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Lion Capital kind of has a point with Ally Financial

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Activism seems to be on the rise in the banking sector. That, I think, is a good thing for shareholders even though regulatory hurdles limit the extent that activists can force a board to change direction. I believe that is why Carl Icahn is not the mid-cap and large-cap counterpart to the likes of Lawrence Seidman, who has been an activist investor in small banks for years. Nevertheless, there is nothing wrong with periodic cage rattling.

On January 4, Ally Financial Inc. disclosed that it had received a notice from Lion Point Capital LP regarding its intention to nominate two candidates for election to Ally's board. The release also indicated that Lion Point had asked the board to establish a "Strategic Alternatives Committee." Or in layman's term, the communiqué asked for a sale of the company. I am not a corporate securities attorney, but I do not believe a board is required to make a decision for short-term gain if there is a reasonable long-term plan to create value. U.S. boards are guided by the "business judgment rule" in which courts typically do not second-guess decisions as long as directors adhere to a standard of care (informed decision making), loyalty and good faith. It is the golden rule equivalent for boardroom decision making as long as there is no breach of duties.

Ally Chairman Hobbs nixed the Strategic Alternatives Committee — at least for now — by noting, "our primary duty as directors is to assess the best path for Ally and all its stockholders. Although we are troubled by Lion Point's tactics, our fundamental disagreement is with Lion Point's clear agenda to force a sale of Ally. Such a course of action would be contrary to the best interests of stockholders and our obligations to all stockholders do not permit us to adopt such a course to avoid a proxy contest."

Lion Point Capital's investment strategy as described in its ADV is focused on "special situations." Most such funds focus on deep value plays in which an activist investor attempts to force (or help!) a company realize value. Usually this will involve the sale of the company. It can also entail the spin-off of a unit that may not be appropriately valued, or leveraging the capital structure to fund a special dividend or buyback.

Ally has the attributes of a special situation opportunity. As of January 8, its shares traded for 65% of tangible book value and 8.4x consensus 2015 EPS. The shares have been miserable the past year, falling 28.3%. Although I did not foresee the drop, directionally it was consistent with a post I had on Ally's then-proposed IPO in March 2014, in which skepticism was expressed about the shares' investment merits.

Ally was a statistically cheap stock a year ago that has gotten cheaper over the past year. Why the woeful share performance? It is not because the company's metrics are rolling over. Ally produced a core ROTCE in the third quarter of 9.2%, which was about the same as the year-ago quarter. The return is uninspiring, but it is not bad when the U.S. 10-year Treasury note yields about 2%. The NIM increased 2 basis points from a year ago to 2.67%, while the efficiency ratio improved to 44% from 49%. Consolidated net charge-offs were little changed from a year ago at 0.61%. Delinquencies are not up much. And management's outlook is positive. CEO Brown targeted 15% EPS growth for 2016 and 2017 at the Goldman Sachs US Financial Services Conference in December.

Maybe Mr. Market is signaling a change is coming as is the case with high-yield bonds and leveraged loans. Among companies that fall into the auto and consumer finance genre, Ford Motor Co., General Motors Co., Discover Financial Services and Capital One Financial Corp. have seen their shares trend (or gap) lower the past year. Valuation has not provided support with all four trading at single digit P/Es based upon 2015 estimates. The market's view could be that auto sales are peaking (18 million annualized presently) and that consumer loss rates are headed higher. On the other hand, a friend of mine who owns a large dealership in Nashville told me in December that the business keeps getting better. Maybe his business is peaking and the market has not told him yet?

Let's hope Ally's board did not unequivocally tell Lion Point to take a hike. The message is helpful for shareholders even if its format is too raw for the board. I assume the board told Lion Capital that management needs more time to execute its growth strategies and to optimize the deposit-centric funding model and capital structure. It is not an unreasonable argument. Ally's cost of funds in the third quarter of 2015 was 1.70%, with deposits accounting for about 46% of funding sources. The cost of funds for deposits was 1.1%, compared to 4.9% for long-term debt. Absent aggressive rate hikes, the NIM should trend higher over the next couple of years as the deposit contribution grows.

As for capital, Ally is getting close to optimizing the capital structure so that on a go-forward basis current earnings can be directed to share repurchases and common dividends. CEO Brown indicated both buybacks and dividends would be part of the 2016 CCAR submission. Unlike some banks that are buying back shares at what I think are high earnings multiples, Ally may get the opportunity to repurchase cheap shares provided earnings are not poised to plummet. Under the current CCAR authorization capital has been used to redeem preferred shares.

Ally's evolving funding and capital positions are two glass half-full attributes that are obvious. I see two glass half-empty attributes. The obvious one is that the corporate bond market is signaling credit costs are going to rise. Why is harder to discern. A Fed policy mistake, ridiculously easy credit for subprime borrowers, or something else may be the culprit. If so, NIM expansion will be offset or maybe more than offset by higher credit costs. Am I reading too much into the bond market? Maybe, but the move in the shares is not inconsistent with the high-yield bond market. Moody's long-term issuer rating is non-investment grade (junk is too strong of a term for Ally) at Ba3.

And the elephant in the room I see is Ally's run-in with the Consumer Financial Protection Bureau. If press reports are true, the CFPB targeted Ally because it was politically weak in order to achieve an industrywide template settlement as to how auto lending is to be conducted. One may retort the issue is settled; however, many bankers I know loathe the CFPB and view it as an unaccountable regulator with an agenda. Why invite more scrutiny by acquiring Ally? Besides, there are only a few potential large-bank acquirers and they are already in the business. As for a similar sized bank such as a CIT Group Inc. entering into a MOE with Ally, it is not going to happen for the same reason.

Capital structure opportunities and the like aside, Ally's fundamental problem is its business model. Although management has done a great job to create a consumer brand in Ally Bank that can produce cheap deposit funding without the baggage of costly branches, the crux of the valuation issue is on the left-hand side of the balance sheet. Excluding subprime lending, prime and near prime auto lending is a low-to-mid single digit yield proposition in the current rate environment. In good times competition squeezes pricing, in bad times charge-offs jump. Ally's business model is a modest P/E proposition as it relates to normalized earnings. That multiple is especially pedestrian today when the likes of Capital One, Discover and even JPMorgan Chase & Co. trade around 10x earnings.

Nevertheless, every asset has a good risk-reward entry price. Ally's downside from here may be limited even if the broader market is entering a bear market. Valuation is never a stand-alone catalyst, but it can provide support — especially if the support comes with buybacks. I think the key to this stock over the next 12 to 18 months will be the outlook for credit losses. If the outlook deteriorates, the market has calculated earnings will decline and buybacks will be put on hold. If credit losses do not increase much and the Fed gives reasonable buyback authority as part of the 2017 CCAR process, the catalyst may be in place. And Lion Capital's cage rattling will not have hurt the cause at all.

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