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NASHVILLE NOTES

Citi's Corbat controls some timing

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The gods of timing smiled on Citigroup Inc. CEO Michael Corbat in October 2012 following the forced resignation of former Citi CEO Vikram Pandit. The latter had the unenviable task of serving as CEO following the resignation of Chuck Prince in November 2007. Pandit rode the crash elevator down, while Corbat has ridden the recovery escalator up.

Validation of the improving fortunes will come again this week when the Federal Reserve likely will not object to Citigroup's capital plan that may call for a return of over 100% of earnings to shareholders over the next four quarters. (The Street's consensus net income is about $16 billion.)

Last year the Fed did not object to Citigroup's plan to return up to $18.9 billion. Assuming approval, Citigroup will be well on its way to returning the $60 billion of capital it has targeted for the 2017-2019 Comprehensive Capital Analysis and Review cycles. The bulk of the capital will be returned through repurchases because the current 32 cents per share quarterly dividend accounts for only about $3 billion of the $19 billion returned in the past year.

Corbat cannot control the economic cycle or the CCAR process, but the timing of share repurchases fits the narrative that corporate America tends to repurchase shares heavily near the top of the market and does so sparingly when the economy and markets have fallen. Citigroup is an extreme example of this behavior, although the circumstances that consumed Citigroup a decade ago were extreme.

Citigroup had 499 million common shares outstanding as of year-end 2007 (adjusted for the 2011 one-for-ten reverse stock split). The share count then proceeded to expand by six times to about 3.0 billion around the time Corbat became CEO because the company raised a lot of capital at very low prices to replenish capital and repay taxpayers for its bailout. Buybacks since then have reduced the share count to just over 2.5 billion as of March 31. This year’s capital actions may see the share count decline by upwards of 10% to around 2.3 billion. That is significant progress, but the projected shares still would be a big multiple (~4.5x) of the year-end 2007 outstanding shares.

I may be unfair in my sell-low/buy-high analogy for Citigroup's capital management. The company had no choice as an issuer in the years immediately after the crash, and what was "trapped" excess capital a few years ago is now being distributed. Management understandably wants to soak-up some of the shares issued at distressed prices to support future EPS growth rather than pay outsized special dividends. Besides, repurchases are being conducted at a reasonable level for shareholders with the shares trading just over tangible book value and about 10x the consensus estimate for the next four quarters.

Of course, Citigroup's shares are inexpensive for a reason. Its 9.2% return on equity and 11.0% ROTCE posted in the first quarter are not industry-leading metrics, and Citigroup decidedly is not an earnings growth story as pre-provision net revenues have been flattish the past five fiscal years. Plus, large cap banks have lagged the market this year in spite of regulatory reform, lower tax rates, a humming economy, rising short-term rates and the expectation that the CCAR process will result in upwards of 100% of earnings being returned to shareholders.

What gives then? Maybe the run in Citigroup's shares and those of its large cap peers in the fourth quarter of 2017 and early 2018 discounted those factors. Buy the rumor and sell the news is the old market saw.

The bigger picture may be that the flattening yield is overshadowing these positive attributes. Citigroup does not have the huge low-cost core deposit franchise that Bank of America Corp. or JPMorgan Chase & Co. have and is therefore more dependent upon wholesale funding sources. More important than the cost of funds and net interest margin outlook is the slowing economy most investors believe pronounced flattening and especially an inverted curve signal for the future.

My take is that when this is occurring investors will discount bank stocks even if earnings are good-to-great because a slowing economy may transition to a recession and therefore much higher credit costs that are not reflected in current earnings. Investors will not take banks out of the penalty box so to speak until they have a sense of "how much" credit costs may rise and/or when the Fed may start to cut short rates.

A slowing economy or recession is not preordained. The yield curve flattened in the mid-1990s, but a recession did not occur until 2001 and credit losses during that cycle were not bad.

A slowdown or worse for 2019 seems unlikely to me. But if it were to occur, Corbat and the Citigroup board can control the timing of what seemed like an aspirational capital return goal of $60 billion when it was announced last year by slowing or halting repurchases if necessary.

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