Brokerages and the Subprime Crash

By Michael Markowski

Many analysts and media pundits are missing an important point as they attempt to pick bottoms for brokerage firm shares and give their predictions as to when the sub-prime mess and credit crisis will be completely digested by the stock market. It seems that everyone is focusing on brokers' exposure to subprime loans and how big the write-offs will be.

However, I don't believe that the subprime crisis will cause the bankruptcy of any of the big five brokerages, since they each have sufficient tangible net worth to weather the storm. For instance, some aggressive analysts have said that Merrill Lynch's exposure could be $15 billion; even if that were the case, it would still leave Merrill with a tangible net worth of $19 billion.

Experts are acting as though it will be business as usual after the brokers have fully disclosed their subprime loan problems and have swallowed their medicine (write-offs against earnings). But there is one issue escaping discussion: What exactly will things look like for brokers once the dust settles?

Broker	Tangible Net Worth (in billions)
Morgan Stanley	$31.7
Merrill Lynch	$33.9
Bear Stearns	$13.00
Goldman Sachs	$33.6
Lehman Bros.	$17.6

Tangible Net Worth of the Big Five Brokers (does not include announced write-offs)

To answer this, let's take a look at the earnings performance of this country's five largest brokers: Goldman Sachs (NYSE: GS), Merrill Lynch (NYSE: MER), Morgan Stanley (NYSE: MS), Lehman Holdings (NYSE: LEH) and Bear Stearns (NYSE: BSC) over the last three years. Each of these brokers reported record earnings per share (EPS) for 2006, and four of the five (the exception being Morgan Stanley) reported consecutive annual record EPS for 2004, 2005, and 2006.

Now let's compare the results from the real estate bubble years of 2004 to 2006 to the per-share earnings performance for the brokers that did not participate in the real estate bubble. Between 1997 and 2003, thanks to the formation and subsequent bursting of the dot-com bubble, Merrill Lynch reported its highest EPS of $4.11 (in 2000) and lowest of $0.57 (in 2001). It wasn't until 2004, when the real estate bubble began to form, that Merrill was able to eclipse its 2000 record, reporting an EPS of $4.38. Eliminate the bubble years, and Merrill's normalized earnings should range or peak between $2 and $3 per share. Merrill's peak EPS in years that were not affected by bubbles were $2.41 in 1997 and $2.63 in 2002. Should Merrill's EPS go back to these normal levels, it would be significantly below the EPS it reported in its most recent three bubble years of 2004 ($4.38), 2005 ($5.16) and 2006 ($7.59). And if that were to happen, expect shares to eventually trade between $20 and $30 until they can find another bubble to re-inflate their EPS prices.

Goldman Sachs and its shares have somehow been immune to the subprime mess; its shares hit an all-time high of $250.70 on Oct. 31, 2007. The word on Wall Street is that Goldman has a short position in subprime securities. Its EPS growth from 2004 to 2006 has been nothing short of stellar, and it reported an EPS of $19.69 for 2006. When Goldman first became a public company in 1998, it earned $5.07 per share. In 2000, it reported its second consecutive year of record earnings, with an EPS of $6. After that, it wasn't until 2004 that Goldman was able to eclipse its 2000 record performance, when its reported EPS was $8.92. (Goldman, as a private company in 1997, actually had higher net income than it did in 1998 or 1999.)

Given that Goldman's EPS has ranged between $4.03 and $6, and its net income has ranged between $2.11 and $3.06 billion from 1997 to 2003, I don't see how Goldman will be able to earn more than $6 per share or $3 billion in earnings in a post-bubble environment.

In my September 2007 article, "Have Wall Street's Brokers Been Pigging Out,"

Annual EPS and Earnings of Goldman Sachs				
Fiscal Year End	EPS	EPS Growth	Earnings (millions)	Earnings Growth
11/30/2006	$19.69	75.6%	$9,398.000	67.6%
11/30/2005	$11.21	25.7%	$5,609.000	23.2%
11/30/2004	$8.92	$51.9	$4,553.000	52.5%
11/30/2003	$5.87	45.8%	$3,005.000	42.1%
11/30/2002	$4.03	-5.6%	$2,114.000	-8.5%
11/30/2001	$4.26	-28.9%	$2,310.000	-24.7%
11/30/2000	$6.00	7.6%	$3,067.000	13.3%
11/30/1999	$5.57	10.0%	$2,708.000	11.5%
11/30/1998	$5.07		$2,428.000	-11.6%
11/30/1997			$2,746.000	

I cautioned investors to avoid the five largest brokers, based on the suspicion that their earnings had been inflated by their packaging and distribution of sub-prime securities. Below is a comparison of how the shares of Wall Street's big five brokers have performed since then.

Company	Symbol	Sept. 2007 Price	Nov. 25, 2007 Price	Percent Change
Merrill Lynch	MER	$78.17	$53.54	-31.50%
Bear Stearns	BSC	$121.12	$94.23	-22.1%
Morgan Stanley	MS	$65.39	49.89	-23.0%
Lehman Hldgs	LEH	$64.78	$60.86	-6.0%
Goldman Sachs	GS	$193.30	$216.48	+12.3%

Even if one assumes that Goldman has or is going to make a lot of money by being smart or lucky enough to be short sub-prime securities, the fact remains that they would not have been able to make those profits without the forming and the bursting of the housing and subprime bubbles. Still, it will be very difficult for Goldman to sustain its current level of profitability. This will become more apparent by the second half of 2008, as the stock market becomes more stable due to greater certainty regarding the possibility of a recession. When it does, expect Goldman's shares to fall below $100.

The low end of Goldman's annual P/E ratio ranged between 8.5 and 14.1 from 2000 and 2006. Should normal EPS head back to $6, Goldman shares could easily trade down below $100—to approximately $84.60 ($6 X 14.1) at the high end of the historical low PE range, or to $51 ($6 X 8.5), which would be at the low end of the low PE range. Therefore, investors should avoid Goldman's and the other four brokers' shares for at least the next several quarters. **E**

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Year	High P/E	Low P/E
2006	15.0x	8.5x
2005	13.1x	9.6x
2004	17.1x	9.7x
2003	19.2x	14.1x
2002	20.5x	13.4x
2001	18.8x	11.3x
2000	19.7x	11.3x

Goldman Sachs' P/E Ratios