DIVIDEND POLICY IN TROUBLED TIMES

by Steve Brown

As we travel around the country, a trend that keeps popping up is banks that have a need for capital, but are still planning on paying out a dividend this year. While many community banks are on this path, so are larger banks such as Zions, Citigroup and Bank of America among others. The argument is that cutting a dividend sends a negative message to investors. While it is true that cutting a dividend hurts marketing and potentially stock price, not cutting the dividend to preserve capital is far worse.

For starters, there is the pure economics of the situation. In good times, the analysis is straight forward. If it is cheaper to raise capital in the current market than it was historically for the bank, then paying a dividend (or conducting a stock repurchase) may make some sense. Investors love a nice steady cash-on-cash return, but they love earnings more.

In times like these, capital is dear and it is getting more expensive with each passing day. Many banks are raising their capital level from 11% of risk-based to 13%, in an admission that management doesn't know how bad things are going to get. Paying a dividend and then turning around and paying a 7% to 15% tax-equivalent all-in cost to replace that capital, is a pure net equity losing activity.

For the investor, having an ownership in a bank that simultaneously raises capital and then returns it, is detrimental to performance. By raising money now, banks are diluting their shareholders at beaten-down share prices. Over time, dilution will have a far greater affect on shareholder performance than suspending the dividend for a year. The math is even worse in that paying out a dividend also creates a taxable event, further hurting shareholder return.

Some managers make the argument that their shareholders would rather have cash right now, than cash in the future (this argument was put forth in a recent WSJ article). This too is faulty logic on two counts. First, because investors have a technical ownership in the cash held at the bank, the economics don't change for the combined entities of the bank and investor - it is merely transferred (at the inefficient taxable rate, as discussed earlier). If cash is valued, then cash held on the balance sheet of an investment should be just as valued.

Second, if cash really is more valuable in the investor's hands than the bank's stock, then the investor can always sell the bank's shares in the marketplace at any time and arrive at the same position. If management is ready to destroy value by paying out a dividend, while simultaneously raising capital, then the future doesn't bode particularly well for earnings. That being the case, it is ironic that while management was hoping to boost its current stock price by paying out a dividend, smart investors often sell their stock, because they realize management is being short-sighted and future earnings will be depressed by the negative capital arbitrage. The result is a further depressed price, exactly the opposite of what bank management was hoping for.

Since banks are trading at historically low multiples, this should improve in the future. If true, it makes more sense for a bank to cut its dividend, conserve capital and enjoy better future earnings (not to mention lower risk). When earnings multiples improve, bank management will be rewarded to a greater extent than the current market allows.

Bank management and boards that have a need for capital, yet still pay out a dividend are ultimately destroying shareholder value. A dividend is a form of discipline and paying one out in troubled times is most likely an admission that management is focused on short-term performance instead of building long-term value. A dividend is also an investment. Like any other investor, the company and its shareholders must ask, "Is this the best use of our money right now?"

BANK NEWS

Bank Closures

The OCC closed First National Bank of Nevada ($4.4B, NV) and First Heritage Bank ($159mm, CA) on Friday and the FDIC as receiver entered into purchase and assumption agreements with Mutual of Omaha Bank ($738mm, NE). Mutual of Omaha Bank will pay the FDIC a premium of 4.41% to assume all of the deposits and will purchase approximately $200mm of assets. Both banks were owned by First National Bank Holding Company ($4.6B, AZ).

Housing Stress

The latest report by RealtyTrac finds 220k homes were repossessed in 2Q, a 14% increase from the 1Q and 121% higher than the same period last year. Overall, 1 in every 171 U.S. households received a filing.

Banking Online

A new study by the University of MI finds 75% of bank websites have design flaws that expose customers to financial loss or identity theft. Problems cited were primarily related to the layout (including placing log-in boxes and contact information on unsecured web pages), as well as failing to keep users on the site.

Tighter Lending

A new survey finds 55% of small business owners say they have had a tough time getting credit in the past 12 months, as banks have tightened standards and other lenders have gone out of business.