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FBC - Flagstar Bancorp Inc to Acquire 52 Branches and $2.3 Billion in Deposits from Wells Fargo Bank in Indiana, Michigan, Wisconsin and Ohio - M&A Call

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PRESENTATION

Operator

Good morning, and welcome to the Flagstar Bank conference call to discuss the Wells Fargo Bank branch acquisition. (Operator Instructions) Please note, this event is being recorded.

I will now turn the call over to David Urban, Director of Investor Relations. Mr. Urban, Please go ahead.

David L. Urban - *Flagstar Bancorp, Inc. - Senior VP & Director of IR*

Thank you, Jonathan, and good morning, everyone. Before we begin, I would like to mention the following comments are subject to the forward-looking statements disclaimer, which can be found in the press release and on Page 2 of the investor presentation. Both of those documents can be located in the Investor Relations section at flagstar.com.

I would now like to turn the conference over to Sandro DiNello, our President and Chief Executive Officer.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Thank you, David, and thank you, everyone, for joining us today. We're very excited this morning to announce our acquisition of 52 branches and $2.3 billion in deposits from Wells Fargo Bank in Indiana, Michigan, Wisconsin and Ohio. This acquisition transforms and strengthens our banking franchise by expanding our footprint and significantly improve the efficiency of our funding base. Subject to customary regulatory approvals, we expect to close this transaction in the fourth quarter.

Joining me today on the call are Jim Ciroli, our Chief Financial Officer; Lee Smith, our Chief Operating Officer; Drew Ottaway, our Michigan Market President; and Steve Figliuolo, our Chief Risk Officer.

I'd like to start by welcoming the Wells Fargo employees and customers to Flagstar. As stated in the press release, Wells Fargo's primary goal, throughout the negotiation of this transaction, has been to make sure its customers and employees experience a seamless transition to Flagstar, and we will ensure that happens. We are confident customers will like Flagstar's big bank lineup of quality products and services, delivered with a high-touch personal service of the community bank. Flagstar has a long tradition of supporting its communities, and fully expects to continue its commitment to good corporate citizenship and community reinvestments in our expanded market area.

With that, please turn your attention to Slide 3, which shows the strategic rationale for the acquisition, the reason this represents a terrific opportunity and transformational transaction for Flagstar. First, it significantly expands our banking business by adding 52 locations and nearly 200,000 new customer relationships, more than double our existing banking customer base. We'll have the #1 share in Portland, Indiana, an attractive market not far from Detroit, and as well as in Michigan's Upper Peninsula. We're excited about the chance to grow our bank in the Midwest, a market we know well. At closing, Flagstar will have 159 branches across the Midwest and California. By the end of this year, we will have expanded our branch network by 60%, increased our retail funding by nearly 50%, and tripled our retail customers, while increasing our banking footprint from 1 to 5 states.

Second, we believe the transaction enhances our franchise value by transforming the bank's balance sheet. We will shift our funding from wholesale borrowings to core deposits, making funding more efficient and reducing the rate sensitivity of our funding base. On a pro forma basis, total demand deposits will increase to 35% of total deposits, and we anticipate an immediate 21 basis point reduction in our overall funding costs. We expect that short-term FHLB borrowings will decline to approximately 12% of total assets from 24% at March 31.

Please turn to Slide 4 for additional details on the terms of the transaction. Two of the most attractive features of the transaction are the low-cost deposits at 4 basis points and a strong market share in northern Indiana. From a financial perspective, the transaction have a lot of pluses. We are paying an effective deposit premium of approximately 7%, and we expect the transaction to be accretive to earnings per share in 2019 on its own merits. However, the real value to our earnings power comes and that the funding will allow us to maintain the very strong balance sheet growth rates we have been generating for some time now. In essence, we are prefunding a couple years' worth of high-quality growth, thanks to this single transaction. As such, the benefits to our earnings profile expands substantially as we put the funds to work. We also estimate the tangible book value payback period will be significantly less than 5 years. We do not plan on issuing capital to support this transaction. We filed the shelf last Friday, so we could quickly issue securities to take advantage of market opportunities. So let me be clear, we do not intend to use the shelf in any way to raise capital for this transaction. Any capital needed is expected to be met through a combination of earnings retention and balance sheet management. We will continue to target a Tier-1 leverage ratio of 8% to 9%, and expect to be in that range on a consolidated basis at the close of this transaction.

Beyond transforming our balance sheet, the transaction transforms Flagstar. We will be bigger player in Michigan with 113 branches, and we will be a strong player in northern Indiana. Our Michigan footprint becomes a Midwest footprint. Our customer base more than doubles. This was an opportunity not to be missed, not only to change our balance sheet, but to fundamentally change who we are, all with an eye to making our franchise more valuable to our shareholders. So we're looking forward to the next chapter.

Given that we are speaking to you this morning, we thought it would be a good time to give you an update on the second quarter. While mortgage revenue is running behind the guidance we provided in April, expenses are running similarly lower. There are additional puts and takes that pretty much offset each other. In other words, while the complexion of the quarter is a bit different than we guided, the bottom line expectation still is about the same.

This concludes our prepared remarks, and we'll now open the call to questions from our listeners.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Bose George with KBW.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Congratulations on the deal. Couple of -- the -- in terms of the deposits, are you expecting any attrition of deposits?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, certainly, there's a good -- there's a chance that there will be a attrition. And we used information in the marketplace from recent transactions to guide us as well as our DCB transaction. But remember, the deposit payment will be paid based on the deposits at closing.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. Great. And then in terms of costs, should we think about any related cost saves? And just curious, what this does to the efficiency ratio?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

We do expect that the efficiency ratio will improve over time, and it will gradually get better and better. But we haven't provided specific information yet on expenses.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Yes. As we stated, the only thing that we really looked at this point are the cost synergies that we get out of the funding synergies, that's going to be a primary driver of the benefits in this transaction.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

And remember, Bose, there's no overlap in branch coverage here, so there aren't automatic branch closures that would be taking place. In fact, we intend to keep all the branches and all the employees.

Bose Thomas George - *Keefe, Bruyette, & Woods, Inc., Research Division - MD*

Okay. Great. Actually, let me just sneak in one on the mortgage side, if I could. Your comment on the lower mortgage revenue, is that being driven by volumes or just competition on the margins?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Principally -- in terms of comparison to the guidance that we gave you, our last are running a little lower than what we told you. And the increase in the margin that we expected is at the lower end of the range that we guided to.

Operator

(Operator Instructions) We'll take our next question from Henry Coffey with Wedbush.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Let me add my congratulations. Obviously, this does a lot just in terms of firming up the regional bank. Is the idea that you will just sort of, not automatically, but automatically flip wholesale borrowings into deposits, and then over time, the balance sheet will sort of revert back to its normal situation -- or what it is the strategy here?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

I think you pretty much have it, yes. So immediately, we'll pay down the FHLB deposits. And then over time, we'll have flexibility to grow the balance sheet as we have been growing it in recent years.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Yes. Henry, this is Jim. I think the real value here is really in the longer term, where these deposits really provide the leverage that opens up the balance sheet for that growth. So in that vein, as we fully invest, accretion will actually get into the low double digits and not relatively short order.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

And then in terms of loan growth opportunities, I know you have sort of a regional middle-market effort. How does that -- how does the new branch footprint interplay with that?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, it makes a lot of sense, of course, that we would expand our middle-market offerings and small business offerings into these new markets. So that's -- it's another lever for us in terms of earning asset growth that we can put in the quiver, if you will.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Great. Congratulations on pretty simple and straightforward deal, where you get to do all the work and we watch the numbers go higher.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, thanks, Henry.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Thanks, Henry.

Operator

Our next question comes from Chris Gamaitoni with Compass Point.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

I'm trying to kind of square the circle on the tangible book value dilution vers modest accretion. Using a 7% deposit premium, am I right there was about 2 [ED] a share in tangible book value dilution?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Yes.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

So less than 5 years, it's something north of $0.50, is that reasonable?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

I think that's -- I think you're in the range. If you're looking at where we fully ramped into EPS accretion, I think that's in the range.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

And just -- if you can give any color on kind of the trajectory or -- I mean, partly and some of the kind of -- as soon as you pay on FHLB, there should be an immediate drop, right? I guess. Is there any other way to think about the ramp and what kind of the offsets are in the near term, kind of what I'm thinking about?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

So I don't know much about the offsets. There is that day-1 accretion that we talked about, which is, just quite simply, the funding cost synergies that we were explaining before. And you are actually right. I think the metric I would guide you to is over the past 3 years, and we've got a slide on this in our analyst call presentation, we've generated roughly 19% to 20% annual CAGR in our earnings asset growth. And importantly, as we've grown that over that period of time, from the fourth quarter of '14 through the first quarter of '18, we've kept net interest income growing at the same CAGR. So I don't know that we need to get to that same level, that 19% level of growth. That's probably -- that's -- I think we can achieve that kind of accretion at a lower growth level than that. But the 19% shows what their franchise is capable of doing.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - Executive VP & COO Flagstar Bank*

I'll just add, it's Lee. That growth does all come organically, whether it's from our commercial lending businesses or mortgage or consumer loan originations that we've put on balance sheet. We have the asset-generating capabilities.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Yes. With exception of the Santander transaction.

Lee Matthew Smith - *Flagstar Bancorp, Inc. - Executive VP & COO Flagstar Bank*

Yes, which we just did. I will explain this.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

Perfect. And how should we think about the costs to operate these branches and the related core deposit intangible amortization?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

So I think the -- let me start with the second half. What we've modeled, and we'll refine that when we get to close, is more than 8-year, some of the years digits, amortization schedule. When you look at the core branch deposits, I'd say whether it was our core, our -- the DCB acquisition or this, they're all pretty much in line, where when you look at the net cost of the branch, looking at the interest expense of the branch, the NIE of the branch, and the fees of the branch that are collected at the branch level, these branches are consistent with the Flagstar branches.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

Okay, and that's very helpful. Oh, and then the 2 more questions. Do you have any sense of the -- is this primarily consumer deposits?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

It's a mix of both consumer -- kind of mass, mass affluent plus small business.

Edward Christopher Gamaitoni - *Compass Point Research & Trading, LLC, Research Division - MD & Assistant Director of Research*

Okay. And what was the impetus for Wells Fargo to offer the -- I assume there were multiple bidders, but what was the impetus for Wells Fargo to sell the branches?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

You'd have to ask Wells Fargo.

Operator

Our next question comes from Steve Moss with B. Riley FBR.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

I just wanted to ask, it looks like in acquiring the deposits, Wells Fargo is still retaining some of the lending relations with the customers. I was wondering, how will that work over time? And will you be servicing the relationships?

Lee Matthew Smith - *Flagstar Bancorp, Inc. - Executive VP & COO Flagstar Bank*

Yes. So the -- some of those deposits were carved out. So where Wells is retaining certain of those customers, those deposits were carved out of the deposits that are coming over we are acquiring. And so most of the deposits that are coming over are relatively clean. And there's relatively few that have continued relationships with Wells Fargo.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Steve, this is Jim. What they carved out was wealth management and middle-market commercial. They're keeping those 2 segments.

Andrew W. Ottaway - *Flagstar Bancorp, Inc. - Executive VP, MD & Michigan Market President of Flagstar Bank*

That's right. And this is Drew. Of the remaining loans that came over, roughly $130 million or so, the majority of those are consumer-related loans. There are small business loans in there. We will maintain those relationships that does offer us the opportunity to expand in that area with the time, Alessandro already alluded to, but the majority are consumers.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. Interesting. That's helpful. And then just wondering, what's the impact do you expect to fee income here on annual basis?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

As I said, when you take the net of the NIE, we would have per branch the fees that we would collect at the branch level plus the interest expense of the deposits. These -- when you add all those together, this -- these are pretty consistent with the Flagstar branches. So obviously, lower level of net interest -- a lower level of interest expense to fees and a higher level of noninterest fees collected at the branch level.

Stephen M. Moss - *B. Riley FBR, Inc., Research Division - Analyst*

Okay. And in terms of the customers coming over, obviously, with Wells' history of more cross selling, are these customers coming over just with more deposit products versus your existing footprint -- customers?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

I'd say it's more of a DDA-focused base. And people coming over with related savings accounts as well.

Operator

Our next question comes from Kevin Barker with Piper Jaffray.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Just a follow-up on Chris' comment. I think you said the majority are high net-worth consumer deposits, is that right?

Lee Matthew Smith - *Flagstar Bancorp, Inc. - Executive VP & COO Flagstar Bank*

No.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

No. No, they've stripped out wealth management.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

That's right. I think Jim described it as mass affluent.

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Yes. Mass and mass affluent.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Got it. Okay. And then in regards -- Jim, I believe you made the comment that the accretion would be in the low double digits when fully baked. When you get to that number, is that something you're expecting by 2020? Or is that something we can expect in 2019?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

I would expect that we're fully ramped into that in about 1.5 years.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Yes. And does that include the core deposit, the CDI amortization?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

Yes, it does.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

And then if I take the accretion of low double digits on 2019 estimates, I would say, maybe 12% to 14%, it's about $0.45, give or take -- about $0.45 to $0.50. Is there an assumption in there that it would ramp over time, given FHLB advances would -- could cost more due to the rising interest rates on the short end?

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

As we've looked at all of this, we've taken into consideration the forward yield curve and the implied forward rates. So all of the model takes into consideration the rate hikes that are baked into the curve currently. So that certainly, when you're acquiring these low-beta deposits, something that continues to provide benefits out into the future, but there is not too many more hikes baked into the curve, so there is a limit to how much that benefit does provide. But I think you're thinking about it exactly right. As we -- as -- on day 1, we're going to pay down our FHLB advances, and that provides some day-1 accretion immediately and with a high degree of certainty. And that's whatever the curve expects to be in Q4. But the real value -- and let me just say that again, these deposits provide the leverage that opens up the balance sheet for growth. So in that vein, as we fully invest these deposits, and that includes taking the liquidity that's created in Q4 and fully investing that liquidity, we would expect that accretion goes to that level. And I think we talked about a $0.50 level, you're talking about $0.45 to $0.50. I expressed that $0.50 was in the range earlier that I think that happens in relatively short order.

Kevin James Barker - *Piper Jaffray Companies, Research Division - Principal & Senior Research Analyst*

Okay. And then over time, I mean, do you feel that the balance sheet will remain similar funding profile over the next 2 or 3 years, whereby your wholesale funding goes down to low to mid-teens on a double-digit basis? You know what you're saying to them, the 13%, do you think you'd be able to stick at that level? Or do you feel like the wholesale funding will continue to move higher given the growth that -- outlook that you have?

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Well, I think we have to be opportunistic on that, Kevin. It depends what happens in the marketplace and what we're able to do on the earning asset growth. And how much we can grow these deposits, not only in the new branches we're acquiring, but in the DCB branches as well as in our Michigan base. But having the flexibility of being able to utilize the Federal Home Loan Bank borrowings, if we need to do that to support the asset growth, is a great advantage that we now have because it essentially, as we said, brought forward funding for $2 billion, $2.5 billion of deposits, which would've taken a long time to grow on the retail side. And these are real commercial deposits in a sense that they are not customers that are going back and forth from bank to bank to look for the absolute best rates, 4 basis points. So these are not interest-rate-sensitive deposits. These are people that have relationships with their bankers. The bankers are going to be the same bankers, and we do business in very much the same way that these banks do. So the transformation here, in terms of adding 200,000 customers that are truly relationship customers, and being able to put this capital to work without bringing on the other bank's problems with their assets and their backroom operations and all of that, I don't think you can overestimate the benefit of this transaction for us in terms of really showing that we're a commercial bank and not a mortgage organization. We're a commercial bank. We're a very strong mortgage organization. And we are now in a position to truly prove that and show good, solid earnings growth going forward, with much, much lower risk to the funding side of the balance sheet.

Operator

(Operator Instructions) We have a follow-up question from Henry Coffey with Wedbush.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Yes. Okay, just to kind of run through the math really quickly. If you pay off all your FHLB advances and refund it at 4 basis points, that's $25 million in savings. And then you've talked about using some of the year's digits for the premium. So the premium's about $130 million. If you straight-lined it, that's about $20 million -- $19 million, but you're going to -- how does that go? It's like $6 million or $7 million at first, and then that amortization charge increases or decreases over time? It's been a while since...

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

It decreases over time.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Are you sure...

James K. Ciroli - *Flagstar Bancorp, Inc. - Executive VP & CFO*

I'm happy to take with -- I'm happy to take that off-line with you and walk you through the mechanics of some of the year's digits.

Henry Joseph Coffey - *Wedbush Securities Inc., Research Division - MD of Specialty Finance*

Yes. It's $25 million in the first year and then it declines, okay.

Operator

(Operator Instructions) Gentlemen, there are no more questions in the queue. I will now turn the call over to Mr. Sandro DiNello for closing remarks.

Alessandro P. DiNello - *Flagstar Bancorp, Inc. - President, CEO & Director*

Thanks for your help, Jonathan, and thanks to everyone for your interest in Flagstar and for taking the time to join us this morning. Over the past 2 years, we've worked diligently to transform our company into a true commercial bank. From team lift-outs, like the Homebuilder Finance group, to the acquisition of Desert Community Bank and the Santander warehouse business to this transaction, we have built a more stable company that can produce consistently strong results. We'll continue to look for opportunities to build a truly great organization and appreciate your continued support. Thank you for your time today, and I look forward to reporting our Q2 financial results next month.

Operator

Thank you. Ladies and gentlemen, this concludes today's teleconference. You may now disconnect.