

SKBA CAPITAL MANAGEMENT

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After the Financial Crisis – What Will Be the Earning Power of Financial Companies?

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Summary & Conclusions

Someday, the current financial crisis will be behind us. But the landscape of companies in the financial sector and other sectors will be quite different. From the public realm, the most notable absence will be among investment banks, as the industry has been decimated in this crisis with the bankruptcies of Bear Stearns, Lehman Brothers, the merger of Merrill Lynch into Bank of America, and the conversion of Goldman Sachs and Morgan Stanley into commercial banks. In addition, there have been numerous bankruptcies among banks, or the equivalent of this, as Washington Mutual and Wachovia were each experiencing classic runs on deposits as frightened customers withdrew billions of dollars in savings. They were headed to bankruptcy if they had not been rescued by acquisition. Furthermore, Fannie Mae and Freddie Mac, while still having some public equity outstanding, are in conservatorship and will likely NEVER reemerge with the reported earnings and profit margins (fictional or real is a source of debate) they earned in their heyday.

And the bankruptcy parade is probably not over. So why bother to talk about the shape of such an uncertain future for financials and the sector's contribution to overall corporate earnings? Indeed, we doubt that even over the next decade, corporate financial sector earnings will recover back to the peak of 2006! The reason is many stock prices of financial sector companies appear to be washed out. And the way to recovery in Main Street cannot occur without the

recovery in the financial sector. We will enumerate the reasons why in the body of this report. In summary, however, these issues are in focus for us as we analyze and humbly attempt to forecast the future:

1. The Shadow Banking System is swiftly contracting and, with the consolidation of highly leveraged companies (i.e., 30 to 1 asset to equity ratios), leverage ratios of roughly half this level will result in a decline in the industry's overall ROA (return on assets).
2. With the desperate need for equity capital, equity issuance, particularly high coupon preferred issues with accompanying warrants to purchase common equity at depressed prices, is enormously dilutive to the common shareholder.
3. Therefore, as one analyzes the seemingly "cheap" price of some depressed stocks, such valuation measures are on a foundation of shifting sand. Until one gets down to bedrock (surviving real capital and earning assets), one cannot be sure what eventual earning power will be.
4. And at the same time, all is not lost. Even without the earnings contribution from the Shadow Banking System, financial companies who possess fortress-like balance sheets and the capital bases to invest will be rewarded with extraordinarily high risk-adjusted net interest margins for several years

post crisis. This starts with a select group of banks; these are the ones that the Federal Reserve Board and the Treasury turn to when they need a private company to rescue another institution on the brink of bankruptcy.

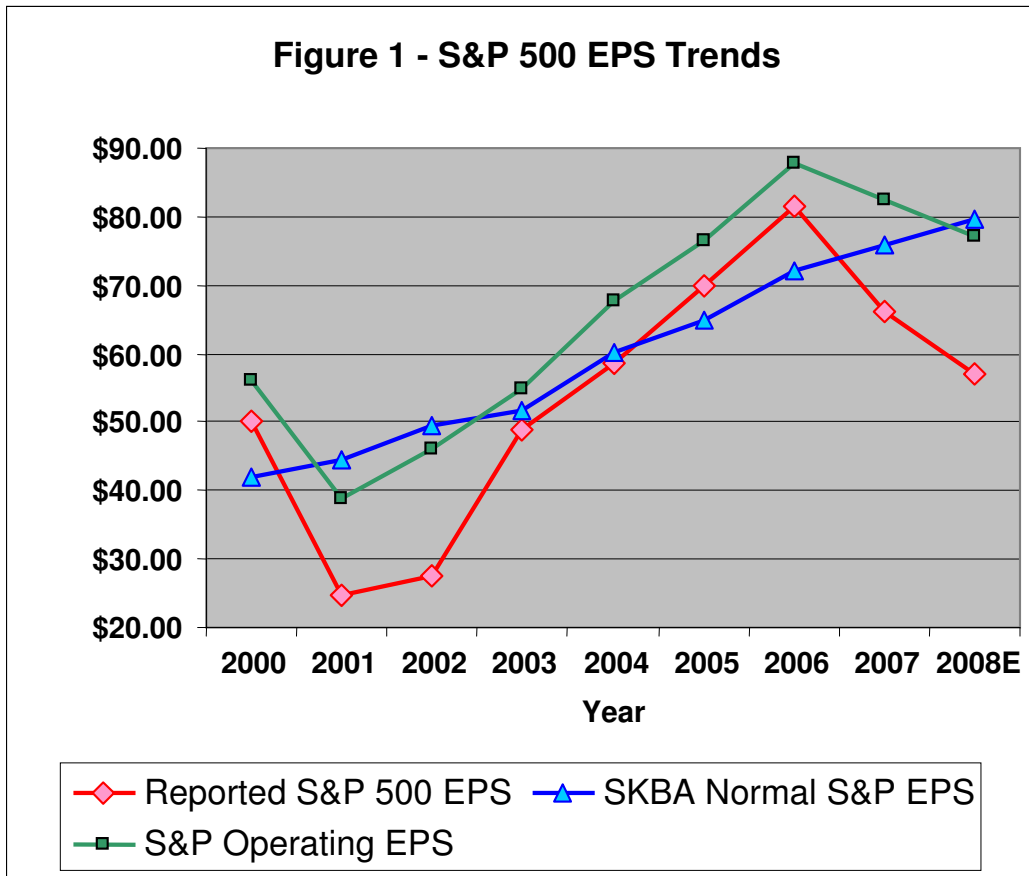
This silver lining keeps us interested in the sector when the world remains gripped in fear.

SKBA’s View of Normal S&P Earning Power

One cannot make sense out of valuation attraction by simply looking at reported earnings. Our research attempts to understand

the underlying profitability characteristics of individual companies and the index aggregates as a whole. This is a dynamic process, but not one subject to the daily whims of market sentiment.

Starting from the perspective of the S&P 500 as a whole, Figure 1 below illustrates SKBA’s view of what the earning power of the S&P represents relative to what were both the reported earnings of the index and the bottom up calculation of “operating” earnings (which excludes all of those “non-recurring” restructuring charges).



Source: S&P/Compustat data and SKBA estimates

As can be seen in Figure 1, the S&P 500 has experienced huge cyclical volatility in reported earnings. After reaching \$50 per share in 2000, reported earnings plunged about 50% to the 2001-2002 economic recession trough. Then, EPS surged to over \$80 in 2006, and over a year ago, many forecasters had been expecting nearly \$100 by now. Yet 2006 turned out to be the peak for this cycle and, with the decimation of financial sector earnings combined with the contraction in non-financial, non-energy profit margins, S&P earnings will be lucky to fall only to around \$57 in 2008. If the market were to decide that this level

is the new norm for the S&P's earning power, the trough valuation of the market might be as low as \$700-\$800! That's a long way to go from today's roughly \$900 index level. We don't believe this is likely, however.

Market forecasters more often focus on "operating earnings" than reported earnings, but we have not believed that this is an appropriate measure of earnings for calculating valuation attractiveness through P/E ratios for example. The reason is those "non-recurring" restructuring charges seem to recur all too often! Obviously this statement reflects our basic skepticism of operating earnings calculations, which are non-GAAP based and subject to the greatest manipulation of interpretation. So part of the market's overvaluation problem from 2007 came with the optimism about the supposed uptrend in and level of operating earnings. Yet in our view, operating earnings materially overstated normal earning power leading to huge earnings disappointments when both reported and operating earnings began to plunge in 2007.

In contrast, we do not share the belief that today's earning power of the S&P 500 is as low as 2008 reported earnings are likely to fall. Based on our combination of top down macro perspectives and bottom up analysis of individual company earnings (that included expensive stock options in normal earning power when companies were only required to disclose the cost in footnotes and assessing that some of the supposed non-recurring charges were actually likely to recur regularly), Figure 1 shows SKBA's estimates on an as-was basis of the normal earning power of the S&P 500 each year this decade. This process has allowed us to avoid getting caught up both in the pessimism of 2001-2002 and the excessive optimism of 2006 and 2007 (pre crisis). Our estimates suggest the S&P 500 normal earning power should rise from just below \$40 in 2001 to near \$80 in 2008. This level of earnings would suggest that if the economy could avoid recession, the S&P 500 is at worst cheaply valued!

Yet, the composition of these earnings has changed dramatically, primarily due to the rise in normal energy prices and to the contraction in financial sector earning power. Figure 2 displays our view of the earnings and trendline (or normal) earnings contributions of each of the ten GICS (S&P's global industry classification scheme) sector groupings for 2006 and 2007. Here are the key observations to note about the difference between reported earnings and SKBA's estimates of normal earning power:

1. In 2006, the reported earnings of the S&P 500 exceeded SKBA's normal earning power by \$107 billion! While every sector except health care reported above-trend earnings, \$43 billion of the above-trend earnings (see red highlighted section for 2006) came in the financial sector earnings! This huge difference is one reason we became more cautious about the sector's outlook in early 2007 – loan loss reserves were simply too low for the risks being taken, derivative books were too big and balance sheets were too highly levered.
2. In our analysis of 2007 reported earnings, financials took loan loss reserves or mark-to-market losses of more than \$100 billion, and reported earnings plunged 43% from \$217 billion to near \$125 billion. Yet by year end, the addition of capital to offset loan losses could already be seen to be highly dilutive to common shareholders. Also, the inevitable (in SKBA's view) shrinking of the Shadow Banking System would take away earning power from the sector, mostly from investment banking activities. As a result, we cut our assumption of the normal earning power of the sector by 19% from \$175 billion to \$142 billion for 2007. This was our best assessment of the relatively permanent effect these fundamental changes would have on earning power.
3. 2008 has seen no let up in the pressure on financial sector earnings and, with massive reserves, dilutive capital additions, and the impact of conservatorship or bankruptcy, financial sector aggregate earnings will be lucky to stay above \$60 billion, which would represent more than 50% decline in reported earnings.
4. Note our view on a few other sectors. We raised our view of the earning power of the energy sector for 2007 by 19% from 2006 due to our belief that the central tendency price of oil had risen

to the \$80-\$90 range. The huge restructuring charges taken in the consumer discretionary and telecommunications sectors pushed each into reported losses in 2007, an even worse performance than for financials. Yet on the basis of our evaluation of normal ROEs and earning power for these sectors, their earning power in 2007 was \$48 billion and \$25 billion above the dismal losses they reported in 2007. Main Street didn't do well in 2007 either.

Figure 2
SKBA Normalized Earnings Forecasts Versus S&P 500 Reported Earnings*

<u>2007 Base Year</u>	<u>Current</u>	<u>Current</u>	<u>Trend -</u>	<u>% Reported</u>	<u>% Change</u>	
	<u>Composition</u>	<u>Composition</u>		<u>Above or</u>	<u>2007 vs 2006</u>	<u>Reported</u>
	<u>S&P500 Trend</u>	<u>Reported</u>	<u>Reported</u>	<u>Below Trend</u>	<u>Trend</u>	<u>Reported</u>
Consumer Discretionary	\$ 61,781	\$ 13,758	\$ 48,023	-77.7%	-4.1%	-76.2%
Consumer Staples	\$ 71,318	\$ 75,520	\$ (4,202)	5.9%	7.1%	8.8%
Energy	\$ 110,173	\$ 126,775	\$ (16,602)	15.1%	19.3%	3.7%
Financials	\$ 142,456	\$ 124,998	\$ 17,457	-12.3%	-18.5%	-42.6%
Health Care	\$ 73,107	\$ 67,021	\$ 6,086	-8.3%	10.8%	9.9%
Industrials	\$ 76,774	\$ 81,068	\$ (4,294)	5.6%	15.7%	-0.9%
Information Technology	\$ 75,522	\$ 84,666	\$ (9,144)	12.1%	15.8%	4.6%
Materials	\$ 21,300	\$ 23,156	\$ (1,856)	8.7%	26.0%	-4.8%
Telecommunication Services	\$ 18,657	\$ (6,865)	\$ 25,522	-136.8%	17.7%	-142.2%
Utilities	\$ 21,216	\$ 27,025	\$ (5,809)	27.4%	5.5%	11.8%
Total S&P 500 Profits - Current Composition 2007	\$ 672,302	\$ 617,122	\$ 55,180	-8.2%	3.7%	-18.3%
Aggregate S&P 500 Profits as Originally Reported		\$ 587,230				
2007 Per Share	\$ 75.77	\$ 66.18	\$ 9.59	-12.7%	5.2%	-21.1%
<u>2006 Base Year</u>	<u>As Was</u>	<u>As Was</u>	<u>Trend -</u>	<u>%</u>		
	<u>Composition</u>	<u>Reported</u>		<u>Above or</u>	<u>Below Trend</u>	
	<u>S&P500 Trend</u>	<u>Reported</u>	<u>Reported</u>	<u>Below Trend</u>		
Consumer Discretionary	\$ 64,400	\$ 57,845	\$ 6,555	-10.2%		
Consumer Staples	\$ 66,609	\$ 69,431	\$ (2,822)	4.2%		
Energy	\$ 92,366	\$ 122,250	\$ (29,884)	32.4%		
Financials	\$ 174,819	\$ 217,799	\$ (42,980)	24.6%		
Health Care	\$ 65,968	\$ 60,964	\$ 5,005	-7.6%		
Industrials	\$ 66,358	\$ 81,783	\$ (15,425)	23.2%		
Information Technology	\$ 65,235	\$ 80,941	\$ (15,706)	24.1%		
Materials	\$ 16,904	\$ 24,322	\$ (7,418)	43.9%		
Telecommunication Services	\$ 15,854	\$ 16,278	\$ (424)	2.7%		
Utilities	\$ 20,108	\$ 24,168	\$ (4,060)	20.2%		
Total S&P 500 Profits - As Was Composition 2006	\$ 648,619	\$ 755,778	\$ (107,159)	16.5%		
Aggregate S&P 500 Profits Reported		\$ 758,031	As Reported for 2006			
Per Share - Current Composition 2006	\$ 72.01	\$ 83.91	\$ (11.90)	16.5%		

*Source: S&P/Compustat Data & SKBA Estimates

Using the current composition of companies in the S&P 500 (as of April 2008), the overall earning power of the S&P 500 for 2007 was nearly \$10 above the reported level and, in our estimation, for 2008, earning power could be more than \$20 higher than reported EPS. And normal earning power could well be above operating earnings, something that rarely happens. If reported earnings are likely to begin to return toward these trend-line levels of earning power in late 2009 or 2010, than the stock market, and the financial sector in particular, could face a sizeable improvement in valuation.

While the winners in this process cannot be clearly identified, we do believe the major banks will initially display the greatest earnings gains. The companies are deposit-based institutions, not nearly as dependent upon securities markets to fund lending activities. They will reap the benefit of the extremely high risk-adjusted net interest margins that are likely to persist for several years, and they are the ones that have had the financial wherewithal to assist the U.S. Treasury and Federal Reserve Board in rescuing troubled institutions. As a result, they are inside the Fed's "protective fence" and will not be allowed to fail

regardless of the length of the financial crisis. With something on the order of \$120-\$140 billion in earning power (“cleaned” of all the past accounting manipulations from derivatives investments) to be recaptured by the sector, these companies will not be the only winners, however, and these higher quality earnings will command a much higher P/E ratio than we have seen this decade. We will be on the look out for companies who are transforming themselves to be successful in this new environment.

Disclaimer: The analysis and opinions expressed in this report are subject to change without notice. They do not represent a buy or sell recommendation and should not be viewed as a promise of future performance.