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Unhappy investors await Comerica's recovery plan

By Tom Henderson

Ralph Babb Jr., chairman and CEO, Comerica Inc.

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Comerica Inc., which moved its headquarters from Detroit to Dallas in 2007, faces its biggest corporate challenge since it merged with **Manufacturers National Bank** in 1992.

As oil prices have plunged precipitously, the bank's portfolio of loans to the oil industry — its corporate home's signature business — has taken a hit and revenue has plunged.

Comerica's disappointing first-quarter earnings released April 19 angered, or at least worried, some institutional investors and analysts. On a conference call, Chairman and CEO Ralph Babb Jr. announced he had engaged the **Boston Consulting Group** to help him decide how to best to improve shareholder value.

All options were on the table, he said, including the sale of the bank, and he would report the group's recommendations at the bank's second-quarter conference call in July. At the very least, the consulting group would devise a cost-cutting plan to boost earnings.

The future matters to Michigan. Years after pulling its headquarters out, Comerica remains a major presence. It is second only to **Chase Bank** for deposit market share, according to the **Federal Deposit Insurance Corp.** As of last June 30, the latest date for which figures are available, Chase had $39.1 billion in deposits in the state for a market share of 20.5 percent, and Comerica had $27.5 billion for a share of 14.4 percent.

In Comerica's earnings, there were plenty of metrics to give shareholders pause.

- First-quarter earnings fell from $132 million in the first quarter a year ago to $59 million.
- Earnings of 34 cents a share in the first quarter were well below analysts' expectations, 30 cents below fourth-quarter earnings and down from 75 cents in the first quarter last year. Driven by its oil-industry

loan portfolio, nonperforming loans increased by 85.6 percent, from $379 million at the end of 2015 to $689 million at the end of the first quarter.
- And 56 percent of its energy loans were marked as "criticized," meaning they are at a higher risk of default.

Those are short-term numbers. Longer term, since Babb took over as CEO at the start of 2002, the bank's stock price has slid about 25 percent, compared with a 19 percent drop for the **KBW Nasdaq Bank Index**. In the past two years, Comerica is down more than 12 percent, while the KBW index is up slightly.

With its headquarters near the Barnett Shale, one of the epicenters for the shale revolution, it is natural Comerica would lend to the industry during its boom, and natural it would now be feeling the effects of the crash.

But that doesn't mollify critics.

Mike Mayo, a managing director at New York City-based **CLSA Americas LLC** who has covered Comerica since the early 1990s and prides himself on being an activist analyst, launched a public campaign to urge Comerica to pursue a board shakeup, management changes, a sale of the bank or some combination, and was widely quoted in a variety of financial media.

He was quoted in an article on TheStreet website as scoffing at the hiring of the consulting group. "A plan to have a plan after a decade of failed plans," he said.

Mayo traveled to Texas for Comerica's annual shareholder meeting April 26 to query Babb directly, as did many others.

"As promised, large shareholders put Comerica Inc. executives on the defensive ... in what has been described as an unprecedented show of investor frustration with the Dallas-based bank's financial performance," wrote the *Dallas Morning News*.

"A string of about a dozen shareholders peppered Comerica Chairman and CEO Ralph Babb at the company's annual shareholder meeting — typically short, staid events — about his team's plans to boost earnings. 'I think you need to start looking at your results,' said Chuck Griege of **Blue Lion Capital**. 'The industry has to change, and you've got to change with it.' "

Representatives of **Fiduciary Management**, the third-largest shareholder, and **Invesco**, the sixth-largest, criticized the bank for its performance, saying it was time to consider a sale.

Jack Barnes, an analyst at New York-based **Samlyn Capital**, Comerica's 13th-biggest shareholder, told Babb he was at the meeting to "demand strategic change."

Last year, each director was re-elected with at least 96 percent of the vote. Approvals were down in the 80s this year, a seemingly high number but considered something of a slap in the board's face given that those elections are typically nearly unanimous.

Babb put on a happy spin at the post-meeting press conference, saying he was pleased with the outcome. "It was in the 80s. That's a good vote," he said.

'Preserve the franchise'

"The ex-CEO of Comerica, Gene Miller, had a mantra when it merged with Manufacturers: 'Preserve the franchise,' " Mayo told *Crain's*. "Almost a quarter-century later, Comerica has preserved the franchise. It is an attractive franchise, especially for its core deposits. And it's been the type of Main Street bank that has lent to businesses that help the economy grow."

"It is a very strong franchise, very high quality," agreed John Donnelly, managing director of Grosse Pointe investment banking firm **Donnelly Penman & Partners**, which has a focus on financial institutions. "But its cost structure is a bit bloated."

Which is a reason, he and Mayo said, that the bank has consistently been among the least efficient of its peers, with lower returns on equity.

"It hasn't had a double-digit return on equity once in the last eight years. Not once. Clearly the low-interest-rate environment has been more difficult than expected, but its peers have gotten around that. Our view is that Comerica needs to show significantly higher returns or shed a geographic region, change management, restructure the bank or sell it," said Mayo.

Having scoffed at the bank when it announced it has engaged a consultant, Mayo nonetheless liked what he heard at the annual meeting.

"Seven different times, Babb said he would consider all options. Seven times. The message was, 'Wait till you see the plan we roll out in mid-July.' We'll see," he said.

In fact, after the annual meeting, CLSA, Mayo's firm, raised its target price for Comerica to $50, up from $44, and lists it as an "outperform."

Other analyst reaction was generally positive to what Babb had to say, that he has got the point that something concrete needs to be done.

TheStreet Ratings gave the bank a buy rating and projected a 12-month price of $48.83; **Rafferty Capital Markets LLC** raised its 12-month range for the stock from $30-$39 to $33-$43; **Raymond James** boosted its rating from "market perform" to "outperform"; and last Thursday, **Goldman Sachs** upgraded it to "neutral."

Terry McEvoy, an analyst at Little Rock, Ark.-based **Stephens Inc.**, doesn't think there are any buyers out there for Comerica, or that it will shed any of its regions.

In a report he issued on May 4, McEvoy wrote: "We feel the highest-probability event is an expense reduction being announced in July," adding that he believed in "the potential for lower expenses, greater comfort around Comerica's energy portfolio and the embedded acceleration in earnings per share once (interest) rates rise."

Later, he told *Crain's* that Comerica's poor performance in recent years isn't so much a case of management mistakes under Babb but its particular niche, a focus — some might call it an over-reliance — on lending to business and industry, where record-low interest rates made margins razor-thin.

"It's Comerica's business model," said McEvoy, describing the bank as "a one-trick pony" compared to its more diversified peers.

"Investors are saying, 'How much longer can we take this?' But they can be too quick to push a sale. Is this the right time to sell? Are there buyers out there who will pay a fair price? I don't think so," he said.

At this point in the cycle, more patience could be a virtue, he said. "Interest rates will rise, and that will reward them."

In fact, Babb told *Crain's* that the small, quarter-point rise in interest rates late last year by the **U.S.Federal Reserve Bank**, a rise seen by many as negligible, will translate to an additional $90 million on Comerica's bottom line this year.

"So you can see how sensitive we are to interest rates. Eighty-five percent of our loans have floating rates," he said.

And with the Fed hinting at another quarter-point rise in June, another boost to the bottom line is likely.

"We are one of the most interest-rate sensitive institutions because of the niche we're in. None of us expected interest rates to be so low this long," said Babb.

Babb said he understood the frustration by institutional investors and, with help from the consultant, would review expenses and look for other sources of revenue.

"We think we'll be closer to double-digit returns even before interest rate hikes," he said.

Babb reiterated all options were on the table. "When you look at our overall returns on equity, that's gone on a long period of time, which is why we're doing what we're doing."

One option that isn't on the table? Voluntary retirement. Babb is 67. The bank requires board directors to retire at the next annual meeting after a 72nd birthday, but there is no retirement age for bank executives.

"We regularly review succession plans with the board for senior executives, including myself," Babb said.

"I have no plans to retire at this point. Our team is really focused on improving results in a challenging environment. Our goal is to build a stronger, more competitive bank."

He may not have long to do that. All eyes are looking at the July calendar, and all ears will be waiting to hear what Babb and his consultants have to say then.