

## SNL Blogs



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## Activist investors, optionality and Comerica

By [Jeff K. Davis](#)

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Dallas-based [Comerica Inc.](#) is having a rough go of it in 2016. Oil cannot find a bottom. And the Street's pipe dream for Fed rate hikes that would push the bank's NIM higher has been replaced with a term that entered the mainstream media's lexicon last week: NIRP, or negative interest rate policies. Neither is good news for Comerica or U.S. banks, though low gas prices should support consumer credit portfolios even if consumers bank the savings rather than spend it. I do not know where to start with NIRP. It is a fraudulent proposition to me — something one could expect from European socialists, but not here.

In the whatever category, S&P downgraded the company's long-term issuer rating to BBB+ on Feb. 9 due to its energy-sector exposure. The headline may not sound great, but the parent company retained an investment grade rating.

The backdrop occurs as Comerica and [CIT Group Inc.](#) have become the target of [Hudson Executive Capital LP](#), a relatively new hedge fund with an impressive roster of executive advisers. CEO partners from the financial services industry include Bill Harrison ([JPMorgan Chase & Co.](#)) Richard Kovacevich ([Wells Fargo & Co.](#)) and Howard Milstein (New York Private Bank & Trust). These are not hacks; they are highly accomplished bankers and investors. Hudson's mission statement discusses value creation through constructive engagement with a target rather than a public contest and proxy battle.

So Comerica is among the larger banks to come under fire to sell of late, joining [Ally Financial Inc.](#), CIT and two that pulled the trigger: [Astoria Financial Corp.](#) and [First Niagara Financial Group Inc.](#) Depending upon when the position was established, Hudson may have lost part of its shirt. Comerica's shares are down 21% year-to-date (and 29% over the past year), as of Feb. 12.

According to media reports, Hudson views Comerica as being too small to incur the cost of being a SIFI. Other reports spoke to the cheapness of the shares, which were trading for about 11x 2016 consensus EPS and 84% of tangible book value, as of Feb. 12. The P/E multiple is higher than peers such as [Huntington Bancshares Inc.](#), [Regions Financial Corp.](#) and [Fifth Third Bancorp](#), although the P/TB multiple for most peers is higher. The difference in book multiples reflects a somewhat lower ROE and ROTE. Comerica posted ROE and ROTE of 7.1% and 7.7% in 2015, down from 8.0% and 8.7% in 2014.

Hudson's approach may be softer than [Lion Point Capital LP's](#) cage rattling of Ally, but it is useful. There is nothing wrong with shareholders who make boards take an intense look at strategy, historical performance, prospective performance, realizable value if sold, and the like. As stated previously, I am not a corporate securities attorney. My take on board governance is that boards are not required to make decisions for a short term gain (e.g., sell) if there is a reasonable plan to create long-term value. The "business judgment rule" has served corporate America, its shareholders and U.S. capitalism well by giving boards the benefit of the doubt as long as directors make informed decisions in good faith that are believed to be in shareholders' best interest.

Comerica is not an illogical choice for Hudson to target based on ROE and ROTE; however, the gap with peers is not that wide given the rate environment and Comerica's business bank model that focuses on C&I lending with a high level of non-interest bearing deposit funding. ROE for the YTD period through September 30 was in the 34<sup>th</sup> percentile (i.e., 66% were above) according to the regulators' bank holding company performance report; it was 48% in 2014.

Middling ROE notwithstanding, I think management has done a good job over the years by avoiding the trap door that is the key arbiter in bank performance over long periods of time: credit. Maybe the highly cyclical nature of the southeast Michigan economy taught management how to navigate lending cycles a little bit better. Or, maybe it instilled more conservatism in management.

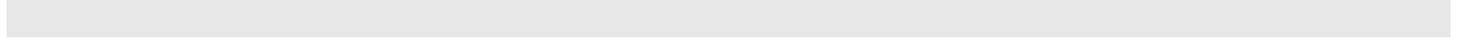
Unlike some peers, Comerica was not forced to raise a massive amount of common equity in the aftermath of the financial crisis. Its sole raise was a 25 million share offering in March 2010 on what was then about 150 million shares outstanding. In a testament to how far bank stocks have fallen the past few months, that offering six years ago priced above the current price at \$35.00 per share. At the time investors were banking on an improvement in credit (correct) and Fed rate hikes that would push the NIM and EPS higher (wrong then, too).

Also, I think management has done a good job in managing the cost structure. The efficiency ratio in 2015 was 67%, which is roughly unchanged over the past few years. That is not a great number and may speak to Hudson's views about the cost structure and ROE; however, it is not bad considering that the NIM was 2.60% in 2015 compared to 3.19% in 2011. That is a lot of foregone net interest income and ROE.

Comerica is not an island. It has to operate in the same rate and competitive environments as its peers. Unlike some peers, the company does not have a big consumer lending franchise, processing business and asset management unit to counter the impact that ZIRP has on the NIM. ZIRP is brutal for banks. It is especially brutal when one of the key tenants of a business model is LIBOR-based commercial lending that relies on a high level of non-interest bearing deposit funding. Competition has compressed the margin at which businesses can borrow over LIBOR, while non-interest bearing deposits add little to the NIM compared to when short rates are "normal." Comerica's loan yields are low; there is no easy or obvious offset to change that.

I have no idea what the board's thoughts are about staying the course versus selling (or buying). The company would appeal to a number of banks, I think. Its geography that encompasses Michigan, Texas and California with smaller outposts in Arizona and Florida is attractive. The eventual retirement of long-time CEO Ralph Babb, age 66, may cause the board to re-evaluate the path regardless of Hudson's engagement. If I were on the board I would want to see how the energy book performed this year. The shares have a high degree of optionality in terms of oil prices moving higher and the dying dream of the Fed being able to "normalize" short rates. On the other hand, NIRP would be an unmitigated disaster for Comerica and its competitors. Hudson's engagement has

occurred at an interesting time when the optionality of where from here is very high.



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