NASHVILLE NOTES

Internally generated capital is the cheapest capital to raise

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What have we learned thus far from the banks that have released first-quarter earnings? Little other than that fees from the Paycheck Protection Program for small and midsize institutions that originate a disproportionate amount of PPP loans will be material. The releases provided no indication of how bad credit losses will be because no one knows yet.

I am not sure what Wall Street was expecting from banks in the first quarter, but I am reminded of Doubleline Capital CEO Jeff Gundlach, whose December 2019 webcast was prophetically entitled "A Rolling Loan Gathers No Loss." Forbearance was extended to many borrowers during March and may be expanded in the second quarter to sort the mess out later this year and next year.

I am being a bit harsh in my assessment of what is occurring, but significant losses are going to be realized. Energy, travel and leisure, and highly levered borrowers will be the epicenter, but the destruction rippling through the economy so far is mostly visible in rising unemployment claims, jaw-dropping lines seen in food giveaways in a few cities, and decidedly cleaner air.

The apocalypse has not arrived just yet as far as the reported numbers are concerned. Most banks have reported a limited uptick in nonperforming assets and an increase in loan loss reserves that I think is just a small down payment for what is to come. We may get a bit more visibility when Ares Capital Corp. and other BDCs begin to report results in a few weeks, but it remains early in this unfolding disaster.

The economic debate underway now is what will be the shape of the recovery as a phased reopening of the economy occurs. The shapes used to describe the rebound include "V", "U" or the Nike swoosh for the optimists, and "L" or "W" for the pessimists.

I like the swoosh. Nike was the Greek goddess of victory; the swoosh represents one of her wings. Here in Nashville, an exact replica of the Parthenon that was constructed in 1897 to celebrate Tennessee’s centennial is still in use. At the center is a huge statue of Athena who holds Nike in one hand.

Our bias is to be hopeful if not optimistic like the Athenians were when a battle loomed, but hope — like panic — is not a strategy.

The reality I see is deflation, potentially significant, from a massive demand shock that occurred in March and April because governments shut down economies to combat COVID-19. The initial shock will be followed by weak demand beyond maybe an initial burst of energy because unemployment is on a trajectory to be staggeringly high. Consumers with jobs will save more and spend less, while businesses will invest less and reduce debt. Overlaid will be social distancing restrictions that will limit business productivity.

The gravitational pull of the economy is toward lower prices, wages and less debt. The Fed and U.S. government are fighting it rather than letting the process run its course due to the societal implications if deflation snowballs. Nonetheless, a huge hole has been blown in the economy that is not going to be filled anytime soon.

As it relates to U.S. banks, it increasingly seems likely to me that broad-based dividend cuts are coming. The cash flows of many borrowers have been deeply impaired, as has the asset value of a wide swath of collateral. Losses are unavoidable, the question is the magnitude — my assumption is deep — and over what time period they will be recognized.

Dividend cuts raise a secondary question of whether capital raises will have to occur. As a friend remarked to me recently, internally generated capital (i.e., dividend cuts) is the cheapest capital banks can raise. I think this will be followed by a not insignificant subset that will have to raise common equity at low prices. Arguably, the low price/tangible book value multiples many banks sport today reflect investor handicapping of capital raises to come.

Of course, there will be big winners, too, including a few banks that looked to be on the ropes that managed to avoid big dilutive common raises. Otherwise, the winners will be the banks that acquire weakened competitors at modest prices, as JPMorgan Chase & Co., PNC Financial Services Group Inc., Wells Fargo & Co. and others did a little over a decade ago.

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