F R I E D M A N B I L L I N G S R A M S E Y

FINANCIAL SERVICES

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Coverage Initiated

J.P. Morgan Chase & Co. (JPM - $35.34)

Accumulate

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Only a Few Clouds Remain After the "Perfect Storm"

- **The bulk of the bad news is behind.** Although J.P. Morgan Chase has been buffeted by the recent spate of corporate bankruptcies, we believe that the concerns about J.P. Morgan Chase's risks that have surfaced in the post-Enron era have been blown out of proportion. More importantly, we think that the spate of credit bombshells and private equity write-downs that shook the stock last year have now largely subsided, and that a renewed focus on risk management will help the company steer clear of repeating past events.
- **Turnaround may be afoot.** We believe that the merger of Chase and J.P. Morgan 15 months ago has finally begun to gel. Further, as a result of last year's head-count reductions and a series of process improvement initiatives, J.P. Morgan Chase is looking leaner and more tightly focused. With core operating expenses down 13% from the 4Q00 run-rate, we think that the company will exhibit a high degree of operating leverage when more normal market conditions return.
- **Still some clouds on the horizon.** With Enron's hearings just getting underway, undoubtedly more corporate bankruptcies to come, and a Street consensus estimate that is still too high for the current economic environment, JPM shares will continue to be subject to downward pressure, in our opinion. However, with the U.S. economy starting to show signs of a recovery, we believe that the long-term upside potential outweighs the downside risk from the few remaining concerns.
- **A good opportunity to build positions.** Currently trading at 10.1 times our 2003 EPS estimate, JPM shares are presently valued at a 52% discount to the S&P 500 and a 21% discount to its large-cap bank and broker/dealer peers. Although we think that investors could achieve a total return of 31% over the next 12 months, we believe that the stock may trade sideways for a while, given the higher risk associated with this stock in the near term, and have therefore accorded it an Accumulate recommendation.

STOCK DATA	
Current Price	$35.34
52- Week Range	$49 - 27
Shares Out (MM)	1,973
Float (MM)	$179,881
Avg. Daily Volume (MM)	10.5
Market Cap. (MM)	$69,740
Dividend Yield	3.8%
Book Value	$20.32
Price/Book	1.74

FINANCIAL DATA	
Total Assets (MM)	$735,973
Return on Avg. Assets	0.46%
Return on Avg. Equity	8.1%
Net Interest Margin	2.00%
Operating Efficiency Ratio	68.39%

EARNINGS PER SHARE OR FUNDS FROM OPERATION			
FY: Dec	**2001**	**2002**	**2003**
1Q	0.70	0.44	n/a
2Q	0.33	0.63	n/a
3Q	0.51	0.67	n/a
4Q	0.12	0.71	n/a
Year	1.65	2.45	3.50
P/E	21.4x	14.4x	10.1x

INVESTMENT SUMMARY

Despite the recent whirlwind of controversy surrounding J.P. Morgan Chase lately, we believe that the worst of times have indeed passed and that a turnaround, the shades of which are becoming increasingly visible, is perhaps finally afoot. After suffering private equity writedowns of nearly $2 billion last year, losses of $450 million related to the largest corporate bankruptcy in history, an additional $350 million in credit costs from

Argentina's default and currency devaluation, and the onset of the first recession in a decade, the still somewha recently merged Morgan Chase has ridden out the Perfect Storm, a little weathered, but still shipshape. To be sure, we don't think it will all be smooth sailing from here. But, we think the few clouds left on the horizon are comparatively benign and that the company continues to possess the earnings power, risk management expertise, diversity of income streams, world-class brand name, and enough capital not only to keep it afloat, but also to catch some wind in its sails as the economy recovers.

For starters, while we expect the credit-quality picture to continue to deteriorate this year given the late stage of the credit cycle, we think fears that there are more Enrons out there were greatly overblown. And even though the stock has snapped back in the last week or so, perhaps as the market recognized that the subsequent string of corporate bankruptcies would not have the same kind of impact on the company's balance sheet, we think concerns over the company's corporate lending and derivatives dealing activities continue to weigh disproportionately on the stock. Although the risk clearly remains that there could be additional problems given Morgan Chase`s historical penchant for its hog share size in some syndications and its large credit derivatives book, we do not expect losses to exceed those typically incurred by money center banks during the late stage of a credit cycle. We would add that the company`s level of commercial nonperformers continues to be modestly lower than its peers, and the reserve continues to look adequate. In addition, we have factored into our earnings estimates a 12% increase in credit costs this year on top of last year`s $4.2 billion provision—a fairly conservative assumption, given the fact that last year`s provision was a 79% increase over 2000.

In addition, we think the heavy write-downs at JPMorgan Partners, the company's private equity outfit, will have largely run their course after the first quarter of this year. Excluding a $300 million loss on the unit`s single largest investment this quarter, the ratio of losers to winners in the public portion of the portfolio is flattening. As a result, we think the unit could significantly reduce its operating loss this year and potentially return to positive results in 2003.

At the same time, we have begun to detect through a series of meetings with management that the merger between the old JP Morgan and Chase Manhattan has finally begun to gel. The series of revolving doors in the management suite seems to have stabilized, and real progress is being made on integrating the various platforms Chase acquired over the past couple of years. As a result, we think the company's capital markets franchise is well-positioned to benefit when more normal market conditions return.

On top of this, we believe the six-sigma-inspired cost cuts and process reengineering initiatives are dramatically improving efficiency, resulting in a leaner, spring-loaded operation. While management had to rapidly right-size its headcount last year in response to the less than hospitable economic environment, they were afforded the luxury of cherry-picking the best talent from both firms (actually from five firms when you look at the overlap with H&Q, Beacon, and Flemings). As a result, we don't believe the knife went as deeply into the organization's muscle (except perhaps in units that have less than stellar long-term prospects in the post-bubble era). Although there may still be some staff redundancies left to pare on the tech support and operations side, we think Morgan Chase entered 2002 a leaner, more tightly focused shop that will be able to get back on track when market conditions improve.

In short, we think the majority of bad news has now come out. More importantly, we believe the dividend is safe for now. Even though regulatory guidelines typically restrict upstreamed dividends to current income plus two years` retained earnings, we believe JPM`s dividend paying capacity is governed by an exemption which allows it to maintain higher leverage, but also restricts its ability to upstream cash from the bank during times of stress. In short, we think the company has to earn the dividend in order to pay it. Given our first quarter EPS estimate of $0.44, we don`t believe Morgan Chase will be forced to reduce its dividend.

That being said, we do think management would consider trading the dividend to avoid being downgraded by the rating agencies if it had to. The central issue here we believe is capital adequacy. In particular, given some criticism over the amount of intangibles on the balance sheet (and in particular an estimated $1 billion piece related to the company`s 1999 acquisition of Hambrecht & Quist), the rating agencies are probably focusing on the level of tangible capital, which at 4.65% of assets does not compare favorably to its closest peers, but more closely resembles the capital structure of the pure-play investment banks. However, in our minds, barring another sizable charge-off or asset writedown, we don`t believe the company will be required to raise new

capital.

In the final analysis, with the US economy ever so slightly showing signs that it may be on the mend, we do not believe the concerns still hovering over the stock present proportionately more downside risk than the amount of upside potential stemming from the operating leverage Morgan Chase possesses when more normal market conditions return.

And although we are not factoring in a recovery in the marketplace until late second quarter, we expect the company's fundamentals to show sharp improvement this year. In particular, we think the company will produce double-digit revenue growth in 2002 reflecting a sharp reduction in private equity and mortgage servicing writedowns as well as 22% projected growth in card fees, while operating expenses may be flat to up slightly Even with credit provisions projected to rise by 12% this year off an already-higher-than-normal year in 2001, we estimate Morgan Chase's core net income could grow 47% this year.

In addition, we think the company's returns on its equity base will also recover and gain momentum throughout the course of the year, starting slow in the 9% range this quarter and then approaching 14% by year-end. While this is still a long ways away from management's targeted range of 20-25%, it would be a significant first step and more than double the 6.2% core ROE the company generated the last nine months of last year.

On a per share basis, however, our earnings estimate for 2002 is only $2.45, which is a full 80 cents higher than last year, but is still 28 cents below the current consensus (which has been declining in recent weeks). As a result, even though we think JPM has begun generating momentum in its core businesses and will eventually restore the earnings power locked in its global franchise, the economic environment is simply not geared to produce the kinds of earnings reflected by the consensus number.

It's worth noting, however, that the trajectory of our earnings estimates are considerably steeper than the consensus opinion with significantly lower than consensus earnings projected in the first quarter, more or less in-line numbers for the balance of the year, and slightly better than the Street estimates expected next year.

VALUATION

In the time since Enron became a household name, JPM shares have been taken on a wild ride, beginning with the admission by management that it had a much larger relationship with the failed energy giant than it had previously indicated. However, the stock continued its free fall even after the Enron news essentially stopped coming out, as investors grew wary of the company's large syndicated loan portfolio.

Particularly noteworthy is the fact that 11 of the 25 most active trading sessions in the stock's history have occurred since January 29. As a result, the market's jitters over corporate accounting and off-balance sheet special purpose vehicles were amplified. While "Enronitis" sickened the markets in general since the last week in November, resulting in a 6% drop in the S&P 500 through the third week in February, JPM shares were particularly hit hard, plunging by 28%, on the fear that the purveyors of credit to corporate america could suffer a tidal wave of defaults and may even have accounting skeletons of their own waiting to escape the closet.

Since then, the market has seemingly recognized that the likelihood of multiple Enrons is slimmer than the headline hyperbole would have led the world to believe. Accordingly, JPM shares snapped back sharply, but they are still down 17% from the middle of 2001 and 28% since the merger between Chase and Morgan was announced. Moreover, the stock continues to trail far behind its peers in both the banking and brokerage industries, which have now retraced the lost ground caused by the recession and the terrorist attacks.

As a result, JPM shares are currently trading at 10.1 times our 2003 EPS estimate, a 52% discount to the S&P 500 and a 21% discount to its large-cap bank and broker/dealer peers. Moreover, the stock's generous dividend yield of 3.8% is the highest in the group and nearly twice the peer group average.

Still, if our EPS estimate is correct (i.e., if the consensus is still too optimistic), the stock is trading at the higher end of the money-center group as a multiple on 2002 earnings. In fact, over the past year, J.P. Morgan Chase has been trading more or less in lock-step with Citi, despite the wide variance in their operating results and not-so-subtle differences in their capital markets franchises. Hence, even though we think the bulk of the bad

news is behind the company, at this point, and that the economy is on the mend, we think that the stock may still have to tread some rough seas this year with Congressional hearings on Wall Street's role in Enron's collapse just getting underway, Global Crossing's hearings scheduled to start soon, and the likelihood that future corporate defaults will land JPM's syndications business in the headlines again. Moreover, if we are right that the Street's consensus EPS estimate is still too high, additional downward pressure will be placed on the stock as analysts continue to ratchet down their earnings expectations again for 2002.

Although achievement of our $45 price target could result in a total return of 31% for shareholders, we believe that the stock may trade sideways for a while, given the higher risk associated with this stock in the near term, and we have therefore accorded it an Accumulate recommendation.

RISKS

- Enron-related losses could include $1.1 billion of commodity contacts, which had been bonded but have since been called into question. On December 19, J.P. Morgan Chase filed a suit against nine insurance companies and a European financial institution that had collectively issued roughly $1.1 billion of surety bonds as a guarantee of Enron's obligations under a series of prepaid forward natural gas and crude oil contracts. The insurance companies, however, allege that no commodity was ever intended to be delivered under the forwards, but rather, that the transactions were merely intended to provide a mechanism to obtain surety bonds to secure loans to be made to Enron in the guise of forward supply contracts. Although J.P. Morgan Chase believes it will ultimately result in a full recovery of the receivable, we believe that the court could find the surety contracts nonbinding and vacate the obligation of the insurance companies if it finds that the nature of the underlying transactions was misrepresented. In our opinion, the outcome of this lawsuit will not be determined for quite some time, and JPM may at some point need to reserve against what could be another large Enron-related credit loss.

- Domestic economic conditions could worsen. Our model assumptions anticipate that the recent recession is essentially over and that a recovery in the marketplace will begin to take hold during the second quarter. If, on the other hand, we were to experience a double-dip, the slowdown in J.P. Morgan Chase's domestic revenues or the increase in loan losses could be worse than we have anticipated.

- Credit quality could deteriorate dramatically even if the downturn does not get any worse. With the sharp increase in unemployment last year, record levels of consumer bankruptcies, and somewhere in the neighborhood of 2 million layoffs during the course of 2001, a commensurate sharp increase in consumer charge-offs could already be in the cards. In addition, it is widely anticipated that there will be an increase in corporate bankruptcies this year, which will likely have a negative impact on J.P. Morgan Chase`s corporate lending portfolio.

COMPANY PROFILE

Formed from the December 31, 2000, merger of J.P. Morgan & Co., Inc. and Chase Manhattan Corp., J.P. Morgan Chase & Co. is a global financial services firm with operations in more than 50 countries. The company is active in corporate and investment banking, consumer and middle-market lending, private banking and wealth management, and securities processing. With total assets of $750 billion at year-end 2001, JPM ranks as the second-largest bank in the United States in terms of assets, and it is one of the 10 largest in the world. The company also boasts relationships with over 99% of the Fortune 1000 companies and more than 30 million consumer customers.

Although its predecessor companies both operated under bank charters, J.P. Morgan really functioned as a global investment bank specializing in equities and advisory services and as a private bank serving the ultra-high-net-worth crowd. Chase Manhattan—the product of the December 1991 merger between Chemical Banking Corp. and Manufacturers Hanover, and the March 1996 acquisition of the old Chase Manhattan by Chemical—contributed traditional consumer, middle-market, and wholesale banking operations in the U.S., and it brought strong syndicated loan and fixed-income underwriting capabilities to the table.

Organized along five major business lines—1) investment banking, which includes the corporate lending operations; 2) wealth management, comprised of the investment management and private banking units; 3) treasury and securities services, which

include a large custody operation; 4) retail banking, which includes the middle-market services; and 5) private equity—J.P. Morgan Chase is ranked among the leaders in nearly every subsector of the commercial and investment banking industries.

The company's wholesale businesses—comprised of the investment bank, corporate lending, treasury and cash management, middle-market banking, securities services, investment management, private banking, venture capital, and private equity—are known as J.P. Morgan, while branch banking, credit cards, mortgage, and consumer finance operate under the Chase brand.

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JP Morgan Chase

$ in millions, except per-share data

	1999	% Chg	2000	% Chg	2001	% Chg	2002E	% Chg	2003E	% Chg
Managed Income Statement Summary										
Net interest revenue (FTE)*	$10,210	*14%*	$9,902	*-3%*	$10,929	*10%*	$11,535	*6%*	$11,544	*0%*
+ Noninterest revenue*	22,115	*36%*	22,413	*1%*	18,386	*-18%*	21,216	*15%*	25,768	*21%*
Total operating revenues	32,325	*28%*	32,315	*0%*	29,315	*-9%*	32,751	*12%*	37,312	*14%*
- Credit provisions	2,439	*-6%*	2,367	*-3%*	4,233	*79%*	4,750	*12%*	3,823	*-20%*
- Operating expenses	17,543	*11%*	20,865	*19%*	20,047	*-4%*	20,346	*1%*	22,681	*11%*
Pretax cash income from operations (FTE)	12,343	*81%*	9,083	*-26%*	5,035	*-45%*	7,655	*52%*	10,808	*41%*
- Noncash expenses	329	*12%*	528	*60%*	729	*38%*	199	*-73%*	199	*0%*
Pretax operating income (FTE)	12,014	*84%*	8,555	*-29%*	4,306	*-50%*	7,456	*73%*	10,609	*42%*
+ Securities gains (losses)	(192)	*NM*	229	*NM*	866	*278%*	276	*-68%*	313	*13%*
+ Nonoperating income	228	*-40%*	1,131	*396%*	0	*NM*	0	*NM*	0	*NM*
- Nonoperating expenses	123	*-86%*	1,431	*NM*	2,523	*76%*	0	*NM*	0	*NM*
Pretax income (FTE)	11,927	*84%*	8,484	*-29%*	2,649	*-69%*	7,732	*192%*	10,922	*41%*
- FTE adjustment	96	*-4%*	84	*-13%*	83	*-2%*	88	*7%*	87	*-1%*
Pretax income	11,831	*85%*	8,400	*-29%*	2,566	*-69%*	7,644	*198%*	10,835	*42%*
+ Income Tax Expense/Benefit on Noncore	(37)	*NM*	100		833	*733%*	0	*NM*	0	*NM*
- Provision for income taxes	3,988	*53%*	3,006	*-25%*	847	*-72%*	2,675	*216%*	3,792	*42%*
- Minority interest	0	*NM*	0	*NM*	0	*NM*	0	*NM*	0	*NM*
Net income from continuing operations	7,843	*107%*	5,394	*-31%*	1,719	*-68%*	4,968	*189%*	7,043	*42%*
+ Cumulative effect of accounting changes	0	*NM*	0	*NM*	(25)	*NM*	0	*NM*	0	*NM*
Net income	7,843	*107%*	5,394	*-31%*	1,694	*-69%*	4,968	*193%*	7,043	*42%*
- Perpetual preferred dividends	106	*-20%*	96	*-9%*	66	*-31%*	52	*-21%*	52	*0%*
Income available to common	7,737	*112%*	5,298	*-32%*	1,628	*-69%*	4,916	*202%*	6,991	*42%*
Per-Share Amounts										
Net income, basic	$4.04	*115%*	$2.81	*-30%*	$0.83	*-70%*	$2.49	*200%*	$3.57	*43%*
Net income, diluted	3.86	*114%*	2.69	*-30%*	0.80	*-70%*	2.45	*206%*	3.50	*43%*
Operating net income, diluted	3.83	*87%*	2.79	*-27%*	1.65	*-41%*	2.45	*48%*	3.50	*43%*
Book value	18.07	*4%*	21.17	*17%*	20.32	*-4%*	21.35	*5%*	23.42	*10%*
Common dividend	1.08	*13%*	1.28	*19%*	1.36	*6%*	1.36	*0%*	1.44	*6%*
Dividend payout	28.0%		47.6%		170.0%		55.5%		41.1%	
Period-end shares outstanding (mil)	1,851	*-4%*	1,929	*4%*	1,973	*2%*	1,963	*-1%*	1,958	*0%*
Average diluted shares (mil)	2,005	*-1%*	1,969	*-2%*	2,023	*3%*	2,009	*-1%*	1,999	*0%*
Selected Performance Ratios										
Core return on assets	1.23%		0.83%		0.46%		0.70%		0.98%	
Core return on common equity	23.3%		15.2%		8.1%		12.0%		15.9%	
Net interest margin	2.11%		1.93%		2.00%		2.08%		2.01%	
Operating efficiency ratio	54.3%		64.6%		68.4%		62.1%		60.8%	
Pretax operating margin	37.2%		26.5%		14.7%		22.8%		28.4%	
Effective tax rate	33.4%		35.4%		32.0%		34.6%		34.7%	
Balance Sheet Summary										
Period-end receivables	$203,008	*2%*	$216,050	*6%*	$217,444	*1%*	$238,225	*10%*	$252,518	*6%*
Period-end total assets	667,003	*6%*	715,348	*7%*	693,575	*-3%*	714,360	*3%*	728,650	*2%*
Period-end deposits	287,064	*7%*	279,365	*-3%*	293,650	*5%*	299,567	*2%*	305,559	*2%*
Average receivables	199,912	*0%*	209,488	*5%*	219,843	*5%*	230,443	*5%*	245,372	*6%*
Average earning assets	483,222	*-4%*	513,404	*6%*	547,126	*7%*	555,036	*1%*	569,965	*3%*
Average total assets	630,023	*-4%*	676,805	*7%*	735,973	*9%*	706,577	*-4%*	721,505	*2%*
Average deposits	277,265	*7%*	270,737	*-2%*	279,403	*3%*	296,614	*6%*	302,563	*2%*
Average common equity	32,931	*2%*	36,176	*10%*	41,348	*14%*	40,899	*-1%*	43,891	*7%*
Average total equity	34,627	*1%*	37,747	*9%*	42,534	*13%*	41,908	*-1%*	44,900	*7%*
Asset Quality Statistics										
Loss reserves	5,879	*14%*	5,806	*-1%*	6,665	*15%*	8,032	*21%*	9,043	*13%*
Net charge-offs	1,747	*12%*	2,470	*41%*	3,383	*37%*	3,711	*10%*	2,812	*-24%*
Nonperforming assets	1,873	*8%*	1,923	*3%*	3,750	*95%*	3,695	*-1%*	3,331	*-10%*
Reserve ratio	1.84%		1.70%		2.08%		2.40%		2.47%	
Charge-off ratio	0.87%		1.18%		1.54%		1.61%		1.15%	
Nonperforming asset ratio	0.92%		0.89%		1.72%		1.55%		1.32%	
Reserve coverage of NPAs	199.6%		190.6%		120.6%		154.8%		186.9%	

* Trading net interest income is included in noninterest revenue