Citigroup's Big Dividend Finally Set to Grow

Price $51.98 **Dividend Holding** **January 25, 2023**

- 4.2% dividend yield.
- Repositioning toward a consumer-centric model, investing money into digital banking and improving customer experience.
- Divesting from most legacy banking outside of North America, ICG (Institutional Clients Group) will stay international.
- Strong labor markets drove fewer credit losses.
- Investment banking losses offset by strength in commercial/customer banking.

Investment Thesis

Citigroup (C) is a multinational investment bank with $2.3 trillion in assets.Citi is repositioning toward a domestic North American powerhouse in the banking and wealth management sector.

Citi ended FY22 with 31% increase year over year in cash on hand and 5% growth in assets. Citi is well capitalized at 13% CET1 ratio, which is higher than the minimum of 12%, and with a liquidity coverage ratio of 118%. The CET1 ratio is a measure of how well a bank would survive an event at the scale of the 2008 financial crisis.

For 4Q22, Revenues increased by 5% year over year primarily because of gains from interest income. Citi expects an increase in operating costs by 6% year over year, driven by transformative investments related to repositioning. Net income was down 18% driven by a higher cost of credit and the previously discussed operating cost increases. FY23 revenue is projected to be at $78 billion ex divestiture impacts which are expected to complete in 2H23. $78 billion would be a 3.5% increase year over year.

Due to the increases in interest income, and the repositioning toward consumer-focused banking, we believe that Citi is a good investment for dividend income. We expect a forward dividend yield of 4.2% for FY23.

Estimated Fair Value

EFV (Estimated Fair Value) = E24 EPS (Earnings Per Share) times PE (Price/EPS)

EFV = E24 EPS X P/E = $7.30 X 9.0x = $65.70 per share

We have chosen the 9.0x PE based on the typical 9-13x ratio commercial banks typically trade at depending on investor sentiment.

Citigroup (C)	E2023	E2024	E2025
Price-to-Sales	1.3	1.3	1.3
Price-to-Earnings	6.9	7.1	6.3

Consumer Facing

Citi's personal banking and wealth management segment encompasses all individual-consumer or family-based services. This segment has $24 billion in revenue derived from $446 billion in deposits and $318 billion in loans. These balances encompass 85 million clients making Citi the #2 issuer of cards in the United States and the #5 largest private bank.

For FY22 Citi saw 8% growth in card income. The risk profile for these is 81% prime or higher, with net credit loss allowance decreasing by 160 basis points. This decrease in loss allowance is driven by the persistently strong job market. The loans on the portfolio have increased by 6% in the consumer segment. Gross loan yield across all segments of the business has reached 7.5%. Year-over-year deposits in the consumer segment have shrunk by 1%. Customers have been switching to interest bearing deposits which now pay 2.1% on average from interest-free deposits; while this trend has resulted in relatively stable deposits, Citi's interest expense has been increasing.

In the corporate banking sector, 84% of loans are considered investment grade, and the allowance for credit losses has been increased by 10 basis points. Corporate loans are diversified across the globe with 56% being concentrated in North America.

Citi has a renewed focus in consumer marketing, with a 3-phase plan to put itself at the forefront of domestic personal banking and a global leader in wealth management. Thus far, this has required $4.3 billion in investment toward technology improvements, additional experienced personnel, and infrastructure costs. Until this transformation is complete over the medium-term horizon of 3-5 years, operating expenses are expected to be higher than usual while revenue growth will only come with a lag.

Part of this shift is divesting from certain Asian operations with the final sell-off of these businesses expected in 2H23. This would lay the foundation to reposition toward high margin businesses like commercial banking, wealth management, and credit cards. Citi expects the shift to grow revenue by 5% CAGR over the 5-year horizon. Over the same period, Citi expects a high single digit CAGR for deposits and a high single digit CAGR to

credit cards. In the Wealth Management sector, Citi expects low double-digit deposit and asset CAGR over the 5-year horizon.

Institutional

ICG (Institutional Clients Group) encompasses the market maker, brokerage house, and other financial services within Citi. This segment has $40 billion in revenue derived from $789 billion in deposits and $205 billion in loans. This represents over 90% of the fortune 500 across 95 countries. ICG is the #1 global provider of treasury and trade services, and #4 for securities. ICG was heavily impacted by the macro environment with a lower deal flow and a reduced appetite for M&A. This is flanked by consumers and institutions alike shifting money toward safer returns in fixed income as interest rates have risen.

Revenue in 4Q22 was up 3% for the ICG segment which was driven primarily by a 32% year over year increase in trade and treasury services and a 15% increase in security services. ICG, which includes investment banking, saw a 39% decrease in investment revenues driven primarily by equity markets.

CCAR Results and Buybacks

Every year the Federal Reserve conducts stress tests as mandated by Dodd-Frank. The tests involve a hypothetical severe economic downturn which in 2022 was defined as a 10% unemployment in the US, decline in GDP of over 3.5%, and quick deflation of assets including a 40% drop in real estate. These tests are critical as they often dictate the minimum capital requirement imposed on banks. The primary measurement is the maximum capital drawdown, with the higher the number the worst a bank would perform under adverse conditions.

Citi performed more poorly than in recent years, but close to banks of a similar size and scope, holding a 3.6%. This has caused Citi to raise their capital buffer to 4% to be safe. As Citi builds a larger cash position through previous reduction of buybacks and pause in growth of dividends, coupled with divestitures, Citi could hold an excellent cash position in FY23.

Currently, Citi trades at a BV (book value to price) of 0.54 with the banking sector median being 1.3. This translates to a tangible book value of $81.65 per share. This is extraordinarily cheap given the cheap earnings value of Citi, making buybacks incredibly attractive. After Citi increases its capitalization buffer in 1H23 we expect buybacks to accelerate significantly in 2H23, with dividend growth likely restarting in 2024.

Risk

Inflation is the primary risk to Citi and most financial companies because the assets they own are priced in nominal dollars and go down in real value with inflation.

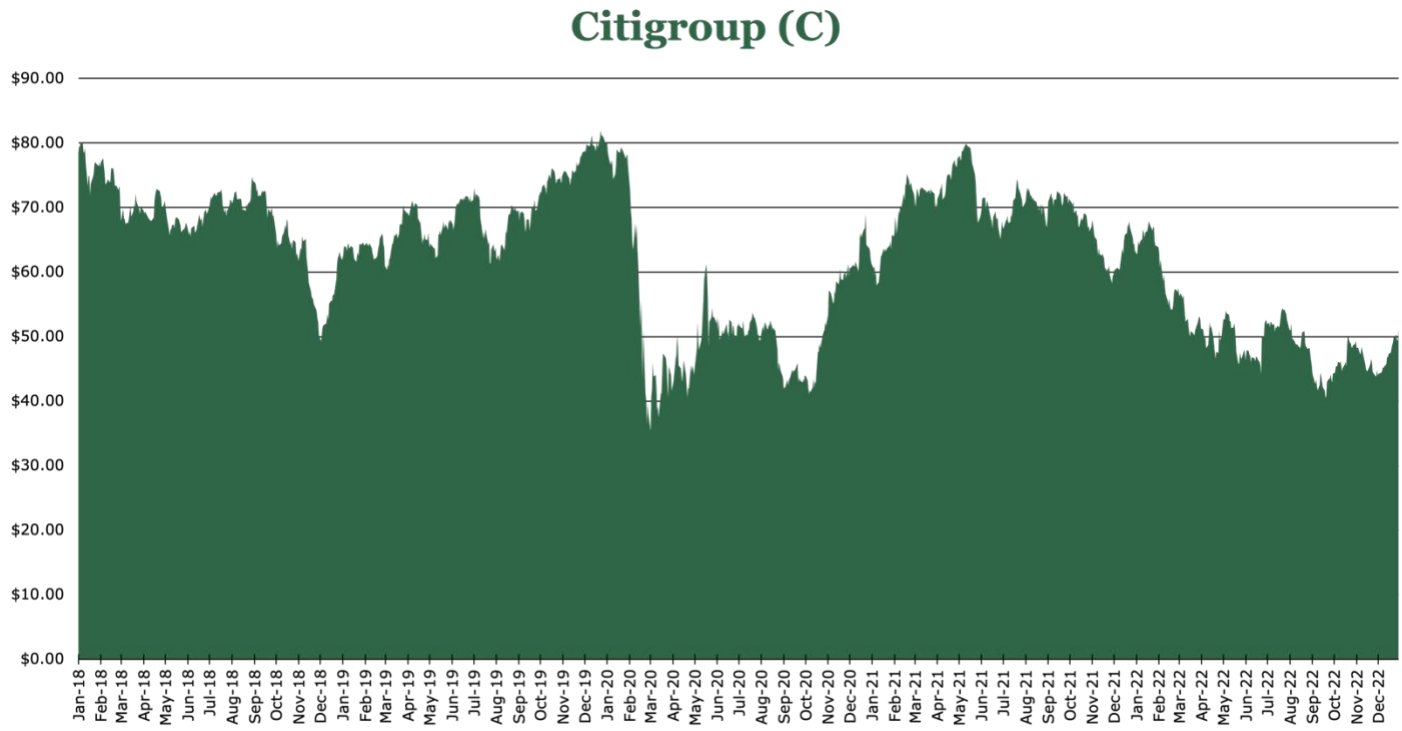
Higher rates are a double-edged sword that allows for higher interest income but is being at least partially offset as depositors move from interest-free deposits to interest bearing deposits. While we expect net interest rates to improve, competitive pressures from potential bidding wars on interest bearing deposits needs to be monitored.

Citi is embarking on a repositioning effort which will raise operating costs. In conjunction with the macroeconomic uncertainty and increasing rates net income has dropped further than anticipated. While we have full confidence in the management of Citi, execution risk of the repositioning is something to note.

The primary risk facing Citi identified by the CCAR stress tests was counterparty risk, in which Citi's partners may be unable to fulfil their contractual obligations in the event of the previously discussed conditions.

Peer Comparisons

	Citigroup (C)	US Bancorp (USB)	Wells Fargo (WFC)	JP Morgan Chase (JPM)	Bank of America (BAC)	Goldman Sachs (GS)
Dividend Yield (FWD)	4.2%	4.0%	2.8%	2.9%	2.6%	2.7%
Price-to-Earnings (FWD)	7.0	11.0	11.0	11.9	11.0	11.3
Price-to-Sales (TTM)	1.4	3.1	2.2	3.4	3.1	2.8
Price-to-Book (TTM)	0.5	1.7	1.0	1.6	1.2	1.2
Return on Equity (TTM)	7.9%	12.9%	9.0%	12.8%	10.1%	12.2%
Return on Total Capital (TTM)	1.3%	1.4%	1.2%	1.2%	1.8%	1.8%


Citigroup (C)
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