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Rainy day liquidity is a good thing

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GETCO Holding Co. LLC yesterday offered to acquire Knight Capital Group Inc., a global market making and electronic execution firm that was forced to recapitalize in August after a software glitch led to a quick $458 million pretax loss in early August. GETCO values its proposal at $3.50 per share, though the mechanics of the proposed transaction are somewhat complex with GETCO being merged into a reorganized Knight holding company. This would then be followed by a cash tender offer, funded with a committed facility from an unnamed bank, for up to 154 million Knight shares at $3.50 per share. The tender shares represent 50% of the shares not owned by GETCO, which was one of the participants in the August recapitalization of Knight.

A competing bid may have emerged in the form of a reported $1.1 billion offer from Virtu Financial LLC, but I see a few takeaways for investors in financial service companies. One is that capital can be quickly lost by unexpected market events, internal issues such as Knight's August software snafu, poorly conceived and over-priced acquisitions, or loan losses. This is one reason in the highly levered world of banking and trading, but not asset management, that modest P/E multiples are usually warranted when one contemplates earning power. Sometimes better-than-average earnings growth may warrant a notably better sector multiple, but that usually applies to a small minority of institutions.

Secondly, dilution can be brutal if a snafu leads to a recap situation as seen with Citigroup Inc. and many smaller lenders as a result of lending and investing decisions made in the years leading up to the financial panic. It can also be brutal as a result of ill-advised acquisitions as has been Bank of America Corp.'s experience with Countrywide Financial. In the case of Knight, its tangible book value was $10.76 per share as of June 30. As of Sept. 30, it was $5.12 per share on a reported basis, and $3.25 per share by my calculation on a pro forma basis assuming conversion of the remaining convertible preferred capital that was raised as part of the $400 million recapitalization. (Note, though $400 million was raised from investors, the investment was recorded on Knight's book at $359 million net of capitalized expenses, and $100 million subsequently converted during the quarter.)

The third point is that rainy-day liquidity is a good thing, especially for investor-operators in a sector that they know. The consortium of investors in Knight purchased convertible preferred that had a strike price of $1.50 per share. In less than 90 days, it appears that GETCO has started a process that has more than doubled the value of its investment, assuming a deal is consummated. I do not know GETCO's motivation. Perhaps it simply sees value and is moving before others do so; perhaps it sees value and an opportunity to consolidate market share at a time when declining (cash) equity volumes are pressuring market participants.

And one final observation is found in Knight's Consolidated Statements of Changes in Equity. As of year-end 2011, the treasury stock account totaled $823 million with 70 million associated shares, representing an average repurchase price of $11.80 per share.

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