then high confidence on getting to the 1.3% ROA, I just wonder if you could remind us your appetite for M&A here, whole bank or other in the near term. And then maybe just comment on the level of conversations taking place in the market, if that's slowing or speeding up.

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

Yes, so again, a little bit of historical context. We did six acquisitions between 2013 and 2016, three in the fee-based area and three in the traditional bank area. And so as we said, and as we delivered on '17, it would be a year to focus, integrate and optimize. We believe we are through that. All of our acquisitions are performing well, either to expectations or slightly above expectations. And we're past the intense integration phase, which obviously not only includes the technical but the people and the customers and the branding and the messaging. So we are, at this point as we exit the year, continuing to look. We believe we have created a great business model that has shown to be replicable, not only organically but across acquisitions. And we believe we've become a high-performing organization that can take other organizations and map that high performance over them. And we also believe we've become a partner of choice in the local marketplace. So especially in Southeastern Pennsylvania, where there are some smaller organizations that are just struggling with long-term viability from a profitability standpoint. We will be looking there. And we will also, consistent with our goal to get to 40% fee income to total revenue, be looking for fee-based acquisitions, probably primarily where we have competency, which at this point is in the Wealth arena. I will stress that, consistent with what we've done, you should expect them to be small but meaningful and disciplined, in terms of both EPS accretion, IRR and any tangible book value dilution earned back.

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

And did you say, Mark, that the -- in terms of bank, the focus would still be on Southeast PA?

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

So yes, that's where we've got presence, we've got momentum and we see the opportunity. And we've also got the branding power now and the team there now to handle that. Down the road, we could look further down the Delmarva Peninsula, but I think that would be down the road.

Operator

(Operator Instructions) I'm showing no further questions at this time. I would like to turn the call back over to Mr. Mark Turner for any further remarks.

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

Thanks again, everyone, for your time, attention and questions. Rodger, Dominic and I will be at a few analyst and investor conferences and events in the near future, and we look forward to continuing the dialogue. So have a great week, everyone.

Operator

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