Triumph Financial, Inc. Q3 Earnings Call | October 20, 2023

Luke Wyse:

Good morning. It's 9:30 and a beautiful morning in Dallas. We'd like to start the call today by thanking you for the interest in TFIN and your attendance today. We know it's a busy day for earnings and we appreciate the time to discuss our third quarter results with you. With that, let's get to the business at hand. We had a strong third quarter and a lot of things break our way, but the quarter continued to present a challenging freight environment, one which we do not yet see improving.

We remain excited about the possibilities and our progress in spite of that. Last evening we published our quarterly shareholder letter. That letter and our quarterly results will form the basis of our call today. However, before we get started, I would like to remind you that this call may include forward-looking statements. Those statements are subject to risks and uncertainties that could cause actual and anticipated results to differ. The company undertakes no obligation to publicly revise any forward-looking statement. For details, please refer to the safe harbor statement in our shareholder letter published last evening. All comments made during today's call are subject to that safe harbor statement. With that, I'd like to turn the call over to Aaron for a welcome and to kick off our Q&A. Aaron.

Aaron P. Graft:

Thank you Luke, and good morning. Thank you all for joining us. We made significant progress in the third quarter on several fronts. Our financial results were also better than in prior periods. In the shareholder letter released last night, I outlined four things that I thought were important to communicate to our investors about the quarter. Those included first Triumph Pays momentum and financial performance has exceeded even our own expectations. Second, we had a unique quarter from an expense perspective that is unlikely to repeat in the near term. Third, the freight market has not rebounded and it could get worse before it gets better. And finally, related to that, the things that make us uncomfortable in the short term we believe will create value for us in the longterm. As it relates to those third and fourth points, the last few days have produced some interesting headlines. Two days ago, freight waves broke a story detailing that Convoy, a well-known tech enabled freight broker had pulled its loads and that an announcement was forthcoming.

We now know that Convoy is in the process of shutting down without a sale. That is something that would have been hard to imagine just a few months ago. Additional stories have followed speculating that several more freight brokers and carriers could face a similar fate. I'm friends with many people in this industry and it saddens me to think about the disruption this will bring to many employees and customers. But however I feel about it, that is the reality of how capitalism works. Companies that are not profitable will eventually fail. And one of the reasons I am bearish on freight over the short term is because I believe that private equity and venture capital have artificially propped up some companies that were attempting to bring disruption to the industry without ever achieving profitability. I believe a significant amount of money will exit the stage in the freight industry and may not return anytime soon.

I also believe that Triumph Financial and specifically what we're doing at Triumph Pay is bringing innovation to the industry. And I know that this change is another healthy force of capitalism. The difference is that we are able to earn our cost of capital while bringing about this advancement instead of being beholden to additional outside funding. My journey into banking started in 2008 and 2009 and going through that process leaves you with a deep appreciation of the need to remain profitable even through the toughest cycles, and that is what we are built to do. As it relates to convoy Triumph has less than 300,000 of counterparty risk outstanding, some of which we expect to collect in short order. And as additional brokers go through difficult times, we will continue to focus our attention on servicing the needs of the industry while we remain vigilant in protecting our own balance sheet as we always have.

Before turning it over for questions let me explain that while my bearishness about the next 12 months or so is real, it also makes me extremely bullish on the long-term future for Triumph Financial. We have a business plan and a balance sheet that is prepared for a soft freight market. We will be one of those companies who emerged stronger through this and we should have a materially greater market share than we do now. We are receiving more inbound inquiries than I can recall at any time in the past.

As companies in the industry look to partner with a known industry leader with the financial wherewithal, operational experience and technology stack to help them navigate this market. And if the market ends up performing better than I expected in the short term, we will be more profitable and that would be great, but I'm far more interested in creating value for the longterm. In conclusion, Triumph Financial is not a typical bank, nor do we desire to be one. We are building a payments network in a market that needs one now more than ever communicating that requires effort. So we put a significant amount of time and energy into our shareholder letters to help investors achieve an informed view. I hope you find those efforts valuable. With that, we're ready to take your questions.

Speaker 3:

We'll now go to Q&A. If you have connected via Zoom and would like to ask a question, please use the raise hand feature at the bottom of your zoom window. Or if you have dialed in, press star nine once called upon. Please feel free to unmute and ask your question. Our first question comes from Michael Perito from KBW. Michael, please go ahead.

Michael Perito:

Hey everybody. Good morning.

Aaron P. Graft:

Good morning.

Michael Perito:

I had a few things I wanted to touch on. Number one, just off of your comments, Aaron, the shareholder letter was very helpful, helpful, so thanks for all the color and thoughts around the current environment on Triumph Pay, obviously a very strong quarter. I know there were a couple things. It sounds like on the expense side you guys highlighted, but one comment in the release that I also noticed was around float and I was just curious. I mean I imagine that's at pretty high margin, so I was wondering if you could maybe just dissect what the contribution of float was to Triumph Pay in the quarter, and is it fair to think that that freight stay at current levels going higher for longer, that that should be kind of a sustainable EBITDA margin contributor or do you expect any volatility around that?

Aaron P. Graft:

Sure. As we've explained in the past, how we calculate float for purposes of inter segment accounting is at the Fed funds rate overnight. So I believe that rate is roughly 5.4%. And so that contribution of that just under $300 million of float at the Fed funds rate would be 16 million in pre-tax revenue. That is very valuable for us. That is very high margin for us. And of course it's going to track what Fed funds do. So if we stay in a market that's higher for longer, then we expect that revenue component to grow because we expect our float will grow as our payment volume grows and we definitely that will happen over the next 12 months.

Michael Perito:

Yeah, that was more the question. It's just does the volume... Obviously the rates are the rates, but does the volume you expect that to continue to grow as your network transaction volume grows?

Melissa Forman:

Yes, we do. Especially as we move further up market into the shipper participants, we would expect that to have exponential growth.

Michael Perito:

Okay. And then secondly, I wanted to ask Aaron, I thought some of your comments around credit stood out, and I appreciate that for you guys, it's less of a percentage of your business and what you're trying to become, but still impactful near term. And so I did see that the non-performing assets ticked up, but it looks like the reserve didn't really change much. I was just wondering if you could give us some color about what you saw on the credit side and maybe near term expectations around any provisioning or reserve build that we should just factor in as we model out the early part of '24.

Todd Ritterbusch:

Yeah, I'll take that one. So on the tick up and the non-performing assets, those particular assets happened to be so well covered that there was no reserve required. That's the short answer to that question. As we continue to look forward, if there are additional credits that need to be downgraded, we'll go through the same analysis, but we're already stress testing the portfolio and we feel very good about secondary sources of repayment.

Aaron P. Graft:

Mike, if I can just add, if you go back and look at our shareholder letters from a year or two years ago, that was the time to make sure you were being vigilant on credit when the market was far more competitive than it is now. And I would never submit to you that we got it perfectly correct. Right? That doesn't happen. But what I do know is because we weren't obsessed with growing our balance sheet and because we know this market operates in cycles, we were very disciplined. We are very thoughtful when we take credit on our books and I believe that will serve us well. And so we have some things I'm sure we will work through in this cycle.

Do I expect there to be material losses? I do not because I know how our team has approached that and the discipline we brought to it in a market when a lot fewer people were thinking about that. But we're going to have to navigate these waters and something may surprise us along the way, but I feel very good about where we sit relative to the collateral position we have in our loan book and the underwriting we did two years ago when a lot of these credits would've showed up.

Michael Perito:

Great. And then just lastly, I'm sure others have questions, so I won't ask too much here, but just on the factoring outlook near term. As you mentioned Darren, it sounds like there continues to be incremental events in the industry that give you guys the clarity that you think the recessionary trends could continue for some time. Do you have any near term outlooks or expectations around invoice volume and average invoice size that we should be thinking over. Or even if it's just directionally what you think that the current environment could mean for you guys as we think about the model?

Tim Valdez:

Mike, I'll take that one. We still see the freight market very soft, and one thing that we look at very closely to monitor that is how the freight market is reacting to fuel. In the third quarter, fuel increased significantly where it took a long time for rates to actually catch up. We didn't see improvement in the rate until late in the quarter. And even still in a vibrant market, those items or those numbers will move more in lockstep. So we see increasing the average invoice amount not so much as demand driven as more expense driven through the fuel side of the business.

Michael Perito:

Got it. Okay. But I guess in high level, it's good. The EBITDA margin improvement on Tpay comes at a nice time for you guys to be able to sustain investment in that business even if the factoring business is a little light for the near term. Yeah. Okay. Thank you guys. I appreciate all the color.

Aaron P. Graft:

You're welcome.

Speaker 3:

Our next question comes from Thomas Wendler from Stevens. Thomas, your line is open. Feel free to unmute.

Thomas Wendler:

Hey, good morning everyone.

Aaron P. Graft:

Good morning.

Tim Valdez:

Morning.

Thomas Wendler:

I just wanted to go back to Tpay. Can you give us an idea of what the critical mass for the network volume looks like and then maybe how the conversations are going with moving some of the legacy pricing up close to that $5 per transaction target?

Melissa Forman:

Yeah, I think I can take that, Aaron. Our projections for critical mass, we think that what the industry needs is for us to be processing and hopefully making payments on one out of two broker freight transactions, over the road transactions. Right now we are touching about one out of three, and so our goal is to continue to build out the network and bring on clients to get to that one of two position and then further beyond. In terms of the $5 per transaction pricing, all of our pricing models for new business have been updated to include the per transaction pricing. However, there are always going to be some cases where we have to be creative in how we price deals to get them on board onto the network and the value that they create for all the participants. There's creativity that happens there, but there has been substantial progress made in repricing existing clients as well as holding pricing on the new business that we are chasing today.

Thomas Wendler:

Great color, thank you. And then sticking with Tpay, can you give us some color around the expansion of network participants into verification only brokers? What does that opportunity look like with your audit only clients?

Melissa Forman:

Yeah, so that's a beautiful question. I'm glad you asked it. So as we have expanded our technology and capabilities, the point of conforming transactions or network transactions is to provide the data that factors need in order to do their verification, validation and cash application processes. Triumph Pay while we're making a little over 21 billion in payments, we are touching over 47 billion in carrier spend. And so we have data associated with the audit only brokers on our platform that are very valuable to the factoring industry. And so over the last couple quarters we've been working on our technology to be able to include those data sets into the conforming transactions or network transactions so that they begin to see the value and are able to utilize that data on the front end even though the payment data is not attached to it.

Thomas Wendler:

Perfect. Thanks for that. And then just moving over to credit, you seem to have some increased fears around CRE and I noticed an uptick in the loan modifications for CRE. Was there any theme behind the loan modifications, any specific group of loans, and then are you expecting to see any more modifications moving forward?

Todd Ritterbusch:

We did allude a little bit to that in the shareholder letter. The theme is that those are variable rate credits and so when you have a variable rate credit that prices up 500 basis points in a short period of time, obviously that puts some borrowers at stress. And so we had to make modifications to address that. We ended up at a rate that is still okay, our economics are not as good as we would love, but it allows those loans to continue to perform and there's still equity in those properties, so the borrowers are willing to work with us on a long-term basis. So we expect more of that to occur over the course of the next few months as more and more of those variable rate borrowers are dealing with the reality of the new environment.

Thomas Wendler:

All right, I appreciate you answering all my questions.

Aaron P. Graft:

Thank you.

Our next question comes from Joe Yanchunis from Raymond James.

Joe Yanchunis:

Good morning.

Aaron P. Graft:

Morning Joe.

Joe Yanchunis:

So on expenses you guys had, you mentioned your shareholder letter that you expect 5% non expense growth in 2024 absent any ramping of large clients. I was wondering if you could flesh out that growth by different segments for payment factoring, community bank and corporate?

W. Brad Voss:

Bulk of the incremental spending that you'll see next year is likely to be in the payment side. You'll see a little bit in corporate, but I would probably couch it as 60% payments, 40% corporate roughly.

Joe Yanchunis:

Okay, perfect. And then whether through deepening customer penetration or the onboarding of new brokers, how much annualized payment volume is contracted to come on to the network in the next six to 12 months?

Melissa Forman:

Yeah, so the way I would describe that for you, Joe, is we speak only about brokers that are in active integrations and so those that are contracted and inactive integrations represent, that's come onboard in Q2, Q3 and then what we expect to onboard in Q4 represents approximately 9 billion in annualized carrier payments amongst all of them. Some of them they've been onboarded and they're in their ramp up stage again, which takes six to 12 months for them to typically fully ramp.

Joe Yanchunis:

So all else equal if no other brokers or factors signed up on the network, you would have 9 billion in incremental volume. Okay. And then-

Melissa Forman:

Yeah, assuming market.

Joe Yanchunis:

Kind of lastly here-

Melissa Forman:

... conditions remain the same. Yeah, right.

Joe Yanchunis:

Of course. So for Tpay, you've announced a lot of major wins on the broker side, but we haven't seen the same type of momentum on the factoring side. I think at this point the quickest way to increase the network transaction penetration, which looks to be about 6% of all invoices in the quarter would be to add some large factoring companies. Can you discuss the progress on that front end when we might see some large wins there?

Aaron P. Graft:

Let me take that one. And we allude to it if you read the factoring section of this letter. The gating issue in my opinion, towards driving greater factor participation in the network has to date been the fact that we were making one out of every six payments to them. And then we were making one out of every four or providing network data on one out of every four and now we're at one out of every three. I believe a day is coming sooner rather than later where it'll be one out of every two. And once you get to that level of penetration, factoring companies now can start to use your technology to change their processes. That is the brand promise that Triumph Pay makes to the factoring industry. If you look at our own factoring subsidiary, it costs us roughly $6 to do the back office processing per invoice. And that's a generalization because it depends whether it's a large fleet, a small carrier, but let's just use $6 as a good approximation.

We need to, for our own benefit and for every other factor we want to join the network, we need to be able to demonstrate we can get that price down to $3. That would be a tremendous margin pickup for them. Well, you aren't going to be able to do that if you don't make a significant amount of their payments or provide a significant amount of audit data for conforming transactions. We are closing in on that mark. The second gating issue is there is required technology improvement in most factoring management systems for them to be able to ingest load data before an invoice is created. No FMS was ever built to do that.

Our own FMS had to be improved to be able to ingest that data. And so one of the things we talk about in this letter is we are thinking through how we can offer to the factoring industry the ability, some of the technology we have built and the operational expertise we have so that they can more easily ingest that data so that they can pick up the cost savings that is the brand promise of Triumph Pay. It's the cost savings and the assurance of the validity of the invoice. That is our promise to them. We are delivering on that. It's a very fair question, Joe. I think it comes in a much faster rate after we achieve that 50% penetration that Melissa, Melissa alluded to and we are working towards that.

Joe Yanchunis:

All right, well thank you much for taking my questions.

Aaron P. Graft:

Sure.

Speaker 3:

As a reminder, if you have a question, feel free to use the raise hand feature, which can be found at the bottom of the Zoom application. And if you've joined us by phone today, you may dial star nine. Our next question comes from Gary Tenner from DA Davidson. Gary, please go ahead.

Gary Tenner:

Thanks. Morning everybody.

Aaron P. Graft:

Morning Gary.

Gary Tenner:

Aaron, I wanted to ask. Your comments in the letter regarding your pessimism or bearishness about the freight industry didn't sound like it was universal but certainly your view of the world. As you looked at the data from say DAT, you've seen van spot rates move up a little bit from the summer lows. But over the last couple of weeks after moving a little higher, loads to van ratio seems like it's fallen off a cliff. Is that more recent data? Is that really a big driver of your view going forward and the lack of capacity coming out of the system?

Aaron P. Graft:

Yeah, I wouldn't tie it to that. That's just one data point. I start with the point Gary, that I think any of us in the industry begin with the hope that we're wrong, right? We all want the industry to return to 2022 levels. Although I think any of us who lived through that would acknowledge, I don't know that that was particularly healthy either. It was very profitable in the short term in 2021 in that time period. What I look at is normally in this part of the season you would see invoice, the spot rates moving and those moves would certainly pick up a movement in diesel costs. Because if you think about what the spot rate is, it's marking to market every night. It's marking to market capacity, it's marking to market input cost of which diesel is a very large one. And at this point in the season, if we believe all that has been written about retailers are at the end of the destocking phase that we went through this bull whip effect that some people were very right on of why the market got so tight for a while.

If we believed we were coming to the end of that, we would see the spot rates more sensitive to the input costs in the system. We are not seeing that and that plus just all of the things we see just leads me to believe we have excess capacity in the system. I would think that many, a very significant number of small carriers are unable to earn their cost of capital taking spot rate loads right now. Of course there are exceptions if you're in a certain lane, but on the whole I believe that to be true and that is why you're seeing the attrition in our own factoring client base. That's why I think you're seeing softness across the market and so my view is it is what it is.

So what is it? I think freight has not rebounded to the point where most carriers can earn their cost of capital, which means we need capacity to lead the system in order to recreate equilibrium. And I hope we're wrong. I don't think we are. How long it takes to do that? There will be catalysts. If you think about what's happened the last few days with the announcements we've referred to, it seems like these things always start slow at first and then they accelerate. And so it may be that the industry recalibrates more quickly than I would expect, but right now my own personal view is this takes the next 12 months for the industry to sort itself out and achieve equilibrium.

Gary Tenner:

I appreciate that. And since you just alluded to recent news and that Convoy wind down, I don't know that particular company particularly well. But was there anything.... My understanding is they were carrier that was kind of tech enabled, but was there anything they were doing that you think was particularly interesting and that kind of plays into your longer term view of the freight industry?

Aaron P. Graft:

I think Convoy built tremendous technology. They were exceptionally talented and smart people. The problem that they and some of these other tech enabled brokers have is that in order to go from just traditional brokerage. If you think about what was traditional freight brokerage, it was contracting with shippers to move loads and then using people and using phones to find carriers to haul those loans and make a 15% margin. Beautiful business model, highly scalable. A lot of freight brokers have done exceptionally well with that. Take the last 10 years there has been this move to we should create digital freight marketplaces and conceptually I don't disagree with that. I think the idea is right, the execution is exceedingly hard. It's exceedingly hard to get the scale and bring in all the dynamics that get priced into this very vibrant, very hard to predict trucking industry that is attached to the global supply chain.

It's just hard. So I think Convoy did great things. I think there are many other tech enabled freight brokers who have built really cool technology, but at the end of the day, cool technology and really good marketing will not make up for the inability to earn your cost of capital and this market and where the capital markets are has brought that to bear and we've known that none of us are surprised that this day is coming. We didn't know exactly when. We didn't know exactly what would cause it, but it's our job at Triumph because we've had freight brokers as our counterparties in our factoring business for over a decade, frankly since the inception of our factoring business back in 2004 before we even bought it. It's our job to think about not who has the best technology or who's in has the best user interface, it's who can afford to repay us when payment is due.

That is a banking discipline and that is a discipline we have never forgotten because we know what it's like when it goes the other way. So I suspect there will be some more. I suspect this technology will live on and we'll improve the industry for all of us. I hope that these really talented people I've gotten to know will land places and continue to make the freight industry better. It's just you have to do this, you have to build things. For us with Triumph Pay you have to build it in a way that when the market inevitably turns against you, you can afford to keep making investments and that is a discipline we take very seriously.

Gary Tenner:

I appreciate your thoughts on that. I just throwing one last really quick question, follow up on the expense question. Really thinking about the fourth quarter and modeling and jumping off point there from a segment perspective. The return or normalization of expenses in the fourth quarter closer to the second quarter, I assume that's similarly weighted towards the payments segment.

Aaron P. Graft:

I would expect the-

Gary Tenner:

Is that accurate?

Aaron P. Graft:

... fourth quarter to look pretty similar, Gary, to the second quarter across each of our segments. And Gary, one thing if I may add on that, those expenses, and I think we're all in a cycle where talking about expense control is appropriate and that's what we should be talking about. But understand that those expense spikes that we sometimes have in Triumph Pay that are tied to the onboarding of a large freight broker are the best kind of expense because that is an investment in a long-term contractual relationship.

And so we take a lot of that expense, not all of it, but we take a significant amount of that expense upfront and we have yet to have a large freight broker ever leave our ecosystems. The duration of those relationships is proving to be very long and every quarter we go forward and do more for these customers, the relationship gets deeper. So we want to be thoughtful about expenses. We don't take it lightly, but those specific spikes, that part of the expense base I will take all day every day because I know over the long-term it creates a lot of value for us.

Gary Tenner:

Fair enough, thanks.

Aaron P. Graft:

Thank you.

Speaker 3:

Our next question comes from Hal Goetsch from B Riley Security. Hal, please go ahead.

Hal Goetsch:

Hey guys, just want to ask about the core banking side of the business you've been true to your word and not really grown the asset side balance sheet. One of the areas where it does appear to have grown commercial estate over year, over year, and I just wanted to get your feel on are you just seeing some great conditions right now to make some good loans to very selective opportunities for your team in that banking segment? Love your thoughts on that.

Todd Ritterbusch:

Yes, I think you characterized it really well. There are a lot of opportunities out there. Not all of them have adjusted to the new realities of this interest rate environment, this economy, but some have. And where we see really strong tenants, really strong borrowers, great risk adjusted returns, we are still open for business and we will continue to be. So yes, that's what drove the growth last quarter.

Hal Goetsch:

Okay, thanks. Thanks you guys. That's all my questions. Thank you.

Aaron P. Graft:

Thank you.

Speaker 3:

There are no other questions on this line at this time. Thank you.

Aaron P. Graft:

Assuming that was my invitation to conclude the call, we thank you all for joining us today. We appreciate your attentiveness and interest in what we are doing and we look forward to speaking with you soon. Have a great day.