NASHVILLE NOTES

Boards sort of follow earnings too

Tuesday, November 12, 2019 8:08 AM CT

By Jeff K. Davis

Jeff Davis CFA 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 he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

A few weeks ago, I was at a party where a bank investor asked me when I expected a particular stock would start to "work." I replied: Whenever the earnings start to work (or rise). Short-term noise aside, stocks follow earnings over time. Boards do the same, in a way.

I'm not a corporate securities attorney, but my take on corporate governance is that boards are not required to enter into transactions that provide an immediate enhancement to shareholder value when there is a reasonable long-term plan to create value. Exactly what that means for a given board will vary, but at the very least directors have leeway to make informed decisions that are believed to be in the best interest of shareholders.

What constitutes a long-term view in the financial services industry may be compressing due to price deflation, however. The online brokerage industry is an example — albeit an extreme one.

Last month Charles Schwab Corp. announced it would end most commissions on stock, exchange-traded funds and option trades. The news culminated a 44-year trend of declining commissions since the SEC deregulated brokerage commission rates in 1975. The industry offset price deflation via a combination of growth in volume and diversification. A few brokers such as Schwab evolved and managed the price decline spectacularly; many other brokers sold or folded.

Among publicly traded online brokers Schwab is the least impacted with an estimated revenue hit of $100 million, which is negligible given its size. TD Ameritrade Holding Corp. has estimated a $220 million to $240 million impact, which equates to about 8% of its last-12-months pretax income. E*Trade Financial Corp. faces the largest haircut. The $300 million impact the company estimates equates to 21% of its LTM pretax income.

E*Trade and many others face the prospect of lower net interest margins, too. E*Trade generates the majority of revenues from net interest income. Its third-quarter NIM was 3.28%, supported by a low 0.49% cost of interest-bearing funds. It is a glass-half-empty question, but what happens if the Fed cuts short-term rates to zero percent in the next recession?

E*Trade's board is in a tough spot, but it could be worse — the company is profitable with a respectable LTM return on equity of 16%, which compares to 18% for Schwab and 26% for Ameritrade. To its credit, management has published a roadmap showing how the company can increase earnings to $7.00 per share by 2024 from LTM-adjusted EPS of $3.97 and $3.10 per share on a pro forma basis net of the commission reduction.

Assuming a price-to-earnings ratio of 10x to 12x, the plan implies E*Trade's shares could rise to $70 to $84 per share in five years from the current price in the low $40s. The implied five-year compound annual growth rate in the order of 10% to 14% is attractive if one buys into my multiple and management's presumably aspirational EPS target.

How much credence should the board give the plan (presumably they see much more detail than what has been disclosed)? What other operational outcomes is the board considering and what alternative actions might be taken, such as pursuing an acquisition or selling the company? A number of years have passed, but E*Trade struggled with material asset quality issues in the aftermath of the last recession. No board ever wants to revisit such a ditch.

A lot of digital ink has been spilled in recent years about the potential for E*Trade to be acquired. To date a transaction has not occurred — perhaps the board does not want to sell or does not want to sell at prices that have been proposed. Maybe the board believes the most likely path for earnings growth and ROE will be sufficient to stay the course.

I do not mean to pick on E*Trade, but its board probably more than most is staring at a lot of earnings pressure before considering the impact of whatever credit deterioration occurs in the next recession. One implication of long-running price deflation in the financial services industry is that boards may need to shorten their time frame for what constitutes a long-term view. The risk is that hard decisions that are put off too long will be forced later when the institution is in a weaker position.

To that point, I think the merger of equals between First Horizon National Corp. and IBERIABANK Corp. makes sense for both banks' shareholders. Neither investor base is being "cashed-out." Both will own what should be a better piece of paper. The counterfactual that a higher price would be obtainable in an outright sale is unknown; yet, this outcome remains a possibility if the combined board makes such a decision in the future.

At the cost of $440 million of pretax merger-related charges and the risk that execution does not go well, shareholders will benefit from $170 million of annual pretax savings once fully phased in. It amounts to less than three-year payback for the upfront costs (and unquantifiable execution risks) to reduce the efficiency ratio to 51% from 55% for IBERIABANK and 60% for First Horizon. EPS accretion for First Horizon before factoring in the impact of CECL is 11%, and 17% for IBERIABANK.

For First Horizon and IBERIABANK shareholders there is nothing dramatic or evolutionary in the merger; however, I think it is representative of what boards across a broad swath of financial services firms need to consider to improve or sustain returns in an operating environment that may be poised to get tougher.

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.