Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Citi's Common Misconception

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Donald Luskin

The troubled bank's exchange offer is pointless, costly and destabilizing.

In 1958, Franco Modigliani and Merton Miller wrote a paper that would win both men the Nobel Prize, putting forth the "capital structure irrelevance principle." In a nutshell, the principle states that the value of a firm is independent of how it is financed. From that standpoint, Citigroup's announcement Friday of an exchange offer of preferred stock for common stock can be seen as a costly exercise in the rearranging of deck chairs -- which, rather than instilling confidence, sends the signal that the bank thinks of itself as the *Titanic*. Or more important, that the bank is afraid that the Treasury does, whether it actually is or not.

Update to strategic view

US STOCKS, US FINANCIAL STOCKS: Citi's exchange offer is a costly mistake that shows bank rescue policy under Geithner's Treasury is in amateurish disarray. Other banks now risk repeating Citi's mistake, and stocks will continue to flail until policy stabilizes.

[see Investment Strategy Dashboard]

Under the threat of some form of "nationalization" if it fails the Treasury's upcoming "stress test," what choice does Citi or any bank have but to bear almost any cost, or to acquiesce in the silliest accounting fetishism, in order to pass? Little more than generalities are known about the stress test. We do know that it is part of the Treasury's "CAP" initiative, an acronym that in some documents stands for "Capital *Assistance* Program," and in others for "Capital *Assessment* Program." And we know that the stress test's touchstone for capital adequacy is tangible *common* equity. Anything less is second-rate capital, suddenly -- so out with *preferred* equity, and in with *common* equity. Never mind that Treasury, over the last six months, has made about $300 billion in *perpetual preferred* equity investments in banks under TARP's Capital Purchase Program, having declared *that* to be the best way to shore up capital adequacy. Never mind that the conversion of preferred to common doesn't create a dime of additional capital. Never mind that in order to incentivize the preferred shareholders to convert, the conversion price had to be set at a level that maximized dilution of common shareholders. The only useful element in the whole sorry affair is the suspension of the preferred dividend -- a measure that conserves capital, which probably explains why Citi's common stock fell less on Friday than the degree of dilution would have led one to otherwise expect. But that could have been done without making the exchange offer at all.

Key documents

Modigliani and Miller (1958)
Citi exchange offer term sheet
Treasury CAP white paper

[Client Resources home]

The risk now is that other banks will decide they must follow

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

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in Citi's footsteps, to do ostensibly voluntarily what they fear they'll be forced to do when they fail the stress test. Ironically, they will fear that they will fail for no better reason than because the Paulson Treasury forced upon them its investment in *preferred* equity, and now the Geithner Treasury has arbitrarily decided that *common* equity is the only capital worth having. It's little real progress from the chaotic days of late summer when financial firms were arbitrarily taken out and shot on Saturday (see "Death by Rescue" November 17, 2008). Now they shoot *themselves*, and on Friday.

We had hoped that the consistent pattern of bank interventions under TARP, begun in mid-October and continued through the Citi rescue in November and the Bank of America rescue in January, would neutralize Treasury policy as a source of uncertainty (see, for example, "Another Rescue, A New Rescue Ranger" November 24, 2008). But Citi's destructive exchange offer sending its stock to new lows, and the rest of the equity market along with it, is an indication that bank policy at the Geithner Treasury remains in amateurish disarray (see "Two Strikes for Tim" February 11, 2009). While the Treasury announces yet another rescue of AIG, and sends banks scurrying to destroy value by making costly but irrelevant changes in their capital structures, it still hasn't managed to get TALF -- the program designed to kick-start the moribund loan securitization market -- up and running. First unveiled at $200 billion in November, and quintupled to $1 trillion three weeks ago, there hasn't even been an announcement of when the program will actually start. The FAQ on the New York Fed's web site still says the start date will be announced by the end of February -- but now it's March, and no announcement, and no TALF. And no loan securitization market, either. No wonder stocks are flailing.

BOTTOM LINE: Citi's exchange offer is a costly mistake that shows bank rescue policy under Geithner's Treasury is in amateurish disarray. Other banks now risk repeating Citi's mistake, and stocks will continue to flail until policy stabilizes.