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CIT's next chapter

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One of the more interesting upcoming quarterly earnings releases will be CIT Group Inc. It is a story that I think has frustrated Wall Street since the company emerged from a prepackaged bankruptcy filing in late 2009. The shares have been a value trap, trading in the vicinity of tangible book value the past five years. The five-year total return through October 8 is just 6%, compared to 75% for the SNL U.S. Bank Index. Carl Icahn predicted underperformance when he sold his shares during 1Q'10 that he obtained when the company exited from bankruptcy.

It is not a reset like the bankruptcy was six years ago; however, the $3.4 billion acquisition of IMB HoldCo LLC, the parent of $22 billion asset OneWest Bank, on August 3 represents the next chapter for CIT.

CIT and OneWest are an odd combination. It probably was a merger of convenience to assuage regulators regarding CIT's lack of core deposits (OneWest added about $14 billion of core deposits). CIT is a commercial finance company in a bank wrapper. OneWest, which the smaller CIT Bank merged into during August and was rechristened CIT Bank, National Association, looks like a thrift in a bank wrapper. OneWest was capitalized by the private equity backers of IMB to acquire the failed IndyMac Bank in 2009. A once busted commercial finance company marries a once busted California thrift.

Upon emerging from bankruptcy in late 2009, CIT initially was incredibly challenging to model due to fresh start accounting that has now mostly run its course. I always have thought it made more sense to think about earning power for CIT rather than period-specific EPS given the accounting and complexities surrounding the company's tax rate. Actually that statement applies to all companies, however.

The Street still seems to be struggling with CIT's earnings. A year ago the mean estimate for 2015 was $3.62 per share according to SNL; it was $2.77 per share as of October 8. Year-to-date EPS through June 30 was $1.25 per share, or $2.50 per share annualized.

But it is October. The Street does not care about the current-year estimate much less last-12-months earnings, though it should. The focus is on 2016. When the IMB acquisition was announced in July 2014, CIT's mean 2016 estimate was $3.73 per share; today it is $3.61 per share. Management's 2016 pro forma adjustments presented at the time of the announcement projected 76 cents per share of EPS accretion to $4.49 per share. The current consensus less the accretion is $2.85 per share, which is closer to where I think reality lies than was the case immediately prior to the acquisition announcement.

The introduction of OneWest will make CIT's reported numbers less transparent again as a result of purchase accounting adjustments. The Street may protest if that is the case, though from an earning power perspective purchase accounting adjustments are noise that eventually burns off. CIT's pretax return on average earning assets YTD was 1.8%. OneWest's YTD pretax return on average assets was 1.5% according to the UBPR. In an era of gradually declining loan yields and low credit costs, I think that is as good as it gets. Further, OneWest acquired failed thrifts. Loss share accounting, yield adjustments and the like presumably distorted OneWest's core earnings. Now it all flows into CIT's financials.

While the big adjustment in CIT's earnings estimates may have already occurred, I would not be surprised if 2016 and 2017 estimates ease even if the first couple of quarters of combined results surprise to the upside. I think the Street has been fighting the impact of gradually declining loan and lease yields for several years as it relates to its out year estimates. CIT is no exception.

As for the stock, the period of material underperformance may be over unless estimates fall from here rather than ease as I envision. The current valuation of 15.3x the 2015 consensus estimate and 89% of tangible book value per share plus buyback activity should provide downside support. Nevertheless, sustained EPS growth and a competitive ROE/ROTE are needed to drive share outperformance. Ignoring a tax benefit booked in 2014, CIT has not produced either thus far since emerging from bankruptcy.

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