

## INVESTMENT DEALER'S DIGEST

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### A Dying Bear

#### *JPMorgan's Takeover of Bear Stearns Offers as Many Questions as Answers*

By Yael Bizouati

Bear Stearns enjoyed a long, storied history, but its end came quickly.

There were the hedge funds' collapse last summer, the "stepping down" and alleged misdeeds of CEO Jimmy Cayne, regulators' investigations into the firm's funds and the mounting criminal and civil law suits alleging its managers conducted massive fraud.

Following the announcement that JPMorgan was acquiring the embattled institution for just \$236 million - and once the market began absorbing the shock - concerns turned to the repercussions of such a transaction. Market participants are questioning the validity of the deal and whether the Fed has set a precedent; the transaction's implications for the broader investment community; its legal consequences and whether other big-name firms might soon go down.

Adding to the complexity of the situation is news that some Bear shareholders are starting to move to try to block the acquisition.

Last week, British investor Joseph Lewis, who owns a 9.4% stake in Bear through his Fla.-based company Tavistock Group, moved to halt the acquisition by teaming up with

Cayne, according to reports. Bear declined to comment.

A source close to Lewis said that he thought a deal at \$2 a share to be derisory to shareholders and he is looking at all of his options."

"People are not thrilled with \$2 a share," the source says. "There are a lot of smart people on both sides in the industry and they're going to seek other options."

Representatives from Tavistock declined to comment. The largest Bear investor, fund manager Barrow, Hanley, Mewhinney & Strauss, which is part of Old Mutual and owns a 9.7% stake, also declined to comment.

Sources close to the deal say, however, that JPMorgan has received "an unprecedented amount of leeway from regulators," which enables it to operate as if the company owned Bear already, although the shareholders' vote hasn't happened yet.

Market sources say the vote will probably happen before the end of the second quarter, but a spokesman for Bear says that it is still to be determined when it will take place. While the standard timeframe from announcement to close for such a transaction

varies from six to eight months, the JPMorgan acquisition should be closed in 90 days.

JPMorgan will most likely retain Bear's "outstanding" prime brokerage, which would help bolster its position, as well as Bear's global clearing and energy businesses, the source close to the deal says. Overlaps are mainly in the investment banking and fixed-income areas. The departments will probably be combined and people will be retained on a "meritocracy basis while jobs will be lost on both sides," the source says, adding that although the process represents a lot of work, it has to be done in a rapid fashion to avoid employees' leaving.

"The deal was done in 48 hours so there wasn't an ability to do a proper due diligence and see the synergies," the source says. "It still needs to be determined what skills and jobs are needed."

Terry Connelly, dean of the Ageno School of Business at Golden Gate University, says Bear's most valuable asset is its core intellectual capital, and JPMorgan will benefit from the firm's securitization market knowledge.

#### How it happened

A combination of factors precipitated Bear's demise. The firm was simply more vulnerable than others, due in part to its over-dependence on one product line - securitization, was not particularly well-liked on Wall Street, and market rumors regarding its illiquidity problems accelerated its downfall.

"Without a ready market to unload its over-weight CMBS positions, it was virtually impossible to value Bear's assets, thus making it too difficult for Bear to access the short-term capital markets," says Evan Flaschen, a bankruptcy lawyer and chair of the financial restructuring group at Bracewell & Giuliani.

The \$30 billion the Fed provided to JPMorgan are for Bear's illiquid securities, namely its CMBS, Alt-A and subprime paper.

"It's not pretty and it will take a while to sell in an orderly way without disrupting the market and by protecting JPMorgan shareholders," the source says.

Although other firms also have large CMBS exposure, they are better diversified and should be able to weather the storm better, he says. "After the market's initial skepticism concerning Lehman Brothers and Goldman

Sachs, for example, their share price jumped when they reported better-than-expected earnings."

Also at work was that a lack of confidence set in just days before the announcement, fueled by a statement Bear released on March 10 denying market rumors regarding the firm's liquidity.

"There is absolutely no truth to the rumors of liquidity problems that circulated today in the market," Alan Schwartz, Bear president and chief executive officer, said in the statement, adding that the firm's balance sheet and capital remained strong.

Don Wojnowski, CEO of New York-based brokerage and investment bank Jesup & Lamont, says Schwartz's comments about the lack of liquidity came at a time when no one was questioning it. "We knew they had issues, that maybe they would sell some assets, but not to this extent. It's a classic case of it being a business of trust."

Other market participants agree.

"The problem is that rumors, typical when panic sets in, have a habit of becoming self-reinforcing, they essentially create a death spiral," says Alex Allen, chief investment officer of London-based fund of hedge funds firm Eddington Capital Management.

In addition, Bear had a reputation of being very difficult, mostly stemming from its position of choosing not to be part of Long-Term Capital Management's bailout effort in 1998. Many on Wall Street view it as a sort of payback.

"It didn't help them in that situation. There was not a lot of weeping," says Dory Wiley, president and co-founder of Dallas-based investment bank Commerce Street Capital and trustee of the Teacher Retirement System of Texas, as well as chair of its alternative assets and investment risk committees.

Wiley was approached about investing in Bear's troubled hedge funds but decided against it. Although he was told they had over-collateralized the loans in the CDOS, it was still bad subprime that was too leveraged and put in a hedge fund format that was too illiquid for the market environment. "You can dress up a pig, it's still a pig," he says.

A quick process

The fact that the transaction was conducted on an emergency basis, preventing Bear to shop itself around, didn't enable other bidders to make offers, although private equity firms JC Flowers and KKR were said to be initially interested. The risks associated with such a transaction significantly narrows the pool of potential parties able to get involved.

"Other PE firms could emerge," Wojnowski says. "And although I haven't heard [Warren] Buffett's name yet, I wouldn't be surprised."

Legally, Bear might be attacked on several fronts and JPMorgan has taken into consideration the problem, setting aside a \$6 billion budget for it.

"JPMorgan's shares went up, so everybody thinks JP got a very good deal," says Fariborz Ghadar, director of the Center for Global Business Studies at Pennsylvania State University. "It will trigger many lawsuits, as investors are not happy."

Last week, law firm Coughlin Stoia Geller Rudman & Robbins filed a lawsuit in US District Court in the Southern District of New York, alleging that the bank misled investors about its financial condition ahead of its stock collapse and had violated federal securities laws.

Several employees and shareholders have contacted law firms, including New York-based Zamansky & Associates.

"We're looking to see whether Bear made misrepresentations about its liquidity and exposure to MBS," says lawyer Jacob Zamansky.

Zamansky already filed a suit in August against Bear following the collapse this summer of its hedge funds - the High Grade Structured Credit Strategies Master Fund and the High Grade Structured Credit Strategies Enhanced Leverage Master. He says the company's collapse will bolster the case of hedge funds investors as in both cases there was a failure to disclose risks.

"They're going to be hit by several suits and there could be very substantial claims," he says. "JPMorgan recognized that by creating the reserve."

In addition, hedge funds that had prime brokerage ties with Bear started to sever them as soon as the rumors started, and even earlier,

when the company's hedge fund problems arose. Those that chose to stay might consider bringing legal action against the firm were they to lose their assets.

Larry Cohen, a partner at New York-based law firm Morrison Cohen, who represents some hedge fund clients whose prime broker is Bear, says those clients are sitting on the fence, wondering if the acquisition will be a good move.

"There is a high level of anxiety, so it's probably prudent to move to an institution they're more comfortable with. In this environment, it makes sense to look at alternative possibilities and see what others have to offer," he says, adding it might be hard to determine who to go with as at this point,

From a damage control standpoint, his clients were told it would be business as usual with respect to the processing of their trades and that a lot of their terms would remain static, But "any prudent hedge fund manager would be reexamining their relationship," he says.

Asked why some funds are still pondering whether to move their securities out of Bear, Cohen says that as the business is relationship-driven, there is a level of understanding and comfort.

"However, money is the ultimate decider. If there is no satisfactory information soon they will move out," he says.

One problem resides in the fact that it is not clear what Bear is doing internally with the funds' assets and whether they are properly segregated. "That money is at risk, which shouldn't be at this stage with Bear not being in bankruptcy and having the capital infusion, but you never know," Cohen says.

A legal source says his hedge funds' clients made informal calls to Bear, but have not received any kind of information so far.

The Bear collapse also puts in perspective the agreements funds have with their prime brokers, he says. "Several of my clients never looked at their prime brokerage agreements, now giving them a cause for concern to revisit a lot of the language, the conditions. People are realizing that these companies are not too big to fail."

The Fed

Although the Fed's move was welcomed by some, others viewed it as setting up a dangerous precedent. Wojnowski's Jesup & Lamont says that although people close to Bear say the firm was forced to enter the deal, it had the desired effect as the markets are performing better and it alleviated market uncertainty. "The Fed has been most accommodating, but whether it's a short-term elixir that we drink too much has yet has to be seen," he says.

Some observers are concerned about the Fed bailing out large financial institutions without imposing conditions to improve their conduct and performance. "Fed Chairman Ben Bernanke and Treasury Secretary Henry Paulson are not up to the task, or last weekend would have turned out differently and they would have made banks clean up themselves," says Peter Morici, a professor at the University of Maryland School of Business.

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Bear Stearns, Start to Finish

1923 Bear Stearns is founded by Joseph Bear, Robert Stearns and Harold Mayer in lower Manhattan.

Oct 1985 Goes public. As of March 2008, company insiders hold 1/3 of Bear Stearns common shares.

June 2001 James Cayne named CEO.

Dec. 14, 2006 Reports record full-year earnings. Net income is \$2.1 billion, or \$14.27 a share, for 2006.

Jan. 3, 2007 Shares trade at \$161 each.

March 15, 2007 Reports earnings of \$3.82 a share for the first quarter, up 8% from year earlier.

May 1, 2007 Bear shares trade at \$155.82 each.

June 26, 2007 Announces it will add more support to its High Grade Structured Credit Fund, a hedge fund managed by Bear Stearns Asset Management.

July 1, 2007 Shares trade at \$143.16 each.

Aug. 1, 2007 Shares trade at \$118.30 each.

Aug 3, 2007 Challenges S&P's decision to change its outlook on Bear. "Contrary to rumors in the marketplace, our franchise is

profitable and healthy and our balance sheet is strong and liquid ... we are confident in Bear Stearns' ability to succeed in this environment as it has in so many others," Cayne says.

Sept. 20, 2007 Reports earnings of \$1.16 a share for the third-quarter, down 62% from a year ago. Cayne says, "I am confident in the underlying strength of our business and proud of the effort and determination displayed by our employees during these challenging times."

Oct. 1, 2007 Shares trade at \$125 each.

Oct. 22, 2007 Bear and CITIC Securities announce strategic alliance. CITIC is to acquire \$1 billion of 40-year Bear convertible trust preferred securities.

Nov. 1, 2007 Shares trade at \$107.94 each.

Dec. 3, 2007 Shares trade at \$98.40 each.

Dec. 20, 2007 Reports net income of \$233 million for the year, compared with \$2.1 billion for year ended November 2006. "We are taking appropriate measures to position Bear Stearns for renewed profitability in 2008," says

Cayne, adding that members of the executive committee will not receive bonuses for 2007.

Jan 8, 2008 Alan Schwartz named chief executive officer. Cayne remains chairman.

Jan 15, 2008 Michael Minikes named CEO of Bear Stearns Securities Corp. and Robert Upton assumes title of treasurer of Bear Stearns.

Feb. 29, 2008 Shares trade at \$79.86 each.

March 12, 2008: Schwartz acknowledges volatility in the market, but denies liquidity problems at company.

March 14, 2008 JPMorgan provides Bear Stearns with a secured loan for up to 28 days. Schwartz says in a statement that Bear's "liquidity position in the last 24 hours had significantly deteriorated."

March 14, 2008 Shares trade at \$30 each.

March 16, 2008 JPMorgan announces acquisition for \$2 a share. The Fed agrees to fund up to \$30 billion of firm's less liquid assets.

March 17, 2008 Shares trade at \$4.