Wednesday, August 29, 2012 11:45 AM ET Exclusive

Revisiting Carl Icahn's CIT debt and equity trades

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A lot of ink has been expended on CIT Group Inc. since 2009 when the company had a liquidity crisis that led to a pre-packaged bankruptcy with creditors owning the company and $10 billion of $55 billion of debt eliminated. Among the losers in the reorganization was the U.S. Treasury, which saw its $2.3 billion preferred equity wiped-out. Although the 7.0% Series C senior notes were not originally issued in the reorganization, the August 20 announcement that CIT will redeem the last of these notes closes the books on the reorganization phase — at least in my view. When I initiated coverage of CIT in September 2010, my thesis boiled down to this: CIT was a great story for debt investors given high coupon debt in a low rate world and a balance sheet that was highly capitalized and liquid; however, the prospects for equity investors were murky given the time it would take to reposition the balance sheet.

At year-end 2009, CIT had $45 billion in debt, excluding Fresh Start Accounting (FSA) marks. Since then, $31 billion has been retired or refinanced. Although CIT is below investment grade (S&P BB-), its debt today trades at spreads that suggest an investment grade rating will be forthcoming. For example, CIT issued five-year senior debt in early August at 358 basis points over five-year Treasurys. The debt has since tightened a bit. In comparison, CIT's since retired 7.0% Series A notes due 2013-2017 traded at a discount with yields-to-maturity in the low teens in February 2010.

CIT's common on the other hand has been range bound most of the time at $35.00 to $45.00 per share after an initial post-bankruptcy bounce. The shares opened at $27.00 when trading for the "new" common began Dec. 10, 2009. They then trended higher to $38.96 per share on March 31, 2010. CIT closed at $38.30 on Aug. 23, just below its June 30 tangible book value of $39.87 per share.

Billionaire investor Carl Icahn had the right call on the debt being a better play than the equity three years ago. Icahn originally opposed management's pre-packaged bankruptcy plan, favoring a standard bankruptcy route while offering bond holders 60% of par. Under the plan that Icahn eventually backed, which included new management and directors, bond holders got new debt and equity worth 70% of the old notes. He also provided $1 billion of debtor-in-possession financing to help see the company through the reorganization; however, during the first quarter of 2010, Icahn sold the 2.4 million shares his fund received, viewing the shares as being reasonably valued. If there is one thing Icahn is not in my opinion, it is a patient investor. He is an activist investor who pushes to unlock value, usually successfully. I bet he views patience as a virtue for a doormat.

While the potential for further spread tightening of the bonds is limited, I think the outlook for the common equity is improving now that CIT is past the halfway point in what I assume is a three-to-four year repositioning process for those with patience. The past two years have been marked by efforts to shift most U.S. asset originations excluding aircraft leases to CIT Bank, refinance high cost debt, sell non-core assets, add management, and build risk management processes to suit banking regulators. Those efforts will be increasingly visible over the next few years.

Progress the past year has been obscured by losses incurred to call high cost debt with net losses recorded in four of the past five quarters. The year-to-date net loss of $515 million nearly matches the $560 million profit recorded in 2010 and 2011. The losses are attributable to acceleration of FSA amortization for discounts applied to CIT's debt when it emerged from bankruptcy. The costs have caused tangible book value per share to decline to $39.87 from $42.70 per share at March 31, 2010. I also think the quarterly losses have made it harder for equity investors to focus on tangible book value excluding both asset and liability FSA marks, which was $50.52 per share per my calculation at June 30, 2012. The same applies to "earning power" when losses are being reported.

With one more quarter of heavy call expense to be incurred, CIT's earnings visibility is poised to improve significantly next year. The cost of funds will be lower and asset origination momentum, if sustained, portends good growth in net finance revenues.

I think that aspect of the CIT story is understood by equity investors. Also, I think the Street understands that CIT has significant excess capital via its 18.0% Tier 1 common ratio. While upward of $2 billion of $8.1 billion of tangible common equity is excess capital (approximately $10.00 per share), it remains to be seen how much flexibility the Fed will grant CIT to return capital via dividends and repurchases, assuming the "written agreement" is lifted by early next year. While some excess capital also may be used for an acquisition of a bank to add commercial banking infrastructure for treasury services and the like, I do not think management is going to blow capital on a large acquisition, especially a bank with a big branch network.

What the Street may be overlooking is the attractiveness of the asset mix in the context of the Fed's zero interest rate policy. About 47% of the $29 billion of commercial loans and leases held as of June 30 consisted of transportation assets. The core assets within Transportation Finance consist of $8.8 billion of commercial aircraft leases and $3.7 billion of rail car leases. These are high yielding, long duration assets. These assets combined with a declining cost of funds have positioned CIT to report an improving margin and ROE over the next few years provided credit quality holds. Most bank and some specialty finance peers will experience declining margins and lower ROEs because their cost of funds is near a floor while yields for new assets are very modest.

Aircraft leases typically entail yields of 10% to 13% for new aircraft with terms that can be as long as ten years. Further, aircraft leasing is a secular global growth story. Aircraft travel has been growing approximately 2x global GDP growth for several decades in a trend that shows no signs of slowing. The need to replace older aircraft with newer fuel-efficient ones provides additional growth potential. Also, airlines are increasingly relying on lessors' balances sheets to free capital.

Railcar leasing in North America may not have the same growth dynamics as aircraft, but gross yields are around 10% with leases running around five years. The corporate finance business unit also produces good yields in the range of 400-500 basis points over 30-day LIBOR; however, growth in corporate finance loans has been hobbled by soft demand beyond refinancing activity and limited capital expenditure financings. Vendor financing yields also are attractive, though the book is small at less than 10% of commercial assets.

The net is that I think CIT has a good shot of pushing its net finance margin closer to the high-end of its targeted 3-4% range over the next few years. CIT posted a 3.02% margin in the second quarter of 2012, excluding debt pre-payment costs; it was closer to 2.50% excluding unusually large interest recoveries and technicalities with depreciation expense for equipment reclassified as available for sale. A rising margin and excess capital — Basel III notwithstanding — are attributes that will separate CIT from other lenders.

There are other positive attributes, too, perhaps the most important of which is the lack of under-performing legacy real estate-related loans. Late last year CIT announced that it was re-entering the CRE lending market. I think the move was well timed, though many lenders are plowing back into the market this year. Also, I think the absence of a large legacy branch network is positive, though management has been clear that it eventually would like to add some physical deposit gathering facilities to complement its internet-based retail deposit gathering channel.

Management has put forth an ROA target of 1.50-2.00% assuming optimization of funding and operating leverage. My base assumption for ROA is 1.30-1.75%, which equates to $600-$800 million of net income. Assuming no share repurchases, earning power of $3.00 to $4.00 per share appears reasonable to me; however, if the margin is closer to 4%, then earning power could push $5.00 per share. In addition to capitalized earnings, shareholders have a $4 billion net operating loss that I put a swag estimate of value around $4.00 per share, plus potentially upward of $10.00 per share of excess capital. If the earnings come through, then I think the shares can trend toward $50.00 per share or higher as investors will focus on improving fundamentals, the non-operating assets, and tangible book value excluding fresh start accounting marks.

The sum of it from my perspective is a company that should report improving results over the next couple of years provided credit holds. That is not to say CIT is going to join Texas Capital Bancshares Inc. as a member of *Investor's Business Daily*'s top 50 stocks. Improvements in profitability and the pace of growth should be steady, but not sufficiently large enough to attract momentum investors. Nevertheless, I think CIT's common equity can outperform many commercial bank and specialty finance peers over this period. Returns may be much better if Europe and/or fiscal cliff concerns cause U.S. equities and CIT to fall this year as occurred during the third quarter of 2011.

Entry points are always the key variable in determining the return. So what could go wrong? A lot of things could negatively surprise, beginning with credit. The current management team is new and has not operated CIT through a full credit cycle, though I think one can take some comfort from the marking of assets at year-end 2009 and intense Fed supervision. Also, until the Fed approves a buyback program and/or meaningful dividend, the shares do not have much defense in a declining market. That was seen last September when the shares traded near $30.00 per share. I think CEO John Thain realized this when he set the floor then by buying 40,000 shares in a series of open market transactions. He bought another 30,000 shares via open market transactions on April 30 around $38.00 per share. While Thain does not know the future and probably has more patience than an event-driven Icahn, I suspect he sees earnings visibility improving after two years of slogging through repositioning CIT and its funding.

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