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Subject: Fw: (BV) Goldman Calls JPMorgan Too Big, Not Too Big to Fail: Matt L

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good article.

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Subject: (BV) Goldman Calls JPMorgan Too Big, Not Too Big to Fail: Matt L

(BV) Goldman Calls JPMorgan Too Big, Not Too Big to Fail: Matt Levine

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Goldman Calls JPMorgan Too Big, Not Too Big to Fail: Matt Levine
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By Matt Levine
(Bloomberg View) -- Goldman Sachs made some news today by publishing an equity research note arguing that JPMorgan should be broken into some number of pieces that is not one. This is a popular theme among bank analysts, and bank critics, and some bank shareholders, and really a whole lot of people who are not bank executives.
Goldman's particular idea -- in a note by Richard Ramsden, Conor Fitzgerald, Daniel Paris and Kevin Senet -- is a pretty standard, Glass-Steagall-ish version of the proposal, in which JPMorgan would split into a "traditional" bank (loans, branches, credit cards) and an "institutional" bank (investment banking, asset management, etc.). Call them New Chase (traditional) and New JPMorgan (institutional), as Goldman sort of does.
In Goldman's theory, these pieces would be worth more than

the whole, in part because of the new rules from U.S. bank regulators imposing higher capital requirements on big "global systemically important banks," which JPMorgan very much is, and which New Chase and New JPMorgan would be to a somewhat lesser extent. Higher capital requirements are expensive, and by becoming less systemically important JPMorgan could escape the clutches of punitive capital regulation and save a lot of money.

Umm, sort of. But not really? Here's Goldman's math:

Source: Goldman Sachs Equity Research, Jan. 5, 2015.

There are a bunch of numbers in that chart, and the print is quite small, but you can ignore most of them. Here are the

moving pieces:

- The combined income of New Chase and New JPMorgan would be about \$3 billion lower than the income of Current JPMorgan Chase, because the new companies would miss out on various cross-selling opportunities and back-office savings.
- The combined capital of New Chase and New JPMorgan would be about \$24 billion lower than the capital of Current JPMorgan Chase, because Current JPMorgan Chase is a giant complicated "global systemically important bank" subject to G-SIB surcharges from the Fed, while the new companies would be just wee little ... I mean, trillion-dollar-plus banks, but relatively simpler trillion-dollar-plus banks, and smaller anyway.
- Conveniently, \$24 billion of capital at a 12 percent cost of common equity costs about \$3 billion a year.

So the math is: New JPMorgan plus New Chase make about \$3 billion less from their businesses, but spend about \$3 billion less on capital, leading to an all-in net improvement in their combined financial prospects of zero dollars.

So that's not really a rousing value add. Somehow, though, those zero dollars of extra income are worth at extra \$10.23 per share, or over \$38 billion, to New JPMorgan and New Chase.

That's a lot of value placed on no new income! Where could it come from?

Goldman's answer is "multiple re-rating," which has a certain refuge-of-scoundrels quality to it: It just means that people would pay more for the same income if you packaged it in two shiny new boxes than if you packaged it in its current somewhat dingy box. This is, of course, entirely plausible: The "conglomerate discount" is a real thing, very much observed in the wild, for some combination of reasons both rational (excess complexity, reduced management focus, an option on a basket is worth less than a basket of options) and irrational (shiny boxes, "the combined business is too hard for investors to understand"). Goldman gamely gestures at a semi-rational explanation -- "We believe this is due to the 'conglomerate discount' investors prescribe to JPM because of its size and greater regulatory/legal burden" -- though it does not insist.

In Goldman's view, there's \$38 billion in value just from shareholders preferring small specialized banks to large diversified banks.

There are other possibilities. Goldman's note seems to ignore the funding benefits of being a giant globally interconnected bank: You can borrow more cheaply because your safer businesses subsidize your riskier businesses, possibly in part because of expectations of a government bailout for those safer businesses. Those benefits are a popular subject of discussion around these parts. How much are they worth? Well that's a hard one. Goldman's implicit assumption is zero, or really negative \$3 billion a year (that is: no funding

benefit, \$3 billion additional capital cost). That might be a bit aggressive (presumably a standalone giant investment bank with significant trading operations would have a higher cost of funds than one folded into a giant commercial and consumer bank?), or it might not be (presumably the standalone commercial and consumer bank would have a lower cost of funds if it was unfolded?). Naively, though, I at least would think that the bigger, more diversified Current JPMorgan would have a lower cost of funds than the combined New JPMorgan plus New Chase. The efficient-market extremist view of the situation would be that JPMorgan cannot create any value just by repackaging its income, and that that \$38 billion of extra value in Goldman's table is just a mirage. If you believe that, then the simple math is: JPMorgan looks like it would create \$38 billion in value by splitting apart. But actually an offsetting \$38 billion in value would disappear from somewhere if it split apart, balancing out the apparent \$38 billion in value creation. Funding costs are a reasonable place to look for the \$38 billion in value destruction. On an efficient-market-extremist viewpoint, you might conclude that JPMorgan gets about \$38 billion in current value -- or about \$4 billion a year at a 9.4x price-earnings ratio -- from the lower funding costs of combining a big investment bank with a big regular bank. That's perhaps too extremist, but there's a certain appeal to it. If it's true, though, it hampers JPMorgan a bit in replying to arguments like this. "Break up JPMorgan," analysts and investors say, "because it's worth more broken up." "No no no," JPMorgan can't quite respond, "it's worth more as a whole because it's cheaper to fund an investment bank that's attached to a deposit bank." That's an argument that might appeal to shareholders, but you don't want to emphasize it in front of the regulators. It's the sort of thing that might tempt those regulators to add even more capital surcharges.

Page 9 of this shareholder letter lays out \$15 billion of revenue synergies and \$3 billion of expense synergies. Goldman discounts these to \$6 billion or so using "JPM's assumptions of a 38% tax rate and 50% overhead ratio"; I don't know how legit that is but whatever. And then Goldman is kind of like, well, some of those synergies would be lost in a two-way split, but some wouldn't; it semi-arbitrarily lops off \$2,976 million in synergies (and applies them half to New JPMorgan and half to New Chase).

That 12 percent is just the implied return on tangible common equity in that table. Feel free to substitute some other cost of capital number if you'd rather. Also I implicitly assume that the cost of non-equity funding is zero, which, sure, why not. Goldman on the conglomerate discount for JPMorgan:

We estimate JPM's discount to pure play peers is over 20% (when applying comparable pure play peer multiples to JPM's segments weighted by income contribution), which provides a considerable opportunity to unlock shareholder value if this discount can be reduced. This would be the most important driver of value creation in a breakup scenario, in our opinion. This means the success of any breakup would largely hinge on its standalone companies trading in line with peers, which is tough to estimate

given disclosure limitations.

That strikes me as an understatement: From the math above, the conglomerate discount looks less like "the most important driver of value creation" and more like the only one.

Even ignoring the too-big-to-fail premium debate, Current JPMorgan is just a bigger and more diversified company, and bigness and diversification should be credit-accretive.

One way to put this is like: Goldman's multiples for the standalone components are right, but the breakup would reduce income -- even beyond the synergies that Goldman already discusses -- until the total value at the higher multiples is equal to the total value of the current company.

Again, not obvious, but we're being extremists here.

That's a lot lower than the Bloomberg View house estimate, which might be because Goldman is wrong, or because View is wrong, or because New JPMorgan and New Chase would still benefit from a (modestly reduced) too-big-to-fail subsidy.

Or, it could just be that that \$38 billion is kind of a minimum; perhaps JPMorgan is in the package it's in because it is a subsidized sweet spot, and really a breakup would make it worth less than it's worth now. This is not of course quite an efficient-markets-extremist view, but it has a certain appeal.

(On the other hand, that \$4 billion a year is before the capital surcharge, which we computed was worth about \$3 billion a year, leaving a net benefit to JPMorgan of like \$1 billion a year, or under 5 percent of net income.)

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