

GRANTS'S

INTEREST RATE OBSERVER®

Special Edition

Two Wall Street, New York, New York 10005 • www.grantspub.com

NOVEMBER 3, 2017

How GE came to grief: a *Grant's* compendium

Monetary corporate welfare

(September 21, 2012) After the Lehman Brothers bankruptcy in 2008, the Bush administration, on behalf of the mute American taxpayer, opened the federal vaults to Wall Street. Sheila Bair, in her new memoir of that crisis season (“Bull by the Horns”), recounts the decision to push TARP funds into the not necessarily needy arms of the CEOs of nine of the country’s largest banks and broker-dealers. “Yes,” relates the former chairman of the FDIC, “it had come to that: the government of the United States, the bastion of free enterprise and private markets, was going to forcibly inject \$125 billion of taxpayer money into those behemoths to make sure they all stayed afloat.”

General Electric was not among the nine. But it presently took its place at the government’s all-you-could-eat steam table. When it received \$139 billion in FDIC debt guarantees and placed \$16 billion in commercial paper with the Federal Reserve, this bluest blood of American blue chips—the last of the original Dow stocks still in the Dow—was rated triple-A. Not many federal supplicants have ever cut a more awkward appearance with a begging bowl.

This was four years ago—four long years ago, to be sure. On Monday, the very same GE—no longer rated triple-A, rather a slice or two beneath it, but still a deep-blue blue chip—showed its face in the credit markets to refinance \$5 billion of 5% notes due next Feb. 1. In the high-cotton days of 2007, the company had placed an issue of 5 $\frac{1}{4}$ % notes due December 2017. If proof were needed that nobody holds a grudge for long on Wall Street, at least not against an institution,

the 5 $\frac{1}{4}$ s were quoted Tuesday at a price to yield 1.54%.

As for the new notes, \$7 billion worth, they were briskly bid for at yields of 0.85% for three years, 2.72% for 10 years and 4.16% for 30 years. The Fed’s tiny interest rates now subsidize a company that, except for its doting Uncle Sam, might not be around today in just its current form to borrow so much as a dime. (Vis-à-vis GE, the government was not entirely doting; on Aug. 4, 2009, the company, or rather its shareholders, paid \$50 million to settle SEC charges that it had cooked the books and manipulated earnings during the great bull market of the late 1990s and early 2000s; see *Grant's*, Sept. 18, 2009). Among the underwriters of the new GE issue was none other than Citigroup, about whose serial bailouts and inept CEO Bair’s memoir is particularly scathing.

“Citi had essentially bought into all the gimmicks to generate short-term profits,” she recites: “poorly underwritten loans, high-risk securities investments, and short-term unstable liquidity. It desperately needed an experienced, traditional commercial banker to right the ship. [Vikram] Pandit had no experience in commercial banking and wouldn’t have known how to underwrite a loan if his life depended on it. But he was the guy [Robert Rubin] wanted and the N.Y. Fed and the OCC acquiesced, so he got the job.”

“Proceeds” from the GE offering “will be used to repay all or a portion of the company’s \$5 billion of 5% notes due Feb. 1, 2013,” S&P reported. “Any remaining proceeds will be used for general corporate purposes.”

Artificial, ultra-low rates harm many. But they do benefit some.

Under the cloak of respectability

(September 18, 2009) Wall Street was away from its desk when the Securities and Exchange Commission and General Electric Co. came to terms on August 4. To settle charges of book-cooking and earnings manipulation, Thomas A. Edison’s corporate brain-child neither admitted nor denied guilt, but paid a \$50 million fine and vowed never again to commit the sins to which it had not confessed. A sell-side analyst obliged a reporter at *The Wall Street Journal* with the comment that, really, the revelations didn’t matter. While the accounting practices at issue might have been “frustrating,” he claimed, “they were never material.”

They were and are material—and entertaining, too, in a shabby kind of way—we are about to contend on this, the first anniversary of the great troubles of 2008. The crimes to which GE allegedly stooped reveal a management besotted with its own share price. More broadly, the SEC complaint invites reconsideration of an era in which powerful people did their all to smooth out the bumps. At GE, it was the untidy ebb and flow of revenue that management sought to pretty up, even to the point of employing, as the SEC puts it, “devices, schemes or artifices to defraud.” At the macro level, it was the ups and downs of the economy itself that the Federal Open Market Committee worked to flatten. The “Great Moderation” is what economists call the 20 or so years in which these efforts seemed to bear fruit. It was a golden time of shallow recessions, measured

expansions and high “visibility.” As to the visibility, the case of the “*Securities and Exchange Commission v. General Electric Company*” is a reminder of how little we ever really know.

The eye that the stock market turns to history is dim enough. The one it uses to see, but yet not to see, the transgressions of the great and good is—actually—legally blind, at least during the bull portion of the cycle. So it was that, “[b]eginning in 1995 and continuing through the filing of form 10-K for the period ended December 31, 2004, GE met or exceeded final consensus analyst earnings per share expectations every quarter,” as the SEC describes it. In a better world, investors would collectively face federal charges for being so gullible as to fall for such a thing.

It’s a fine irony that GE, the bluest-blooded of American blue chips, triple-A-rated from 1956 until 2009, the last of the original Dow stocks still in the Dow, wound up funding itself through such public assistance programs as the Commercial Paper Funding Facility (CPFF) and the Temporary Liquidity Guarantee Program (TLGP). It’s an even finer irony that the government was succoring GE even as it was investigating it. “[W]e believe,” comment the equity analysts at J.P. Morgan in a September 8 research report, “GE will go down as the least publicized ‘too big to fail’ story in the crisis.”

The Morgan report, incidentally, takes a guardedly bullish line toward the stock, calling it “one of the last stocks

for which a little good news can still go a long way.” And the analysts, with C. Stephen Tusa Jr. in the lead, add that, “[i]n the look for non-consensus, catch-up stories, GE stands out as the last, in our view.” Not disagreeing with this judgment, we hereby lift our own fatwa on GE (e.g., *Grant’s*, Sept. 5, 2008), now quoted at 10.3 times trailing net income, half of the post-1990 average of 22 times, a fifth of the 51 times peak multiple at year-end 1999 and at a 40% discount to the valuations of its global peers. However, our interest in this investigation is not so much the share price as the remarkable story of the company that couldn’t seem to stop watching it.

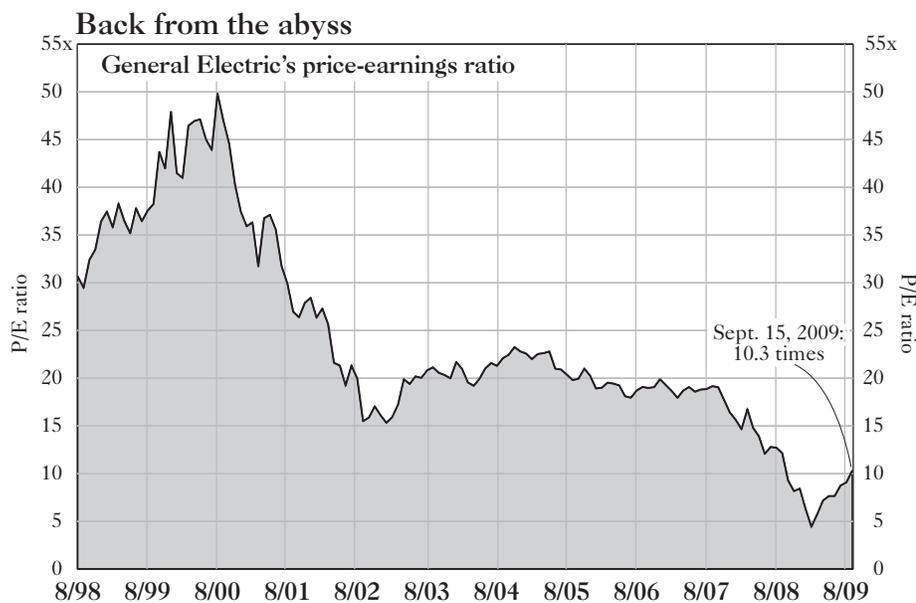
The infractions that the SEC complaint identifies allegedly occurred on the watch of CEO Jeff Immelt in 2002 and 2003. But Immelt’s predecessor, Jack Welch, had run the company for the preceding 20 years until Sept. 6, 2001, and it might just be that Welch had something to do with the corporate culture that valued the price of GE common above the kingdom of heaven. In his unintentionally revealing memoir, “*Jack: Straight from the Gut*,” published in 2001, Welch describes the rallying round of his lieutenants to the news that a \$350 million hole had opened up in the balance sheet of GE’s brokerage-house subsidiary, Kidder, Peabody. The news had hit on April 14, 1994, as the Street awaited the release of GE’s first-quarter earnings. They would be a little light, though not for want of loyalty in the GE hierarchy.

“The response of our business leaders was typical of the GE culture,” Welch relates. “Even though the books had closed on the quarter, many immediately offered to pitch in to cover the Kidder gap. Some said they could find an extra \$10 million, \$20 million and even \$30 million from their businesses to offset the surprise. Though it was too late, their willingness to help was a dramatic contrast to the excuses I was hearing from the Kidder people.” This was, to repeat, in 1994, after which the Six Sigma GE accounting department somehow was able to match or beat each quarterly earnings estimate through Dec. 31, 2004.

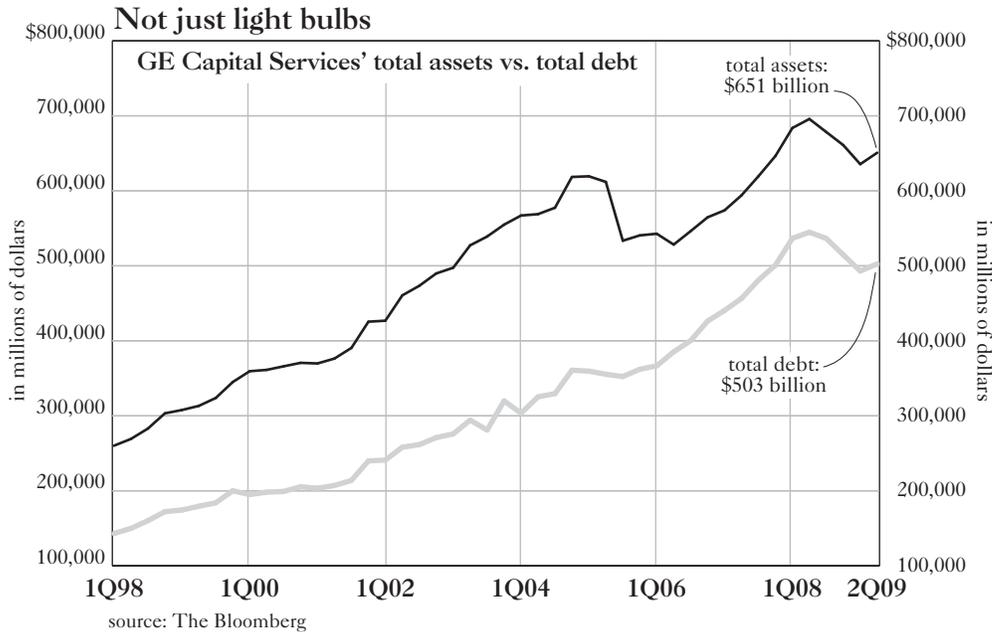
Be that as it may, Immelt was in command when the SEC’s investigation turned up four kinds of accounting irregularities. One had to do with interest-rate hedges on commercial-paper borrowings, a second with another kind of interest-rate hedge and a third with the accounting for spare parts for commercial aircraft. The fourth seems closest to the everyday ruse of pressing one’s thumb on the scale. It concerns the mistimed recognition of revenue from the sales of GE’s locomotives. As the complaint says:

“In the fourth quarters of 2002 and 2003, GE improperly recorded revenue of \$223 million and \$158 million, respectively, for locomotives purportedly sold to financial institutions with the understanding that the financial institutions would resell the locomotives to GE’s railroad customers in the first quarters of the subsequent fiscal years. The six transactions were not true sales and did not qualify for revenue recognition under GAAP. GE personnel at the business level orchestrated these transactions in order to improperly accelerate revenue recognition. A member of GE’s corporate accounting group approved the accounting for these transactions despite learning that GE maintained significant obligations that (1) suggested that the risks of ownership for the locomotives had not passed and (2) should have precluded revenue recognition under GAAP.”

To convey some size of the scope of this apparent fiction, the locomotive “bridge financing” transactions in the fourth quarter of 2002 accounted for 131 of the 191 engines ostensibly sold in that period. “Inclusion of these



source: The Bloomberg



transactions significantly overstated the performance of the GE Transportation Systems,” according to the complaint, “significantly overstated the performance of the GETS business in the fourth quarter of 2002, with GETS revenues and profits being overstated by 45.1% and 39.6%, respectively.” And again in the waning months of 2003: “bridge-financed” locomotive sales represented 42.8% of the quarter’s locomotive unit sales, overstating fourth-quarter revenues and earnings, according to the commission, by 22.6% and 16.7%, respectively.

Enron was crashing and burning in 2001, but not until 2003 did the import of that fraud seem to register either on GE or its Wall Street enablers. Thus, the complaint relates, “In December 2003, the [GE] business team informed the senior accountant that the financial intermediaries had requested GE represent that the rail transactions had been disclosed to GE’s outside auditor and accounted for in accordance with GAAP. When he asked why the financial intermediaries were seeking the representation, the senior accountant was told they were concerned about their risk of liability for helping influence another company’s financial statements in the wake of a recently reported financial scandal. As in 2002, notwithstanding the above, GE’s corporate accounting group permitted GE to recognize the revenue and income on year-end rail deals in the fourth quarter of 2003.”

Nobody can say that GE was paralyzed by contrition. It disclosed the early-August settlement with the SEC in a press release asserting the corporate commitment “to the highest standards of accounting.” A little awkwardly for a communiqué meant to affirm the company’s fidelity to the letter of GAAP, there was, at the top of the release, the familiar GE logo set alongside the corporate motto, “Imagination at work.” Just when GE decided to walk the accounting straight and narrow, the statement didn’t say, though the zeal-of-a-new-convert tone of a letter to the editor of *The New York Times* that came shooting out of the Fairfield, Conn., headquarters a few days later suggests a relatively recent adaptation. Contrary to the insinuation of *Times* columnist Floyd Norris, management protested, there was nothing Enronesque about the locomotive transactions. “. . . GE locomotives were purchased and retained by our railroad customers,” management pointed out. “GE prematurely recorded these sales based on intermediate sales to financial institutions—an error that has led to improved controls. But there were no returns and no fictitious revenues.”

As for Welch, he, too, turned over a new leaf without acknowledging that there ever had been an old one. In a March interview with the *Financial Times*, the most famous disciple of shareholder value asserted that, “On the face of it, shareholder value is the dumbest idea in the world. Share-

holder value is a result, not a strategy. . . . Your main constituencies are your employees, your customers and your products.”

Welch’s auditors were possibly too astonished by this remarkable volte-face to tax the corporate icon on the glaring omission from his short list of vital GE constituencies. This was in March—the panic was on—and GE owed its liquidity, if not its solvency, to the U.S. government. In his memoir, Welch berates himself for taking on faith the retrospectively implausible proposition that Joseph Jett’s bond trades could legitimately generate almost a quarter of the earnings of the Kidder, Peabody fixed-income department—and that that department could legitimately account for more than 100% of Kidder’s earnings. “When they [the bond people] spoke, the firm listened, and few questioned their success,” recounted Welch.

By the same token, perhaps, neither Welch nor Immelt delved deeply enough into the sources of the monumentally unlikely success of the in-house leveraged financial institution. “So profitable and so fast-growing was GE Capital Services,” observes colleague Ian McCulley, “that it eventually accounted for nearly half of consolidated GE profits and more than four-fifths of companywide assets. It was GECS’ heavy reliance on short-term funding sources that nearly brought down the company last fall. Absent GECS, GE would be basking in praise for preserving profit margins, generating lots of cash and generally weathering the storm. Instead, management has Japanese real estate, Hungarian mortgages and U.S. restaurant financings to worry about.”

Then, again, without GECS, GE would hardly be recognizable today. It might have been said in 1990 that Jack Welch’s company was an industrial business with a finance subsidiary bolted on. By 2006, one could almost say that GE was a bank that happened to manufacture appliances, jet engines, locomotives and the rest. Certainly, the solvency of the industrial side was hostage to the funding of the financial side, although that was not the kind of observation that seemed germane during the Great Moderation.

To allay lingering fears about solvency and funding, GE in late July handed out a 63-page slide deck

brimful with reassurances about its financial problem child. No capital raise was in the works, credit losses were in line with the numbers set out in the Fed's stress test and GECS would be well-positioned coming out of the recession, was the gist of the message. Kathryn Cassidy, vice president and treasurer of GECS, told listeners-in to a conference call that GE had won approval from the FDIC to issue long-dated commercial paper on its own hook—a hook now rated only slightly lower than triple-A. “Our remaining guaranteed commercial paper will roll off quickly over the next couple of months,” Cassidy went on. “We have also made a lot of progress in our long-term funding, completing our total year 2009 plan and funding about \$18 billion of long-term debt towards our plan for 2010. We've issued over \$12 billion in non-guaranteed, long-term debt so far this year in a variety of currencies—dollars, euros and sterling. Last week, we raised almost \$3 billion worth of euros in a five-year transaction at an equivalent spread of mid-swaps plus 190 basis points. We were pleased to see strong demand and a diversified investor base.”

GECS is on a post-crisis, balance-sheet weight-loss plan, but the shrinkage will be gradual. Borrowings at June 30 footed to \$503 billion, down not much from \$515 billion at year-end 2008. There was \$173 billion of short-term debt and \$329 billion of long-term debt. Short-term loans featured \$82 billion in bank deposits and only \$50 billion in commercial paper. In that year of innocence, 2006, GECS had issued as much as \$100 billion in CP, and \$72 billion was outstanding as recently as December 31. The company would like you to know that it has stopped issuing into the Fed's CPFF, a step on the road back to capitalism.

This purportedly blue-chip paragon of financial strength, however, remains very much beholden to the taxpayers. At last report, GE had borrowed \$69 billion through the TLGP, consisting of \$21 billion of commercial paper and \$48 billion in longer-term debt. “To compare,” observes McCulley, “TLGP consists, in toto, of \$320 billion, so GE has something like one-fifth to one-quarter of total issuance. And even though GE can access capital markets on its own at a price, it reopened one

of its TLGP issues, the 2s of 2012, at the beginning of September to raise an additional \$1 billion on top of the \$650 million it borrowed in late July. And so far in 2009, it has sold far more guaranteed debt than not.”

The Treasury doesn't rent out its gold-plated credit rating for nothing. Since the inception of the TLGP and CPFF programs last year, GE has paid \$1.9 billion for the privilege of borrowing under the name of the United States of America. At that, GE must consider the trade a bargain, saving itself, as it did, interest expense on the order of \$750 million to \$1 billion, while foreclosing the possibility of a bankruptcy filing, a not remote risk during the credit upheaval.

Now that the crisis has passed, GE is extricating itself from the arms of its savior, as the latest 10-Q report disclosed with evident pride: “At the request of GE Capital, on July 21, 2009, the FDIC approved an application filed by GE Capital which positions it to exit the TLGP. As a result, GE Capital will no longer issue FDIC-guaranteed commercial paper with maturities of 31 to 270 days and will be able to issue non-guaranteed long-term debt with maturities of 18 months to three years. The FDIC and GE have also agreed to reduce GE's aggregate limit under the program, resulting in approximately \$14 billion of remaining long-term debt capacity under the TLGP at July 21, 2009.” The last of the TLGP borrowings won't roll off until 2012.

Some day, financial historians will try to make sense of it all: the mere existence of a \$100 billion GE commercial paper program (the number today seems incredible); the ideal of “shareholder value” carried to the point of alleged institutionalized fraud; an industrial company recreating itself as a highly and precariously leveraged financial institution with nary a peep of protest from the stockholders; the close brush with insolvency of a company still bearing the imprimatur, triple-A. Finally, the historians of the future will scratch their heads to understand why Jack Welch and Alan Greenspan, icons of the late 20th century, put so much stock in an idealized “stability” that can only appear to exist in a dynamic world but that can never be present in fact. To these historians, we say, Good luck!

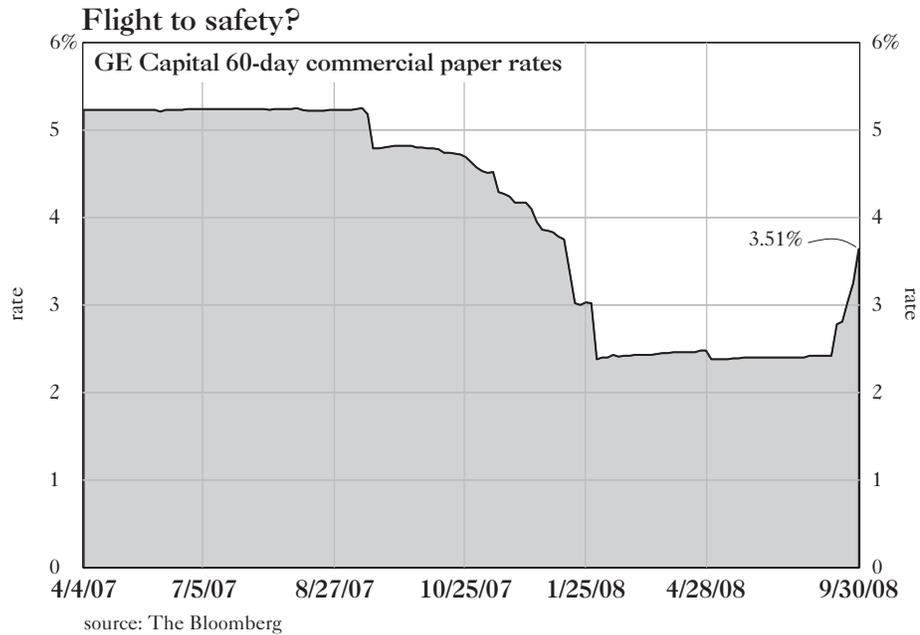
'Uncle,' cries GE

(October 3, 2008) “You know, we're going through a normal credit cycle here. . . . We've got unprecedented financial market volatility.” —Keith S. Sherin, General Electric vice chairman and chief financial officer, quoted on pages two and three of the transcript of the September 25 conference call

When financial conditions veer from “normal” to “unprecedented” in the space of two short paragraphs, as they did in the remarks of CFO Keith Sherin on last week's GE earnings call, you can bet that the world is in flux. For the second time in nine months, management lowered its 2008 profit outlook, to between \$1.95 and \$2.10 a share from between \$2.20 and \$2.30 a share. The principal cause of the ratcheting down was the shortfall at GE Capital, and the company promised no quick fix. For 2009, now ventures the chairman and CEO, Jeffrey R. Immelt, the finance subsidiary will earn up to 30% less than what is expected in 2008. Henceforth, instead of its accustomed 50% or more contribution to corporate net income, the megabank will deliver 40%.

The *Grant's* analysis (see the September 5 issue) was thus abruptly affirmed by GE management itself. On September 14, a reassuring set of bullet points had gone forth from the investor-relations department. It was a cranky and unobliging reader who, upon reviewing it, still harbored doubts about the company's \$91 billion commercial real estate portfolio, its \$28 billion of U.K. mortgages and its capacity to fund itself in tumultuous markets. Far from fleeing GE Capital's commercial paper, Sherin insisted last week, the market is actually flying to it. Nevertheless, he disclosed, management would cut back the size of the commercial paper program as it proceeded to de-lever the GE Capital balance sheet, to 6:1 from 7.2:1. Corporate share repurchases would be suspended.

GE long ago made its corporate bed, and a fine piece of furniture it had seemed to be. Not just any company is going to earn \$20 billion in this unprosperous year, Immelt reminded listeners-in. “Our industrial segment earnings should be up between 10% and 15% in the quarter, excluding com-



mercial and industrial,” he said. “Our financial services earnings will [be] in excess of \$9 billion in 2008, dramatically outperforming their peers. And the company remains financially strong.” Besides, the CEO added, the shares yield 5% (the \$1.24-per-share common dividend is graven in stone through the end of 2009), and that vital, unquestioned, company-defining triple-A credit rating remains intact.

Why did the company say what it said, just when it said it? A little-known fact about GE, noted the sharp analytical eyes at Portales Partners, New York, last week, is that GE Capital Services, holder of every share of GE Capital, is a “regulated entity,” and its regulator is the Office of Thrift Supervision. Embarrassed by IndyMac’s costly keeling over, OTS is under “pressure to review the business models of ‘non-bank’ entities for safety and soundness issues, particularly in light of the failures of American International Group, Lehman Brothers and Bear Stearns.”

And why might OTS have leaned on GE to rein in its financial sub? Portales ticked off a number of possible reasons; e.g., Capital has only \$60 billion in shareholders’ equity, against which it holds \$82.5 billion in “other assets,” mainly real estate, the aforementioned \$91 billion in commercial real estate, \$15 billion of Level 3 assets, \$53.2 billion of securitized assets (including \$22.6 billion of credit-card receivables held off-balance sheet) and \$31.6 billion of goodwill and in-

tangibles. On the liabilities side of the balance sheet can be found \$202 billion of short-term borrowings.

“Finally,” Portales advised, “we remind investors that the SEC formal investigation, which started in 2005, into GE Capital’s use of hedge accounting for derivatives is still ongoing.”

Serving up bad news, GE executives manage to sound like Oprah. Earnings aren’t reduced but “reframed,” financial services aren’t shrinking but are being “resized,” and consumers aren’t broke but “challenged.” However, for one brief, manly moment, Sherin did find his tongue and speak plain English. Would GE consider drawing on its \$62 billion of bank lending facilities? an analyst asked. “Absolutely not,” the CFO replied, before rattling off a long list of the company’s sources of liquidity. Come the day that GE changes its tune on this point, take cover. Then again, most of us are already doing business from under our desks.

Not your father’s GE

(September 5, 2008) General Electric under Jack Welch, like the Fed under Alan Greenspan, was an enterprise seemingly touched by the gods. It launched a thousand case studies—for growth, profitability, reinvention, globalization and all-around, Six Sigma excellence. And a wonderful business only became more lucrative when a

finance subsidiary was grafted on to a manufacturing superstructure.

GE Capital is our featured topic, and we are bearish on it, just as we are on the GE share price. Our indictment comes in two counts: No. 1, Capital is setting aside too small a reserve against future credit losses; No. 2, the softening world economy will take a greater-than-anticipated toll on the parent’s sales of aircraft engines, railroad locomotives, power plants, wind turbines and other staples of the great 21st-century infrastructure boom.

Our previous analysis of the greatest corporate brainchild of Thomas A. Edison (“Mythical triple-A,” *Grant’s*, November 30) concluded with a credit judgment: On the merits, GE deserved a downgrade to single-A, a two-notch demotion from top-flight, we said. Some scoffed, but we’ve been proven overly sanguine, not hypercritical. When we last wrote, the annual cost of insuring the obligations of the parent and subsidiary against default over five years was 64 basis points and 66 basis points, respectively. Today, five-year credit-default swaps are quoted at 125 basis points and 166 basis points, respectively. These are levels that implicitly place GE and its finance subsidiary in the marginally investment-grade bin marked “Baa3,” according to Moody’s Market Implied Ratings. (For the record, Egan-Jones Ratings, the advertising of which sometimes ornaments the back page of this journal, calls GE double-A-minus.)

In his 2001 memoir, “Jack: Straight from the Gut,” the hard-charging Welch describes his dawning realization that the business of lending and borrowing was, or could be, a gold mine: “Since I had been involved in making things all my life, pounding and grinding it out to make a nickel, I couldn’t believe how easy this ‘appeared’ to be.” So GE Capital’s footings grew and grew, to \$696 billion in 2008 from \$11 billion in 1980. Over the past three years, Capital has contributed an average of 48% of GE’s net income. On June 30, this one, massive subsidiary accounted for 82% of company-wide assets.

You’d suppose it walks on water the way it defies the worldwide credit storm. It is as if there were no such blow—or, rather, that the seas crashed and the winds shrieked only for others. Thus, in the 12 months to June 30, Capital managed to increase its

assets by 17%, though its earnings dropped by 6%. Not only does it seem to be untouchable, but it has also managed to profit by others' misfortunes. In this year of salty credit tears, Capital has acquired a Merrill Lynch middle-market finance business, which tacked on \$10 billion of assets in the first quarter, and a Citigroup commercial-leasing and equipment business, which added another \$13.2 billion of assets in the third quarter.

"If you have the capital and you can do the underwriting," Keith Sherin, GE's vice chairman and chief financial officer, told listeners-in on the second-quarter call, "there are great opportunities available. We have got \$24 billion of year-to-date volume at about a 30% return on equity. We are raising our price across our flow businesses." Capital's financing-receivables book summed to \$428 billion on June 30, up from \$388 billion at year-end. Double that increase and Capital would log a 20% rise in receivables for all of 2008. It would be like growing strawberries in Vermont in January.

"We believe that the company is really in fine shape to face the types of economic conditions we see today and in the near future." So declared Welch's successor, Jeffrey Immelt, on the same conference call. Granted that GE is an American, indeed, a global, icon, it still does business on planet Earth. What kind of economic conditions was Immelt, the CEO, referring to?

Approximately half of GE Capital's \$696 billion of assets falls under the heading of commercial finance, while consumer lending contributes 32% (the remainder is related to aviation and energy financial services). GE Money is the consumer lender; it deals in credit cards, mortgages, home-equity loans, personal loans and auto loans across 50 countries, in some of which—e.g., Turkey, Hungary, the Philippines—it owns a bank. GE Commercial Finance provides loans and leases and conducts a real-estate financing operation. In the second quarter, revenues and earnings in Commercial Finance grew by 14% and 7%, respectively. GE Money, not keeping up, logged a revenue gain of 6% and a net-income decline of 9%.

Just reading the papers, you would doubt that the consumer business can long continue to do even that well. It came out on the conference call that, of the \$79 billion of non-U.S. mort-



gages held by GE Money, \$29 billion are in the U.K., a nation suffering its own swoon in residential property prices. "Everything we do in the U.K. is originate-to-hold," Sherin assured his conference-call audience. "We have our own in-house appraisal and servicing group. These are experienced GE employees who go out and validate the values of every property. We have insurance on properties that are more than 80% loan-to-value."

It speaks well to the industry, not to mention the fleetness of foot, of GE's "in-house appraisal" group that it has found the means to "validate the values of every property." If GE lent against properties at the average U.K. price of £165,000, and if it lent at a nice, low, prudent loan-to-value ratio of 71% (as it says it does), it owns no fewer than 131,000 individual mortgages. That's a lot of front porches to inspect. Be that as it may, Britain's own property bubble is fast deflating, with house prices down by 10.5% year-over-year and 11% below their 2007 peak. Standard & Poor's disclosed the other day that U.K. prime mortgage delinquencies reached 2.94% in the second quarter, the highest since record keeping began in 2004.

"That GE's non-American mortgage portfolio is not of uniformly pristine credit quality can be gleaned from an interesting footnote in GE's 2007 annual," colleague Ian McCulley relates. "It discloses that 'approximately 26% of the [non-U.S. mortgage] portfolio comprised loans

with introductory, below-market rates that are scheduled to adjust at future dates, with high loan-to-value ratios at inception and whose terms permitted interest-only payments or resulted in negative amortization."

As for the commercial side of the business, GE exudes Welchian optimism. It makes senior secured loans. It operates in middle markets. It has (in its mid-market leasing business) a million customers. It is hugely diversified across markets and regions. It has "incredible credit and restructuring expertise," which is self-explanatory, and "deep domain expertise," which, to us, is not. "We are not traders or speculators," Sherin assured his audience on the call. "We don't borrow short and lend long. We are match-funded, so we focus on credit or asset risk. We are not a passive buyer of packaged assets." And, it has 20 years' experience in the financial realm.

This last point, we absolutely discount—Citigroup, after all, has been dancing since 1812—and we have our doubts about the others, too. Lenders don't earn 25% on equity or grow by 20% a year in a credit storm just by being extra prudent. A case in which GE Commercial Finance trod where others could not, or would not, tread was a \$960 million collateralized loan last spring to iStar Financial, the reeling nonbank commercial real estate lender. Proceeds paid off the bridge loan that financed iStar's ill-omened purchase of the commercial and construc-

tion portfolio of the Fremont (Calif.) General Bank. The GE credit matures in three years and pays Libor plus 340 basis points with a floor of 6.25%. Before the credit crisis burst out into the open, iStar paid Libor plus 165 points for similar accommodation. Plainly, GE is earning more for the risk it's bearing than preceding creditors did. Whether it is earning enough is the open question. In the past year, iStar's share price has plunged to \$5.59 from \$37.

Operating as it does on this planet, in these markets and in this crisis, GE is susceptible to credit-related losses. You would hardly know it, however, by a glance at Capital's reserve against impaired assets. "The allowance," McCulley notes, "currently stands at \$4.5 billion, or 1.05% of gross receivables, compared to \$4.2 billion, or 1.08% of gross receivables, at year-end. The reserve has actually gone down, not up, since 2003, when it was 2.5% of receivables. Over the same span, the allowance for loan losses as a percentage of nonaccruing assets has fallen to 69% from 147%. It's a pretty stark contrast to open the new FDIC quarterly banking profile."

Of course, in GE's eyes, it is no mere bank, far from it. "We have got great risk management," to quote Sherin again. "Our loss averages over the last 20 years have been far below the banks'. We manage the company as a triple-A from the board of directors, down to the Capital board, down to the management teams. Everything we do is about making sure we keep it triple-A. . . ."

However that may be, America's insured depository institutions boosted their allowances as a percentage of loans and leases to 1.8% at the end of June from 1.08% at year-end 2006. As for reserves expressed as a percentage of nonaccruing loans, they have fallen to 89% from 172%—a decline, yes, but one not nearly so steep as GE's. Some may object that the comparison is apples to tangerines, or to mangoes, because half or more of GE's loan portfolio is outside the 50 states. But that is only to underscore how heavily the company is exposed to the weakening economies of Europe and Asia. It would cost GE \$6.2 billion, or 62 cents a share, after tax, to restore its loan-loss reserves to 2.5% of loans and leases, the level prevailing in 2003. It's the equivalent of about a quarter-and-a-half's net income.

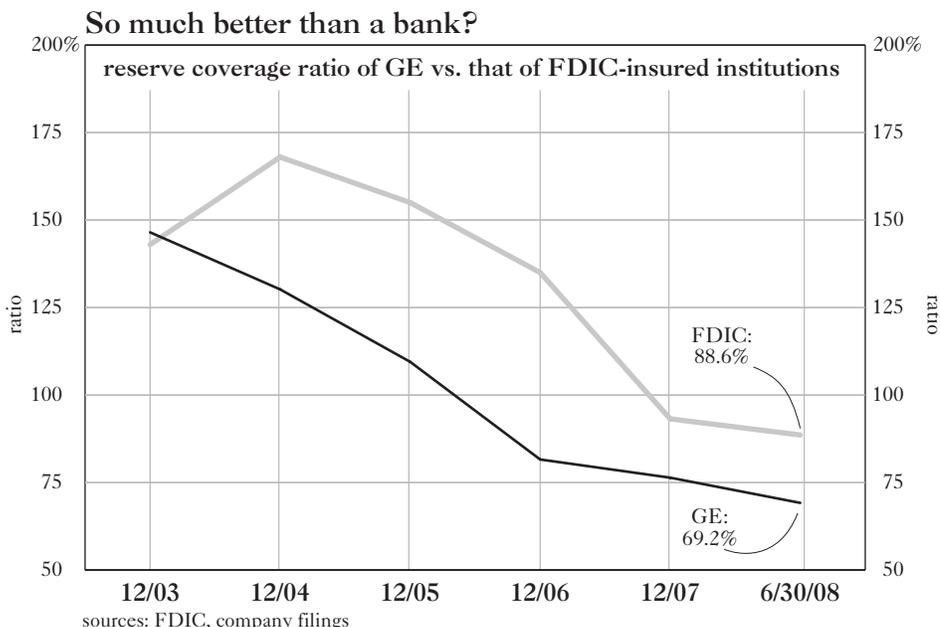
Not many companies could prosper in a recession overlaid on a credit contraction. And though GE Capital professes to be making hay in the current disturbances, we doubt that either the financial sub or the parent will exit the cycle unscarred. For instance, GE's aviation-related businesses, which profited from the tailwind of growth in airline travel, stand equally to suffer from the headwinds of recession. According to the International Air Transport Association, global air-passenger traffic in June was up by just 3.8% from the year before, the smallest such gain since 2003. Weakness in domestic U.S. air travel may be old news. Not so, how-

ever, the slowdown in traffic in Asia and the Middle East. Thus, in June 2007, Middle Eastern carriers logged year-over-year growth of 18.1%. By May of this year, their year-over-year growth had subsided to 12.8%; in June, it was down to 9.6%. It may be, just as Immelt insisted on the conference call, that, in the interior of China and India, "[t]here are cranes everywhere, and you just don't see the kind of slowdown driven by the U.S. consumer." If that's the world we live in—no longer dependent on American consumption but thoroughly decoupled—then GE may be the stock for you.

It is, of course, the demand from Asian and Middle Eastern airlines that has put the bulge in the Boeing and Airbus order books. That both manufacturers are sold out at least through 2011 encourages the GE faithful. But order books are the kind of volumes that never get set in type and are forever subject to cyclical expansion or contraction. "Deferrals and cancellations are beginning to trickle in," McCulley reports, "and it's unlikely that every plane ordered will actually be built and delivered with GE engines hanging on the wings. Safran, GE's French joint-venture partner, reported disappointing earnings at the end of July and ventured a downbeat outlook for the rest of the year (upon which its share price broke)." In another sign of the times, Kingfisher Airlines, a fast-growing Indian carrier, took steps last week to defer delivery of some Airbus planes it had ordered to 2010 through 2012 instead of 2008 and 2009. Kingfisher is "one of the biggest stakeholders in the Airbus order backlog by number of planes," as Reuters notes.

GE has another touch point on the softening airline business. Through its aircraft-leasing subsidiary, GECAS, it owns 1,479 planes with a value of \$30 billion. Through GE Capital, it holds \$12 billion of aircraft loans. Dowager 737s and other gas-guzzling narrow bodies make up perhaps 9% of the overall GE aircraft portfolio. That these flying antiques may be recycled for service in poor nations, rather than mothballed in the American desert, is the ardent hope of the GE front office.

"Infrastructure" is the GE division that overshadows all others. Aviation, transportation, fire detection, oil and gas, water, power plants, wind turbines: the sum of these disparate busi-



nesses produced \$17.6 billion of revenues and \$3.2 billion of segment profit in the second quarter, up 26% and 24%, respectively, from the year-earlier period. "Solid performance in a tough environment," said GE, with a modest pat on its own back. An impartial observer might, instead, shout, "Bravo!" Over the past three years, Infrastructure's revenues and profits have surged by 40%. More than any other segment's contributions, they have powered corporate growth. All the more reason, then, to hark to the story in last week's *Wall Street Journal* about the evident turn in the investment cycle. "Morgan Stanley recently estimated that 8%, or \$60 billion, of the \$750 billion of infrastructure projects slated for 2008 are being delayed or cancelled," the paper said. "That is four times the historical cancellation rate of 2% a year."

Hydra-headed, the credit markets hold not one monolithic view of GE, but two, at least. There is the verdict of the money markets, bullish, and that of the credit default swap market, guarded. "Funding in terrific shape," the company's second-quarter hand-out boasts of GE Capital: Out of \$80 billion to \$85 billion in required 2008 funding, Capital has already secured \$60 billion. The commercial-paper market is the willing financier of \$97 billion of GE's and GE Capital's unsecured IOUs—and would gladly take more, management says.

The ratings agencies (ex-Egan-Jones) broadly concur with management. And listening to Sherin on the call, one can hardly imagine the agencies changing their minds. The company and the analysts who rate it could almost be reading one another's minds, the CFO suggested. "It is really not anything like being limited to an annual review," he said. "It is a real-time, open-book, constant-communication relationship." We will not say that, in the face of this full-court press, Moody's or S&P wouldn't dare to issue a downgrade. But if they did choose to snatch away that sacred triple-A, the explosion at GE headquarters in Fairfield, Conn., could be plainly heard at the Manhattan offices of Moody's and S&P. All the more important, then, to attend to the credit-rating relationship that GE can't manage, i.e., the cost of insuring its obligations in the credit-default swap market. As noted, those prices imply a rating much lower than the one in place.

If, as we judge, the CDS market is on to something, the stock market is missing something; they can't both be right. Just how violently they disagree shines through in a sum-of-the-parts analysis of the house that Welch built. Ex-Capital, continuing operations at GE have produced \$11.8 billion in earnings in the last 12 months. McCulley observes that there is no company exactly like it—and perhaps, for the true believers, that is the real point. Nevertheless, United Technologies, Emerson, Siemens and Rolls-Royce do provide some points of comparison. They change hands in the market at from 12 to 16 times trailing net income. "Give Jeff Immelt the benefit of the doubt," McCulley suggests, "and say that GE's particular business portfolio is better than average, with faster growth and higher margins. Put a 16 multiple on it. That values the nonfinancial side of the company at \$188 billion, or \$18.80 a share.

"The financial side of the business," McCulley winds up, "has a tangible book value of \$28.5 billion. Delinquencies and nonaccruals are—apparently—under control. Better-quality financials are valued at two to 2.5 times tangible book. A 2.5 multiple values Capital at around \$71 billion. The combined value of both businesses comes to \$259 billion, or a little less than \$26 a share. The stock, in contrast, changes hands at \$28.63 a share."

On Wall Street, the consensus of analytical guesswork has GE's earnings growing by 7% in 2009 and by 10% in 2010. An unscripted decline in worldwide economic growth would reduce industrial earnings while turning up the heat on GE's massive credit exposures. In such a scenario, it is not so farfetched to expect that multiples would contract and that GE common—seemingly so cheap in the high 20s—could become even cheaper. Coming soon from NBC Universal, the GE entertainment subsidiary, is "Burn After Reading," with George Clooney and Brad Pitt. Clooney, we allow ourselves to imagine, plays the chief Moody's analyst at one of the grander Wall Street broker-dealers. Pitt is an analyst at one of the great bond-rating institutions. Each has an interest to protect. . .and a secret to keep. Now there's a popcorn movie.

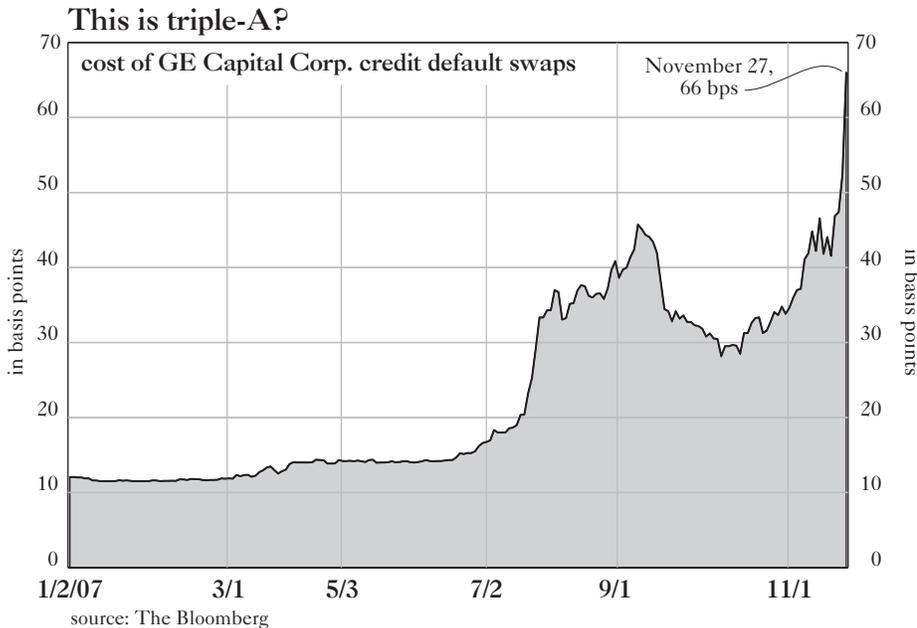
Mythical triple-A

(November 30, 2007) GE's new high-thrust jet engine, the GENx, is expected to go flying off the production lines and onto the wings of the forthcoming Boeing 787. But that isn't the kind of flight now under discussion. Rather, the subject at hand is the flight to quality, a kind of mind travel induced by credit disturbances.

Since the turn of the cycle last summer, the destination of many such anxiety-propelled flyers has been the triple-A-rated balance sheet of General Electric Co. On the third-quarter conference call, Keith Sherin, GE's chief financial officer, told the story of how, one scary Friday in August, a certain state pension fund phoned to ask GE if it would accept a \$5 billion investment. We are about to propose that those frightened stewards of other people's money called the wrong number.

As the world has learned to its cost, triple-A is a judgment handed up by fallible human beings who draw their pay from the very borrowers they rate. GE is a hugely successful, globe-girdling corporation that—contrary to popular perception—is not so much an industrial giant as a financial one. Measured year-over-year in the first nine months of 2007, revenues delivered by financial services jumped by 18%, as opposed to 8% growth on the industrial side. No less than 42% of the behemoth's \$124 billion in nine-month revenues derived from lending, borrowing and investing. In all but name, GE is a bank within an industrial company, or—based on the comparative revenue-growth curves—an industrial company within a bank. Yet it discloses much less about its financial position than a comparable-sized American commercial bank has to tell. And it leans heavily on the sometimes-flighty commercial paper markets. GE is unequivocally a strong, investment-grade credit, but it is scarcely the triple-A fortress it once was and still pretends to be.

This verdict won't shock the credit-default swap market, which, in fact, has beaten us to the punch. Last spring, the cost of insuring GE debt obligations against nonperformance was 12 basis points per annum for five years. By Labor Day, the cost was more than 40 basis points, and it was 64 basis points this week. The kind of issuer



that should expect to be quoted at that level is typically rated Baa1, according to Moody's Market Implied Ratings; 64 basis points indicate a rating seven notches below the one that another branch of the Moody's credit enterprise has actually assigned to GE.

As with the parent, so with the subsidiary. General Electric Capital Corp., the largest nonbank finance company in the United States, has itself been taken down a few pegs in the CDS market. The annual cost of insuring GECC stands at 66 basis points, up from 13 in the spring. For perspective, five-year CDS on United Technologies (rated A2 by Moody's and single-A by Standard & Poor's) are quoted at 24 basis points, while those of Siemens (A1/AA) trade in the low 40s. Five-year protection on 3M (Aa1/AA) and Procter & Gamble (Aa3/AA-minus) are quoted in the mid-teens and mid-20s, respectively. In some phases of the credit cycle, it doesn't pay to be a bank.

You wouldn't suppose that a company with a \$384 billion market cap, a \$762 billion balance sheet and a storied 115-year history could hide much from the scores of analysts who swarm around it like the Lilliputians poking at Gulliver. But GE has done it. It hides its secrets in plain sight. In his introductory remarks on the third-quarter conference call, Jeffrey Immelt, the chairman and CEO, delivered the good news in staccato fashion: "The environment, we believe, remains good for GE. Global markets are solid, and the finan-

cial market risk is repricing. This shows up in phenomenal growth numbers. Our revenues were up 12%, orders up 20%, assets up 23% and organic growth at 8%." On the isolated evidence of that report, an observer might wonder if the global credit tumult had ever happened. Certainly, he or she would not have guessed that it was about to flare up again or that GE, within five weeks of the conference call, would choose to allow the investors in one of its own short-term bond funds to absorb a 4% loss of principal rather than buy their good will by making them whole with an outlay of, perhaps, \$24 million.

GE did write off \$890 million, after tax, on a Japanese consumer-lending subsidiary and \$43 million, also after tax, on a North American mortgage lender. But such is the GE way: Identify underperforming businesses early, dispose of them promptly and direct analytical focus away from "discontinued" lines to the thriving continuing ones. And Immelt did acknowledge to his conference-call listeners that American consumer delinquencies were "trending up slightly" and that housing finance and subprime mortgages were "still tough." But he gave no sign of concern that the American subprime crisis is actually a global credit crisis in which GE is bound to be caught up, so extensive are its exposures across market segments and time zones. He instead gave the impression that the company is above it all. "GE, we believe," he said into

the speaker phone, "is very well positioned in this environment with our global strength, our infrastructure technology, our diverse business mix, tremendous triple-A-rated balance sheet and risk management. . . ."

Third-quarter credit results were no less rousing than the CEO. Thus, delinquencies in commercial finance were just 1.35%, up 13 basis points from year-end 2006 but flat year-over-year. Delinquencies in GE Money, the worldwide consumer finance subsidiary, were 5.24%, essentially unchanged from year-end 2006 and lower year-over-year. Nonearning assets, i.e., those 90 days or more past due, were 1.5% of the combined portfolios on September 30, and were down 10 basis points from year-end. Those, of course, were historical data. Hearing the howling of the cyclical winds outside its Fairfield, Conn., headquarters, what did management do about reserves for future credit losses? It left them unchanged, at 1.1% of gross receivables on September 30. As recently as year-end 2005—before the skies blackened and the rains came—they stood at 1.6%.

GE's many admirers see in these numbers further confirmation that the mega-bank cum manufacturer is—just as it claims to be—a "disciplined growth machine." Unusually in this day and age, GE chooses to keep most of its loans and leases on-balance sheet. Now there is a bankable expression of confidence on the part of the underwriter, the bulls contend. On September 30, such assets footed to \$361 billion. Securitized assets held off-balance sheet totaled \$51 billion, for which GE was obligated to provide \$2.9 billion of liquidity support and \$2.5 billion of credit support.

The illustrious corporate name is no small source of GE's ratings stature. The numbers alone don't quite measure up to triple-A. "On a consolidated basis," colleague Ian McCulley observes, "the ratio of debt to trailing 12 months' EBITDA is something like 8:1, though that is a misleadingly high figure because a lot of this debt is supported by assets held at the GE Capital level. So the ratings agencies make their adjustments. They analyze GE as an operating company and GE Capital as a financial company. GE, standing alone, has \$13 billion of debt against \$27 billion or so of EBITDA and \$8 billion of cash—a profile much more

in keeping with a top-drawer rating. GE Capital has \$620 billion of assets against \$562 billion of liabilities and \$56 billion of equity, for a ratio of equity to assets of 9%. The loan book is widely judged to be first class.”

Yet, as McCulley also observes, if GE and GECC didn't exist yesterday, but materialized in their present form

today and presented themselves at Moody's tomorrow, neither could expect to be crowned triple-A. Moody's itself, in a recent comment on GE, seems to admit as much: “Utilizing the ratings factors identified in the Heavy Manufacturing rating methodology, GE's rating drivers suggest an Aa2 rating which is two notches lower than

the current rating. . . . The actual assigned rating of triple-A,” the comment continues, “incorporates GE's strong management, conservative financial policies and predictable cash flows derived from its leading market positions globally in a broad range of products and services.” And there is this consideration: As one of the world's most prolific debt issuers, GE is what is known in the ratings industry as a very good customer. To demote it from triple-A may or may not be a sound credit decision (we judge it to be sound). For the first agency to pull the ratings trigger, it would certainly be a questionable business decision.

Just as Moody's notes, GE's products—from desalinization plants to gas turbines to wind-generation technology to jet engines, etc.—are dazzling. So dazzling are the company's industrial achievements, in fact, that it is easy to forget how extensive is GE's banking business. GE Money is a global consumer finance business with operations in more than 50 countries. Its stock-in-trade encompasses credit cards, mortgage loans and personal loans. At year-end 2006, more than 75% of its \$157 billion portfolio was outside the 50 states, and its assets over the past dozen years have grown at a compound annual rate of 18%. Eleven months ago—that being the latest parting of the curtain—assets included \$58 billion of non-U.S. mortgages, \$36 billion of non-U.S. revolving credit and \$25 billion of non-U.S. auto credit. There were five banks under GE Money's wing, including GarantiBank in Turkey, GE Money Bank in the Czech Republic and Kepel Bank in the Philippines.

The GE consumer finance franchise does not entirely skirt the 50 states; domestic credit-card programs totaled \$29 billion at year-end. But the company has wisely refused to export aggressive, boom-time American underwriting practices. Globally, GE Money says, it hews to an average loan-to-value ratio of 70% and a debt-to-income ratio of no more than 35%. It says it does no negative-amortization lending.

In short, if you believe that foreign economies have “decoupled” from the slightly weary U.S. model, GE Money is the business for you. No doubt, McCulley advises, GE Money has done its customary crackerjack job of underwriting in foreign parts. “But,” he goes on, “the simple fact is that credit booms

General Electric Company

(in \$ millions, except per-share data)

	12 mos. to			
	<u>9/30/07</u>	<u>12/31/06</u>	<u>12/31/05</u>	<u>12/31/04</u>
Sales of goods and services	\$106,436	\$100,700	\$92,589	\$84,705
GE Capital Services	69,187	59,957	55,430	48,712
Other revenue	<u>1,391</u>	<u>2,734</u>	<u>2,223</u>	<u>1,582</u>
Total revenue	177,014	163,391	150,242	134,999
Cost of goods and services	(76,753)	(74,110)	(66,814)	(61,759)
Interest and other financial charges	(22,860)	(19,286)	(15,138)	(11,611)
Investment contracts, insurance losses and annuity benefits	(3,451)	(3,214)	(5,474)	(3,583)
Provision for losses on financing receivables	(4,855)	(3,839)	(3,841)	(3,888)
Other costs and expenses	(40,888)	(37,414)	(35,271)	(33,096)
Minority interest	<u>(907)</u>	<u>(908)</u>	<u>(986)</u>	<u>(728)</u>
Earnings from continuing operations	27,300	24,620	22,718	20,334
Income taxes	(4,396)	(3,954)	(4,085)	(3,708)
Earnings (loss) from discontinued operations, net of tax	(838)	163	(1,922)	534
Net income	<u>22,066</u>	<u>20,829</u>	<u>16,711</u>	<u>17,160</u>
Diluted earnings per share	2.14	2.00	1.57	1.64
Cash	19,848	14,275	9,011	12,152
Investment securities	45,209	47,826	53,144	56,923
Current receivables	12,705	13,954	14,851	14,233
Inventory	13,319	11,401	10,474	9,778
Net financing receivables	361,684	334,205	287,639	282,699
Other GECS receivables	16,704	17,067	14,767	11,340
Net property, plant and equipment	76,292	75,966	67,528	63,103
Net intangible assets	94,317	86,433	81,726	78,456
Other assets	114,257	97,112	87,425	89,667
Assets of discontinued operations	<u>7,372</u>	<u>0</u>	<u>46,756</u>	<u>132,266</u>
Total assets	761,706	697,239	673,321	750,617
Short-term borrowings	180,403	172,153	158,156	157,195
Accounts payable	18,716	21,697	21,273	19,137
Other current liabilities	28,524	26,664	25,498	23,805
Long-term borrowings	311,220	260,804	212,281	207,871
Investment contracts, insurance liabilities and annuity benefits	34,074	34,499	45,432	48,076
Deferred income taxes	10,758	14,171	16,312	15,308
Other liabilities	55,363	46,884	40,632	42,779
Liabilities of discontinued operations	<u>2,309</u>	<u>475</u>	<u>36,332</u>	<u>112,935</u>
Total liabilities	641,367	577,347	555,916	627,106
Minority interest	7,508	7,578	8,054	12,603
Shareholders' equity	112,831	112,314	109,351	110,908
Shares outstanding (millions)	10,257			
Price per share	\$37.45			
Market capitalization	384,125			
Price/earnings	17.4x			
Price/book	3.4			

in emerging markets sometimes end badly, as, indeed, do credit booms in developed countries. Recall South Korea's experience with credit-card defaults earlier this decade. Some of GE's new borrowers had, before GE came along, never been able to raise a mortgage loan. Now they are happily enjoying home ownership, and will keep on paying their interest and principal unless and until the global economy turns down. Surging asset growth is always a good thing in a boom. Not so much in a bust."

Just 29% of GE's loan book exists to support GE's industrial sales; the purpose of the much bigger remainder is to generate earnings growth for the parent. The operations of the commercial finance subsidiary are as eclectic and far-flung as those of GE Money. At year-end, the commercial segment held \$76 billion in equipment lease obligations, \$49 billion of commercial and industrial loans and \$28 billion of real estate loans. Nor is GE exclusively a lender against real estate collateral; as of 11 months ago, it also owned \$27 billion of property in its investment accounts. In the nine months to September, such loans and investments generated \$5.1 billion in revenue, roughly 20% of commercial finance sales, up from \$3.4 billion for the like period a year ago. The grand total of assets associated with real estate jumped to \$72 billion as of September 30, compared to \$54 billion last December 31.

In the wake of the disclosure that one of its short-term bond funds was redeeming its investors' shares at 96 cents

on the dollar, rather than, say, 100 cents on the dollar, GE issued a press release stating that "GE and GE Capital have no exposure to special [sic] investment vehicles (SIVs) and less than \$50 million in collateral [sic] debt obligations (CDOs)." If we were Jeff Immelt, we think we would do as he did—let the outside investors absorb a small loss, let people talk—if we expected that more losses were in the offing and we did not want to establish a potentially costly precedent of reimbursing the investors, of whom there are many, indeed. GE manages \$96 billion of outside money, including, according to the GE Asset Management Web site, a certain number of funds with structured products in their portfolios.

To us, and to any who believe that the 2007 credit drama is still unfinished, it's a foregone conclusion that GE must bear more losses. No global financial institution can hope to escape untouched. There was, as noted, no such concession on the third-quarter conference call last month. But, to judge by the response to the bond-fund dustup, management might be changing its mind.

The principal risk to GE investors, we believe, is the gap between perception and reality—between the complacent belief in Fortress GE and the risks presented by the huge pile of assets and liabilities in the midst of a planetary credit blow. As to the liabilities, GE does most of its borrowing through GECC, the largest commercial paper issuer in the world and one of the world's

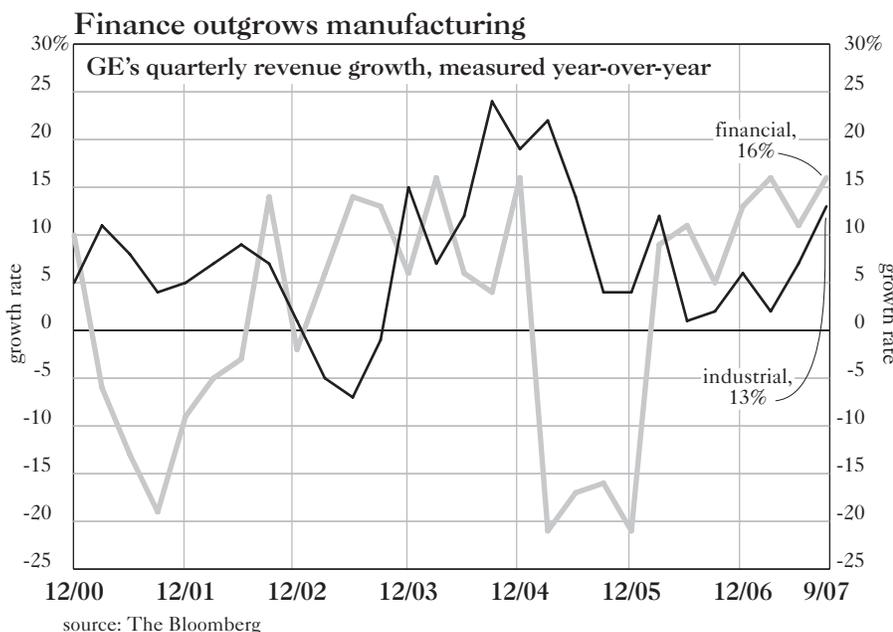
busiest issuers of corporate bonds. (GE's bonds are denominated in 19 different currencies, its commercial paper in nine.) On September 30, the finance subsidiary had outstanding \$178 billion in short-term debt, of which \$65 billion was in U.S. dollar-denominated commercial paper, \$27 billion of non-U.S. dollar-denominated commercial paper, \$53 billion of maturing long-term obligations and \$5 billion of asset-backed commercial paper. The long-term debt was very largely unsecured and stretches out to 60 years in maturity. At the other end of the funding curve, GE depends on the health and confidence of the sometimes-fragile paper market.

Today, there seems nothing fragile about the GE paper program. The finance subsidiary is paying 4.51% to borrow for 30 days, only a quarter-point higher than the federal funds rate, and last month's conference call elicited not one anxious question on the quality of the loan book. In an August bulletin on funding, or liquidity, risk, Moody's judged that GE was sitting pretty. Backup lines of bank support appeared more than adequate, the agency decided. They sum to \$61 billion, of which 60% can be drawn for longer than one year.

For ourselves, we don't doubt that this virtual nation-state of a global corporation will sail through the 2007 credit dislocations. What we do doubt is that the equity and money markets will continue to ignore the risks that every credit crisis must present to every leveraged financial institution. CEO Immelt insists that GE is triple-A. Moody's agrees in a hedged sort of fashion. The bond market demurs, while the CDS market is adamant that the risk is that of a borrower rated no better than Baa1. Grant's judiciously estimates that the truth lies somewhere in the middle—in the neighborhood, say, of a strong single-A credit. As for the bond and stock markets, we judge that they believe, with Immelt, in Fortress Triple-A. It may come as a jolt when they're disabused of that myth.

Saps take umbrage

(May 4, 2007) Doormats to private-equity promoters, real-estate speculators and hedge-fund titans, creditors have actually staged a revolt. They have ordered the rotten apples removed from the barrel of collateral that



was to support a pending sale of commercial mortgage-backed securities. Otherwise, they said, they would sit on their wallets. The issuer, none other than General Electric, submitted.

"In a highly unusual restructuring," the April 27 *Commercial Mortgage Alert* reported, "an underwriting syndicate this week was forced to pull \$277 million of loans from a \$4.2 billion fusion offering after bondholders raised concerns about credit quality. The deal (GE Commercial Mortgage Trust, 2007-C1) ended up pricing at significantly wider spreads than the prevailing levels after a much-extended marketing campaign." Five such overripe pieces of fruit were extracted, including a \$201 million interest-only loan to a Long Island apartment complex. According to Moody's, the loan had a "stressed" loan-to-value ratio of 138% and a "stressed" debt-service coverage ratio of 0.63:1.

Many were stressed by this unaccustomed show of spine by members of the creditor class. In the contraction phase of the cycle, of course, lenders do talk back and frequently forget where they put their checkbooks, but then they act on fear more than conviction. "The changes amounted to more than the ordinary tinkering that can occur at the last minute," the *Alert* said. "Indeed, market players described them as among the most extensive ever seen in the late stages of a conduit marketing campaign. More importantly perhaps, they marked the first time that investment-grade investors won a concession from dealers in the form of kicking a large loan out of a deal."

The uprising attracted little attention in the general press. Then, again, as colleague Dan Gertner observes, it's the coincident indicators, not the leading ones, that usually garner the ink. Certainly, the coincident indicators of the commercial real-estate market glow with good health. Tuesday brought news of the sale by HSBC of its London office tower to Metrovacesa, the Spanish property company, at a cap rate of only 3.8%, a yield well below the sterling-denominated base-lending rate of 5 1/4% (HSBC will obligingly advance the funds). And on the same day came word of the sale of the old House of Error, *The New York Times* headquarters building in midtown Manhattan, for \$525 million; the seller, Tishman Speyer, had paid \$175

million, one-third of the new price, only three years earlier.

Such valuations may or may not be justified by the real estate fundamentals (we're certain they're not); what makes them possible are willing lenders. But the mutiny of the CMBS investors suggests that lenders are changing their minds. They have every reason to.

Earlier in April, Moody's raised its voice against overgenerous lending terms in the commercial real-estate branch of structured finance. The agency pointed to record-high loan-to-value ratios, the surging popularity of interest-only deals (85% of first-quarter conduit transactions had featured them) and the evisceration of junior tranches (the shock absorbers for the investment-grade tranches).

"The negative credit implications of the ongoing erosion of conduit loan underwriting, particularly the increase in leverage, now exceed the benefits of generally positive property fundamentals," said an April 10 Moody's bulletin ("US CMBS: Conduit Loan Underwriting Continues to Slide—Credit Enhancement Increase Likely"). "As a result, real estate capital market participants can expect to see higher subordination levels phased in to Moody's-rated CMBS deals over the next few months."

But that was not the most arresting news concerning a sanctioned debt-rating agency in the second calendar quarter of 2007. According to the April 20 edition of the *Commercial Mortgage Alert*, Fitch has already increased its subordination levels for CMBS transaction deals. It has bumped them up by 10%. And, it has already paid a price for it. Since imposing the tougher new standard, said Fitch, it had been hired to rate just four of 11 deals; at the start of the year, it had won 14 of 17.

Zanda Lynn, a Fitch managing director, told the *Alert* that lenders think nothing of valuing a property on the basis of distant projections. "In some cases," said the *Alert*, attributing Lynn, ". . . lenders have used rent increases projected 15 years out to underwrite loans with terms of only three years." Lynn told the newsletter that, to make such a deal work, you needed two things: the rent to go up and never go down, and "a take-out lender to refinance the property just as aggressively as the current lender has. It's an excessive practice, and we're seeing it a lot."

On the basis of recent sightings, credit is tightening for commercial real estate as it already has for residential. If so, it's a good thing for the lenders—and a very bad thing for property valuations.

The most imperfect investment

(November 8, 2002) On the third-quarter General Electric conference call, management virtually asserted that GE is cycle-proof. In so many words, Jeffrey R. Immelt, CEO, declared that it's business as usual in Fairfield, Conn.—bear market, credit contraction and post-bubble syndrome notwithstanding.

"So no issues, now, Jeff, on pricing?" inquired an analyst of the man who succeeded Jack Welch. "I mean, the concern is that as customers, your airline, especially, and power customers get squeezed, that they're looking to get some room within the contracts on service."

"I think just the opposite. . . ." Immelt replied. "I'd say that pricing has stayed very attractive, particularly in power and engines and in medical, because of the value created in the customer." In fact, according to Immelt, so formidable—so "unbelievable"—is the management team of the aircraft engine unit that GE stands aloof from the threatened serial bankruptcies of the airline industry. "[W]e think in any environment for the aviation business, this situation is manageable," he said.

"GE will earn \$4.1 billion in the fourth quarter, up 25%," the boss prophesied (he spoke on October 11, less than two weeks into the quarter). "This is approximately the same amount we earned in all of 1992, and I'm proud of our team's effort. . . . Here's what we'll deliver in 2002: Solid earnings growth. Strong cash flow."

The nation's second most-valuable company is always topical, but it's more timely than ever for the readers of *Grant's*. Already heavily leveraged, GE Capital last month filed a shelf registration for \$50 billion in new debt securities. Then, too, the 11th-hour scratch from the October 24 conference lineup of Ravi Suria, credit analyst of renown (his topic was "GE Capital—Fact, Fiction and Book Value"), has left the *Grant's* community with a sense of GE-

Comparing balance sheets... GE Capital Services vs. CIT, as of September 30 (in \$ billions)

	GECS	CIT
Assets		
Cash and investments	\$124.1	\$2.3
Earnings assets ¹	232.1	35.3
Intangible assets, net	22.5	0.4
Other assets, PP&E	<u>94.6</u>	<u>4.8</u>
Total assets	473.4	42.7
Liabilities and equity		
Short-term borrowings	128.3	8.7
Long-term borrowings	<u>133.3</u>	<u>23.8</u>
Total debt	261.6	32.5
Minority/preferred	4.4	0.3
Shareholders' equity ²	<u>31.6</u>	<u>4.8</u>
Total capitalization	297.6	37.5
Reserves/financing receivables	2.64%	2.73%
Equity/assets	6.67	11.14

¹includes financing receivables, operating lease equipment, other GECS receivables and mortgage portfolio
²as reported.

deprivation. The following analysis attempts to fill the void.

In it, we examine the global icon's financial leverage (growing), its free cash flow (negative, as we define free cash flow), its asset quality (riskier), its disclosure (artfully unforthcoming) and the risk-reward proposition presented by its debt securities (little upside, much downside). In the past decade, GE has become less of an industrial enterprise and more of a financial institution. The same company that makes aircraft engines, power plants and locomotives also houses one of the world's biggest unregulated banks. In 2001, the industrial side of the business contributed 56% of revenues and 65% of pretax income; the financial side accounted for 90% of liabilities. The GE balance sheet is one of the most neglected documents in the SEC trove.

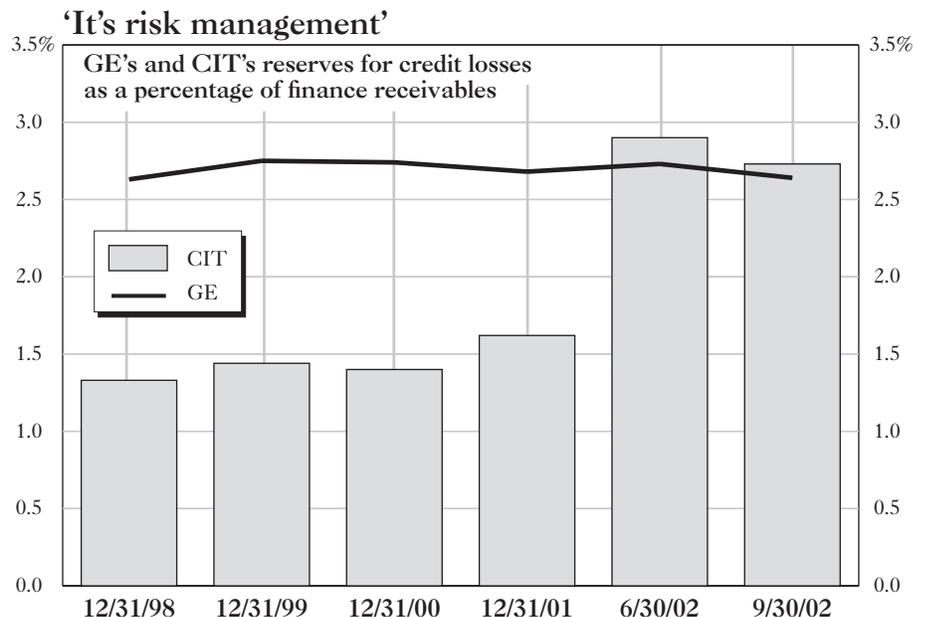
In its financial capacity, GE is a giant arbitrage engine. It borrows at low, triple-A rates and invests at higher, riskier ones. It does what banks do but without taking deposits and without submitting to the prying of federal regulators. The issue before the house is whether the bank of GE—i.e., GE Capital, or GECS, which we use almost interchangeably—is as sound as its triple-A rating. We conclude that it isn't.

As big as it is—\$555.5 billion in consolidated assets as of September 30—

GE constitutes a living symbol of the U.S. economy. It is seemingly invincible. It is a hothouse of productivity-enhancing technology. It is seemingly ubiquitous (among the many businesses in which GE Capital engages—businesses you might not have heard of—is the business of buying GM receivables at a discount from GM suppliers). GECS, though a global enterprise, is as American as apple pie in its increasing application of leverage to higher-yielding assets. Though represented as im-

pervious to the business cycle and the credit cycle, it is, in fact, capitalized to profit in one particular phase of those cycles. The favored phase is the bullish one, naturally. GE is a bull market enterprise, structured by American optimists and geared to rising asset prices. The risk to the creditors of GE Capital is that asset values do not rise but stagnate or slump. In such a setting, GE would suffer the same kind of credit troubles borne by those lenders who put their pants on one leg at a time. Responding to difficulties in its immense book of business in credit cards, leveraged leases, mid-market business leases, consumer loans and aircraft leasing, it would step up its allowance for credit losses. So doing, it would reduce its contribution to the peculiarly predictable parental earnings stream.

Our analysis proceeds from bedrock principles of life and finance. No. 1, if something is too good to be true, it probably isn't. No. 2, business cycles and credit cycles happen to every large financial institution, even to GE. No. 3, a triple-A-rated credit has nowhere to go but down (an adage we borrow from Michael Milken, 1980s' junk-bond impresario). Jack Welch, in his 2001 autobiography, "Jack: Straight from the Gut," marveled at GE Capital: "Looking back over the years of uninterrupted double-digit growth," he wrote, "it almost seems surreal." What, to us, is more surreal is the claim that this globe-girdling unregulated bank is somehow detached from the credit cycle.

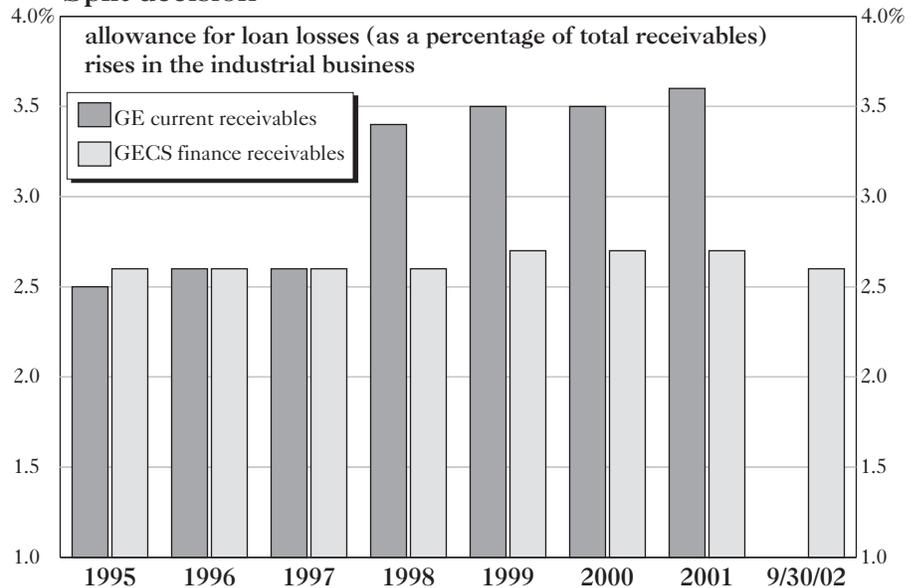


A contrarian may wonder if the bad news on GE isn't already fully discounted. The stock, which is down by 56% from the August 2000 peak, trades at a discount to the S&P 500 market multiple. Bearish critiques have recently appeared in *Fortune* magazine and *The Economist* (and before that—on March 29—in *Grant's*). Eight months have gone by since the manager of the world's biggest bond fund criticized GE Capital's habitual reliance on commercial paper financing not fully supported by backup lines of credit (through the 1990s, a decade in which GE was regally above criticism, commercial paper represented half of total GE indebtedness). To placate the market, GE subsequently replaced billions of dollars worth of that paper with longer-term obligations. However, as Imelt explained over the air waves, the company absorbed no incremental cost by moving to the higher-yielding end of the yield curve. This was because it swapped long yields back into short. In a policy statement on its Web site, GE Capital is at pains to assert that it never speculates—not in currencies, derivatives or emerging markets. It is at pains to assert its devotion to matched funding, i.e., to the practice of offsetting interest rate risk on one side of the balance sheet with interest rate risk on the other. With all that said, GE must have a greater net sensitivity to short rates than to long ones.

Though no longer the corporate ideal of the Welch days (and of the days of Gary Wendt, longtime head of GE Capital, who quit in 2000 to mastermind the supposed turnaround of bankruptcy-bound Consec Inc.), GE is still, by the market's acclamation and that of the leading rating agencies, triple-A. GE Capital, too, is triple-A rated, although an S&P analyst observes that the bank of GE is not cut from exactly the same triple-A fabric as the parent. "On a stand-alone basis," says Lisa J. Archinow, director, financial services ratings, of the capital subsidiary, "it's AA-ish." And if it were deserving of more than a double-A rating before the 2001 acquisition of Heller Financial, the big mid-market finance company, it could hardly be so afterward; before GE bought it, Heller was rated A-minus.

GE Capital isn't paying noticeably more to its creditors, in relation to Treasury yields, than it did a year ago.

Split decision



The GE 6 3/4s of Sept. 11, 2003, are quoted at 103.96, a price to yield a little less than 1.98%. All the way out on the long end of the curve, the GE 6 3/4s of March 15, 2032, are quoted at 104.05, a price to yield 6.14%. (GE Capital does the corporation's public borrowing under its name.) Such low nominal interest rates, as much as they please the borrower, deprive the lender of the margin of safety. The possible disasters that could befall a creditor of a triple-A company between 2003 and 2032 would fill more than these 12 pages. If the dollar were debased, GE's yields would climb, whatever feats of management virtuosity the company performed. In that case, the bondholders would be the losers. Yet, if the dollar were not debased but—on the contrary—gained purchasing power, the bondholders would also very likely be the losers. A deflationary environment would harm GE's creditworthiness by degrading the quality of the tens of billions of dollars of loans and leases that fill the GE investment portfolio.

The words "GE Capital" and "triple-A" together signify "the best." Actually, the bonds are among the worst. They would depreciate amidst inflation but not necessarily appreciate in the absence of inflation. They will not—repeat, not—be upgraded. Is there a worse bet in the bond market? None so widely owned, we believe.

When 99% of the investment world agrees that a certain color is black, it falls to the dissenter to produce the evidence to persuade a fair-minded

observer that the color is actually red. GE is that proverbial color black. It is one of the last 12 triple-A-rated U.S.-based corporations. Tracing its origins to Thomas Alva Edison and the Edison Electric Light Co., it is the only surviving original component company of the Dow Jones Industrial Average. At \$264 billion, its stock-market capitalization represents 59% of that of the entire German market (as measured by the DAX index), to pick a global benchmark. At year-end 2001, calculates Egan-Jones Ratings, pretax corporate income covered fixed charges by 25.1:1. For the full 12 months, net income produced a 25% return on equity.

GE did not get its reputation as an all-season profit machine for nothing. In the 1990s, Wendt would rally his GE Capital troops with the battle cry: "We're going to win the war. You've got to take ground." And they took it. Concerning the perils of the credit cycle (on which this essay heavily leans), a Standard & Poor's analyst has pointed to cyclically induced opportunities. In the early 1990s, when the banking system was clogged with bad real estate loans, federal regulators shifted from a posture of unwarranted leniency to one of unwarranted severity. They required the banks to make special capital allocations against loans that, though still performing, might one day become nonperforming (these "nonperforming performing loans" were a regulatory sore spot of the elder Bush's one-term presidency). "One of the few available buyers of such loans was GECC," re-

calls S&P, “whose asset management skills, coupled with the deep discounted purchase prices and low funding cost, enabled it to generate strong returns on those assets over time. This strategy of opportunistically purchasing distressed assets at discounts and managing through the credit risk over time enabled GECC to reap substantial benefits later in the cycle.”

Today, there are plenty of distressed assets for sale, and GE is no doubt opportunistically buying some of them. However, it also owned a good many of them as they were becoming distressed. Many will contend that GE can operate in the current down cycle as nimbly as it did a decade earlier. S&P does so contend. So great is GE Capital’s diversification, both by product line and geography, says the agency, that it can maintain “consistency in its consolidated profitability throughout the business cycle. . . .” What S&P believes, we doubt.

In a generalized credit crisis, diversification would count for little. What has befallen the domestic credit markets post-bubble is a long way from that, but it does suggest what could happen. The investment-grade wing of the corporate debt market, never mind the junk division, is roiled by downgrades. U.S. Airways has filed for bankruptcy protection, and its debt obligations secured by aircraft collateral (so-called equipment trust certificates) are quoted at 15-20 cents on the dollar. The public, unsecured debt of such power-plant customers as Calpine and Mirant is quoted at 40 cents on the dollar. Household International and Sears, among other seasoned consumer lenders, have admitted to credit woes. CIT, recently divested from Tyco International, has lifted its reserves for credit losses. As for junk bonds, it was noted in the previous issue of *Grant’s*, 40% of the issuance from 1997-99 has already defaulted. Did GE Capital, going for growth, not also succumb to the underwriting errors of the manic phase of the boom? In the three years of the junk-bond bacchanalia, assets of the bank of GE grew to \$345 billion from \$227.4 billion.

In recent disclosures, GE owned up to \$4.4 billion of exposure to U.S. Air and United Airlines and made “provisions for probable losses” (amounts not specified). It identified \$12 billion of investments in, and commitments to,

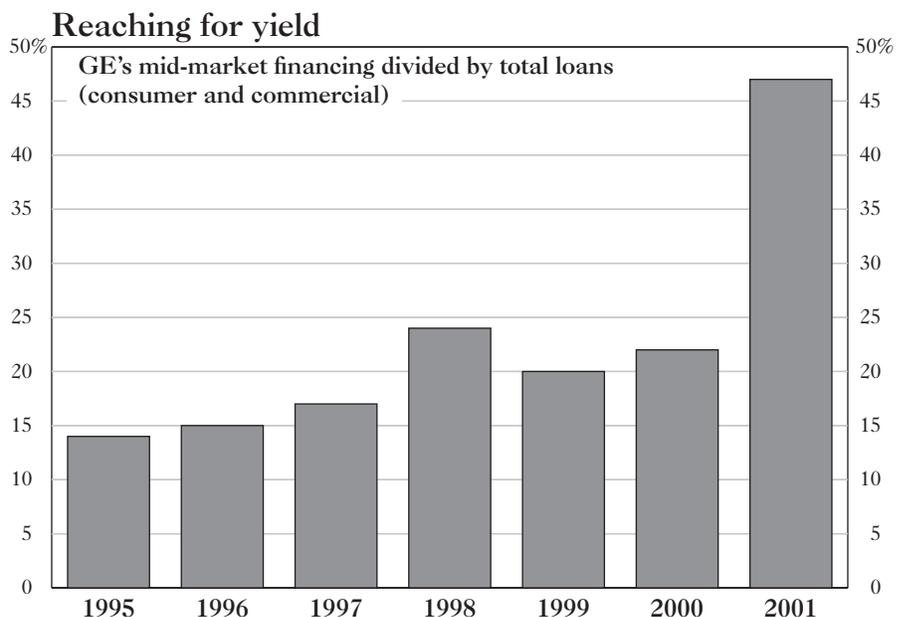
the telecommunications and cable industries. It admitted to a \$600 million rise in impaired receivables “primarily associated” with its Heller commercial finance subsidiary, increasing “nonearning and reduced-earning receivables” from 1.4% of outstandings at year-end to 1.7% at September 30. And it announced plans to wind up its \$3 billion private equity fund. Yet, in the main, GE Capital has suffered fewer slings and arrows than the average outsized financial institution in this cycle. According to the September 10-Q, non-earning consumer receivables have declined by 50 basis points since the start of the year, to 2.4% of outstandings. And the overall credit reserve for finance receivables at GECS declined in the third quarter: at 2.64% of receivables, it was the lowest since December 1998 (reserves hovered between 2.7% and 2.8% over the preceding seven years).

The accompanying graph plots GE’s reserve for credit losses against that of CIT, formerly the bank of Tyco and now, post-spin-off, a freestanding commercial finance business again. It shows that, while CIT set aside significantly less than GE from 1998 to 2001, it suddenly stepped up its provisioning in 2002. Colleague Peter Walmsley asked a CIT representative if best practices in the matter of credit allowances had come in for redefinition since the company left the executive oversight of L. Dennis Kozlowski, former Tyco CEO. “Don’t even go there,” the spokesperson said, by which she seemed to

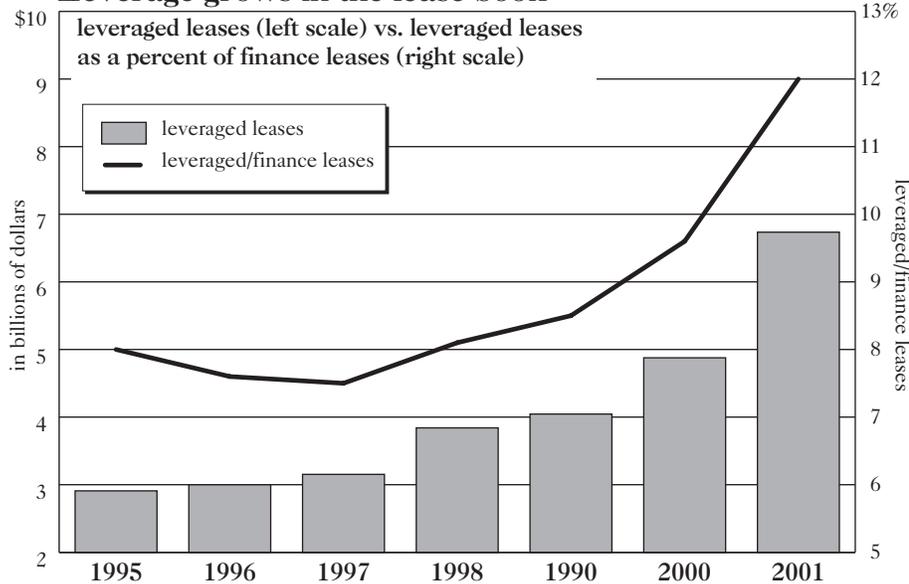
mean, “No.” Admittedly, CIT and GE Capital are not perfectly comparable (the former is relatively small, the latter absolutely immense, its immensity encompassing consumer debt as well as commercial). But we are stumped by GE’s evident imperviousness to the cyclical tides that seem to be washing over everyone else’s feet. GE has provided an answer. It has plotted its losses in consumer and commercial credit (measured as a percentage of average outstandings) against those of the top 100 banks; since the mid-1990s, its results are consistently superior.

However, we notice an intra-company anomaly. The industrial side of the company began to raise its allowance for losses on current receivables in 1998, and continued to raise them at least through 2001 (no more current data are available). Is the credit experience of the industrial side of the business so different from that of the company bank?

It’s not as if GE Capital were only buying Treasury bills and gold bars. Making its capital sweat, the finance division has been reaching for yield in its loan and lease operations. Exhibit A is the upsurge in “leveraged leases” as a percentage of overall leases. Exhibit B is the boom in so-called middle-market financing, which embraces commercial equipment financing, vendor financial services (“financial solutions and services to over 100 equipment manufacturers and more than 4,500 dealers/distributors”) and, of course, Heller Financial, which extends com-



Leverage grows in the lease book



mercial credit to operating businesses with annual sales of as little as \$5 million (and as much as \$250 million) and to real-estate concerns with assets of as little as \$1 million (and as much as \$40 million). Are Heller's customers bullet-proof? Is Heller?

To listen to Immelt and to surf the GE Web site is to be invited to believe that "six sigma quality, digitization, customer centricity" and the other celebrated GE management methods can trump the credit cycle. We wonder how. Employers Reinsurance Corp., GE's underachieving insurance subsidiary, has had trouble conquering the insurance cycle. Its actuaries are presumably as six-sigmatic, customer-centric and digitized as any in the business. Yet, by underestimating the claims resulting from business written in 1997-2000, they have brought about insurance losses sufficient to deflate the earnings growth of GECS in the just-ended quarter. "I'll tell you," said Keith Sherin, GE's chief financial officer, "it's disappointing to be talking about ERC again." On watch for possible downgrade by Moody's and S&P, Employers Re is also thought to be on the block for possible divestiture (one rumored buyer is Berkshire Hathaway).

On October 30, CBS MarketWatch.com corrected a previous day's report that GE expected "probable losses" of \$4.4 billion in connection with its exposure to United Airlines and U.S. Airways. Actually, noted MarketWatch, "only part of that amount is at risk, because the loans are backed by collateral

including aircraft and engines." True, of course. But, given the parlous condition of the airline business, the question is how much the collateral is worth. General Electric Capital Aviation Services (GECAS) owns 1,000 commercial aircraft and manages another 300. Its list of client airlines numbers 200. It's easy to remember which major carriers are at risk of bankruptcy. All are at risk. Besides slumping travel demand and high variable costs, the airlines are up against the logic, or illogic, of the American way of bankruptcy. Emerging from Chapter 11 proceedings with its debts reduced, U.S. Airways is expected to operate with a cost structure considerably smaller than that of the day it filed. Reconfigured in this fashion, it is ideally equipped to drive its competitors into bankruptcy.

An investor we know is an owner of privately placed U.S. Airways equipment trust certificates. These are amortizing debt obligations secured by aircraft, and the aircraft are leased to the carrier. However, the carrier rejected the leases—its privilege under the Bankruptcy Act. Before the rejection, the certificates paid \$200,000 per plane per month. Now, our source relates, they will pay \$90,000 per month (owners of public certificates may have to settle for \$75,000 per plane per month). The aircraft that secures our friend's certificates is the Boeing 737-300. This, the workhorse of the civil aviation fleet, cost \$27 million per copy to build and retains a so-called blue-book value of \$9.5 million. The current

quoted price, however, is \$3 million to \$3.5 million, or a small fraction of the cost of a new Gulfstream V.

GE, though it has acknowledged an unspecified loss in its exposure to U.S. Airways and United Airlines, has admitted to no general impairment of the value of its airplane fleet—a spokesman characterizes it as new and coveted. However, we think, impaired it must be. And impaired it will be if United gives up the ghost. Then, again, in whistling past the graveyard, GE is whistling in a duet, if not in a larger ensemble of optimists. "Despite the slowdown in commercial aviation," comments Hank Greenberg, chairman and CEO of AIG, concerning the third-quarter results of the insurer's aircraft leasing subsidiary, International Lease Finance Corp., "there continues to be strong market demand for ILFC's modern and efficient fleet. Virtually all planes coming off lease in 2002 have been placed with other airlines, and all deliveries of new aircraft for the balance of 2002 and scheduled for delivery in 2003 have also been successfully leased." We scratch our heads. We cannot reconcile the expressed optimism of the aircraft lessors with the desolation in a broad segment of airline debt obligations, secured and otherwise. How can cost compression and lease rejection be anything but bearish for the owner of 1,000 commercial airplanes, late-model or new?

No company in America will breathe a deeper sigh of relief than GE if the stock market, by rallying, is foretelling the end of this painfully slow economic recovery. To gauge GE's prospective happiness, consider the growth of an asset called "estimated unguaranteed residual value of leased assets." Deconstruct the phrase: "estimated," as in Kentucky rifle windage; "unguaranteed," as in no promises; and "residual value," as in an uncertain future value. In a footnote to the GECS balance sheet, estimated unguaranteed residual value of leased assets totals \$9 billion, equivalent to the subsidiary's tangible stockholders' equity.

The story of the equity is intimately connected with the story of what we'll call the corporate "mystery meat." GE's mystery meat is assets of uncertain provenance, and it comes in two varieties: "intangibles" and "all other assets." The sum of these line items was \$134.2 billion on September 30—\$44.6 billion

of intangibles and \$89.5 billion in “all other assets.”

Some of the mystery is dispelled by a reading of the footnotes in the 10-K report (you won't find it in the 10-Q). In Note 17 is a partial listing of these “all other assets,” \$80.5 billion strong at year-end 2001. Included, for example, are “prepaid pension assets,” “mortgage servicing rights” and GECS' real estate portfolio. In a spirit of generosity, we mark these items at par.

We are less inclined to assign par value to the items of deeper mystery, i.e., by name, “net mystery meat.” Included is \$15.6 billion of “other other” assets, the unexplained residue from Note 17 (“all other assets”); \$2 billion of “derivative instruments”; \$9 billion of the previously cited “estimated unguaranteed residual value of leased assets”; and \$31.6 billion of intangibles, most of which are goodwill but which include \$1 billion of “other intangibles” and—a favorite around here—\$2 billion of “present value of future profits.”

Interestingly, this net mystery meat has grown in lockstep with equity and

is approximately equivalent to equity. If, suddenly, there were no net mystery meat—if an auditor were to take an eraser to it—there would be no equity. We do not say that it deserves to be written off. We do not assert that it deserves to be discounted heavily from the value at which it is being carried (not knowing exactly what it is, we are in no position to assert any such thing). All we say is that the public documents do not instill confidence in it, whatever it is.

In any case, the balance sheet is not the document that GE would prefer we pay attention to. Immelt has decreed that a spotlight be turned on segment information of the income statement, the better to “improve investors' ability to understand these businesses and benchmark them against their peers.” This is, however, as colleague Walmsley points out, a red herring. What investors need is a brighter light on the balance sheet—and on the cash-flow statement.

“The income statement,” to quote Walmsley, “shows a smoothed, quar-

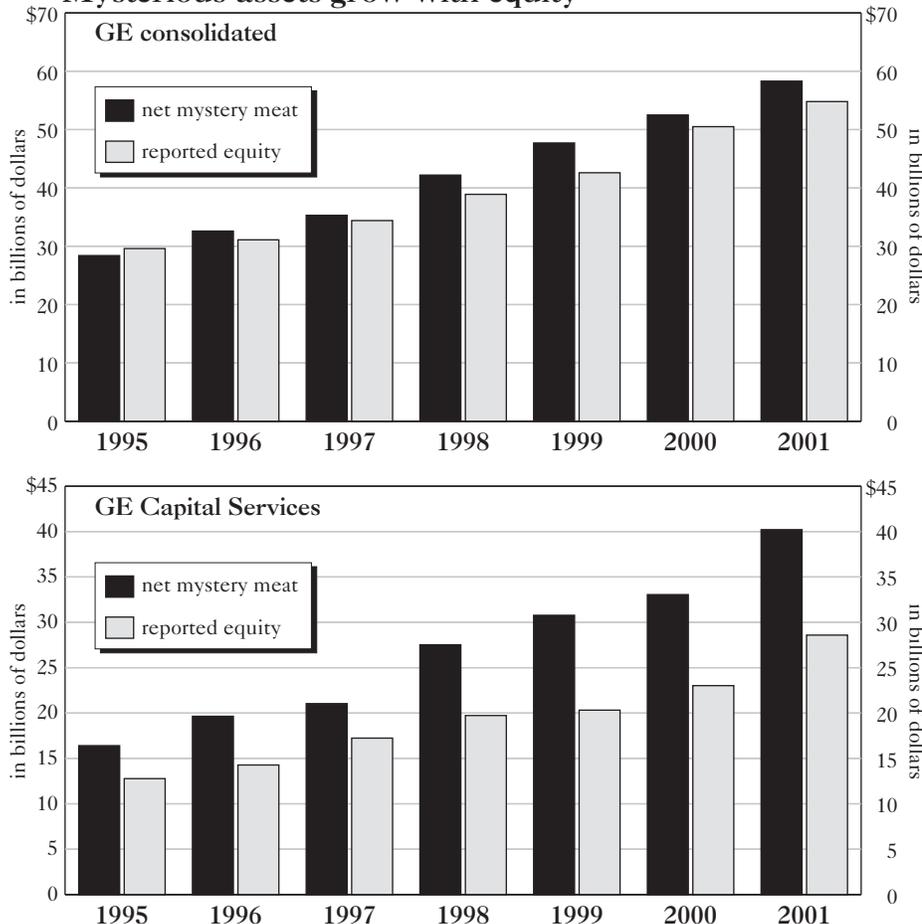
ter-to-quarter view of the profitability of the business. But to take an even longer-term view it helps to turn to the cash-flow statement. Here you have three vantage points. No. 1, cash from operations, comprised of earnings plus a variety of non-cash adjustments that trace the changes in balance-sheet items like working capital, asset depreciation and amortization and deferred tax changes. No. 2, cash from investing activities, which shows mainly what a company spends on M&A and on fixed assets. Its special relevance to GE is that it highlights the costs of GE's fabled active portfolio management. No. 3, the difference between operating and investing cash flows, which answers a definition of ‘cash flow.’”

Admittedly, cash flow is one of the most expansive concepts in finance. Immelt avers that his company is cash-flow positive. By cash flow, he means cash flow from operations. *Grant's* asserts that GE is free cash-flow negative. By free cash flow, we mean the difference between cash from operations and cash used in investing activities, calculated over a span of years. From 1993 through 2001, the difference between cash flow from operations and cash used in investing has consistently been negative.

The accompanying graphs plot one of the anomalies of triple-A GE. The industrial business has, by the cash-flow criterion set out by *Grant's*, been consistently profitable. Yet, the consolidated enterprise—GE in full—has, by the same cash-flow criterion, been consistently unprofitable. Where is the cash coming from? Where is it going?

On the evidence, the cash is coming from GE Capital. Where it is going is to the parent. In the March 29 issue, we wrote, “Between 1989... and 1993, the ratio of GECC assets to GE assets was virtually unchanged, at around 47%. By 1997, the figure had grown to 75%, and now it stands at 76%.” So it stood on September 30. At year-end 1995, tangible equity at GECS represented 3.3% of GECS' assets. On September 30, 2002—6 3/4 years later—tangible equity at GECS amounted to 1.9% of GECS' assets. Not knowing better, you would suppose that the finance business had been dead in the water. On the contrary, it has been making flank speed. The graph shows how the cumulative net income of GECS would have grown if the front office had left the money

Mysterious assets grow with equity

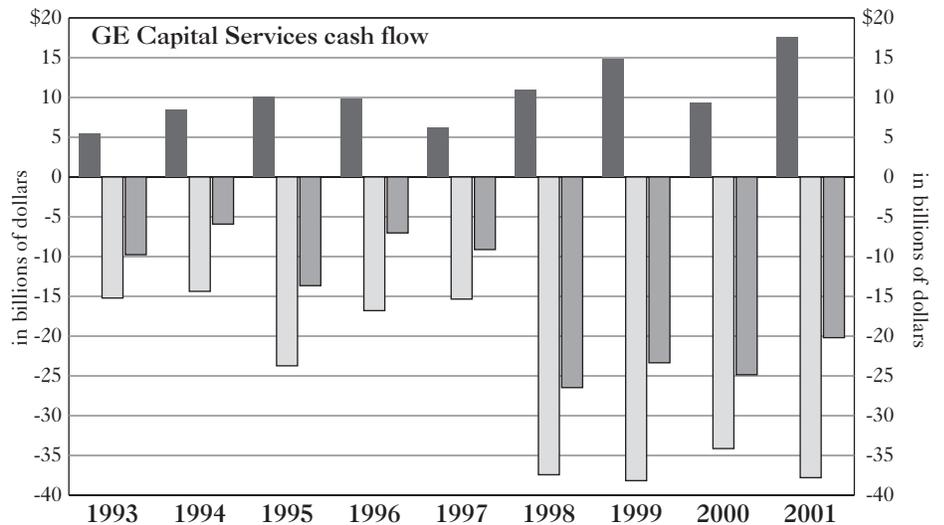
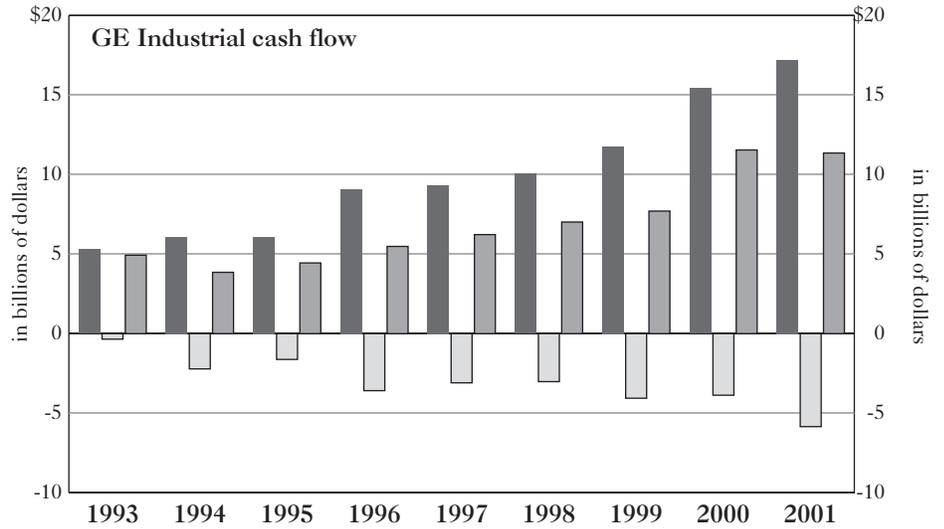
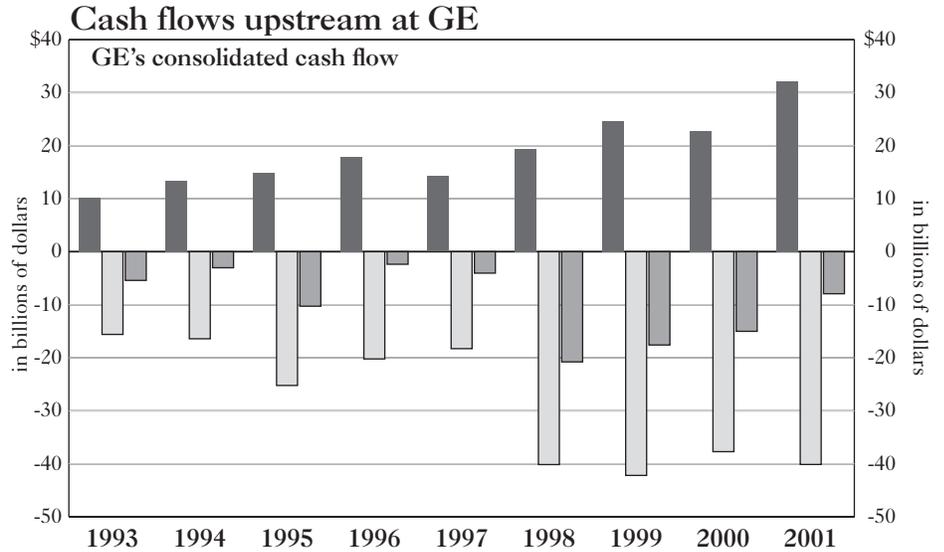


where it was earned. Instead, however, the money has been divided up to the parent. Since 1994, at GECS, on a compound annual basis, tangible equity has grown by 10%, while intangibles have grown by 21%.

At the top of this article, we taxed GE with “artfully unforthcoming” disclosure. There is no better example of the nondisclosed disclosure than a \$3 billion capital infusion last year from GE to GE Capital (which, don’t forget, is the subsidiary with its name on the public debt). The fact is divulged at the back of the 2001 10-K report in a statement of supplemental cash flows. No blinking lights highlight the number, and no text explains it; Gretchen Morgenson, Pulitzer Prize-winning correspondent of *The New York Times*, was the first to drag it out into public view.

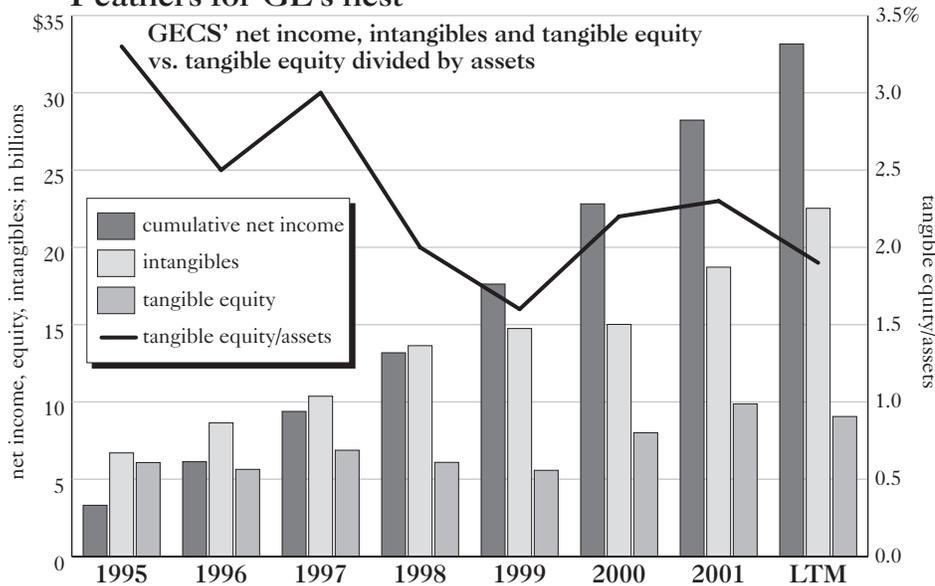
Naturally, a fact so deeply buried concerning so large a sum of money has caused tongues to flap in that intimate circle of people who read financial footnotes. Some have suggested that the reason for the transfer had something to do with the acquisition of Heller Financial by GE Capital late last year. It was the biggest acquisition in the history of the bank of GE, and it cost \$5.3 billion in cash. Yet, the footnote readers observe, Heller was less leveraged than its acquiror (on Sept. 30, 2001, Heller showed a debt-to-equity ratio of 6.37:1; GE Capital’s ratio was 7.36:1). Why, then, they wonder, would GE Capital have had to put money into it? Walmsley put the question to GE spokesman David C. Frail: “The \$3 billion transferred,” said Frail, “it didn’t go to Heller. It went to Capital to support the transaction, to maintain. . .the leverage that the rating agencies require for GECS overall. It’s not going to show up at Heller.”

By now, the reader will have surmised that we harbor doubts about GE, GE Capital and the titans who manage it. Many people do not. Many will refuse to believe that GE would stoop to obfuscation, dissimulation or the lower forms of financial engineering. But there is strong inferential evidence to the contrary. For one thing, Welch himself has described how his corporate lieutenants rallied round following the shocking \$350 million loss booked by Kidder Peabody in 1994. “Some said they could find an extra \$10 million, \$20 million and even \$30 million to



■ operating □ investing ■ operating and investing

Feathers for GE's nest



offset the surprise," wrote Welch in his autobiography (see page 225), describing a corporate culture exactly suited to earnings management. Welch is gone, if not forgotten, but the culture still seems to thrive. Read carefully Bloomberg's account of the recent sale of GE's B2B e-commerce unit:

New York, Sept. 27 (Bloomberg)—General Electric Co. lent \$235 million to the buyer of its electronic-commerce unit because money wasn't available from the bond market. Buyout firm Francisco Partners LP was unlikely to raise sufficient funds to finance the \$800 million purchase price of Global eXchange Services given that "the bond markets were not good in June when we announced the agreement, and they've gotten worse since then," said GE spokesman David Frail. The option to provide financing was in the original agreement, Frail said. . . .

GE, which has businesses ranging from power plants to credit cards and plastics, will have a profit of \$300 million from the sale of the Web-based business-to-business marketplace. That will add 3 cents a share to third-quarter profit, which GE said yesterday will rise 24%. GE announced the sale of Global eXchange Services on June 24, and said at the time it planned to close the transaction by Oct. 31. The business no longer fits with GE's Internet strategy, GE said.

As is typical with most buyouts, Francisco Partners initially got a commitment from an investment bank to finance the GE purchase. Credit Suisse

First Boston agreed to provide \$445 million in loans, and planned to replace \$235 million of that with high-yield bonds. Last week, the GE Commercial Finance unit decided to buy the \$235 million of bonds, freeing CSFB of its commitment, for the purpose of 'expediting the closing' of the sale, Moody's Investors Services said. . . .

Alternatively, we would speculate, GE agreed to buy the bonds for the purpose of "expediting the achievement of an earnings target." Timing gains on sale to the advantage of reported earnings is hardly unique to GE, but GE is the subject at hand. Thus, in 1995 and 1996, GE's 10-Ks do not show any unusual gains or charges. In 1997, a large gain was booked on a complex asset swap with Lockheed, a gain matched by charges for restructuring and other special events. No transactions of note occurred in 1998. In 1999, GE sold Internet assets to NBCi, a publicly traded affiliate, and took unusual charges that netted out to the exact amount of the gain. In 2001, there was a gain on the sale of PaineWebber but it was partially offset with losses on the liquidation of Montgomery Ward. In 2001, no charges offset the sale of stock in Americom, a satellite company. It contributed 6% to pretax profit.

The purpose of the foregoing has been to show that this most admired corporation is growing in leverage but not in free cash flow (as we have defined it). We have contended that it is no more disengaged from the credit cycle than Employers Re was from the

insurance cycle. And we have argued that, in pursuit of growth, it has taken on a bigger book of riskier assets. Possibly, GE, its stockholders, its stakeholders and its bondholders may disagree with a point or two. However, few impartial professional investors would dispute that there's more to fear than to like in GE Capital's debt securities. In triple-A-rated, gold-plated, widely owned, institutionally certified investments, it was ever thus. The brighter the luster, the greater the downside.

As for the GE Capital balance sheet, we commend a study of its wonders and mysteries to the dean of the School of Management at Cornell University, Robert J. Swieringa. An accounting professor by trade and a past member of the Financial Accounting Standards Board, Swieringa was elected last month to the board of General Electric as a non-executive director. GE needs him and so do its bondholders.

After the cult

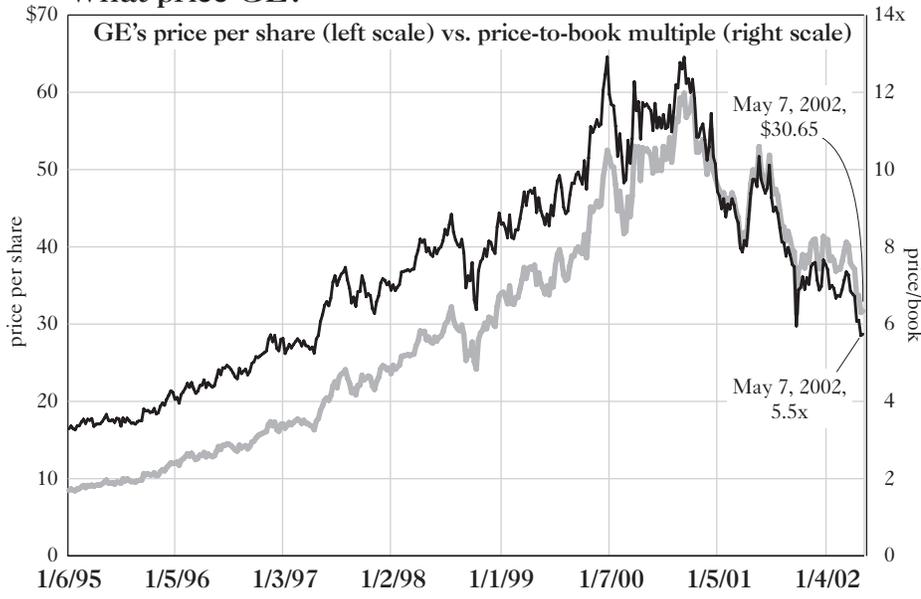
(May 10, 2002) At the recent GE annual meeting, chairman and CEO Jeff Immelt lodged a complaint about the share price. "To be specific," said the man who succeeded Jack Welch, "the stock is where it was three years ago, and since I became chairman, it's dropped more than 15%. I hate where our stock price is today."

GE changes hands at \$30.65 a share, the equivalent of 21 times trailing earnings and 18.5 times the consensus 2002 estimate. Only one year ago, with Welch at the helm, the Greatest Company on Earth commanded a 40 P/E multiple. Immelt sounded as if he wanted to break Mr. Market's leg.

"Our stock price doesn't reflect the performance of this company or its value," he told the meeting convened in Waukesha, Wis., home base of GE Medical Systems. "In 2001, we grew our earnings by 11%. In the first quarter, we grew our earnings from operations by 14%. These performances compare with the decline in the S&P 500 earnings of more than 20%. In fact, our company now makes more money, 50% more money, than we did three years ago."

In the past three years, the chairman proceeded, GE generated \$35 billion of cash. Revenues actually grew in 2001

What price GE?



source: The Bloomberg

(up 4%), a recession year, and are expected to grow again in 2002 (by 5% to 10%). All this in a perfectly forgettable global economy.

Citing years of extraordinary returns, Immelt declared that GE excels in all seasons and cycles. Yet, alluding to the post-New Economy, he went on, “we live in a new age. Performance is not enough.” Rattled by the usual financial and psychological bear-market dislocations, investors have turned to doubting from trusting. “You want to know even more about GE,” Immelt acknowledged, “and that’s fine with me; I welcome it.”

During the boom, no particular knowledge of General Electric was sought or required. It was enough to know that Welch was at the helm. Now, Immelt is having to explain what used to be self-evident. “It really is simple and powerful,” he said of GE. “You see leadership—number one businesses, a strong and accountable culture, and massive financial strength.” He mentioned “long cycle” businesses (four in all: power, medical, engines, transportation) and “short-cycle” ones (e.g., NBC, plastics, materials, industrial). He mentioned finance. “We have the world’s most diversified financial services business with consumer finance, mid-market financing, insurance, equipment management and specialty segments,” Immelt said. “We’re growing assets in GE Capital by 15%. With [a] favorable interest rate environment, strong risk management, and the

cost advantage generated by a triple-A balance sheet, Capital is on track for excellent earnings growth in 2002 and 2003. The importance of GE Capital is that it can use GE’s financial and industrial strength.”

Possibly short of time, Immelt did not allude to the *Grant’s* critique (see the March 29 issue) in which colleague Peter Walmsley traced the soaring growth of “other assets.” As you may remember, this “other” is significantly greater than year-end shareholder equity—for the parent, \$81 billion of “other” assets on \$55 billion of equity; for GECC, \$52 billion of “other” assets on \$32 billion of equity.

Search the footnotes with a flashlight, you wouldn’t find an explanation, let alone an appraisal, of \$16 billion of this mystery meat. Concluding his analysis, Walmsley wrote: “If you de-

ducted from equity these unidentified other assets, in addition to deducting intangibles to get a modified tangible book value, you would see that GE’s ratio of assets to modified equity has increased to 65.1 times in 2001 from 32.8 times in 1993.” So, in addition to its trademark Six Sigma-caliber operations, its unparalleled culture of excellence, its unprecedented devotion to corporate reinvention and customer satisfaction, GE has generated higher returns through financial leverage. In this, it has done what many other companies have done, not each and every one of them great.

All of which is by way of seeking an answer to Immelt’s poser: Does the share price deserve to be hated?

Immelt has predicted earnings per share in 2002 of \$1.65 to \$1.67. Seasoned GE watchers will expect nothing less than \$1.68 a share, a penny per share above expectations. Spread over 10 billion shares, \$1.68 would imply \$16.8 billion of net income. Assign a multiple to these earnings more to Immelt’s liking and the share price would become less ridiculous (as Immelt views it). At, say, a 25 multiple, it would be \$42.

That would be a stretch, we think. A 25 P/E multiple would imply a 7.7 price-to-book multiple. “They are an industrial company that has morphed into a financial services company,” recently observed Robert McCarson, director of corporate relations for Fannie Mae, concerning GE. As a description of the balance sheet, McCarson hit the nail on the head. At year-end 2001, GE Capital Corp.’s assets constituted 77% of consolidated assets. As for the income statement, GECC contributed about 40% of net earnings.

Name your price GE value per share, based on assumed price/book and price/earnings multiples*

	price/book (GECC)				
	1.0x	2.0x	3.0x	4.0x	5.0x
10.0x	\$12.94	\$15.80	\$18.66	\$21.52	\$24.38
15.0x	\$17.98	\$20.84	\$23.70	\$26.56	\$29.42
20.0x	\$23.02	\$25.88	\$28.74	\$31.60	\$34.46
25.0x	\$28.06	\$30.92	\$33.78	\$36.64	\$39.50
30.0x	\$33.10	\$35.96	\$38.82	\$41.68	\$44.54
35.0x	\$38.14	\$41.00	\$43.86	\$46.72	\$49.58
40.0x	\$43.18	\$46.04	\$48.90	\$51.76	\$54.62

*matrix assumes GECC contributes 40% of estimated 2002 earnings per share of \$1.68

GE, therefore, is neither a bank nor a nonbank, but a little bit of each. It is bank enough, however, not to trade at 7.7 times book.

For clarity, Walmsley has performed a breakup analysis. "We'll be generous," he openhandedly begins. "Apply the fattest plausible multiple to the bank, i.e., three times book. Attach a 25 times P/E multiple to the nonbank. If we assume that the bank will continue to generate 40% of net income, \$6.7 billion of this year's \$16.8 billion would be bank-derived. The industrial side of the company would contribute \$10.1 billion. The 10-K says GECC's book value ended 2001 at \$28.6 billion."

Apply these multiples as in the nearby table and you get a value for GE of around \$338 billion. Over 10 billion shares, you get a share price of \$33.78. According to this exercise, Immelt was right. GE is, today, \$3 per share too cheap. "We're not like everybody else," Immelt reminded the hometown crowd last month.

"We are blessed to have the most talented leadership team in the world," Immelt said later on. "This is confirmed by magazines, polls, and even by other recruiters. We've retained this team through a leadership transition and a recession. We are a performance-driven group. We like to make numbers and we look at the stock price as a way to keep score. But above all else, we value the reputation of this company. No one, not one leader in this place, would ever put personal gain ahead of the company. We perform and we always do it with integrity."

Either GE is an institution truly impervious to the weakness of the human flesh and the vicissitudes of the business cycle, or it is merely a very good corporation. We say it's a very good corporation. So saying, we expect that before the bear market runs its course, GE's multiples will contract. Possibly, the \$16 billion of other assets holds a bearish surprise. Maybe the corporation that never, ever misses a number will miss. It would be a rare thing—though, to be sure, not an impossible thing—for a leveraged financial institution to trade at three times book at the bottom of a bear market. The accompanying table suggests a range of possibilities.

Immelt may gnash his teeth, but patient holders of cash are already the beneficiaries. The lower the share

price, the lower the risk. There may yet be the chance to invest in a very good corporation at a very good price. It's an opportunity worth waiting for.



Welch comes clean

(March 29, 2002) In the issue dated July 17, 1998, *Grant's* asked how GE could deliver perfectly predictable stair-step earnings growth, year in and year out. How could a company so big, so leveraged and so exposed to the vicissitudes of the world economy never miss?

After due consideration, GE has framed a reply. "This is a confusing time for investors," the 2001 annual says. ". . . [I]t is a time when consistent, excellent performance confuses some pundits [sic], who then imply that it is 'managed.' It is almost as if an earnings 'miss' would be more virtuous than meeting your commitments during tough times—but that is not GE."

Perhaps not. But once upon a time, GE was ready, willing and able to manage its earnings. Jack Welch, the retired CEO who somehow can still get his name in the papers, admits it.

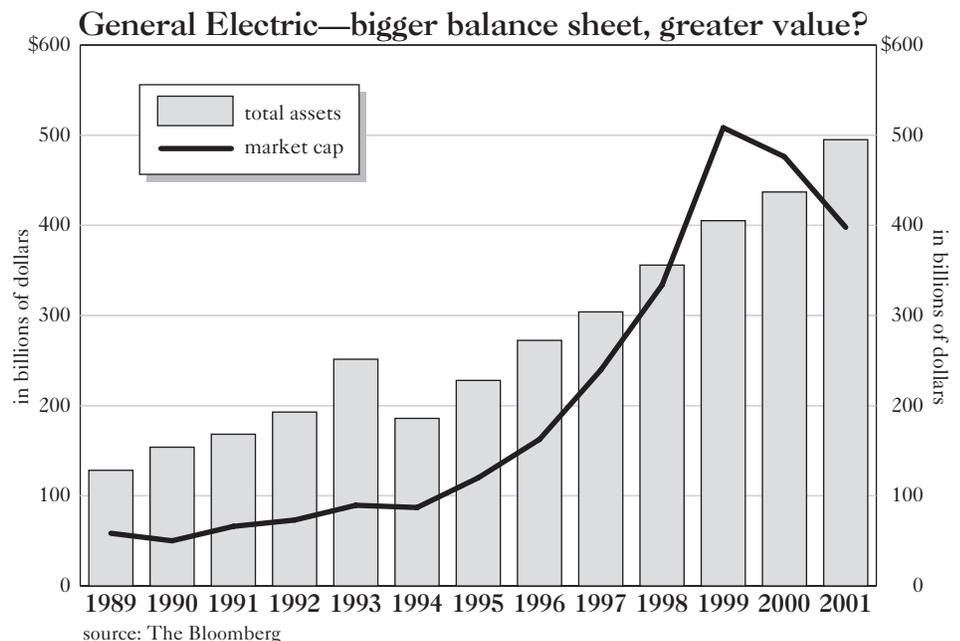
The year was 1994, and Kidder Peabody, a GE subsidiary, had sprung a \$350 million leak. Welch was heart-sick—he had nobody to blame but himself. There would be a black mark in the first quarter's press release, due in two days.

We know Welch's state of mind because it's recorded in the new, best-selling autobiography, "Jack: Straight from the Gut." And from the same source we know the attitudes of Welch's top lieutenants.

"The response of our business leaders was typical of the GE culture," Welch writes. "Even though the books had been closed on the quarter, many immediately offered to pitch in to cover the Kidder gap. Some said they could find an extra \$10 million, \$20 million, and even \$30 million from their businesses to offset the surprise. Though it was too late, their willingness to help was a dramatic contrast to the excuses I had been hearing from the Kidder people."

In the wake of the Kidder crisis, *The Wall Street Journal* published a two-part report on the astonishing predictability of the GE earnings stream. In denying that the company took charges against earnings with the intent of smoothing reported net income, Dennis Dammerman, the GE chief financial officer, said, "It's not like we're creating some big cookie jar."

Fast-forward to the present and to last week's Bill Gross-GE melee. In his instantly famous posting on the Pimco Web site, Gross, manager of the world's biggest bond fund, renewed the long-simmering charge that it isn't through pure excellence that "the best company in the world" (as Dammerman put it in 1994) can put up 15% annual earnings growth in fat years and lean.



GE vs. the financial crowd (in \$ billions)

	<u>total assets</u>	<u>price/book</u>	<u>assets/equity</u>
Citigroup	\$1,051	3.1x	11.9x
Fannie Mae	800	3.2	31.8
J.P. Morgan Chase	694	1.7	16.7
Bank of America	622	2.2	12.8
Freddie Mac	617	2.9	31.9
GE	495	6.8	9.0
Morgan Stanley	483	2.8	21.0
AIG	469	3.7	8.8
Merrill Lynch	419	2.3	18.5
GM	324	1.7	10.1

source: The Bloomberg, company filings

To make the numbers, Gross charged, GE imprudently feasts on the low-cost portion of the yield curve. It scoops up acquisitions and generally imposes on the trust and hospitality of the U.S. financial markets. Dammerman, now a GE vice chairman, called Gross to show him the error of his analysis. According to Gross, each party hung up shouting.

Not long after, there was a greater and louder spectacle, as Fannie Mae accused GE of opacity and hypocrisy. Fancy GE complaining about the quality of Fannie's disclosure, said Robert McCarson, the GSE's director of corporate relations: "We know less about the financial condition of GE Capital than we do about any bank."

Just so. For all its promise about greater disclosure in this age of *glasnost*, GE is only a lighter shade of black. "They are an industrial company that has morphed into a financial services company," added McCarson, right again.

"It's on the balance sheet that GE's dependence on GECC shows up principally," observes colleague Walmsley, "and where the black-box nature of GE's financial reporting is most evident. Between 1989 (when *Grant's* first looked at GE) and 1993, the ratio of GECC assets to GE assets was virtually unchanged, at around 47%. By 1997, the figure had grown to 75.3%, and it now stands at 77%. From 1993 to 2001, goodwill at consolidated GE grew by 17% a year. Over the same span, goodwill at GECC grew by 32% a year."

Strip away goodwill and intangibles, and you're left with tangible book value, a useful thing to know. In 1993, the ratio of parent assets to parent tangible equity was 16.3 times. In 2001, it was 21.4 times.

"A deeper look into the balance sheet raises more questions," Walmsley continues. "Both GE and GECC have 'other assets' on their balance sheets significantly in excess of their shareowners' equity: GE's is \$81 billion on \$55 billion of equity, while GECC's is \$52 billion on \$32 billion of equity. Most of this gets explained in the footnotes, except for a few billion dollars worth of unidentified 'other' within the 'other assets.' Like the Russian dolls that you keep opening and finding more inside, and eventually open the innermost doll, thus do GE's other assets finally come to an end.

"Consolidated GE's innermost doll is \$16 billion of unidentified other assets that can be found only in the footnotes, which do not describe their contents at all, much less appraise their value. If you deducted from equity these unidentified other assets, in addition to deducting intangibles to get a modified tangible book value, you would see that GE's ratio of assets to modified tangible equity has increased to 65.1 times in 2001 from 32.8 times in 1993."

"GE is a company you can trust," writes Jeffrey Immelt, Welch's successor, in the new annual. You have no choice.

General inspection

(February 16, 2001) General Electric, the House that Welch Built, is the biggest company in the world by market cap and the only surviving member of the original 12 Dow industrials. (Long GE and short Distilling & Cattle Feeding was the pair trade of 1896.) It is so great and powerful that it has managed to persuade Wall Street of a near im-

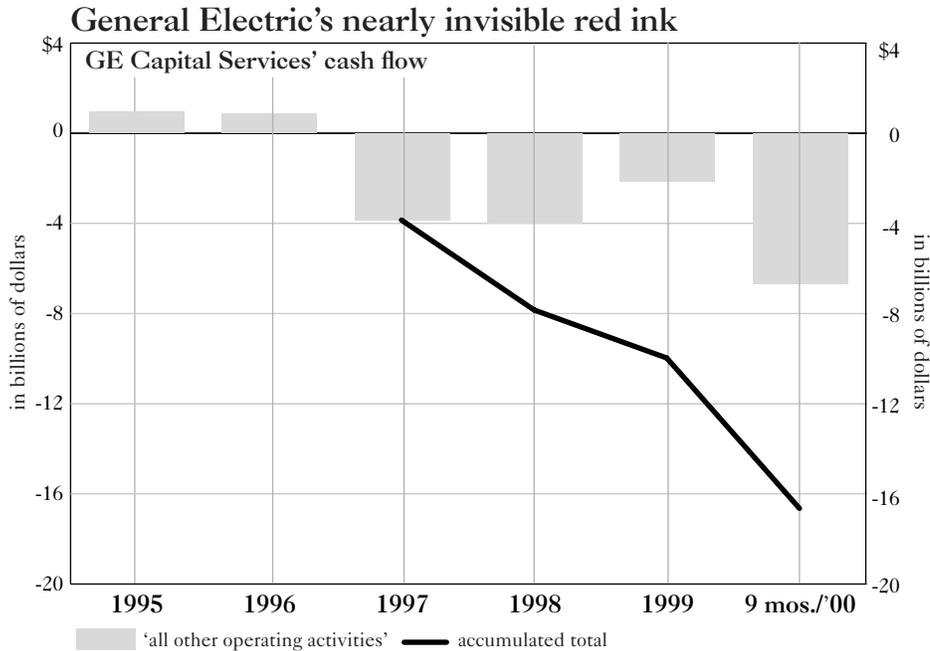
possibility: Supposedly, the unfolding business slump will happen to lesser companies but not to the one that accounts for 1.3% of the U.S. GDP.

Eric Fry, editor of GrantsInvestor.com, led a team of analysts to get behind, among and in front of the numbers. "Wading through the latest 10-Q," he writes on behalf of his colleagues Rose Ann Tortora and Robert Tracy, "we discovered that even as the company increases reported EPS, its operating cash flow is declining and its 'all other operating activities' line is looking conspicuously unhealthy. By our calculations, consolidated cash flow from operations dropped by 30%, or \$4.9 billion, through the first nine months of 2000 compared with the year-ago period."

Only by excluding General Electric Capital Services (GECS) from the calculation, as Wall Street is wont to do, can cash flow from operations be made to appear positive. Expressed in this light, without the dragging financial business, it was up by 34% through the nine months. But that would be an analytical half-truth.

"The main culprit," Fry goes on, "appears to be GECS' acquisition last March of Toho Mutual Life Insurance Co. of Japan. As the GECS September Q explains, 'The decrease in cash from operating activities. . . was largely attributable to policyholder redemptions associated with the Toho acquisition and a smaller decrease in mortgages held for resale.' The 'insurance liabilities, reserves and annuity benefits' line on the cash-flow statement listed a negative \$1.9 billion for the nine months vs. a positive \$2.8 billion the year before. This \$4.7 billion decrease in GECS' cash from operations largely explains the \$4.9 billion decline reported in cash flow from operations for GE as a whole.

"GE's Edison Life subsidiary rescued the insolvent Japanese insurer last year," Fry goes on, "paying more than \$2 billion for Toho's 'business rights' and its three million policies. Japan's Policyholder Protection Corp. kicked in about \$3.6 billion to facilitate the acquisition by GE. Six months into the deal, the results seem underwhelming. No doubt, GE anticipated some policy redemptions within its new insurance subsidiary. But we wonder if it was prepared for the staggering number it got."



If cash flow from operations on the capital side of GE had climbed by 72%, Wall Street would certainly not have neglected to mention it. But a decline in cash flow of that magnitude, not offset by a correspondingly large positive number, has struck the analytical community dumb. What does it mean when consolidated cash flow from operations drops by 30%? At the least, it means that it's no easy matter to manage a \$431 billion balance sheet in the interest of expanding a \$468 billion stock-market cap and generating to-the-penny, seven-sigma-quality earnings results.

"We found a second curiosity," Fry proceeds—"a \$6.5 billion negative swing in another GECS line called 'all other operating activities.' Included in this category, according to the Q, are 'adjustments to current and non-current accruals and deferrals of costs and expenses, increases and decreases in progress collections, adjustments for gains and losses on assets, increases and decreases in assets held for sale, and adjustments to assets.' Asked to elucidate, John Oliver, spokesman for GE, promised to investigate; no wonder he was still at it as we went to press. Within such a line-item casserole, it's impossible to tell if a change in consistency was produced by too little mayonnaise or too much celery salt. Whatever it is, it doesn't taste good. The 'all other operating activities' turned down in

1997 and has been consuming billions of dollars a year ever since."

What do they say about triple-A credits? Nobody's going to upgrade GE.



One in 50 billion

(July 17, 1998) General Electric Co. earned in the second quarter exactly what analysts had somehow known it would earn: \$2.45 billion, or 74 cents a share.

In the house of John F. Welch Jr., total quality management extends even to the quarterly earnings report. As in jet engines, light bulbs and financial services, zero defects and absolute reliability are the orders of the day (you know how Jack hates surprises!). So advanced is quality control within the finance department that GE was able to report year-over-year growth in net income of 11%, plus or minus a few tenths of a percentage point, for eight consecutive quarters. (In the June 1997 period, which ended the string, net rose by 13.1%. Evidently, somebody slipped up.)

Green Tree Financial, Laser Mortgage Management, Oxford, Boston Chicken, Sunbeam and Cendant all stand as testament to the risk of poor and/or questionable corporate financial disclosure. The perfectly predictable earnings stream does not occur

in nature. Yet when GE delivers the goods—the customary Six Sigma predictable rise in after-tax profits—an analyst can be counted on to marvel, in effect (as one recently did in fact): "It's the certainty at GE."

In his new book, "Contrarian Investment Strategies: The Next Generation," David Dreman demonstrates that securities analysts usually fail to forecast earnings to within 5% of the actual number. In fact, he calculates, the odds of their getting to within a 5% tolerance for 10 consecutive quarters are 1 in 200,000.

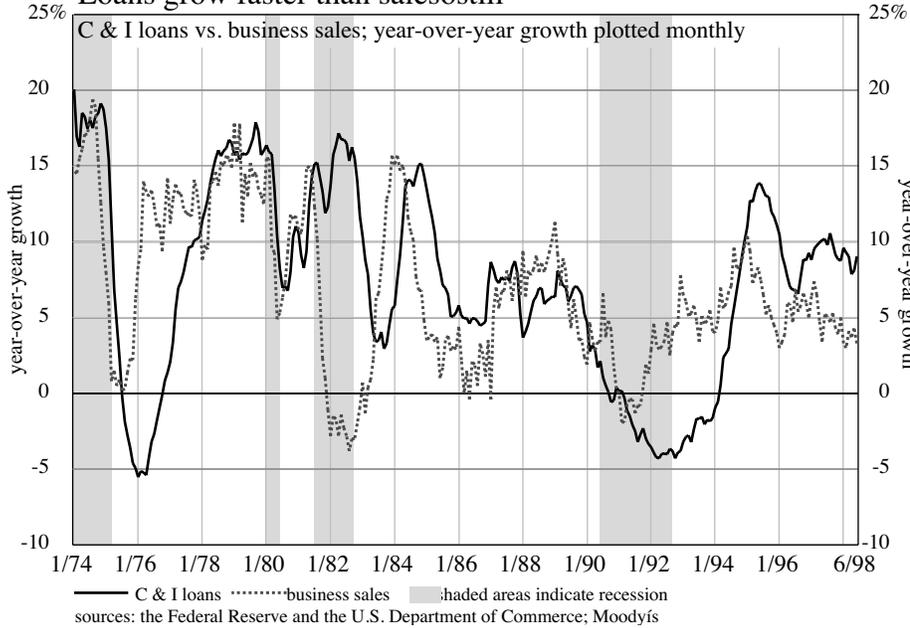
The inverse of this analysis ought to be true, as well, we have been thinking: The odds of a company disclosing a number that comes within 5% of the analytical consensus for 10 consecutive quarters also ought to be 1 in 200,000. (The probability calculations are derived from a study conducted by Dreman and his collaborator, Michael Berry, of approximately 500,000 analysts' forecasts committed to paper between 1973 and 1996.)

Yet, as Koby Oppenheim of this staff has determined, GE uncannily beats the odds. The analytical consensus was easily within the implausibly difficult 5% range for the past 10 quarters in a row. It was, in fact, within 2%. For the past 20 quarters, the consensus was within 2.37% of the mark. The odds of such a display of clairvoyance on Wall Street, according to Dreman, are 1 in 50 billion. Who says that bull markets make you stupid?

Which, however, begs the question: How does a company that sells everything under the sun almost everywhere under the sun generate a perfectly predictable earnings stream? It's the very size and diversity of the enterprise, a spokesman responds, that "equals stability and consistency."

Be that as it may, the July 13 issue of Business Week contains a bombshell on the quality of blue-chip corporate earnings in general (it does not mention GE in particular). Tucked away in an advertising supplement are the results of a poll of 160 delegates to the magazine's seventh annual forum for chief financial officers last April. Employing "audience response electronic keypads," the attendees, drawn from what BW probably did not call the Fortune 500, were asked to respond to the following proposition: "As CFO, I

Loans grow faster than sales still



have fought off other executives' requests that I misrepresent corporate results."

The responses were:

55% Yes; I fought them off.

12% I yielded to the requests.

33% Have never received such a request.

In other words, observes James S. Chanos, paid-up subscriber and gimlet-eyed reader (it was he who picked up on the BW revelations), two-thirds of the magazine's sample set have been asked to lie about the numbers. On the other hand, he notes, lending balance, fully one-third have not been asked to lie. Preceding this revelation into print by a few days was an "Abreast of the Market" column in *The Wall Street Journal* in which the argument was advanced that corporate accounting has become more conservative, not less. Companies are writing down more assets not to bury future expenses but to acknowledge mistakes in a forthright way, the thesis went. "With accounting questions playing a big part in some spectacular recent stock blowups," the article said, "investors might wonder just how believable are the earnings now fueling record stock prices. Rest easy: They are more believable than in previous decades."

If the *Journal's* argument is right, it seems to us, *Business Week's* poll results must be wrong, and vice versa. For reasons ably laid out by Albert Meyer, of

Martin Capital Management, Elkhart Ind., we are inclined to trust in BW.

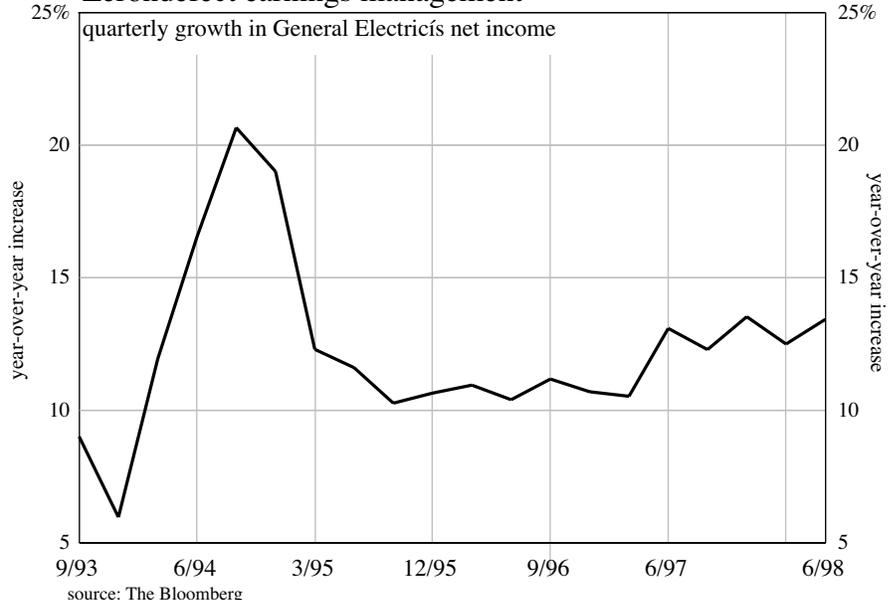
What's right with accounting, says Meyer, our principal source on the Coca-Cola story in the June 19 issue of *Grant's*, are the standards promulgated by the Financial Accounting Standards Board. They are absolutely rigorous. However, Meyer goes on, human nature at Dow 9,300 is working strongly against rigor: "[T]he salaries and wealth of senior executives [are] linked to options like never before, and there is a massive temptation there to do everything possible to increase the

stock price. . .," he says. "[H]uman nature being what it is, the wealth of executives tied to the stock price, I would imagine there is heavy pressure on the accountants to push the envelope."

"There is a lot of fudging going on," says Chanos, who sells stocks short for a living. "While maybe it isn't company-killing, like at Oxford, you are still corrupting the marketplace. Companies will do anything they can not to miss somewhat aggressive earnings estimates when the penalty for missing by a penny or two is, in some cases, to see a high P/E multiple cut in half. That is the corruption. The incidents of the Sunbeams, Oxfords and Boston Chickens are still in the great minority. But everyone has gotten used to the nudge and the wink about the abilities of companies to massage the bottom line through a variety of subterfuges and artifices, so there is not even a slight disappointment.

"What I have a problem with," Chanos goes on when asked to name his pet peeves, "is when, in addition to the goodwill write-downs [which, he says, are not objectionable], you see these kitchen-sink restructuring charges that write down all sorts of things or set up reserves that aren't needed. For example, a company will write down accounts receivable as uncollectible at acquisition and then collect them, with no cost associated. Writing down perfectly good plant and equipment to zero, and then having no depreciation expense against it. And then my favor-

Zero defect earnings management



ite, setting up accrued liabilities, sort of nebulous future charges, and reversing them as no such costs are incurred. We noticed that in Sunbeam. And mergers give you all sorts of opportunities for accounting chicanery." Mergers and a one-way stock market.



No upgrade possible

(November 21, 1997) General Electric, as big as the Great Lakes, earns upwards of \$8 billion a year from continuing operations and generates \$87 billion a year in revenues. "Arguably the world's most successful company," to quote *Fortune*, GE has the biggest stock-market capitalization in the greatest bull market in the world: \$217 billion. In Jack Welch, it has arguably the most admired chief executive officer in the world. In Gary Wendt, it has arguably the most admired head of a financial subsidiary in the world. Triple-A up and down the line, the company is valued as it has never been valued since at least 1972 (except for a moment at the peak of the market last summer). The current valuation parameters are: 2.5 times revenues, 27.4 times net income and 6.4 times book value.

We turn to GE because the world has turned against it without Wall Street seeming to notice. In support of this hypothesis, we invoke the CEO himself. "[T]he challenge is that there is excess global capacity in almost every industry," the *Financial Times* quoted Welch on October 1. "Pricing pressures are dramatic across sector after sector."

At GE, financial services (insurance, credit cards, leasing etc.) complements capital goods (aircraft engines, power generation and transmission equipment, locomotives etc.) and consumer and miscellaneous products (appliances, broadcasting, licensing revenues etc.). This combination has delivered average annual growth in net profits over the past quarter-century of 11.4%.

Now comes the Asian crisis, featuring industrial overcapacity and debt contraction. It is a deflationary world in which, it seems to us (and seems as well to a reader of ours, William M. McGarr), the marginal unit of capital expenditure is likely to be postponed and the marginal dollar of debt financing to

be prepaid, downgraded or defaulted on. GE would seem to be vulnerable on all counts.

Proof that this is not the consensus opinion is evident both from the valuation of the stock and the tone of the company's press. "Big challenges, big plans, big resources—and day by day a bigger reputation," wound up a piece on GE Capital Services in the November 10 *Fortune*. "But ultimately, what's most interesting about Capital is that the risks it confronts are so different from those of the businesses it competes with. Most companies are terrified of a recession. At Capital, many people hope for one. A recession would bring down asset values, they say, letting Capital do more of what it does best—pounce on trouble."

If a recession would be bullish for Capital, we wonder, would an even greater prosperity be bearish? If a recession would be bullish for Capital, would it also be bullish for the larger capital goods division? Would it be bullish for the holders of GE common?

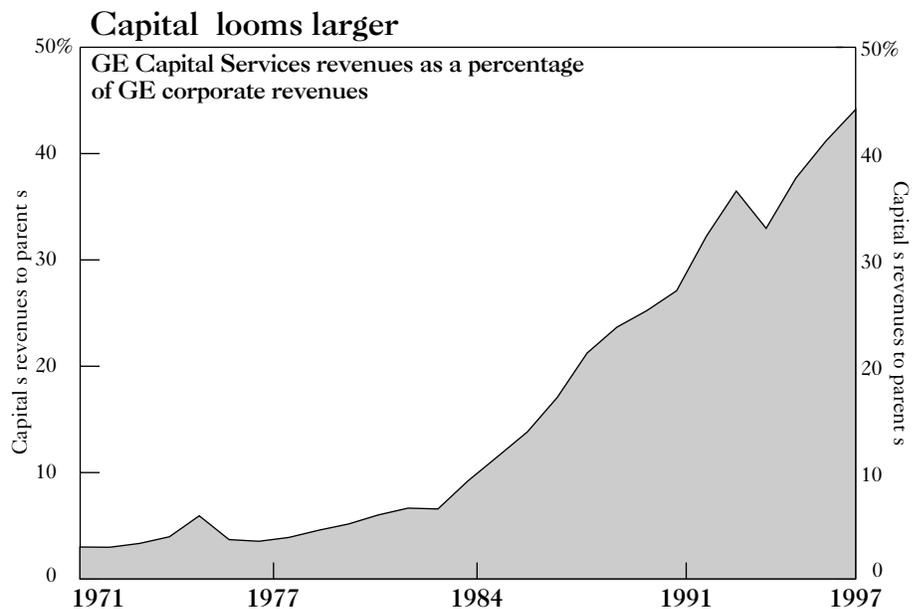
It would not be bullish for the stockholders, we are sure. Then, again, at these levels of valuation, not even perfection would likely measure up. As much as most companies in the great bull market, GE is priced for the ideal outcome.

And ideal its outcomes have almost continuously been, Capital's most of all. Thus, over the past 25 years, net profits at the financial-services division have grown at a 19% annual rate, significantly higher than the company's

11.4% average annual rate. (The difference is, of course, enormous: \$1 at 11.4% over 25 years becomes \$14.90; \$1 at 19% over 25 years becomes \$77.40.) Over the past five years, the divergence has narrowed somewhat, with companywide profits growing at 12.9% a year, Capital's at 16.1% a year.

The previously cited *Fortune* article is the last word on how well Capital has succeeded, how fast it has grown (head count has leapt to 53,000 from 30,000 in the past five years) and what pains it has taken to stay out of trouble along the way. The 27 businesses that Capital comprises are so widely diversified (both as to function and region) and so tightly managed, the bullish argument goes, that no mere Asian crisis could do any serious damage to them. And as for the parent, a spokesman sums up the situation as follows: "We're on record as saying we're going to have another record year. We're going to participate in the region and may see some opportunities for acquisitions."

For ourselves, we have no pet theory as to how Asia-related troubles might surprise to the downside. If the so-called currency crisis is really an economic crisis, the growth of capital spending will be bound to slow, inside Asia and out. As Welch himself admits, there's no shortage of productive capacity in place today. Or perhaps the Asian debt contraction is going to be transmitted to the rest of the world via banks and the emerging economies, provoking a global contraction in lending and borrowing. Or perhaps no

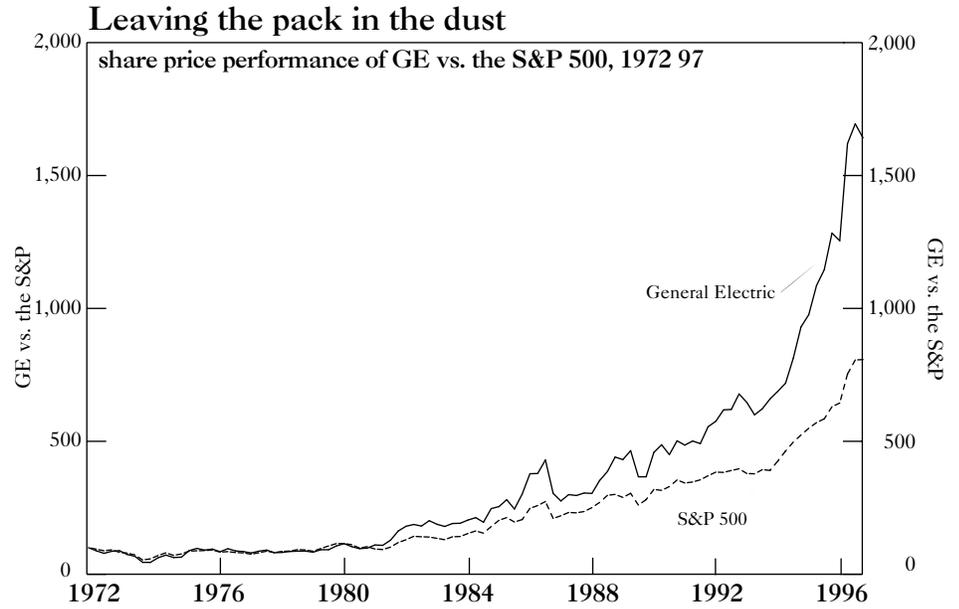


such dire eventuality will come to pass. Maybe the worst that will happen on the other side of the world is a puny little growth recession.

However, we believe, GE stockholders would be at risk even in that benign outcome. They would be at risk even if Jack Welch were elected co-President of the United States and Wendt were named co-Treasury Secretary (each man retaining, of course, his post at GE). Although we happen to think that GE is in for rough sledding in capital goods, we do not rest our bearish case on the possibility. The root of the trouble, we think, lies in Wall Street. Nobody—not even Welch and Wendt—could live up to the expectations embedded in current GE valuations.

One way to test the proposition that GE is overpriced is to compare its valuation to those of its peers. The method is to assign a multiple to the earnings of the major parts and compare those multiples with the competition. GE itself lends a hand in this exercise by comparing its performance to that of the S&P 500 (and to the Dow Jones Industrials as well—the numbers are published in the proxy). As the graph points up, Welch, Wendt & Co. long ago left the index behind.

To sharpen the focus of the analysis, Ken Shirley of this staff divided GE into its two basic parts, industrial and financial. Starting off with industrial earnings, he capitalized them at the multiple prevailing on the S&P 400 (i.e., the industrial segment of the



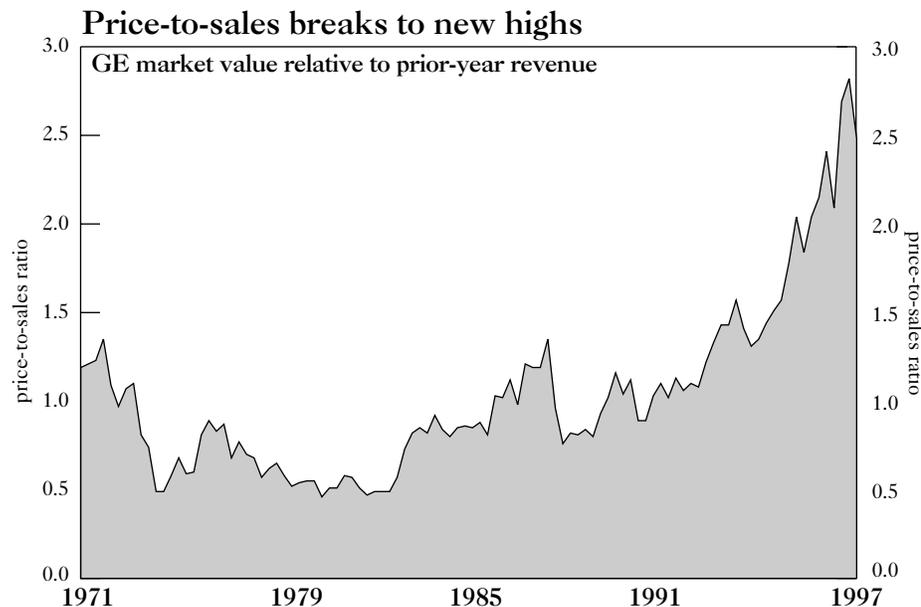
500-stock index). The S&P 400 trades at 25 times trailing net income; thus, the \$5.5 billion of GE's industrial earnings "should be worth" \$137.5 billion in the marketplace.

On to the financial component. GE itself makes no separate comparison of Capital's performance. In doing the job himself, Shirley followed the lead of Travelers Group. The yardstick to which Sandy Weill & Co. compares itself is a smorgasbord of S&P industry-group indices, including S&P Personal Loans, S&P Property/Casualty Insurers, S&P Multi-line Insurers, S&P Money Center Banks etc. Companies in the relevant industry averages trade at a multiple of ap-

proximately 15.6 times. Multiplying Capital's earnings—\$3.16 billion—by that P/E yields \$49 billion. That is what Capital's earnings "should be worth" in the marketplace.

Combining the two capitalized sums—\$137.5 billion and \$49 billion—makes a grand total of \$186.5 billion, or about 14% less than the actual \$217 billion market cap. "That really stands out," notes Shirley, "when you remember that both of the peer group multiples are at or near all-time highs. Furthermore, the industrial portion of the multiple is overstated by the inclusion of GE's own high multiple. GE makes up 3.168% of the S&P 500 (a breakdown of the 400 isn't available), by far the biggest component of the index. To summarize: relative to a peer group that is itself trading at historically high multiples, a buyer of GE chooses to pay a premium of 14% to own the stock." Each to his own.

Then, maybe, GE is cheap in its own terms, relative to its own history? No, again. As noted, GE trades at 2.5 times revenues; the previous high in this department going back 25 years (leaving aside the slightly higher peaks reached last summer) was 1.35 times, set in the fourth quarter of 1972. Today, the stock trades at 27.4 times net income; the 25-year high, prior to 1997, was set—once again—in the fourth quarter of 1972. The multiple then was 28.1 times. Incidentally, the all-time record for the past 25 years was set last summer, at 30.7 times. As for book value, the Nifty-Fifty high of 4.7:1 is a pale



shadow of the current ratio of 6.4:1 or of last July's 7.2:1.

"Since 1972 was the last great peak in GE," Shirley writes, "what would the return have been for a buyer at the top? Not including dividends, the lucky GE stockholder lost 14.6% over the next five years, and earned 5.0% compounded over 10 years, 7.7% over 15 years and 8.9% over 20 years. Only through the magic of the newest new era has a 1972-vintage GE stockholder done well. The compounded rate of return from then until now is 11.8% (our unit of measure, by the way, is stock market cap)."

Can growth explain these generous, even unprecedented, valuations? You be the judge: Over the past five- and 10-year periods, net profits have risen by 12.9% and 14.1% per annum, respectively. Over the same spans of time, revenues have grown by 8.8% and 6.2% per annum, respectively. The P/E multiple is, as noted, 27 times.

GE, a brilliant company, is priced for the perfect outcome, but the times are increasingly imperfect. Where's the margin of safety?

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Hot Light on GE

(September 14, 1990) There being no quadruple-A bond rating, as what's-his-name from Beverly Hills was always saying, the credit of a triple-A company has no place to go but down. By definition, it cannot be improved, but — the times being what they are — it can easily be disimproved. Only 12 American industrial corporations still command the top debt rating of both Moody's and Standard & Poor's.

General Electric, one of that elite number, makes a provocative case in financial evolution. In size and gravitas, it is the ultimate triple-A. Its bonds yield only a little more than the government's, and that interest-rate spread is now as thin as a dime. Perhaps, investors have come to favor cash-flow-positive debt issuers (e.g., GE) as opposed to cash-flow-negative ones (e.g., the Treasury), even if the cash-flow-negative issuer can tax and print money. Or perhaps investors are so hungry for extra yield that they have forgotten to ask the most basic fixed-income question in the book: What can go wrong? And the inevitable follow-up question:

Am I being paid enough to weather the storm if something does go wrong?

General Electric makes aircraft engines, medical equipment, light bulbs, power-generation equipment, refrigerators, satellite heat shields, satellites, television shows, locomotives, electric motors — and loans. It makes all these things by the carload, and its financial parameters never fail to suggest a comparison with the Hong Kong GNP. It is the largest U.S. commercial-paper issuer, with \$28 billion outstanding. Its revenues last year totaled \$55 billion; earnings, \$4 billion, and assets, \$128 billion.

General Electric Financial Services (GEFS) is the name of the financial division. General Electric Capital Corp. (GECC) is GEFS's principal, triple-A-rated and fabulously successful company. Employers Reinsurance Corp. is the No. 2 financial holding and Kidder Peabody Group is No. 3.

In 1980, the forerunner to GEFS competed exclusively with other industrial finance companies. Except indirectly, it did not compete with banks,

brokerage houses, thrift institutions or insurance companies, as GEFS does today. It earned \$115 million through secured lending and financial leasing, and its field of operations was domestic. Now, to quote the latest annual report, which does not exaggerate, GEFS "is one of the world's leading suppliers of capital, packaging sophisticated financial products uniquely tailored to customer needs." In 1989, the financial division earned \$927 million through leveraged buyouts, consumer credit cards, commercial real-estate lending, junk bonds, computer leasing, aircraft leasing, auto leasing, auto auctions, railcar leasing, dry van cargo leasing, mortgage insurance, reinsurance and securities sales and underwriting. It operates worldwide. In the Decade of Debt, the compound annual growth of its operating earnings was 26%.

GEFS, as you may or may not remember, played an instrumental role in financing one of the decade's first miracle deals, the Gibson Greeting Cards leveraged buyout of 1982. That year did not mark the beginning of

General Electric Co.—time marches on

selected historical data and ratios

(in \$ millions, except per-share data)

	1932	1957	1974	1982	1989
Net sales	\$147.2	\$4,335.7	\$13,598.9	\$26,500.0	\$54,574.0
EBIT ¹	14.7	521.7	1,180.8	3,097.0	12,210.0
Net income	14.4	247.9	608.1	1,817.0	3,939.0
Earnings per share	\$0.41	\$2.85	\$3.34	\$8.00	\$4.36
Total assets	405.1	2,346.6	9,369.1	21,615.0	128,344.0
Long-term debt	2.0 ²	300.0 ³	1,195.2 ⁴	3,099.0	16,110.0
Total equity	345.4	1,216.6	3,704.3	10,198.0	20,890.0
EBIT margin	10.0%	12.0%	8.7%	11.7%	22.4%
Net income margin	9.8%	5.7%	4.5%	6.9%	7.2%
Long-term debt/assets	0.5%	12.8%	12.8%	14.3%	12.6%
Long-term debt/equity	0.6%	24.7%	32.3%	30.4%	77.1%
Current ratio	2.3 x	1.9 x	1.3 x	1.3 x	0.8 x ⁵
EBIT/interest	46.8 x	46.5 x	6.6 x	9.0 x	1.9 x
Return on assets	3.6%	10.6%	6.5%	8.4%	3.1%
Return on equity	4.2%	20.4%	16.4%	17.8%	18.9%
Net income of GECC as % of parent	—	3.2%	7.0%	11.3%	20.7%

¹ Earnings before income and taxes; includes all income sources.

² GE gold debenture 3¹/₂s, due 1942; Aaa-rated, 40-year bonds.

³ GE debenture 3¹/₂s, due 1976; Aaa-rated, 20-year bonds.

⁴ Five issues, including \$300 million of GE 8¹/₂s, due 2004; Aaa-rated, 30-year bonds.

⁵ Current assets include only those time sales, loans and rental receivables of GEFS that mature in 1990. Including all GEFS receivables, current ratio is 1.2 x.

debt (as 1963 marked the beginning of sex, according to the poet Philip Larkin), but it suggested the infinite possibilities of a leveraged balance sheet to a new and historically innocent generation of bankers and investors. With Gibson, the 1980s were off and running, and almost nobody ran faster or farther than GE.

Many of the runners have stumbled (some into the arms of the law), and the rate of expansion of debt is slowing. At the margin, we think, the expansion of private-sector debt may be grinding to a halt. The possibility of stagnation or even contraction has not yet engaged the attention of the corporate bond market, except for the junk-bond branch, which thinks about nothing else.

We happen to have a little theory: The bear market in junk is of a piece with the bear markets in bank stocks, commercial real estate and so-called stub stocks (i.e., the equities of leveraged corporations). They are of a piece with the bear market in Japan. What each disturbance has in common is the refusal of formerly willing lenders to say yes. The breadth of the downturn raises urgent questions, one of which provoked this essay: If a very good company — indeed, a triple-A company — actively participated in the 1980s, how could it not actively participate in the 1990s? How could a company profit so handsomely by the expansion of debt yet not suffer through the contraction?

GEFS is the decade of the 1980s under one roof. It financed leveraged cable-television deals, insured mortgages,

leased planes and cars, insured municipal bonds, lent against the collateral of commercial real estate, financed leveraged buyouts and became the largest issuer of private-label credit cards in the country. It became a bank-of-the-future: an unfettered “niche” institution with a triple-A balance sheet. Like the First National Bank of New York in the 1920s or Dai-Ichi Kangyo Bank in the 1980s, it basked in its reputation as the holder of vast “hidden assets.” Everyone knew that GE Capital Corp. had taken equity positions in the buyouts it helped to finance. And everyone was familiar with the prevailing, indeed inevitable, direction of equity values in successful leveraged buyouts: up. Thus, as Standard & Poor’s put it last fall, “Equity positions, taken by GECC as part of its leveraged buyout financing activity, have grown to a substantial size and are expected to make a large contribution to future earnings as gains are realized.” Note the bull-market construction, “. . . as gains are realized.” A year later, the correct turn of phrase has become, “. . . if gains are realized.”

We had a list of questions for GE almost as long as its arm. We’d wanted to ask about the cable-TV loans (reported to total \$1.8 billion), the \$740 million junk-bond portfolio (acquired from Kidder Peabody last March), the buyout portfolio and, more generally, the prospects for consumer lending, now that a business slowdown has been overlaid on a real-estate slump. We had hoped to ask if GEFS, to improve its return on equity, has been stepping up the sale of its “hidden assets,” i.e., war-

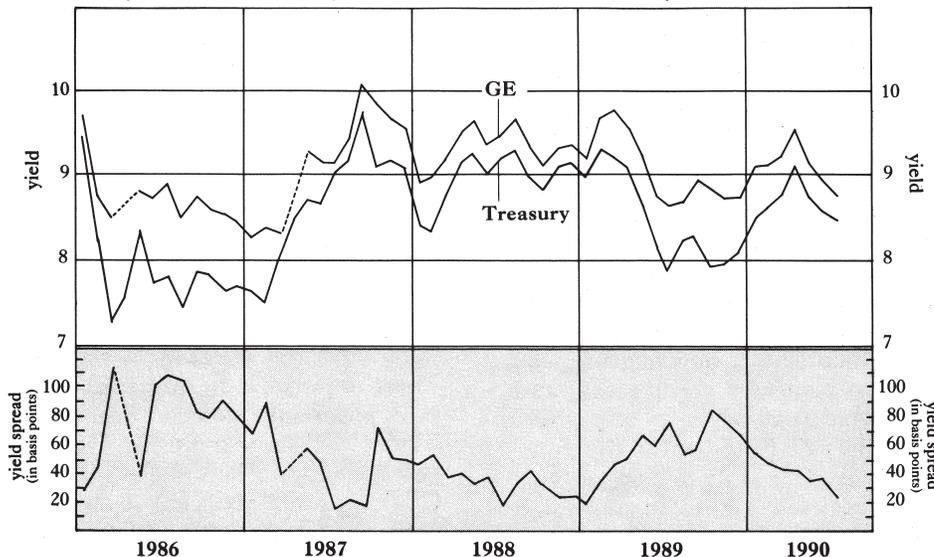
rants in its corporate-finance clients, such as Tiffany. And we had prepared a follow-up question: In the light of the bear market in stocks, aren’t warrant values fast eroding? We’d looked forward to hearing what the brass at GE would say to the proposition that, in a credit contraction, trouble begins at the fringe but eventually visits the center, no matter how strong the center is, or seems to be.

In the time saved by not visiting GE headquarters in Stamford, Conn., Jay Diamond, our associate publisher, compiled a fascinating historical table. The information describes the parent company’s consolidated finances in a succession of business downturns, starting with 1932, which happens to be the year in which the forerunner to GECC was started. It ends in what may or may not prove to be a recession year, pending statistical revisions, 1989. Evolution has meant more leverage, thinner coverages, lower returns on assets and rising contributions to consolidated income by financial activity.

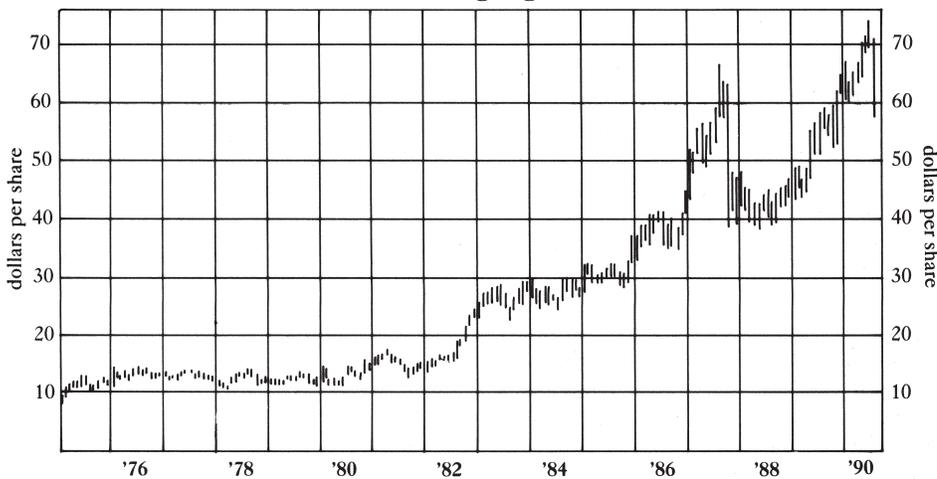
Interestingly, GE’s debt rating hasn’t changed in the past 58 years, even though its financial profile has. At the bottom of the Great Depression, long-term debt was negligible, interest coverage was massively redundant and the current ratio was better than 2:1. In 1989, a non-depression year, long-term debt constituted 77% of equity, interest coverage was less than 2:1 (surely a remarkably low reading) and the current ratio was less than 1:1.

To the universal question, So what?, we can offer several answers. In the first place, the leveraging of GE is emblematic of the leveraging of America. For another, the stability of GE’s debt ratings over the years is proof that “triple-A” is a subjective and relative term, like “thin.” By the lights of 1990, GE stands as straight as an arrow. By comparison with its weakest years in the past half-century or so, however, the company slouches and has difficulty touching its toes. To us, the second most striking line on the table, after the melting of interest coverage, is the one that shows the rising contribution of financial activity to the consolidated bottom line. Let us agree that the alchemy business has seen its best days and that the warrant value of leveraged companies is going down. In that case, the profit contribution of GE’s financial businesses is bound to decline, and perhaps quickly.

GE yields more—only a little—than the Treasury



General Electric Co.—standing eight feet tall



source: M.C. Horsey & Co.

On the trip to Stamford we didn't take, we'd meant to ask GE about the significance of GEFS. "Do you see what we see?" we were going to ask the person across the table, apropos of the credit contraction. "And if you do, do you anticipate any circumstances in which the parent's credit might be needed to assist the financial subsidiary's?" The rating agencies seem to agree that, standing by itself, GE Capital Corp. would not command the triple-A debt rating it now does. "Although no guarantee or formal support agreement exists between GECC and General Electric Co.," S&P, for instance, comments, "the parent historically has provided considerable support to its financial services subsidiary, a significant factor in GECC's ratings."

Excusing themselves, the GE spokespeople told us that what they had to say about credit they would say to the rating agencies. So we called the agencies. To our question of whether they worried about the highly leveraged transaction (HLT) portfolio, the real-estate and cable TV loans and the junk-bond and warrant portfolios, their composite answer was, "Yes, a little, but there are offsetting factors." Rodrigo Quintanilla, the Moody's analyst on the GECC case, admitted the potential for problems. He acknowledged that the GECC portfolio is untested by recession. But he cited, among other mitigating circumstances, the subsidiary's presumed call on its rich parent. And he added that, if GECC's debt rating ever did come in for scrutiny, the bonds, not the commercial paper, would be the candidates for downgrade

(not that they are now, he added). As for the parent, Martin Knoblowitz, S&P's analyst, said that its diversification and sheer mass were so great that a troubled GECC (if there ever were one) would not immediately threaten GE's triple-A rating. As for the issue of whether the triple-A halo has lost some of its wattage over the years, Knoblowitz said, "We don't go in terms of numbers alone in looking at credit quality."

Next, we turned to a new report on GECC by our friends at Fitch Investors Service. Although bullish, the report is fact-filled, and it can be usefully read by bears and independents.

The summary addresses the company's size, intercontinental reach (20 businesses, each well-established in its respective market) and strength-giving affiliation with GE. As for HLTs and commercial real estate, we are advised not to lose any sleep over them: "Fitch does not expect that potential deterioration in related asset quality will hurt the company's financial integrity, since profits and the underlying capital/reserve base provide a substantial foundation."

Every financial idea stands on a theory, even if the proponent of the idea doesn't consciously know what it is. Our theory is that attitudes toward credit are cyclical. Collectively, lenders and borrowers progress from being brash to being timid, not pausing long at the midpoint marker of reasonableness. There are long cycles and short, the long having to do with the passing of generations and the short having to do with the rise and fall of business activity. Once in a blue moon — now, for instance — the long cycle is su-

perimposed on the short one. We are, we think, beyond the manic phase of this consolidated cycle and into the depressive one. In the depressive phase, credit contracts, asset values fall and business slows down. Among financial institutions, failures proliferate. Failure begins at the margin but eats its way into the middle, like a mouse. Thus, junk bonds show the strain before home-equity loans, and Drexel Burnham Lambert fails before Bank of New England. In a severe contraction, even the strongest lenders are tested, as the process of shrinkage and deflation nullify the financial assumptions that, in the boom, had seemed conservative.

Fitch does not declare a credit theory. It seems to imply, however, that every institution rises or falls on its merits and that good management overcomes problems. The authors salute the capital company's asset quality — "surprisingly good and consistent given the loan portfolio's fairly high-risk profile" — and commend its management. They acknowledge that the GE executives are only human because there were energy-related loan losses in 1986. They do not deny that GE managers are any less human in 1990. But they do not directly address the possibility that real estate and corporate finance produced bigger and more dangerous bubbles than energy, with the corresponding likelihood of large future loan losses at GE.

We do worry, of course — that is our lot in life — and the coolness of Fitch's prose only makes us sweat more. For instance, concerning the most lucrative GECC business line, corporate finance, the authors write:

Senior and subordinated financing and equity investments in leveraged corporate restructurings total \$7.9 billion. This has been a high profile and high profitability business for GECC for a number of years. The company's approach can be differentiated from others in the industry by its willingness to take control of and manage businesses, which reduces losses. The portfolio is diversified among over 100 borrowers and by industry, with a slight concentration in media and cable, which together represent 26% of loans. . . .

Strong credit management and a very sizable unrecognized gain from the warrant portfolio are sufficient to cover the variance in credit quality that is anticipated.

So, barring a recession, rabbits of equity will be plucked from the corporate hat. Fitch does have one anxiety. It is that the good old deal days are over:

Of perhaps more concern, is the dearth of leveraged buyout activity in the current market environment. However, while this business has represented such a strong profit contributor to the company (a full 25% of 1989 results), the slowdown so far has not had a material effect on profitability, as other businesses have provided greater earnings.

The more we thought about GECC's call on the financial strength of its parent, the more circular it became to us. GECC itself has contributed an ever larger share to the parent's net income.

To that extent, therefore, GECC is an important source of the very strength that it may one day seek to lean against.

If GE's and GECC's credit ratings cannot get any better, neither can the companies' standing on Wall Street. In a Barron's poll this week, GE turned up as one of the stocks most favored by institutional equity investors. As for the bond market, investors increasingly prefer GE to the United States government.

Maybe the credit contraction is a figment of our imagination. Or maybe GECC will glide through whatever contraction there is, unscathed. In either case, markets are priced accordingly. If not, there will be some adjustments.



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