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JPMorgan: Channeling Jeff and Ned Kelly, the forklift and the warehouse

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL.

In early 2007 I was meeting with Jeff Kelly, then CFO of Cleveland-based National City Corp.

The financial crisis was just beginning to unfold, but Nat City had sold subprime lender First Franklin to Merrill Lynch in September 2006 and managed to book a $984 million pretax gain. I asked Kelly two questions that resonated with me when thinking about large companies then, and more recently JPMorgan Chase & Co.

One was related to EPS trajectory. He responded, rightly, that Nat City was more than net income divided by weighted average shares. I got a similar answer about the net interest margin. Kelly noted Nat City had a number of business lines from which the consolidated NIM was derived, and he/I had no idea how the curve would evolve in 2007 (it flattened). I paid less attention to the more important questions that ultimately mattered to the fate of National City: what about the hard to sell/value nonagency mortgage assets that Merrill did not take and funding resiliency.

In January 2007 National City announced a modified Dutch-tender offer to purchase up to 75 million shares at $35.00 to $38.75 per share for a maximum cost of $2.9 billion. Ultimately, 40 million shares were acquired in March for $1.6 billion, which represented about 15% of year-end 2006 tangible common equity. A year later, the company began to raise capital, consisting first of nondilutive Tier 1 capital, and then a dilutive raise led by Corsair Capital LLC. Ultimately, PNC Financial Services Group Inc. acquired Nat City during late 2008 in a fire-sale for $2.23 per share, or $5.6 billion in the aggregate. Bond holders and preferred equity investors rejoiced, however.

The failure of New Century Financial Corp. in April 2007 was the first notable warning shot, but it was the August margin call in mid-2007 for two Bear Stearns sponsored hedge funds that crystallized the issue for the Street. The funds were incurring margin calls, which in turn panicked the Street in August once the lenders realized selling collateral in a frozen market meant price discovery for similar assets held on their balance sheets. Previously liquid markets began to freeze in the fall of 2007. They did not begin to thaw until Spring 2009 when Fed actions, the administration's signal that it would not nationalize the large banks and the revival of the bond trader's mantra that "price cures price" was invoked as liquidity returned.

I assume Nat City's board was frustrated with their stock price in early 2007. The Company had made a lot of money during the 1990s through 2006 by bolting a mortgage company onto one of the nation's best commercial lending franchises; yet, the share price closed on December 2006 virtually unchanged from year-end 1998 at $36.56 per share. During that nine-year period tangible book value increased to $16.73 from $8.96 per share; earnings rose to $3.72 from $1.61 per share; and dividends rose to $1.52 from $0.97 per share. Something happened, however. National City's shares performed in-line with the KBW50 during 2002-2004, but then underperformed during 2005-2006 by rising just 6% versus 20% for the index.

The stock appeared moderately valued based upon the tender-offer range. The high-end of the tender range entailed a valuation of 10.4x trailing EPS, 12.8x trailing core EPS, and a 4.0% yield. By the standards of the day, the P/TB multiple was not unreasonable, though it was not inexpensive either at 225%. By year-end 2007 the shares had fallen to $16.46 per share. Issues in the mortgage bank caused EPS to fall 86% to $0.51 per share, while an ill-timed and over-priced foray into Florida and a dividend that exceeded EPS clipped TBVPS by 28% to $12.03 per share. The dividend was subsequently reduced by 49% in early 2008.

I am not arguing JPMorgan is on the verge of imploding like Nat City was as 2007 unfolded. I have been a long-time admirer, especially since I read Ron Chernow's book "House of Morgan" nearly 20 years ago. The build-out of the global investment banking franchise that has been completed by Jamie Dimon is amazing. JPMorgan pressured Alan Greenspan in the late 1980s to create an opening for the money-center banks via the cumbersome Section 20 subsidiaries to underwrite commercial paper and other securities. After all, why is underwriting and distributing a bond or equity more risky than underwriting and holding a (proprietary) loan? It's less risky, which is why JPMorgan developed credit default swaps in the mid-1990s to synthetically hedge its commercial loan portfolio that was not marked-to-market. Risks associated with the originate-and-warehouse model is why most of the large corporate loan market is now structured along the lines of the corporate bond market in which loans are underwritten, traded and subject to price discovery.

Dimon touched on it during the second-quarter conference call, saying that the strength of the franchise is the diversity of the business units that lessen the cyclicality of credit losses. Also, most of the units are global leaders. From the perspective of bond holders and the FDIC that insures JPMorgan Chase Bank NA's deposits, this is critical. For equity investors, I think the diversity is subject to debate. JPMorgan may be worth more broken-up, even at the cost of more earnings volatility. That debate assumes Chase Bank is spun-out as a U.S. focused retail and middle market bank, leaving JPMorgan as a global corporate/investment bank with asset management, a global treasury business and deposit funding. The Glass-Steagall argument that is usually put forth by someone from Washington or from elements of Wall Street that benefited from restricted underwriting competition is off-base in my view.

Bloomberg News' Mary Childs broke the London Whale story. One can debate whether the London CIO operation was a hedging activity — akin to what securities portfolios usually represent for banks when the economy slows, interest rates fall and credit losses increase — or a prop desk. What I am arguing is that the Whale fiasco speaks to the opaqueness of it all, and the market prices uncertainty via discounting what it does not know. There is a reason JPMorgan's shares are down 19% over the past three months and now trade for 8x FY12E, 7x FY13E and 1.0x TBV. Few knew of the scope of the CIO effort. It has added to the uncertainty of JPMorgan's $65 trillion notional value derivatives book, much of which appears to represent basic interest rate contracts executed by global clients to manage their rate exposure.

Dimon may have performed well in the earnings call, but he is well-paid to perform. Notably, the shares are little changed since the earnings call in spite of the added information about the London effort, $2.1 billion reserve release, $1.0 billion of security gains and $545 million positive mark adjustment to a Bear Stearns first-loss note that on a combined basis roughly offset the chief investment office's $4.4 billion loss.

Transparency for a company the size of JPMorgan that operates in virtually all global markets is an abstract concept, in my view. Bank balance sheets are akin to a warehouse. No one knows what is in them and what the contents are worth. Losses and expenses for contingent liabilities can appear unexpectedly as was the case this quarter for Bank of America Corp., First Horizon National Corp. and PNC as it relates to mortgage repurchase liability. If a gain is needed to offset a large credit or legal-related loss, a forklift can be sent into the warehouse to find an asset to sell to book a gain.

About seven years ago I was visiting with Ned Kelly, who was then CEO of Mercantile Bankshares Corp., a high-performing commercial bank that was based in Baltimore. Kelly was a lawyer by training who eventually migrated to JPMorgan where he was an investment banker responsible for financial institutions. He was recruited to Mercantile to replace the retiring CEO in 2000. I remember Kelly telling me that commercial loan competition was (then) ridiculous and that if he took a typical deal for a small middle market "A" credit to the Street (to be priced) the result would not be par; however, there were no such price discovery requirements, the bank made money on other aspects of the relationship, and investors probably would not have cared anyway given then pristine credit metrics. Mercantile went on to acquire a couple of banks to round-out its footprint, but I was not surprised when Kelly sold the company to PNC. He could see the writing on the wall.

What Dimon did in both the May and July conference calls was to solidify why a modest multiple is appropriate for normalized earnings of large, complex banks because there is no way anyone can know what is there for sure. The executives had no idea of what had transpired in the London chief investment office. In the case of JPMorgan, earning power may be $24 billion, or about $6 per share, but why is it a high multiple proposition? It is not when much is not knowable about the value of the assets, derivatives and contingent liabilities. Credit losses are cyclical and highly variable. The chief investment office fiasco followed the national mortgage fiasco, which for JPMorgan was mostly inherited from the Bear Stearns and Washington Mutual acquisitions. Further, Federal Reserve intervention in the capital markets has supported asset values and suppressed credit losses in recent years. When much can go wrong in a business that is levered like banking, the earnings multiple on normalized earnings should be modest. A P/E of 7-9x on earning power may be reasonable — even generous — if the economy in the developed world is going to trend sideways for years; however, in the case of JPMorgan the implied value would be $40 to $50 per share versus the current $35 per share value that approximates TBVPS. If so, maybe JPMorgan is due to outperform Goldman Sachs Group Inc., Wells Fargo & Co. and U.S. Bancorp over the next 12 months.

Jeff K. Davis, CFA, is the Managing Director of the Financial Institutions Group of Mercer Capital. He is also a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com.