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Harkness Consulting
Project Overview

JPMorgan Chase asked Harkness Consulting to devise an appropriate strategy concerning the acquisition and integration of the various divisions of The Bear Stearns Companies Inc. The following report will give a background on the acquisition, a history of both the acquirer and the acquiree, analyze the financial condition of the acquiree, examine the various divisions of the acquiree, determine an appropriate integration strategy, and make strategic recommendations to Mr. Jaime Dimon, CEO of JPMorgan Chase, based on the aforementioned analysis.

Acquisition Overview

On Sunday March 16, 2008, JPMorgan Chase (JPM) announced that it would purchase The Bear Stearns Companies Inc. (BSC) for $2 a share and assume all of its liabilities and obligations outstanding as of that time. At the same time, JPMorgan announced that the Federal Reserve Bank of New York (FRBNY) planned to establish a $30 billion non-recourse lending facility to JPMorgan for the purpose of the acquisition in which the FRBNY would assume $30 billion of illiquid securities as collateral for the loan. On Monday March 24, JPMorgan, in the wake of widespread protest by Bear Stearns shareholders and employees over the $2 per share purchase price, increased its offering price to $10 per share. At the same time, FRBNY revised the terms of the special lending facility so that JPM would assume the first billion dollars of losses on the $30 billion of illiquid securities with the FRBNY assuming the next $29 billion of losses. The original merger agreement changed to reflect the events of the 24th and also stipulated that 95 million new shares would be issued by BSC and purchased by JPM. The result of these changes to the original offer makes the current price of the acquisition around $6.95 billion.1

The Bear Stearns franchise is a sound business with core competencies in fixed income and equity sales and trading, investment banking, global clearing services, and wealth management. An adverse situation in the repurchase markets coupled with the holdings of tens of billions of dollars of illiquid securities precipitated the fall of Bear Stearns, not a fundamental problem in the operating model of the company. This is not to say that Bear Stearns is not without
problems, especially in risk and balance sheet management; rather, it is an assertion that the company will be able to generate substantial profits in the future.

The fall of Bear Stearns was caused by a lack of what can be called counterparty confidence in the repurchase markets. Investment banks fund their operations by borrowing and lending money for very short periods of time in what is called the repurchase market. When two parties agree to a repurchase agreement, commonly called a repo trade, the counterparty borrowing funds pledges what tend to be highly liquid securities against the value of the loan, which tends to be highly levered. The other counterparty, engaging in what is known as a reverse repurchase agreement, then lends the borrower the money for usually no more than one to three days. In the case of Bear Stearns, their collateral became so illiquid that the counterparty lending them money demanded more of that same collateral for fear that the securities pledged possessed little or no value. This essentially lessened Bear Stearns’s ability to borrow funds, crippling the operations of the bank. Bear Stearns, finding themselves subject to margin calls from multiple counterparties, decided that without emergency funding, they would be compelled to declare bankruptcy, an altogether inauspicious result for the Federal Reserve and US Department of the Treasury as Bear had some $13 trillion of derivatives contracts outstanding. The fall of the bank, therefore, would have caused a systemic crash in the financial markets as contracts and swaps would not have been honored. The fundamental problem was not one where the operating model failed to generate cash; rather, the problem was that the other counterparties lost faith in Bear’s ability to make good on their outstanding loans and commitments in the future. Believing this, they cut off Bear’s lifeblood by refusing to enter into repo trades with the bank.

The business is, therefore, fundamentally sound and can be resurrected by injecting a degree of confidence into the creditworthiness of Bear Stearns. Having the JPMorgan Chase name behind Bear will undoubtedly restore confidence and enable Bear to return to operations as normal. For this reason, the acquisition is a good investment on the part of JPM as it allows them to cheaply purchase a fundamentally sound business.
Corporate Histories
JPMorgan Chase

J.P. Morgan Chase & Co. is the result of several large mergers and acquisitions, with its predecessors origins beginning in the 18th Century, making it one of the oldest banking institutions in the United States. Its history is the history of four major companies.

The Manhattan Company was formed in 1799 with the explicit intent to create a water distribution business and a loophole opportunity to facilitate the creation of a bank. With the intention of Aaron Burr being to compete with the Bank of New York and the Bank of the United States, this company had a charter that allowed it to use leftover capital for other business dealings. A bank soon followed. Its first President was Daniel Ludlow. In 1808, the company sold its water operations to the City of New York and focused exclusively on its banking business. The bank’s charter proved to be unrestricted allowing it to loan money to a wide variety of patrons, including merchants, land speculators, manufacturers, and the New York state government itself. This ability to lend to a wide variety of entities was important to the funding of the westward expansion occurring in the United States at the time, and the bank became one of the largest originators of loans and holders of deposit accounts in the country by the turn of the 20th Century. By the time it merged with Chase in 1955, the Bank of Manhattan operated 67 branches throughout New York City.

Chase National Bank was established in New York in 1877. It was named after Salmon P. Chase, Secretary of the Treasury under Abraham Lincoln. In 1911, Albert Henry Wiggin became president of the bank. Before Wiggin’s tenure, Chase was a relatively small bank. His actions reshaped it into the diverse powerhouse that it remains to this day. He expanded trust services, starting Mercantile Trust in 1917. Later that year, he oversaw the creation of Chase Securities Corporation to distribute and underwrite stocks and bonds. Wiggin’s largest achievement was the acquisition of seven major banks between 1920 and 1932. Quickly, Chase had become the largest bank in the world.
Wiggin was forced to step down in 1932. A congressional investigation uncovered several unsavory business practices, such as using the bank’s reserves for personal stock speculation. One particularly painful revelation was that Wiggin had made $4 million selling short Chase stock—using the bank’s funds—during the crash of 1929.

Wiggin’s successor, Winthrop Aldrich, oversaw international growth at the expense of domestic growth. One key mistake was ignoring the growing importance of branch banking. In 1955, Aldrich arranged a merger between Chase and the Bank of Manhattan, an important strategic alliance due to Bank of Manhattan’s extensive branch system.

In 1969, David Rockefeller became chairman of the board of directors. In that same year, the Chase Manhattan Corporation was founded and the Chase Manhattan Bank N.A. became its wholly owned subsidiary. As the head of Chase Manhattan, David Rockefeller appeared to be more concerned with expanding the international power of the bank, focusing on the role the bank could play in US foreign relations, often at the expense of growing the business.

The 1970s were difficult for Chase Manhattan. Regional banks gained increasing prominence with fewer consumers choosing larger banks for their personal loans. Additionally, Chase lost millions of dollars on defaulted loans to Latin American countries, eventually resulting in its placement on the Federal Reserve’s list of “problem banks”. Furthermore, Citibank emerged as a powerful national competitor. Despite these difficulties, Chase Manhattan remained the country’s third largest bank, with 226 branches in New York City and 105 branches and 34 subsidiaries around the globe.

The 1980s saw several acquisitions, including international banks and American savings and loans institutions. Chase continued to finance international governments. They had the largest exposure to Third World country debt by the late 80s due to their aggressive lending practices. This came to a head in February of 1987 when Brazil announced that it would suspend payment
on its foreign debt. As a result, Chase posted a loss of $894.5 million in 1987, the worst year for American banking since the Great Depression. Continuing concern over Third-World debt resulted in the reduction of Chase’s workforce by over ten percent in the next year. Losses continued into 1989 and 1990 when Chase suffered huge losses from commercial real estate loans. Then President Willard C. Butcher was asked to resign. Thomas G. Labrecque was named President.

Labrecque’s main goal was to reduce Chase’s dependence on international business by improving Chase’s domestic operations. Under Labrecque, Chase cut costs, trimmed staff (another ten percent of its workforce by the end of 1991), and focused the business. Labrecque sold many of Chase’s international retail banking operations and eliminated branch banking operations outside the New York area. Chase’s areas of concentration were reduced to three: regional banking in the New York tri-state area, national consumer operations in credit cards, mortgages, and automobile loans, and international investment banking. Another key development was the bank’s increased implementation of technology, which included alliances with Microsoft Corporation, Intuit Inc., America Online, and CompuServe, and resulted in the bank being one of the first to introduce online banking. Labrecque’s business moves proved largely successful. Chase followed a net loss of $334 million in 1990 with net income of $520 million on revenues of $3.35 billion in 1991, which grew to $1.08 billion in net income on revenues of $3.69 billion in 1994. Despite the organic growth, the myriad bank mergers from 1993 to 1995 caused Chase’s ranking among banks based on total assets to fall from 2nd to 7th. Additionally, its stock price was weak, hampering any plans to acquire banks and leaving Chase as a possible acquisition target.

On August 28, 1995, Chemical Banking Corporation announced a merger with Chase Manhattan. The deal was a $10 billion stock swap, combining the nation’s fourth and sixth largest banks into the largest with total assets of over $300 billion. The company took the Chase name, the more prestigious of the two. The deal was finalized on March 31, 1996. Chase was a clear leader in New York banking by this point. On a national level, it was among the leaders in
private banking, corporate lending, credit cards, and new mortgage origination. Chase eliminated many redundancies through the deal, cutting 12,000 jobs and many branches with estimated annual cost savings of $1.7 billion.

Chase Manhattan was pushed by shareholders to make further acquisitions in the environment of deregulation. Adding to this pressure was the recent creation of Citigroup Inc., formed in 1998 by the merger of Citicorp and Travelers Group Inc., owner of the brokerage firm Salomon Smith Barney. This led Chase’s management to seek out a deal for a major investment bank. Late 1999 and 2000 saw a series of large acquisitions by the bank, including San Francisco-based investment bank Hambrecht & Quist Group for about $1.35 billion, the mortgage business of Mellon Bank Corporation, and the credit card portfolio of Huntington National Bank. Chase purchased a much larger investment bank in August of 2000 when it spent approximately $7.7 billion in cash and stock for Robert Fleming Holdings Ltd., a privately held British firm. This gave Chase an investment-banking foothold in Europe and Asia. One month later, Chase announced that it was merging with J.P. Morgan & Co. Incorporated.

J.P. Morgan & Co. was created as a New York sales and distribution office by John Pierpont Morgan Sr. in 1861. Upon his father’s death in 1890, J.P. Morgan integrated his father’s company, the merchant bank, J.S. Morgan & Co., into his own. J.S. Morgan & Co. had its roots in a London-based merchant bank started in 1838. The younger Morgan’s company would become a key financier of many of America’s burgeoning industrial companies including General Electric, U.S. Steel, and AT & T. His influence was also felt in 1907, when he singlehandedly helped the US avert a major financial crisis.

Morgan and his bank received much criticism and attention for his push to have his partners on the boards of 47 different corporations with a total worth of over $10 billion. The Federal Reserve Act of 1913 and the Clayton Antitrust Act of 1914 were responses to the banks system of reciprocal directorships and ended the practice.
After J.P. Morgan Sr.’s death in 1913, J.P. Morgan Jr. became the firm’s senior partner. While J.P. Morgan & Co. continued to have strong results, it was not immune to the effects of the 1929 stock market crash. The subsequent banking regulations in the 1930s would have long-term effects on the bank. The Glass-Stegall Act enforced the separation of commercial and investment banking. J.P. Morgan & Co. chose to continue its commercial banking business and created Morgan Stanley & Co. in 1935.

In 1942, J.P. Morgan & Co. went public after choosing to incorporate in 1940. In search of more capital, the firm merged with Guaranty Trust Company in 1959, at first taking the name Morgan Guaranty Trust Company of New York, but later forming the holding company J.P. Morgan & Co. and retaking the historic name.

A key development of the 1960s and 70s for J.P. Morgan was its reentry into the investment banking business. In order to avoid the Glass-Stegall Act, the company restricted its operations to outside the United States. In 1989, the Federal Reserve began giving U.S. commercial banks more leniency, permitting J.P. Morgan to underwrite corporate debt and, one year later, equities.

J.P. Morgan moved slowly into this space, organically growing the business while many of its competitors went searching for acquisition targets. As such, they were not positioned to profit from the many IPOs the tech boom provided in the late 1990s. Another key misstep in the period was its continued focus on high net worth individuals in its asset management business, meaning that the eagerness of the public to invest in this period did not drive business growth for J.P. Morgan. Realizing their weakness, J.P. Morgan purchased a 45 percent stake in American Century Investments in 1997, a direct distributor of mutual funds.

In 2000, Chase Manhattan acquired J.P. Morgan in a deal valued at approximately $32 billion. The resulting firm was named J.P. Morgan Chase & Co., and had assets totaling $660 billion, ranking it behind only Citigroup and Bank of America Corporation. The firm has two main
units. The first, J.P. Morgan, is comprised of global commercial banking services, including investment banking, wealth management, institutional asset management, and private equity. Chase has the consumer banking operations, including bank branches in the New York area and Texas, credit cards, mortgage banking, and consumer lending. In an attempt to cut costs, J.P. Morgan Chase announced that it would eliminate 5,000 jobs from its workforce, would consolidate the processing systems of its two predecessor firms, and would sell off $500 million in real estate.

*Bear Stearns*

Bear, Stearns & Company, Inc. was founded in 1923 with $500,000 in capital by the original partners Joseph Bear, Robert Stearns, and Harold Mayer. Originally focused exclusively on equity trading, the firm was a response to the growing equity markets of the Roaring Twenties. The company was well positioned to cope with the crash of 1929—it suffered no employee layoffs and continued to pay bonuses. A key development of their post-crash business activities was Bear Stearns’s new focus on the bond market, an attempt to promote the financial plans of President Franklin Roosevelt. Their first outsized profits were made in this line of business when the firm sold bonds to banks with excess cash since the demand for loans was almost nonexistent during the depression.

In 1935, Congress passed the Securities & Exchange Commission's (SEC) Public Utilities Holding Company Act, which precipitated a breakup of utility holding companies. As new securities were being issued for the formerly private companies, Bear Stearns positioned itself to take advantage of the opportunity, buying aggressively at what company Chairman Salim "Cy" Lewis later called “the most ridiculous prices you ever saw in your life.” The firm saw rapid growth in its international business during this period. In 1955 the firm opened its first international office in Amsterdam. As its international business increased, the company opened other foreign offices, including ones in Geneva, Paris, London, Hong Kong, and Tokyo.
A key development of the late 1960s was Bear’s decision to focus on and develop its retail business. This meant opening many domestic offices starting with San Francisco in 1965 and followed by Los Angeles, Dallas, Atlanta, and Boston. The main focus of this business was managing accounts for wealthy individuals. One important opportunity this made possible was the expansion of a large margin trading business.

In May 1978, Alan "Ace" Greenberg became chairman of Bear Stearns, following the death of Cy Lewis. Bear Stearns cultivated a reputation during the merger wave of the 1980s as a leader in the corporate takeover business. Bear Stearns’s management announced a plan to go public in October of 1985. The stated intention was to raise capital to focus on larger trades. The IPO spurred the creation of the holding company The Bear Stearns Companies, Inc. Shortly after the offering, Bear Stearns reorganized, becoming a full-service financial organization with divisions in investment banking, institutional equities, fixed income securities, individual investor services, and mortgage-related products.

The company was hit hard by the 1987 Wall Street crash and was forced to layoff employees. They recovered strongly. By 1992, Bear had seen earnings double to over $295 million. In that year, the company managed more than $13 billion in initial public offerings (IPOs) for a variety of U.S. and foreign corporations. In 1993, James E. Cayne succeeded Alan Greenberg as CEO.

Bear Stearns came under fire from the SEC in 1997 for its role as a clearing broker for a smaller brokerage named A.R. Baron, which had gone bankrupt in 1996 and defrauded its customers of $75 million. After two years, Bear Stearns settled civil and criminal charges with the SEC and the Manhattan District Attorney for a total of $42 million in fines.

By mid-2000 the securities industry was experiencing a wave of mergers and acquisitions, and the stock of Bear Stearns was at a two-year low. One difficulty facing the firm was the competition of their newly merged competitors who could offer a fuller range of services. Many speculated that the firm would be bought out by a larger firm that would find Bear’s global
CEO James Cayne maintained that his company would be successful if it remained independent, but did not rule out the possibility of a merger. After the terrorist attacks of September 11, 2001, Bear gave in to the need to reduce expenses by laying off 800 bankers, about 7 percent of its workforce.

In this period, Bear Stearns found itself in a unique market position, smaller than the bulge brackets but certainly one of the largest financial players. It had maintained its emphasis on clearing operations, honing in on the housing boom by increasing its focus on packaging and selling mortgages, and selling bonds to investors who had avoided the volatility of equities. As such, Bear Stearns was the only securities firm to report a first-quarter profit increase in 2002. Bear was recognized as the "Most Admired" securities firm in Fortune's "America's Most Admired Companies" survey for 2005, 2006, and 2007.

More recently, their business plan has left Bear Stearns open to the downturns in the housing and credit markets. In July of 2007, Bear Stearns disclosed that the two hedge funds had lost nearly all of their due to large investments in sub-prime mortgage backed securities. In November, Bear announced that they were writing down a further $1.2 billion in mortgage-backed securities and would face their first loss in 83 years. In response, Standard & Poor's downgraded their credit rating from AA to A. Following months of poor performance, Alan Schwartz replaced James Cayne as the Chief Executive Officer of Bear.²

**Financial Analysis**

**Overview of the Purchase Price**

JPMorgan will exchange 0.21753 shares of its stock for each share under the amended acquisition agreement. This implies a $10 per share valuation of Bear Stearns. Additionally, JPM will purchase 95 million newly created shares at the same price as the merger agreement. JPM expects to incur approximately $6 billion of pretax expenses related to the merger. These expenses will include the costs of litigation, de-leveraging, technological integration, and severance. The FRBNY arranged to establish a special lending facility in order to manage...
illiquid assets held by Bear Stearns at the time of the merger. JPM will assume the first billion dollars of losses associated with the assets with the Federal Reserve assuming any and all losses of the subsequent $29 billion.³

At the time of the merger, the registrant had approximately 145 million shares of Bear Stearns common stock listed. The exchange of JPM shares for BSC shares equates to a purchase price of approximately $1.46 billion. The issuance and subsequent purchase of the newly created 95 million shares of Bear Stearns translates to an additional cost of $950 million. Assuming that JPM faces a marginal tax rate of 35%, they will assume $3.9 billion of post tax costs associated with the merger. Further assuming that they will have to write down the first billion dollars of the thirty billion dollars of illiquid assets assumed, they will incur an additional expense of $650 million on a post-tax basis. The total purchase price, therefore, comes to approximately $6.95 billion.

*Bear Stearns Financial Situation in 2007*

The fiscal year 2007 proved extremely difficult for Bear Stearns. Net revenue declined by 35% from $9.2 billion in fiscal 2006 to $5.9 billion in fiscal 2007. The drop was due to the decrease in income in the fixed income division where revenues went from $4.19 billion in fiscal 2006 to $685 million in fiscal 2007. Other business divisions grew only marginally, not able to offset the decrease in fixed income operations. Operating expenses dropped slightly with employee compensation decreasing but remaining the largest expense that Bear incurs at 57.6% of net revenue. Employee compensation margins for JPM are typically around 32% of sales, reflecting the fact that Bear’s business model relies much more heavily on human capital for trading operations than does JPMorgan’s diversified platform. Operating income dropped reflecting the decrease in the top line to $193 million, at a 3.2% margin, down from the normal 30% operating margins that Bear generally witnessed over the past several years.⁴

Looking to the balance sheet, the largest concerns about Bear are the number of illiquid securities that they currently hold. In terms of mortgage exposure, Bear Stearns, at the date of
the original merger announcement, had gross exposure to $16 billion of Commercial Mortgage Backed Securities (CMBS), $15 billion of Prime and Alt-A mortgages, and $2 billion of subprime mortgages. However, Bear was net short subprime mortgages as of November 2007 (see figure 1). However, this may have changed as of the current date. Of the mortgage-backed securities, which total $33 billion in aggregate, $20 billion will be covered by the non-recourse facility, leaving JPMorgan with $13 billion of net long mortgage exposure. In terms of credit exposure, Bear Stearns has $8.9 billion in leveraged loan commitments outstanding, of which a portion can be pledged against the non-recourse facility.

($) in millions

AAA - Super Senior Exposure: November 30, 2007
   High - Grade Collateral $ 167
   Mezz Collateral 597
   CDO*2 Collateral 1

Total AAA - Super Senior Exposure 765
Total Below-AAA Exposure (10)

Total ABS CDO-Related Exposure $ 755

($) in millions

U.S. Subprime Mortgage Exposure:
   Subprime whole loans $ 496
   Investment-grade Subprime securities 1,062
   Non-investment-grade subprime securities 211
   ABS CDS (2,351)

Total U.S. Subprime Mortgage Exposure $ (582)

Figure 1

Bear groups its businesses into three main segments: capital markets, global clearing services, and wealth management. The capital markets segment includes institutional equities, fixed income, and investment banking. This is the segment which will record any gains and losses stemming from proprietary trading. Global clearing services provide execution, margin lending and securities borrowing to clients. Customers include clients of money managers, hedge funds,
and other professional investors. The wealth management segment includes private client services (PCS) and asset management.

The capital markets segment posted a 46% decrease in net revenues from $7.32 billion in fiscal 2006 to $3.92 billion in fiscal 2007. The second half of 2007 witnessed a serious retraction in the global credit markets, affecting all financial services firms. Those firms holding large amounts of asset backed securities found themselves taking large write-downs associated with the retraction of global credit. Bear Stearns is one of several major firms that were greatly exposed to toxic debt issuances which subsequently lost a great deal of value when marked to market. In the current market environment, banks have seen markets which were previously highly liquid turn illiquid or even disappear entirely. Bear Stearns still holds a large number of highly illiquid securities as mentioned before. JPMorgan need not be too concerned by this as many losses will be covered by the FRBNY non-recourse facility. JPM will, however, assume the entirety of Bear’s outstanding commitments. Bear currently serves as counterparty for approximately $13.2 trillion of derivatives contracts.

Breaking down revenues by area, institutional equities saw a 10% increase in net revenues, investment banking revenues decreased 8%, and fixed income revenues decreased 84%. The company took a $2.3 billion hit to revenues as the result of a net inventory write-down associated with the unwinding of ABS CDO warehouse facilities. They further wrote off $260 million related to leveraged finance commitments. Spreads rose significantly during the credit crisis, causing outstanding commitments to lose a significant portion of their value. The deteriorating situation in the global credit market resulted in a loss $232 million for the capital markets segment for fiscal 2007.8

The global clearing services division posted an 11% increase in net revenues from $1.08 billion in fiscal 2006 to $1.20 billion in fiscal 2007. Pre-tax income increased by 22% to $566 million for fiscal 2007 as a result of top-line growth coupled with margin expansion from 43.2% in fiscal 2006 to 47.2% in fiscal 2007. GCS is undoubtedly the jewel of the Bear Stearns acquisition. It is a
great business that continues to grow larger with the explosion in the number of hedge funds and money managers around the world. The division enjoyed a degree of immunity to the credit crisis as it experiences fairly steady commissions and fees. Figure 2 details the interest-bearing accounts in GCS for the fiscal years ended 2007 and 2006:

<table>
<thead>
<tr>
<th>(in billions)</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Margin debt balances, average for period</td>
<td>$90.3</td>
<td>$68.4</td>
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<tr>
<td>Margin debt balances, at period end</td>
<td>85.8</td>
<td>70.6</td>
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<tr>
<td>Customer short balances, average for period</td>
<td>95.6</td>
<td>82.6</td>
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<tr>
<td>Customer short balances, at period end</td>
<td>88.0</td>
<td>95.8</td>
</tr>
<tr>
<td>Securities borrowed, average for period</td>
<td>64.3</td>
<td>55.0</td>
</tr>
<tr>
<td>Securities borrowed, at period end</td>
<td>63.0</td>
<td>57.6</td>
</tr>
<tr>
<td>Free credit balances, average for period</td>
<td>36.6</td>
<td>32.8</td>
</tr>
<tr>
<td>Free credit balances, at period end</td>
<td>36.1</td>
<td>32.6</td>
</tr>
</tbody>
</table>

Figure 29

The Wealth Management division posted revenues of $830 million for fiscal 2007, a 3% year-over-year decrease. The division posted a pre-tax loss of $45 million. Within the wealth management division, the asset management wing (BSAM) took a $200 million write-down associated with the failures of two internal hedge funds: the Bear Stearns High-Grade Structured Credit Fund and the Bear Stearns High-Grade Structured Credit Enhanced Leverage Fund. The loss stemmed from the closure of the $1.6 billion lending facility extended by the parent company to BSAM.

Valuation

At $7 billion, Bear Stearns is an attractive purchase as it is expected to generate $1 billion in post-tax earnings going forward. The Global Clearing Services division justifies about 40% of the purchase price. It is a phenomenal business in which Bear Stearns has a leading market share among second tier brokers such as Merrill Lynch and Bank of America. The clearing business has seen and continues to see explosive growth as hedge funds and other professional money managers need banks to provide execution, margin lending, and securities for
borrowing. It is extremely difficult to enter into the industry as the upfront capital expenditures are quite large, and the brand name of the institution carries great sway with clients. The trouble with this business, however, is that up front capital expenditures are quite large as it is expensive to establish the technology required to provide a high level of service. Furthermore, from the client’s perspective, the switching costs associated with moving prime brokers are large, so top line growth is difficult to achieve. Once a prime brokerage has a client though, that client is very hesitant to leave.

To arrive at a value for the global clearing services division at Bear, we constructed a discounted cash flow model as there are no applicable publicly traded comparable brokers. Almost all prime brokerage units are divisions within major investment banks such as Morgan Stanley and Goldman Sachs. Assuming an immediate loss of 50% of net revenues for GCS as a result of losing clients during bankruptcy speculation, we come to $600 million in net revenues for fiscal 2008, increasing by 5% from 08-09, and ten percent thereafter with a terminal growth rate of 5%. We’ve further assumed a discount rate of 10%. Without numbers for depreciation, amortization, capital expenditures, or net working capital changes, we have assumed that changes in net working capital are negligible and that the addition of depreciation and amortization are offset by an equal amount of capital expenditures (See figure 3).

<table>
<thead>
<tr>
<th>BSC GCS DCF</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$1,200</td>
<td>$600</td>
<td>$630</td>
<td>$693</td>
<td>$762</td>
<td>$839</td>
</tr>
<tr>
<td>growth</td>
<td>-50.0%</td>
<td>5.0%</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
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<tr>
<td>Pre-tax Income</td>
<td>$566</td>
<td>$270</td>
<td>$284</td>
<td>$312</td>
<td>$343</td>
<td>$377</td>
</tr>
<tr>
<td></td>
<td>47.2%</td>
<td>45.0%</td>
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<td>45.0%</td>
<td>45.0%</td>
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<tr>
<td>Taxes</td>
<td>$198</td>
<td>$95</td>
<td>$99</td>
<td>$109</td>
<td>$120</td>
<td>$132</td>
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<tr>
<td></td>
<td>16.5%</td>
<td>15.8%</td>
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<td>15.8%</td>
<td>15.8%</td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>$368</td>
<td>$176</td>
<td>$184</td>
<td>$203</td>
<td>$223</td>
<td>$245</td>
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<tr>
<td>Discount rate</td>
<td>10.0%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discounted Value</td>
<td>$160</td>
<td>$152</td>
<td>$152</td>
<td>$152</td>
<td>$152</td>
<td></td>
</tr>
<tr>
<td>Growth rate</td>
<td>5.0%</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Terminal Value</td>
<td>$1,891</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Value</td>
<td>$2,660</td>
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</tbody>
</table>
We arrive at a value of approximately $2.6 billion for the entire GCS division. It should be noted that enhancements to the technological platform of the division may significantly positively affect the business and this is not taken into account in the model. Assuming the capital markets division can return to as little as 50% of its 2005 pre-tax income, JPMorgan can post another billion dollars to pre-tax income, or $650 million on a post-tax basis. If we assume that JPMorgan scraps the wealth management division, then using the current, 10x multiple associated with JPMorgan’s shares, we have a total combined value for the two divisions in the range of $9-10 billion.

**Bear Stearns’s Business Segments**

Bear Stearns is divided into three business segments: Capital Markets, Global Clearing Services, and Wealth Management. JPMorgan should evaluate each segment independently and in tandem with its own business segments to determine a proper integration strategy.

**Capital Markets**

The Capital Markets division is comprised of Equity, Fixed Income, and Investment Banking.

The Equity division provides institutional investing clients with trade execution and liquidity on prime brokerage services, global security exchanges, and clearing services for equity derivatives and other broker-dealers.\(^{10}\) Within the equity division, Bear Stearns specializes in a number of equity products, outlined below. The Institutional Equity department offers complete brokerage services to institutional investors across the globe through sales, trading, and research. Structured Equity Products focuses on trading exchange-traded and OTC equity derivative products for institutional investors and Bear Stearns. These derivatives allow customers to build risk/return portfolios tailored to their needs, to implement trades, develop packaged solution to problems, and use standardized documentation in transactions.\(^{11}\)
Bear Stearns engages in both classic and risk arbitrage for its own account. Classic arbitrage focuses on analyzing and trading events and capital structures that involve equity, debt, or derivatives. Such events may include but are not limited to mergers, stock repurchases, restructurings, or spin-offs. Classic arbitrage seeks to profit from price discrepancies between markets, between the price of a convertible security and its underlying security, between securities that will be exchanged in the future, and between the prices of securities with contracts that expire on different dates. This department also examines pairs or different levels of capital structures within firms that Bear Stearns believes ought to be highly correlated.

The Global Equity Research Department provides detailed financial analysis of companies. Since 2007, this department has expanded its research in Asian and European markets, adding over 100 companies to its portfolio. As of November 30, 2007, this department researches and publishes reports on approximately 1,200 companies in over 100 industries. This department also provides technology to help clients access information, such as BearCast™ (podcasts) and Really Simple Syndication (updates on breaking news).

The equities division also includes divisions that focus on Convertible Securities, Electronic Connectivity and Trading, and Specialist and Market-Making. Within the context of the JPMorgan merger, Bear Stearns’s equity platform will help JPM by strengthening execution abilities’ market share while building a larger platform through increased products.

Bear Stearns has a strong energy trading platform that covers forward and futures markets in energy commodities including natural gas, crude oil, coal, emission credits, electric power and related products across the US and Europe. Bear Energy L.P. works as a middle point in the energy value chain by providing energy participants with comprehensive financial tools.

**Fixed Income**

The Fixed Income division conducts business in both new issue and secondary markets both domestically and internationally. Through participation in the repurchase and reverse repurchase markets, this division is also able to provide short-term collateralized financing.
The Fixed Income division has traditionally been an industry leader in mortgage and credit-related securities and products. Government Bonds and Agency Obligations, specifically US Treasury Bills, notes, bonds, and stripped principal and coupon securities are dealt through Bear Stearns. Bear also trades in government securities in European and Asian bond markets. Mortgage-Related Securities and Products lie at the heart of Bear Stearns’s Fixed Income division. Commercial and residential mortgage loans are purchases and originated through subsidiaries in the US, Europe, and Asia. Bear Stearns is a leading underwriter and market leader in residential and commercial mortgages, asset-backed securities, US agency-backed mortgage products, and collateralized debt obligations. In addition to dealing various securities, Bear Stearns also focuses on purchasing, originating, selling, and servicing loan portfolios of varying quality. These portfolios are created by Bear Stearns Residential Mortgage Corporation (Bear Res) and purchased by EMC Mortgage Corporation (EMC), a state-licensed mortgage company. Despite the recent downturn in low-grade mortgage markets, Bear Stearns’s leading position as an originator, dealer, and manager of mortgages enhances JPMorgan’s long term platform in these profitable industries. Bear Stearns also specializes in trading and creating markets in both dollar and non-dollar investment-grade and non-investment-grade corporate debt securities, sovereign and agency securities, commercial loans, and preferred stocks in New York, London, and Tokyo.

The Fixed Income Analytics and Research group employs economists, quantitative analysts, industry analysts, and strategists in order to provide timely and accurate analysis for the entirety of the fixed income markets. They department publishes its findings as well as its analytical tools and data on a global scale.

*Investment Banking*

Bear Stearns’s investment bank is a global player in a full range of capital formation and advisory services. The culture of the investment bank is focused on recruiting driven individuals who will work hard and compete to work to the top. In order to maintain a competitive edge, the bank focuses its corporate finance team on industries where it believes it
has a competitive advantage because of its expertise and established leadership. The addition of Bear’s investment bank should serve to increase the wallet share at JPMorgan and grow the client base of the bank.

*Global Clearing Services*

Global Clearing Services works primarily with hedge funds, broker-dealers, registered investment advisors, and high-net-worth individuals to provide trade execution, custody, security clearing services, financing, securities lending, and technology solutions. Bear Stearns aims to maximize yields while maintaining liquidity and ensuring safety of principal. Within the Global Clearing Services segment, Bear Stearns is the leading provider of prime brokerage services. This includes securities clearing services, custody, advanced web-based portfolio reporting, enhanced leverage and term financing products, securities lending, and cash management services. Hedge funds and other professional investors are typical prime brokerage clients. As of November 30, 2007, Global Clearing Services held approximately $288.5 billion of equity in its accounts.

JP Morgan stands to benefit tremendously from the acquisition of the Global Clearing Services segment. The acquisition will allow the firm to get a foothold in the prime brokerage space and hopefully expand the business to compete with top tier prime brokers.

*Wealth Management*

As of November 30, 2007, the wealth management division had $42.7 billion in assets under management compared to $52.5 billion a year before. Wealth management is comprised of the Private Client Services and Asset Management divisions. Working from six regional and eight satellite offices, Private Client Services provides high-net-worth individuals with an institutional level of transaction, wealth management, and advisory services. The Asset management division provides asset management services to institutional clients and high-net-worth individuals across the globe through direct and third-party channels. Fees are determined as a percentage of asset value. Bear Stearns provides a full array of services to its clients, including
services in money markets, fixed income, equities, and currencies through a variety of investment styles.

**JPMorgan Chase-Bear Stearns Integration**

The most difficult question to answer will be which divisions to keep and which ones to discard as the Bear Stearns merger goes forward. There will obviously be a significant lag between the time that the merger is actually completed and Bear Stearns’s remaining employees are efficiently integrated into the new company. So far, we have witnessed a number of employees, especially within the investment bank, maneuvering to find other jobs in the financial services industry. It will be very important to quickly identify the top talent at Bear Stearns and heavily incentivize those individuals to stay with the firm, at least until the company can determine which divisions from Bear Stearns will be downsized.

Of the six primary business divisions within JPMorgan Chase: (i) investment bank, (ii) card services, (iii) commercial banking, (iv) treasury and security services, (v) retail financial services, (vi) asset management, only two will be significantly affected. The investment bank will have a significant infusion of personnel, especially it seems at the upper levels. Additionally, the firm will need to identify which broker dealers to keep online. This report is recommending keeping the fixed income, institutional equities, energy, and commodities broker-dealers from Bear Stearns in the post-merger company. Within corporate finance, we recommend keeping on all the upper-level personnel and only the associates and analysts necessary to pick up any additional deal flow that may come about in the post-merger environment.

The asset management division at JPMorgan dwarfs its Bear Stearns counterpart in terms of both assets under management and employees. The JPM asset management division needs to move quickly to retain only the most senior people within Bear Stearns’s private clients services (PCS) and asset management wings. Quickly transferring over lucrative relationships will enlarge fees in asset management going forward while increasing costs only marginally.
The integration of the Global Clearing Services division is of the utmost concern. This is by far the most valuable asset that JPMorgan will gain as a result of the acquisition. However, the question arises as to whether or not the inabilities of the division to participate in CDS disintermediation over the past six weeks permanently damaged the business. As mentioned previously, when Bear found its balance sheet overloaded with assets with dubious values, counterparties began to question whether or not they had the collateral to sustain operations. In one and three-day repo trades, Bear put up extremely illiquid securities as collateral. More often than not, a market did not even exist in which these securities were trading. Bear’s counterparties in the repo trades begin demanding more collateral, even if the collateral itself was toxic. These margin calls drastically reduced the available cash on hand to fund operations. This led to a run on the bank in the repo market beginning when Goldman Sachs, exercising circumspect judgment, refused to enter into CDS disintermediation with Bear Stearns on behalf of its clients. Every other major bank followed suit and Bear found itself in an extremely precarious position before FRBNY and JPM stepped into the picture.

As this situation unfolded, it is likely that many of the clients Bear primed would have pulled assets from their Bear accounts and transferred those assets to other prime brokers for fear that if Bear declared bankruptcy, a freeze might be placed on all assets held by all Bear facilities, even those legally immune from bankruptcy at the parent company. Why is this of great concern? In prime brokerage, the top ten percent of clients provide 90% of the net revenues. These will be large clients with multiple prime brokers and they will quickly move assets for fear that they will be frozen. As a matter of fact, Bob Sloan at S3 Partners advised his clients, hedge funds, to pull their money from Bear Stearns’s prime brokerage which purportedly resulted in $25 billion being transferred.13

If it is indeed the case that the most-prized customers that Bear primed for have transferred their assets out of the bank, then it will prove to be an extremely difficult task for JPMorgan and Bear Stearns to gain back these clients as the business is very sticky with high costs associated
with switching. For these reasons, it seems likely that there will be a 50% hit to the top line of the division going into fiscal 2008. The main goal of JPMorgan, then, needs to be to retain as many of the prime broker’s top clients as possible.

Going forward, JPMorgan will need to decide whether to roll the division in with their Worldwide Security Services arm or to keep clearing services as an autonomous unit. Whatever they choose to do, they will need to inject capital into the unit if they hope to have a first tier prime brokerage. At this point, they should strive to be leader in the field, targeting clients with assets over $200 million. The problem with staying in the second and third tier is that a new independent company, Merlin Securities, has begun delivering high-quality services from a technologically advanced platform at a very low cost. The technology that Bear Stearns Prime Brokerage uses is outmoded and prevents them from competing with first tier brokers such as Morgan Stanley and Goldman Sachs whose advanced platforms allow clients access to dark pools and ECN. If JPMorgan effectively employs capital to develop great technology for the prime brokerage unit, then there is the distinct possibility that they will reap significant gains in the next five to ten years.

**Strategic Recommendations**

Based on the above analysis, Harkness presents the following recommendations for your consideration:

- Keep key employees from the asset management/PCS division with the most lucrative relationships and dissolve the division
- Give monetary incentives to clients who have left/are considering leaving Bear Stearns Prime Brokerage Unit to return or stay
- Invest heavily in an advanced technological platform for GCS/Prime Brokerage in order to compete effectively with the top tier prime brokers, i.e. Goldman Sachs & Morgan Stanley
- Reposition Prime Brokerage to compete for clients with larger asset bases
- Retain Fixed Income, Institutional Equities, and Energy broker-dealers
• Within IBD, retain only senior investment banking personnel and those mid and lower-level employees necessary to service deal flow

The asset management/PCS division at Bear Stearns proved itself to be a laggard in the field and cost the company billions when its hedge funds collapsed. Furthermore, JPMorgan has one of the best asset management divisions in the world. It would be unnecessary overlap to keep the division in its entirety. Instead, employees at Bear Stearns with the most lucrative relationships should be rolled into the JPMorgan asset management division with what remains of their client base.

The biggest gain for JPMorgan out of this acquisition is the gain of Bear Stearns’s GCS division with its lucrative prime brokerage. Successful integration of this division should be the primary focus for JPM senior management over the next 12 to 18 months. We believe it to be highly advisable to give monetary incentives to clients to return assets to Bear Stearns knowing that the full facing credit of JPMorgan Chase is behind the accounts. Going forward, the prime brokerage will face greater competition as more banks try to enter this extremely profitable space. Developing advanced technological platforms that can fully service the most demanding clients will allow the division to prime clients who have large asset bases and trade frequently. Ultimately, effectively developing the division will be of greater importance than the acquisition itself.

Bear Stearns’s core competencies have always been in trading, especially on the fixed income side. Retaining businesses which consistently drive top and bottom line growth is desirable and ultimately will be accretive. Obviously, the entire Bear Stearns trading platform needs to be subject to the kind of stringent and sophisticated risk management systems that are the cornerstone of a strong balance sheet.

1 See “Financial Analysis of The Bear Stearns Companies---Overview of the Purchase Price”
2 Fundinguniverse.com


Ibid.


Ibid.

Ibid.


