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Opportunism still knocks

A lamentation from Chris Burn, paid-up subscriber and founder of Goshen Investments: "The markets are so screwed up, with systematic interference with price discovery going on. How do you run a bank in this environment? Bank equities offer levered exposure to mispriced, distorted credit markets. It's difficult to have confidence in longs."

Amen to that, but a cheap stock is a cheap stock. In search of the better grade of bargain, colleague David Peligal has been raking the ashes of the once-beloved financial services industry. In preview, not all is lost, the profitless yield curve, fire-eating regulators, vanishing net interest margins and questionable book values notwithstanding. Blackstone, the alternative asset manager featured in these pages on Oct. 7, continues to grow—and continues to receive the back of Mr. Market's hand.

The searcher after statistical bargains could easily fill a shopping cart on Wall Street alone. Discounts range from 54% for Morgan Stanley to 25% for Goldman Sachs to 13% for Knight Capital Group. The banking business, too, has its host of optically cheap names. Institutions that commanded multiples of tangible book value in the salad days of the early 2000s now trade at discounts. The dinged-share roll call includes SunTrust, whose stomping ground encompasses the fast-reviving Gulf Coast (see *Grant's*, June 29).

"But one might ask: Are they really cheap?" Peligal inquires. "Adjusted for properly reserving for bad loans? Adjusted for properly reserving for litigation risk? Adjusted for properly discounting their diminished earnings capacity?"

As for the last point, interest rates fall first on the liabilities side of the balance sheet. But—regrettably for bank earnings—they do eventually get around to falling on the asset side, too. "So rates get slashed," Peligal writes in order to illustrate. "Initially, you reprice liabilities faster than you reprice assets. Deposit rates fall first, loans and securities get repriced later. Imagine that you, a bank, hold two-year Treasurys paying 2%. Thanks to the Federal Reserve, you have been cutting deposit rates. It has been heaven on the P&L. But by and by your 2%-yielding two-year notes mature, and you replace them with 0.2%-yielding two-year notes. No more heaven: 180 basis points of interest income vanish. You've moved from the virtuous cycle of the low-rate world to the vicious cycle of the low-rate world, because you are repricing your book downwards. Bye-bye, net interest margins."

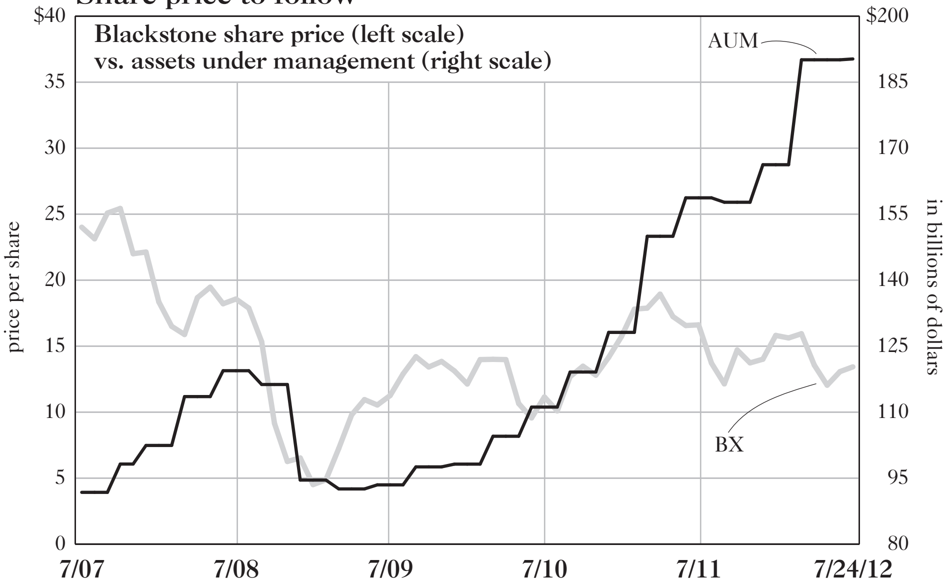
Thus the careful investor gives the fish-eye to discounts to tangible book these difficult days. We ourselves are inclined to credit the net worth calculation if we see validation from the checkbooks of the senior executives of the institution that published the figures. Insider buying is the sincerest form of bullishness. It's encouraging to see corporate share repurchases, inspiring to see real people spending real, af-

Words and deeds
taking advantage of discount to tangible book value

company	disc. to tgbl. book	stock repurchases 2Q12
Goldman Sachs (GS)	25%	14.3 million shares; avg. cost of $104.81
Morgan Stanley (MS)	54	none
JPMorgan Chase (JPM)	3	46.5 million shares; avg. cost of $30.88*†
Knight Capital Group (KCG)	13	850,000 shares; avg. cost of $13.06
SunTrust Banks (STI)	13	none

* includes impact of aggregate repurchases of 18.5 million warrants
†CEO Jamie Dimon buys 500,000 shares; avg. cost of $34.27

Share price to follow



source: company reports, the Bloomberg

ter-tax money. Nowadays, Jamie Dimon, who spent $17.1 million to buy 500,000 shares of JPMorgan Chase on July 19 and 20, appears the exception to the rule that the bankers are even more frightened than the rest of us. Maybe they know more.

Which brings us to Blackstone (BX on the New York Stock Exchange), the asset-management company that has grown like a weed but gets no credit for growing. On behalf of its clients, Blackstone invests in hedge funds, real estate, private equity, workouts and credit instruments. "In an environment characterized by slowing global growth and heightened investor caution," the chairman and chief executive, Stephen A. Schwarzman, was quoted as saying in the Blackstone second-quarter earnings release, "our limited partner investors are entrusting us with a greater share of their capital. We ended the quarter with total assets under management of $190 billion, up 20% on the year. Our newest global real estate fund is over $12 billion in total size, which is the largest fund of this type ever raised."

Blackstone's economics are a little different from the economics of the asset managers that buy only public securities. Like them, Blackstone earns management fees. Unlike them, Blackstone also earns investment incentive fees, a.k.a. carried interest. It's carried interest that Blackstone executives are working for. And it's the carried interest that the public investors in Blackstone are in it for, too. Carried interest is how Mitt Romney escaped from the upper middle class.

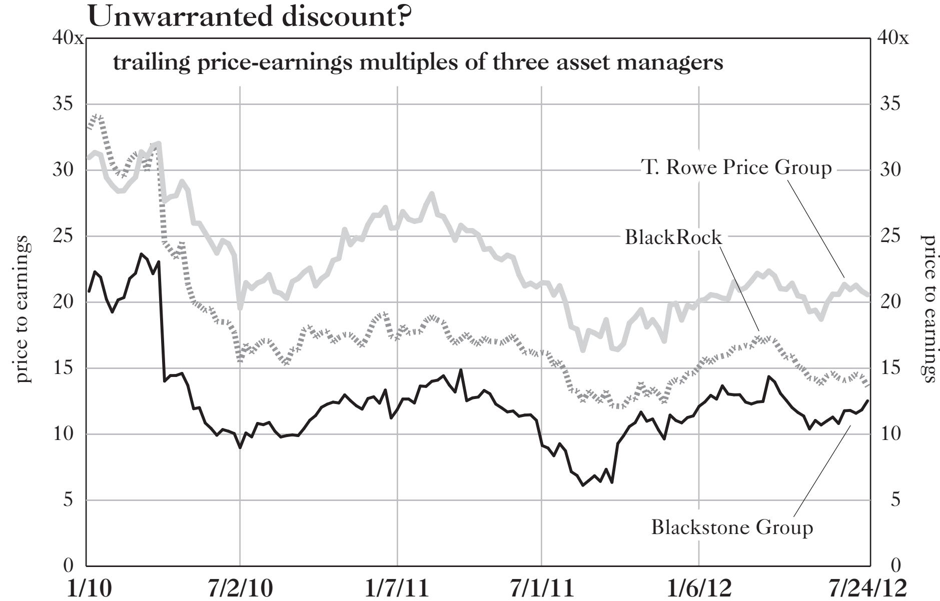
At last report, $49.1 billion of Blackstone's assets were earning a performance fee. Another $34 billion, yet uninvested, may produce fees once it's put to work, while another $37.7 billion, currently invested, is producing no carried interest because it is earning none. That the uninvested money will be invested and the underperforming investments will finally bear fruit, constitutes the heart of the Blackstone bull case.

BX is quoted at $13.91 a share, of which net cash amounts to $3.70 a share. In the second quarter, fee-related earnings—i.e., the 1% or so that Blackstone charges to pay the rent and turn on the lights, as distinct from the brass ring of carried interest or incentive compensation—amounted to 13 cents a share. Annualize 13 cents and you get 52 cents. Apply to that 52 cents the 17 times multiple that the loftiest public asset managers command, and you arrive at $8.84 a share. Add the net cash and you come up with $12.54 a share, or over 90% of the Blackstone share price. Carried interest comes almost for free.

"Though Blackstone trades at a P/E discount to, for instance, T. Rowe Price and BlackRock," Peligal concludes, "Blackstone would appear to be the superior business. Blackstone is taking market share, the others aren't. Blackstone's assets are locked up, typically for 10 years, the others aren't. Blackstone is growing, and while T. Rowe Price saw a 9% year-over-year jump in assets under management in the first quarter, BlackRock suffered a 3% fall in the second quarter."

Last word goes to the unnamed Blackstone bull we quoted in our October analysis. "We would argue," he tells Peligal, "that the

Unwarranted discount?



source: The Bloomberg

IRRs of what they're deploying today would be well north of 20%. If you run the numbers and say $4 billion per quarter is being deployed at 20%-plus IRRs—it's a tremendous amount of earnings power that's being built on a quarterly basis. Even though the stock is flat, you have the earnings power growing at a rapid clip. . . . The earnings power from carried interest ranges from zero in really bad times to $3 a [share] in great times. Of course, that great times scenario requires private equity to really kick in. But it doesn't require a lot to get you to $1.50 a share of carried interest."

For which you are currently paying very nearly nothing.

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