SNL Blogs

NASHVILLE NOTES

Tuesday, February 24, 2015 6:09 AM CT

Biased against special dividends?

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

There will be plenty of fodder for the Street to write about over the next two weeks with release of the Dodd-Frank Act mandated stress test results on March 5 and then the Comprehensive Capital Analysis and Review (CCAR) on March 11. This year, 31 bank holding companies with more than $50 billion of assets are subject to CCAR. Presumably there will be a surprise or two as it relates to the Fed objecting to capital distributions. That the primary U.S. subsidiary of Deutsche Bank AG is poised to fail according to media reports last week probably should not constitute a surprise.

I think Dodd-Frank and its thousands of pages of regulation has put an unreasonable anchor around the U.S. banking system and slowed the recovery at the margin; however, having the Fed shine a bright light on stress testing and capital planning is not a bad thing even if the Fed's (and/or its consultants') conclusions may seem off-base sometimes. A modest amount of additional capital is a synonym for value investors' "margin of safety" concept. The margin may not help the upside, but it cushions the downside where tail risk can be draconian for levered financial institutions.

What the annual CCAR process may really tell us about the industry is that the transformation to a quasi-utility model is nearly complete. The Fed's review of capital plans in which it objects or does not object to requested capital distributions for the coming year is sort of like a utility going before a rate setting commission to ask for a rate increase. Before Dodd-Frank, I believe most bank holding companies informed the Fed of capital distribution plans that were deemed to be material.

With little organic revenue growth for most regional and large banks, the shareholder return calculus for the time being is predicated upon the return of internally generated capital. Comerica Inc., Fifth Third Bancorp and Huntington Bancshares Inc. are representative of where most banks may find themselves in time having returned about 70% to 85% of 2014 earnings to shareholders.

Capital formation as measured by the median return on average tangible common equity is running in the low teens for regional banks and large banks. In a world where the 10-year U.S. Treasury yields about 2.0%, a low-teen return on average tangible common equity is not bad. However, the bias may be for returns to decline given pressure on loan yields. And I would not look to valuation to compensate investors via multiple expansion. Banks seem fully valued to me trading around 15x LTM EPS with little credit costs embedded in the earnings.

The Fed limits regular dividends to about 30% of earnings over the ensuing four quarters. The swing factor for requested capital distributions greater than 30% of earnings has been share repurchases. Given where valuations are and the muted outlook for earnings growth — Street estimates notwithstanding — I raise the question whether large share repurchases make sense today. The price paid matters a lot for the expected return on any investment.

I realize management and institutional shareholders who are focused on beating a benchmark have a vested interest in repurchases. The premise of institutional research firm TrimTabs is that stock prices are based upon supply and demand rather than fundamental value. Decreasing supply is positive for price action. The view is logical, but it does not answer the question: do repurchases make sense at any price?

Share repurchases also benefit management to the extent repurchases soak up shares that are issued as part of compensation plans. And contingent compensation that is tied to EPS growth benefits from repurchases. What is not accretive when the opportunity cost of funds used to repurchase shares is close to zero? Does EPS accretion from share repurchases really mean anything in a zero-rate world?

Then there is the obvious in hindsight: share repurchases do not make sense when credit quality is poised to deteriorate. I do not think that is where the industry is today after suffering through a 100-year flood during 2008-2009. Management is not omnipotent in its ability to see the future, but they should have a sense of where the institution stands in terms of the outlook for credit and whether the shares feel expensive or cheap. One has to wonder about National City Corp. upping its share repurchase program by 40 million shares in April 2007 as the implosion of subprime mortgage finance was obvious by then.

And what about the impact on tangible book value per share when most banks today trade comfortably above tangible book value excluding value traps such as Citigroup Inc.? Repurchases at prices above tangible book value are dilutive. When a publicly traded bank announces an acquisition, typically the investor presentation will note the amount of dilution to tangible book value per share and the number of years required to recapture the dilution. Why not the same calculation for repurchases? Maybe because no one seems to object even though there are no cost saves to offset such repurchases.

My intent is not a diatribe against repurchases; rather, it is to raise the point that periodic special dividends may be a better way to return excess capital to shareholders. Cash is cash. There is no question about its value and the equitable nature of its distribution. Besides, recipients can always elect to reinvest.

A review of SNL data indicates few special dividends were paid during 2012, 2013 or 2014 by banks with assets greater than $2 billion. Notable was a special dividend of $1.30 per share ($1.50 before adjustment for subsequent stock dividends) paid by Commerce Bancshares Inc. in November 2012. The Kemper family, which maintains a sizable ownership position in Commerce, was focused on the then changing tax treatment of dividends. More recently T. Rowe Price Group Inc. declared a special dividend of $2.00 per share on February 19. It too last paid a special dividend in late 2012 of $1.00 per share.

Commerce, T. Rowe Price and a few others are exceptions for banks and other companies that are not organized as pass-through entities such as REITs. With bank shares elevated, in my view, and income a challenge in light of the Fed's zero interest-rate policies, bank management and boards may serve their shareholders well by allocating a portion of targeted capital distributions for year-end special dividends.

Published with permission.
Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.