NASHVILLE NOTES

PNC's position may be better than the Street believes

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By Jeff K. Davis

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Last week, PNC Financial Services Group Inc. monetized one of the great investments of the late 20th century by selling its 22.4% stake in BlackRock Inc. The position was valued at roughly $17 billion on May 11 when subsidiary PNC Bancorp Inc. entered into an agreement to sell the bulk of it via a secondary offering, while BlackRock bought the balance.

The original investment totaled $245 million when it was made in 1995. It was carried on the balance sheet at $8.7 billion as of March 31, 2020, under the equity method of accounting — meaning PNC wrote up (or down) the investment each quarter based upon its share of BlackRock’s retained earnings. PNC received an increasing dividend flow over the years, too.

In the vernacular of Wall Street, the investment amounted to nearly a 70 "bagger" (plus or minus) excluding dividends. Another Wall Street adage that comes to mind is "one does not go broke taking profits."

PNC has now greatly fortified its balance sheet to withstand what appears to be an emerging depression with or without the "Great" moniker. PNC may get the opportunity to buy a wounded regional later as it did when it acquired National City Corp. for a song in 2008.

As an aside, National City's preferred and sub debt rallied on the October 2008 announcement once the possibility of bankruptcy was off the table, while common investors may have been dumbfounded that a once great Midwest franchise was acquired for about $2 per common share.

Timing and price paid matter a lot to investors and acquirers; PNC seems to be exceptionally good at both. Bank of America Corp., which inherited an approximately 49% interest in BlackRock when it bought Merrill Lynch in 2008, exited the position by May 2011. With the benefit of hindsight that Bank of America did not have, BlackRock’s shares have more than doubled since then.

Another aspect of PNC's capital position worth lauding is that of the parent company. As of March 31, the parent company had $6.5 billion of liquid assets while its senior and sub debt totaled $11.5 billion. Importantly, PNC Bancorp, a sub-tier holding company, held the shares rather than PNC Bank NA, where excess capital can be trapped when the economy tanks. Presumably, the parent company's liquid assets now exceed its debt after the BlackRock transaction settled and the IRS was paid its share.

I think bank equity and credit investors should pay a lot of attention to parent company capital structures. My take is that they tend to be overlooked by equity investors when the economy is performing well and there is not much concern about credit quality. Perhaps that is understandable, but it can be a fatal mistake once the cycle turns, as occurred abruptly during March 2020.

Other than cash on hand and capital raising activities, bank holding companies are largely dependent upon upstream dividends from the subsidiary banks for cash. A subsidiary bank is a legally distinct entity from its parent company. Cash and other assets do not freely flow from the bank to the parent. Only the accountants merge the balance sheets.

This may seem like a nuanced distinction, but it is not because upstream dividends from a bank to the parent easily can be curtailed or fully precluded due to asset quality and capital issues within the bank.

PNC now has a strategic advantage vis-à-vis most of its peers. It has greatly augmented both its capital ratios and its parent company liquidity that one day may be used to fund a material acquisition; or in an extreme downturn some of the excess parent cash could be injected into PNC Bank to shore-up bank-level capital ratios.

Since the last financial crisis occurred, large banks such as PNC operate with more parent company liquidity and therefore margin of safety from a creditor standpoint; however, I am not sure that is the case with smaller bank holding companies.

The just-in-time upstream dividend to the parent from the bank for debt service and dividend payments easily could be interrupted if this downturn is as deep as I think it is. And unlike trust preferred securities in which dividend payments could be omitted up to 20 quarters without triggering a default, sub and senior debt entails no such provision.

Leverage cuts both ways for lenders, too. I am not (yet) predicting widescale issues because capital ratios are higher today than in 2007 when the last crisis began, but I suspect equity investors in smaller banks do not fully appreciate the potential risks.

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