CAPITAL MANAGEMENT

Citigroup

Citigroup (C) has been the clear laggard of the big U.S. banks since the Financial Crisis.

It was a poorly constructed collection of businesses, run inefficiently for decades. With that said, there have been opportunities to make a lot of money in the stock by buying at sizeable discounts to tangible book value, while prices close to tangible book value have made for good selling prices. There is hope that Citigroup's management team is on the right track and finally should start hitting the inflection points where we see improving operating leverage, which should greatly enhance normalized earnings. Citigroup easily has 50% upside potential over the next 3-5 years for investors willing to endure the frustrations that come with being a Citigroup shareholder.

One of my favorite metrics in evaluating a stock is a free cash flow, or for a bank, an earnings yield. An earnings yield is basically the net income divided by the market capitalization of the company, and it reflects how much the business would pay to shareholders if it was able to pay 100% of net income out. Currently, Citigroup is under-earning its potential, as it incurs heavy costs associated with CEO Jane Frazier's material restructuring, but even now, the earnings yield on a forward basis is greater than 10%, along with a nearly 3.6% dividend.

If the company can achieve its medium-term targets of a 10-11% ROTCE, Citigroup would be earning between $8.50-$9.50 per share, which would equate to a 15.2% earnings yield at today's prices using the median.

In a free-market environment where banks could make their own judgments with their excess capital, stock buybacks would be an absolute no-brainer at the current valuation. By buying back stock at a large discount to tangible book value per share, both TBVPS and earnings per share would grow rapidly. However, we do not live in a free-market environment when it comes to the banks, for better or worse. Regulators are regularly changing the models and capital requirements, so the banks, especially those with the checkered history of Citigroup, can't capitalize on all the opportunities that Mr. Market presents. I'd wager that if Citigroup was once again able to use most of its net income to buy back stock as it has in the past, the stock price would rapidly converge once again towards tangible book value. This dynamic makes banks less attractive than many other industries to invest in, but at the right price, they can still be very fruitful.
On April 12th, Citigroup reported net income of approximately $3.4B, earnings per share of $1.58 and an ROTCE of 7.6% on over $21B of revenues. Revenues were up 3% YoY, excluding divestitures.

Expenses were up 7% on a reported basis and excluding divestiture-related impacts and the incremental FDIC special assessment, expenses were up 5%. Citigroup has been engaged in a radical reorganization, which has tremendous potential, but the huge ascension in fees has plagued returns over the last several years. The bank has incurred approximately $1B of restructuring costs over the last two quarters, which are expected to result in $1.5B of annualized run rate savings over the medium term. Improved operating leverage should be proof that the strategy is working towards the back half of this year. If that does occur, I would expect the stock to begin re-rating a bit higher, as it would greatly enhance confidence in the strategy. Citigroup's $2.4T balance sheet is funded by a $1.3T deposit base, which is well diversified across regions, industries, and customers. $812B of deposits are corporate and span 90 countries. Many of Citigroup's clients are multinational that rely on the bank to really integrate with their own operations.

Net interest income decreased by $317MM, largely driven by markets, which resulted in a 4-basis point decrease in net interest margin. Excluding markets, NII was basically flat. Average loans were up by $4B, primarily driven by loans spread in markets, as well as card and mortgage loans in Personal Banking, partially offsetting declines in Services.

Average deposits were up by nearly $7B, driven by Services, where the bank is growing its high-quality operating deposits.

Cost of credit was roughly $2.4B, driven by higher card net credit losses, which were partially offset by ACL releases in wealth, banking, and the legacy franchise. We are seeing normalization in credit after unprecedented stimulus allowed credit to be pristine for much longer than in a normal cycle. At the end of Q1, Citigroup had nearly $22B in total reserves with a reserve to funded loan ratio of approximately 2.8%. Across branded and retail services, approximately 85% of Card loans are to consumers with FICO scores of 660 or higher. The bank is well reserved with a reserve-to-funded loan ratio of 8.2% across the total card portfolio. In the Corporate portfolio, most of the credit exposure is investment grade, which is exhibited by non-accrual loans of just .5% of total corporate loans. Citi's loan loss reserves incorporate a scenario-weighted average unemployment rates of approximately 5%, which includes a downside scenario unemployment rate of close to 7%.

During the 1st quarter, Citigroup returned $1.5B in capital to common shareholders, including $500MM of share buybacks. Citigroup's CET1 ratio ticked up to a preliminary 13.5% and the company grew its tangible book value per share to $86.67.

With the stock trading at just 68% of tangible book value per share, stock buybacks should be a huge emphasis of management to create shareholder value, but unfortunately, uncertainty regarding increased regulatory requirements is causing them to use immense caution now. Hopefully, as more progress is made in cutting costs and improving margins, management will reward the patient shareholders that have waited out this restructuring.

Citigroup's management has the medium-term goal to achieve an 11-12% ROTCE on a sustainable basis. To achieve that, management is guiding to 4% to 5% revenue growth from the current baseline. That is going to require higher ROTCEs in Banking, Markets, and Wealth, which has been a major lagger and is now under new leadership. Citi has a great opportunity in Wealth Management, which offers high potential margins and growth. New management is focused on reducing costs, growing revenues, and creating a better client experience. This is one of the areas where I think investors should be really focused on and management should be held accountable for the success or failure that comes. Investment Banking was quite weak last year, but is showing improvement this year, which will help on the fee revenue growth goals, as NII is likely to be quite flat.

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The other major lever is that expenses should begin making material improvement, as the cost savings plans flow through the income statement. If management doesn't deliver on the 4-5% revenue growth, further cost cuts may be required, as there is a lot of credibility on the line with these targets, and this management team has been given a long leash thus far.

The biggest risk to the Citigroup thesis is that regulators will continue to increase capital requirements, reducing returns and preventing the accretive stock buybacks, which are so long overdue. Another risk is that the geopolitical environment continues to deteriorate, causing chaos in the global economy. Citigroup's global operations has made it susceptible to many of these events in the past, including with Russia, China, and Argentina, just in the last few years. I think most of the known risks are priced into the stock at current prices.

At just over $59 per share, Citigroup trades at about 68% of tangible book value. The company seems adequately reserved for the credit environment and we are finally at the key inflection year on expenses. If management delivers, there is no reason that the stock price can't converge towards a growing tangible book value per share in the high $80's. Another potential catalyst would be if regulators tamper down their capital requirement increases, as that could accelerate potential stock buybacks. Citigroup has performed well to start the year, but there is a lot of upside to go. I'd encourage investors to dollar-cost average, as the stock often has volatile peaks and valleys through any given year.

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