Citi: Pandit's defense boosts Wall Street

Mara Der Hovanesian

The bank CEO's talk of profits sparks a stock rally, but others still worry about Citi's toxic assets.

Strip away the billions of toxic assets and the billions more that the feds have pumped into Citigroup (C), and what you have is a dandy little bank that actually makes money. At least that was the upbeat takeaway from Citi's beleaguered CEO Vikram Pandit, who distributed a memo to employees late on Mar. 9 about the bank's bright prospects, despite the current $1-a-share price tag.

Pandit emphasized in the memo that the bank was adequately capitalized, had passed stringent self-imposed stress tests, and was profitable through the first two months of 2009, delivering its best performance since the third quarter of 2007. In coming weeks the Treasury Dept. will conduct its own stress tests of banks—assuming further deterioration in the economy, employment, and home prices—on which will hinge further U.S. assistance.

"Despite the steps we've taken to strengthen our capital base, I am, like you, disappointed with our current stock price and the broad-based misperceptions about our company and its financial position," Pandit wrote. "I don't believe it reflects the strengths of Citi, our newly strengthened capital base, our unique global franchise, and most important, the quality of our people. These are unprecedented times in the markets, but over time, the markets will recognize the many strengths of Citi."

A sustained stock market rally?

The memo bolstered the broader markets and investors cheered that the federal government's handiwork in bolstering the ailing bank with fresh capital and guarantees might actually pay off. The Dow Jones industrial average closed trading up 379 points, or 5.8%, to 6,926, and Citi's stock price rallied 37%, to 1.44..

"Citigroup is the poster child for what happens when things go wrong, but I think enough people on Capitol Hill have had a soft spot for them," says Gary Hager of Integrated Wealth Management in Edison, N.J. "I think the plan will work and they will lead the business out of this by the end of 2009; it's a screaming buy."

Like Hager, Michael Church of Addison Capital in Yardley, Pa., is optimistic that the rally could be sustained given the coincident news from Fed Chairman Ben Bernanke that the recession might very well be over by yearend. "That Citi is saying they are making money is good enough right now," says Church. "The market was factoring in a doomsday scenario, and we were well oversold. I wouldn't be surprised if this turned into a serious rally."

That doesn't mean that all of Citi's woes are somehow miraculously behind it. Pandit's memo noted that for the first two months of the year, the bank was booking operational profits for the first time since the third quarter of 2007, thanks to $19 billion in revenues through the end of February. Pandit pinpointed stable deposits and strong investment-banking advisory fees as contributors to the earnings strength.

Citigroup has posted more than a year of losses, totaling more than $37.5 billion since it reported a $2.1 billion profit in the third quarter of 2007. Just two years ago, Citigroup was the world's biggest bank by market value, at about $270 billion. But its shares had plummeted from an all-time high of 55 to below 1 last week, for the first time ever, as investors continued to lose confidence in the government bank bailout. At that point, Citi's value had fallen to about $6 billion.

Toxic assets remain a question mark

"As the markets are reflecting, the Citigroup news is good," said Jerry Paul, a financial adviser with Essential Advisers in Denver. "Banking is going to be very profitable going forward given interest rate levels at which they can borrow vs. lend. This is true for Citi, except for the bad asset book they carry."

That's a very large exception. Key market participants are still circumspect about the dark hole of toxic assets on all bank balance sheets. Pandit did not address Citi's balance sheet in his comments to employees, except to say that he felt confident of the bank's capital strength, based on its stress tests. He added that a joint venture with Smith Barney would add another $14 billion to Citi's tangible common equity, which he said could increase to $81 billion.

"In a climate of no liquidity, most financial institutions are insolvent if 'mark-to-market' accounting is applied equally and forcefully to all," says Tom Barrack, founder of Colony Capital and a veteran manager of distressed bank assets dating back to the 1980s savings and loan crisis. "The dilemma Citi is constantly confronting is that it cannot accurately create enough loan reserves or provisions to adequately address the onslaught of losses. We're in this massive fight to regain financial credibility. [But] every month the banks are wrong because short-sellers liquidate related mortgage securities of their own at artificially low prices, forcing the banks to correlate mark-to-market of their own securities based on an isolated or random transaction." He believes the solution is a method of allowing banks to sell bad assets to a "bad bank" at market-clearing prices.

So far, Citi has taken about $49 billion in writedowns on its portfolio of bad assets. Analyst reports consider as ongoing problems a $68 billion home-equity loan portfolio and some $166 billion in foreign-consumer loans that are outside any implicit U.S. government guarantees.

Skeptics on the sidelines

While Pandit is doing his level best to convince investors that Citi is in a strong capital position and won't need more bailout money, market skeptics like Barrack still abound. In a new note, for instance, analyst Tim Backshall of Credit Derivatives Research said that despite the U.S. Treasury's best efforts, credit risk is still high and little can be done to "fill any of the holes in bank balance sheets" as a result of the ongoing deterioration in the value of mortgage loans and other investment vehicles that are stuffed full of bad debt.

Until investors can feel confident that the worst is over and the bloodletting of bad assets has stabilized, many view bank stocks—and Citi in particular—as high-risk propositions.

"What they are pointing out is that on an operating earning basis, they are still a viable entity, but we're not buying it at this point," says Dan Genter, chief investment officer of RNC Genter Capital in Los Angeles. "What you have are these assets, some of which you put a big blanket over and call toxic. They are saying that when that is dealt with they are worth more than $1 a share, and I think that is a valid point.

"The capital backstop by the government is helping them earn their way out of this, but if you are a buyer [of Citi stock] you are a high-risk buyer. The stock can be up 50% in a heartbeat or it can be down. Bank stocks look attractive, but we're probably going to wait for a little more confirmation."

BusinessWeek, London, 10 mar. 2009, Top News, online. Disponível em <www.businessweek.com>. Acesso em: 11 mar. 2009.