Financial Stocks And The Cost Of Capital

"Y' know, every now and then / I think you might like to hear something from us / Nice and easy" – Ike & Tina Turner

Let's go rolling back down the river to an analysis introduced in February 2007 on the economic value added by corporations and whether it was at all related to either their historic total returns or to their prospective earnings. The conclusion was, "no," to which we added:

> *The overall effect may be shocking to most but expected to those who have studied the relationship between risk-acceptance, return and profitability in the stock market. It is one of those things that appear so logical that we assume them to be true. Assumptions do not count; analysis does.*

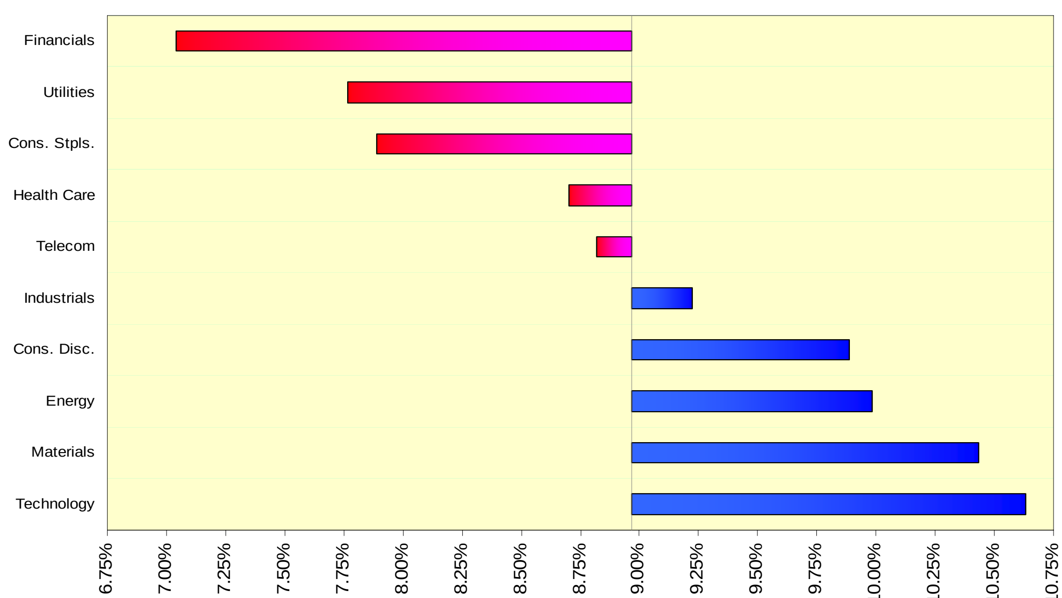
This general subject came to mind last week with a question whether all those financial firms who have been recapitalizing like mad have been paying too much to bolster their balance sheets. And as the question was focused simply on the cost side, that is where we will keep the answer, the weighted average cost of capital (WACC) for firms in general and for financial firms in particular.

What is that WACC? *Bloomberg* estimates on each firm's cost of both equity and debt. These are perforce estimates; the cost of equity, for example, involves an estimate of the return implied in an equity index' price given estimates of growth rates, earnings, dividends and payout ratios and a beta, or relative volatility estimate, between each firm and the index. The cost of debt estimate includes estimates for the default probabilities for each credit rating and spreads to reference debt indices. You might be excused for thinking there is no small amount of guesswork involved.

Now let's take the S&P 1500 index and divide it up into the ten economic sectors used by Standard & Poor's. If we weight each firm's WACC by its weight in the S&P 1500, we can create a sector weighted average WACC. The WACC for the index as a whole is 8.965%.

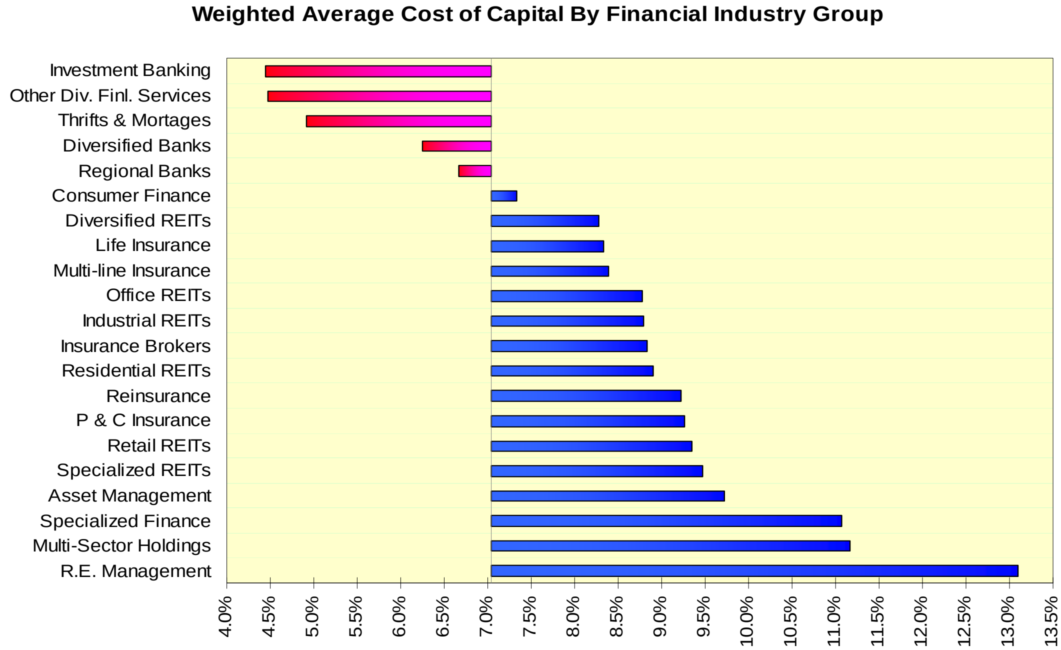
Five sectors, industrials, consumer discretionary, energy, basic materials and information technology have above-average WACCs. Five sectors, financials, utilities, consumer staples, health care and telecommunications, have below-average WACCs. And shock of shocks, the financials' WACC is lowest. More on that below.

Weighted Average Cost Of Capital



Now since we never, ever do anything nice and easy, let's subdivide the financial sector into its constituent industry groups and look at each group's WACC in relation to the sector's 7.036% WACC. Who has the lowest WACCs? Incredibly, the investment banks, other diversified financial services (S&P's understated name for Citigroup, JP

Morgan Chase and Bank of America), thrifts & mortgages, and both diversified and regional banks. The highest WACCs belong to REITs, the subject of a recent column extolling their strong performance to-date in 2008.

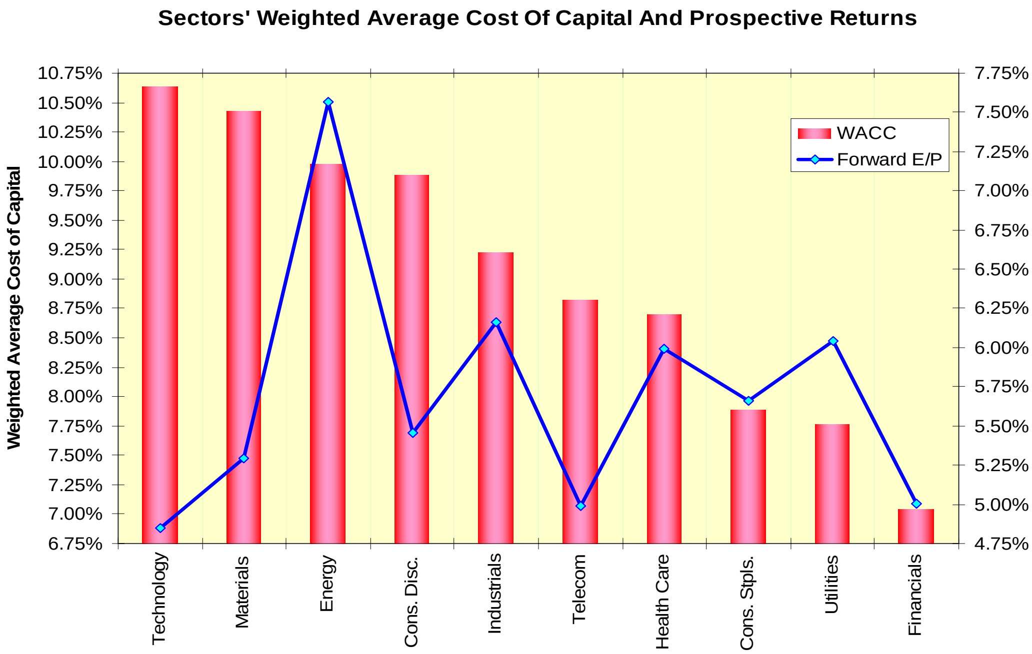


Enter Expectations

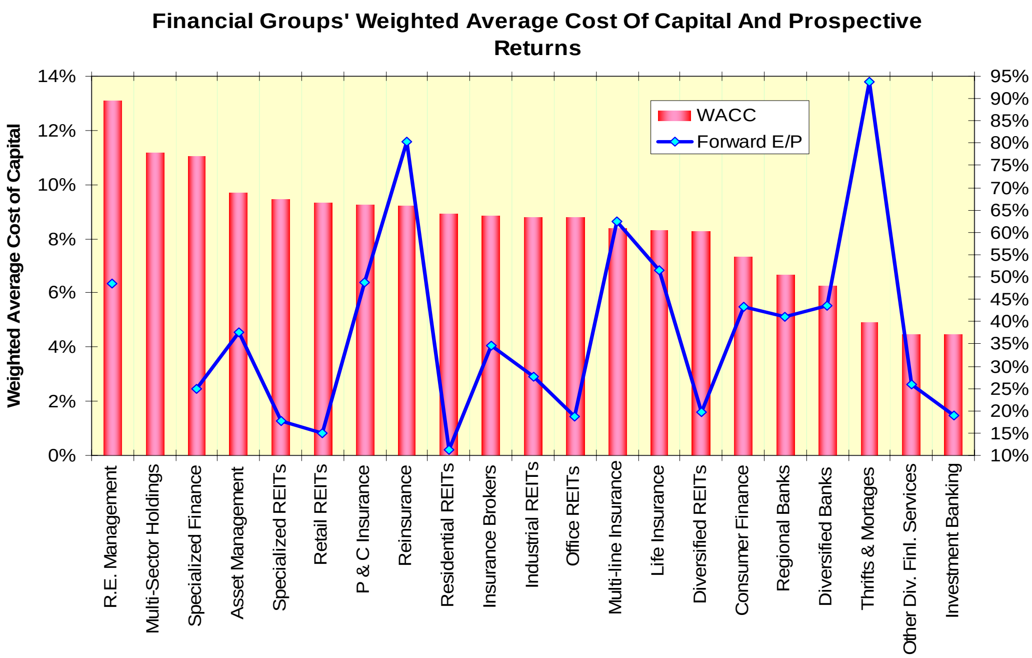
Well, big wheel keep on turning: Has the market taken complete leave of its senses by rewarding the very groups at the epicenter of the credit crunch and penalizing those cleaving to the ancient and honorable profession of using Other People's Money?

No; those investors throwing new capital at the financials are not doing so out of the goodness of their hearts. They are accepting a low initial return in exchange for future common equity, as in the case of the many convertibles issued, or seniority in the capital structure, in the case of the many preferred issues, or what may be boardroom influence in other cases.

Is there a relationship between WACC and investor expectations that can confirm this hunch? Yes, and it is not the one you might expect. If we overlay weighted expected earnings to price ratio, the reciprocal of the expected P/E ratio, against the weighted average WACC for each sector, we see how investors are willing to pay a very high expected E/P for financials, telecommunications and technology, all sectors where earnings can be unusually volatile. The opposite holds for energy, industrials, utilities and health care.



Within the financials themselves, a similar map of expected E/P ratios against WACC for each group shows investors willing to pay a high expected E/P for retail, residential, office and diversified REITs and for investment banking. They are willing to pay a low expected E/P for reinsurance – are you listening, Mr. Buffett? – for multiline insurers and for thrifts & mortgages.



The conclusion from above is ratified. Unless we are willing to believe buyers of bank preferred and convertibles issues or private and sovereign equity investors are a complete bunch of starry-eyed knaves, we have to conclude they have bought something in return for providing cheap capital to the financial sector in general and to the wonderful folks who brought you the credit crunch in particular.

If you do believe this group of investors has overpaid in exchange for bank capital, say goodbye to the U.S. financial system. It will collapse during any next leg of the credit crisis, and no one will step up to its rescue again. Today's investment bankers will be cleaning a lot of plates in Memphis if that happens.