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Bank distributions play to the income zeitgeist too

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Banks are supposed to be boring. The second-quarter earnings reports for the large banks that reported as of July 18 did not disappoint in that regard. There were not any meaningful surprises. I doubt the super-regional banks will surprise either. Credit is in good shape for the time being. Energy-related reserve building is (or nearly is) over, unless oil prices dive again. Incremental NIM pressure remains following a reprieve in the first quarter after the December rate hike. The one surprise was better-than-expected fixed-income results, but trading conditions were good. Brexit increased volatility while the trend during much of the quarter was bullish, as treasury yields declined and credit spreads narrowed.

With little revenue growth beyond periodic bursts of trading activity, I see the dominant investing theme for the large-cap banks as an income play. I occasionally hear the bank income theme referred to as a shareholder ATM. That is a stretch because a turn in the credit cycle will nix large-scale buyback activity. If it is bad enough, dividends will be trimmed too. Bank distributions for common shareholders are hardly a perpetuity. Nevertheless, there is something to be said for a more acquiescent Fed for the time being.

Based upon data from SNL Financial, large-bank distributions ranged between roughly 40% and 80% of earnings in 2015, with 20% to 35% in the form of dividends and the balance via buybacks. A few such as Capital One Financial Corp. and Bank of New York Mellon Corp. were higher, while laggards Citigroup Inc. and Bank of America Corp. should see distribution increase to around peer levels based upon the recent approval of their 2016 CCAR submissions. BB&T Corp. is set to return more capital to its shareholders via buybacks, rather than other banks' shareholders, as it takes a break from M&A for the time being.

Returning excess capital, rather than sitting on it and perhaps eventually blowing it by making marginal loans and acquisitions, is a shareholder friendly outcome. Distributions in a near zero-rate environment fit well with the zeitgeist of our times. With P/E ratios based upon 2016 estimates in the vicinity of 10x to 14x, the earnings yield approximates 7% to 10% for the large banks. The yield to shareholders is 6% to 8%, assuming an 80% distribution rate. Earnings that are not distributed build book value. Aside from the issue of whether banks at times may be overpaying for repurchases, I think the math is not bad with the ten-year yielding less than 2%.

The zeitgeist of an era eventually ends, however. Sometimes a new distinct era emerges, other times it fades to something that is ill-defined. The unanswerable question for the current era of excess capital and high distributions is: How long will it last before the inevitable credit cycle reappears? If it is years away, the large banks may absorb a sizable amount of their share base before it ends, although not so ironically at much higher prices than issuances occurred in the years immediately after the financial crisis. If the view is the cycle will turn next year, then going up capital structure to invest in the banks' preferred and sub debt for less income will make sense.

I could make an argument that if the focus is income (or high distributions) as long as there is little revenue and earnings growth, then a synthetic bank portfolio consisting of investments in BDCs, residential mortgage REITs and commercial mortgage REITs could make more sense. Mortgage REITs and BDCs as broad asset classes sport dividend yields in the vicinity of 10%. As a business model proposition, REITs and BDCs are disadvantaged vis-à-vis banks given the absence of cheap, stable deposit funding and (much) fee income; however, traditional REITs and BDCs do not pay income taxes as pass-through entities provided at least 90% of taxable income is distributed. That is a huge income advantage in a low-rate environment, though the credit risk profile of BDCs and commercial banks is hardly the same.

Not everyone likes BDCs as a quasi-bank substitute due to high external management fees, investment underperformance and corporate governance issues among some BDCs; however, returns to BDC shareholders would improve if the rhetorical question put forth by a credit investor I heard at a conference comes to fruition in which he predicted few BDCs (as currently structured) would survive if Vanguard Group Inc. launched a viable low-fee BDC.

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