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Investors will wield sizable pricing power in the Citizens Financial Group IPO

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Royal Bank of Scotland Group Plc filed a long awaited S-1 to take public U.S. subsidiary Citizens Financial Group Inc. on May 12. After reviewing the S-1, I cannot help but think of another IPO from May 2012 — Facebook Inc.

While the roadshow for Facebook was sheer hype with cameras following Mark Zuckerberg around Manhattan, the IPO itself is widely viewed as a disaster. Among the issues were trading problems that plagued NASDAQ and a pre-pricing briefing of analysts regarding lower revenue expectations that may have disadvantaged retail investors. But the biggest issue, in my view, was an IPO that was substantially over-priced at $38 per share. Hyping shares and working the media sometimes can influence IPO pricing. In early May 2012, the targeted price range per share was $28 to $35.

The subsequent drop in the shares to around $31 per share over the days following the IPO and under $18 per share by early September is what is known as "breaking price" in the vernacular of Wall Street. It should not have happened to one of the hottest IPOs of the past decade. Press reports subsequently emerged that Facebook executives leaned hard on book runner Morgan Stanley to push pricing. The other two leads for Facebook included JPMorgan and Goldman Sachs & Co.

SNL's Ken McCarthy and Jack Chen penned a piece on May 19 suggesting that bank IPOs were likely to continue, but the performance of ServisFirst Bancshares Inc.'s IPO could impact pricing. ServisFirst priced at $91 per share (15.4x LTM EPS of $5.90 per share and 2.5x TBV of $36.16 per share) on May 13. Since then the shares have fallen about 11% to $80.95 per share as of May 19. I do not think the drop in price reflects fundamentals. I have known ServisFirst and its management for years. It is the real deal in terms of high profitability and high growth — though it is a reasonable question to ask if both are sustainable as the company gets bigger. Maybe the underwriters overpriced the IPO in a market where investors are starting to realize that bank returns are going to decline, not rise, if the rate environment does not improve.

Morgan Stanley, Goldman Sachs and JPMorgan are the lead underwriters for Citizens' IPO. Unlike the Facebook IPO, I think investors are going to control pricing as was the case with Ally Financial Inc., which priced at the low end of its expected range. Citizens' returns are weak and do not show much promise for improvement beyond distributing excess capital, in my view, because Citizens is dealing with a commodity product that is subject to intense competition. However, that does not mean Citizens cannot be a good stock over an intermediate time frame provided investors force the underwriters to price the shares sufficiently cheaply.

Citizens' positive attributes include its size (13th largest retail bank holding company and 25th largest overall BHC at year-end 2013), a 12-state footprint that includes the second largest deposit market share position in New England (No. 2 in Boston), $77 billion of low cost deposits excluding CDs, a lightly levered parent company and a sizable capital position (13.5% Tier 1 common equity ratio at year-end 2013). The capital position and little loan growth probably ensure a competitive dividend provided the Federal Reserve is okay with whatever reworking of Citizens' capital plan may occur. The Federal Reserve objected to certain qualitative aspects of the 2014 capital plan, though Citizens was allowed to continue to take capital actions consistent with 2013. During 2013 the company paid $185 million of common dividends, while the subsidiary banks paid $210 million of upstream dividends to the parent. Assuming a competitive dividend, Citizens' shares may be attractive for equity-income focused portfolios. Also, the S-1 notes that management plans to swap $1.0 billion of common equity for other forms of capital in 2014, which would reduce the pro forma Tier 1 common equity ratio to 12.5% as of year-end 2013.

If the Federal Reserve were more amicable to large banks getting larger through M&A, then Citizens probably would be a good candidate to acquire. I question how much of a free rein Citizens may have given its $122 billion of assets at year-end 2013, but perhaps Citizens will be able to lever capital through limited M&A. Like its plan to increase loan originations, M&A is a highly competitive proposition. An alternative transaction might be a quasi-MOE with KeyCorp, which would increase market share in the Northeast and Ohio in addition to offering significant expense savings. However, public policy is such that large banks are not going to be allowed to get a lot bigger through M&A.

The negatives before discounting the IPO price are sizable. Among Citizens' problems are weak earnings and declining revenues. The NIM was 2.85% in 2013, down 4 basis points from 2012. Excluding a $4.4 billion goodwill impairment charge in 2013, Citizens posted net income of $654 million, compared to $643 million in 2012. The return on average tangible common equity excluding the charge was 4.95%, and the return on average assets was 0.54%. These are not competitive returns. Maybe the loan loss provision can decline from 0.56% of average loans in 2013, but probably not enough to materially drive a sustained improvement in earnings. Also, revenues declined about 3% in 2012 and 4% in 2013. Investors usually will look past limited profitability when a company is on a growth trajectory.

The Street probably will focus on the value proposition based upon pricing relative to $12.3 billion of tangible common equity as of year-end 2013. If Citizens prices such that the market cap is around $12 billion, then the implied P/E based upon 2013 net income excluding goodwill impairment would be nearly 19x. A cheap stock might be 80% of tangible book value, which would equate to a still sporty 15x. The dividend yield and discount to tangible book value may be the arbiter in the pricing equation for institutional investors. How much of a discount RBS is willing to accept is unknown. The U.K. government wants RBS to shed assets and focus on the U.K. market, but presumably it does not want Citizens to be given away. However, its leverage appears limited to me unless the roadshow convinces investors returns are going to meaningfully improve absent the mythical hike in short rates that has been fantasized about for years.

Citizens falls into the class of large banks that some institutional investors call a "big ugly" given size but uninspiring returns and an absence of growth. It is a pejorative term, but not completely off-base. However, I could be wrong. Citizens could prove to be a great stock because management is able to reposition the balance sheet and produce revenue growth at the same time expenses are cut to produce big operating leverage. It seems unlikely, but sometimes shares like those of Citizens can surprise investors by outperforming peers when investors have low expectations, the valuation is modest and management forces the Street to rethink its thesis by producing better returns and growth than expected.

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