

CIT Group, Inc.

Q1 2019 Earnings Conference Call

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CORPORATE PARTICIPANTS

Ellen Alemany - *Chairwoman, Chief Executive Officer*

John Fawcett - *EVP, Chief Financial Officer*

Barbara Callahan - *SVP, Head of Investor Relations*

PRESENTATION

Operator

Good morning, and welcome to CIT's first quarter 2019 earnings conference call. My name is Andrew, and I will be your operator today. At this time, all participants are in a listen-only mode. There will be a question-and-answer session later in the call. To ask a question you may press star then one on your telephone keypad. To withdraw your question, please press star then two. If at any time during the call you require assistance, please press star then zero, and an operator will be happy to assist you. As a reminder, this conference call is being recorded. I would now like to turn the conference over to Barbara Callahan, Head of Investor Relations. Please proceed, ma'am.

Barbara Callahan

Thank you, Andrew. Good morning, and welcome to CIT's first quarter 2019 earnings conference call. Our call today will be hosted by Ellen Alemany, Chairwoman and CEO, and John Fawcett, our CFO. After Ellen and John's prepared remarks, we will have a question-and-answer session. As a courtesy to others on the call, we ask that you limit yourself to one question and a follow-up and then return to the call queue if you have additional questions.

Elements of this call are forward-looking in nature and may involve risks, uncertainties and contingencies that may cause actual results to differ materially from those anticipated. Any forward-looking statements relate only to the time and date of this call. We disclaim any duty to update these statements based on new information, future events or otherwise.

For information about risk factors relating to the business, please refer to our 2018 Form 10-K. Any references to non-GAAP financial measures are meant to provide meaningful insights and are reconciled with GAAP in our press release. Also, as part of the call this morning, we will be referencing a presentation that is available in the Investor Relations section of our website at CIT.com. Thank you. I'll now turn the call over to Ellen Alemany.

Ellen Alemany

Thank you, Barbara, and good morning, everyone. Thank you for joining the call. I'm pleased to report that we had a solid first quarter. We began to deliver on the next phase of our strategic plan and posted net income of \$119 million or \$1.18 per common share. In addition, our tangible book value per share was up 2.5% compared with the fourth quarter. With our simplification efforts completed, we began the year on a much stronger foundation. We remain committed to our financial and operational goals for the year, and our plan to power forward the next chapter of CIT is outlined on page 2 of the presentation.

Let me hit a few highlights for the first quarter. We grew average loans and leases by 2% and continued to see strong origination volumes in Commercial Banking. Our average consumer deposits grew significantly by about 8% from last quarter, driven largely by the Direct Bank. This is from the tremendous success of the Savings Builder product, which has accelerated our deposit growth faster than planned, but nonetheless, we are encouraged that so many customers have chosen CIT in a crowded marketplace.

We returned about \$205 million of capital to shareholders between stock repurchases and dividends. We remain focused on reducing operating expenses, and we're continuing to drive efficiency while also investing in the business. For example, we have been investing in modernizing our systems and digitizing our operations, and this will drive operating efficiency and the ability to unlock greater business potential. And the broader credit environment remains

stable, credit reserves were strong, and we continued to be disciplined in our underwriting despite competitive markets.

John will walk you through a detailed account of results, but first let me touch on a few business updates. Our Commercial Banking volume was up 5% year over year, and we continue to find good opportunities in the market that speak to our core strengths. Average loans and leases in Commercial Finance were up 4% from last quarter and 7% from a year ago. Some of this was driven by strong originations in the fourth quarter that drove greater asset growth in the first quarter. We also saw lower prepayments.

The underlying business opportunities remain strong, particularly in more collateral-based lending. Our growth in the quarter was driven by deals in our power and energy, communications and technology, healthcare and C&I verticals, which have strong market positions. The equipment financing areas within the Business Capital division also posted strong results with average loans and leases up about 3% from last quarter and 12% from a year ago. Our proprietary technology in this business is a key advantage and helped to drive a significant portion of our 17% origination growth year over year. We continue to grow market share in small and mid-ticket equipment financing and have core competencies in this market.

We remain highly selective in commercial real estate. We're seeing good opportunities based on our strong relationships and industry knowledge, but average loans are down 1% from the prior quarter and 3% from last year. We have an experienced team, and we are being disciplined. Average loans and leases in the North American Rail division were flat quarter over quarter and up 2% from last year. Utilization rates were strong at 97%, and we continued to proactively manage the portfolio through the cycle.

As I mentioned earlier, we had a strong quarter of deposit growth in the Consumer Banking segment, driven by the Direct Bank. We welcomed nearly 50,000 new customers to CIT and grew average deposits by \$2.4 billion in the quarter. The Savings Builder product has had strong appeal and has helped us increase our non-maturity deposits as we strategically reduce our time deposits. We continue to monitor our deposit growth and will adjust as needed going forward to best align with our funding needs.

Before I wrap up, I also want to mention the addition of Bob Rubino and Jim Hubbard to the management team. Jim is our new General Counsel, and Bob will help drive our growth strategy as head of our Commercial Banking segment. They both bring a tremendous amount of key banking and marketplace expertise to CIT, and I'm happy to have them on the team.

So we're off to a strong start, and were focused on powering forward to deliver on our plan for the year. With that, let me turn it to John.

John Fawcett

Thank you, Ellen, and good morning, everyone. We're off to a solid start this year with net income available to common shareholders of \$119 million or \$1.18 per common share as we continue to make progress towards our 11% return on tangible common equity target for the fourth quarter of this year. We achieved these solid results by executing on our strategy. We grew average loans and leases in our core business by 2% from the prior quarter and 7% from the year ago quarter. We continued to see strong origination volumes in Commercial Banking, which grew 5% from the year ago quarter, driven by growth in Commercial Finance and Business Capital. We stayed disciplined in our credit underwriting. We remained focused on our operating expense initiatives while continuing to invest in technology to improve operating

leverage over the longer term. We continue to look for opportunities to optimize our funding profile, and we repurchased \$180 million of common stock below tangible book value this quarter.

With the business transformation completed and our financial statements much simpler, we had no noteworthy items this quarter. However, given that prior periods were impacted by noteworthy items, I will refer to our comparative results from continuing operations excluding noteworthy items, unless otherwise noted. I will now go into further detail on our financial results for the quarter.

Turning to slide 6 of the presentation, net finance revenue declined from the prior quarter as higher deposit costs in the current quarter and lower net operating lease income were partially offset by an increase in revenues on our loans and investments. On slide 7, net finance margin was 3.20%, down 19 basis points from the prior quarter. The prior quarter included three basis points from elevated benefits related to favorable usage collections in rail, as well as a special dividend from the Federal Home Loan Bank. In addition, we estimate the lower day count in Q1 reduced margin by 2 to 3 basis points. The remaining decline this quarter was primarily driven by higher deposit rates, lower net yields on rail operating leases and the impact of higher percentage of average cash and investment securities in average earning assets, which was partially offset by lower borrowing costs.

As Ellen indicated, we experienced strong performance in our Savings Builder product, which was designed to attract long-term savers and increase non-maturity deposits, which we believe will result in longer relationships and better performance in this portion of the cycle. We increased the rate on the product to 2.45% early in January, and while it is currently one of the higher online savings rates in the market, it is lower than online term CDs and gives us more pricing flexibility over the cycle.

With the Savings Builder performance, average total deposits increased 8% this quarter, well ahead of our expectations. As a result, the mix of average cash and investment securities increased to a higher than normal percent of total average earning assets, which we estimate resulted in an almost 8 basis point drag on our margin. We utilized these excess deposits to repay higher cost Federal Home Loan Bank borrowings towards the end of the quarter, and we anticipate utilizing a portion of this liquidity to offset upcoming CD maturities next quarter. In addition, over the course of the next couple of quarters, we intend to deploy the excess cash as we continue to grow loans and leases.

Loan yields remained relatively constant as a full quarter of benefits from the increase in market rates in the fourth quarter of last year were offset by our reduction in day count and yield-related fees. Lower net rail operating lease revenue reduced margin by three basis points from continued repricing pressure in the absence of favorable usage collections in the prior quarter.

Higher deposit rates reduced margin by 16 basis points, reflecting the increase in the Direct Bank Savings Builder rate early in the quarter and continued migration of our customers from products with lower rates. Borrowing costs benefited margin by 7 basis points as the decline from liability management actions taken last quarter was partially offset by an increase in Federal Home Loan Bank rates.

Turning to slide 8, other noninterest income increased \$5 million compared to the prior quarter and includes \$6 million in property tax income related to the amount of estimated property taxes to be collected from customers with an offsetting charge in operating expenses. This change in

financial presentation was a result of the adoption of a new lease accounting standard, and we currently estimate the impact in both property tax income and expenses will be \$25-30 million for 2019.

Capital Markets fees grew from low levels in the prior quarter and will vary depending on the level of activity and type of transactions. For example, recently we've been originating more collateral-backed loans, which generally provides for lower fee opportunities. Last quarter we completed the sale of our private label MBS portfolio acquired in the OneWest acquisition, which had higher yields and higher risk weightings. As a result, going forward the gains on the sale of investment securities are expected to be modest, more opportunistic and dependent on market conditions.

Turning to slide nine, operating expenses excluding intangible asset amortization, increased \$18 million from the prior quarter. \$14 million of the increase was seasonal from higher employee costs related to benefit restarts and acceleration of cost from retirement eligible employees. In addition, there was an estimated \$9 million of operating expenses that resulted from the adoption of a new lease accounting standard, including \$6 million that was offset in other noninterest income that I just mentioned. These increases were partially offset by lower professional fees and technology costs, which can vary from quarter to quarter depending on the timing and progress of various initiatives.

The efficiency ratio increased to 58%, reflecting elevated operating expenses, and we estimate a little over 100 basis points of the increase resulted from the adoption of the lease accounting changes. We remain committed to further reducing operating costs while also investing in our businesses, and we are laser focused on achieving our target operating cost reduction of at least \$50 million through 2020 as we highlighted last quarter.

Slide 10 shows our consolidated average balance sheets. Average earning assets grew 5% from the prior quarter, most of which was from increase in interest-bearing cash and investments resulting from strong deposit growth. Average loans and leases grew 1%, reflecting 2% growth in our core portfolio, partially offset by the runoff of the legacy consumer mortgage portfolio. Average interest-bearing cash and investments increased about 250 basis points to 21% of average earning assets this quarter. The average duration of our investment securities book declined to a little over two years from about three years as we repositioned some of our book to reflect the higher level of liquidity and the flatness of the yield curve.

Slide 11 provides more detail on average loans and leases by division. Strong origination volume, particularly in Commercial Finance and the Equipment Finance businesses within Business Capital drove growth in our core portfolios. As Ellen mentioned, in Commercial Finance while middle-market activity slowed this quarter and continues to shift to nonbanks, given the diversity of our business we continue to see good collateral-based lending opportunities. In particular, communications and technology, power and energy, healthcare and various sub-verticals within C&I experienced strong origination volume this quarter while a higher level of origination volume at the end of the year, as well as lower prepayment activity also contributed to the 4% average loan growth this quarter.

In Business Capital we continue to see strong growth across our equipment financing portfolios, which was mostly offset by a seasonal reduction in the Factoring business. The real estate finance portfolio was down this quarter as we remained disciplined in a highly competitive market. We continue to see good opportunities stemming from our strong relationships, deep industry knowledge and speed of execution.

Our rail portfolio remained flat this quarter as new deliveries offset depreciation and our portfolio management activity. Utilization declined slightly to 97% but remains strong as leases repriced down 10% this quarter. We continue to see strengthening in the tank car market, and although new leases continue to reprice down, the gap has narrowed over the past year. Our freight cars continue to reprice near par; however, small covered hoppers used to transport sand and grain cars are repricing down.

Weakness in the sand market is due to the shift from northern white sand to local brown sand, which we expect to continue. Weakness in grain is due to lower exports, which is being impacted by uncertainty in trade policies. We continue to expect lease renewals on the total fleet to reprice down 15% to 20% in 2019 but will vary quarter to quarter based on the amount and type of cars renewing.

Slide 12 highlights our average funding mix, which reflects the trends I mentioned earlier. One additional item to note is that while Federal Home Loan Bank advances increased modestly during the quarter, period end balances were down as we repaid almost \$1.6 billion in February and March, which had an average rate of 2.8%.

Slide 13 illustrates the deposit mix by type and channel. Average deposits increased \$2.4 billion from the prior quarter to \$33.3 billion, reflecting growth in our online savings account deposits. We also closed four branches in the fourth quarter as part of our cost reduction initiatives with a minimal reduction in branch deposits. The cost of deposits increased as the cumulative beta since the first rate hike of the current tightening cycle in December of 2015 increased to 31% from 23% last quarter. While prevailing market rates have flattened, we continue to expect deposit costs to rise over the next couple of quarters as deposit repricing cycles through and customers migrate to higher savings rate products.

Turning to capital on slide 14, in January we communicated that we had received a non-objection from our regulators to repurchase up to \$450 million of common stock through September 30, 2019. During the quarter we repurchased approximately \$180 million in common shares, consisting of 3.7 million shares at an average price of \$49.16, which was 6% below tangible book value, ending the quarter with just under 98 million shares outstanding.

For the second quarter, we have also increased our common dividend to \$0.35 per share from \$0.25 per common share, a 40% increase. This is our third increase since 2017, and we aspire over time to increase our payout ratio to approximately 30% to 40%, consistent with our regional bank peers. Despite loan growth and capital returns in excess of earnings, our common equity tier 1 ratio at the end of the quarter remained at 12%, the result of regulatory and accounting changes that impacted the risk weightings of certain assets and our trajectory towards our target common equity tier 1 ratio.

A regulatory rule changed the definition of High Volatility Commercial Real Estate, or HVCRE loans, which reduced the risk weighting on those loans from 150% to 100%. This change caused a \$1.15 billion decrease in risk-weighted assets, which we think better reflects the risk characteristics of these loans.

Offsetting some of this reduction was an increase in risk-weighted assets of approximately \$200 million, resulting from the adoption of a new lease accounting standard that required us to record on balance sheet the future liability for our leased facilities and equipment along with the corresponding assets. The net decrease in RWAs will mostly be offset next quarter with the

expiration of the loss share agreement with the FDIC, which is expected to increase RWAs by approximately \$800 million. The impact on our common equity tier 1 ratio was an increase of 26 basis points, which will be mostly offset in the second quarter resulting in a minimal net impact. We maintain our guidance of an 11% common equity tier 1 ratio by the end of this year.

Slide 15 highlights our credit trends. The credit provision this quarter was \$33 million, primarily driven by net charge-offs of \$34 million or 43 basis points, which was within our guidance range. Over the past three quarters, net charge-offs have been at the low end or below our guidance level. The higher net charge-offs this quarter were primarily driven by increases in Commercial Finance, most of which were previously reserved for, and Small Business Solutions within Business Capital. Nonaccrual loans increased this quarter but still remain below 1% of total loans. Reserves declined slightly to 1.56% of total loans, and 1.87% for Commercial Banking, reflecting continued better risk ratings on new originations and the reduction of loans with higher reserves. The broad credit environment remained stable, and new business originations continue to come in at better risk ratings than the overall risk rating of the performing portfolio. Our reserves remain strong and continue to reflect more than four times the last 12 month net charge-offs.

Slide 16 highlights our key performance metrics, reflecting the trends we just discussed. Our return on tangible common equity from continuing operations was 9.7%, down from the prior quarter, reflecting elevated seasonal operating expenses in the current quarter. If you normalize for the semiannual preferred dividend that is paid in the second and fourth quarters, our return on tangible common equity would have been 9.3%. As Ellen indicated, we remain committed to continuing to improve our returns and are focused on achieving a return on tangible common equity of 11% in the fourth quarter of 2019 and at least 12% by the fourth quarter of 2020. Further improvements will come from capital optimization, revenue growth in our core businesses and reductions in operating expenses.

Page 17 highlights our outlook for the second quarter. We continue to expect low single-digit quarterly growth in our core portfolio and slightly lower growth in the total portfolio, reflecting the runoff of the legacy consumer mortgage portfolio. Net finance margin is expected to be in the low to middle area of our target range due to continued headwinds from a higher mix of cash and investments, as it will take a couple of quarters to work through the excess liquidity. We also expect higher deposit costs, reflecting a full quarter impact from the deposit growth and continued migration of our depositors into higher rate products. However, these costs will be partially offset by lower borrowing costs from the Federal Home Loan Bank debt we repaid towards the end of the quarter.

Finally, downward pricing on the rail book will also continue to pressure margin. We expect operating expenses to decline from elevated seasonal compensation and benefit costs in the first quarter but continue to reflect the lease accounting changes. We have also provided guidance for the full year to reflect the impact from the lease accounting changes. We continue to expect operating expenses for 2019, excluding intangibles and the impact of lease accounting changes, to decline approximately 3% from the 2018 level of approximately one billion fifty. However, for modeling purposes we now include our full-year operating expense guidance, our expectation of a 1%-2% increase, including the impact of lease accounting changes.

The net efficiency ratio is expected to remain in the mid to high-50% area next quarter, reflecting the trends I just mentioned and including the impact of lease accounting changes.

Credit metrics and the effective tax rate absent any discrete items are expected to be consistent with our full-year outlook. And with that, I will turn the call back to Ellen.

Ellen Alemany

Thanks, John. In closing, I want to reiterate our commitment to achieve an 11% return on tangible common equity at the end of this year and at least 12% by the end of next year. We remain focused on steady execution of our plan and delivering long-term shareholder value. With that, we're happy to take your questions.

QUESTION AND ANSWER

Operator

We will now begin the question and answer the session. To ask a question, you may press "*" then "1" on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please press "*" then "2." At this time, we will pause momentarily to assemble our roster. The first question comes from Moshe Orenbuch of Credit Suisse. Please go ahead.

Moshe Orenbuch

Great, thanks. I wanted to talk a little bit about the net finance revenue and net finance margin. You mentioned the online deposit costs and it looks like they widened maybe as much as 10 basis points relative to your bank deposit costs. And I mean, you said you're going to be able to use the deposits a little more efficiently, I guess, as we go through the year, but what are your thoughts in terms of the pricing as you go through with respect to deposits? And then I'd like to follow up on some of the yield items.

John Fawcett

Yeah, so Moshe, this is one of the things we look at pretty closely. I think if the 2.45% was clearly at the high-end of the range in terms of the market, there are rates that are higher. There's a couple right around 2.45% and there's a bunch at 2.40% and 2.30%. So we are a little bit long in terms of rate, but I think that was part of the plan. If you look back to what we did back in the first quarter of 2018, we launched the same kind of promotion.

I think one of the things that we are really pleased with in terms of this promotion is that we added almost 50,000 new relationships. If you went back to last year, it took us the first and second quarter to actually add about \$3 billion of deposits and it took us two quarters to raise about the same number of relationships. So we are pleased with that.

I think the second thing is that we are competing in, you know, the money market space as opposed to the CD space. And so if you look at one of your CDs, they're 2.80%, 3%. And so that feels pretty good. I think the test of time will be our ability to actually hold onto those relationships. But this isn't just a wide net cast. These are targeted relationships that we are going after and so we're looking for generation X, Y, and Z. This is the population that comes in with relatively small balances, \$45,000 and less and the savings builder program was built as a program that you could be a continuous saver by adding \$100 a month to an account and get the preferred rate. So you know, I think we are pleased with the program. If I had my druthers sitting in a finance chair, I guess I wish it was a little bit less successful, but we are what we are.

Moshe Orenbuch

Got it. And then maybe turning to the yield side, you mentioned the railcar, you know, I guess we were sort of sitting here hoping for rising energy prices and that we got it and now I guess, I

mean, maybe could you just elaborate a little on your comments about the yields on some of the various cars and maybe when we could expect those to inflect back in kind of a more upward direction?

John Fawcett

Yeah, let me start with last year in terms of the guidance that we provided last year. And so last year, we guided to prices down 20 to 30% and we actually came in down about 14, 15%. This year we are guiding down 15 to 20%. If you look at the renewals actually in the first quarter, it was a fairly low population in terms of the type of cars that actually renewed. And we are seeing at least in the tank cars, they're repricing ahead of plan. They are still less than prior renewal rates, but ahead of plan.

I think what we're starting to see a little bit of challenge is, and I mentioned this in the old script, is in the sand cars and the challenge between northern white sand and more local brown sand as it relates to fracking. And so that's become a bit of a challenge and we are seeing the sand car re-price down. I think the good news from a sand car perspective is that they are multi use cars and they can be repurposed into cement, and so we'll see how that goes. But that was a part of the drag that we saw in the first quarter and I guess as the geology around brown versus white sand continues to play out, we would expect potentially that more of our sand cars would be converted into cement cars.

Moshe Orenbuch

And just around that, given that you, you know, your first half margin will likely be kind of in the lower half of your guidance range, what is it that gets it back? Is it the utilization of those deposits in the back half of the year? How does it, when is it going to get back up?

John Fawcett

Yeah, so clearly, it's part deposit utilization. I think in Business Capital, we are continuing to experiment with price expansion. And we started that in the second and third quarter of last year, we are continuing to keep our toe in the water in terms of where we can start to expand. Given the flatness of the yield curve, it's not likely that were going to see any margin expansion in Commercial Finance or Commercial Real Estate.

And then, there are opportunities to continue to pay down some of the more expensive federal home loan bank borrowing and we do have a fairly robust pipeline in terms of new business activity that's coming. And so little bit of a way to think about this is we pre-funded growth on the left-hand side of the balance sheet and as we plan out in terms of the overall mix of deposits, we do have some CD clips coming in the second and third quarter of this year, which again, we are pre-funded on.

Moshe Orenbuch

Got it. Thank you.

John Fawcett

You're welcome.

Operator

The next question comes from Eric Wasserstrom of UBS. Please go ahead.

Eric Wasserstrom

Thanks very much. Just to get to maybe a different topic in the efficiency ratio and just kind of to understand the quarterly cadence, obviously you started the year up at 58 and if the full year is a mid 50 target including the accounting changes, it suggests that you're ending the year in the low 50s. So can you just, because it seems like that's the primary Delta in terms of the improvement in the ROTCE, so can you just help me understand what gets you there over the next three quarters, where we should look for the changes? Yeah, I guess that's really the core of the question.

John Fawcett

Yeah, so Eric, obviously in the first quarter, we had the impact of the FICA resets and some of the retirement benefits that have kind of cycled through. The lease accounting actually presents a bit of a challenge for me internally because I don't want to keep two sets of books, but that's probably worth another 125 basis points, which kind of resets the expectations around where we are going to go on the efficiency ratio.

In terms of the things that we are doing in the expense space, we are literally looking at everything. I think Ellen has made a very conscious effort to invest in technology and digitization of the company in rightsizing people as we kind of invest in the technology to support the place. I think one of the ways that I kind of look at the expenses is that if you compare the fourth quarter X intangibles of \$270, you back out the accounting changes, so property tax is six, the deferred origination cost another three, adjust for benefit restarts and I get down to about \$247, which is apples to apples versus Q4.

So if you just run rate the first quarter for these anomalous one-time events, you get to a run rate that's about \$1 billion, which kind of suggests that we are on the path to continue to be bigger. Now, there's going to be ups and downs quarter to quarter, but through the first quarter absent some of the noise in the accounting and FICA resets, we feel like we are in a pretty good place and we haven't taken our eye off this ball.

Ellen Alemany

Yeah Eric, this is Ellen. If I could elaborate more on the expense side, so we have a lot of specific initiatives to target against the whole \$50 million number reduction that we had identified. Just in terms of labor cost optimization, we are looking at lower cost locations, we are still working on rightsizing, we are converting contractors to perms at a much lower rate, we have some strategies to reduce FDIC insurance costs. You know, John had mentioned we have done some branch closures and were also looking at further real estate rationalization. Credit reengineering is a really big opportunity for us. And then, you know, just other things like records management, travel and expenses, so we've got all of these are well underway and we are making good progress.

Eric Wasserstrom

Thanks for that, Ellen. And just to clarify, the 11% target, is that inclusive or exclusive of the impact from accounting change?

John Fawcett

It includes the effects of the accounting change. It's 11% return in terms of common equity in the fourth quarter of 19.

Eric Wasserstrom

Got it. And so if I'm just understanding correctly, it would seem that the accounting change is approximately a 90-basis point headwind to that target, is that right?

John Fawcett

I don't think it's that high. Yea, we'll take we can take this off-line and Barb will follow up with you, but it's not 90 basis points. It's smaller than that.

Eric Wasserstrom

Great. Thanks very much.

John Fawcett

Thanks, Eric

Operator

The next question comes from Chris Kotowski of Oppenheimer. Please go ahead.

Chris Kotowski

Yeah, good morning. My favorite slide was slide 20 when there were no noteworthy items this quarter.

Ellen Alemany

Ours as well

Chris Kotowski

And I guess what I'm wondering is, you know, Ellen, you outlined a vision of a national middle-market bank a couple of years ago and at that time, the only thing that I can think of that doesn't fit with that vision is still the maritime portfolio. And I'm curious, are we kind of done with a major restructuring items now? Are there still more things to go, and can you update us on whether the maritime, is that strategic in core or are there any other major restructuring items left as far as you can see?

Ellen Alemany

Sure. So one is just in terms--I mean, I think the focus on Commercial Finance are really collateral-based portfolios. And to the extent that maritime fits that, we're going to do more collateral-based deals. I think in terms of the major divestitures, we are pretty much finished, although I have to say that looking at our portfolios is a dynamic process; we are always looking at ways to market opportunities and ways to optimize the portfolio. But just in terms of the core strategy, we are basically, every business has a set of revenue initiatives that we are working on, we're going to continue with strengthening our funding profile going forward.

Right now, deposits are roughly represented about 81% of our total funding and we have a loan to lease deposit ratio of 92% at the bank. John and team have been making really good progress on the capital front. Operating efficiency, you know, we put the new \$50 million target out there and then really from a risk perspective, as I said, the whole shift in the portfolio has been to more collateral-based.

That being said though, we set out the target of at least 12% next year, which we recognize is still behind other banks. And so we are opportunistically looking for portfolio purchases, small deposit acquisitions. We recognize that where our stock trades, it's really difficult for us to make an acquisition. And so as I said, we're hoping that we get one of these opportunities to accelerate the 12%.

Chris Kotowski

Okay. Alright, that's it for me. Thank you.

Operator

The next question comes from Arren Cyganovich of Citi. Please go ahead.

Arren Cyganovich

Thanks. I guess just kind of following up on your last comment, Ellen, M&A, it seems like you would have some opportunity if you could acquire some sort of lower-cost deposit based at least maybe some better opportunities than some other peers. I know that you don't have a great currency for that, but can you talk about the ability or how you think about acquiring some lower-cost, higher-quality deposits? And then the comment on portfolio purchases, what would you say the environment is for that? Are you seeing very many portfolios available to add to the balance sheet?

Ellen Alemany

Yeah, so one of the things we want to do to improve our valuation is to continue to have more deposit funding as a franchise. And we also think that there's still a lot of upside in our valuation. I think the portfolio purchases, most of the portfolio purchases we are looking at would be in the Business Capital space. You know, we are acquiring large programs, so what we did was we created a sales force and Business Capital that's really hunting for the large programs out there and having a conversation with the customer, how can we help you with your customer financing. And if you win one of these programs, you can get significant volume.

You know, there's been I would say over the last 18 months a fair amount of leasing companies that have put themselves up for sale. We've looked at some of these transactions and we, either because of price or credit, we didn't win any of these transactions, but as I said, we are still continuing to look there. And then with the deposit acquisition, you know occasionally we see something come up in the marketplace and it really is coming down to price on these transactions.

And then we also, I mean, there have been some obviously MOEs announced in the marketplace and I think the nice part of these transactions is that it can create value without paying a premium for the transaction. We've had lots of discussions with our Board where we are all interested in maximizing long-term shareholder value and we are very open to any type of a transaction.

Arren Cyganovich

Okay, that's helpful. Thank you. And then I think John had mentioned in the Commercial Banking, Commercial Finance that you're facing still some non-bank competition. Can you talk about where that's coming from? Is that coming from private funds, is it coming from BDCs just something that whatever we talked about a lot of our non-bank commercial mortgage rates, BDC's they typically, they don't really indicate they are competing with banks. I'm just trying to understand better where you are saying that competition coming from.

Ellen Alemany

Yeah, I think in the leverage finance space in particular, we are competing with the BDC's, but I think it was a little less this last quarter as reflected by some of the lower prepayments that we've had in the business. But as I mentioned, our strategy is to go more towards the collateral-based transactions and we've, for example, we've increased our healthcare real estate portfolio, we are expanding our corporate and industrial financial services group, we reintroduced aviation

financing, we've done a little maritime lending, so that's where we've seen most of our growth going forward.

And then we are still active in communications and technology and in energy. But we are seeing still a lot of competition in the BDC space, which was one of the things that drove us to form the Northbridge joint venture to allow us to participate in some of these transactions without--we can originate them and not put them on our books.

Arren Cyganovich

Okay.

John Fawcett

I guess the only thing I would add to that is that, especially as it relates in the commercial real estate space where we are actually seeing average loan balances decline, we've opted not to compete on terms and conditions, and so we're kind of sticking to our discipline and that's across the board. So we are not trading credit for volume and won't.

Operator

Was there a follow-up, Mr. Cyganovich?

Arren Cyganovich

No, sorry. I'm good. Thank you.

Operator

Again, if you have a question, please press "*" then "1" on a touchtone phone. The next question comes from Scott Valentin of Compass Point. Please go ahead.

Scott Valentin

Yeah, good morning, everyone. Thanks for taking my question. Just with regard to the increase in net charge-offs linked quarter, I know you kind of attributed it to just general Commercial Finance and Business Capital, but any specific industries or geographies you're seeing, any stress?

Ellen Alemany

Yeah, so this is Ellen, Scott. In Business Capital, we did experience a higher level of net charge-offs in Small Business Solutions, which is our direct online banking platform and we saw some pockets in the transportation and restaurant industries that showed some weakness there. And you know, we think that these are industries that have been impacted by labor market shortages and higher wages.

We also had some challenges in our collection process in that area, and as a result, we've quickly modified our underwriting practices and we also augmented some of our collectors. You know, the business has been growing rapidly and I don't think we hired as many collectors as we should have, so we had this kind of blip in charge-offs in Business Capital. But I would say that otherwise in general we haven't seen anything abnormal. We're still projecting losses and everything to be within the guidance that we've given the market.

Scott Valentin

Okay, that helps. And then I think you mentioned healthcare as being one of the, healthcare real estate as being one of the areas you focused on for growth, there seems to be a lot of uncertainty around healthcare currently, I'm just wondering how you'd kind of be comfortable

with these kind of the longer-term loans typically in real estate and just given potential changes in the healthcare environment, how you're getting comfortable or what assets you're selecting to minimize credit concerns.

Ellen Alemany

Yeah, I think in the healthcare real estate portfolio, we've increased a portfolio by roughly I think around \$.5 billion over the last couple of years. And you know, the idea there is we are secured by real estate, we are focusing on medical office buildings, and then we are also specializing in skilled nursing and assisted living facilities there.

Scott Valentin

All right, that's it for me. Thank you very much.

Ellen Alemany

You're welcome.

Operator

The next question comes from Vincent Cantic of Stephens. Please go ahead.

Vincent Cantic

Hey, thanks. Good morning. Two related questions. So first on the volume growth and then on yields. So the first question, so nice to see that the core average loans and leases were up 7.5% year-over-year. I guess for your guidance for next quarter and then also for the full 2019, you're in the low to mid-single digit growth range. So I am wondering was there something in the first quarter that drove higher than what would be for the years' growth rate? Is there any seasonality or anything of that nature? And then relatedly on the yield side, I would've thought that yields would have been higher just from seeing a LIBOR move higher, so I'm just wondering if you could expand on maybe some of the yield guidance for some of those different asset classes moving lower. Thank you.

Ellen Alemany

I'll have John address the yield, but I think in terms of the volumes, I mean one is we have the impact of some of the liquidating portfolios and on the business. But you know, I think in general, customer sentiment remains pretty optimistic. You know, the rate environment is competitive, but pipelines are strong, especially in Business Capital and Commercial Banking. You know, some customers still have some concerns with the broader economy, there are some concerns with tax reform in China and Brexit, some of the uncertainty there, but I would say it's just a solid sentiment on business and that in both commercial banking and in business capital.

John Fawcett

So as it relates to, and I just want to make one other point, around the balances that you're seeing in Commercial Finance, it was a lot of activity in the last couple of weeks of the fourth quarter, which did reflect the average balances of the fourth quarter, but obviously carried through to the entirety of the first quarter of 2019. On a normalized basis, we'd probably expect to see within Commercial Finance growth of 1% to 1.5 to 2% quarter over quarter. But still the predominant growth engine for this franchise is in Business Capital.

In terms of what you're seeing in yield is a lot more of it is that we are doing collateral based lending. And so inherently less risk. There's a change in mix that we live with quarter on quarter, and then also in the first quarter, we had a lower level of prepayments and you'd probably have

to go back to the first quarter of '17 to see as low a level of prepayments, which also impacted yields.

Vincent Cantic

Okay, got it. Makes sense. Thanks so much.

John Fawcett

You're welcome.

CONCLUSION

Operator

This concludes our question and answer session. I would like to turn the conference back over to management for any closing remarks.

Barbara Callahan

Thank you, Andrew. And thank you, everyone, for joining this morning. If you have any follow-up questions, please feel free to contact me or any member of the investor relations team. You can find our contact information along with other information on CIT in the investor relations section of our website at cit.com. Thank you again for your time and have a great day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.