NASHVILLE NOTES

Investing In Under-Earning Franchises

Tuesday, January 30, 2024 10:29 AM ET

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The more things change, the more they stay the same. JPMorgan Chase & Co. continued to excel in 2023 while Citigroup Inc. remains a turnaround story.

Although management has said it before, kudos to JPMorgan CFO Jeremy Barnum for acknowledging in a Jan. 12 earnings call that the company is "over-earning." JPMorgan posted a return on tangible common equity (ROTCE) of 21% in 2023, which is 400 basis points above the through-the-cycle target. The big picture guidance was that ROTCE should start to trend toward the target in 2024.

That statement presumably excludes a huge pickup in the trading environment, or another bargain purchase, as occurred with First Republic, that would delay the normalization process. Having top or near-top market share in most business units does not guarantee a competitive return on equity, but it is a good starting point.

Citigroup CEO Jane Fraser also spoke truth in calling the 2023 fourth quarter, in which the company lost $1.8 billion due to an assortment of one-time charges, disappointing. I would characterize the year as disappointing with an ROTCE of 5% compared to an underwhelming 9% in 2022. Management has a tough job to remake Citigroup.

The job would be easier, and possibly not necessary, had Wells Fargo & Co. not snatched Wachovia from Citigroup in the fall of 2008. Wachovia would have added about $450 billion of deposits to a company that has always been light on low-cost deposits from my perspective. The loss of the Solomon Smith Barney operation to Morgan Stanley is another "what if": The deal has contributed to Morgan Stanley's strong returns — 13% ROTCE in 2023 — and helped cement recently retired chief executive James Gorman as a top CEO.

> ***Citigroup shares can be bought on the cheap, but it's the performance of the company that will drive returns more than price paid.***

Citigroup's shares have been a lousy stock the past five years with a total return of negative 2% through Jan. 19, compared to 89% for JPMorgan, 128% for Morgan Stanley and 113% for Goldman Sachs. Citigroup does not seem quite the laggard when compared to Bank of America Corp. and Wells Fargo, which posted five-year total returns of 24% and 11%, respectively.

Nonetheless, Citigroup is an interesting stock for value investors. As of Jan. 19, its shares were trading for about 9x the consensus 2024 EPS estimate and 60% of year-end 2023 tangible book value per share, compared to about 11x and 200% for JPMorgan.

The past five years have brought tremendous volatility for bank stocks, ranging from the March 2020 and March 2023 busts, to euphoric runs in 2021 as the economy reopened, and late last year, in expectation of Fed rate cuts. However, most stocks have not done much. To the extent that earnings have risen over this time, price-to-earnings ratios have compressed.

Reversion to the mean is a powerful concept for investors, as JPMorgan's Barnum indirectly noted regarding the company's current outperformance versus management's view of earnings power. Citigroup is under-earning, but its checkered history makes its long-term earnings power tough to define beyond "do better."

> ***For banks that do not grow and that produce so-so returns, there are few alternatives to driving returns higher by cutting costs while growing revenue.***

A money manager friend recently asked me about investing in banks that do not grow and that produce just so-so returns.

Aside from hoping for an attractive offer from PNC Financial Services Group Inc., my thought is the same as what Citigroup is trying to achieve: drive return on equity higher by creating operating leverage through cutting costs, overlaid with a little bit of revenue growth. Use excess capital generated to buy back shares year after year. Citigroup has no alternative.

An entry price is the one variable an investor exercises absolute control over, and it is a key determinant of return over a short-to-intermediate time frame. Citigroup shares can be bought on the cheap, though that has often been the case. Longer-term, the performance of the company will be the driver of returns more than price paid.

The skew for prospective Citigroup investors seems to be positive, with a lousy return on equity and mediocre price-to-earnings ratio in which there is theoretical upside to earnings, versus expectations and room for the multiple to expand if materially better performance can be sustained.

The skew would be more positive if the economy were at the beginning of a new credit cycle rather than at the end of an extended positive cycle.

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