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Ally's proposed IPO — count me as skeptical of the investment merits

By Jeff K. Davis

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Barring a break in the market, 2014 is shaping up to be another great year for IPOs. Pundits may debate whether some of the new tech-, media- and health care-related issues represent sustainable business models, but I think the renewed boom in IPOs is great for U.S. business. New equity capital usually represents growth capital, something that is good for our 2% +/- growth economy. And private equity investors who liquefy investments via secondary offerings obtain cash to reinvest in new ventures.

Financial services firms are well represented in the IPO wave. This year, nine financial services IPOs have priced through March 11, including specialty finance subprime auto lender Santander Consumer USA Holdings Inc., specialty finance CRE lender Ladder Capital Corp and Talmer Bancorp Inc. These companies respectively raised $2.1 billion, $259 million and $233 million inclusive of the underwriters' overallotment. Among the anticipated IPOs are investment bank Moelis & Co. LLC, General Electric Capital Corp.'s consumer unit, RBS Citizens Financial Group Inc. and Ally Financial Inc..

Assuming the Federal Reserve does not object to the company's capital plan and stress test this month, the U.S. Department of the Treasury and private equity investors are expected to sell up to $4.5 billion of existing Ally common shares in what would be the largest financial services IPO since the pre-crisis era. Ally will not receive any of the proceeds from the IPO, according to the S-1.

Count me as skeptical, but I question how enticing Ally's contemplated IPO will prove to be as an investment versus a possible quick trade even though Ally has largely shed its legacy mortgage-related baggage. Ally is a consumer finance company in a bank wrapper that originates very low yielding auto loans and leases. Although the transition in Ally's funding model to substantial reliance on low-cost deposits is a plus, I think Ally faces a daunting task in boosting ROE and growing its core earnings much beyond driving its fourth-quarter adjusted 2.21% cost of funds lower.

Ally raised $1.3 billion in November via a private placement by selling 216.7 million shares, which represented 14.0% of the company's 1.55 billion outstanding common shares as of year-end. If my math is not off-base, the raise valued Ally's common equity at $9.3 billion, which approximated 84% of $11.1 billion of common equity as of Sept. 30 and 100% of tangible book value when the $1.7 billion of "original issue discount" mark applied to the company's debt is excluded from equity without an offset from the $1.2 billion deferred tax asset allowance (amortization of the OID is certain, recapture of the DTA allowance is not).

The private market seems to have followed the appreciating public market since then. The government subsequently sold 410 million shares in January to investors for $3.0 billion. The sale represented 41.8% of the government's then 982 million share interest and 26.5% of the 1.55 billion common shares. The sale valued Ally's common equity at $11.3 billion, which approximated 107% of year-end common equity and 126% of tangible book value (again excluding the OID mark).

Ally reported "core pre-tax income, ex-repositioning expenses of $161 million in the fourth quarter and $271 million in the third quarter. Excluding a $98 million charge incurred in the fourth quarter related to a regulatory settlement, Ally reported adjusted pretax income of $530 million in the second half of 2013, or $1.06 billion annualized. The January transaction equates to 10.7x annualized pretax income and 16.4x assuming a normalized tax rate of 35%. The calculation is generous. Ally reported net income of $361 million in 2013, though results were loaded with charges and $249 million of OID amortization expense. Santander's valuation as of March 11 was 11.8x consensus 2013 EPS and 337% of tangible book value.

SNL published a Data Dispatch on March 10 about auto financing by U.S. banks that noted Ally retained its lead as the largest auto lender in 2013; however, the article also got to the crux of one of several issues that I think matters a lot for Ally — its exclusivity deals with Chrysler and General Motors have expired.

The exclusivity deal with Chrysler expired in April 2013. Santander Consumer subsequently entered into a ten-year deal with Chrysler and has since used the agreement to accelerate its expansion into prime auto financings beyond its traditional subprime franchise. The diversification of Santander Consumer's franchise probably helped management sell the company's IPO too, though the shares remain little changed from the January 22 IPO price of $24.00 per share. Not surprisingly, Ally's share of Chrysler's consumer financings declined to 14% in 2013 from 32% in 2011 per Ally's 10-K.

The agreement with General Motors that expired in February this year was replaced with a new agreement that no longer provides exclusivity for GM financings. Ally accounted for 29% of GM consumer financings in 2013, down from 38% in 2011. The share may fall further, or Ally may have to price more aggressively to maintain it. And Ally may face competition from GM, which acquired AmeriCredit Corp. in October 2010 for $3.3 billion and rechristened it General Motors Financial Co. Inc. Although AmeriCredit was a subprime lender, it may push deeper into Ally's turf.

Another issue that Ally and IPO investors face is a business that is highly cyclical. The auto finance business the past several years has been unusually good, marked by low losses, low financing costs and auto sales that increased for the fifth consecutive year to 15.5 million units. The all-time peak was 2005, according to DBRS, when 17.3 million units were sold. The backdrop has attracted a lot of competition, which in turn has started to weigh on loan and lease rates.

The third challenge is the Consumer Financial Protection Bureau. Ally entered into a consent order with the CFPB and Department of Justice in December that resulted in a $98 million pretax charge for dealer reserve pricing (by the dealers) that was deemed by the CFPB to be discriminatory. Although the issue has been settled, the CFPB may prove to be a self-induced governor on pricing and loan growth going forward.

In effect, it appears to me that the IPO may be occurring near an industry cyclical peak in terms of profitability and loan growth, though a recent report by DBRS assumes further growth for 2014. And Ally does not produce great returns to cushion a downturn — though a plateau rather than a downturn may be what follows. If the company's adjusted pretax ROE is around 10%, and maybe 7% after-tax, it is well below Santander Consumer's 2013 ROE of 27.8%. In a nod to the company's outsized-run in terms of net interest margin, ROE and earnings growth since the financial crisis, Santander Consumer management is shooting lower, targeting ROE in the low 20s. Ally management is targeting a "double-digit ROE over time."

My bet is that Ally's shares are going to be a plodder — producing unspectacular returns while not facing liquidity issues during periods of market stress given deposit funding. In fact, Ally may represent something akin to a deep cyclical stock. The best returns usually are obtainable when the economy and the company's financials are at a cyclical low point, not after a five-year recovery in the sector that has intensified competition and maybe looser underwriting standards to qualify more buyers.

Pricing of the IPO should be interesting to observe with the January private placement serving as a benchmark and presumably a hoped for floor value by the sellers. That is not to say a successful IPO cannot be executed. The old bond saw "price-cures-price" applies to equities too in which an asset priced cheap enough will draw investors.

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