The New York Times
nytimes.com

SPONSORED BY STARBUCKS.COM

November 17, 2002

J.P. Morgan's Thorny Dilemma on Troubled Loans

By RIVA D. ATLAS

Weighed down by a troubled loan portfolio, a depressed market for its investment banking business and a demand by investors for better results, William B. Harrison Jr., the chief executive of J. P. Morgan Chase, appears to have backed himself into a corner.

After nearly two years of mostly disappointing results, the bank's stock has slumped almost 40 percent this year alone — more than three times the drop of its benchmark index.

Investors want J. P. Morgan to put the past behind it, rid itself of problem loans and investments and start fresh. It could begin, they say, by selling its worst holdings in the telecommunications industry and taking yet another charge against earnings before the end of the year.

But the bank, which made many of those investments at or near the peak of the market, is resisting selling them at or near the bottom. And it is chary about antagonizing the credit rating agencies, which have already cut the bank's creditworthiness because earlier writeoffs have eaten into its capital. Giving up on more loans could send the bank's debt ratings even lower, raising costs and crimping its trading operations.

"You can see that they are hamstrung," said Thomas M. Finucane, an analyst with State Street Research.

Mr. Harrison is pleading with investors to be patient, insisting that the bank's corporate lending and investment banking businesses will revive when the economy does.

But, as the person who is responsible for this mess, his credibility is weak. Investors and analysts are not in the mood to cross their fingers and hope for the best. If results do not improve soon, even officials within the bank acknowledge that a management change may be inevitable.

"Management should bite the bullet and cut the dividend and get out of the denial they are in," said Michael L. Mayo, an analyst at Prudential Financial.

He pointed out that the dividend has not changed since just after the merger creating the bank was completed on Dec. 31, 2000, even as earnings have plunged. "The bank is paying out too great a proportion of its earnings in dividends," Mr. Mayo said. Last quarter, it paid its usual dividend of 34 cents a share, even though its operating earnings were less than half that, 16 cents a share. The bank dipped into its capital to make up the difference.

J. P. Morgan executives, including Mr. Harrison, who was traveling and not available to be interviewed for this article, have said they are reluctant to cut the dividend because its relatively high level — over 6 percent of the share price as of Friday's close — attracts investors to the stock.

Dina Dublon, the chief financial officer, acknowledged in an interview last week that the bank's position was difficult. "There is no silver bullet" to slay all the bank's demons, she said.

Some professional investors agree, but that is hardly good news for the bank.

Michael F. Price, the legendary value investor who made a fortune for investors in his Mutual Series funds by loading up on Chase Manhattan stock in the mid-1990's, said he was not tempted by J. P. Morgan even at today's prices. Instead, he recently bought shares of Citigroup.

While Citigroup's shares are also down this year — they are off almost 22 percent — Mr. Price said he found Citigroup's businesses easier to analyze and value, and its earnings less volatile than J. P. Morgan's.

"I don't look at things when I can't understand them," said Mr. Price, who now manages $500 million in personal and college endowment funds. He said that he would not consider buying the stock until it was trading closer to half its current value. "If there is more uncertainty, I want a lower price," he said.

What sums up the dilemma facing Mr. Harrison and his team. Doing nothing means not addressing investors' anxieties. But doing enough, too quickly, to fix its problems — say selling a large portion of its loan portfolio at a steep discount — might lead the ratings agencies Standard & Poor's and Moody's Investors Service to lower the bank's credit rating again.

Both S.& P. and Moody's lowered their ratings on the bank's debt in recent weeks. A lower rating, which suggests greater risk, can mean higher borrowing costs for a bank, and other institutions may demand more collateral to trade with the company, also raising costs.

According to investors who met with Ms. Dublon earlier this month, she said that Tanya Azarchs, an S.& P. analyst, told her that the agency did not want to be "surprised."

Ms. Dublon and Ms. Azarchs both declined to comment on the conversation, but Ms. Azarchs has indicated in her written reports that she would like to see steadier, less volatile earnings from the bank. As one example, she noted, J. P. Morgan's trading revenues in the third quarter dropped 67 percent from the previous quarter, far worse results than at other banks.

J. P. Morgan got itself into this fix fairly recently. Mr. Harrison bet big on expanding its presence in investment banking, undertaking a string of deals in 1999 and 2000, just as the stock market was peaking.

As the chief executive of Chase Manhattan, he bought Hambrecht & Quist, an investment bank specializing in technology stocks, for $1.35 billion; the Beacon Group, a merger advisory boutique, for an estimated $450 million; and Robert Fleming Holdings, an investment bank based in London, for $7.7 billion.

In September 2000, Mr. Harrison made his biggest bet of all, initiating the $31 billion merger of Chase with J. P.

Morgan.

At the same time, Chase became one of the largest backers of telecommunications companies, financing such ill-fated businesses as Global Crossing and Lucent Technologies. One recent fiasco came in July, when Genuity, an Internet services company, defaulted on a $2 billion bank loan. J. P. Morgan had originally provided $500 million of that loan, although it may have since reduced its holding. Genuity is in negotiations with its lenders and has since repaid $208 million to its banks.

When J. P. Morgan reported its results for the third quarter last month, Mr. Harrison conceded that the bank had made too big a bet on telecommunications. But he insisted that the company's strategy of expanding in investment banking would yet pay off.

"We have made some mistakes," he said in a conference call with analysts on the day the results were announced. Still, he added, "these actions that we are taking do not detract in any way from our commitment to our long-term strategy."

Some investors may have been persuaded, or perhaps the stock's steep drop made it irresistibly cheap. J. P. Morgan's shares closed at $22.09 on Friday, up nearly 45 percent from Oct. 9, when it dropped to $15.26.

If the economy and the markets continue to lag, it could take a long time for J. P. Morgan to recover. The weak economy is forcing the bank to cut back its stock-underwriting business. Building that business was one of the goals of the merger of J. P. Morgan and Chase. It also said it would lay off more than 2,000 investment banking employees.

The retreat has led some analysts to worry that J. P. Morgan will lag behind its competitors once the economy comes back — and that if the downturn continues the bank's already weak profitability may lead it to look for further savings.

"These cuts could run the risk of eliminating revenue-generating capacity when markets eventually recover," wrote Peter Nerby, an analyst at Moody's, when he lowered the bank's ratings last month.

All this would bode poorly for J. P. Morgan's stock, and a weaker stock could make the bank vulnerable to a takeover and increase pressure on Mr. Harrison and his team to resign.

For weeks, investors have been speculating that the Bank One Corporation in Chicago would look to acquire J. P. Morgan. Bank One's chief executive, James Dimon, is the former president of Citigroup and was a longtime aide to Citigroup's chief executive, Sanford I. Weill, before Mr. Weill forced him out in 1998. Some investors have wondered whether Mr. Dimon, who is still trying to turn around Bank One, has ambitions to run a much larger empire.

"Jamie has said in private that under the right set of circumstances it would be a wonderful deal to do," said one investment banker, adding that no such takeover appears imminent. Representatives of J. P. Morgan and Bank One declined to comment on the possibility of a takeover by or merger of the banks.

For now, Mr. Harrison is battling to win back investors' trust by acknowledging, tacitly, his previous mistakes. At the presentation earlier this month, he used the phrase "but we've been wrong before," Mr. Finucane said. "That's not lost on us," he said of the analysts' community.

The credibility of J. P. Morgan's management has been falling for nearly a year, since the bank acknowledged last December that it was owed $2.6 billion in a deal linked to Enron — $1.7 billion more than what the bank had

previously disclosed. J. P. Morgan announced the higher number only after it filed a lawsuit to recover about $1 billion from a group of insurance companies that had backed some energy trades between the bank and Enron.

Since then, J. P. Morgan has reported results that have lagged those of its competitors. In the most recent quarter, J. P. Morgan's profits tumbled 91 percent from the period a year ago as it wrote down the value of loans to telecommunications and cable companies and took additional reserves against future losses.

J. P. Morgan announced in the third quarter that it would tighten lending limits so that it would not risk as much capital in a single industry or on a single borrower. This year, J. P. Morgan has cut its telecommunications loans to 4 percent of its outstanding loans from 6 percent, Marc J. Shapiro, the bank's vice chairman for finance and risk management, said in a recent conference call with analysts.

It plans to ultimately reduce its exposure to these loans further, though the bank is reluctant to sell right now since prices for these companies' debt are depressed.

"We have had a strategy for some time to reduce our concentrations," said Donald H. McCree III, the head of global credit management at J. P. Morgan. In addition to selling parts of loans as its arranges them, the bank has also been selling more of its share later in the secondary market. "But if you sell a large part of your portfolio as a distressed seller, you won't get value for it," he said.

Ms. Dublon, the chief financial officer, agreed that the bank would have to wait a while to reduce the size of its loan portfolio.

"I don't think all that we want to do is achievable in the short term," she said.

She also dismissed speculation that J. P. Morgan will take an extraordinarily large charge against earnings in the fourth quarter to write down the value of its riskier loans as well as investments in these industries made by its private equity arm, JPMorgan Partners, which has already lost $699 million this year.

This notion some people have that you can front-load everything that might go wrong is a mistaken and naïve notion," she said. "It is not allowed under accounting rules to do that."

If the bank took an extraordinarily large charge, that would reduce its capital and might also make the rating agencies nervous, said Steven Wharton, an analyst at Loomis, Sayles & Company.

Some of J. P. Morgan's competitors were quicker to sell their problem loans earlier in the economic cycle. Bank of America, for example, reduced its outstanding large corporate loans to $60 billion in the latest quarter from $94 billion in January 2001. In contrast, at J. P. Morgan, outstanding loans declined to $97 billion from $119 billion in the same period.

Bank of America was spurred to sell part of its loan portfolio after the heavy losses it suffered on its share of a $1.7 billion loan to the Sunbeam Corporation in late 2000. J. P. Morgan executives say that the problems with their telecommunications loans got serious much more recently.

While the industry has been under pressure for some time, it took a while for the losses suffered by stockholders to affect the banks, which are the first creditors to get paid off in the event of a bankruptcy, said Suzanne Hammett, the head of credit risk policy at the bank.

Some analysts said they have resigned themselves to a long wait for the lending and private equity businesses to recover. They are looking for signs of stability elsewhere first.

"The money's been lent and the money has been invested," said Henry H. McVey, an analyst at Morgan Stanley. "What management can control is the trading business."

Fair enough, believes Ms. Dublon. She said that the bank was now focused on a straightforward strategy: "Be honest about what the issues are, and to deliver stronger results."

She, along with Mr. Harrison and the rest of the bank's management, can only hope investors have the patience to wait.

Copyright The New York Times Company | Permissions | Privacy Policy