

# NIM and expense pressure aside, First Republic continues to shine

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San Francisco-based First Republic Bank generated double-digit growth across its core operations, substantially expanding its third-quarter top and bottom lines.

The results extended a long-running success streak for the bank. Over the last five years alone, total deposits, loans and assets have all more than doubled. Net income has steadily climbed every year along with that expansion.

Investors continue to jump on board. Shares of First Republic are up nearly 200% over the last five years. The stock has climbed more than 15% this year. That is far better than SNL U.S. Bank Index, which is down more than 2% in 2016.

The company, since its founding in the 1980s, has focused on heavily populated, prosperous growth markets on the West Coast and East Coast. Its largest market is its home base, the San Francisco Bay Area, but it also has notable penetration in Greater Los Angeles, New York, Boston and other coastal markets peppered with growing businesses and wealthy families — the bank's areas of focus. For a bank with nearly \$68 billion in assets, First Republic maintains a relatively simple business model, one centered on bread-and-butter lending, deposit gathering and wealth management services.

"We continue to perform very well because we remain completely and absolutely focused on what we do best," Chairman and CEO James Herbert II said during an Oct. 13 call with analysts, shortly after posting third-quarter results.

The company reported net income available to common shareholders of \$154.4 million, or \$1.00 per share. That was up from \$119.5 million, or 82 cents, a year earlier, and better than the S&P Capital IQ consensus estimate of 99 cents.

First Republic generated deposit growth of more than 24% from a year earlier to \$55.1 billion. The vast majority of that funding is low cost, with more than 60% of deposits in checking accounts.

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Reflecting robust demand and the economic vigor of its core markets, third-quarter loan originations soared 33% from a year earlier to \$6.5 billion, the second-best quarter in the bank's more than 30-year history. Loans outstanding, excluding loans held for sale, climbed nearly 18% to \$49.9 billion. Net interest income of \$460.6 million was up more than 18%.

Third-quarter wealth management revenue of \$71.9 million was up 27% from a year earlier. Nearly two-thirds of that growth came from net inflows of client assets, with the remainder from market appreciation, executives said on the earnings call.

"The growth components are still very much intact," Stephens Inc. analyst Terry McEvoy said in an interview.

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**-- First Republic Bank Chairman and CEO James Herbert II**

Total third-quarter revenue of \$557.9 million was up 19% from a year earlier.

"They consistently bring in good, quality deposits," FIG Partners analyst Tim Coffey said in an interview, "and the loan growth is not only solid but high quality."

Third-quarter nonperforming assets represented a mere 8 basis points of total assets, First Republic said, while net charge-offs of \$627,000 accounted for only 1 basis point of average loans.

Herbert attributed the progress in large part to the company's service-first culture. To be sure, all banks tout customer service, but he said First Republic motivates its employees with incentives geared at developing long-term business connections, exceptional customer reviews and referrals — as opposed to providing bonuses simply for landing new accounts.

He said client attrition is only about 2% each year, roughly a fifth of what it is for the bank industry as a whole.

First Republic also uses a popular independent measure of client satisfaction to compare itself to other banks as well as prominent companies in other industries. Herbert said the bank's most recent Net Promoter Score was 62%; that, he said, was roughly twice that of the average for the bank industry.

"We don't only focus on client service; we measure it," Herbert said. "Half of our clients consider us their lead bank and when they so designate us, their score of our ser-

vice goes to an even higher 77%. At this 77% level by half of our clients, we're up above the world's most respected brands, such as Apple and Amazon."

Against the backdrop of the sales scandal at Wells Fargo & Co., the largest bank based in San Francisco, Herbert added: "Our clients' very strong satisfaction is based upon principles that are the very bedrock of this institution. We build deep, stable relationships with clients one at a time, and we do the right thing for them every time."

Despite the consistency demonstrated in the third quarter, First Republic's stock dipped more than 4% in morning trading Oct. 13 after it reported earnings.

Analysts attributed part of the drop to an overall decline in the market, led by downward movement in the banking sector. But they also said investors likely took notice of continued pressure on First Republic's core net interest margin, which fell 5 basis points during the third quarter to 3.11%. The bank cited higher average cash balances and interest costs tied to a subordinated notes issuance.

The bank's expenses also rose along with its growth in lending and wealth management activity. An uptick did not surprise the Street, but the rise in costs, due in part to higher regulatory expenses, was enough to push First Republic's efficiency ratio to 60.5% for the third quarter. That was up from 59.8% in the prior quarter and up from 58.9% a year earlier. Executives said on the call that they would likely continue to operate above the 60% level.

Coffey, the FIG Partners analyst, said that investors had wanted to see First Republic keep its efficiency ratio below 60% even as it grows, viewing the ratio as an important measure of the bank's ability to keep costs in check.

But that measure aside, and stepping away from margin pressure that is ubiquitous in the banking industry given the prolonged era of low interest rates, Coffey said First Republic's growth trajectory, fueled by its stellar reputation, is almost unassailable.

Stephens' McEvoy agreed. "For First Republic," he said, "it's almost an honor to be a client of theirs."