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JPMorgan Chase — JPM and the Whale

JPMorgan Chase & Co (JPM) provides global financial services and retail banking. The company renders services such as investment banking, treasury and securities services, asset management, private banking, card member services, commercial banking and home finance. JPM serves business enterprises, institutions and individuals and is the largest bank in the US by assets. JPM is trading at a 12M fwd P/E of 8.6x and a 12M fwd DY of 3.1%.

JPM's metrics are as follows:

Spot ($)	45.47
Mkt Cap $mn	172,850
12M trailing P/E	8.7
12M fwd P/E	8.6
10-year average P/E	13.5
10-year average DY	3.2
FYE	31-Dec
P/Book Ratio	0.9
12M trailing DY	2.6
12M fwd DY	3.1

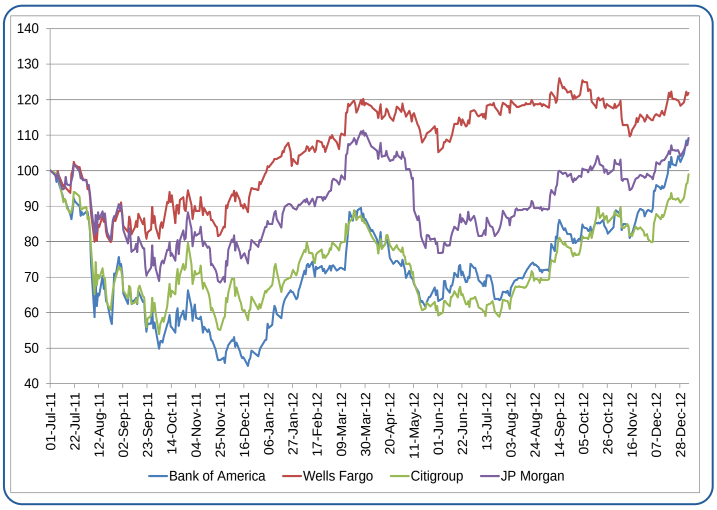
Source: Bloomberg, Anchor Capital

The group has six business units:

- Investment Banking (IB);
- Retail Financial Services (RFS), this includes commercial and business banking and their Mortgage Production and Real Estate Portfolios;
- the credit card handling unit, Card Services and Auto (CSA);
- Treasury and Securities Services (TSS), which provides investment and information services with assets of $16.9trn;
- Commercial Banking (CB), which provides lending and investment services to incorporated entities; and
- Asset Management (AM) which provides investment management services to its retail customers.

US banks: A brief overview

Selected US banking stocks share price performance (rebased to 100)



Source: Company reports, Anchor Capital

Global Ideas is a daily newsletter which is available only to clients of Investor Campus and Anchor Capital. The key objective of this newsletter is to provide ideas for investment in the global investment universe.

We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watchlist, which is continually reviewed and updated.

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In general, 2012 was a positive recovery year for US banking stocks as the industry continued to build capital resulting in fewer big banks now trading below their book value. Although it is unlikely 2013 will see many US banks return to a normalised earnings performance, the combination of stronger capital and liquidity, the housing recovery, credit improvement, expense reductions and a step-up in mortgage activity is likely to buoy the continued recovery of US banking counter's share prices. Improved economic data in the US, including higher consumer spending and gross domestic product (GDP), an improving housing market and declining unemployment rate also point towards optimism for the sector. The fact that, during 3Q12, only 12 Federal Deposit Insurance Corporation-insured (FDIC) banks failed -- the lowest since 4Q08, also indicates a turnaround. As at mid-December 2012, the number of failed banks came in at 51 for the year compared with 90 in the same period a year ago. By the end of 3Q12 the number of the FDIC's so-called "problem institutions" had declined to 694 (from 732) – the lowest since 3Q09.

Nevertheless concerns remain and, on the negative side, favourable top-line growth is still uncertain due to expected stagnant loan growth, pressure on margins due to the continued low interest rate environment in the US and a less flexible business model as a result of stringent capital requirements courtesy of Basel III.

Basel III is a comprehensive set of reform measures which were designed to improve regulation, supervision and risk management within the banking sector. It was first published in late 2009 and at that stage gave banks c. 3 years to satisfy its requirement which included maintaining proper leverage ratios and meeting certain capital requirements. It was largely in response to the credit crisis and the implementation of its requirements from 2013 is expected to boost minimum capital standards although adjusting liquidity management processes are likely to cause a short-term negative impact on US banks' financials. However, a greater capital cushion should help the larger banks withstand internal and external shocks in the long run. It would appear US commercial banks have significant direct and indirect exposure to Europe and thus the European debt crisis is also expected to aggravate the situation. However, potential costs should be manageable unless the crisis deepens, in which case it will be a big blow to worldwide capital markets, and the US.

Therefore, despite US banks actively responding to legal and regulatory pressure, indicating a competence to face the issues at hand, the banking sector is not expected to return to pre-recession highs in the near future. Although quantitative easing (QE3) efforts are expected to stimulate loan demand, a complete recovery in lending activity is extremely unlikely as memories of the recession and job losses remain in consumers' minds.

JPM - The good

JPM is one of the few financial institutions that emerged from the 2008-2009 global financial crisis (GFC) in relatively good shape as the group acquired Bear Stearns for very little, giving it a leading market share in the global prime brokerage business. In September 2008, JPM also purchased all the assets and only certain liabilities of Washington Mutual for $1.9bn. Both these purchases were extremely inexpensive compared with the market share they added to the company.

JPM is trading at an attractive fwd P/E multiple of only 8.6x and a 12M FWD dividend yield of 3.1, while Bank of America's (BAC) share price increased by 108.8% in 2012 it doesn't have as large a 12M fwd DY (currently at only 1.1%) while its fwd P/E of 11.6x is almost double that of JPM. The only bank that can be compared with JPM is Wells Fargo (WFC), which has a P/E of 9.6 and a yield of 3.0%, however Wells Fargo's share price in 2012 only increased by 24%. Although Citigroup's share price gained 50.4% in 2012 and it compares better with JPM on a P/E basis, its dividend yield is nearly a third below that of JPM.

JPM vs other US banks P/E and DY comparatives

Name	Currency	Price	12M fwd P/E	12M fwd DY	Mkt cap (mn)
Bank of America	$	11.43	11.6	1.1	123,193
Wells Fargo	$	34.71	9.6	3.0	182,723
Citigroup	$	42.04	9.1	1.1	123,283
JPMorgan Chase	**$**	**45.47**	**8.6**	**3.1**	**172,850**

Source: Bloomberg, Anchor Capital

The following are what we perceive to be positives for the JPM share price

- **Expansion plans -** Late last year JPM announced plans to expand its branch location network to bring in additional deposits for lending and other money-making activities. Although this might initially seem a waste of resources in the digital age of online and mobile banking, several studies have shown consumers prefer branch banking, and even make their decision on which bank to use based on this. JPM will also be ramping-up its private banking business by targeting the so-called "mass affluent". According to a *New York Times* report JPM has created c. 250 Chase Private Client branches in areas where clients are sold pricier bank products such as mutual funds and other investments. JPM has also increased its mortgage lending activity and net income from home loans rose $358mn since 2011, to $563mn in 3Q12, while originations grew 29% (second only to Wells Fargo). With a turnaround expected in the US housing market (see below) this should be positive for the bank.

- **US housing market recovery** – It would appear that there's a housing recovery underway in the US. The National Association of Homebuilders estimates housing and related services contribute up to 18% of GDP and a housing recovery would thus be good news for the US economy as a whole. This in turn would be positive for the banking sector which provides home loans to individuals. In 3Q12, JPM made $50bn (+29% YoY) from home loans. Although other big banks are staying put or decreasing their exposure to the housing market, JPM is increasing its exposure, a decision which could prove extremely lucrative in the long run. With the US population growing by around 3mn p.a., implying a significant need for housing, and growth of households likely to absorb pre-existing housing supply, this denotes the prospect of significant growth in JPM's lending division, especially if the bank is 'first to the party'. New loans may also be able to offset losses from its pre-existing lending portfolio. The November 2012 existing home sales data came in at 5.04mn (+10.1% YoY), a significant improvement over October's 4.76mn. The Case-Shiller Home Prices Indices also reported good growth in home prices in 20 major US metropolitan areas (not only in existing homes sold) with a growth figure of +4.3% YoY.

JPM's performance in Mortgage Banking: 3Q12 vs 3Q11

	3Q12	3Q11
Production revenue (mn)	$1,778	$475
Production income before taxes	$1,087	$594
Servicing revenue (mn)	$754	$57
Servicing income before taxes	($159)	($6)
Real estate portfolios revenue (mn)	$1,006	($145)
Real estate portfolio net charge offs (mn)	$1,420	$521
Real estate income before tax (mn)	$100	$211
Mortgage banking net income (mn)	$623	$485

Source: Company data

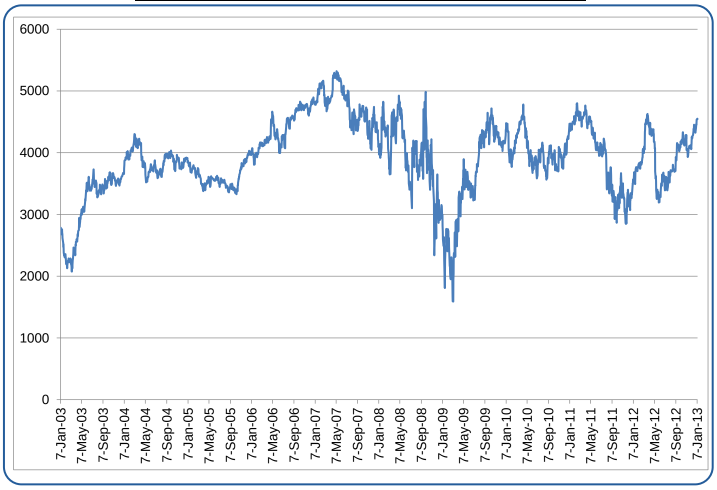
- **Syndicated loans** – The bank was ranked no 1 in the syndicated loan market by *Thomson Reuters* in the Global Debt & Syndicated Loans and Mandated Arrangers of Global Loans categories. *Bloomberg*'s Global Syndicated Loan Markets Review gave JPM the title of Top Arranger for US loans, noting that of a total number of 2,122 loans made during the 9M12 period, JPM was involved in 642 (with a value of over $173bn) of these.

- **Continued growth in its non-core businesses**, added certainty in the regulatory environment, improving customer satisfaction, a growth in the number of branches, favourable economic conditions, as well as declining loan losses should also be positive for the business as a whole

- **CEO Jamie Dimon** - Dimon is highly regarded within the investor community and he has a reputation in the market as a taskmaster who double-checks everything to make sure the company is not placed in a risky situation. Although this image of Dimon was somewhat tarnished last year due to the London Whale fiasco, in his 31 December *DealBook* column, Too Big To Fail author Andrew Ross Sorkin notes that one of the people who got at least one thing completely right last year was Dimon. "You did something most executives would not have done," Sorkin wrote, alluding to Dimon's conduct following the London Whale trading disaster, "you admitted to the mistake". It was refreshing to see that once the London Whale story broke, Dimon immediately came clean on the matter in the media. It is highly likely that had he not done this, the JPM share price might not have recovered from the freefall it went into not long after the scandal broke. Barron's, which has listed JPM as one of their top picks for 2012 have also noted the company's excellent management as a reason for choosing JPM. Warren Buffett even suggested in an interview that Dimon would be his choice as a replacement for outgoing Treasury Secretary Timothy Geithner.

- **JPM's share price performance** - At the beginning of 2012, shares of JPMorgan were trading at $34.98. By the end of March, when rumours and press speculation started circulating that JPM was making huge derivatives trades which were far too complex for it to control, the stock traded at $46.27. By April, investor concern over issues at the bank saw the share price losing ground. On 1 May 2012 the share traded at $43.79 and by 31 May it closed at $33.15 (down 24.3%). The share price bottomed at $31.93 on 1 June. From this 2012-low the share price has risen steadily, closing the year at $43.97/share - only 5.2% off its pre-London Whale high of $46.27. Although past share price performance is not a guarantee for future performance, the fact that JPM's price rebounded from the impact of an event as significant as the London Whale, shows the fundamental strength of the group.

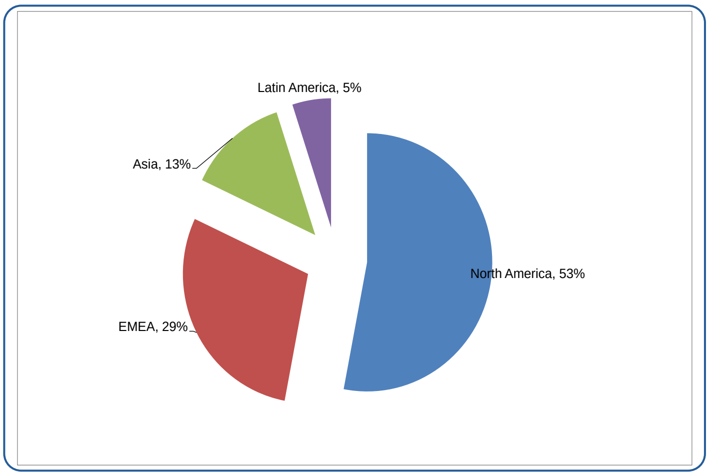
JPM share price performance (USc)



Source: TimBukOne, Anchor Capital

- **Foreign market expansion** - JPM has significant opportunity to grow its investment banking activities in foreign markets. Below we show the current revenue split for JPM by region.

JPM revenue by region



Source: Company data

JP Morgan – the bad

The bank has seen its fair share of negative headlines over the past decade or more. The most noteworthy (besides London Whale) being the bombardment of subpoenas and lawsuits against JPM from around the globe due to its alleged involvement in LIBOR (London interbank offered rate) manipulation. LIBOR is a key short-term bank lending rate which affects mortgages and other interest rates throughout the global economy. It is also the average interest rate at which big global banks borrow from each other and is regarded as one of the most important numbers in the financial world. It's alleged 16 of the largest international banks, including Bank of America (BAC), Citigroup, HSBC and JPM, that submit data to set the daily LIBOR rate were in fact 'fixing' global interest rates.

Among the many other lawsuits and regulatory probes the company has faced in recent years we highlight the following, which the company unveiled in an August 2012 US Securities and Exchange Commission (SEC) filing:

- **Enron** – Over ten years after the Enron fiasco both the bank and a number of its executives are still being sued over its relationship with the failed, fraud-riddled energy colossus.
- **The Milan swap deal** – JPM faced lawsuits and criminal investigations over a 2005 interest-rate swap deal it made with the city of Milan (Italy). Despite settling a civil suit, the bank and some of its employees are still facing pending criminal charges.
- **Bernie Madoff's Ponzi scheme** - Several lawsuits have accused the bank of aiding and abetting Madoff's Ponzi scheme. The court-appointed trustee and others have also sued the bank in an attempt to retrieve some of Madoff's clients' money.
- **Credit card swipe fees** - Litigation, filed in 2005 alleged that Visa and MasterCard conspired with large banks that issue credit cards, including BAC and JPM, to set credit card fees at arbitrarily high levels. In its filing JPM said that it will pay c. $1.2bn to settle charges it conspired with the credit card companies to rig swipe fees.
- **Energy price manipulation** – In 2012 the Federal Energy Regulatory Commission (FERC) investigated charges that JPM manipulated power markets in California and the Midwest through a subsidiary business which operates power-generating stations and bids against other firms to sell electricity. According to regulators, the JPM subsidiary may have received at least $73mn in "improper payments" due to potential electricity market manipulation. JPM denied this saying it complied with legislation. However in December 2012 US regulators imposed a six-month electricity trading ban on JPM, thereby preventing it from selling electricity at competitive market rates. Dimon has said that the company would fight the ban.
- **MF Global** - Regulators are investigating the company's relationship with failed brokerage firm, MF Global and JPM is also being sued for allegedly aiding and abetting MF Global's misuse of client money.
- **Mortgage-backed securities (MBS)** - A number of investors are suing the bank for its bundling and selling of MBS packed with bad mortgage debt before the GFC. According to the bank "There are currently pending and tolled investor claims involving approximately $130bn of such securities ...". In December the National Credit Union Administration (NCUA) sued a unit of JPM claiming Bear Stearns, which JPM acquired in 2008, misled investors about MBS in 2006 and 2007 and that it used misleading documents to sell $3.6bn in MBS to four corporate credit unions which later collapsed.
- **Foreclosure abuses** - The bank was part of a $25bn settlement with the US government over mortgage-foreclosure abuses. However, there are still several lawsuits and regulatory actions pending over its foreclosure practices.
- **LIBOR** – As mentioned above the bank is being investigated by regulators from across the globe for its alleged involvement in LIBOR manipulation.
- **Peregrine Financial Group (PFG)** – JPM was also involved in the failure of the Iowa brokerage firm, PFG. JPM holds some customer money for the firm, and it was recently involved in court action with the PFG bankruptcy trustee.
- **Community-lending practice downgrades** - On 2 January regulators disclosed downgrades of JPM's community-lending practices for the second time in six months - something that rarely happens with a large US bank. The Office of the Comptroller of the Currency lowered the bank's primary deposit-taking bank and credit-card-lending unit to "satisfactory" from "outstanding" after examining its performance under the Community Reinvestment Act, which is designed to encourage banks to lend to low- and moderate-income neighbourhoods.

Over the past 13 years, JPM has paid settlements in six fraud cases:

- Over $2bn was paid to settle fraud charges in the WorldCom case;
- $135mn in the Enron case;
- Over $153mn was paid to settle charges of investor fraud regarding MBS.
- The company paid c. $750mn in fines and lost fees over the Jefferson County, Alabama bribery case.
- $25mn for unlawful IPO (stock) allocations;
- $25mn plus for what was in effect illegal restraint of trade in forcing retailers to use the credit card network it co-owned; and
- $6mn for illegal profit-sharing and tie-ins at JPM Chase Securities.

JPM – the 'ugly'

Although, as mentioned, JPM has seen its fair share of negative newsflow the so-called London Whale debacle kept the company in the spotlight in 2012 and resulted in a significant loss for the group. Bruno Isksil, a trader at JPM, known in the market as the 'London Whale' made large bets on credit derivatives, amassing positions linked to the financial health of corporations that were so large he drove price moves in the $10trn market. Isksil operated from the company's Chief Investment Office (CIO) in the UK. In July 2012 JPM said the loss stood at $5.8bn and that it would have to restate its 1Q12 earnings because of "questions about the integrity of the trader marks", it went on to say the maximum amount of pay is being clawed back from the three employees involved.

For a company that came out of the 2008 GFC in a far healthier state than its peers, this loss was a huge embarrassment. To contain the fallout it shut down the risky trading activities at the CIO, overhauled management and enhanced governance standards within the group. In July, JPM said that their London office will now maintain a more conservative approach.

Conclusion:

As mentioned JPM has arguably been the most stable major US bank throughout the GFC and although it suffered along with other banks when the US real estate market crashed, since 3Q12 it has been the second-biggest mortgage originator in the US and the number-three mortgage servicer. Overall the company reported good 3Q12 results in October despite obstacles such as the low interest rate environment and increased competition for loans. Net income came in at a record $5.7bn (vs $4.3bn in 3Q11) on the back of a strong performance across the company's major business lines. Revenue was $25.9bn, up 6% compared with 3Q11. EPS was a record $1.40/share, compared with $1.02/share in 3Q11. In December it was rated the US's most popular big bank according to the American Consumer Satisfaction Index financial services survey. BAC was the nation's least popular bank scoring 66 points, 8 points lower than JPM, which leapt in the rankings to a total score of 74.

Unlike other big banks JPM has an unusually open disclosure policy regarding its litigation risks which is a positive for investors as you are aware what you are buying into. According to the company ongoing litigation expenses were $3.8bnn during 9M12, compared with $4.3bn for the same period of 2011. In this regard it is very difficult to make a comparison with other banks as few quantify their potential litigation exposure as openly as JPM does. It is likely that most big international lenders face a similar myriad of lawsuits and investigations.

In March 2012, approval was given for JPM to repurchase $12bn in common shares to the end of 2012. However, following the trading losses by its CIO, the buybacks were suspended in May but in November the company announced it would resume buybacks in 1Q13, repurchasing approximately $10bn p.a. for three years. This will shrink the share count and should bolster EPS growth and potentially improve the company's P/E multiple.

The Dodd-Frank Wall Street Reform Act will likely result in banks not being allowed to speculate in financial securities (such as stocks and derivatives) using bank-money, which could have a significant impact on earnings growth going forward. However, JPM is likely to offset the loss of revenue by opening new bank branches, continuing international expansion, gaining market share in deposits and through recovering economic conditions, both domestically and overseas.

	Basic EPS	P/E (x)
2003	$3.24	11.34
2004	$1.59	24.53
2005	$2.43	16.33
2006	$4.16	11.61
2007	$4.38	9.97
2008	$1.35	23.36
2009	$2.27	18.36
2010	$3.98	10.66
2011	$4.50	7.39
2012	$5.01	8.74

Source: Company data, Yahoo Finance

The EPS data above show that throughout the 2003-2007 the company grew earnings. The decline in earnings between 2003 and 2004 was due to a one-off drop in provisions for credit losses worth $3bn (in 2003). This drop in credit losses inflated earnings for 2003. Throughout 2007-2009 earnings contracted due to the recession, but following the recession the company was able to grow earnings again.

JPM's share price has been on a continuous uptrend since September 2012, ending the year 32.2% higher at $43.97/ share. The share price was also up 37.7% since it hit a low of $31.93/share following news of the London Whale disaster. The stock has thus been able to recover following news like the London Whale debacle – an event which could have sunk a lesser company. With a P/E of below 9, JPM offers a good buying opportunity and one can even go so far as to say that at current levels it is a bargain. The company raised its dividend last year by 20%, after it passed the regulators' stress test with flying colours and Barron's expects it to further hike its dividend. Barron's has also listed JPM as one of its top stocks picks for 2013.

The company will report 4Q12 financial results on Wednesday, 16 January 2013.

Marco de Matos

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