INSEAD

J.P. Morgan Chase & Co.

06/2001-4960

This case was written by Shantanu Chakraborty, under the supervision of Ingo Walter, Professor at Stern School of Business, New York University and Visiting Professor at INSEAD. It is intended to be used as a basis for class discussion rather then to illustrate either effective or ineffective handling of an administrative situation.

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"There goes another big one!" said John Till, a senior banking analyst at Fidelity Investors in September 2000. He was speaking on the telephone to one of his colleagues who, like himself, made strategic investment recommendations to the portfolio managers. Chase Manhattan Corporation (CMB) and J.P. Morgan & Co. Inc. (JPM) had announced that they had agreed to merge to form J.P. Morgan Chase & Co. in a transaction valued at US$33 billion. "A few years ago you never would have thought that the great J.P. Morgan could be on the block, but there you are." Roses can fade fast on Wall Street when the rules of the game shift.

The deal was the third in a series of giant Wall Street mergers announced in just two months. Donaldson, Lufkin & Jenrette (DLJ) was bought by Crédit Suisse First Boston for about US$11.5 billion (3 times book value) and PaineWebber was acquired by the other giant Swiss universal bank, UBS, for about US$10.8 billion (3.4 times book value). The market had been abuzz for months with rumors of a possible acquisition of JPM by a number of potential suitors (including Deutsche Bank, HSBC, Merrill Lynch and Chase), so the actual announcement brought some closure to the situation. Commentators suggested that even Morgan, once the most respected bank in the United States, had at last realized that it was not possible to go it alone in an era of an apparent return to universal banking and financial conglomerates. In this environment greater size and scope would be critical.

Fidelity had a substantial stake in JPM and in its various funds. As John thought generally about the industry trend toward consolidation, and about the JPM-CMB merger in particular, the question uppermost in his mind was, "Does this merger really have the potential to create value for both companies' shareholders?" John had recommended an investment in JPM shares exactly one year earlier, in September 1999, when the stock price was at about US$118. Since then, the shares had risen to about US$175, an annualized gain of 48%. Barring the astronomical returns on some tech stocks, this was a reasonably handsome gain in relative terms, and John was pleased with his recommendation. Still, he knew that the recent spike leading to the high return on paper was more due to merger rumors than to Morgan's own performance. He was however, not sure whether this announced merger would add any further value to JPM shareholders, who would receive 3.7 shares in the new JP Morgan Chase for each share of JPM.

Chase

CMB was a broadly diversified global banking and financial services company, and conducted its business through various bank and non-bank subsidiaries, including:

1. The Chase Manhattan Bank, - a New York bank holding corporation.
2. Chase Manhattan Bank USA, National Association, - a national bank.
3. Chase Securities Inc., - a securities dealer engaged in all aspects of investment banking.

CMB's activities were internally organized into the following major business franchises:

1. National consumer services (retail banking and credit cards).
2. Investment banking.

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3. Private equity investments through Chase Capital Partners.
4. Global services (information and transaction processing).
5. Wealth management and private banking.

Morgan

JPM was a leading global financial services firm that operated in the following primary business segments:

1. Bank credit markets.
2. Corporate finance (M&A) advice.
3. Equities and equity investments.
4. Interest rate & currency markets.
5. Asset management services.
6. Proprietary trading.

The key financial information and other statistics for the two companies are provided in Exhibit 1.

The Transaction

Both JPM and CMB had been struggling to establish themselves in the securities underwriting and M&A advisory businesses, - areas that were clearly more profitable than traditional commercial banking. CMB had never made a secret of its desire to buy an equities franchise to complete the line-up of its wholesale and investment banking operations. In its bid to strengthen equities underwriting CMB - the product of a combination over several years of the old Chase Manhattan Bank, Chemical Bank, and Manufacturers Hanover Trust Co. - chose a path of successive acquisitions (Hambrecht & Quist, Beacon Group and Robert Fleming) to strengthen its investment banking capabilities. Even still, it had not been able to break into the top-10 in the equity underwriting or M&A business.

JPM's future, on the other hand, had become increasingly uncertain. Its costly transformation from a commercial bank into an investment bank failed to bear as much fruit as had been anticipated. Despite a stellar client list, Morgan found it very difficult to compete in these areas. Its tradition of wholesale banking, lack of relationships with 'new economy' companies, and insignificant presence in the retail segment, all mitigated against it. JPM's stock price reflected the firm's disappointing performance. Once the most valuable bank in America, its capitalization fell to the US$30 billion range, far short of its onetime peers such as Citigroup (US$247 billion at December 2000). Amidst takeover speculation, its stock had already seen a gain from about US$110 in early July to US$177.75 on September 12, 2000, the day of the merger announcement. From that perspective, J.P. Morgan's sell-out was not surprising.

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As the press release issued jointly by the companies boasted, the JPMC combination (Exhibit 2), would create an organization with unparalleled client base, global capabilities and product leadership in growth markets. The merger envisaged an all-stock offer by Chase that valued each JPM share at US$207 based on the pre-announcement CMB share price of US$56.06 - a premium of about 16% over the pre-announcement market price of JPM.

Strategic Considerations[1]

Complementary Strengths in Clients, Geographies and Products

The addition of Chase's non-investment grade clients, middle-market clients and clients engaged in 'new-economy businesses' to J.P. Morgan's existing client base (comprising mainly blue-chip, investment grade companies) was to provide increased opportunities for cross-marketing the combined company's product array. The newly merged firm would thus be a globally-balanced wholesale financial services company (see Exhibits 3-6).

It would also have a total of US$720 billion of assets under management, ranking it as the second largest active asset manager in the US, behind Fidelity Investments. These assets would be highly diversified being comprised of: 52% equities, 25% fixed income, and 23% cash and other classes. They would also be spread geographically (US 65%; outside US 35%), as well as by client type (institutional investors 60%; private clients 40%), (see Exhibits 7-9).

The merger would create a firm with leading positions in fixed income underwriting / trading, syndicated lending, risk management products, private equity, asset management and private banking, as well as custody, asset management and several areas of retail banking (see Exhibit 10).

The post-merger league tables in the various areas of operations of the two firms are provided in Exhibits 11 and 12.

Greater Diversification of Business Lines

The combined company would be broadly diversified to encompass an array of financial services businesses, which could be expected to provide a more stable revenue stream than those experienced by a pure wholesale bank.

Enhanced Scale and Global Reach

The combined company would be among the top five global financial institutions in terms of market capitalization (at about US$95 billion), and among the top three in the US, after Citigroup and Morgan Stanley Dean Witter.

1 The following section is based on the Joint Proxy Statement / Prospectus issued by the companies.

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Synergies and Cost Savings

On a pre-tax basis, the cost savings and incremental revenue accruing to the combined entity, two years on, are estimated at US$1.5 billion and US$400 million, respectively.

J.P. Morgan fully diluted shares	186 million
Exchange ratio	3.7x
Chase shares issued	688 million
Chase consensus EPS (a)	US$4.00
Required earnings from J.P. Morgan	US$2.8 billion
J.P. Morgan 2000 cons. earnings (a)	US$2.1 billion
Required break even synergies	**US$0.7 billion**
Expected Synergies:	
Incremental revenue (gross: US$1 billion), net of incremental expenses	US$0.4 billion
Cost Savings	US$1.5 billion
Expected Synergies (pre-tax)	US$1.9 billion
Expected synergies (post-tax)	**US$1.2 billion**

Already, the two merging banks had made significant progress. Fee income had attained almost 70% of total earnings (Exhibit 13) while efficiency and credit problems of both banks had recently improved substantially (Exhibits 14 and 15). This progress had contributed to pushing combined return on equity above 20% (Exhibit 16).

Merger Issues

As John was pondering his next move, a number of questions came to mind.

1. Integration processes in such a merger could be a Herculean challenge with significant overlap in areas such as fixed income and trading, as well as duplicate offices in various international locations. John had heard that as many as 10,000 employees in the combined entity could lose their jobs. What impact would that have on employee morale? What would the challenges be in areas such as systems integration? Of course, Chase (i.e., the old Chemical Bank) did enjoy a reputation for carrying out mergers smoothly in the past, but to do so this time they would have to move very quickly in order to minimize any uncertainties and disruptions in operations.

2. What if the anticipated revenue synergies and cost savings are not achieved? The US economy and its financial markets, after the most sustained period of economic growth in modern history, were beginning to show signs of weakness. Would this trend act as a hindrance to achieving the projected revenue gains?

3. How would the market react to the near-term dilution of Chase's earnings per share as a result of the merger?

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4. How big was the risk caused by the diversion of both companies' management from other strategic priorities to implementation of the merger integration efforts?

John also wondered how this merger would affect other smaller players such as Lehman Brothers and Bear Stearns. Would pressure on them to sell out and become part of larger financial services giants increase? With the global financial services industry converging at a frenetic pace, surely these firms would not want to be left out. Did ongoing developments validate the financial-conglomerate strategy initiated and pursued most aggressively by Sandy Weill`s Citigroup? And what about larger securities firms such as Goldman Sachs and Merrill Lynch, who had hitherto steered clear of commercial banking and insurance businesses? It was already becoming clear that traditional pure-play securities firms with limited capital were facing difficulties in providing debt financing and other financial commitments to larger clients (Exhibits 17 and 18).

As he was driving to his office after the JPM Chase merger announcement, John knew that he had to decide soon whether he should recommend holding on to Fidelity JPM stakes or to exit them immediately. He knew he was already late in making his decision. Immediately after the announcement the day before, CMB stock had dropped 9.6% to about US$51 per share from its earlier close of US$56 (even as JPM moved up to US$181.5 from its earlier close of US$177.75), thus in effect reducing the value of a JPM share to US$187.5 at the proposed exchange ratio of 3.7 shares

Case Questions

1. Do you think this combination will create or destroy value for shareholders? What is the probability that positive net economic value will emerge from it?

2. What are the sources of value creation for shareholders in this transaction, if any?

3. How long will it take for any enhanced values to be realized?

4. What are the likely repercussions of the merger in terms of the cultural fit between the two companies? What will be the implications of the potential downsizing in areas of overlap?

5. How is the merger likely to impact the process of further consolidation in the financial services industry?

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Exhibit 1

Chase Manhattan Corporation and J.P. Morgan – Key Financial and Operating Information
(at year ended December 31, 1999 in US$millions except where stated)

	Chase Manhattan Corporation	**J P Morgan**	**Combined Company**
Net Interest Income	8,744	1,541	10,285
Non-Interest Revenue	13,473	7,140	20,645
Net Income	5,446	2,055	7,501
Weighted avg. common shares outstanding (million)			
Basic	1,243.2	181.0	-
Diluted	1,285.5	194.4	-
Earnings per share ($)			
Basic	4.32	11.16	-
Diluted	4.18	10.39	-
Total Assets	406,105	260,898	667,003
Total Stockholders' Equity	23,617	11,439	35,056
Return on equity	23.7%	17.6%	21.7%
Return on Assets	1.47%	0.79%	1.13%
Book value per share ($)	18.29	57.83	-
Dividends paid per share ($)	1.09	3.97	-
Market price per share ($) at 21 September 2000	161.75	45.69	-
Market capitalization (at 21 September 2000)	56,774	25,665	82,439
Employees	74,801	15,512	90,313

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Exhibit 2
Excerpts from Press Release

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Chase and J.P. Morgan Agree to Merge

New York, September 13, 2000 -- The Chase Manhattan Corporation (NYSE: CMB) and J. P. Morgan & Co. Incorporated (NYSE: JPM) today announced that they have agreed to merge. The merged firm will be named J.P. Morgan Chase & Co. Leveraging premier brands and comprehensive capabilities across an unparalleled client franchise, J.P. Morgan Chase & Co. will be a formidable global competitor in financial services, positioned for superior growth and profitability.

The merged company will have assets of approximately US$660 billion and stockholders' equity of more than US$36 billion. On a pro-forma basis, J.P. Morgan Chase & Co. in 1999 would have had net income of approximately US$7.5 billion and revenues of approximately US$31 billion.

The merger agreement, which has been approved by the boards of directors of both companies, provides that 3.7 shares of Chase common stock will be exchanged for each share of J.P. Morgan common stock. Each series of preferred stock of J.P. Morgan will be exchanged for a similar series of preferred stock of Chase, the surviving corporation of the merger. The transaction is expected to be accounted for as a pooling of interests and to be tax-free to J.P. Morgan and Chase stockholders. Based upon Chase's closing price yesterday, the transaction would have a value of approximately US$207 for each share of J.P. Morgan common stock.

The wholesale business will be known globally as J.P. Morgan and will encompass investment banking (including strategic advisory, equity and debt capital raising, credit, and global trading and market-making activities), operating services, wealth management, institutional asset management and private equity. The retail business will be known as Chase, consisting of credit cards, regional consumer banking in the New York tri-state area and Texas, mortgage banking, diversified consumer lending, insurance and middle-market banking.

Douglas A. Warner III, Chairman and CEO of J.P. Morgan, will become Chairman of J.P. Morgan Chase & Co. and co-Chair of the firm's Executive Committee, its senior policy making management group, comprised of senior executives from both Chase and J.P. Morgan. William B. Harrison, Jr., Chairman and CEO of Chase, will become President and CEO of J.P. Morgan Chase & Co. and co-Chair of the Executive Committee. In addition to Messrs. Warner and Harrison, the Board of Directors of J.P. Morgan Chase & Co. will consist of eight members from the current Chase board and five members from the current J.P. Morgan board.

"This merger is a breakthrough for J.P. Morgan and Chase that will position the new firm as a global powerhouse," said Mr. Warner. "With a formidable client franchise and a potent array of capabilities to address the full spectrum of clients' needs, we see exceptional prospects for sustained growth and profitability. A diversified revenue stream enhances those prospects. And our clients will find a common commitment to high standards of integrity, excellence and service."

Mr. Harrison said, "This transaction combines the most comprehensive group of clients with extensive financial and intellectual capital. We will have the capability to meet our clients' needs anywhere in the world with trusted advice and integrated execution. Our new firm will have leadership positions across a broad array of businesses in growth markets."

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Exhibit 2 (Cont'd)

"Our past mergers have demonstrated that the expansion of product capabilities applied to a complementary set of clients results in incremental revenue growth. Expense savings will also result as we combine duplicate functions. As in the past, we will focus on a smooth integration and make the new organization the best of both," said Mr. Harrison.

The members of the Executive Committee, reporting to Mr. Harrison, will be: Geoffrey T. Boisi, David A. Coulter, Ramon de Oliveira, Walter A. Gubert, Thomas B. Ketchum, Donald H. Layton, James B. Lee, Jr., Marc J. Shapiro and Jeffrey C. Walker. Gubert will be chairman of the J.P. Morgan investment bank. Messrs. Boisi and Layton will be co-CEOs of the investment bank and coordinate all of the wholesale banking activities. Mr. Lee will head the investment bank's new business and commitments committees, working with many of the firm's most important clients on new business initiatives. Mr. de Oliveira will head the institutional asset management and wealth management businesses.

Mr. Coulter will continue to head the retail business of the firm and lead its Internet initiatives. Mr. Walker will continue as head of the new firm's private equity group. Mr. Shapiro will continue in his present capacity as head of finance, risk management and administration. Mr. Ketchum will co-chair the merger transition team with Mr. Shapiro. In addition, Denis J. O'Leary and Nicolas S. Rohatyn will co-head the combination of Chase.com and LabMorgan, reporting to Mr. Coulter.

The merger is expected to result in synergies of approximately US$1.9 billion (pre-tax), consisting of estimated cost savings of approximately US$1.5 billion (pre-tax) and estimated incremental net revenues of approximately US$400 million (pre-tax). The synergies are anticipated to be achieved by the end of the second year following the merger, with one-third estimated to be realized in the first year. It is anticipated that the merger will result in costs of approximately US$2.8 billion (pre-tax), a portion of which will be taken as a charge upon closing.

The deal is expected to close in the first quarter of 2001 and is subject to approval by shareholders of both companies, as well as by U.S. Federal and state and foreign regulatory authorities.

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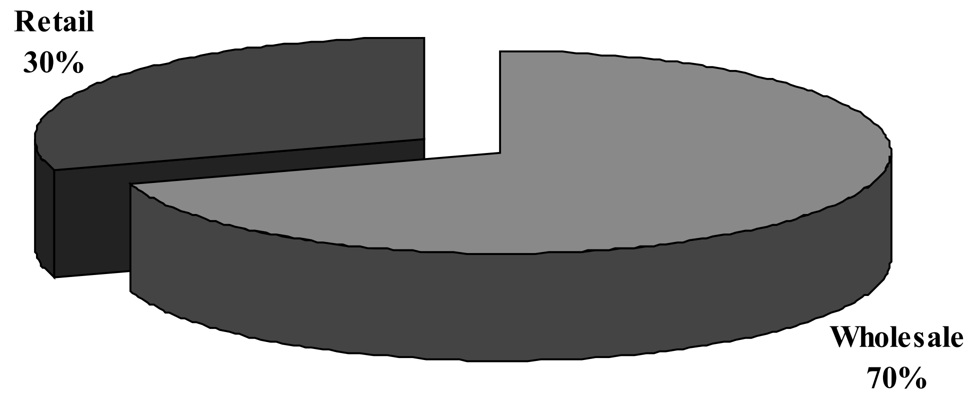
Exhibit 3
Pro Forma Total Revenue Composition



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Source: CSFB Company Reports.

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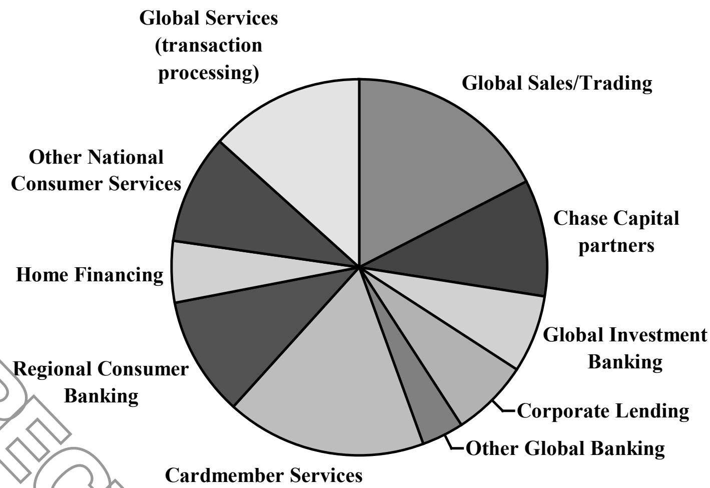
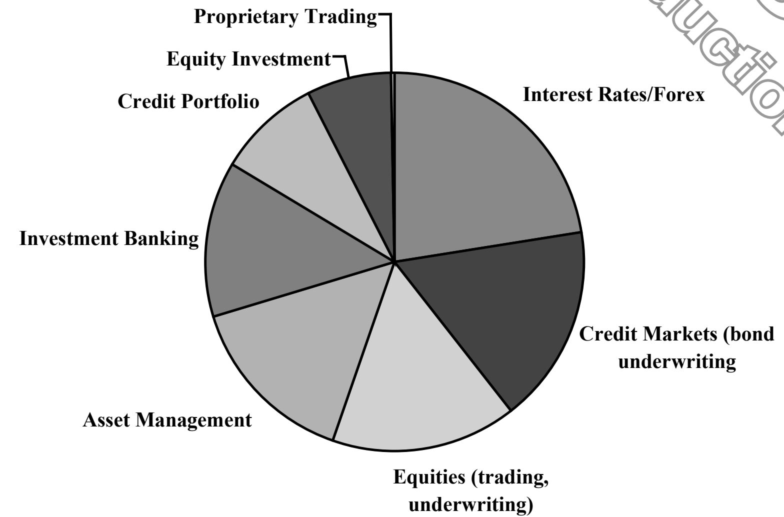
Exhibit 4
Sectoral Breakdown of Revenues (2000 first-half)

Chase Manhattan
Operating Revenue, 2000 (first half)
(in billions)



JP Morgan
Operating Revenue, 2000 (first half)
(in billions)



Sources: Companies, Wall Street Journal, Datastream.

Note: Pies reflect operating revenues and figures are rounded.

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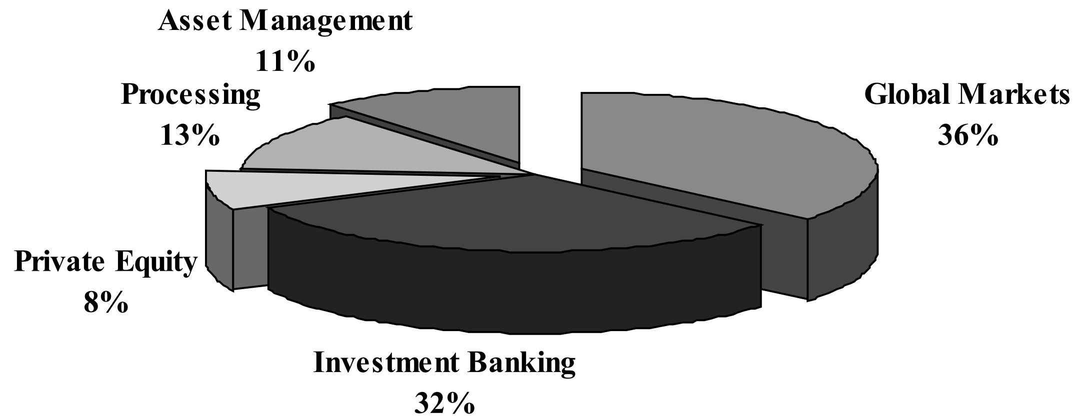
Exhibit 5
Pro Forma Global Wholesale Revenue Breakdown



Source: CSFB Company Reports.

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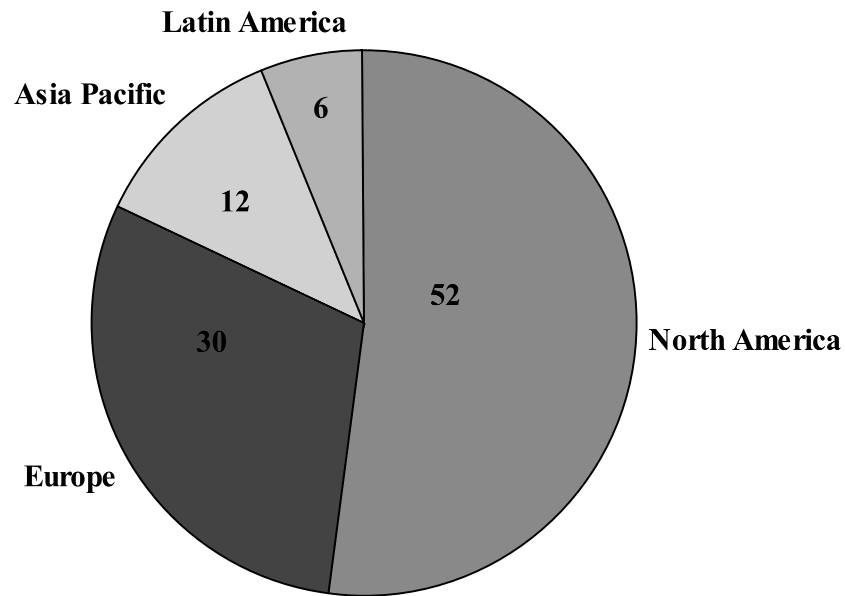
Exhibit 6
JP Morgan Chase Pro Forma
Revenue Distribution by Region (%)*



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* Year ended 12/31/99.

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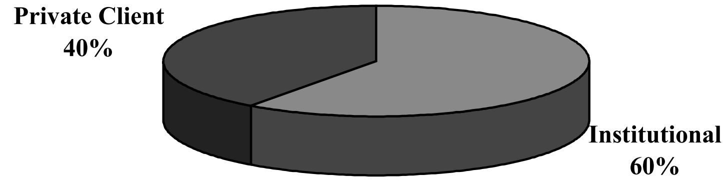
Exhibit 7
Pro Forma AUM by Client-Type



Source: Company reports, CSFB.

Exhibit 8
Pro Forma AUM by Asset Class

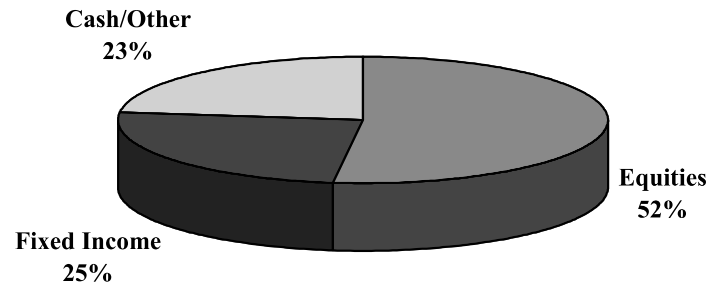


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Exhibit 9
Pro Forma AUM by Geographic Region

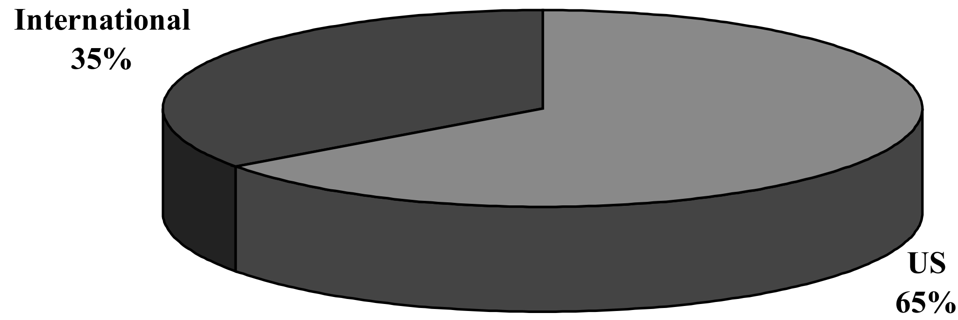

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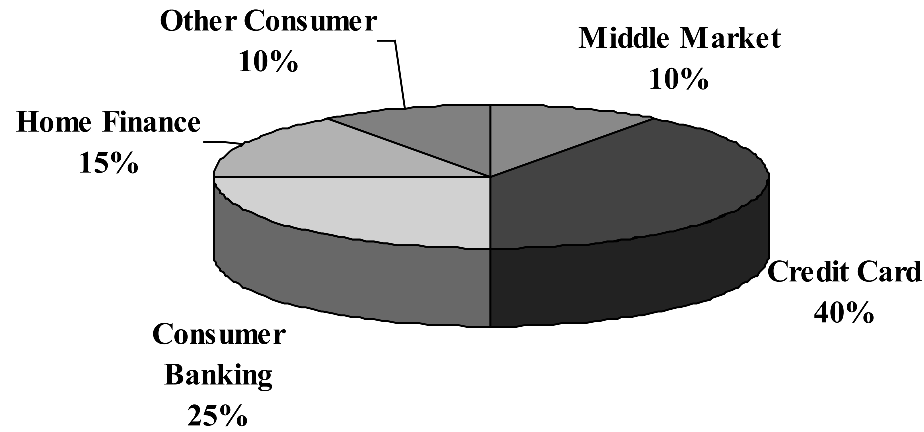
Exhibit 10
National Consumer Services Revenue Breakdown



Source: CSFB Company reports.

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Exhibit 11
JPMC League Tables
(1/1/2000 – 13/9/2000)

Rank	Managers	Market Share (%)
Global Debt		
1	Merrill Lynch	12.4
2	Salomon Smith Barney	11.3
3	***JPM Chase***	***10.1***
4	CSFB/DLJ	8.9
5	Morgan Stanley	8.2
Global Common Stock		
1	Goldman Sachs	18.9
2	Morgan Stanley	14.1
3	CSFB/DLJ	11.6
4	Merrill Lynch	10.9
5	Salomon Smith Barney	8.5
7	***JPM Chase***	***5.2***
Global Initial Public Offerings		
1	Goldman Sachs	20.5
2	Morgan Stanley	24.5
3	CSFB/DLJ	11.4
4	Merrill Lynch	11.3
5	Salomon Smith Barney	10
8	***JPM Chase***	***2.9***
US Initial Public Offerings		
1	Goldman Sachs	22.9
2	Merrill Lynch	14.1
3	Morgan Stanley	13.7
4	CSFB/DLJ	13.4
5	Salomon Smith Barney	11.7
8	***JPM Chase***	***3.3***
Global High Yield		
1	CSFB/DLJ	18.4
2	Goldman Sachs	13.8
3	Salomon Smith Barney	12.4
4	Morgan Stanley	12.2
5	***JPM Chase***	***8.6***
US High Yield		
1	CSFB/DLJ	21.6
2	Goldman Sachs	16.2
3	Salomon Smith Barney	12.6
4	Morgan Stanley	12.5
5	***JPM Chase***	***8.6***

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Exhibit – 11 (Cont'd)

Rank	Managers	Market Share (%)
	US Syndicated Loans	
1	***JPM Chase***	***36.3***
2	Bank of America Securities	24.1
3	Salomon Smith Barney	11.1
4	BANK ONE Corp.	4.6
5	CSFB/DLJ	3.2
	US Leveraged Loans	
1	Bank of America Securities	24.1
2	***JPM Chase***	***23.6***
3	CSFB/DLJ	6.6
4	FleetBoston	5.9
5	Deutsche Bank	5.2
	US Common Stock	
1	Goldman Sachs	21.6
2	Morgan Stanley	14.7
3	CSFB/DLJ	13.8
4	Merrill Lynch	11.2
5	Salomon Smith Barney	10.3
6	***JPM Chase***	**6.5**
	Global Announced M&A	
1	Goldman Sachs	36.4
2	Morgan Stanley	35.8
3	CSFB/DLJ	26.4
4	Merrill Lynch	21.6
5	Salomon Smith Barney	21.1
8	***JPM Chase***	**11.8**
	US Announced M&A	
1	Goldman Sachs	43.7
2	Morgan Stanley	35.1
3	Merrill Lunch	32.1
4	CSFB/DLJ	27.7
5	Salomon Smith Barney	26.1

Source: Thomson Financial Securities Data, 2000.

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Exhibit 12
US Money Managers

Rank	US Institutions	31/12/99 AUM (US$B)
1	Fidelity Investments	956
2	Barclays Global Advisors	783
3	JP Morgan/Chase pro-forma	720
4	State Street Global Advisors	672
5	Capital Group Cos.	558
6	Merrill Lynch Asset Mgmt	557
7	Mellon Financial	463
8	AXA Financial	463
9	Morgan Stanley Dean Witter	420
10	Citigroup	419

Data: Institutional Investor.

Assets Under Custody
(billions of US dollars)

Global Custodian

		30/6/99		30/6/98	
Rank	**Company**	**Assets**	**% of Total**	**Assets**	**% of Total**
1	The Bank of New York	5,900	18%	4,900	17%
2	State Street Corp	5,300	18%	4,500	16%
3	JP/Morgan/Chase pro-forma	5,100	18%	4,500	15%
4	Deutsche Bank	4,200	13%	3,900	14%
5	Citigroup	3,400	11%	3,000	11%
6	Mellon Bank	2,100	6%	1,500	6%
7	Northern Trust	1,300	4%	1,200	4%
8	Midland Bank	1,000	3%	700	2%
9	UBS AG	900	3%	900	3%
10	Banque Paribas	700	2%	600	2%
11	Brown Brothers Harriman & Co.	700	2%	600	2%
12	Royal Trust Corporation of Canada	600	2%	600	2%
13	Sociéte Generale Group	400	1%	400	1%
14	ABN AMRO Bank N.V.	300	1%	500	2%
15	Lloyds Bank Securities Services	300	1%	300	1%
	Total	**$32,200**		**$28,100**	

Data: Institutional Investor.

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Exhibit 12 (Cont'd)
Credit Card Issuers

Rank	Company	Outstandings (US$ billions)
1	Citigroup	$86
2	Bank One/First USA	66
3	MBNA	61
4	**JP Morgan Chase pro-forma**	32
5	Providian	22
6	Bank of America	21
7	Capital One	16
8	Fleet	14
9	Household	14
10	Wells Fargo	8

Data: The Nilson Report.

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Exhibit 13
Pro Forma Fee Income to Operating Revenue

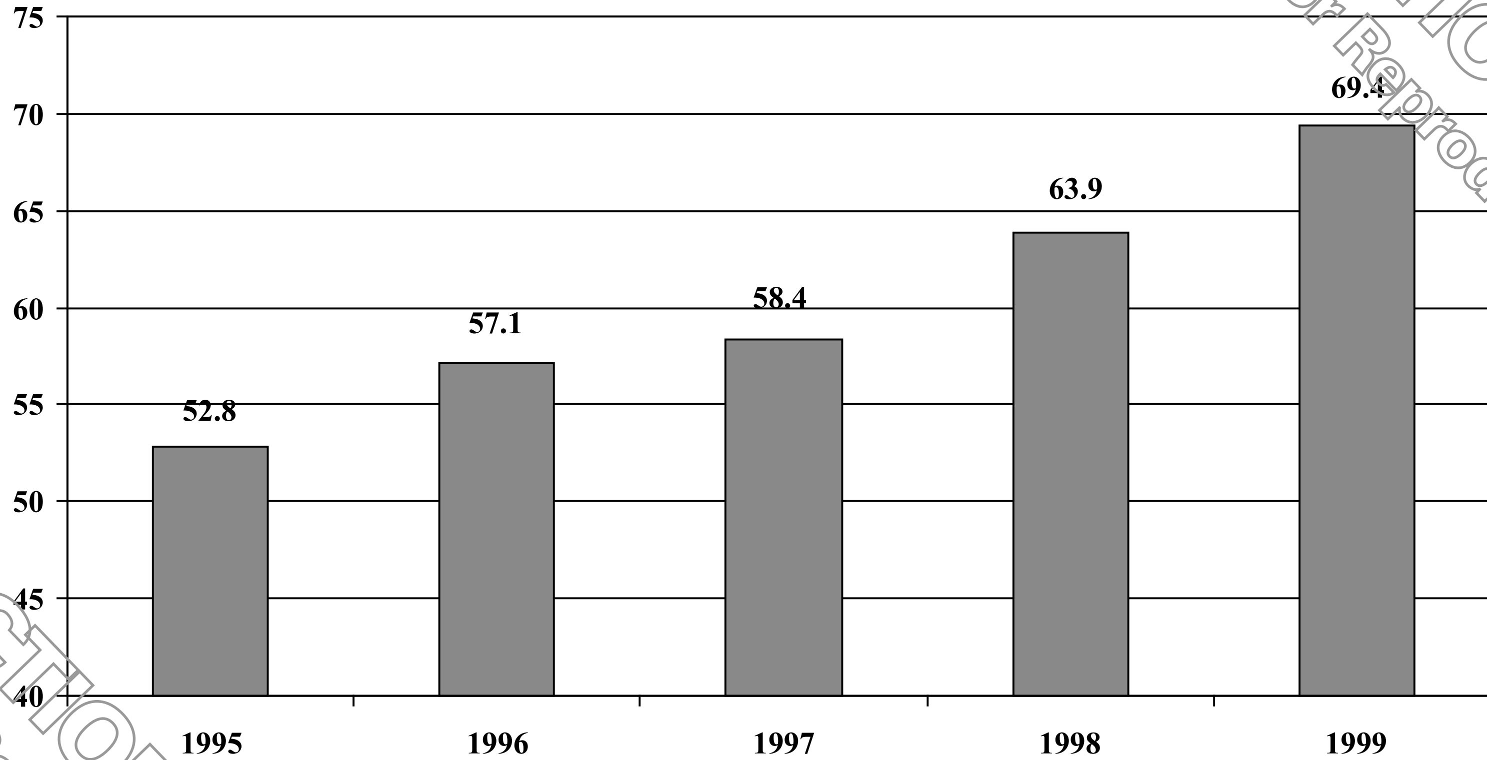

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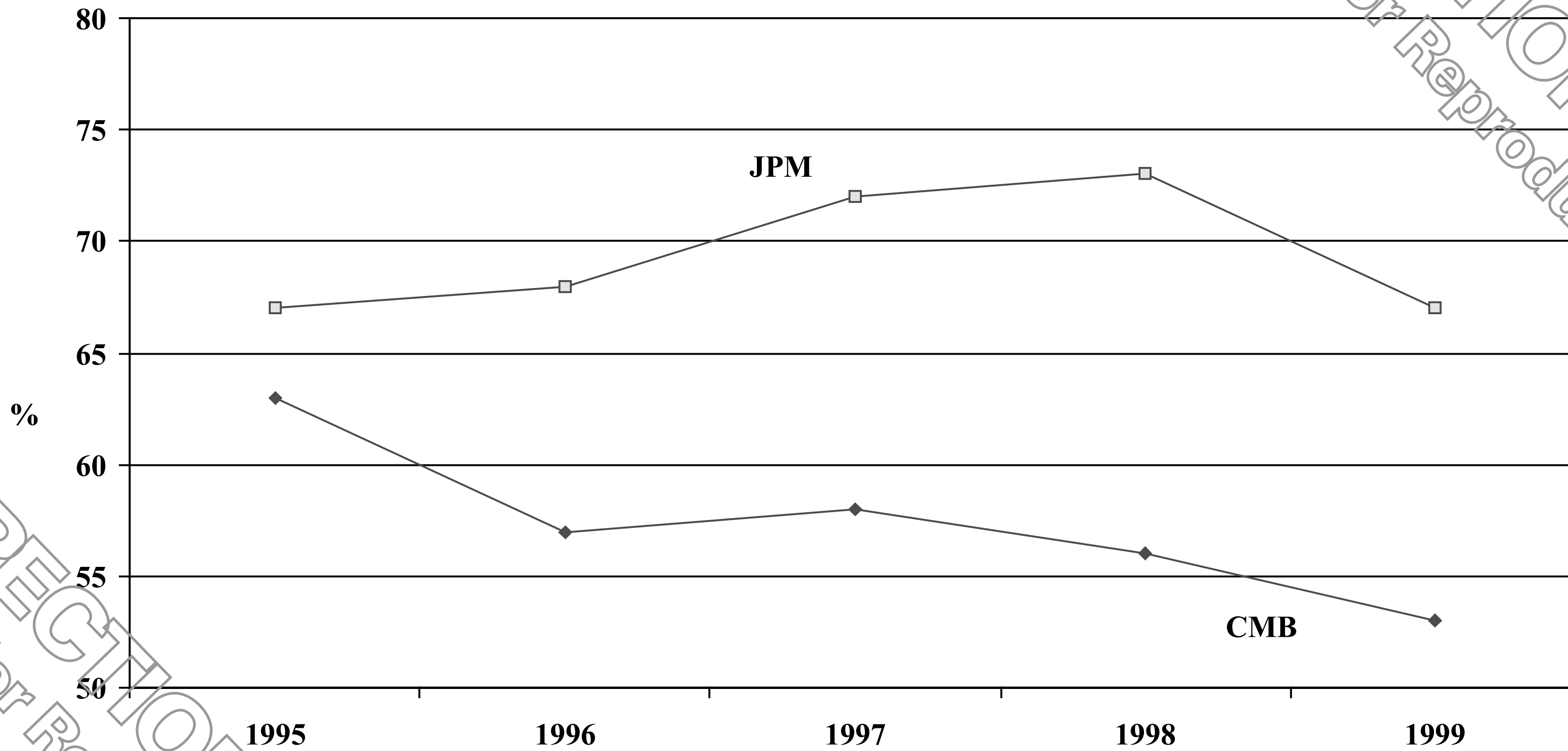
Exhibit 14
Efficiency Ratios



Source: CSFB, SNL Securities.

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Exhibit 15
Net Charges-off

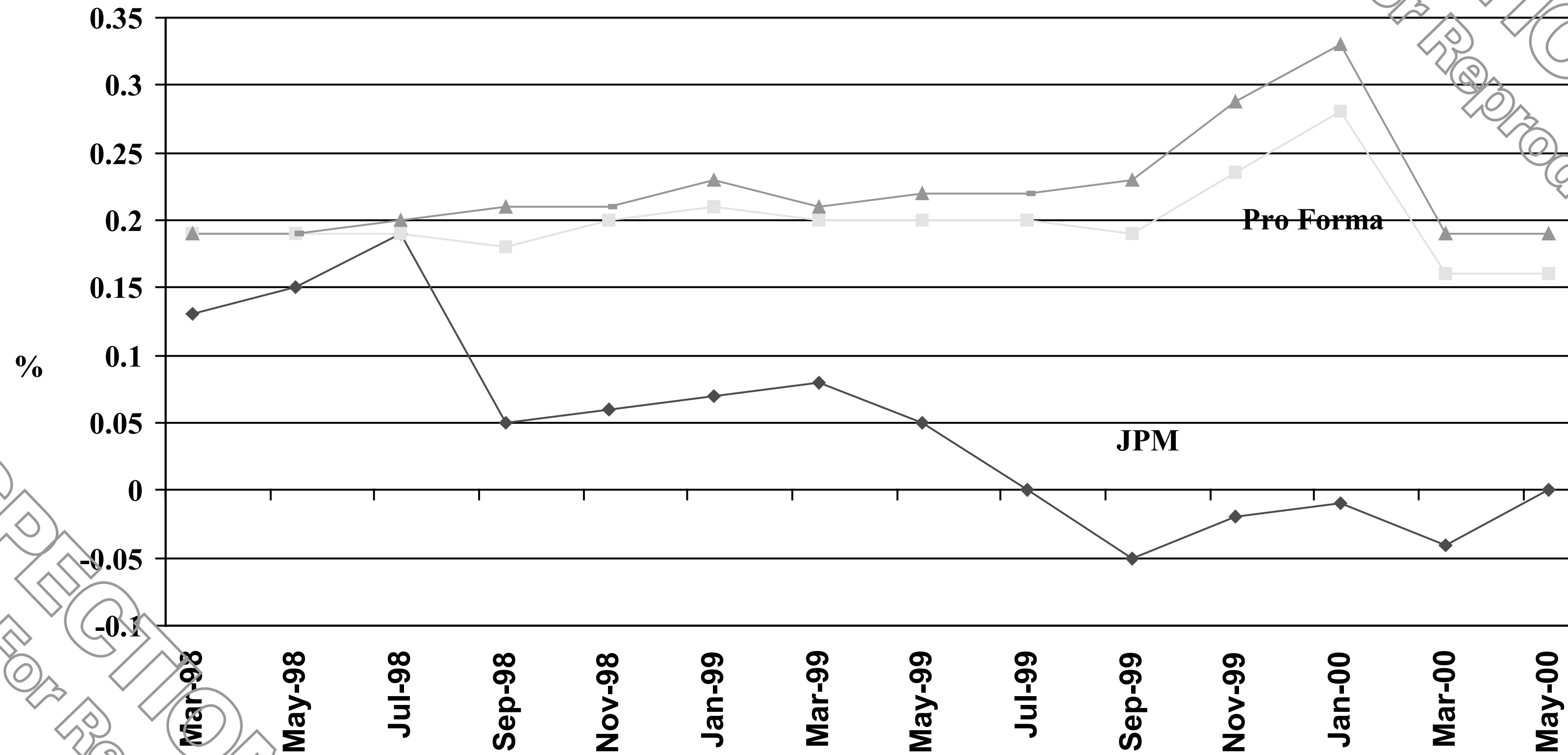

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Exhibit 16
Pro Forma Core Return on Equity

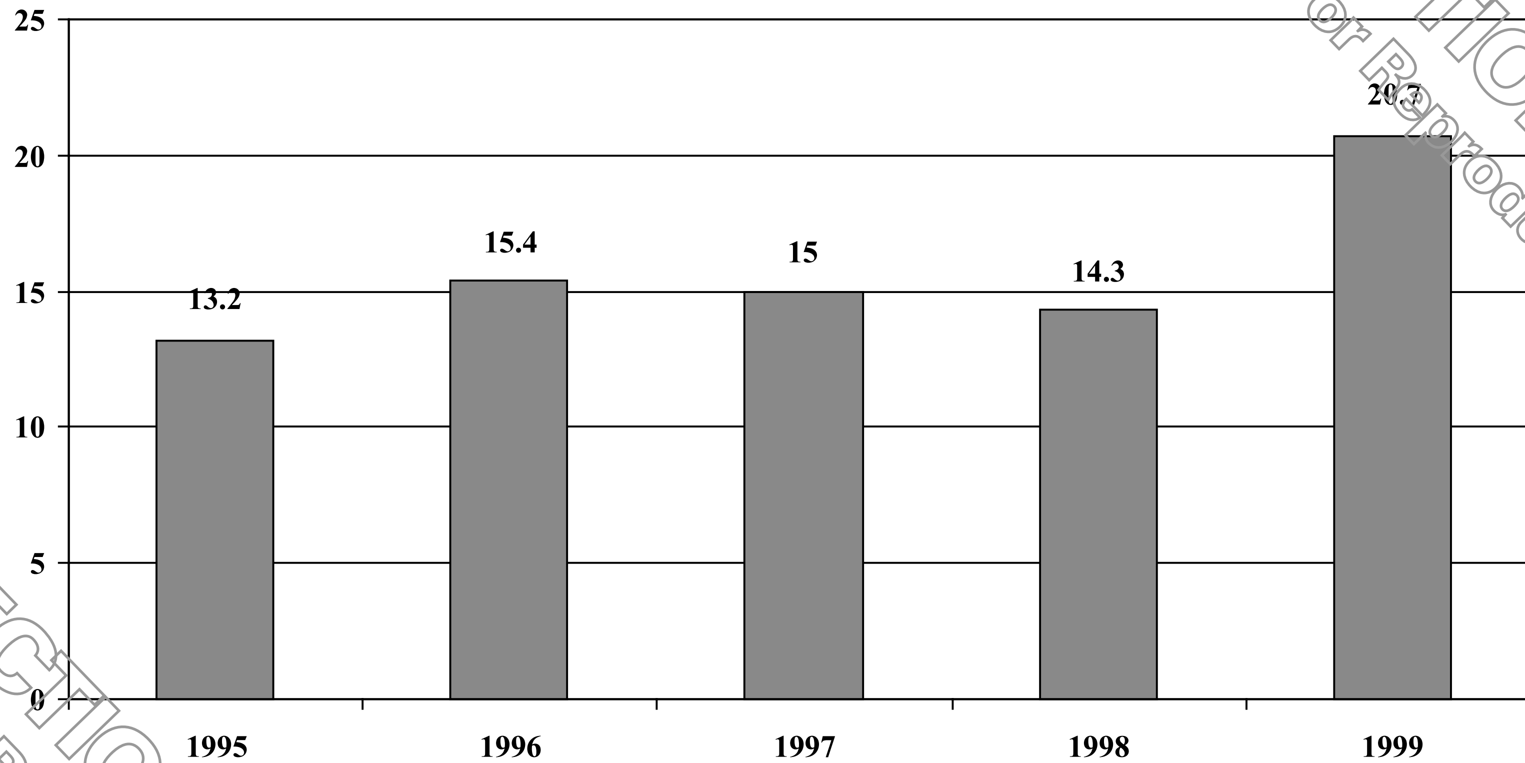

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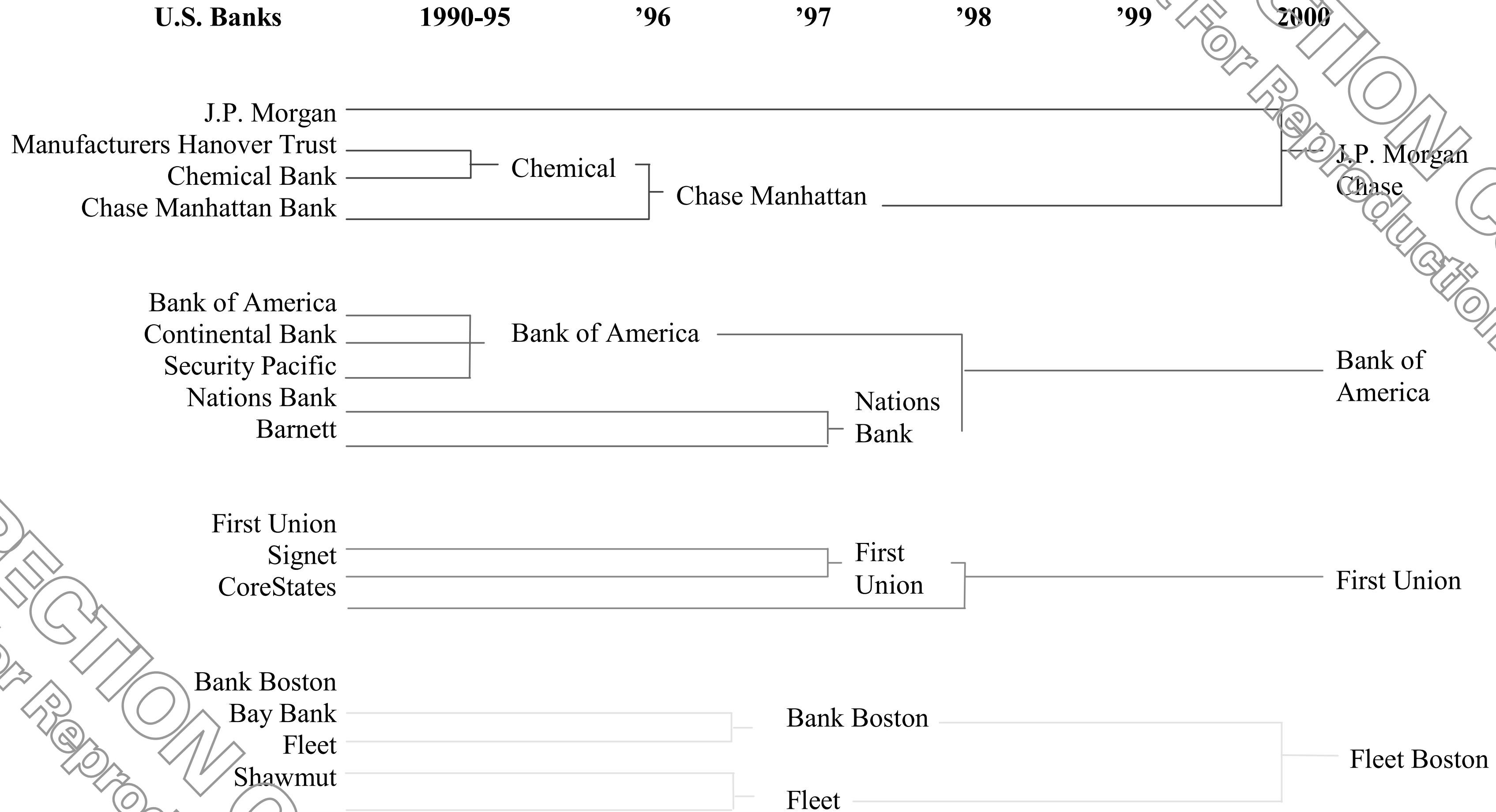
Exhibit 7
Four Major US Banking Consolidations



Source: J.P. Morgan Chase.

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Exhibit 18
The World's Most Valuable Financial Services Firms
(Regional Top 20, July 2000, Billions of US $)

North America		Europe	
Citigroup	150.9	HSBC Holdings	93.7
AIG	141.6	Lloyds TSB Group	72.0
GECS	139.9	Allianz	66.1
Bank of America	112.9	UBS AG	63.4
Berkshire Hathaway	109.4	ING Groep	50.8
Banc One	66.8	Zurich Fin. Serv.	49.1
Wells Fargo	66.4	Crédit Suisse Grp.	48.1
Chase Manhattan	61.1*	Aegon	47.9
Morgan Stanley DW	55.1	Barclays Bank	45.8
American Express	54.5	NatWest	38.8
First Union	44.7	Generali	36.6
Charles Schwab	42.9	Deutsche Bank AG	32.2
Goldman Sachs Group	32.3	Halifax	31.4
Merrill Lynch	30.2	BBV	30.1
Allstate	29.5	Münchener Rück.	29.8
Associates First Capital	28.5	Abbey National	29.3
Bank of New York	27.2	Swiss Re	27.6
J.P. Morgan	24.5*	Prudential Corp.	25.7
U.S. Bancorp	23.6	Unicredito Italiano	23.3
Washington Mutual	22.7	Fortis	22.7
Total	**1189.8**	**Total**	**864.4**

Note: Top Asia market capitalization rankings are DKB-Fuji-IBJ 86.1, Bank of Tokyo-Mitsubishi 61.8, Sumitomo Bank 36.6, Sanwa Bank 28.3.

* Merger announced September 13, 2000.

Data: Business Week, 12 July 1999, Bloomberg Financial Markets, American Banker.

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Annex

Analyst Commentary: Chase Manhattan Corp. (Deutsche Bank Alex. Brown Research)

A look at J.P. Morgan Chase & Co

September 19, 2000
Rating remains: Market performer.

Highlights

- The merger has strategic merits in terms of geographic and product synergies
- From a financial perspective, the transaction is dilutive.
- The ability to earn out of the dilution maybe hampered by revenue dis-synergies and natural integration chaos.
- As a result of the dilution, we have lowered our 2001 EPS estimate to US$4.15.
- Financial merits of the deal may not be visible until 2002.
- In our view, the shares are not apt to outperform in the near term.
- We maintain our MARKET PERFORMER rating on the shares.

Thesis

With the pending acquisition of J.P. Morgan, Chase is attempting to better attach itself to the secular growth in capital market services. While we believe the deal has strategic merits in terms of geographic and product synergies, from a financial perspective, the transaction is immediately dilutive and does not materially change league table rankings in equity underwriting or merger advisory. Overall, the case for revenues synergies could be feasible but most likely will not be visible until 2002 at best. This, together with the fact that cost savings will not really kick in until 2002, suggests earnings visibility could be weak for some time. This earnings uncertainty will inhibit the shares from outperforming in the short run, in our view.

Investment Rationale

- Merger creates platform with potential to reach bulge bracket.
- Biggest revenue synergies are in equity business. Capturing 20% of CMB's 1,000 largest clients could add US$400 mm in revenues.
- Global trading to diversify into opportunistic, but volatile proprietary strategies.
- Earnings contribution from sluggish consumer business declines to an estimated 21% to 33%.

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- Cost savings of US$1.5 billion appear conservative; revenue synergies more difficult to forecast.
- The shares are fairly cheap versus other capital markets; however, this, in our view reflects the risks inherent in the transaction.

Investment Risks

- Prior integrations were premised on cost savings, this deal hinges on revenue synergies, which could be less predictable.
- Financial risk, including immediate dilution and revenue uncertainty, is likely to limit out-performance in the short term.
- Cost savings, although certainly within reach, may not be significant until 2002.
- Overlap in certain market making businesses, such as FX and interest rate products, may dampen expected revenue synergies.
- Follow-on costs could be higher than expected both in terms of employee retention and employee acquisition.

Investment Thesis

The New New Chase

Chase is reinventing itself again. The 'old' Chase was about financial discipline, patience and leveraging scale. The new new Chase appears committed to an endgame that can no longer be achieved by financial discipline and patience. Management appears to have recognized that building "bulge bracket" investment banking capabilities is too slow and strategically disadvantageous given the market share concentrations forming in capital market services. As a result, the company has acquired Hambrecht & Quist, Flemings, Beacon Group and now main J.P. Morgan. Chase agreed to issue 3.7 of its shares for each J.P. Morgan share. The deal is expected to close in 1Q01.

Our analysis of this transaction is summarized as follows: the strategic merits of the deal are considerable, but still the company will not have attained its goal of "bulge bracket" status. Further, the financial cost of the deal is high. It is easily dilutive to 2001 earnings though this dilution in 2002 is not clear. In our view, the new new Chase now has more earning risk than before and its strategic objectives have not been fully attained. In general, this points to the high cost of buying secular growth for banks looking to evolve from traditional businesses. We believe the shares are not likely to enjoy PE multiple commensurate with this growth potential until there is visibility in the earnings stream. Given the integration turmoil that is a part of such large in-market transactions, it is likely that earnings visibility may not improve until 2002. That being the case, the shares are likely to perform in line over the next few quarters.

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Attributes of the Transaction

Combining Growth with Expected Volatility

There is little doubt that the more Chase can attach itself to the secular growth in capital markets services the better. The company has had the earnings volatility of a pure play (due to its venture capital business) but not the secular growth. The company has not been a major factor in the two most important growth sectors – equity underwriting and M&A. And while bulge status is not attained with this transaction, the broader equity/advisory platform should help long-term growth. In addition, the deal further reduces the contribution from Chase's more sluggish consumer business. We estimate that the contribution from the consumer businesses will fall from 43% of revenues (as of 2Q00) to an estimated 26% in 2001 (pro forma for both J.P. Morgan and Flemings).

A Broad Platform

While the transaction does not bring Chase bulge bracket status, it does provide the platform to build such status in a realistic manner. This reflects complementary contributions from both J.P. Morgan and Chase in terms of geographic, product and client overlap. The company will still need to build equity and M&A capabilities. However, there is little doubt of its strengths in fixed income, foreign currency, derivatives and syndicated lendings. Furthermore, the geographic overlay is complimentary, particularly in Europe where J.P. Morgan ran a very strong operation and Chase was lacking. We estimate 21%-25% of total 2001 revenues will be generated in Europe and about 60%-65% in North America.

The potential synergies are significant. For example, Chase analyzed equity fees paid by its top 1,000 clients over the past three years. Management indicated that if the company could capture 20% of this business, it would have produced US$400 million in annual revenues. Based on discussions with management, the company believes leveraging Chase's client base with the J.P. Morgan equity platform is the biggest source for revenue synergies. Moreover, the company believes the overlap is modest, as the top 100 investment banking fee-paying clients at Chase overlapped with only 6% of J.P. Morgan relationships. Overall, Chase's management believes the J.P. Morgan client base was too narrow and therefore limited the company's ability to leverage the cost sunk into building its investment banking infrastructure.

Asset Management

Chase has enjoyed scale in most of its businesses, except one – asset management. This transaction will bring Chase US$372 billion in managed assets (as of 2Q00 and excluding J.P. Morgan's 45% interest in American Century, which managed US$113 billion in 2Q00). On a pro forma basis, the company indicated it would have US$672 billion under management (excluding American Century), creating the third-largest asset manager in the United States and the sixth largest in the world.

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The Other Side of the Coin

However well this deal maps out strategically, we believe it creates substantial risks financially. From the stock's perspective, this financial risk is likely to limit attractive price performance in the near term.

The financial risks include immediate dilution and stalled revenue growth. Specifically, we believe revenue risk could come from several factors, including: (a) lower-than-budgeted trading fee revenues; (b) the reduction of credit concentrations in Chase's own loan and counterparty book; and (c) the risk that productivity will be impaired during integration.

The company has indicated that it expects pretax expense savings of US$1.5 billion (20% of J.P. Morgan's estimated 2001 expense base) – one-third to be realized in the first year, 2001, and the balance by the end of 2002. The company also expects US$1 billion in pretax revenue synergies by 2002 (US$400 million net of expenses). We believe the expected cost savings are realistic. They represent 7% of the estimated pro forma expense base for 2000 and according to management represent 12% of the relevant (i.e., capital markets-related business) pro forma expense base. The company compares this cost savings associated with their previous large mergers, which were closer to 20% of the combined expense base. This suggests a degree of conservatism, and we agree.

On the other hand, we believe the net revenue synergies will be more challenging and represent a risk to fulfilling growth expectations over the next 12 months. To a certain extent, where true synergies are created, they could be partially (or fully) offset by revenue outflows. Also, the company could find follow-on costs higher than expected both in terms of employee retention and employee acquisition.

Looking forward to 2002, assuming that pro forma 2001 net income increases 15% and the balance of the cost savings are realized (US$650 million after tax), the resulting EPS is US$5.03. This is only 13% increase over the US$4.45 EPS estimate we had posted for Chase prior to this transaction. This highlights how crucial net revenue synergies become.

Integration Risk

Integration is probably the biggest wild card. Chase has a terrific track record in integration given the outcome of its two merger-of-equals transactions – Chemical/Manufacturers Hanover and Chemical/Chase. However, we believe three factors make this integration different. First, this earlier integrations involved more capital-intensive businesses such as lending, securities processing and retail banking. In those deals, the integration was more a function of decision-making and execution. Second, during the periods of those mergers, the banking industry was shrinking its employee base – the people side of the equation was less sensitive than it is today. Third, the previous mergers were not reliant on revenue synergies. In our opinion, revenue synergies are more difficult to plan than cost savings.

In the current environment, the top-producing employees will look after their own interests. That often means seeing if a better deal can be attained elsewhere. Overall, we believe periods of change create uncertainty, and the uncertainty lowers productivity. We also would note that the pro forma company will have investment banking and equity functions run by Chase

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executives. There is no doubt that the Chase people are capable, but the heart of the platform that Chase is acquiring will not be run by their own people. The risk that this disaffects employees is not inconsequential in our view. Chase is to be admired for making a quick decision as to who will be running key divisions. We note that in many cases, co-heads have been named, which tends to dilute the very benefit of a quick decision, since it may not be clear to employees which co-head has more power. Overall, we would expect to see some high-profile defections, but eventually the company will settle down and begin to build its businesses and grow revenues.

Overall, the case for revenue synergies is feasible. However, the risk of revenue outflows from the trading and credit businesses early after the acquisition closes, plus integration risk suggests revenue growth may not be visible until 2002 at best. This, together with the fact that cost cuts are not expected to really kick in until 2002, suggests earnings visibility could be weak for some time.

Valuation

Overall, earnings uncertainty will inhibit the shares from outperforming in the short run, in our view. In terms of valuation, the shares will appear cheap at 11.3x our 2001 estimate, particularly in contrast to other capital markets players such as Goldman Sachs and Citigroup with respective PE of 17.6x and 17.7x. In our opinion, this stock market pays a lot for established growth, or certainty – and punishes risk. The relative value argument is less valid for Chase given the risks now embedded in the company. Successful integration would reduce many of these risks, but will take time.

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Pro Forma Earnings Analysis (2001 Estimates)[2]
(Amounts in US$ million)

	Chase Manhattan	JP Morgan	Pro Forma JP Morgan Chase
Revenues			
Net Interest Income	7,975	1,749	9,724
Trading Fees	3,240	3,687	6,927
Investment Banking	4,281	2,175	6,456
Asset Management	3,995	1,385	5,380
Credit Card	2,112	-	2,112
Other	6,024	1,733	7,757
Total Revenues	**27,627**	**10,729**	**38,356**
Operating Expenses			
Staff Expenses	10,003	4,835	14,838
Amortization	514	32	546
Other	6,108	2,473	8,581
Total Expenses	**16,625**	**7,340**	**23,965**
Provision	1,816	0	1,816
Pre-tax earnings	9,186	3,389	12,575
Net Income	**5,902**	**2,237**	**8,139**
Avg. shares	1,325		2,013
EPS (in $ per share)	**$4.45**		**$4.04**

2 Source: Deutsche Banc Alex. Brown estimates and company information.

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Analyst Commentary: Chase Manhattan Corp. (Morgan Stanley Dean Witter)

Strong Buy

Valuation

We rate Chase Manhattan Bank (CMB) Strong Buy with a target price of US$65. We believe the JP Morgan deal significantly enhances Chase's long-term growth prospects, providing the company executes well. With a pro forma market capitalization of US$100 billion, the new company would be the world's fifth largest financial services company. We believe that joining the ranks of the mega-cap companies may help close the valuation gap between Chase's stock valuation and that of the other global giants.

Key Investment Positives

Strong Wholesale Financial Business

The wholesale finance business is a good business, with strong market growth being driven by expansion of global capital markets and technology. Clients value the services provided and the barriers to entry are significant. By combining with JP Morgan, Chase becomes an even more global, more wholesale company.

Disciplined Management

We believe management is disciplined. This includes credit, expenses, capital, acquisitions and risk. As a result, the value of Chase's leadership positions accrues to shareholders, in our estimation. We expect the Executive Committee members of the new JP Morgan Chase to work together effectively as partners, as did the predecessor group at the old Chase. The breadth and depth of senior management is impressive.

Well Positioned

We believe Chase is well positioned: it has a strong balance sheet and an enormous client base. The new JP Morgan Chase will have an even broader client base, geographical range, and product set.

Merger should Accelerate Long-term Revenue Growth

Chase and JP Morgan's client bases are complimentary, bringing together new economy and blue chip accounts. On a pro forma basis for 2000, the combined company shows product leadership in syndications, investment-grade debt underwriting, high-yield debt, European M&A, global M&A, US Common Equity underwriting and global common equity. We think the new JP Morgan Chase will have a competitive advantage in hiring, as prospective employees should find the broader scope of business attractive.

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Key Investment Risks

Execution

In evaluating any merger, one must evaluate execution risk, especially when it involves large companies with 'mobile' employees. Chase has an excellent history of combining large companies, and the company understands the importance of including the best and the brightest employees from both sides, with an attitude of inclusion.

Dilution

Based on our forecast that Chase will be able to achieve roughly one-third of its targeted cost savings and revenue additions, we estimate dilution to 2001 tangible EPS (originally estimated at US$4.56) to be roughly 5%.

Overlap

There seem to be some concerns about overlapping business lines, specifically in derivatives and fixed income. We believe that the differentiated focus of each bank will minimize the risk in overlap. For instance, in fixed income, Chase has been more dominant in the US, while JP Morgan has been more dominant in Europe.

Operating Leverage like an Investment Bank

If revenues were to decline, Chase would not be able to cut costs sufficiently in the short run to fully offset the effect of lower revenues on income.

Significant Investment Spending

We do believe Chase is investing well on behalf of its owners. Yet the significant investment spending may limit somewhat the valuation investors will accord Chase in the near term.

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