NASHVILLE NOTES

Stakeout vs. Rescue Capital

Tuesday, August 27, 2024 10:24 AM CT

By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

The banking zeitgeist is evolving: 2023 was about a liquidity crisis that claimed three banks that were members of the S&P 500; 2024 is shaping up as the year of capital raises by a handful of regionals to deal with the aftermath of the Fed's rapid rate-hiking moves.

I, like most investors I think, was surprised by the $2.8 billion investment The Bank of Nova Scotia will make in KeyCorp via a two-step purchase of about 163 million newly issued common shares that once consummated will equal 14.9% of the pro forma shares outstanding.

KeyCorp's and KeyBank NA's Tier 1 Common Capital ratios of 10.5% and 12.6%, respectively, as of June 30, were fine if not outwardly ample. On the other hand, the non-regulatory tangible common equity ratios of 5.2% and 6.9% were thin(ish) due to the unrealized losses in the available-for-sale bond portfolio and receive fixed/pay variable swaps. Those unrealized losses are smaller today given the roughly 50-basis-point reduction in the five-year US Treasury yield through Aug. 23.

The one capital question I thought relevant for KeyCorp was the common dividend. Margin compression has weighed on earnings that in turn has limited internal capital generation since 2022. During the 12-month period ended June 30, KeyCorp generated EPS of 77 cents compared to 82 cents per share of dividends. The last substantial buyback activity occurred in 2021. If the economy were to tank, then credit costs could become problematic and endanger the current payout.

Hindsight is easy. Rates rose more and have stayed higher longer than KeyCorp management likely assumed in 2021. Otherwise, the bond portfolio would have a shorter maturity and the receive fixed/pay variable swap book would be smaller. About half of the proceeds from the Scotia investment will absorb losses to restructure a portion of the balance sheet to produce better net interest income going forward.

Scotia's investment in which it will pay $17.17 per share represented about a 15% premium to the 10-day volume weighted average price through Aug. 9, though KeyCorp's shares have since risen to $17.07 per share as of Aug. 23. Also, the investment price equates to about 1.5x pro forma tangible book value per share as of June 30 and 10.6x the current 2025 consensus EPS of $1.61. That seems optimistic to me given current earnings. Nonetheless, the purchase price represents a validation of the balance sheet where the primary issue is "rate" rather than "credit," though a downturn in the economy would test the credit theory.

Rates rose more and have stayed higher longer than KeyCorp management likely assumed in 2021.

Scotia's investment is a strategic investment in contrast to rescue capital for New York Community Bancorp Inc. and First Foundation Inc. raised earlier this year at deep discounts to the market price and tangible book value per share. From

KeyCorp's perspective, I see it as a less painful strategic equity raise given Scotia's purchase price than selling high return-on-equity generating insurance units as Truist Financial Corp., Cadence Bank and other banks did — admittedly at great prices — to fund balance sheet restructurings.

KeyCorp has been involved in rescue capital before, however. KeyCorp had 389 million shares outstanding as of year-end 2007 as the Great Financial Crisis was getting under way, then issued 367 million common shares during 2008, 2009 and 2011 at an average price of $7.36 per share that netted about $2.7 billion. As of June 30, KeyCorp had 943 million shares outstanding, which includes 352 million shares that were issued for the 2016 purchase of First Niagara Financial Group Inc.

KeyCorp's parent company will obtain $2.8 billion of cash before deducting transaction expenses. How much is moved downstream into KeyBank versus retained at the parent may vary from the disclosed plan depending upon how the bond market moves. If the recent rally continues, maybe less restructuring will occur, or the same amount of capital will accomplish more.

Aside from the investment itself, a notable attribute is the increase in the parent company's financial flexibility. As of June 30, the parent had $3.5 billion of cash compared to $4.8 billion of debt of which only $600 million matures within a year. Pro forma cash will be around $5 billion assuming half the proceeds are injected into KeyBank. The company should have substantial flexibility to fund tuck-in acquisitions or a capital reserve for KeyBank if the economy tanks taking credit with it.

That said, investors may be assigning a greater than nominal probability to Scotia's strategic minority investment one day becoming a control investment through an acquisition of the shares it does not own.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.