

Recommendation: HOLD

Estimated Fair Value: \$40 – \$53

1. Reasons for the Recommendation

JPMorgan Chase & Co. (JPMorgan) has a healthy operation and profit margins that are better than the industry average.¹ The net interest margin is also greater for JPMorgan compared to the industry average, and JPMorgan's consumer banking business is doing an exceptional job of gaining new clients. Even though the industry is contracting, consumers are leaving other financial institutions for JPMorgan; this shows consumer confidence and trust in JPMorgan. In addition, net loans growth has been outpacing the industry slowly since the recession. JPMorgan has a well-established position in the financial industry and is ready to acquire new customers as the economy improves. In 2012 JPMorgan had the lowest customer attrition in 10 years, gained many new customers and had record average deposits and transactions for debit cards.

In addition, the global presence and continuous investment in Asia, Africa and South America is an important factor for JPMorgan that will translate into higher profits. JPMorgan is growing its multi-business presence internationally as revenue has been increasing faster or decreasing slower than its competitors in most regions.² Latin America, Asia and Africa are significant population hubs, with approximately four billion people. JPMorgan can leverage its expertise in multi-business management and grow with the developing countries as saving and investing becomes more common among people living in these countries.

On the other hand, the most recent stress tests show that JPMorgan is not doing very well compared to its peer institutions. JPMorgan was one of the worst performers across the board in the most severe stress tests scenario performed by the Federal Reserve. JPMorgan is performing poorly in these scenarios primarily because of the Investment and Corporate Banking segment has some risky investments, which most likely underperform during a projected recession; however, these investments produce good returns during prosperity. If we combine Investment Banking severe scenario returns with the other segments, then the net brings all of the segments results down as the riskiest positions are held by the Investment Banking. Clear proof is that six out of eighteen banks that have investment banking segments perform poorly in the most severe scenario. The Federal Reserve might prepare investment bankers for more regulation, which translates into smaller profits and less competitiveness. JPMorgan Investment Bank could possibly become independent from the corporation, which, however, is unlikely to happen with the current management.

Basel III capital ratios such as Tier 1 common, Tier 1 capital, Total Capital and leverage ratios are all lower for JPMorgan than industry average capital risk ratios. JPMorgan has to maintain more safe assets to offset their risky assets, which will most likely result in lower profits. In addition, as JPMorgan is classified as a "global systematically important bank" ("GSIBs") it is required to hold an additional 2.5% capital conservation buffer mandated by the Financial Stability Board (FSB). This rule does not apply yet but will soon and will put more pressure on future profits.

I believe that keeping JPMorgan in the Regents' portfolio will result in good returns. In JPMorgan's last 10-K, several segments reported high growth for returns, for net income, and for factors that increase both returns and income: deposits, loans, and other activity. JPMorgan does have a good position in the market at this point and it has been increasing its customer base as smaller banks lose customers to JPMorgan.

¹ JPM stock data. Finance.Yahoo.com. April 5, 2012. Web.

² 2012 JPMorgan 10-K. Sec.gov. April 5, 2012. Web.

JPMorgan has a 10% market share in the commercial banking segment, which is estimated to grow 5% annually for the next five years.³ The Credit Card segment, in which JPMorgan has a strong 26% of the market share, is also projected to grow 5% for the next five years.⁴ However, there are some uncertainties involved as noted earlier that may or may not get resolved.

2. Company Analysis

JPMorgan Chase is the largest multi-business bank in the US and it operates globally in Europe, Asia, South America and Africa. It has Consumer Business and Wholesale Business, which are each separated into segments. Consumer Business has the Consumer and Community Banking segment and Wholesale Business has three segments: Corporate and Investment Bank, Commercial Bank and Asset Management.

JPMorgan is a multi-business bank that has several strengths over its competitors. It has an advantage because it offers clients one-stop shopping: they can get consumer business loans, a credit card, mortgage loans and investment consultation at the same place. JPMorgan has also a well-known brand that includes a long presence in terms of physical consumer banking locations around the US, and it has rapidly expanded its physical presence with the last two years by building over 400 new branches and over 2500 new ATM locations in the US. JPMorgan is a market leader in many banking industry segments that will show stronger growth once the recession is over. Lastly, the economies of scale and online technologies are some of the marginal strengths for JPMorgan.

Weaknesses for JPMorgan include internal risk control, the size and complexity of the business (it is known as “too big to fail”), the struggle to keep the assets performing at historical levels and the possible internal pressures to take on unnecessary risk to meet and exceed the historical performance. Additional marginal capital conservation buffers discussed earlier (2.5% of capital conservation buffer) will also hinder meeting the performance targets. JPMorgan recently went through a restructuring to improve internal risk procedures and reduce the likelihood of severe damage to the company through employee investments and bets. Time will tell if the most recent restructuring worked and if there are any other losses incurred.

JPMorgan has many opportunities by capitalizing on competitors’ weaknesses. First, JPMorgan can take clients from smaller banks by offering clients more services under the “same roof” and 21st century services thereby making accessing services simpler and more convenient for customers. JPMorgan has been investing in an online user interface and mobile interface. The number of mobile users has tripled since 2010 because of JPMorgan’s commitment to making services more easily accessible via these devices. In addition, the Commodity Dealing and Brokerage, where JPMorgan has the largest 14% market share in the US, is expected to grow by 6% annually. The commodity business is still in the growth stage, and JPMorgan has the opportunity to increase its share of the market especially in the next upcoming years. Many competitors in the commodity business are still hurting from the recession, which could potentially give JPMorgan an edge.

Regulators such as the SEC, the FDIC, and the US government pose many threats to JPMorgan. They impose additional regulation on the banking industry, which makes the whole industry less appealing to outside investment. Stress test results showed how JPMorgan has good capital ratios, but during stress tests fell faster than most of its competitors in the severely adverse scenarios in which JPMorgan had some of the lowest or worst ratios. This result stems from JPMorgan’s size and the nature of its business.

³ IBISWorld. Commercial Banking industry. April 9, 2012. Web.

⁴ IBISWorld. Credit Card issuing in the US. April 9, 2012. Web.

If the Investment Banking sector were a separate corporation from JPMorgan, then stress test results would have resulted more favorably. Many regulators and institutions believe that JPMorgan is too large in size and it needs to break itself apart. Some regulators believe that imposing more requirements on JPMorgan might push them to break themselves apart.

Last but not least, macroeconomic factors are extremely important for JPMorgan, over which it does not have any control. These include a possible Euro-zone collapse and exit of Greece or Cyprus from the euro monetary union. In addition, further slowdown in Asia, South America or Africa and low growth economy in the US do not help most companies in the banking industry. Other political and fiscal issues such as the risk free rate, the debt ceiling and the budget development are outstanding problems for the US economy.

3. Industry Analysis

JPMorgan Chase & Co.'s 10-K for 2011 divides the company into the following six business segments: Investment Bank (IB), Commercial Banking (CB), Treasury and Securities Services (TSS), Asset Management (AM), Retail Financial Services (RFS) and Card Services & Auto (Card). The last two segments are consumer businesses and the rest are wholesale for institutional clients. Each segment offers different services and products whose customer bases differ greatly.

Investment Bank (IB)

IB offers a wide range of services beginning with advising on corporate structure and strategy and ending with market-making with cash securities, research, derivative instruments and prime brokerage. The main clients are spread across the globe, and they include financial institutions, large corporations and institutional investors. The fixed income, currency & commodity trading segment from Bloomberg is categorized as Investment Banking (IB).⁵ Its primary activities include underwriting, originating or maintaining markets for securities issuance and principal and proprietary trading.

According to Bloomberg, the IB business brought in \$16.34 billion in revenues, comprising 16.04% of total JPMorgan's revenues for the year. JPMorgan's IB is number one in the industry in terms of revenue, which is \$3.39 billion more than the revenue of the company coming in at number two, Citigroup's IB, whose IB business totaled \$12.26 billion, comprising 15.83% of Citigroup's total revenues. The IB industry is approximately a \$1.17 trillion industry by total market cap and has over 160 competitors. The top 30 largest firms by revenue from the IB sector receive over 85% of the total revenue. This sector is extremely hard to enter because of vast capital investments, heavy regulation, difficulty in obtaining clients' trust and finding skillful labor. There is an upward trend in IB as the activity is expected to pick up in 2013 when the economy recovers and clients invest more.⁶

Demand for IB could be characterized by some key economic drivers: high corporate profit, low investor uncertainty, yield on 10-year Treasury note, and number of initial public offerings. In recent years there is large amount of new regulation that IB has to follow, which will negatively impact profits. We know that the industry has been terminating bankers during the recession era. JPMorgan fired 10% of its employees, or approximately 3000 people, in 2008 since it needed to adjust overcapacity.⁷

⁵ Bloomberg business segments. February 2012. Web.

⁶ IBISWorld Industry Report. Investment Banking. February 2012. Web.

⁷ Hester, Elizabeth. "JPMorgan May Fire 10 Percent of Investment Bank Staff." 20 Nov, 2008. Bloomberg. Web.

Commercial Bank (CB)

JP Morgan's CB services target mid-sized organizations with annual revenue anywhere between \$10 million and \$2 billion. CB clients include municipalities, corporations, not-for-profits and financial organizations. The worldwide CB industry is approximately \$4.2 trillion large by total market cap. In the CB industry, the largest 30 companies earn approximately 72.32% of the total revenue. The sector includes 555 companies, but most commercial banks are closely tied to their home markets.

The Bloomberg Corporate Banking segment ties in closely with JPMorgan's 10-K. According to Bloomberg, JPMorgan receives 2.20% or \$2.1 billion of total revenues from the sub-industry. JPMorgan has the 45th largest CB in the world by revenue. The top two CBs by revenue are in China, the following two are in Hong Kong, and, finally, the fifth largest CB is Wells Fargo & Co. in the US.

The main business drivers within CB, according to an IBISWorld industry report, are prime rate, aggregate household debt, corporate profit, external competition for the industry and regulations. CB has been one of the most profitable segments for JPMorgan: in 2011 it earned an ROE of 30%, and in 2010 it earned an ROE of 26%. From 2010 to 2011 JPMorgan earned 14% more in revenues, but the actual market size contracted -3.3%. This means that JPMorgan is aggressively taking over the market share from other companies and acquiring smaller banks as it did in 2008 with Washington Mutual.

Treasury and Securities Services (TSS)

Treasury services offer trade, liquidity, wholesale card products and services. It also works with small and mid-sized companies, governments, large international corporations, brokers-dealers and financial institutions. It also deals with clearing, servicing securities, cash transactions and managing various depositary programs on a global scale. Transaction Services have a \$375 billion market cap, and Asset or Investment Servicing has a \$202 billion market cap. JPMorgan has the second highest revenue following Sinochem Corporation in the Transaction Services (TS) sub-business.

Sinochem Corp specializes in this segment by receiving approximately 98% or 45.98 billion of its total revenues from TS. JPMorgan is a market leader by revenues in the Asset or Investment Servicing (AIS) segment by having 4.04%, or \$3.9 billion, of revenues from this segment. The top four companies have just over 90% of the whole market revenues in AIS segments.

More technology is brought in-house and services get automated to create efficiencies and lower cost in order to increase the margins. Only the largest players in the industry are capable of doing this. Even though there has been a revenue growth of approximately 4% in 2011, JPMorgan's profit has been falling at 4.7% in annualized terms because of new and cheaper technologies that are lowering spreads.⁸

Asset Management (AM)

AM clients include investment funds, retail investors, high-net-worth individuals and multinational institutions all over the world. Clients can invest in hedge funds, fixed income, equities, pension funds, bank deposits, real estate, money-market instruments and private equity. The majority of AM clients keep their investments in actively managed portfolios. The total market cap for AM is approximately \$1.8 trillion and includes about 97 companies. Among the top ten competitors for JPMorgan are several large American and European banks such as Bank of America, HSBC, Commerzbank and Citigroup.

Bloomberg's Private Banking segment shows that JPMorgan is the third largest by \$5.1 billion in revenue right after Bank of America with \$17.3 billion in revenue and IND & Comm Bank with \$11.2 billion in

⁸ IBISWorld. Industry Market Research- Major companies. JPMorgan Chase & Co. Web.

revenue. Bank of America derives 18.33% of its total revenue from AM, and IND & Comm Bank derives 15.36% of its total revenue from AM compared to JPMorgan who gains 5.35% of its total revenue from AM.

The service is very similar within the industry and is differentiated by small variances such as the quality of the customer service and the reputation of the asset management business. Clients often use all-in-one service providers that are larger banks, but this might be changing as the economy continues to struggle.⁹

Retail Financial Services (RFS) (2011 10-K) or Community Banking (2012 10-K)

Retail Securities Brokerage (RSB), Retail Banking (RB) and Mortgage Services (MS) are all categorized under one segment that has a total combined market cap of \$4 trillion dollars. It is a very competitive business with over 400 companies involved among all three segments. MS has been on a rollercoaster ride since the mortgage bubble burst in 2008 and the housing prices skyrocketed before 2008. After 2008 many participants in the MS segment lost revenue due to high default rates and tightening liquidity. 2013 is expected to mark a positive upturn according to IBISWorld report. This trend appears to be supported by other important factors such as foreclosure rates, mortgage default rates, increased domestic spending and consumer confidence.¹⁰

JPMorgan is the first by revenues of \$4.5 billion in MS, followed by Corelogic Inc. with \$834 million and Suntrust Banks with \$733 million in revenues. Nomura Holdings has the highest revenues of \$4.4 billion in RSB segment, whereas JPMorgan is fifth largest with \$2.2 billion in revenues. In RB, JPMorgan is fourth largest with \$22.3 billion in revenues, only behind Banco Santander with \$55.5 billion in revenues, Wells Fargo & Co. with \$50.7 billion in revenues and HSBC with \$42.6 billion in revenues.

In 2011 JPMorgan's revenue grew 4%, and its net income grew 12%. Even though the industry grew at 2%, it shows how JPMorgan is taking over the market share from its competitors like Wells Fargo & Co., Bank of America, Citigroup and smaller competitors by offering its clients better terms on their retail banking needs.¹¹ IBISWorld predicts industry revenue growth as the prime rate and loan demand rises with the improved economy.

Card Services and Auto (CS&Auto)

CS&Auto total segment market value is approximately \$2.7 trillion. JPMorgan is the ninth largest company by revenue with \$3.3 billion in the Auto Finance segment and the fourth largest competitor by revenue of \$15.8 billion in its Credit Card issuing segment. Only American Express, Bank of America and Citigroup are larger in the Credit Card issuing segment than JPMorgan. In addition to conventional competitors, automotive companies such as Volkswagen AG, Toyota Motor, Ford Motor are also considered competitors.

The auto industry is in a difficult position because of currency market fluctuations and the slow economy. People buy fewer vehicles and institutions are delaying upgrading their fleets. Net revenue for JPMorgan's CS&Auto segment has been falling for the last 2 years in 2011 by -7% and in 2010 by -12%; however, net income grew in 2011 by 58% to \$4.5 billion.¹² JPMorgan has gone through a restructure to cut costs in every possible way to bring in the same amount of revenue.

⁹ IBISWorld. Industry Market Research- Portfolio management and competitive landscape. Web.

¹⁰ Izzo, Phil. "Scant Pickup in Economic Growth Seen for 2013." WSJ.com. 7 Feb 2012. Web.

¹¹ IBISWorld- Industry reports. Consumer banking. Web.

¹² JPM 10-K. Sec.gov

The auto services industry is expected to grow at 2.3% a year until 2017 and then around 1% a year as the industry matures.¹³ As the economic conditions improve, then people start buying new vehicles and dispose of old ones. During this recession, the age of an average vehicle in the US increased from 8.4 years in 1995 to 11.1 years old in 2011.¹⁴

¹³ IBISWorld. Auto leasing and Loans- Industry outlook. Web.

¹⁴ Tuttle, Brad. "Jalopy Nation? The average Car on the Road Has Never Been Older." 18 Jan. 12. Business Time. jalopy- Web.

Appendix A: Inputs into the Residual Income Valuation

JPMorgan Historical Data

	2012
Net Income	\$ 21,284.00
Beginning BV of equity	\$ 195,011.00
Return on equity (5Y avg.)	10.78%
Risk premium	6.00%
Yahoo Finance beta	1.63
Cost of equity	11.58%
Dividend payout ratio (2011)	22.30%
Dividend payout ratio (2012)	23.10%
Dividend payout ratio (TTM)	23.10%
ROE (5Y avg.)	8.19%
ROE (TTM)	10.72%
10 Year risk free rate	1.80%

**Sources: 10-K, Morningstar, Yahoo!Finance*

Appendix B: Inputs into valuation using multiples

Investment Bank	EV/EBIT
Citigroup	29.83
Deutsche Bank	20.57
Goldman Sachs	31.23
Bank of America	-18.24

Retail Financial Services	EV/EBIT
Rakuten Inc	3.60
HSBC Holdings	3.73
Royal Bank of Canada	-1.16
Citigroup	29.83

Card Services & Auto	EV/EBIT
Nissan Motor	15.86
Citigroup	29.83
Bank of America	-18.24
Discover Financing	2.28

Commercial Banking	EV/EBIT
Bank of America	-18.24
Wells Fargo	-0.16
PNC Financials	-4.23
US Bancorp	N/A
Goldman Sachs	31.23
Fifth Third Bancorp	-0.52
Comerica Inc.	-4.34

Treasury & Securities Services	EV/EBIT
HSBC Holdings	3.73
Syndicate Bank	N/A
Almendral Sa	N/A
Ind & Comm Bk	N/A

Asset Management	EV/EBIT
HSBC Holdings	3.73
FRANKLIN RES INC	10.99
Citigroup	29.83
Bank of America	-18.24

*Source: Yahoo! Finance

Historical Multiples

Price/Book	2008	2009	2010	2011	2012	TTM
JPM	0.9	1	1	0.7	0.9	1
S&P 500	1.7	2.2	2.2	2	2.1	2.2
Ratio	0.53	0.45	0.45	0.35	0.43	0.45

**Source: Morningstar, Inc.*