

SNL Blogs



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Not certificates of confiscation

By Jeff K. Davis

Jeff Davis is a veteran bank analyst and SNL contributor. The following does not constitute investment advice, and the views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

I was recently in Washington, D.C., for a couple of IMF-related gatherings. Deflation (and regulation) seems to be top of mind for central bank types. Financial media headlines of late have been about Europe and what Mario Draghi is going to do to prop up Europe's weak economy.

I am not sure what to make of the talk, especially considering the impact central banks have had in reflating asset values with their zero rate policies. Other than consumer electronics, I do not know what deflation (or disinflation) means when almost everything that my family purchases seems to be higher in price than a year or two ago. I also do not get the arguments about why the Fed and other central banks want inflation to run around 2% per year. If borrowers need inflation to subsidize debt service, then they have borrowed too much. Why should you and I see the value of our currency cut in half every 36 years to subsidize their debt service? How about no change in value as an objective?

Markets are edgy after the most recent run in most equity indexes that spanned late 2011 through mid-2014, and they may be spent as the Fed winds down QE bond purchases. John Hussman, Jim Grant and Jeremy Grantham among others have been vocal that the policies of central bankers have pulled returns forward by suppressing "risk-free" Treasury rates and risk premiums. If they are right, then price almost always cures price — meaning over-valued assets that offer little prospective return will see the risk-return math improve as the price drops. Bond daddies — a Memphis term for successful institutional fixed income salesmen — know that there are no bad bonds, only bad bond prices.

Given this as a backdrop, it may seem odd that I point to preferred stocks — specifically bank preferred shares — as an interesting asset for some investors. Nonconvertible, fixed-rate preferred shares are the ultimate in terms of a long-duration fixed-income security. Ignoring an issuer's call option, preferred shares are sometimes referred to as "perpetuals." There is no hold-to-maturity off-ramp.

So why bank preferred stocks? They would be toxic if longer-term rates increased much, or if another severe credit cycle visited banks. Neither seems likely to me anytime soon, however.

In a very low rate environment, the yields seem reasonable with mid-cap issuers such as [City National Corp.](#)'s series C preferred shares yielding about 6.2% and [Synovus Financial Corp.](#)'s series C preferred yielding about 7.3%, or roughly 400 basis points to 500 basis points over the 10-year U.S. Treasury as of Oct. 13. Another way to think about preferred shares is relative to common equity. The median last-12-months return on tangible common equity for banks with more than \$10 billion in assets was 11.3% as of Oct. 13, but the median price to tangible book value multiple was 1.6x. The math may be simplistic, relying upon the broad brush median, but my point is that the price adjusted ROTCE was only 7.1% (ROTCE divided by P/TBV). In effect, the adjusted yield is within the same ballpark as the preferred shares.

Preferreds issued by smaller banks can yield more. Kroll Bond Rating Agency is in the process of carving off a niche for itself rating smaller banks and specialty finance companies. Their efforts may improve liquidity, at least around the edges of a market that traditionally has been illiquid. Even if liquidity is not helped, having more banks rated that issue senior and subordinated debt and preferred shares should produce a price discovery process that is more informed.

As for fundamentals, bank profitability has improved and capital in the banking sector is high and may continue to build until loan growth really picks up, unless buybacks and M&A absorb excess capital for a given issuer. And though not well advertised, post-crisis most parent companies operate with excess liquidity and therefore are not dependent upon the next upstream dividend from the subsidiary bank to fund interest expense and dividends. SNL's Tim Zawacki has [written extensively](#) about small bank holding companies that have found their way into bankruptcy proceedings due to an absence of liquidity.

Investors will sometimes benefit from a ratings upgrade when a larger bank that is higher rated acquires a smaller and typically lower rated issuer. While I am not predicting it, an acquisition of Synovus Financial (S&P's long-term issuer rating of BB-) or [First Horizon National Corp.](#) (BB+) by [Fifth Third Bancorp](#) (BBB+) or [BB&T Corp.](#) (A-) would be an example. The same logic applies to smaller issuers that may be acquired by the likes of [IBERIABANK Corp.](#)

If the world blows up and takes the financial system with it, bank preferreds will be part of the pain trade; however, if the global bond market is telling us that the economy is going to slow, the preferreds should be a good place to be. Yields of roughly 6% to 7% will look good. For common equity investors, preferred shares can be a bridge to lower prices to re-enter bank common shares. Of course, if inflation takes off and the Fed aggressively responds, long duration assets like fixed-rate preferreds will be a bad investment. During the high inflation of the 1970s, CDs and bonds were called "certificates of confiscation." Variable rate preferreds should perform better. The series C Synovus preferred shares have a fixed-rate dividend of 7.875% presently, which resets to a variable rate equal to 90-day LIBOR plus 639 basis points on Aug. 1, 2018, when the issue also becomes callable.

Besides, it just seems to me that a highly levered U.S. economy cannot take materially higher rates. And maybe that is the message that bond markets in

the developed world are trying to convey to us.

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