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Did Comerica see it coming?

By Jeff K. Davis

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Detroit's Chapter 9 bankruptcy filing earlier this month was in process for decades. A booming auto business in the late 1990s (\$1 gas did wonders for SUV sales on the heels of the collapse of Asian economies in 1997) and a federal bailout of the auto industry in 2009 did not prevent the filing. The beauty of the American bankruptcy process is that it allows for an orderly restructuring of an entity assuming liquidation does not occur. Detroit should be no different, though the "winners and losers" among bondholders, employees, retirees and taxpayers will not be known for a while. Unfortunately, the city will continue to struggle with poverty and social dysfunction.

On March 6, 2007, [Comerica Inc.](#) announced that it would relocate its corporate headquarters to Dallas from Detroit. For a year or so I had a hunch the board might move the headquarters, though I thought Los Angeles would become the headquarters if such a decision were made. It could not have been an easy decision. Much of senior management and the board were longtime Michigan residents; many were graduates of the University of Michigan or Michigan State University. Vice Chairman Joseph Buttigieg, who has since retired, had noted in a diplomatic (sort of) way on more than one occasion that the state (and Detroit) was not always supportive of business and that businesses had options. But Mr. Buttigieg held his undergraduate degree from the University of Notre Dame. In the apparently thin-skin world of Michigan, the Detroit zoo was forced to relent in 2005 when it named two wolverine pups "Bucky" and "Sparty."

Today, Michigan (and Detroit) remains a key part of Comerica's franchise, contributing about \$14 billion (31%) of loans and \$20 billion of deposits (38%). The shares look modestly expensive to me, trading for about 14.5x consensus 2013 and 2014 EPS at a time when there is no credit leverage and loan growth is slowing. The Street is focused on the potential for a much higher net interest margin (and EPS) from higher short-term interest rates because a large portion of the loan portfolio is tied to 30-day LIBOR, while most of the funding is obtained from noninterest bearing deposits and other low cost deposits. The same debate was occurring in early 2004 before the Fed began to raise short-rates from 1.0% that year. Then the NIM was about 4.0%, down from about 5.0% in the late 1990s; it was 2.86% in the first six months of 2013. While the NIM initially rose with Fed rate hikes in 2005, price competition for loans and a receive-fixed swap book pre-empted much of the lift the Street then expected.

No doubt higher short-rates are a catalyst for Comerica's earning power and share price today; however, I think management's strategic moves have had more positive impact on long-term value creation than is appreciated. Comerica entered Texas and California in 1988 and 1990, respectively, when banks were struggling from the collapse in oil prices and commercial real estate values. While only small banks were acquired, the foundation was laid to diversify what was then a franchise that was totally dependent upon Michigan and therefore the auto industry.

The California franchise roughly doubled in 2001 with the \$1.3 billion acquisition of \$7.4 billion asset Imperial Bancorp, an acquisition that created a few credit and integration issues. After Imperial, management reverted to organic growth, supplemented with a branch building program that has since been curtailed. The only other acquisition since Imperial was the \$1.0 billion deal for Houston-based Sterling Bancshares in 2011, which added about \$5.0 billion of assets. The Street hated the Sterling deal due to pricing. I thought (and still believe) the deal had lots of strategic merit, though the toughest aspect of the deal was the currency math. At announcement, Sterling entailed a price/tangible book value multiple of 2.3x and closer to 4.0x with credit marks, while Comerica issued shares that the market valued at about 1.2x.

While I am sure the Sterling deal has had a few personnel and integration issues, the transaction solidified Comerica as a Texas bank, and Texas is one of the best markets in the U.S. Good real estate does not come cheaply. [Cadence Bancorp LLC](#) confirmed Sterling's price when it paid \$251 million, or 2.4x tangible book value, in cash for Houston-based [Encore Bancshares Inc.](#) in 2012. Perhaps today's valuation is not fully explained by an anticipation of higher short-rates; maybe Comerica is being partially awarded a "Texas premium."

The other strategic decision that comes to mind is from credit actions that Chief Credit Officer Dale Greene took following heavy C&I losses in 2002 — some of which were attributable to Imperial. Greene told me that management was embarrassed by the losses and were going to retool credit so that it would not reoccur. Aside from reworking processes, Greene was an active seller of automotive-related credits in 2005 and 2006 when collateralized loan obligations, hedge funds and other investors were aggressively buying corporate loans. There also was an intensive scrub of direct and indirect homebuilder exposure that began in 2007. The effort was largely successful, though the link to subprime buyers for one California homebuilder portfolio was missed before it was too late.

The result was that Comerica's performance was much better than peers. Commercial net charge-offs in the dominant C&I book peaked at 1.53% in 2009, compared to the peer average of 2.44% (based upon the Y-9C as compiled in the Bank Holding Company Performance Report) as did CRE inclusive of C&D at 3.06%, compared to the peer average of 2.81%. Greene had stated to me that he intended to prove to investors that 2002 was an aberration, which he did.

As a side note, prior Comerica CFO Beth Acton was instrumental in helping Ford Motor Co. survive 2008-2009 without any direct taxpayer assistance. As treasurer of Ford, Acton positioned Ford in the late 1990s so that it could raise significant amounts of liquidity if it needed to do so in addition to strengthening Ford's capital structure. Ford implemented the plan in 2007 by hocking most of its unencumbered assets and thereby rode out the auto industry depression.

Buttigieg once quipped to me that Comerica and the Detroit auto industry knew how to operate in a deep recession. A few years later, the company got to prove it. I suppose it is surprising that European banks — including troubled Franco-Belgian Dexia Group — have significant exposure to Detroit municipals. Comerica, on the other hand, long ago took steps to reduce its exposure. The shares have modestly outperformed the SNL Large Cap Bank Index since March 6, 2007, producing a total return of -15% through July 26, 2013, compared to -29% for the index. Higher short-rates should be the catalyst to widen the gap, though the Street may be over its skis about 2015 being the year that the Fed acts.

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