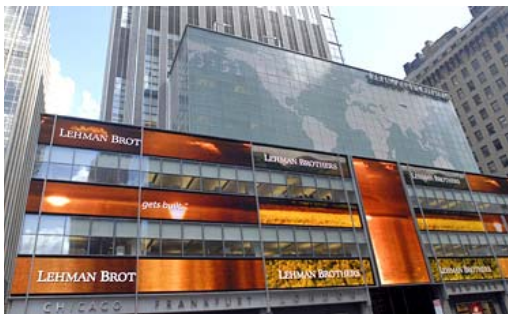
The Debt Shuffle

by Jesse Eisinger Mar 20 2008

Wall Street cheered Lehman's earnings, but there are questions about its balance sheet.



Bear Stearns (http://www.portfolio.com/resources/company-profiles/1221) **collapsed (/guides/Bear-Stearns-Collapse)** for two reasons. It had a short-term funding crisis where lenders pulled their loans and customers pulled their cash. But it also had a longer-term leverage problem. Last week's crisis didn't happen in a vacuum; that leverage eventually led to the collapse in confidence.

After the collapse, Wall Street's attention naturally turned to the other investment banks, especially **Lehman Brothers (http://www.portfolio.com/resources/company-profiles/2718)**, perceived as the most vulnerable. So, investors were thrilled when Lehman topped earnings expectations on Tuesday—as the firm took pains to reassure the markets that it has plenty of cash to ride out the turbulence.

Yet aside from a smattering of attention here and there, investors and the media mostly overlooked the balance sheet. In other words, they forgot what happened mere hours earlier with Bear Stearns. Wall Street's short-term memory is notoriously lousy, but this must set a record. (Could Jimmy Cayne be sharing his stash with his hedge fund buddies?)

What actually happened to Lehman's balance sheet in the first quarter? Assets rose. Leverage rose. Write-downs were suspiciously minuscule. And the company fiddled with the way it defines a key measure of the firm's net worth. Let's look at the cautionary flags:

Lehman's balance sheet isn't shrinking, as we'd expect.

Lehman finished the first quarter was total assets of $786 billion, up almost 14 percent from the previous quarter and 40 percent from a year earlier. Other financial institutions are taking down their exposure right now amid the market turmoil to be prudent. Lehman says it wants to. It is not.

Lehman got more leveraged, not less.

The investment banks "gross" leverage hit 31.7 times equity, up from the fourth quarter and way up from last year's 28.1. According to Brad Hintz, an analyst with Bernstein Research, Lehman's leverage reached its highest point since 2000. Lehman, like all the investment banks, prefers to look at net leverage, excluding hedges, and that went down. And the firm says that the asset rise was mainly a result of increases in short-term items that have low risk. But we've heard a lot of that lately across the financial world. It's quite simple: The more leverage Lehman has, the less room assets have to fall to wipe out its equity.

Lehman includes debt in its calculation of equity. Say what?

It's always worrisome when a company changes a key definition of a closely watched measure of financial performance. In a note in its earnings release, Lehman said it has a new definition of "tangible equity," or the hard assets that it has left over after subtracting its liabilities. This is a measure of net worth, the yardstick by which investment banks are valued. Lehman's new definition allows for a higher portion of long-term subordinated borrowings (which it calls "equity-like") in tangible equity. Previously, it had a cap on the percentage of "perpetual preferred stock," a form of equity-like debt that doesn't have a maturity date, in its equity. Now, it doesn't have a cap. Think of it this way: If you borrow money from your parents to make your down payment on your house and they don't expect to get paid back right away (at least not before you pay your mortgage off) is it equity in your house? No, it's a loan. And Lehman hasn't borrowed from mommy and daddy.

Lehman says it is merely conforming to the Securities and Exchange Commission's definition of tangible equity and had contemplated making the change for a while. And the firm says the change didn't result in any difference to its net leverage ratio.

Lehman reaped substantial earnings gains because investors thought it is more likely to go bankrupt.

For several quarters, all the investment banks have been taking gains on their liabilities. Say you owe $100 to your friend. But you run into severe problems and your friend starts to figure you can only afford to pay back $95. If you were an investment bank, the magic of fair value accounting dictates that you could get to reduce your liability. What's more, that $5 gain gets added to earnings. Because investors thought Lehman was more likely to default, its liabilties fell in value and Lehman garnered earnings from this. How much did Lehman win through losing? $600 million in the quarter. How much was its net income? $489 million.

Lehman and all the other investment banks are following the accounting rules on this, but that $600 million is hardly the stuff of quality earnings. Indeed, Bernstein's Hintz called the bank's earnings quality "weak."

Lehman's write-downs seem tiny.

Lehman finished the quarter with $87.3 billion of real estate assets. These include residential mortgages and commercial real estate paper. The bank only wrote these assets down by 3 percent. And its Level III assets —the hardest to value portion of these instruments—were written down by only the same percentage. The indexes and publicly traded instruments and companies that serve as proxies for these securities generally fell more than that in the quarter. Lehman points out that took larger gross write-downs and then made money through hedges, for a smaller net number.

Lehman remains exposed to lots of dodgy mortgages, including a group labeled: "Prime and Alt-A." Prime mortgages represent loans to good quality borrowers; Alt-A loans go to borrowers a mere step up from subprime, and represent an area with almost as many problem loans as subprime. The total amount of such mortgages on Lehman's balance sheet was $14.6 billion in the first quarter and it actually rose from $12.7 billion in the previous quarter. Is this the time to be increasing exposure to questionable mortgages? More ominously, only $1 billion of that figure is prime and the rest is Alt-A, according to Hintz's estimate.

The picture emerging is that of an investment bank that is dancing as fast as it can. If Lehman can keep piling up more assets, and if these assets come back, Lehman comes out a big winner. But if it didn't properly mark down those assets during these bad times, the investment bank's returns —and therefore its profitability—will be much lower in the future.

And that's the good case. If the assets do not recover, then time is against the firm.

There is a larger, monetary policy issue here. The Federal Reserve has announced that it will lend to investment banks for the first time since the Depression, acting as a lender of last resort. At the very least, regulators should be demanding that the investment banks bring down their leverage and reduce their risk. Are the regulators sending a stern-enough message to Lehman? If so, it's not getting through.

See our in-depth coverage of Bear Stearns' collapse. (http://www.portfolio.com/guides/Bear-Stearns-Collapse)

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