

November 14, 2007

Note

RE: Washington Mutual (WaMu)

In a matter of a few months, WaMu lost more than half its market value. Troubles in the mortgage business have translated into a 36% earnings decline, which raises the shocking specter of a dividend cut by this former Blue Chip stock. A dividend cut is a major event for any company, but of even greater consequence for a company such as WaMu with a tradition of paying generous dividends. So what does an investor in WaMu do? The answer depends upon perspective. Speculators and traders with their short-term investment horizons have made their exits, as WaMu will undoubtedly be “dead” money for a time. Investors with a more patient view may elect to hold in anticipation of a substantial recovery per the following investment case.

WaMu’s earnings have declined from \$3.74/share FY’06 to an expected \$2.40 FY’07. Exacerbating matters are lowered consensus analyst long-term earnings growth expectations, from 11% to 9%, and the previously mentioned threatened \$2.24 dividend that is now covered by only a few pennies of earnings. Anyone who understands valuation math will realize these are major issues, yet the fact remains that WaMu remains a profitable concern and S&P just affirmed its Investment Grade rating, so is a \$20 share price justified?

A Discount Model is used to answer this question. While few investors bother to run this math, it’s taught at every business school and is the stock and trade of Investment Banking and Private Equity, appropriate for valuing anything from a multi-billion corporation to the corner drug store. Business worth is a function of an expected earnings stream discounted to a Net Present Value using an appropriate Discount Rate, which for equities today is about 11%. Load WaMu’s previous \$3.74 earnings, \$2.24 dividend and 11% expected growth and out pops an estimated worth of about \$80. Compared to its \$40-45 stock price earlier this year, that significant discount reflected the expected difficult mortgage environment ahead. However, the subsequent earnings decline became part of a market panic, tanking WaMu’s stock price and unpleasantly surprising WaMu investors, who believed that the earnings decline was already imbedded in its price. So the question remains, is a \$20 share price justified?

Using the same Discount Model, loading reduced earnings of \$2.40, drastically cutting WaMu’s dividend to \$1 and lowering expected earnings growth to 9% produces an estimated worth of \$40. To get to a \$20 valuation is hard and requires making highly unlikely parameter adjustments. Valuation is most impacted by expected earnings growth; so reducing that from 9% to 0%, which the most pessimistic analysts don’t anticipate, knocks worth to \$25. To get to \$20, in addition to no earnings growth WaMu’s dividend must be eliminated entirely rather than just reduced, which is an even more unlikely event. At the end of the day, considering the reality of WaMu’s financial position rather than the hype and hysteria, there’s no reasonable way to justify a \$20 price.

This example is fairly typical of many quality financials today. In the late-90s, it was Value stocks priced in this manner. The point of the above is that price can be a very poor indicator of underlying worth in the short run, as market supply and demand forces will periodically create severe distortions. This creates both problems and opportunity for investors. Holders of these beaten-up financial positions have just experienced the brunt of the problem - with patience they’ll realize the opportunity, with yesterday’s big rally the first installment.

Keep the faith!

Lowell