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CIT's soft attempts to sell?

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On Feb. 8 Reuters reported that CIT Group Inc. had informally given a green light to Goldman Sachs Group Inc. to discern the level of interest among a handful of large banks in acquiring CIT. Toronto-Dominion Bank and Wells Fargo & Co. were reportedly contacted, but apparently did not bite — at least not yet. Presumably others were contacted too. Wells Fargo is making a push in aircraft leasing, CIT's largest commercial asset category. TD has strung together a combination of regional banks along the East Coast and more recently specialty finance via acquiring Chrysler Financial to build a significant U.S. presence. CIT might be an interesting specialty lender to add to the mix.

The timing is curious, but it may point to frustration with the time it has taken to reposition CIT's assets and funding since emerging from a prepackaged bankruptcy in December 2009. Also, the Federal Reserve has taken longer than originally assumed three years ago to release the parent company from a "written agreement" that remains in place today.

From my perspective, CIT is progressing along the lines of my original investment thesis, which assumed post-bankruptcy CIT's debt (primarily the 7% second lien Series A and B notes) were a compelling investment; however, the outlook for equity investors was assumed to be less compelling given the three to four-year timeframe I thought it would take to reposition. CIT is now in the seventh inning of its repositioning in my view.

In the spring of 2010 CIT hosted an informal gathering of sell-side analysts to talk about the business post-bankruptcy with new executive management, including CEO John Thain. At the time CIT was not making formal outward bound presentations to investors. The confab was intended to help the Street decipher CIT's post-bankruptcy plans and introduce Thain to the analysts who had not covered him at previous stints at Merrill Lynch & Company, NYSE Euronext and Goldman Sachs.

One of the questions was: why not sell the company? Thain responded that if one was going to acquire the company, it would have made sense to do so immediately upon exiting from bankruptcy when the market cap was around $6 billion based upon a share price that was around $30 per share. By the time of the meeting, the market cap was near $8 billion with the shares trading around $40 per share. Corporate raider Carl Icahn, who was instrumental in CIT's bankruptcy by taking a position in its debt, sold shares received in the reorganization because he did not see further upside, or at least in a reasonable amount of time.

The question I did not ask, but should have asked Thain was: after saving Merrill Lynch and running NYSE Euronext and Goldman Sachs (where he was president and COO until 2003), why CIT — a midsized lender with an above average cost of funds that was handcuffed by the Fed and the FDIC?

I assume it was not money, though the 2011 and 2012 proxies indicate compensation in the C-suite at CIT is not bad, and probably has good upside if CIT achieves its financial objectives over the next few years. The opportunity to rebuild CIT at a time when Wall Street's competitive landscape was in flux probably was a powerful draw. Unlike the executives of Lehman Brothers and Bear Stearns who created smoldering ruins from once great companies, Thain rescued Merrill Lynch after joining it less than two years earlier. Even if Secretary Paulson and Chairman Bernanke had not allegedly leaned on Ken Lewis at Bank of America Corp. to close the deal when BofA's inclination was to invoke the material adverse event clause, no one would have blamed Thain for what would have then happened to Merrill Lynch.

So is the Reuters article plausible? It may be, because the economic trajectory and lending environment that most contemplated, perhaps including Thain, as he was being recruited, in late 2009 and early 2010, have been weaker than the consensus anticipated at the time. The result has been a slower repositioning of the business — at least from an asset perspective — given sluggish loan demand and a hyper competitive lending environment. From a regulatory perspective, Dodd-Frank had not been signed into law in early 2010. Also, I believe the thought process at CIT throughout 2010 was that the Fed would lift the written agreement in 2011. That has yet to occur, so to the extent CIT management hoped to use excess capital to acquire a business bank to add commercial banking infrastructure, the written agreement has precluded any whole-bank acquisitions. On the plus side is recent management commentary that its 2013 capital plan submitted to the Fed includes a provision for a modest return of capital. Presumably CIT informally asked for the Fed's view on a distribution lest management and shareholders be surprised as was the case last year with Fifth Third Bancorp and Citigroup Inc.

CIT continues to face many challenges, but I think my original investment thesis when I initiated coverage in 2010 is correct: the repositioning process would take three to four years. CIT outperformed the SNL U.S. Bank Index in 2010 as it emerged from bankruptcy and saw its shares trade from a sizable discount to tangible book value to around tangible book value in the absence of current earnings and a hope then that the economy was gaining steam. Since year-end 2010, the shares have underperformed (-10% vs. +9% through February 12).

With the repositioning process to be largely completed this year and the cost of funds falling further, earnings visibility should notably improve this year.

Further, a large portion of CIT's asset base consists of high yielding, longer duration aircraft and rail car leases. As a result, I think the shares have a good chance of moderately outperforming the large-cap bank indexes in 2013 even without much M&A speculation.

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