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Options on recovery

As to whether the world will survive, opinion is mixed. Some say yes and some say no, and others are on the fence. Neither is there any firm consensus concerning the nation's banks. Will even one remain in the private economy on the day the Great Recession expires? You can get an argument.

Now unfolding is an exploration into the crisis-related investment opportunity. We write, we hope, with a due sense of the gravity of the times. It's not just every cycle in which a certain Ayn Rand disciple and former Fed chairman plumps for nationalizing American banks. Then again, the bad news is not exactly news anymore. From its peak, the Keefe, Bruyette & Woods bank-stock index (BKX) has fallen by 82%, while the financial-stock component of the Standard & Poor's 500 Index weighs in at just 9.5% these days, down from 22.3% as recently as September 2006.

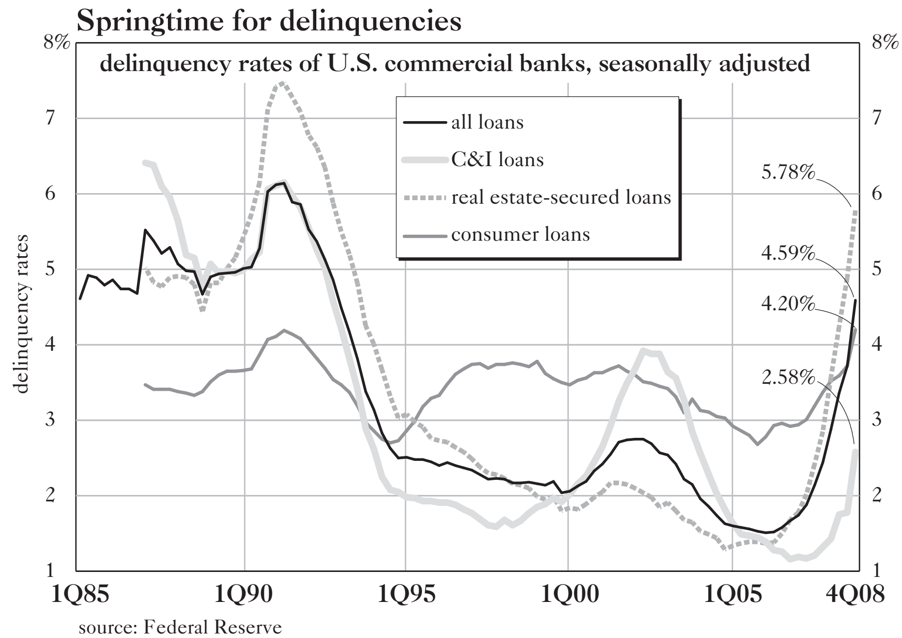
Yet, your editor is here to attest, if there is anything scarier than owning the stocks of banks, brokers and insurance companies during a credit liquidation, it's being short them during the post-crisis moon shot. Citi, for example, was an $8.50 stock in December 1991. Within two years, it was a $40 stock. Within six years, it was earning—almost—its intraday-low 1991 share price. The Bank of New Hampshire traded at $3.50 a share in September 1991, two weeks before the FDIC seized seven other Granite State institutions. In April 1996, it fetched $43.50.

Maybe today's basket cases will produce per-share earnings equal to today's share prices at some not-too-distant date. We don't rule it out. Neither do we dismiss the possibility that Sheila Bair will wind up controlling every bank in the BKX. But, born optimists, we attach a higher probability to the former outcome than we do to the latter.

"High expenses for loan-loss provisions, sizable losses in trading accounts and large writedowns of goodwill and other assets all contributed to the industry's net loss," noted the FDIC in reporting that, in the final three months of 2008, insured financial institutions suffered their first quarterly loss since 1990. No surprise, then, that, despite the highest ratio of reserves to loans in 14 years, coverage ratios stand at 16-year lows, or that nonperforming loans climbed by 107% last year to reach 2.93% of overall loans, the highest in 17 years. Also came the report that the top-secret FDIC list of "problem" banks comprised 252 institutions controlling $159 billion of assets, compared to the year-earlier tally of 76 institutions controlling $22 billion of assets. Evidently, Citi is beyond problematical; it alone controls $1.9 trillion of assets. So what is the bullish-bearish-hopeful-confused investor to do?

An options strategy, perhaps. Pick an assortment of banks of varying degrees of survivability. Buy call options at strike prices double the current price, with maturities clustered in early to mid-2011. The reason not to do any such thing is that options tick like time bombs. The reason to stop one's ears to the ticking is the likelihood that the cycle will turn within 24 months and financial stocks will lead the way up, with the book-entry share certificates themselves crying hallelujah as they go.

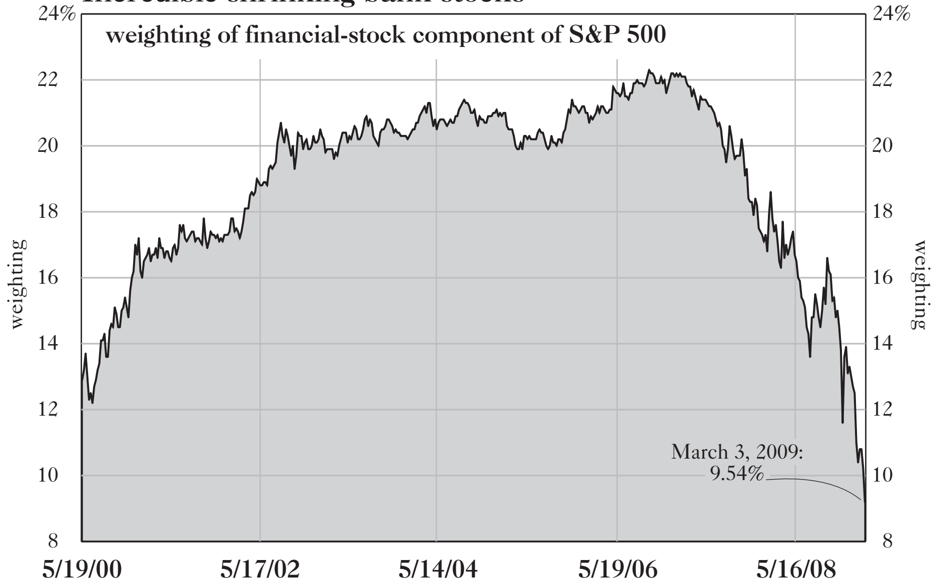
Clairvoyants, seeing into the future, naturally do their bank-stock investing at the bottom. Fearless because they are all-knowing, they buy the junior-most security of the shakiest survivors, the



stocks that go up the fastest and farthest. For the rest of us, lacking perfect foresight, we might consider options on the shares of a cross-section of financials, three or so, let us say, from each of the three departments of the financial triage ward: ambulatory, salvageable and doubtful.

BB&T Corp. (BBT on the Big Board) fills the bill of a Ward 1 candidate. The 12th-largest financial-services holding company, Winston-Salem-based BB&T conducts a diversified business—brokerage, capital markets and insurance, besides basic banking—in the American southeast, including formerly bubbly Florida. Nonperforming loans, at 1.34% of total assets, are, so far, manageable, though $8 billion of home builders' loans ("residential acquisition, development and construction loans") and $11.5 billion in commercial real-estate loans may yet break out in hives.

Incredible shrinking bank stocks



source: The Bloomberg

BB&T performed the astounding trick of turning a fourth-quarter and full-year 2008 profit (of 51 cents and $2.71 cents per share, respectively). It lent more in the fourth quarter than it did in the third, and more in 2008 than it did in 2007. Net cash interest margins fattened by two basis points in the fourth quarter compared to the third, and by 22 basis points compared to the fourth quarter of 2007. Net interest income, before provisions for bad debts, jumped by 7.5% from the 2007 fourth quarter. BB&T did issue $3.1 billion of preferred stock to the U.S. Treasury toward the end of last year in connection with the TARP, but it seems that it didn't have to. With $8 billion of tangible common equity against $152 billion in assets, the bank is sitting in the capitalization catbird's seat—barring, of course, another year or two worth of seismic jolts in credit and business activity.

But, one must consider, what about the other possibility? How would it be for BB&T if all this World War II-grade fiscal stimulus and Weimar-caliber credit creation "succeeded"? Even as it is, according to CEO Kelly S. King, speaking on the fourth-quarter conference call, the market is coming BB&T's way. Customers have come knocking, for one thing. They seem to like a solvent bank. "[I]f you see something that says they can't get a loan, give them my number," King invited the listeners-in.

Then, too, King went on, the collapse of the shadow banking system has done a world of good. "I'm very, very pleased with what is going on with regard to restoring pricing discipline," the CEO stated. "We had an interesting thing for the last 20, 25 years. We disintermediated the banking industry as a huge amount of loans left the banking system and went through securitization into various conduits and other investment areas, which caused two things to happen. One is we lost the volume and put enormous pricing pressure on loans, because a lot of these investors didn't have the capital and reserve requirements that we do. And so I started making loans 36 years ago, and over that period of time, we've lost about 300 basis points on the same kind of loans. We haven't gotten it all back yet. It will take a little while, but on the larger-size credits, we've already seen a 100-plus basis-point improvement just in the last three or four months. We're beginning to install floors on credits because absolute rates are so low, and there is a lot of receptivity to that in the market."

PNC, too, is the kind of bank to which nervous, safety-seeking customers have been flying—transaction deposits climbed by $5.9 billion, or 10%, in the fourth quarter—and we place it, side by side with BB&T, in the first department of the *Grant's* triage clinic. On the February earnings call, James E. Rohr, PNC's chairman and CEO, sounded as cheerful as Barack Obama used to before he took office. "We've been open for business throughout this period by adhering to our business model and leveraging our success at building long-term relationships with our clients, and by allocating capital based upon risk-adjusted returns, we've delivered significant value to the shareholders over time."

So far as the dividend is concerned, there will be 85% less of it, PNC disclosed on Monday, suggesting it was the regulators' idea. Up til then, the Pittsburgh-based super-regional had been on the offensive. At the end of December, it doubled its customer base by swallowing Cleveland's National City Bank for $5.6 billion of stock and an odd lot of cash. The combined entity shows $291 billion in assets, $175 billion in loans and $193 billion in deposits. It has a 33% ownership stake in BlackRock, a capital-markets business and a custody business. Nonperformers stand at 74 basis points of total assets, and the allowance for bad loans covers 236% of known duds. National City was choking on bad loans, home-equity credits among others, and PNC was able to mark some of these assets as low as 42 cents on the dollar.

Come the turn, shareholders will thank CEO Rohr for his courage and foresight in buying low. Pending that happy event, however, they will have to live with the possibility that Rohr did not, in fact, buy low, but rather, like so many others on Wall Street, mistook a calamity for a business cycle. As the regulators count capital, PNC is amply covered, with a so-called Tier 1 ratio of capital (equity and preferred) to assets of 9.7%. But the market puts no more

Option basket
(in $ billions)

	ticker	mkt. cap	total assets	5-yr. comp. asset growth	non-perf. to total assets	allw. for loan losses to nonperf. loans	tgbl. comm. equity-to-assets	price to tgbl. book value
PNC Financial	PNC	$10.6	$291	33.67%	0.74%	236%	2.90%	1.23x
BB&T Corp.	BBT	8.6	152	10.94	1.34	110	5.30	1.07
Goldman Sachs	GS	41.6	885	16.99	NA	NA	4.82	0.97
Morgan Stanley	MS	19.5	659	1.80	NA	NA	4.33	0.68
Key Bank	KEY	3.2	104	4.24	1.41	147	5.95	0.52
Comerica	CMA	2.1	68	5.11	1.46	84	7.21	0.43
Regions Financial	RF	2.4	146	24.66	1.18	141	5.23	0.33

source: company filings

stock in the bank regulators these days than it does in the ratings agencies, and the market is focused on tangible common equity. Preferred doesn't count. "Owing to the National City acquisition," colleague Ian McCulley observes, "PNC has a tangible common equity ratio of just 2.9%. Asked on last month's call if another capital raise is in the offing, management was noncommittal. (PNC is one of the few banks that could raise private capital.)" Rohr reaffirmed at a conference on Tuesday that there is no plan to raise common equity.

The *Grant's* triage ward sorts its patients by price-to-book ratios. Goldman Sachs (GS) and Morgan Stanley (MS), unloved though they may be in Washington, D.C., are welcome here, in Ward 2, the salvageables, reserved for shares quoted at a discount, though not a gaping one, to book. The Fed's openhanded lending has quieted fears about the pair's liquidity, and disaster has thinned out the competition. In 2008, each shed some of the excess pounds accumulated during the bubble years. Morgan Stanley, for instance, shrank its balance sheet by 37%, to $659 billion. True, for the time being, neither will be raking in billions from highly leveraged proprietary trading. But wider spreads will allow for profitable dealing even on lower leverage. Though the equity advisory business is likely to be as quiet this year as a 2009 off-site, there's work to be had in restructuring and debt underwriting—and in asset management. In the 12 months to November 30, Goldman's asset-management business, which includes prime brokerage, generated $3 billion in pretax earnings on period-end assets of $779 billion, down just 10%. Morgan Stanley's asset arm performed no such feat, showing a $1.8 billion pretax loss after write-downs. The wealth-management business did generate $1.2 billion in pretax earnings, however, and the Morgan Stanley-Smith Barney merger holds promise for the next up cycle. Before it took Smith Barney off the trembling hands of Citigroup, Morgan had 8,400 brokers superintending $546 billion in client assets. Bigger now than Bank of America, which famously bought Merrill Lynch, the new Morgan Stanley will field 20,000 brokers overseeing $1.7 trillion in client assets.

So much for Ward 2. We now come to the institutions about which Mr. Market entertains a reasonable doubt. The likes of Comerica (CMA), Key Bank (KEY) and Regions Financial (RF), among many others, trade at steep discounts to book. They are officially doubtful. Yet, despite their well-aired troubles, each shows a relatively high amount of tangible equity and reserves in relation to nonperforming loans. A word about Regions: With its shrinking net interest income, its immense 2008 net loss ($5.8 billion, owing to a $6 billion write-down of goodwill) and its heavy exposure to residential real estate and construction loans in Georgia and Florida, the bank would appear to have what the early Americans called a churchyard cough. But the insiders, or some of them, seem deaf to it. Over the past six months, they have bought 227,000 shares and sold none.

A glance at the balance sheet conveys no sense of the depth of the bank's admitted problems. Assets foot to $146 billion and shareholders' equity to $16.8 billion, of which $7.3 billion is tangible. Nonperforming assets account for 1.2% of total assets, and loan-loss reserves represent 141% of nonperforming loans. However, on the January call, management warned that 9% of the loan portfolio was "distressed." Residential homebuilder loans amount to $4.4 billion, home-equity loans to $16.1 billion and a portfolio of third-party-originated consumer loans (RVs, autos, boats) to $3.9 billion. Management has been more aggressive than most at charging off bad loans, and nonperforming assets actually ticked lower in the fourth quarter.

Then, again, the loan book would be worth $15 billion less than the value at which it is carried if it were marked to market, the recently filed 10-K report discloses. True, under U.S. generally accepted accounting principles, the loan book is not marked to market, but the common stock is. On Tuesday, it was quoted at a ratio to tangible book value of just 0.33%. It seems fair to conclude that good news is not exactly built in.

Alternatively, rather than buying calls on a self-selected basket of potential crisis survivors, McCulley points out, one could use the Financial Select Sector SPDR Fund (XLF). "You can buy call options that expire in January 2011 with a strike of $15 for 65 cents a piece," he winds up. "XLF was last quoted at $7, and come the turn, the sector could easily double. It's happened before."

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