DIVIDEND OR BUYBACK?:

by Steve Brown

For banks with a higher than needed level of capital, the question comes up for 2012 whether it is better to increase your dividend or repurchase shares? Low interest rates and low valuation multiples make a solid case for banks to repurchase shares.

To better understand dividend and buyback programs, let's look at the dynamics of both. Each tactic serves to send a signal of the Bank's increasing expected financial performance and both have the ability to increase the return for shareholders. The dividend does so in the current period of dividend declaration, whereas the stock repurchase may or may not impact shareholders in the current period depending on where the price is set. This is an important distinction, as the dividend usually results in a higher perceived value to shareholders as it delivers instant gratification.

For the sake of this discussion, let's set aside tax ramifications. Historically, a share buyback program has been markedly more tax advantageous for the investor, due to the treatment as a capital gain instead of ordinary income. However, due to dividend income classification, hold period restrictions and volatile tax positions (more tax losses these days), the net effective tax impact of the two strategies have been relatively the same over the past couple of years. That said, it is important to understand, particularly for closely held banks, that a share buyback program allows the investor to choose when to liquidate future shares, thereby theoretically resulting in a lower tax bill. Conversely, a dividend declaration allows no such flexibility and thus is usually perceived as less tax advantageous. This tax assumption makes more sense, as for this review (given the current market) we will also assume that management believes current equity valuations are below the expected future value of the firm.

Given the above assumption, stock repurchases can then be treated like any other investment. A bank should repurchase shares, as cash allows up to the expected risk-adjusted return of the next investment alternative, or the expected future cash flows discounted at the cost of equity. In other words, bank CEOs need to attempt to quantify a buyback return on investment. Presumably, the Board and management have the best insight into cash flow generation for existing lines of business, so a repurchase program often requires a lower return (or lower risk adjustment factor) when compared to alternative investments in new products, markets or companies. To put this in perspective, because of how banks are trading, a common performance metric over the last 2Ys for well-performing banks with the ability to repurchase shares at a discount, as been a 30%+ buyback ROI, pushing TSR from a 9% ROE to 14% future ROE (assuming the same level of earnings in the future). Of course, this strategy comes with risks, such as if earnings or share price decline, investors have fewer outstanding shares to absorb the loss.

Unfortunately, these days alternative investment choices are limited, as banks are having a hard time earning above their cost of capital. If this the case, paying a dividend or repurchasing stock is a clear choice for excess capital. If you can pick up shares at a discount, then usually a share buyback program will result in better total return performance for both the Bank and the shareholders. Not only do you have fewer shares (thus resulting in higher future earnings per share), but the value of the difference between the purchase price and true value of the equity gets accreted in the future as well.

Some banks we talk to that have a good feel for their interest rate sensitivity are putting off their buyback decision until they have more confidence rates will rise (thereby increasing margins and giving them higher confidence of hitting a targeted buyback return). Still other banks are choosing to both buyback stock on a regular basis and at a set dollar amount (thereby ensuring that more shares are purchased when the price is lower and paying a dividend for marketing value). Whatever the case, this market presents an ideal time to create value through better capital management, particularly for CEOs compensated on either an ROE or EPS basis.

BANK NEWS

M&A

River Valley Bancorp ($402mm, IN) will buy Dupont State Bank ($82mm, IN) for $6.3mm in cash (approx. 83% of book) and rename itself River Valley Financial Bank.

Equity Raising

A new bill has been introduced in the Senate that would raise the current 500-shareholder threshold for SEC registration to 2,000 for banks and also raise the deregistration threshold from 300 to 1,200 shareholders.

New Regulation

The CFTC has approved a rule that tightens controls on how US futures brokerage firms can invest client money. The final rule prohibits firms from investing in repurchase agreements or the sovereign debt of foreign countries (the sorts of assets believed to have caused the collapse of MF Global). Allowable investments include Treasuries, municipal bonds, certificates of deposit and money-market mutual funds (with some restrictions).

More Mobile

Research firm Gartner projects mobile payment transactions will nearly double this year, to $86.1B from $48.9B in 2010.

Consumer Credit

Banks have increased credit card mailings by 85% since early 2010 according to the WSJ. The move has pushed credit card purchases up 9.0% in 2Q and 10.6% in 3Q of 2011, compared to gains in debit card use of 8.3% and 5.9% for the same quarters.

Professional Management

Analyst Abby Joseph Cohen of Goldman indicates 70% to 80% of mutual fund managers underperformed their benchmarks, as volatility roiled markets this year, one of the worst performances in recent memory.