NASHVILLE NOTES

Capital management religion

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KeyCorp Chairman, President and CEO Chris Gorman was recently interviewed by Bloomberg News. He said acquiring banks (i.e., low-cost core deposits) were less of a priority, but if the company considered deals its focus would be in the Pacific Northwest, where it has a decent presence and significant wealth has been created from the decades-long tech boom.

The anchors did not ask him, but I assume KeyCorp may have been one of multiple unnamed bidders listed in the S-4 filing for Denver-based FirstBank Holding Co., which PNC Financial Services Group Inc. is in the process of acquiring. That would make sense, given that KeyCorp has more than $4 billion deposits in the Denver area.

Institutional investors are touchy about the use of capital, as they should be. The business model is predicated upon compounding capital. The past 15 years have been tough, with dilutive common raises by many at low prices after the Global Financial Crisis, horrific bond purchases during 2020 and 2021 by most, common raises to cover capital holes from selling bonds at a big loss by a few and over-priced acquisitions that have consumed capital by others.

Stephens raised the issue of whether a potentially acquisitive KeyCorp would elicit the ire of Holdco Asset Management LP, which had a very well-timed pressure campaign on Comerica Inc. to sell and is pressuring other banks to do far better. The KeyCorp media flap follows the First Horizon Corp. third-quarter earnings call, when the company's stock was punished after the CEO said the company could make acquisitions. Investors had assumed First Horizon would soon follow Comerica as the next regional seller.

> ***The focus on capital management by activist investors is a reminder that investors depend upon the compounding of retained capital plus distributions for their returns.***

If there was one deal that got investors really focused on pay-to-trade multiples and the time to earn back day one dilution of tangible book value per share, it was KeyCorp's deal for First Niagara Financial Group, announced 10 years ago. Investors did not react well to the announcement, which included a pay-to-trade ratio of roughly 150% (not shown in the deck), 12% dilution to tangible book value per share and six years to recover the dilution including revenue synergies.

First Niagara may have been a perceived "have-to-have" rather than "would be nice to have." Or perhaps one of KeyCorp's Ohio regional competitors pushed pricing in a competitive process. Nine years later, the increased density that First Niagara brought KeyCorp in the Northeast could be what attracted The Bank of Nova Scotia to make a $2.8 billion equity investment in KeyCorp last year at a premium to the market price. A portion of the capital was used to fund a restructuring of its balance sheet, while the balance is excess capital today in the form of extra parent-company liquidity.

The focus on poor capital management at some banks by Holdco, PL Capital LLC and other institutional investors is a good reminder that investors are dependent upon the compounding of retained capital, plus distributions for their returns. There are no moonshots in an industry where it is easy to under-earn by a little bit for year after year or, worse, lose money by the bucketful given inherent leverage in the balance sheet.

> ***Capital management has always mattered. It just sometimes is obscured by a strong economy and the absence of credit losses.***

Among the big decisions boards face is how to allocate internally generated capital and any excess capital, whether to retain it for organic growth, distribute it via dividends and/or share repurchases, leverage it an acquisition or some combination thereof. Spending capital on acquisitions is the toughest to address given execution risks.

Buybacks get a lot of attention as a safe use of capital, but not always, because price paid matters a lot, like in any investment. While buybacks shrink the number of shares and presumably are accretive to earnings per share, the impact on tangible book value per share depends on the multiple paid and how much the repurchased capital might have compounded if not distributed.

Cleveland-based National City Corp. offers a cautionary tale about buybacks. The company conducted a modified Dutch auction in 2007, a little over a year before its fire sale to PNC after facing a liquidity crisis. Maybe the extra capital would not have mattered, or it might have been the increment needed to give lenders confidence to roll funding. We will never know.

Capital management has always mattered. It just sometimes is obscured by a strong economy and the absence of credit losses. As for KeyCorp, it seems to me a more likely outcome than a string of bank acquisitions is that Scotia follows up its 2024 minority investment by acquiring the balance of the company at some point in the unknowable future.

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