CIT Group, Inc.

Second Quarter 2020 Earnings Conference Call

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CORPORATE PARTICIPANTS

Ellen Alemany - *Chairwoman, CEO*

John Fawcett - *CFO*

Barbara Callahan - *Head of Investor Relations*

PREPARED REMARKS

PRESENTATION

Operator
Good morning and welcome to CIT's second quarter 2020 earnings conference call. My name is Rocco and I will be your operator today. At this time, all participants will be in a listen-only mode. There will be a question and answer session later in the call.

As a reminder, this conference call is being recorded. I would now like to turn the call over to Barbara Callahan, Head of Investor Relations. Please proceed ma'am.

Barbara Callahan

Thank you, Rocco. Good morning, and welcome to CIT's second quarter 2020 earnings conference call. Our call today will be hosted by Ellen Alemany, Chairwoman and CEO; and John Fawcett, our CFO. Also joining us for the Q&A discussion is our Chief Credit Officer, Marisa Harney.

During this call, we will be referencing a presentation that is available in the Investor Relations section of our website at cit.com. Our forward-looking statements disclosure and non-GAAP reconciliations are included in today's earnings materials and within our SEC filings. These cover our presentation materials, prepared comments, and the question and answer segment of today's call.

I'll now turn the call over to Ellen Alemany.

Ellen Alemany
Thank you, Barbara. Good morning and thank you for joining the call. The COVID-19 pandemic has continued to affect the broader economy and that has carried over to our financial results in the second quarter, although to a lesser degree than we experienced in the first quarter.

As a result, we posted a net loss this period of $98 million or $0.99 per diluted common share.
CIT began this year in a position of strength. With the multi-year strategic transformation reinforcing our foundation and the completion of the recent acquisition adding to our franchise capability. That strength, along with the agility of our team, will help us to continue to navigate through this unprecedented time. John will go into a detailed account of the drivers in the quarter but some key factors in performance were lower net finance revenue, primarily due to lower interest rates and holding elevated levels of liquidity during this turbulent period, lower factoring commissions, due to retail store closures; and a $73 million net charge-off related to a single factoring bankruptcy exposure. We also continued to build our allowance for credit losses, but with the substantial reserve build in the first quarter, the impact on our provision was much lower.

Despite these factors, there were also pockets of strength in the quarter. Our average deposit costs declined by 27 basis points, and we were able to use some excess liquidity to repurchase $235 million of unsecured bank notes at a discount. Our average loans and leases were up 2% from last quarter, which included defensive draws on revolvers in March, as well as new originations in stronger segments of the commercial market. Our capital and liquidity positions remained strong. Our integration plan from the recent acquisition is on track, and we are unlocking greater operating efficiencies than originally anticipated. Our operations have continued uninterrupted with all our branches remaining open and our customer operations running smoothly, many in a remote model. And, we are proactively managing our credit risk through this dynamic period.

I want to spend some time on what we're seeing in the business and how we are leveraging our strengths in the current environment. First and foremost, CIT's business model is very diverse. We operate across a variety of commercial segments and have deep industry and asset class expertise to support those segments. That is a tremendous advantage across market cycles. It enables us to pivot quickly, take advantage of attractive opportunities and manage our exposure in areas that are more directly impacted by the current environment. And, that is exactly what we've done through this pandemic. Let me focus on a few of the opportunities first.

The Power & Renewables business has continued to be very active with virtually no disruption through the pandemic, and CIT is a leader in this space, ranking third in the league tables. We closed five deals where we were the lead or co-lead since March, and we have another ten lead deals in the pipeline for the second half. Most recently, we announced a $118 million deal for a 112-megawatt solar facility in North Carolina, which demonstrates the continued demand for renewable power.

In addition, we are seeing strong transaction activity in the Technology, Media and Telecom division as stay-at-home guidelines have supported continued investment in telecom infrastructure, cloud-based datacenters, as well as additional streaming media content production and distribution. Our Capital Equipment Finance division had a record quarter as borrowers were looking to leverage their fixed assets. We were able to finance several investment grade and near investment grade borrowers given our deep asset class expertise. There are good yields in this asset class, and we were also able to opportunistically purchase small portfolios from larger banks looking to manage obligor limits. CIT has a long history in the asset-based lending business, and this is an area we are expanding as we see some solid opportunities in the pipeline for the second half that align with our capabilities. And, on the Business Capital front, we began to see an uptick in applications and volume toward the end of the quarter as certain businesses started to return to their operations. As a result, our volumes in June were consistent with where they were a year ago. In short, we are seeing opportunities open up and our agility, expertise and balance sheet strength have allowed us to capture those opportunities.

Credit, of course, does remain a challenge in this environment, but many of the qualities I mentioned that help us originate business, also help us manage our risk. Our size, industry knowledge and asset class expertise allow us to quickly adapt and proactively manage issues when they arise.

As soon as the pandemic began, we implemented heightened monitoring and portfolio management practices. That included a loan-by-loan review, daily portfolio and industry reporting, and redeployment of resources to help manage portfolios that are most-affected by the economic disruption. We have granted relief across more than 10,000 smaller ticket Business Capital loans and leases and about 200 Commercial Finance and Real Estate contracts totaling about $2 billion in net investment combined, and we are underwriting each larger ticket loan modification to ensure there is a path to recovery. We participated in the PPP program, with the majority of customers accessing the program being community-based small businesses in our branch footprint. We also recently launched the Main Street Lending program for our midsized clients. We are staying disciplined to find new opportunities and assist our current customers through this period, when possible.

Before I pass it to John, I want to touch on some of our strategic initiatives. The integration of our recent acquisition of the former Mutual of Omaha Bank is progressing nicely and remains on track for this year and ahead of schedule on operating efficiencies. Despite all the complexity the pandemic has brought, the team is making great progress in bringing together the teams, technology, products and footprint.

The homeowner association deposit team is hitting their goals with average HOA deposits up 8% to 5.3 billion. This is great progress and was a key driver of the acquisition. Continuing to build out this channel will give us even greater funding flexibility and at lower costs. Likewise, the newly integrated Treasury & Payment Services team is bringing in additional commercial deposits from new and existing clients, also at lower costs. These average deposits are up 18% in the quarter to $3.9 billion, with costs down to 43 basis points. Build out of these deposit channels complement our consumer deposits in the direct and branch channels and provide great funding flexibility and diversity.

As part of our integration efforts we also recently signed an agreement to sell the wealth management business that was part of the former Mutual of Omaha Bank product offering. As we conducted a strategic review of the business, we determined it was not the right fit for our model. This is a very small transaction and is more about CIT focusing on areas of strength and divesting of activities that are not aligned to our strategy. We expect the deal to close in the coming months, and we will provide additional detail at that time. As I mentioned, we are unlocking synergies through the acquisition faster than anticipated and, as a result, will be realizing about $25 million of our 2021 cost savings ahead of schedule this year.

In recent years CIT has proven time and again that we have a culture of performance and the fortitude to deliver on our commitments and continuously improve. That spirit remains through this pandemic. We understand the economic disruption is not behind us yet, however, we took prudent actions in the first half of the year to anticipate the impact of this downturn, based on the best available information. While the environment remains dynamic, based on what we know today, we are cautiously optimistic for the second half of the year and in our ability to restore a modest level of profitability, assuming the macroeconomic environment does not deteriorate further.

With that, I'll turn it to John.

John Fawcett
Thank you, Ellen, and good morning everyone.

As mentioned, we reported a GAAP net loss of $98 million or 99 cents per diluted common share, and a loss of $61 million or 62 cents per share excluding noteworthy items. Our results this quarter continue to reflect the ongoing global pandemic and low interest rates as we manage through the current environment. Overall business activity slowed in the earlier part of the quarter, but in June we began to see activity pick up in many sectors where we have strong capabilities.

Assuming there is no significant change in the current or forecasted macro environment, or in the expected credit performance of our portfolio, we expect to return to profitability and generate modest positive earnings in both the third and fourth quarters of 2020. Last quarter, we were proactive in our implementation of CECL and appropriately added substantial reserves reflecting the COVID-19 environment. While this quarter's credit provision was considerably lower than in the prior quarter, it remained elevated as we continued to bolster reserves and incurred a $73 million charge related to the bankruptcy of a single factoring customer in the retail industry. The factoring loss was a result of unique circumstances directly related to the precipitous economic shutdown and store closures. While we have reserved for additional charges in the retail industry, we do not anticipate another single customer loss of that magnitude in our factoring business.

Overall, based on our forecasted view of the macro environment, we expect the provision to continue to moderate next quarter, obviously subject to conditions, which remain fluid. Our net finance revenue and margin were significantly impacted this quarter by the lower market rates, primarily Libor, which reduced our floating rate loan yields. In addition, we had a higher level of excess cash, primarily due to strong deposit growth, which we estimate reduced our margin by 30 basis points as it earned only about 10 bps at the Fed.

We took actions to offset some of this margin pressure by lowering our deposit costs throughout the quarter, particularly in our on-line channel where we lowered our savings builder rate by 80 basis points to below 1 percent at quarter end. We utilized some of our excess cash to tender for our unsecured bank notes, repurchasing $235 million at a discount, recognizing a $15 million gain and reducing interest expense by approximately $7 million annually. Assuming Libor rates remain relatively constant, we believe the margin has bottomed and we will see a 10-20 basis point improvement over the course of the third and fourth quarters as the benefits of lower deposit costs continue to be realized and we reduce our excess liquidity.

Other non-interest income was impacted this quarter by lower factoring commissions as volumes declined considerably due to retail store closures. We also had lower gains on asset sales as we suspended some of our portfolio management activities. Factoring volumes improved in the first half of July and have been running at approximately 98% of 2019 levels, as retailers replenish inventory. While we expect factoring volumes and commissions to improve from second quarter levels, uncertainty of the back to school season may temper that improvement. We are also seeing renewed opportunities to resume selling pools of loans in our legacy consumer mortgage portfolio and would expect to complete a transaction if existing conditions continue to prevail.

We continue to look for opportunities to improve upon our operating efficiency. This quarter we took a restructuring charge of $37 million primarily related to employee cost and contract terminations. $15 million was already planned as part of the Mutual of Omaha Bank merger and integration costs, while the other $22 million related to cost reduction initiatives that we expect to realize over the next 12-18 months.

We are lowering our full year 2020 operating expense target, excluding noteworthy items and intangible asset amortization, by $25 million to approximately $1.185 billion, as we are realizing some of our 2021 cost savings ahead of schedule. This reduction includes the acceleration of cost synergies related to the integration of Mutual of Omaha Bank as we bring our two businesses together. In addition, we are responding quickly to the current environment, which has allowed us to accelerate our plans to rationalize our footprint, including the optimization of former Mutual of Omaha Bank branches and the streamlining of office locations. We plan to reduce our occupancy by 500,000 square feet, representing 30% of our total footprint. These actions are expected to result in an impairment charge of approximately $15 million in the fourth quarter, with an estimated payback period of 18 months or less. We remain focused on continuous improvement and will provide an update to our 2021 operating expense target as we gain more clarity on the operating environment.

I will now provide some additional color on our operating trends and refer to our earnings presentation starting with Net finance revenue and margin on slides 7 and 8. As I mentioned, the sharp decline in both net finance revenue and margin were primarily driven by lower market rates and a higher mix of cash.

Average Libor rapidly declined by around 100 basis points this quarter, impacting margin by approximately 40 basis points as our floating rate loan yields declined. About 60% of our floating rate loans have interest rate floors and, since the downturn, we have been getting Libor floors of 75-100 basis points on most new commercial loan originations in Commercial Finance and seeing improvement in spreads in many of our industry verticals. As I mentioned, the higher mix of cash coupled with lower rates also negatively impacted our margin by 30 basis points. We expect some of this to reverse as we deploy our excess liquidity and higher cost term CDs run off.

Lower rail utilization and renewal rates as well as increased storage costs for cars off lease reduced margin by 10 basis points in the quarter. The North American industry railcar fleet continues to be oversupplied with 32% of the fleet now in storage driven by the general slowdown in economic activity. While our fleet is diverse and representative of the broader economy, many car types saw a reduction in utilization and pricing on new leases.

Our rail utilization declined approximately 300 basis points to 88% and lease renewals, repriced down 30% this quarter reflecting current market conditions and the mix of cars that came up for renewal. In particular, sand cars used in the E&P space weighed heavily on repricing activity this quarter while grain cars, plastic pellet covered hoppers and certain box cars continued to renew at above average rates.

Macro indicators in recent weeks are starting to show some rail recovery from COVID-19 as many factories have resumed at least partial production late in the quarter, and although still well below 2019 levels, rail loadings have improved over the past few weeks from their COVID-19-trough levels. As the economy starts to recover and commodity prices drift higher, we expect rail utilization and pricing to improve, although with a bit of a lag as excess capacity from cars in storage, but still on lease, will be brought on line first. With that background, assuming the forecasted macro environment, we anticipate a modest reduction in net rail yields over the next two quarters as leases continue to reprice down. We expect utilization to push back up into the low 90% area over the next few quarters and improve to the mid 90% area by the end of 2021. We believe our young, diverse fleet with more high load capacity cars are competitive advantages, resulting in higher demand for our railcars, while sand cars used in the E&P space, particularly fracking, are expected to continue to weigh on the recovery.

On the liability side, to offset the impact of lower rates on our assets, we have been aggressively lowering deposit costs. We improved our margin by 21 basis points in the quarter as CDs repriced lower and we lowered our non-maturity deposit rates across all deposit channels. The biggest rate decline in the quarter was in our Online Channel where we lowered our Savings Builder rate by 80 basis points, ending the quarter below 1%.

We also grew average lower cost HOA and commercial deposits by about $1 billion dollars, further contributing to lower deposit costs. The HOA deposit channel reached its highest level ever at $5.3 billion and growth in commercial deposits was driven by both new and existing commercial clients while costs declined by about 20 basis points. As Ellen indicated, we are pleased with the progress we are making expanding these channels and remain on pace to realize growth projections in the HOA channel. As I indicated earlier, we expect the margin will improve over the course of the third and fourth quarters by 10-20 basis points as the full impact of the recent rate reductions are realized along with continued downward repricing or reduction in maturing CDs and growth of lower cost HOA and commercial deposit channels. In addition, we continue to look for opportunities to reduce non maturity deposit rates while balancing our liquidity needs.

Slide 12 provides more detail on average loans and leases by division. Average loans and leases grew by 2% this quarter, which includes the impact of increased defensive revolver draws in Commercial Finance at the end March, new business volume in key sectors where we are seeing opportunities in the current environment and a lower level of prepayments. End of period balances declined as repayment of factoring invoices outpaced new factoring volume and defensive revolver draws from the end of last quarter were repaid.

While origination volumes were down reflecting the current environment, we continued to close deals for our clients and are seeing opportunities in certain industry verticals and in equipment lending where we have strong leadership as well as industry and asset class expertise. New business activity in Commercial Finance was driven by key verticals such as Power & Renewables and Technology, Media and Telecom, which included opportunities for capital markets and derivative fees.

As Ellen indicated, we are also seeing good opportunities in the current environment within Capital Equipment Finance. Overall pipelines in Commercial Finance are lower than last year reflecting the business slowdown, but we continue to see increased activity in the areas I just mentioned, along with Healthcare and asset-based lending. We are also seeing wider spreads and structural improvements, including Libor floors, on new originations.

In Business Capital, Equipment Finance is taking market share as other small ticket equipment lenders have paused or exited the market. We are also seeing increased demand in programs where we partner with technology manufacturers to provide financing to their customers.

In Small Business Solutions, we are taking a more focused approach and providing lending in industries less impacted by the COVID-19 pandemic while pulling back from certain higher risk industries. Overall Business Capital applications, which slowed considerably earlier this quarter have seen a pick-up in in the past several weeks as June origination volume increased to June 2019 levels. We remain cautiously optimistic for an increase in origination activity in the third quarter in select areas.

As Ellen indicated, we continue to work with our customers to provide payment deferrals for qualifying customers impacted by the economic events brought upon by COVID-19. As of the end of the quarter, we had granted relief requests to about 1,700 consumer customers with a carrying value of approximately $630 million. We also granted about $1.4 billion in relief requests for over 200 commercial transactions across Commercial Finance and Real Estate Finance, as well as $550 million representing approximately 10,000 smaller ticket equipment contracts in Business Capital and another $180 million over 100 contracts in our SBA business.

It is still early days as some of the first deferrals are just expiring, but so far the trends are relatively consistent with our expectations as we have been staying close with our customers. For example, we conducted a comprehensive calling campaign, making about 9,000 outbound calls to our Small Business Solutions customers over the quarter and continue to be in touch with them as their deferral period ends.

In our middle-market loan book, we have not experienced a large second wave of deferrals yet, but expect deferral requests in third quarter as borrowers begin refining their 12 - 18-month financial forecasts. We are closely monitoring this activity and have provided some additional information on slide 3 of the presentation.

Overall, we think average loans and leases will be relatively flat next quarter reflecting the lower end of period second quarter balances and as we continue to support our customers and focus our originations activity on strong risk adjusted opportunities that play to our strengths.

Slide 15 and 16 highlights our credit trends and provision. Net charge-offs increased significantly this quarter to $170 million. Apart from the one factoring customer bankruptcy of $73 million that I previously mentioned, net-charge offs were $97 million, or 1.02% of loans, about three-quarters of which were already [specifically] reserved for and therefore did not have a [significant] impact on our provision.

The retail sector had been facing headwinds prior to this current crisis and we had been actively reducing exposures to troubled retailers prior to the onset of COVID-19. The $73 million charge related to a single factoring bankruptcy was unanticipated and a direct result of the retail shut down, which precipitated a voluntary bankruptcy. While there were a number of retail bankruptcies this quarter, with the exception of the one I just mentioned, we either did not have exposure to those names or we had previously exited or reduced our exposures to low levels prior to the bankruptcy. We expect continued pressure in this industry, and we are monitoring the developments in this sector closely and remain in constant contact with our customers and clients.

Our current factoring exposure in the retail sector is approximately 1.7 billion, down considerably from $2.9 billion at the end of last quarter as collections have outpaced new factoring volume driven by the store closures brought on by the COVID 19 pandemic. In addition, only $250 million of receivables had extended terms at the end of June, down from $900 million in April. Our top 25 exposures include traditional retailers as well as well-known online, big box and discount retailers. The top 5 customers, which are rated single A to double A, comprise a little over 40% of the total factored retail exposure. The next 10 largest exposures are between $25 to just under $50 million dollars of which five are investment grade with the largest being non-investment grade. After that, the remaining customer base, comprising approximately $600 million of exposure, is very diversified across approximately 28 thousand accounts.

As I mentioned, so far July activity has been surprisingly strong as retailers look to restock depleted inventory levels. We are also seeing strength in the furniture sector and increased factoring volume with discount retailers. That said, a second wave of COVID 19, which could result in reduced traffic and/or store closures, remains a concern. We have a robust approval and monitoring framework in place to review customer exposures on a weekly and monthly basis and where appropriate, we continue to implement risk mitigation actions and price enhancements.

With respect to our credit reserves, this quarter we established reserves of $58 million on individually evaluated accounts and increased our collectively evaluated reserves by $107 million for on-balance sheet exposures. This quarter, we utilized the June baseline scenario from a provider well known in the industry that assumed a more [severe] V shaped recession and longer recovery than the March baseline scenarios that we used to determine our credit provision in the first quarter.

We also applied a qualitative adjustment for other factors that include macro uncertainty, model uncertainty and sensitivity to changes in assumptions as well as additional risks to specific industries or portfolio segments, such as oil and gas, factoring and small ticket commercial loans. As a result, our coverage ratio increased approximately 40 basis points to 3.5% on commercial banking loans and 30 basis points to 3.2% for total loans. Assuming no significant change in the outlook, we expect the provision to continue to moderate next quarter. Non-accrual loans increased significantly in the quarter primarily driven by loans in Commercial Finance and Real Estate Finance.

As Ellen indicated, we have put in place heightened monitoring to carefully watch specific industry trends and indicators of delinquencies. In Commercial Finance, Real Estate Finance and Rail, we have conducted a loan by loan review, identified high risk exposures, performed stress analyses and prioritized our most vulnerable accounts.

We are monitoring revolver advances and borrower relief requests for vulnerable borrowers on a daily basis. We have also adjusted our underwriting to reflect the current environment. We are individually underwriting each transaction request for modification in Commercial Finance and Real Estate Finance and rail to ensure the borrower has a path to recovery. We have restricted our underwriting in the most distressed industries. and suspended auto-decisioning in acute areas of risk. We are staying disciplined in our pricing and structures while continuing to evaluate opportunities that utilize our capital most efficiently. We have updated our slides in the appendix for additional information on portions of our portfolio expected to be more impacted by the current environment

Slide 17 highlights our Liquidity position at quarter end. Our liquidity remains robust at both the bank and the bank holding company. During the quarter we issued $500 million of unsecured debt at just 3.929% at the bank holding company and our next maturity is not until March 2021 and is for same amount with a coupon of 4 and 1/8th. At the bank, we increased our available borrowing capacity at the FHLB with the assets acquired from Mutual of Omaha Bank, substantially increasing our sources of contingent liquidity.

Turning to Slide 18. Our CET1 ratio advanced 30 basis points in the quarter and remains strong at 10%, well in excess of the Federal Reserve's minimum levels including the capital conservation buffer. The growth in the ratio this quarter was driven by the decline in end of period loans and a mix shift to lower risk weighted assets, including cash and PPP loans, which have risk weightings of zero.

As the economy starts to recover and business activity improves, we expect risk weighted assets to increase from the deployment of excess liquidity and a lower level of PPP loans. We also expect positive earnings will offset the deployment of capital. Over the next two quarters, assuming the forecasted macro environment, we expect our CET1 level to remain in the 9.8% to 10.0% range depending on the mix of lower risk weighted assets.

With that I will turn it back over to Ellen

Ellen Alemany
Thanks, John. As I have mentioned before, the work we have done to transform CIT over the last few years has strengthened us, tested us and best positioned us to navigate this period. The business is diverse and adaptable.

The company is as strong as it’s ever been, and our deposit costs are declining. The management team is seasoned, agile and resilient. We established a considerable, appropriate reserve in the first half to increase our allowance for credit losses and actively manage risk. And, we are heading into the second half cautiously optimistic, but also mindful that this is a rapidly changing environment.

With that, we are happy to take your questions.