First Republic Bank (FRC)

Service that Delights...From a Bank

"Costco has an enormous appeal to its constituency, and they surprise and delight their customers, and there is nothing like that in business. If you haven't delighted customers, you're a long way home."

—Warren Buffett, BRK's 2018 Shareholder Meeting

SEAN POMPA, CFA
Research Analyst

Sean joined Weitz Investments in 2019. He has a BSBA in finance and a BA in political science from West Virginia University and an MBA from UCLA's Anderson School of Management.

First Republic Bank (FRC) is an ultra-high-touch bank and wealth management company offering personal banking, business banking, trust and wealth management services. The bank caters to low-risk, high-net-worth clientele (households with $1 million+ in investable assets) as well as households that are likely to become high-net-worth in the future. The San Francisco-based company was co-founded by current Chairman/CEO Jim Herbert in 1985 with eight employees and $8 million in bank assets. Since then, FRC has grown to become the twenty-fifth largest bank in the U.S. with 4,800+ employees, $133 billion in bank assets, and a combined $168 billion in client wealth management assets under management (AUM) and assets under administration (AUA).

The Business Model:

We view FRC less like a commodity spread lender (even though net interest income comprises over 80% of pre-provision revenue) and more like a rarified luxury service organization making money through banking and wealth management services. FRC's earnings growth is less a function of market interest rates (although higher rates certainly wouldn't hurt) and credit cycles, and more fueled by the efficient acquisition of customers with high lifetime values that grow over time. This focus has historically driven consistent increases in bank assets and client AUM/AUA, and we believe this will continue long into the future.

Most banks – community, regional, and money center – employ attempted cost leadership strategies that are meant to serve a broad customer base and keep operation costs low in order to support attractive pricing. FRC on the other hand takes a differentiation focus approach aiming to serve a narrower customer base with high-touch service that provides high utility. This differentiation strategy has been consistent since the company's founding and has many interesting, interdependent aspects, including:

1) Focusing on high-net-worth and young professional households in a handful of large U.S. metropolitan areas where target households are concentrated and growing. FRC's core markets are the San Francisco Bay Area, Southern California, New York City and Boston. Concentrating infrastructure in locations with large and growing addressable markets supports a more favorable operating leverage profile, where much of the incremental profits can be reinvested back into the business to support continued growth.

2) Giving these households – particularly the younger ones that are earlier in their earnings lifecycle – an incentive to become clients by offering favorably priced jumbo residential mortgage loans (originated balances over $725,000), student loan refinancing (FRC only wants to refinance clients that have already graduated – predominantly from graduate schools – and have attractive credit profiles), and professional loans (e.g. loans backed by the client's equity in their law firm, medical practice, private equity firm, etc.).

3) Offering top-notch client service to attract, retain and expand client relationships. FRC's superior service starts with a difficult-to-replicate organizational structure – one that emphasizes intimate personalization and teamwork rather than hierarchy, red tape and competing fiefdoms. When a new client walks in the door looking for a specific product, whichever frontline advisor (relationship managers, business bankers, wealth managers, etc.) services the transaction becomes that client's point person (or "face of the bank") for the entire duration of that employee's tenure at FRC, regardless of career progression. As the client's relationship grows (e.g. expanding beyond personal banking products to business banking

and/or wealth management services), the point person quarterbacks each transaction across the organization in a way that creates little friction for the client.

Our view is that FRC's primary selling point is not just having a comprehensive menu of financial products, but saving clients' time, energy and peace-of-mind as they navigate evolving financial situations. FRC attracts customers who want banking and wealth management to be a pleasant, even enjoyable experience rather than an extended chore. The return on this differentiated client service can be evaluated across multiple data points. First, FRC's Net Promoter Score (a widely adopted measure of customer satisfaction) has historically been roughly double that of the banking industry average and runs above leading non-bank brands like Apple, Ritz-Carlton and Southwest Airlines. Second, annual deposit attrition is just 2% versus the bank industry average of 8%, making it much easier to grow the business and do it with low-cost funding. Finally, over half of the bank's growth is coming from expanded relationships with existing clients and nearly a third from new clients brought on by existing client referrals.

4) Sustaining the service engine through exceptional employee retention, achieved by offering high compensation, the right incentives, and more capacity to service customers. FRC's focus on well-heeled clientele naturally translates to more complex banking needs (the average FRC client has a high-single-digit number of products at the bank) and higher average client balances. As a result, FRC employees handle a large amount of assets/AUM/AUA/deposit dollars, yet those dollars are tied to a much smaller-than-average number of client accounts. To highlight this efficiency, it's worth noting that FRC's bank assets per employee ratio is 1.5x that of peer banks, annual revenue per employee is around 1.75x that of peers at roughly $700,000, and the number of deposit accounts is just one-fourth that of peers. This translates to more bandwidth to service clients and a sustained ability to pay the average employee more than 2x that of peers. We would venture to guess that this is a primary driver behind FRC's low-single-digit frontline employee turnover each year. Such retention coupled with matching bankers and clients in the same age cohort help reinforce the "personal banker for life" value proposition.

   The client's personal banker is ultimately compensated on each client's customer lifetime value while bankers who serve in support roles on a given transaction are incentivized to provide exceptional service because they share in the incremental compensation pool. Aside from driving client growth and cross-selling, frontline employee incentives importantly emphasize conservative underwriting through aggressive clawbacks (i.e. paying back 4-7x the bonus paid on an impaired loan). Further, executive compensation is geared to maintaining pristine credit, strong regulatory performance, and double-digit returns on equity.

The end result is a bank that has consistently grown its earning assets at a high-teens annualized growth rate and AUM/AUA at a slightly faster rate, all while maintaining attractive returns.

With low-risk clients, exemplary underwriting, and correspondingly benign credit costs (cumulative net charge-offs just 0.12% on all loans originated since 1985), net income tends to track earning asset growth plus or minus impacts from changes in the ***net interest margin***. Earnings per share (EPS) growth is slightly lower due to share count growth (FRC partially finances its rapid balance sheet growth by periodically issuing equity, staying above target capital ratios). Over the last five years, earning assets have grown 19% annualized, net income has grown at 15%, and EPS has grown at 11%.

Net Interest Margin is a function of market interest rates and balance sheet mix, net interest margin is the difference between interest income on average earning assets and interest expense on average liabilities all over average earning assets. Net interest margin multiplied by average earning assets = Net Interest Income, FRC's chief source of revenue.

The Long-Term Outlook

Going forward, we believe FRC can sustain low teens EPS growth and maintain a premium valuation multiple (although we seek to buy aggressively at attractive discounts).

On one hand, there's a risk that earning asset and AUM/AUA growth moderates relative to historical growth rates, at least in the near-to-medium term due to potentially weaker high-net-worth household growth and deterioration in target client financial health. Additionally, the COVID-19-led recession may result in near-term credit costs that exceed what occurred in the Great Financial Crisis of 2008-2009. However, we think such costs are likely to be very manageable and well below whatever industry average shakes out due to a stronger borrower profile and high collateral coverage (~80% of the loan book is secured by real estate, and loan balances to real estate appraisal values are below 60% on average across lending lines). Further, our comfort around prospective credit performance takes into account FRC's historically stable and diversified loan mix, which notably has low exposure to direct impacts from pandemic-related social distancing (i.e. low exposure to restaurants, hotels, and travel-related borrowers, and no credit card or auto loans).

Balancing the risks, the long-term earning asset growth setup appears attractive when accounting for a 10+ year strategic initiative that has skewed the client mix towards younger demographics (i.e. less mature banking relationships = more room for cross-selling and account balance growth), a big remaining cross-selling gap between the bank and wealth management divisions, and the ability to take target client share in a downturn via the attractively priced "client acquisition" loans (e.g. jumbo residential mortgages) previously discussed. FRC has consistently taken high-net-worth household market share over its history, yet the bank's penetration of these target clients remains just under 5% within its operating footprint. We think the runway for growth is quite long.

Finally, while FRC's net interest margin is somewhat less sensitive to movements in market interest rates, suffice it to say that the decade-plus low-rate environment has been a headwind. However, with the Federal Reserve's current zero interest rate policy and many years of adverse balance sheet repricing baked in the cake, the odds of net interest margin just staying neutral or becoming a meaningful tailwind to earnings (something we're still hesitant to build into our base model) are now much better, thus offering additional upside optionality that seems far from embedded into today's stock price.