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Bill Gross, Carl Icahn and share repurchases

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I doubt Bill Gross was looking to pick a fight with Carl Icahn when @PIMCO tweeted Oct. 24: "Icahn should leave #Apple alone & spend more time like Bill Gates. If #Icahn's so smart, use it to help people not yourself."

It took a couple of days, but Icahn responded Oct. 28: "To Bill Gross @PIMCO: If you really want to do good, why not join http://givingpledge.org/ like Gates, I and many others have?"

Gross then caved. He called for higher taxes on the 1% in his monthly investment outlook that was published Nov. 1.

Icahn does not seem to be a likeable guy, but it is encouraging that he shows no sign of giving up the fight at age 77. Icahn has had several reasons to gloat this year. He reveled in publicly belittling hedge fund manager Bill Ackman in their battle over the direction of Herbalife. In August, Icahn told Fox Business Network that he made $500 million being long on the stock. Ackman had touted Herbalife as a top short idea in late 2012. Herbalife is up more than 93% in 2013 to date. According to Forbes, Netflix Inc. has produced an $825 million profit for Icahn.

Icahn probably got a good belly laugh when Ackman was forced to unload his long position in J.C. Penney at a massive loss in August. Worse, Ackman could not quietly leak the shares into the market. Citigroup Inc. managed a secondary offering to dump his 39 million share position. A block trade met a block discount that the market knew was coming.

Icahn has crushed it from an investing perspective, though like any good investor there are plenty of bombs — Dell Inc. being the most recent. But the apple of his eye today is Apple Inc. Icahn is calling for Apple to repurchase $150 billion of stock using existing cash and newly issued debt. Earlier this year, Apple sold $17 billion of bonds. In the fiscal year ended Sept. 30, Apple generated net income of $37 billion, paid dividends of $11 billion and repurchased $23 billion of common stock.

I have no idea if Apple's shares are cheap or expensive. Icahn has a view on value, but I suspect his push for a $150 billion buyback is an effort to make management justify the lightly levered capital structure and distribute excess cash. As of Sept. 30, the company's cash and investments totaled $146 billion, while debt-to-EBITDA was less than 1x. A year ago Apple's cash and marketable securities totaled $121 billion. The market likes Apple as a credit. Its April debt issue included a tranche of 10-year fixed-rate debt that priced at just 75 basis points over U.S. Treasuries, allegedly then the most expensive global asset.

Banks do not have Carl Icahn pounding them to repurchase shares, but many bank analysts have been arguing that investors should buy bank stocks because capital is building faster than it can be deployed. The Federal Reserve, unlike during the pre-crisis era, is governing the amount of capital returned to shareholders. Basel III is another governor, especially given the enhanced leverage ratio requirement large U.S. banks are facing.

But are buybacks a good idea for bank managers today? I question the wisdom of many of the repurchases that are occurring when bank stocks are trading at price-to-earnings ratios in the mid-teens and at 1.5x to 2.0x price to tangible book value. The bane of buybacks, and M&A for that matter, is the human propensity to engage in risky behavior at the top of the market when all is well and risks seem minimal.

Share buybacks are not high finance. Use excess capital or cheap debt to fund the repurchase of shares. From a flow-of-funds perspective, repurchases also support share price — especially for small-cap banks that are thinly traded. Nevertheless, I do not think it is simply a constant P/E ratio and higher EPS from a reduced share count that yields a higher stock price. Value matters too for repurchases.

Ideally buybacks will occur when a stock is depressed, not when it is pressing a 52-week or multiyear high because the Fed has had the monetary spigots wide open for five years. The majority of publicly traded banks today are producing a return on tangible common equity in the range of 9% to 15%. If the shares are trading at 1.5x to 2.0x tangible book value, the effective return for new money is about 6% to 8% (based on the return on tangible equity divided by the price-to-tangible book value multiple) if the bank can reinvest retained earnings at a comparable return on tangible equity. Of course, returns could increase, but that seems doubtful to me when the mortgage refinancing boom is over, loan yields are grinding lower and credit costs for many banks are low.

Banks that repurchased shares in 2012 have seen varied results. It may be that banks producing the lowest returns, such as First Horizon National Corp., acquired shares in 2012 at a bargain price compared to banks that trade at higher multiples, such as Bank of Hawaii Corp.

JPMorgan Chase & Co. is an unanswered question too. Repurchases made in 2012 may prove to be money well spent — provided it is not going to be needed to shore up capital for litigation-related losses. JPMorgan's 2012 repurchases occurred at an average price of $42.19 per share, which was a modest premium to tangible book value. Today, the shares trade around $52, even though the company's outlook may be cloudier than it was in 2008.

CapitalSource Inc., Huntington Bancshares Inc., Fifth Third Bancorp and KeyCorp appear to have spent excess capital well in 2012 given a combination of low valuations and adjusted returns in the low teens. The homerun among the group is CapitalSource, which repurchased 17.2% of its year-end 2011 shares during 2012 for an average price of $6.91 per share and has bought back 7.0% of its year-end 2012 shares during 2013 for an average price of $9.14 per share. The company subsequently agreed to be acquired by PacWest Bancorp on July 22; its share price was $13.11 at the closing bell Nov. 4.

Having capital and the willpower not to repurchase requires discipline. It is also a tacit admission by a management team that the company's shares may be over-valued. So what is the alternative in the context of capital, profitability and growth "in that order," as ex-Whitney Holding Corp. CEO Bill Marks used to say? One option is to sit on capital waiting for the inevitable cyclical downturn, though that may be a long wait given the lack of loan growth and Fed actions that are indirectly supporting credit quality. Another option is to do acquisitions using excess capital and richly-valued shares.

A third option is to return capital via special dividends. However, Wall Street has never been as excited about special dividends compared to buybacks because they are one-time events with no impact on EPS or market demand. In the case of Apple, a special dividend cannot fund the repurchase of Icahn's position, but I agree with Icahn that there is no reason for a company to sit on shareholders' excess capital — after allowing for a conservative reserve. If the Fed manages to engineer further appreciation in asset prices, including bank stocks, the sector may see more boards electing to use special dividends to return capital — provided the Fed is agreeable.

Price matters: Are all a good use of capital?

Company (ticker)	11/4/13 closing price ($)	11/4/13 price/ LTM EPS (x)	11/4/13 price/ TBV (%)	YTD average buyback price/ YE12 TBV (%)	2012 average buyback price/ YE11 TBV (%)	YTD buybacks as % of YE12 shares (%)	2012 buybacks as % of YE11 shares (%)	YTD adjusted ROATCE (%)	2012 adjusted ROATCE (%)
Associated Banc-Corp (ASBC)	16.35	15.1	145	136	120	3.4	2.8	7.14	7.53
Bank of Hawaii Corp. (BOH)	57.23	16.8	265	227	219	1.5	3.8	6.61	7.64
Beneficial Mutual Bancorp Inc. (MHC) (BNCL)	9.85	54.7	157	NA	261	1.5	1.3	NA	1.28
Bank of New York Mellon Corp. (BK)	32.51	17.8	291	150	137	NA	4.1	12.52	16.92
BOK Financial Corp. (BOKF)	61.83	13.0	163	160	157	0.3	1.0	7.79	8.87
CapitalSource Inc. (CSE)	13.11	17.5	182	132	126	7.0	17.2	7.68	26.81
Capitol Federal Financial Inc. (CFFN)	12.50	26.0	113	102	102	4.9	7.5	4.05	3.86
Community Bank System Inc. (CBU)	36.19	17.8	303	112	96	NA	0.0	15.96	16.43
Comerica Inc. (CMA)	43.30	14.8	126	179	171	3.1	5.2	4.97	4.79
Commerce Bancshares Inc. (CBSH)	45.75	16.0	206	NA	NA	1.9	3.0	NA	NA
East West Bancorp Inc. (EWBC)	33.55	16.4	240	NA	180	NA	6.2	NA	8.43
Fifth Third Bancorp (FITB)	18.84	9.4	144	NA	NA	NA	4.8	NA	NA
First Commonwealth Financial Corp. (FCF)	8.65	20.6	150	NA	92	NA	5.4	NA	7.72
First Financial Bancorp. (FFBC)	15.49	14.8	NA	NA	117	NA	1.3	NA	9.68
First Horizon National Corp. (FHN)	11.01	NM	138	NA	151	3.4	5.6	NA	-0.78
First Citizens BancShares Inc. (FCNCA)	210.26	12.9	110	130	107	NA	6.4	8.61	7.09
Fulton Financial Corp. (FULT)	12.19	14.9	157	NA	133	4.0	1.1	NA	8.06
Huntington Bancshares Inc. (HBAN)	8.78	12.0	145	130	125	2.0	2.7	9.99	11.00
International Bancshares Corp. (IBOC)	22.87	15.5	139	NA	111	NA	0.1	NA	7.77
JPMorgan Chase & Co. (JPM)	52.04	11.8	134	130	127	2.4	0.9	8.28	11.91
Kearny Financial Corp. (MHC) (KRNY)	10.47	NM	193	177	166	0.2	1.3	1.66	0.83
KeyCorp (KEY)	12.50	13.4	126	116	90	3.8	3.3	8.56	10.56
MB Financial Inc. (MBFI)	29.79	16.6	190	186	140	0.2	0.2	6.60	7.88
National Bank Holdings Corp. (NBHC)	20.45	NM	110	98	94	2.1	0.0	1.18	0.31
National Penn Bancshares Inc. (NPBC)	10.30	26.4	173	NA	151	0.0	4.9	NA	7.31
Northern Trust Corp. (NTRS)	56.65	19.0	188	191	173	1.4	1.5	5.70	6.04
Northwest Bancshares Inc. (NWBI)	13.79	20.0	135	NA	117	NA	4.5	NA	5.55
Old National Bancorp (ONB)	14.67	15.0	189	162	155	0.8	0.3	8.06	7.97
Oritani Financial Corp. (ORIT)	16.41	17.5	142	NA	111	NA	21.5	NA	5.37
People's United Financial Inc. (PBCT)	14.32	19.6	181	158	143	7.2	5.1	5.88	6.10
Provident Financial Services Inc. (PFS)	18.66	15.3	174	142	140	0.7	1.1	7.96	7.88
Simmons First National Corp. (SFNC)	33.22	19.9	160	125	121	4.5	4.2	6.16	6.67
State Street Corp. (STT)	70.92	16.2	271	246	195	5.1	6.9	NA	9.53
StellarOne Corp. (STEL)	23.33	21.4	168	NA	NA	NA	0.0	NA	NA
UMB Financial Corp. (UMBF)	58.98	19.9	NA	271	287	0.1	1.2	NA	NA
Union First Market Bankshares Corp. (UBSH)	24.21	16.9	167	200	193	2.0	4.2	5.23	5.62
U.S. Bancorp (USB)	37.54	12.6	272	133	113	3.0	3.1	17.28	21.33
ViewPoint Financial Group Inc. (VPFG)	21.56	24.0	NA	150	NA	0.2	0.0	NA	NA
Westamerica BanCorp. (WABC)	52.24	20.0	347	299	313	3.2	4.0	6.03	6.83

Pricing as of Nov. 4, 2013.
Adjusted return on average tangible common equity, or ROATCE, equals ROATCE divided by the average price/tangible book multiple for each year.
Includes all publicly traded U.S. banks and thrifts that announced a share repurchase program in 2012 and had a market capitalization greater than $500 million as of Nov. 4, 2013.
NA = not available
Source: SNL Financial

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