NASHVILLE NOTES

Buybacks Were Once Illegal for SEC Registrants

Wednesday, October 7, 2020 9:03 AM CT

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A couple of days ago I heard Bank of America Corp. CEO Brian Moynihan on CNBC state the company is ready to resume buybacks whenever regulators give the company a green light. That will not be in the fourth quarter when an interim stress test is conducted by the Fed. Perhaps it will occur in the second half of 2021 after next year's stress test and CCAR.

Moynihan is not the bravado-type of CEO who never acknowledges the downside to a company's prospects. I thought it was an interesting comment given a deep but apparently short-lived recession earlier this year. Thus far large banks have built significant loan loss reserves, but sizable credit write-downs have not occurred yet. I assume that will occur in 2021 and 2022, although there is a good argument to be made that the real losses reside in the CMBS market, BBB-credit universe and private credit funds.

The future is never clear; however, it is especially murky this year in which the market may signal two opposite credit outcomes are possible based upon the amount of liquidity the Fed has coaxed into the equity, high yield bond and leverage loan markets.

One is that the torrent of liquidity is oblivious to insolvency issues in all but the most obvious instances and thereby has papered-over losses by allowing weak credits to raise new capital; or, liquidity flows reflect investors' wager that the economy will be much better than the consensus thinks in 2021. If so, Moynihan may get the greenlight from regulators to resume buybacks in size.

Hilltop Holdings Inc., which is not subjected to the Fed's stress test and CCAR, announced a $350 million modified Dutch Auction tender offer to purchase what would amount to roughly 20% of its shares based upon the proposed repurchase price of $18.25 to $21.00 per share. The timing of Hilltop's announcement opposes the narrative that Corporate America tends to repurchase shares heavily near the top of the market and sparingly when the economy and markets have fallen.

Hilltop has a lot of capital and presumably liquidity at its parent company following the sale of an insurance unit for $154 million. Its common equity tier 1 and total risk-based capital ratios as of June 30 were 18.5% and 21.8%. The repurchase price looks entirely reasonable given tangible book value of $21.85 per share.

I think buybacks are a legitimate use of capital for businesses that are not highly cyclical and capital intense, especially when not financed through borrowing and the repurchase price is moderate. Buybacks also are a form of discipline for management. Excess capital that is distributed is capital that cannot be blown on over-priced and/or poorly executed acquisitions. Besides, the market may not always value excess capital dollar-for-dollar because non-control shareholders cannot force the board to distribute it.

There are downsides to buybacks, however. National City Corp. repurchased shares via a modified Dutch Auction in mid-2007. Had the board known what was about to unfold in 2008 that culminated in a fire sale to PNC Financial Services Group Inc., the buyback never would have occurred. Also, some argue that buybacks are a way to unjustly enrich management through supporting share prices in which buybacks largely just soak up shares issued via option grants.

Some of you reading this, if young enough, may be surprised to learn that buybacks by SEC registrants were illegal until 1982 when the 10b-18 rule was promulgated to create a safe-harbor to do so. Prior to then, buybacks were viewed as a form of price manipulation rather than a means to return capital to shareholders.

Next year could be a big year for share repurchases if the trajectory of the recovery surprises to the upside. Nonetheless, buybacks and dividends that do not occur remain the cheapest capital any company can raise. Given a number of banks that have dividend yields near 6% or higher, I think the market is handicapping there are more dividend cuts to come beyond Wells Fargo & Co., Capital One Financial Corp. and a few other banks that have announced cuts. Buybacks for now are a well-timed option for Hilltop and a small subset of very well capitalized institutions.

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