NASHVILLE NOTES

Fraser gets the baton at Citigroup

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A couple of years ago I had a post on Citigroup Inc. that opined the gods had smiled on Mike Corbat in his selection as CEO in October 2012 following the forced resignation of Vikram Pandit. At the time, Citigroup was in the process of exiting the government's ICU ward following the 2007-2009 financial crisis. Pandit followed Chuck Prince, who resigned as CEO in November 2007.

Jane Fraser, the first woman to head a major Wall Street bank, succeeded Corbat as Citigroup CEO at the beginning of March; Corbat surprised the Street by announcing his retirement last September. In October, Citigroup's primary banking subsidiary, Citibank NA, entered a consent order with the Office of the Comptroller of the Currency regarding deficiencies in "data governance, risk management, and internal controls that constitute unsafe or unsound practices and that contributed to violations of law or regulation."

I am sympathetic to Corbat's plight. There will always be "issues" at any large company like Citigroup.

Apparently, the blunder last August that saw Citibank as administrative agent mistakenly wire $900 million of principal rather than only interest received from debt-laden Revlon to the syndicate lenders was too much for the OCC. Citi has since lost its case in court to force a return of funds and had to restate 2020 earnings in February. The issue may be reversed on appeal, but the damage was done in August when the matter became public.

Whether Corbat agreed to jump into the volcano or was pushed does not matter. Fraser has been handed a CEO baton that has proven tough to hold by every successor since Sandy Weill last held it in 2003.

During the January earnings conference call, Fraser noted her focus was on efforts to position Citigroup to "win," to improve returns significantly and address issues raised by regulators. The internal controls issue raised by the OCC presumably will be expensive to address.

While the press has focused on her position as the first female CEO of a major U.S. bank, I think the more notable description, if realized, would be the CEO who oversaw changes at Citigroup that narrowed or eliminated the return on equity gap between its competitors.

Citigroup's return on average capital employed has ranked in the bottom half when compared to Bank of America Corp., JPMorgan Chase & Co., Wells Fargo & Co., Goldman Sachs Group Inc. and Morgan Stanley in nine of the past 10 years. During the last five years it produced the lowest ROACE in three of the five years.

In the 10-year period ended in 2006, Citigroup was in the top half of the group for seven years when it was never worse than fourth. The period was a Pyrrhic victory for Weill and Prince because returns attributable to the residential mortgage securitization efforts would end in tears by 2008.

Maybe there are divestitures of a couple of business lines or countries that could materially impact the company's returns, but count me skeptical. If there was a clear path to boost returns from levels realized the past several years, it would have been implemented long ago.

An opportunistic acquisition sufficiently large to boost overall returns is out of the question given the consent order. Besides such opportunities are episodic at best. Citigroup would be in a stronger position today had Wells Fargo not snagged Wachovia after Citigroup agreed to acquire it in September 2008. Also, the postcrisis sale of retail broker Smith Barney to Morgan Stanley contributed to Morgan Stanley's stellar returns in recent years.

Alternative histories are interesting, but Citigroup management must play the hand it has been dealt on behalf of shareholders that includes two significant headwinds.

Remediation costs that will enrich lawyers, consultants and systems providers will weigh on its cost structure as has been the case with Wells Fargo for several years.

The revenue equation is tough, too, given ultra-low rates in the developed world. Warren Buffett in his most recent letter to shareholders opined that fixed income investors "face a bleak" future. Buffett did not reference banks per se with the comment, but he could have with the caveat that bleak is too strong an adjective.

Fraser and the executive team do not have an easy task. Most likely they may improve Citigroup's ROE at the margin while eventually satisfying regulators with whatever systems upgrades are required after spending a boatload of money.

That is probably a consensus view; however, if Fraser and team surprise to the upside, Citigroup's valuation discount has a lot of room to narrow against peers. As of March 5, the gap was wide, but Citigroup has been a perennial value stock for years. The shares were trading for about 95% of tangible book value and 10.6x consensus 2021 earnings compared to 180%/15.0x for Bank of America and 231%/14.3x for JPMorgan.

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