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Business bank bolt-on could be best play for CIT

By Jeff K. Davis

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CIT Group Inc. CEO John Thain was one of the lead stories in *The Wall Street Journal* on June 6. When asked about regrets, he offered taking the Merrill Lynch job in early 2008. I bet the events of 2008 were gut-wrenching even before Lehman blew as Merrill's treasury unit struggled to fund the balance sheet. The *Journal* also had a poetic justice sidebar that showed CIT's shares easily outperforming Bank of America Corp.'s shares since Thain became CEO in February 2010, not that current CIT investors care about the personal aspects of the story.

Perhaps it speaks more about the Fed and what is occurring in the U.S. regulatory apparatus than CIT that the Federal Reserve terminated its 2009 written agreement with CIT two years later than CIT management expected in 2010. The lifting is the final chapter in the company's financial crisis episode that saw CIT be designated as a bank holding company in late 2008, receive $2.3 billion of TARP capital, and then enter into a prepackaged bankruptcy 10 months later when it could not roll enough debt or get regulatory approval to transfer assets to CIT Bank.

The quick prepackaged bankruptcy that Carl Icahn helped orchestrate was a success. Common and preferred equity shareholders, including Treasury, were wiped out. About $10 billion of $55 billion of debt was eliminated, too. CIT emerged a viable and increasingly vibrant lender. Since then, management's efforts have been focused on refinancing debt, growing the bank and its deposit funding, and resuming asset growth.

It has been a slow process, and I do not think the lifting is going to change the pace much. Investors should be prepared for more of the same as it relates to the shares — a slow grind — but one with a positive bias as long as the economy holds. Even if Thain wanted to do something dramatic, the lifting of the written agreement does not mean the ball can be heaved down field to dramatically change the company's strategic position.

CIT has a couple of advantages relative to its commercial lender peers. One is its historic focus on higher yielding assets, which matters a lot as the Fed's zero rate policies continue. The yield on the $22 billion loan portfolio was 6.8% in the first quarter (+7% ex-the runoff student portfolio), and the yield on the operating lease portfolio (aircraft and railcars primarily) was 9.5%. Absent a change in rate and price competition, yields will drift lower, but CIT has room for its funding costs (3.6%) to decline, too. The net finance margin now comfortably exceeds 4%. The company also has lots of capital (16.4% Tier 1) and no massive branch network that has to be pruned.

On the other hand, CIT has some disadvantages. One that is not discussed among investors is the absence of much fee income beyond factoring commissions and other miscellaneous sources. Fee income in the first couple of years post-bankruptcy was supported by gains from asset sales, but that is running its course and represents a very low multiple earnings source. I doubt the lifting of the written agreement is going to lead to an acquisition that materially changes the fee equation. Asset managers, payment processors, insurance agencies and mortgage banking do not fit at CIT.

While CIT was not precluded from acquiring blocks of assets, whole bank acquisitions were, in effect, precluded under the written agreement. CIT can now acquire whole banks, but the delay cost it a shot at acquiring a failed bank to build branch-based core deposits that I think regulators want CIT to have. Ironically, I believe CIT Bank did not lose any of its brokered CDs during 2009 when the parent could not maintain adequate funding.

In the near term, I think if management had its way it would make an acquisition of a small business bank to augment its banking platform, especially as it relates to commercial deposit and treasury services. There are not many smallish banks that fit the business bank definition of being 10%-15% the size of Comerica Inc.. Someone may tell me otherwise, but I believe the last notable business bank to be acquired was in 2008 when U.S. Bancorp acquired Mellon 1st Business Bank from Bank of New York Mellon Corp. Management may have to settle for a small real estate-focused bank that otherwise has a robust commercial-focused deposit franchise and infrastructure that can be levered.

The other obvious outcome of the Fed's action is a more robust return of capital than the $200 million repurchase action that was announced May 30. The authorization represents about 2% of the current market cap. Barring acquisitions and really strong loan demand, CIT may have upward of $2 billion of excess capital. I assume a more aggressive distribution policy awaits the early-2014 capital plan review by the Fed. Also, retained earnings were only $88 million at March 31, so a bit more time to accumulate earnings may support the dividend level later.

Return of capital is shareholder-friendly. In the case of CIT buybacks, they will be occurring at a slight premium to stated tangible book value ($40.35 per share at March 31) and a modest discount to tangible book value excluding residual fresh start accounting (about $52 per share). But buybacks, absent lots of dry powder during bear markets, usually do not get shareholder juices flowing. Still, a material return is a prerequisite to boosting the 8% ROE posted in the first quarter. As for earnings, first-quarter earnings arguably represent a good run rate for CIT when pretax income of $188 million equated to a pretax ROA of 2.19%.

So, I would not look for something dramatic from CIT. Bloomberg, Reuters and other media outlets have discussed the potential for CIT selling. I do not dismiss the possibility for the reasons enumerated here, but given the tough regulatory environment I question if a buyer could get the Fed to approve a deal for CIT today. Large deals do not work. If CIT seems like a slow-grind repositioning story with lots of excess capital as was the case three years ago, that is because it is. But visibility of the transformation will be much better going forward. The easy money buying the common was made immediately after CIT exited from bankruptcy in late 2009 and again in the third quarter of 2011, when Thain bought shares around $30 per share amid a global rout in equity markets. Still, I think CIT represents a good risk-reward story as revenues and ROE grind higher while those of many peers will see some slippage.

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