A belated high-five for First Niagara’s board

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL Financial contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

Bloomberg News reported last week that First Niagara Financial Group Inc. has hired JPMorgan Chase & Co. to help the board review strategic options. It is board code for pulling the ripcord to find a buyer.

Boards can have a number of reasons for pulling the exit ripcord. In the case of First Niagara, let’s hope the culprit is mediocre returns and lousy share price performance. If so, the board is acknowledging the past and rejecting hope over experience when looking ahead. Absent getting past a credit challenge following an ill-advised push into a particular credit sector, underperforming banks rarely turn into above-average performing institutions without taking above-average risks that tend to blow up in time. Otherwise, generic commercial banks work with the same yield curve and products. DNA matters in banking.

The past five years have been rough for the company’s shareholders. First Niagara’s tangible book value declined to $6.67 per share at year-end 2014 from $8.01 per share at year-end 2010. The 2014 dividend and current annualized quarterly dividend of 32 cents per share is half the 2011 dividend. Excluding a goodwill impairment charge of $1.1 billion and a few other nonrecurring items, the company reported operating EPS of 71 cents in 2014 compared to 70 cents in 2010. Return on average common equity has been in the mid-single digits the past five years and year-to-date, with the exception of 2014 when the impairment created a sizable GAAP-basis net loss. Return on average tangible common equity has not been impressive either.

The bloodless verdict of the market reflects this. For the five-year period ended Sept. 22, First Niagara’s shares fell more than 21%, compared to a gain of nearly 58% for the SNL U.S. Bank Index. Over a 10-year period First Niagara fell about 36% while the index declined about 26%. On Sept. 23, the first day one could trade on the Bloomberg report, the bank’s shares rose more than 14%.

If the media reports are true, the board deserves a high-five for recognizing the obvious. Time is money. The longer the board waits, the more shareholders probably will be penalized.

Why now? As widely discussed in SNL and elsewhere, it appears the window has opened from a regulatory standpoint for large banks without regulatory issues to resume whole-bank acquisitions. BB&T Corp. is the example cited with its three transactions announced since September 2014. Maybe another sign will be obtained if M&T Bank Corp. is approved soon to acquire Hudson City Bancorp Inc., three years after the agreement to merge was announced.

Another window is the credit cycle. First Niagara’s annualized net charge-offs are low at 29 basis points in the first half of 2015, a level that is comparable to the prior three years. The current economic expansion eventually will run its course. Credit losses will increase, though not necessarily dramatically. High -yield and, to a lesser extent, investment grade credit spreads have been widening for a year from a level that probably will prove to be the cycle lows. Sustained widening does not preordain a downturn, but the corporate bond market usually arrives at a conclusion about credit within a sector or the economy well before equity investors. It is a notable data point. Besides, buyers and capital providers usually are plentiful when not needed and they are scarce when life depends upon it.

And then there is the window that may never open. The Federal Open Market Committee may have played a role in the board's decision by passing on raising short rates at its September meeting. First Niagara’s reported net interest margin has declined from 3.64% in 2010 to 3.23% in 2014; it was 3.02% in 2011 and three years after the acquisition. Regardless of the repricing characteristics of the loan portfolio, higher short rates are required to change the deposits’ contribution to the NIM — especially for noninterest-bearing deposits. Unfortunately for all bankers, the Fed just does not seem to have the nerve to pull the trigger.

The Street does not see an imminent turnaround either. A year ago the mean consensus estimate for 2015 was 70 cents per share; today it is 60 cents per share.

What went wrong is what could cause an acquirer to hesitate: M&A and expectations. First Niagara is a roll-up with just over $39 billion of assets as of June 30. The company had about $8 billion in assets at year-end 2007 as the financial crisis was getting underway. A string of acquisitions that included Harleysville National Corp. in 2010, NewAlliance Bancshares Inc. in 2011 and HSBC USA Inc. branches in 2012, among others, were probably too much, too fast. The Street and maybe even management and the board never really knew what the company’s real earning power was. There was no history, just pro forma financials until the past couple of years revealed an underperforming institution without the cover of pro forma financials predicated upon the next acquisition.

A string of acquisitions also can create operational issues. Last year the company disclosed a “process issue” with its deposit system during the third quarter. Regardless of whether that issue has been completely resolved, its existence raises the question of what else may surprise. Maybe nothing material will surface, but from an M&A perspective it raises two dictums that all buyers should keep in mind: (a) Do not let other peoples’ problems become your problem; and (b) All surprises are negative following an acquisition.

Negatives aside, there is a market clearing price for First Niagara unless the consensus is wrong about the resumption of whole-bank acquisitions by large banks. Whether the market clearing price is high enough for the board to say ‘yes’ is to be determined.
First Niagara will be a large consolidation play in a slow-growing region of the U.S. The company's year-to-date annualized net income attributable to common shareholders is approximately $193 million. Pro forma net income assuming 30% expense savings and a 35% tax rate is about $384 million. A multiple of 10-12x pro forma earnings implies there could be more upside for the shares based upon the company's market cap of $3.7 billion as of Sept. 25. Nevertheless, I think JPMorgan as the reported investment banker for First Niagara is going to have to work hard to earn its fees.

Published with permission.
Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.