CIT Group

September 9, 2019
9:00 AM EDT

Ellen Alemany: Good morning, everyone, and thank you for joining us today. And for those on the webcast, you can access our presentation on cit.com.

Before we start, I want to point you to our safe harbor language, on Slide 1.

Today, CIT is a leading national commercial bank focused on lending and leasing to middle-market and small businesses. We have executed on a three-year transformation plan that has simplified the company, strengthened our financial profile, and reduced our risk. Through that process, we divested more than $14 billion of non-core assets, optimized our funding and capital composition, reduced annual operating expenses, and strengthened our risk management practices and credit profile. We also returned $6.4 billion of capital to shareholders and hired a strong and diverse management team with extensive experience in the banking industry.

Today, we have more than $50 billion in assets. We are 85% deposit-funded. We are a market leader in each of our core businesses, including middle-market lending, equipment financing, rail car leasing, factoring services, and commercial real estate. We are also a Top 10 provider of online banking.

The common thread that runs through our core businesses and differentiates us from the commercial marketplace include a focus on collateral-based lending, our longstanding client relationships, our deep industry knowledge, our strong origination and asset management capability, our superior credit and structuring expertise, and our proprietary digital platforms that integrate with our vendor partners and business customers. And we continue to be selective and disciplined in the face of the current competitive market conditions, emphasizing opportunities that build upon our expertise and provide an appropriate risk-adjusted return.

As highlighted on Slide 3, our strategy has been and will continue to be driven by our four strategic pillars. We continue to grow our core businesses. Growth in our core loans and leases for 2019 is expected to be in the mid-single digits, and we anticipate growth to be particularly strong in our middle-market lending and equipment finance businesses, as pipelines in both divisions continue to be encouraging.

We continue to optimize our balance sheet. Growth in consumer deposits has enabled total deposits to now constitute 85% of our total funding, up from 64% at the end of 2015. We have also continued to optimize capital as we have significantly reduced our common tier equity Tier 1 ratio over the past few years, and we expect to bring that level down to our target range next year.

We remain vigilant on our operating expenses, and there are further opportunities for expense reduction, primarily driven by organizational efficiencies and digital process automation in both our businesses and our functional areas.

And from a risk management perspective, through our transition we have exited businesses with higher credit, asset, and regulatory risk and shifted our focus to lending against assets with higher-quality collateral and meaningfully reduced our cash flow exposure.

Through our transformation, we laid the groundwork to unlock the potential of our core businesses, and we will continue to leverage our core competencies and build on our strengths, going forward.

On Slide 4, we lay out our core businesses for our commercial banking and consumer banking segments. Over all, our expertise and market strengths lie in working with small and midsize companies as we continue to identify specific business initiatives and market opportunities in each of our divisions to support our growth plan and expand our core capabilities.

In Commercial Finance, we are an established middle-market lender with deep and diversified industry and product expertise, a national franchise, and significant scale. We are focused on expanding our collateral-based businesses, which we believe is a competitive advantage for us and should reduce losses over a credit cycle. This includes our re-engagement in the aviation lending and maritime markets and our continued expansion of our presence in healthcare real estate and power and energy finance, among other key verticals. We also focus on lead-managed business, which provides for greater opportunities for capital markets and derivative fees.

We continue to build out our Payments and Treasury Services, as well as our asset management capabilities. In July, Jim Gifas joined the management team to lead the Payments and Treasury Services initiatives across the enterprise. Jim is a proven leader in this space, and he will be driving the integration of these banking services in our product portfolio. This is an important area to advance our growth and strategy and deliver a more holistic set of products and services.

In addition, we recently hired Phil Robbins as President of Asset Management and Capital Markets. In this role, Phil will manage CIT's asset management activities, along with the capital markets portfolio of products and the syndicated loan group. He will focus on leveraging our expertise to expand our addressable market and generate fee income through existing and new asset management structures.

In Business Capital, we provide financing across a variety of industries for equipment, ranging from technology and other essential-use equipment for small businesses to manufacturing equipment and yellow iron equipment for larger businesses. Business Capital continues to be a strong growth engine for CIT. The key driver of that growth is our proprietary platforms, which we believe help drive integrated relationships with our customers that should enable us to continue to take market share.

Our factoring business also resides within Business Capital. We have been a leader in the factoring business for decades, with a long history of successfully managing customer and client exposure levels with minimal losses.

We are also the fourth largest rail equipment lessor in North America, with a young, high-quality, and diverse fleet, strong customer service with broad market coverage, and approximately 14% market share. Our rail team has done an outstanding job maintaining a high utilization rate in an oversupplied market, and we continually manage our portfolio of rail cars, opportunistically purchasing new cars where we see demand and disposing of cars that are no longer economic. We also continue to seek opportunities to move more rail cars in the bank to optimize the funding of these assets.

And in our real estate finance business, we focus on commercial construction loans, bridge loans, and small-balance multifamily term loans to commercial real estate investors and developers. Our core focus is on the northeast corridor and California markets, although we seek opportunities in other markets with attractive fundamentals and strong investor interest.

On the consumer banking side, our focus has been on growing our residential mortgage business through multiple origination channels. We also serve our local communities by offering mortgages and providing SBA products to small businesses, primarily in the southern California area.

Turning to Slide 5, our deposit strategy has been to continue to drive long-term relationships while optimizing our deposit costs. We believe our targeted non-maturity deposit customers are sticky and that our continued shift from time deposits to non-maturity deposits should improve our performance through this portion of the cycle.

Our key consumer deposit channels are our online channel and our branch network in southern California. As I said before, we are a Top 10 national online bank. We utilize highly focused customer acquisition strategies and predictive analytics to attract online customers who value our high-quality customer service and an outstanding digital experience.

We are also investing in a more targeted and efficient advertising and marketing to raise awareness and drive deposit growth. Our online savings builder product has been a key part of this strategy, and it has contributed to the shift in our deposit mix from time deposits to non-maturity deposits.

We think of our branch strategy channel as a ballast for our deposit base. Our retail branch customers value our attractive rates and personal relationships with bankers, and our average customer relationship in the branches is more than 12 years. Our branch network also provides us with diversity in our deposit sources and connections to the local community. Our branches carry average deposits of about $175 million per branch, well above industry averages, and we expect the balance to remain relatively constant as we continue the shift towards a higher non-maturity deposit base.

Turning to Slide 6, as you know, last month we announced that we are acquiring Mutual of Omaha Bank. For some time now, we have been forthright with the market that we have been seeking strategic opportunities that align with our strategic plan and would accelerate CIT's next phase of growth. We're very excited about this transaction. We expect it to immediately enhance our deposit and commercial banking franchises and to accelerate our strategic plan by broadening our addressable markets, strengthening our long-term earnings growth profile, and accelerating the improvement in our profitability.

In this transaction we are acquiring $6.8 billion in deposits, including $4.5 billion in scalable, low-cost, and stable home owner association, or HOA, deposits that have a significant runway for growth and give us a leadership position in the marketplace. These deposits diversify our deposit gathering strategy and immediately lower our cost of deposits by about 20 basis points. We believe that we can double the HOA and adjacent deposit channel in the next five to seven years, which will continue to lower our overall cost of deposits. We are also acquiring about $4 billion in middle-market commercial loans with a strong credit profile that are in attractive markets with appealing demographics.

The transaction also improves our loan-and-lease-to-deposit ratio, and the commercial banking business adds talent and expertise in key markets across the Midwest, West, and Southern regions to supplement our presence in the Northeast and California.

As a result, we expect this transaction to generate double-digit EPS accretion over time and improve our ROTCE by 80 basis points in 2020, with the cost fully phased in, and by more than 100 basis points over the next two years.

We believe Mutual of Omaha Bank is a good fit with CIT and will make us a stronger and better company.

And starting with Slide 7, let me tell you a little more about the business we are acquiring. This acquisition also includes Mutual of Omaha Bank's community association banking and commercial banking business, both of which are highly strategic to CIT.

The community association banking, or CAB, business is an established leader in the highly attractive HOA industry, with a 9% market share, providing deposit, cash management, and lending solutions to community associations and property management companies and a track record of entrepreneurialship and growth.

Mutual of Omaha Bank's HOA deposits have several highly attractive attributes. These are low-cost deposits, with an average cost of 63 basis points. They are stable, long-duration, and scalable nationally with significant growth opportunity. These deposits will immediately enhance our deposit funding strategy and support our commercial growth initiatives.

The commercial banking business has a national middle-market banking presence and is focused on traditional commercial banking. Its portfolio includes C&I, commercial real estate, and small business loans and is highly diverse in terms of both type and geography. This business also includes several talented banking teams and commercial loans with a stronger risk profile than our existing middle-market portfolio. Additionally, the business has more than $2 billion in commercial and retail deposits, with 26 financial centers in attractive growth markets. Mutual of Omaha Bank also provides its clients with a full suite of technology solutions and Treasury management services that we expect to complement or improve CIT's capabilities.

Let me give you more detail on the HOA deposits and commercial banking opportunities. Turning to Slide 8, as a result of this transaction we will create a new core HOA deposit channel to complement our current branch and online deposit channels, and we'll add a smaller amount of commercial and retail deposits. The HOA market is large, highly fragmented, and growing, with $50 billion in total deposits today. We will be a leader in this market, with relationships with more than 1,200 property management companies serving over 31,000 community associations, primarily HOAs, and with 4.5 million households nationwide.

The HOA deposits we are acquiring are highly attractive for several reasons. They're well below our current cost of deposits, and the duration of relationships average 10 years. HOA deposits will be a powerful channel for us, as they are stable and highly scalable, and we have significant opportunity to acquire share.

Turning to Slide 9, Mutual of Omaha Bank's double-digit historical growth in the CAB business and the stability of the HOA deposit base have been driven by their proprietary tech-enabled solutions embedded in their customers' payment and reporting systems that address their complicated collections and general ledger integration needs. HOAs and property management companies generally rely on the bank to provide resources in technology integration, and Mutual of Omaha Bank's expertise in this critical service component is a key reason for their market leadership position. Their strong client service culture is also a key differentiator.

Recently, however, this business' growth has been constrained by its parent's desire to keep total assets below a regulatory threshold. As a result, they only serve five of the nine largest HOA markets and eight of the next 12. As part of CIT, this business will have access to the requisite resources to take advantage of strong industry tailwinds, significant underserved markets, and Mutual of Omaha Bank's strong capabilities. As a result, we believe we can double the current deposit base over the next five to seven years.

Turning to Slide 10, Mutual of Omaha Bank's commercial banking business is also highly complementary to CIT's commercial banking business, and we believe there is a strong cultural fit in terms of risk culture and customer and community focus. Mutual of Omaha's high credit quality commercial portfolio includes middle-market C&I loans and commercial real estate loans in high-growth markets serving a broad customer base of companies, generally with $10 million to $200 million in revenues. Its traditional banking model essentially creates incremental commercial banking line for us. Mutual of Omaha's model focuses on direct originations and relationships and leads with deposits and Treasury management services, whereas at CIT our model has been more sponsor-driven and focused on industry verticals.

On Slide 11, we further discuss how Mutual of Omaha Bank complements our business. Mutual of Omaha Bank provides a talented team of commercial bankers operating in attractive markets with strong demographics and sizable relationship opportunities. Also, its focus on middle market expands our addressable market and footprint.

Conversely, this transaction also provides us with the opportunity to bring CIT's differentiated value proposition to a whole new set of client relationships. For example, with CIT's larger balance sheet and broader capabilities, we can offer Mutual of Omaha Bank's customer relationships more lead positions as well as capital markets, derivatives, and leasing products. Specifically, we expect CIT's solution-based approach to client issues, supported by our industry, asset, and capital markets expertise, to set us apart from our competitors.

As illustrated on Slide 12, we believe the acquisition of Mutual of Omaha Bank is consistent with the strategic pillars we have previously outlined and will accelerate our long-term growth strategy. It enables us to grow our core deposit franchise by creating a new HOA channel and accelerates returns in our commercial banking business by expanding our middle market opportunities and capabilities.

It enhances our balance sheet with scalable, low-cost, and stable deposits that immediately reduce our deposit costs, increases optionality to existing channels, and strategically deploys capital. Most important, the addition of Mutual of Omaha Bank's community association and commercial banking businesses makes us a stronger and better company.

It continues our path forward as a leading national commercial bank, lowers our deposit costs, diversifies our risk profile, meaningfully expands our ROTCE, and drives double-digit EPS growth over time.

Thank you. And I'll now turn it over to our CFO, John Fawcett.

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

Turning to Slide 13, we have been improving our credit ratings both at the CIT Bank and the CIT Group level. Our deposits are rated investment-grade, and we remain committed to achieving an investment-grade rating for our senior unsecured debt. The rating agencies have responded favorably to the Mutual of Omaha Bank acquisition. They have all highlighted that it is a net benefit to our funding, risk, and profitability profiles and have reaffirmed their ratings and outlooks. And while they will want to see how the execution and integration of the transaction proceed, we believe the deal furthers our case that an investment-grade rating for CIT is appropriate.

Turning to Slide 14, we have returned $6.4 billion of capital to common shareholders since 2015 in the form of share repurchases and dividends, meaningfully reducing our common equity Tier 1 capital ratio and cutting our share count by more than half. At the end of the second quarter, our common equity Tier 1 ratio was 11.6%, and we had set a target of 11% by the end of this year, driven primarily by share repurchases.

However, as a result of this transaction we have suspended share repurchases, and our common equity Tier 1 ratio is expected to increase to the high 11% area by the end of the year. Pro forma for this transaction, our common equity Tier 1 ratio is expected to decrease to approximately 10%, the lower end of our target range. After the closing of the transaction, our intention is to remain out of the market for our common shares to increase our common equity Tier 1 ratio to 10.5% within the ensuing 12 months, which is the middle of our current target range.

We do not anticipate any change to our quarterly dividend, and we continue to believe that a dividend payout ratio in the 30% to 40% range, similar to that of other midsize regional banks, is appropriate.

As illustrated on Slide 15, we believe that this transaction can meaningfully improve our profitability. As Ellen indicated, assuming that expected cost savings are fully phased in, we anticipate that the transaction should increase our 2020 return on tangible common equity by 80 basis points, mainly driven by the cost savings and deployment of our excess capital in the deal. Over two years, we believe the opportunity grows to more than 100 basis points as we continue to leverage our new capabilities and as growth synergies begin to be realized.

The addition and expected growth of the HOA deposit channel immediately lowers our overall cost of deposit funding by 20 basis points, expanding our net finance margin. In addition, because of the strong expected growth in the HOA channel, this should take some pressure off the online deposit channel in terms of pricing and deposits raised [for] marginal growth, which could lower our cost of deposits further.

The lower cost of deposits also should expand our commercial banking addressable market. Today, there is a significant portion of the middle market where we are not competitive. However, with this improvement in our cost of deposits we would expect to be able to earn better or equivalent risk-adjusted returns on loans we were previously priced out of and to have greater opportunities to earn fee income.

Additionally, growth in the asset base at the bank is a step forward being able to move more rail assets into the bank and, consequently, enable us to further lower our cost of funds by financing those assets with deposits.

Also, the stronger credit profile of the commercial banking assets we are acquiring should lower our overall credit costs and enhance the case to the rating agencies that our holding company should be rated investment-grade. An investment-grade rating at the parent should serve to further lower our funding costs, not to mention potentially improve our ability to raise commercial deposits.

Further, we believe the increase in our assets should over time enhance our ability to drive operating leverage through the business, accelerating the improvement in our efficiency ratio.

And finally, the overall improvement in our risk profile could allow us to migrate our capital ratios to levels closer to that of our bank peers, potentially enabling the unlocking of capital. So, longer term, we believe there are several factors from execution of this transaction that could lead to meaningful improvement in our return on tangible common equity beyond the 100 basis points expected over the first two years.

Turning to Slide 16, while we are focused on closing and integrating the transaction, we continue to take advantage of opportunities to improve our operating expense base while simultaneously investing in our infrastructure and growth initiatives. Apart from the transaction, we are still targeting a reduction of at least $50 million in 2020, compared to the 2018 level, driven primarily by continued organizational efficiencies and digital process automation, along with rationalization of our real estate footprint. This reduction also excludes the change in lease accounting rules.

While we are looking for opportunities across our entire expense base, we expect cost savings to be primarily driven by three key areas: digital process automation, organizational simplification, and the continued reduction of professional fees, notwithstanding costs related to this acquisition. Now, since the closing of the Mutual of Omaha Bank transaction is expected in the first quarter of next year, tracking these cost savings may be difficult. However, we will do our best to clearly demonstrate our progress in reducing operating expenses.

Turning to Slide 17, we also think it's important to understand that a significant part of the transition that CIT has been through includes the development of a more robust risk management framework, with strong risk governance and practices consistent with that of other regulated midsize regional banks. This includes a strong risk culture along with underwriting and credit standards that are focused on a balance of prudent growth and solid risk-adjusted returns. The result of these robust credit standards and risk culture, along with our focus on strong structures and collateral-based lending, has generally led to stable and solid credit performance, with a modest level of losses.

New business originations continue to come in at better risk ratings than the existing performing book. We still are not seeing any indications or pockets of weakness in our portfolio, and our near-term outlook is that we will be able to maintain these stable credit cost levels. Also, as I have said, we believe the acquisition of Mutual of Omaha Bank will improve the credit portfolio and profile of the combined business.

Slide 18 demonstrates how much our portfolio has changed since the last downturn. As you can see, we are out of the riskiest asset classes that made up our portfolio back in 2007 and contributed to the higher concentration of losses, including subprime and Alt-A mortgages, mezzanine commercial real estate, private student loans, and our international equipment finance businesses. We also sold Commercial Air, which reduced asset and liquidity risk, and government-guaranteed student loans, reducing regulatory risk. Further, we have significantly reduced our exposure to cash flow loans, which now make up about 11% of our total exposure.

We are continually looking at opportunities to improve our risk profile, such as earlier this quarter when we sold approximately $200 million in book value of non-performing loans within the legacy consumer mortgage portfolio that were acquired as part of the OneWest acquisition.

On Slide 19, we take a closer look at the credit characteristics of our portfolio. We are being selective and disciplined in the face of current competitive market conditions. Here, you can see that we are focused on collateral-based lending, with strong structures and collateral values and products that align with our expertise. This is evidenced by low loan-to-values in asset classes such as commercial real estate, aviation, and maritime lending and in our consumer mortgages.

Our remaining cash flow loans today are all senior-secured loans. They have average leverage through senior debt of less than 4x and average total leverage of less than 5x, levels we are comfortable with and below the regulatory leverage lending guidelines.

The majority of our remaining cash flow loans are in industries where we maintain an industry vertical and have particularly strong expertise. About two-thirds of these loans are club deals, where we have a significant relationship with the borrower. In addition, our borrowers in consumer mortgages and small business solutions maintain strong FICO scores.

I'd also point out that in our equipment finance business we finance essential-use equipment and in our factoring business we finance short-term receivables. In both cases, we have decades of data through numerous credit cycles that inform our risk management practices. With our deep industry expertise, structuring capabilities, and experience with collateral-based lending, we are confident that we are properly balancing our growth strategy with our underwriting strategy. We believe this approach will reduce our loss severity going forward, and that we are properly prepared and reserved for the turn in the credit cycle whenever it comes.

Turning to Slide 20, we will adopt CECL at the beginning of next year, upon which the allowance for credit losses must cover credit losses over the entire remaining expected life of loans and commitments and will consider future changes in macroeconomic conditions. We have formed a cross-functional implementation working groups in preparation for the adoption of CECL, and we continue to develop and test our loss forecasting models and methodologies. Our expectation today is that the impact on tangible book value will be relatively modest, at $50 to $100 million. From a regulatory capital perspective, we maintain the option of phasing in the capital impact over a three-year period.

We expect the increase in our allowance for loan loss reserves, however, to be around $200 million to $300 million, as the increase is expected to be largely driven by our purchased credit-impaired, or PCI, loans in the legacy consumer mortgage portfolio. I would emphasize that tangible book equity would not be impacted by the increase in reserves from PCI loans, as the reserve will essentially replace the existing non-accretable discount with a corresponding increase in the loan balance.

Our current estimated range assumes moderate economic growth, continued low levels of unemployment, and a stable credit environment. It would also be driven by economic conditions and the composition of our loan portfolio at the adoption date and, therefore, remains subject to change.

Finally, on Slide 21, we have made significant progress over the past few years transforming CIT into a leading national commercial bank focused on lending and leasing to middle-market and small businesses. We are well positioned to grow our core businesses, optimize our balance sheet, and enhance operational efficiencies while maintaining strong risk management.

And with that, it appears that we have time for about one or two questions. And subject to time running out here, we'll be in a room next door to take more questions. Thank you.

Unidentified Audience Member: The ROE accretion that you gave on Mutual of Omaha, can you give us what that equates to in terms of ROA? How much of that is just getting the capital out the door versus improving profitability?

John Fawcett: Well, it's capital return, obviously, but it's also a lot of expense synergies. It's also growing the business. So, embedded in there there's about a $1.8 billion correspondent loan portfolio that's probably got a yield on it about 3.5%. That will run off, and we expect that we'll be able to replace that with higher-yielding commercial loans. So, it's revenue synergies, it's expense synergies, and it's return on capital. It's all three components.

Unidentified Audience Member: I got that. But just, there must be an equivalent ROA for that 80 to 100 basis points of ROE. Can you – is that –?

John Fawcett: I'm not going to get into that exactly. We have to see the portfolio that actually comes over. But we modeled it. It's higher than what we have today.

Unidentified Audience Member: Got it. And then a second question, somewhat unrelated – fully unrelated – on CECL, I recognize it's not a – I don't think it's going to be a huge deal for you. It's going to be a bigger deal for some other banks, at least from an accounting point of view. Have the rating agencies fully acknowledged that, like, "Look, we get it. It's all accounting. We don't – it's not a credit event," or are you still not clear how the rating agencies are going to handle it?

John Fawcett: I'm personally not sure how the rating agencies are actually going to handle it. I think from our perspective I think we're pretty relaxed with them understanding. We spend a lot of time with them. We don't meet with them just once a year when they're going to credit committee. We have quarterly meetings. And so, we kind of keep them apprised of what's going on with the portfolio and with the underlying business. So, I think they understand what's going on.

In terms of the broader market, I'm not exactly sure what their expectations are around the impact of CECL. For us, we expect it's going to be pretty modest. But then again, the macro environment from our perspective actually seems pretty benign, even into the foreseeable future.

Unidentified Audience Member: Do you have a view on what the impact is on an ongoing basis as you make new loans relative to what it would have been pre-CECL?

John Fawcett: It's going to cost us $50 million to $100 million more. I think, look, the loans that are coming into the portfolio are fundamentally better than what's in the existing portfolio today. A lot of what drives CECL is your forward look in terms of the macroeconomic environment, and also it's very tenor-sensitive. And so, the shorter the loans, the better off you look.

Unidentified Audience Member: Okay. Thank you.

Unidentified Audience Member: Good morning, and thanks for your time. Can you spend a few minutes discussing the characteristics of the assets that sit outside of the banking unit and then how that aligns with the strategy of strengthening the banking unit?

John Fawcett: So, the assets that are basically in the holding company are about $1.5 billion of factoring assets, and then there's about $2.5 billion of rail assets. So, every time we buy the next rail car, the rail car actually goes into the bank. As you might see quarter on quarter, probably for the last two and a half years, we've been rationalizing the portfolio. And when we sell assets out of the rail portfolio, we're typically taking them out of the holding company. The holding company rail assets are typically fresh-start accounting. So, there are embedded gains in them from the bankruptcy 10 or 11 years ago.

In terms of factoring, we're actually looking at some options in terms of things we might be able to do with the factoring business.

But the two big pieces that are actually in there are the factoring business and the rail business. And we're also mindful that I think when you look at most other regional banks, what you see in the holding company is investment in subsidiaries, and that's kind of it. And this makes us a little bit anomalous. And so, it's something we spend a lot of time thinking about in terms of how do we become more bank-like. And Ellen has been on this for the three years that she's been CEO of the company.

I think I'm getting the rope.

Ellen Alemany: I just want to make sure, though, the strategic alternatives we're looking at on factoring, Our strategy is to get all of factoring into the bank, not sell factoring.

Brian Morton, Barclays: Please join me in thanking Ellen and John for their presentation.