THE UNIVERSITY OF ALABAMA

Banking Industry Report

Money Center Banks

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excellent analysis!

P: 10
R: 10

I. Introduction to the Banking Industry

Banking is a financial business that primarily uses assets, in the form of loans to businesses and consumers, to generate revenue above and beyond the cost of their liabilities from accounts of depositors. The main purpose of banks is to provide money to businesses with deficit funds from businesses and account holders with a surplus of funds. Through this ability to issue loans, banks serve to increase the money supply of the economy. Banking is the centerpiece of our World's economy; it allows businesses and individuals to take loans, and fosters economic growth throughout the country.

Today, the banking industry has much more to offer than simple loans and deposits. Banks have evolved into financial supermarkets that offer a wide variety of services and products ranging from underwriting an initial public offering to wealth management and interest only mortgages to Collateralized Debt Obligations (CDO). The Banking Act of 1933, better known as the Glass-Steagall Act, initially separated Banking from Investment Banking. Investment Banks were not allowed to accept deposits, and Banks were not allowed to partake in activities such as underwriting for a stock sale. This was done so that deposits could not be risked in the market through proprietary trading. However, in 1996 congress reinterpreted the Glass-Steagall Act and began to deregulate the banking industry. Consequently, banks were allowed to earn up to 25% of their revenue in investment banking activities. Then, in 1999, the Gramm-Leach Biley Act repealed the Glass-Steagall Act altogether, deregulating the industry entirely. This allowed banks to expand and offer a variety of services and products, essentially creating financial juggernauts such as JP Morgan Chase and Bank of America. In these "super market" banks, all the clients' financial needs could be met under one roof, from deposits to investment banking.

The deregulation of the banking industry under the Riegle-Neal Act of 1994 allowed banks to stretch across state lines and helped create the Money Center Banks that dominate the financial industry today. In 1920, there were around 30,000 banks in the United States, more than any other country in the world, and most with less than 1 million in capital. However, after several depressions and recessions, the number of small banks has dramatically declined as huge Money Center Banks have acquired smaller competitors or merged with struggling banks. Today, the largest 4 U.S. banks (J.P. Morgan and Company, Citigroup, Inc., Bank Of America

Corporation, and Wells Fargo and Company) make up 64% of the assets of all U.S. Commercial Banks.

II. Organization and Structure

Banks vary widely across the country, from small community banks such as Bryant Bank, to regional banks that dominate a geographic region of the country such as Regions Financial Corporation, to giant financial holding companies such as J.P. Morgan Chase. Besides the varying size of these banks, the products and services offered vary as well. There are several different types of banking, and most banks are categorized according to the lines of banking in which they participate. Some of the largest banks choose to operate in every form of banking, while other smaller banks tend to specialize in one or two areas. The largest banks, such as Wells Fargo and Company and Bank of America Corporation, are known as "Money Center Banks" and provide customers with every level of banking service. The most common types of banking are: Investment Banking, Retail, Private, Business, and Corporate/Commercial.

Investment Banking

Investment Banking is also referred to as corporate finance. It is a very lucrative business. For example, it made up 26% of the revenue of JPM in 2009. Investment banking includes raising money for corporations and governments through capital financing, assisting with mergers and acquisitions or divestures, underwriting IPO's, secondary offerings, and bond offerings, and assisting companies with the managing of their balance sheets to avoid risks such as exposure to foreign exchange rates. Investment banking is a fee-based business and does not include customer deposits.

Retail Banking

Retail Banking is broken up into consumer lending and small business lending. It provides individuals and small businesses with checking and savings accounts. These accounts provide individuals and small businesses lines of credit and other short term financing. Some retail banks also work in investments. Also, they provide home, business, auto, and student loans. Many larger banks run most of their retail banking operations out of smaller local branches. The retail bank makes its money from both fees and interest income.

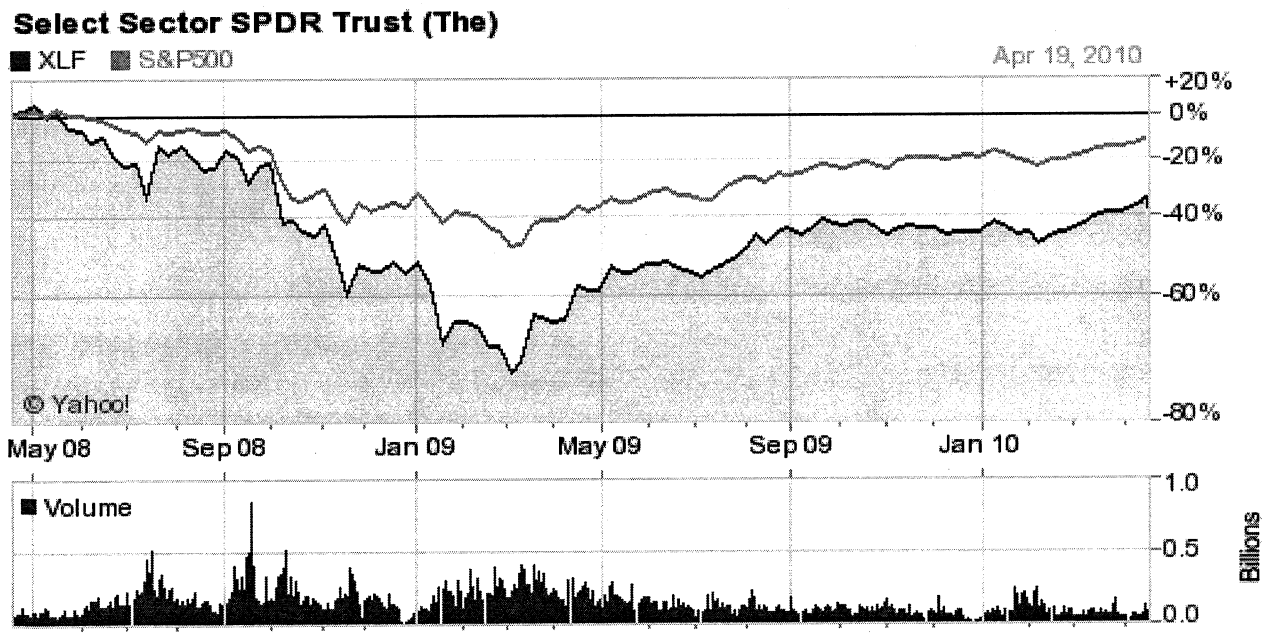
Private Banking

Private Banking is often referred to Wealth/Asset Management. Its services are geared toward high net worth and ultra high net worth individuals or corporations. The Private Bank works in two main areas. First, investment management, where they help to manage cash, offer equity, fixed income and alternative investment strategies. Investment management also administers 401(k) plans for companies. The second part of private banking is wealth management, which provides investing, portfolio structuring, capital advisory, philanthropy, banking, and estate planning services to wealthy individuals and families.

Business and Commercial/Corporate Banking

Business banking provides loans to medium sized companies, whereas commercial banking gears its services toward large corporations, governments, and large non-profit corporations.

III. Recent Performance and Trends



Banking and the Recession

The recent economic recession of 2008 devastated the world economy, and the financial sector was no different. The main cause of the recession was the implosion of mortgaged backed securities, which was caused by poor underwriting quality on the loans. Initially, mortgaged backed securities were considered a safe investment due to the rising real estate prices. During the economic boom of the late 1990's and early 2000's, every loan appeared to be profitable no matter how risky the company. Wall Street was paying a higher P/E multiple for faster growing banks, which enticed many banks to make sub-prime loans with high returns. Banks underwriting standards on mortgages became even more lax than their other loans. This was in large part due to the securitization of the loans. Banks would create a bundle of mortgage-backed securities for with sub-prime mortgages, and would immediately sell them on the market. In addition, banks were encouraged by the government through the Community Reinvestment Act to issue mortgages to lower income families, which consequently gave rise to sub-prime, adjustable rate mortgages.

When the housing bubble burst, homeowners were unable to refinance their homes and began to default at an alarming rate. Also, many of these mortgage backed securities, largely owned by financial institutions, dramatically declined in the value due to the decrease in value of the underlying assets. This caused incredible shortages in capital for many banks causing a credit crunch. They also had costs associated with the disposal and maintenance of the collateral on their bad loans such as foreclosed real estate. The banks that survived the initial crisis became more focused on raising capital and sorting through poor performing or defaulted loans rather than making more loans, which had been its number one goal in the preceding decade.

As the chart above shows, the banking industry dramatically underperformed the S&P 500 during the recession. However, the banks that managed to stay afloat have seen fantastic returns recently. These returns can be largely attributed to how depressed the prices became during the recession as investors overreacted to financial news.

Bank Failures and TARP

According to the FDIC, 25 banks failed in 2008, 140 in 2009, and 57 in 2010, including Wachovia and Washington Mutual, the sixth and seventh largest banks, respectively. This all happened despite the largest government bailout in our nation's history. Through the Troubled Asset Relief Program (TARP), the government purchased $700 billion senior preferred shares in qualifying banks and other struggling institutions; banks could qualify for a maximum of 3% or their risk-weighted assets. The purpose of the program was to give firms enough capital to stabilize their troubled financial status. Banks such as Citigroup and AIG were devastated by the recession, in large part due to derivative trading on sub-prime mortgages. The government deemed these companies as "Too Big to Fail" because their failure would have severe consequences and a negative impact on the economy. Despite the initial $700 billion dollars approved by T.A.R.P., the program only ended up disbursing $565 of the $700 Billion, but losses from the program are expected to be $117 Billion.

Brief TARP Summary

Name	**Type**	**Amount Disbursed**	**Amount Returned**
BAC	Bank	$45 B	$45 B
C	Bank	$45 B	$20 B
JPM	Bank	$25 B	$25 B
WFC	Bank	$25 B	$25 B
RF	Bank	$3.5 B	0

Mergers and Acquisitions

Much of the TARP money received by larger, "healthier" banks was used to buy smaller or failing banks. J.P. Morgan Chase made two notable acquisitions throughout the recession. They acquired Bear Stearns for $236.2 Million and Washington Mutual for $1.9 Billion. Bear Stearns was bought for only $2 per share, a 93.3% discount to its market cap. Bank of America

bought Merrill Lynch for $50 Billion. Wells Fargo acquired the struggling Wachovia for $15.1 Billion, and Barclays acquired Lehman Brothers for only $1.75 Billion. Several other mergers and acquisitions have occurred over the last few years, and there are sure to be several more. M&A intensifies during recessions because it is an easy way for stronger banks to increase their market share for a cheap price.

Re-Regulation and Taxes

Currently, the Obama administration is promoting a re-regulation of banks that will dramatically influence the future investment activities of several banks. The proposed regulation will place new limits on the size and activities of our nation's banks. The purpose of these new regulations is to avoid the "Too Big to Fail" scenario in the future. Because of the deregulation of the 1980s and 1990s, banks have been able to take partake in very risky activities such as hedge funds, mortgage backed securities, and CDO's. While these activities proved very profitable during the economic boom, they also led to the demise of many banks once the economy turned.

In Obama's view, "You can choose to engage in Proprietary Trading (i.e. hedge funds), or you can own a bank, but you can't do both". This new legislation will encourage banks to focus on the traditional less risky activities of banking and forgo the riskier activities that helped ignite the recession. Many people view this reregulation as a movement back to the Glass-Steagall Act. The first part of this regulation calls for the expansion of a 1994 law that will forbid a bank from acquiring another bank if the deal would give it more than 10% of the nation's insured deposits. Obama has also proposed a "Financial Crisis Responsibility Fee", which will tax the liabilities of financial institutions with assets of more than $50 Billion at a rate of 15% per year. This new tax hopes to raise $117 Billion over 12 years to recover the loss from TARP. A regulation that has already taken effect is the increase in FDIC insured deposits from $100,000 to $250,000 per depositor per bank. This is great for the consumer, but banks are having to pay higher premiums to the FDIC for this added insurance. The last proposed tax on banks that received TARP is a 50% tax on bonuses exceeding $50,000. Legislation that has already been passed dramatically effects credit card regulations, which restrict the issuers' ability to change rates and prohibits other practices that are not considered consumer friendly. JPM expects these new regulations to decrease after tax income by $500-$750 Million. Additionally,

changes have been made to charges on overdraft accounts, which can decrease revenues for mid-sized regional banks such as Regions Financial Corporation by as much as $50 million. Until the legislation is known and the consequences of its implementation can be assessed, large Money Center Banks face an uncertain long-term future, which investors should heed.

Interest Rates

In 2007 the yield curve became inverted, meaning that the short-term interest rates were higher than the long term rates. The inverted yield curve usually means that a recession is on the horizon, and it also has an extremely negative effect on banks. Banks deposits (liabilities) are usually much shorter term than its loans (assets). The longest that a bank might hope to keep a deposit is in a 5 year Certificate of Deposit, whereas many of its loans are for 5+ years. When the yield curve becomes inverted as it did in 2007, banks are paying out more interest to depositors than they are receiving as interest income from loans.

Price/Earnings Ratio Analysis

The Banking industry has consistently traded at a higher P/E ratio than the S&P 500. The average P/E ratio of the S&P 500 is 16.36 and 18.36 for the Banking Industry. At the beginning of 2008, the banking industry was trading at a P/E around 40. This is the highest that it has ever been in recent history, and goes back to the fact that Wall Street paid a premium for growth. A P/E level that high is not sustainable, and once the economy collapsed, the industry P/E ratio plummeted to below 6.33. P/E ratios were hard to calculate in the midst of the recession because many banks had negative or zero earnings. Even now, the P/E level is very high, but as earnings begin to normalize, so will the P/E ratios.

IV. Future outlook of the industry

Most economists agree that the worst of the recession is over. Banks have seen fantastic returns in the last 3 months- up 16.44%. We expect the industry to continue to recover as the economy improves. By now, most banks have worked through a majority of their bad loans, and with the discount rate at historic lows, banks have a cheap source of funds that they are able to loan out. Because the discount rate remains so low and the credit costs are decreasing for most banks, interest rate spreads are increasing. As the economy continues to rebound, the fee-based services

such as investment banking will be in higher demand, giving banks a steady source of income. The banking industry has a very positive outlook for the next 1, 3, and 5 years. This is primarily due to the amount by which prices were depressed during the recession. There are, however, two major concerns for the outlook of the industry; first, there is a lot of uncertainty about potential future regulations and taxes on the industry, and, second, what will happen when the Federal Reserve stops keeping interest rates artificially low. If any regulations or taxes are placed upon the already depressed banking industry, it could have some very adverse consequences, especially on the large money centered banks. For the second concern, the discount rate is currently at .75%, which is very close to its historic low. If the Fed increases this rate before the banking industry has fully recovered, loan margins will greatly decrease, causing banks to become less profitable.

V. Introduction to Investment calculations:

Five money center banks were selected to evaluate their current price and determine the intrinsic value of each stock. These banks include:

1. Bank Of America Corporation (BAC)
2. Citigroup, Inc. (C)
3. JPMorgan Chase & Co. (JPM)
4. Regions Financial Corp. (RF)
5. Wells Fargo & Co. (WFC)

To evaluate each stock, a combination of Value Line forecasts, the capital asset pricing model, and the dividend discount model were used to determine the growth opportunities of each stock, its price three years from now, its required rate of return, and its intrinsic value.

VI. Growth Opportunities:

To determine the future growth of each stock, the following equation was used:

$$(ROE_{forecast})X(B)= G_{future}$$

*Where B is equal to the plowback ratio (or 1 minus the dividend payout ratio) and the forecasted ROE is from the Value Line Investment Survey.

The following chart demonstrates these calculations for various money center banks:

Description	ROE % (Forecast)	dividend payout ratio	plowback ratio	**Growth Rate**
Money Center Banks	4.8%			
Bank of America Corporation	9.0%	18%	82%	**7.38%**
Citigroup, Inc.	15.0%	24%	76%	**11.40%**
JPMorgan Chase & Co.	9.0%	25%	75%	**6.75%**
Regions	8.0%	34%	66%	**5.28%**
Wells Fargo & Company	10.5%	42%	58%	**6.09%**

VII. Required Rate of Return:

To determine the required rate of return, the capital asset pricing model was used. According to this model,

$$K=R_f+\beta(R_m-R_f)$$

Where K is the required rate of return for a particular stock, R_f is the risk-free rate, β is the value determined by Value Line to represent the firm's relation of its returns to the financial market, and R_m-R_f is equal to the Risk Premium, or the expected rate of return above the risk-free rate that an investor requires.

In all of our calculations, the risk-free rate was determined using the yield for a 30-year treasury bond on February 19, 2010, or 4.71%, which is the date that the Value Line was published, and the Risk Premium was assumed to be 5%, which is the historical average for the past 70-80 years.

Using these variables, the risk free rate for the same money center banks was determined:

Bank	**Risk Free Rate**	**Risk Premium**	**Beta**	**Required Rate of Return**
Bank of America Corporation	4.71%	5%	1.85	**13.96%**

Citigroup, Inc.	4.71%	5%	2.1	**15.21%**
JPMorgan Chase & Co.	4.71%	5%	1.25	**10.96%**
Regions	4.71%	5%	1.15	**10.46%**
Wells Fargo & Company	4.71%	5%	1.35	**11.46%**

VIII. Stock Price for Year 2013:

To calculate the stock price for the year 2013, the projected Earnings Per Share and Price-to-Earnings ratio determined by value line for each stock were used according to the equation:

$$(P/E_{2013}) \text{ X } (EPS_{2013}) = Price_{2013}$$

Applying this equation to each stock gave the following results:

Bank	Projected Price-to-Earnings	Projected Earnings per Share	Projected Price
Bank of America Corporation	11	2.85	**$ 31.35**
Citigroup, Inc.	12	0.75	**$ 9.00**
JPMorgan Chase & Co.	13	5.1	**$ 66.30**
Regions	13	1	**$ 13.00**
Wells Fargo & Company	14	3.2	**$ 44.80**

IX. Dividend Calculations:

To calculate the expected future cash flows for the next four years, Value Line's projections for the dividends declared per share were used for the year 2010 and 2013. Afterwards, a straight-line graph was used to determine the dividend for each intermediate year, such that,

$$D_1=D_0 + (D_4-D_0)/4 \text{ X } (X)$$

Where D_1 is equal to the next dividend, D_0 is equal to the dividend for 2010, D_3 is equal to the dividend for 2013, and X is the number of years since D_0.

Using this formula, the dividends of each stock were calculated for the next four years:

Bank	D_0	D_1	D_2	D_3	D_4
Bank of America Corporation	$ 0.04	$ 0.13	$ 0.22	$ 0.31	$ 0.40
Citigroup, Inc.	$ -	$ 0.05	$ 0.09	$ 0.14	$ 0.18
JPMorgan Chase & Co.	$ 0.25	$ 0.49	$ 0.73	$ 0.96	$ 1.20
Regions	$ 0.04	$ 0.08	$ 0.12	$ 0.16	$ 0.20
Wells Fargo & Company	$ 0.20	$ 0.49	$ 0.77	$ 1.06	$ 1.34

X. Dividend Discount Model:

After having calculated the future dividends and the future price of each stock, the intrinsic value of each stock could be calculated by discounting it by the required rate of return.

$$V_0 = D_1 / (1+K) + D_2 / (1+K)^2 + D_3 / (1+K)^3 + (D_3 + P_{2013}) / (1+K)^4$$

Where V_0 is the value of all future cash flows discounted by the required rate of return, K

Using this equation, the intrinsic value for each stock was calculated and compared to its current stock price.

Banks	Intrinsic Value of Stocks	Current Price of Stocks
Bank of America Corporation	$ 21.68	$ 18.28
Citigroup, Inc.	$ 6.08	$ 4.93
JPMorgan Chase & Co.	$ 50.26	$ 45.35
Regions	$ 9.94	$ 8.79
Wells Fargo & Company	$ 34.17	$ 33.01

XI. Interpretation of Results:

By combining Value Line's projected Price to Earnings ratio, Earnings per Share, and Dividend payout rate with the dividend discount model and the capital asset pricing model, we have successfully derived an intrinsic value of all future cash flows.

For each bank that we evaluated, we have determined that the intrinsic value of future cash flows for each stock is greater than the current market price, and therefore is undervalued. If our calculations are correct, then each stock can be bought with the expectation of turning a profit in the next three to five years.

However, each firm holds a certain amount of risk that must be assessed before a decision is made about which stocks to invest in.

Bank of America Corporation:

Bank of America was given a rating of B by Value Line, and a rating of 1.74 (Buy-Strong Buy) by analysts of the Wall Street Journal. Bank of America is expected to have a difficult 2010 due to low loan demand, which affects the bank's assets, so investors should not expect immediate results. However, the balance sheet's assets are interest sensitive and their value should increase as the interest rate rises. According to analyst reports and our intrinsic value, Bank of America Corporation should be bought with the expectation of holding for approximately five years.

Citigroup, Inc.:

Citigroup was given a rating of C+ by Value Line and a rating of 2.76 (Buy-Hold) by analysts of the Wall Street Journal. The 1-year forecast for Citigroup is not particularly optimistic, and the long-term prospects are equally as cloudy as Citigroup tries to restructure its organization. Citigroup repaid $20 billion of the $45 Billion dollars in taxpayer funds this past year, which should allow many government restrictions to be lifted in the near future. However, the company issued a sizable amount of common equity to repay its government loans, which has diluted shareholder wealth. Citigroup is currently trying to reduce its "bad" asset holdings, which will consequently cause Citi to face steep asset write-offs for the next few years, potentially affecting earnings. Given this risk, however, Citigroup does have a higher required return than many other banks and our estimates give it a considerable growth rate in the near

future. Citigroup may be considered by very "venturesome" investors who are willing to assume the risk for the potential reward. In all, Citigroup has the potential to rise the most, but at a very steep price in regards to risk.

JPMorgan Chase & Co.:

JP Morgan was given a rating of A by Value Line and a rating of 1.83 (Buy-Strong Buy) by analysts of the Wall Street Journal. This past year, many of JP Morgan's investment banking activities exhibited higher than normal returns, but these returns are expected to moderate this year. JP Morgan's biggest risk is its consumer banking and card services, which were unprofitable for the 5th consecutive quarter, which is contributing to high credit costs for the company. The company should exhibit stable growth over the next five years, as indicated by both Value Line and our own calculations. Furthermore, JP Morgan has a favorable intrinsic value for the next three years and should be considered one of the safest money center banks for investors. However, like all money center banks, potential litigation could have a serious effect on the investment practices of the firm, and consequently we do not recommend holding an investment for the long run.

Regions Financial Corporation:

Regions Financial was given a rating of C++ by Value Line and a rating of 3.05 (Hold) by analysts of the Wall Street Journal. The company is primarily located in the southeast, but recent decline in real estate activity in the area as well as a weak loan demand have hurt the company's assets. The company is expected to remain unprofitable for the coming year due to high loan losses reserve and exposure to commercial real estate mortgages. In addition, the company faces a potential loss of $40-50 million due to new litigation limiting insufficient funds charges. Furthermore, the company is not expected to repay the preferred stock sold to the government under TARP, which will affect common equity as the preferred stock is deferred. However, the stock does possess better-than-average recovery potential for the next five years and should be considered by risk investors.

Wells Fargo & Co.:

Wells Fargo was given a rating of A by Value Line and a rating of 2.55 (Hold-Buy) by analysts of the Wall Street Journal. Wells Fargo reported solid results this past year, and Value line expects them to report record-breaking profits in the coming year, partly due to their acquisition of Wachovia and improvement in the economy as a whole. Furthermore, the company should report even more profits in the subsequent year as loan growth accelerates and interest margins widen. Most analysts believe that Wells Fargo possesses the size, reach, and management for long-term consistent growth. Ironically, our calculations show relatively little growth potential in the next three to five years and a fairly efficiently current market price. However, the long-term prospects of Wells Fargo are far more optimistic than its other big bank peers.

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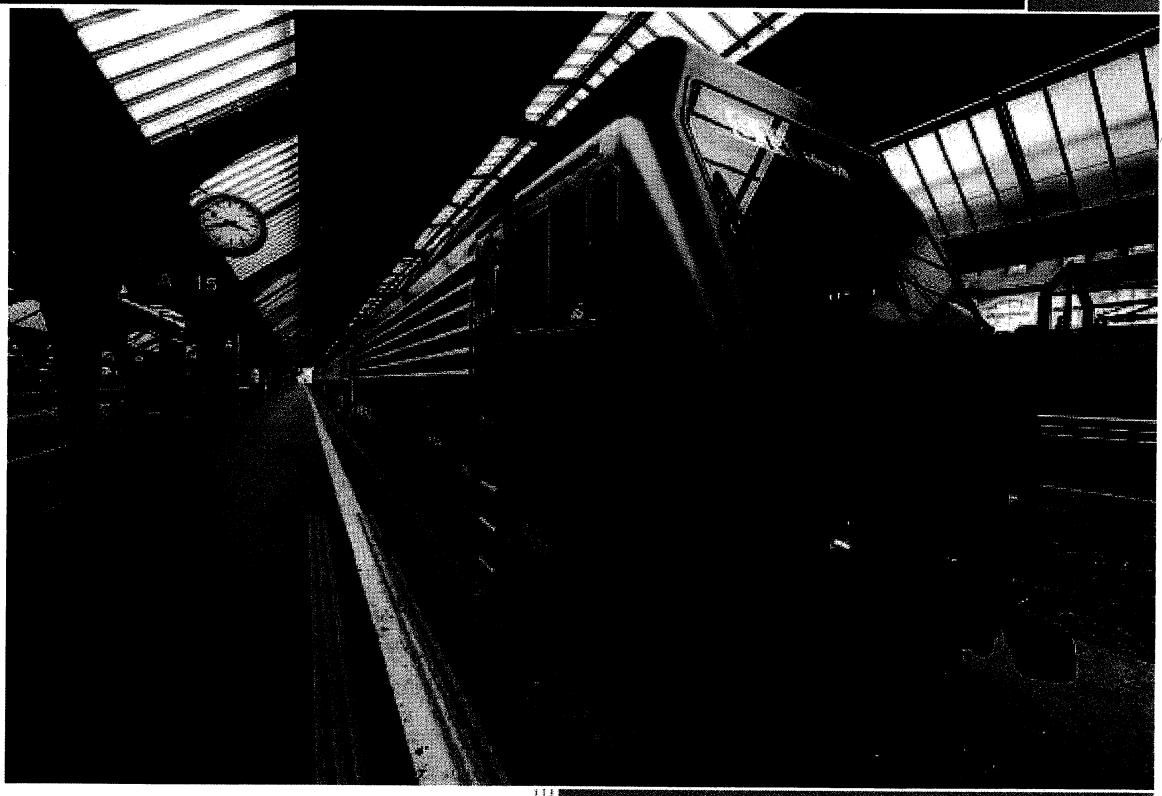
Railroad Investment Project



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R: 10

great analysis!
very minor
grammatical errors!

Russ Lloyd, Matt Williams
The University of Alabama
FI 514, Spring 2010

Industry History

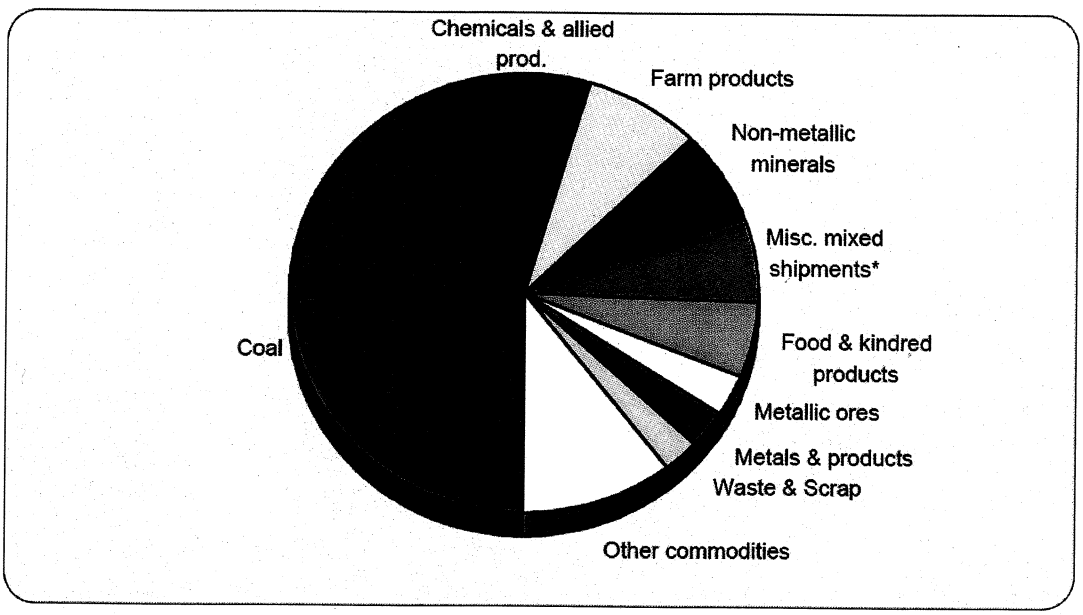
The railroad industry has been around since the advent of the steam locomotive in England in 1797. Once the locomotive industry found its way to America in the 1830's, it grew at a rate up to and even higher than the growth of the US's GDP and population expansion. The joining of the Union Pacific and Central Pacific railroads in Utah in 1869 signified not only how far the railroad industry had come, but also a unification of the east coast with the west coast. For decades the US railroad system continued to be the fastest, most reliable mode of transportation for both goods and people. However, with other modes of transportation gaining popularity in the 1940's coupled with the drastic improvements in other forms of infrastructure in the country, the railroad industry began to slide. Cars soon became the favored mode of transportation for pedestrians, and trucking soon began to dominate the freight shipping industry. The industry continued to struggle into the late 1970's and saw many railroad companies file for bankruptcy. However, the Staggers Act of 1980 allowed for deregulation of the railroad industry and allowed railroads to join into contracts with shippers to agree to mutually advantageous prices and services. Although multiple railroad companies continued to go under in the 1980's, the industry as a whole began to grow again. Today the railroad is experiencing growth not seen since post World War II. The industry currently ships approximately 1.9 billion tons of coal per year with an average annual revenue of $60 billion.

Railroad Classifications

The North American railroad industry can be classified into several different categories. The first category group is passenger vs. freight transportation railroads. Although passenger railroads were once by far the fastest and most popular way to travel long distances, this

industry has shrunk substantially over the past half century. Freight transportation, has gained significant popularity in recent years due to the perception of it as the more efficient mode of transportation for many commodity products. Because traffic often slows down the delivery of any good travelling by truck, many commodity (especially food) buyers and sellers prefer rail to truck as trains are less likely to be delayed. Many forecasters believe that the freight mode of transportation will gain increasing popularity as roads become more congested with traffic and are unable to increase capacity. Freight rail is also popular for transportation of commodities such as coal, which currently represents about 40% of all tonnage shipped in the US. The chart below shows the relative fractions each commodity represents in the industry. All analysis in this paper will deal with railroads operating primarily in the freight transportation industry.

2008 Class I Railroad Tons Originated



great ✓

Railroads can also be classified according to their relative size (in terms of operating revenue). Class I railroads are all railroads with operating revenues above $401.4 million. All railroad companies and trends analyzed in this paper are Class I railroads. Each of these

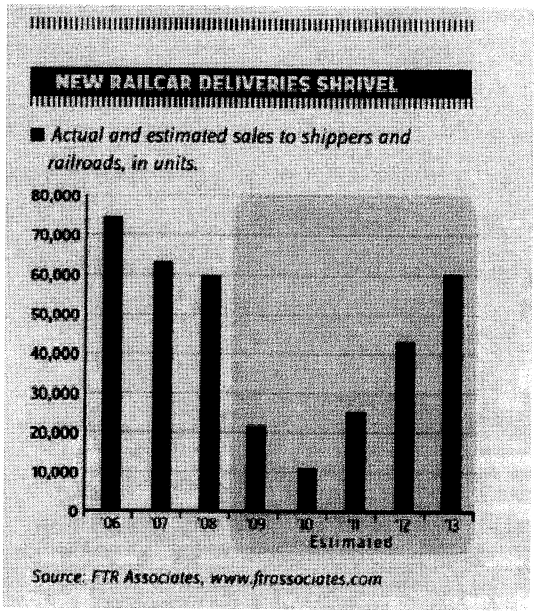
companies is very large, and most have resulted through the mergers and acquisition of smaller railroads over the past few decades. Only the 7 of the nation's near 50 railroad companies classify as class I railroads. Class II railroads, or regional railroads, earn more than $20.5 million in revenues, but less than Class I railroads. Class III railroads have operating revenues of less than $20 million, and are typically short line railroads. This means they service only a few towns or industries.

Industry and Competition Trends

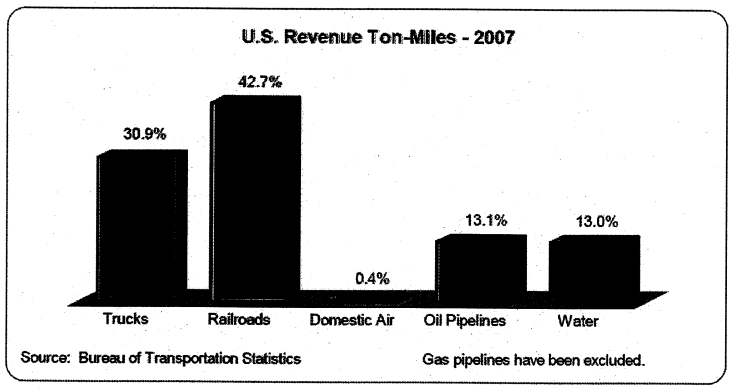
Although in its infancy the railroad industry was highly fragmented, years upon years of mergers of railroad companies, and the lack of new competitors emerging (due to high startup costs), the industry is highly concentrated. The top 50 railroad companies produce nearly all of the revenue for the industry. The top 7 companies (those that fall in the Class I) earn nearly 90% of that revenue and about 66% of overall track mileage. Demand in the industry is highly dependent on the price and demand for the commodity being transported. Thus, when prices for commodities such as coal (which compromises approximately 40% of all tons shipped in the US) go down, shipping that coal via rail becomes more expensive. The most successful railroad companies survive by effectively controlling operating efficiency and by controlling maintenance expenses. These companies also must have access to both the supply of the commodity, as well as access to where the demand is. Thus ability to acquire rail either through new construction or through contract with an existing rail company is vitally important.

Although the recent economic crisis has certainly hurt the railroad industry, analysts predict that the industry will emerge and resume its recent growth. One indicator of the slowdown in the railroad industry is the decrease in purchase of new equipment. Because the

construction industry was a very large market for railroad companies, the crisis has led to many freight cars to sit unused. However, the FTR estimates that new railcar delivery will double next year, and again in 2012, as seen the graph below.



When compared to other modes of freight transportation, railroads are not only the most dominant (as shown in the graph below), but many believe will continue to be the most efficient mode of transporting large amounts of commodity goods, and thus will continue to outperform other segments of the market. Because railroads are nearly three times more fuel efficient than a fleet of trucks, trains not only cost less to operate, but are perceived to have less of an impact on the environment. This has led to a steady revenue increase across the industry of approximately 2.5% per year.



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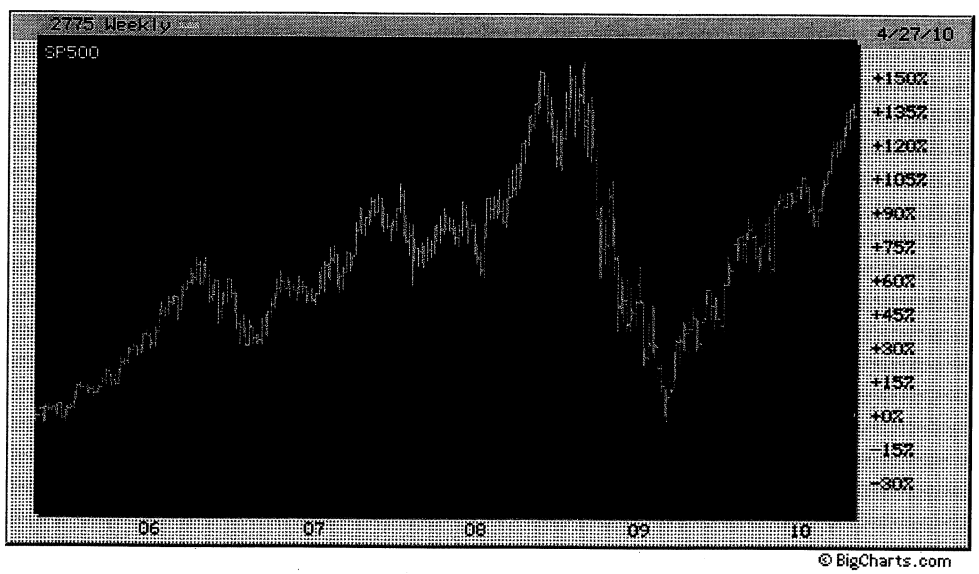
As shown in the graph below, the railroad industry has consistently outperformed the market average over the past 5 years. Although there was a steep decline between 2008 and 2009, this has been countered by a very steep increase in industry value over the past year. Analysts predict that this upward trend will continue as fuel prices increase, and government regulations push for more environmentally friendly forms of travel and freight transportation. Expected growth of the S&P 500 over the next five years is estimated to be at 10.6%, while estimated growth for the railroad industry is almost 14.9%.



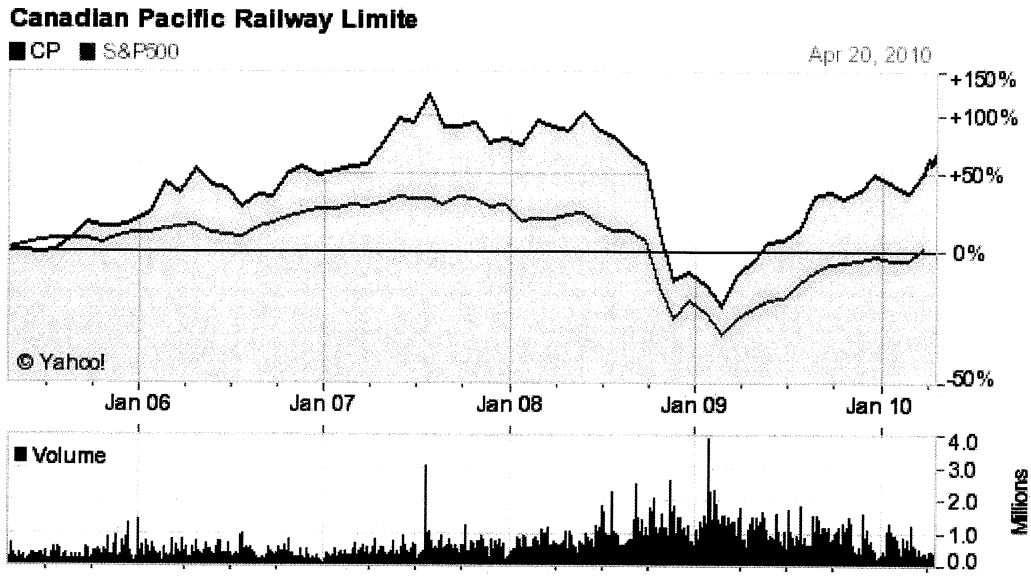
Technology Upgrades

Despite the relative age of the railroad industry, technology upgrades continue to shape the landscape of the industry. Extreme road congestion in many European countries have led government owned railroads to invest billions of dollars in creating new state of the art railroads. Some of these railroads, such as the $15 billion dollar tunnel boring thorough the Alps are designed for freight travel. Other countries (especially in Asia) are investing in technologies for bullet trains for pedestrian travel, which can reach an estimated top speed of 275 mph. Privately and state owned railroads in the US are also investing in new technologies for railroads. The recently passed stimulus bill allocated an approximate $14.9 billion to help upgrade some of the declining railroad infrastructure. Some analysts speculate that his money, although substantial, is not sufficient to provide for the upgrades the infrastructure needs. California, for example, has plans to build a "bullet train" type railroad between Los Angeles and San Francisco which some estimate could cost up to $40 billion.

There are also many grants and tax incentives for investing in clean fuel powered railroads. Some European countries are investing in clean diesel powered railroads, while some domestic companies, such as Norfolk Southern, are investing in completely electronic powered railroads. These clean powered investments benefit railroad companies for several reasons. First, the opportunity for grant money from the government makes this research more feasible. Second, trains that are more fuel efficient will cost less to transport the same amount of goods, thus increasing profits. Finally, with the possibility of a Cap-and-Trade bill in the works, many companies might see a tax credit for reducing their emissions.

Canadian Pacific Railway

Canadian Pacific operates about 13,200 miles of track across most of Canada and in the Midwestern and Northeastern United States. CP is the second-smallest Class I railroad by revenue and route miles. CP hauls shipments of intermodal containers, grain, coal, fertilizer, and other merchandise.



CP has outperformed the market over the past five years and is highly correlated with the market. CP hauls mostly noncyclical items, which allow it to keep constant demand year around. CP also mimics the market because it hauls a variety of different products, which broadens CP's risk over different industries.

Annual Earnings Estimates

	12-10		12-11	
	$	Growth %	$	Growth %
High	3.73	1.6	4.53	36.4
Low	3.04	-17.2	3.73	12.3
Mean	3.32	-9.5	4.01	20.8

Forward Comparisons

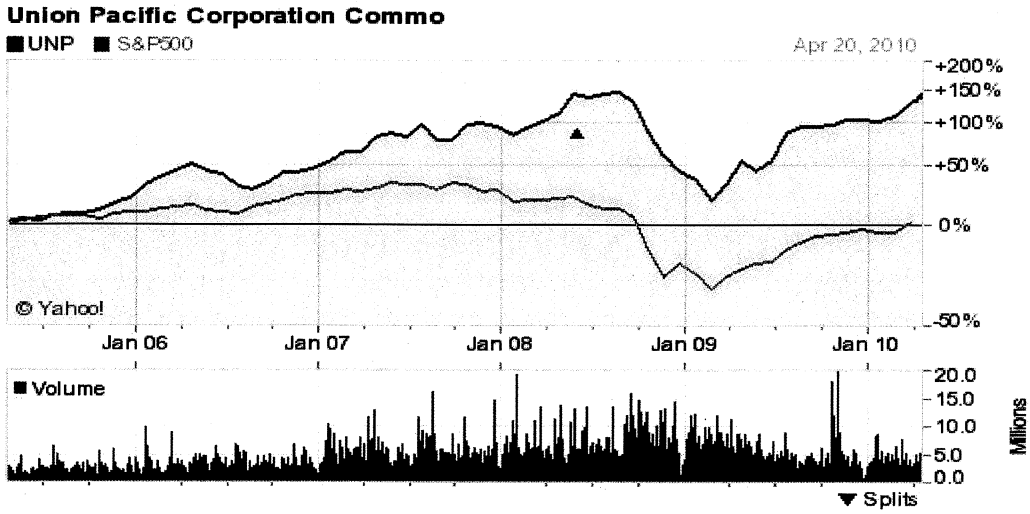
	Next 5 Years' Estimated Growth%	Forward P/E

Stock	10.3	14.7
Industry	14.9	---
S&P 500	10.6	14.4

We rate CP as a sell, because its 5 year growth estimates according to Morningstar underperform the market and are lower than the industry. And even though its mean estimated growth in 2011 is optimistic, the 2010 estimates look bleak. In the short run CP will not be a good investment and in the long run it looks to be a gamble. The regulation on the railroad industry from both Canada and the U.S. will hurt CP, and in particular the revenue cap on grain headed westward in Canada. CP is heavily invested in grain transportation and this regulation could cause a loss of profits in the future. Overall, the outlook for other firms in this industry is brighter than for CP because of regulation in Canada, the low growth expectation, and the weather in the north that can be unpredictable and cause issues for transportation. The weather for CP, being mostly in Canada and northern U.S, is a large obstacle because it can cause less efficiency in their rail lines. Another concern for CP is there debt, with debt/ capital at .45. This may limit their expansion in the future and burden them compared to their competitors. Finally the 52 week range is $60- $32.32, and the current price is $59.43, the current stock price approaching so close to a 52 week high is often a sell indicator.

Union Pacific Railroad Co.

Union Pacific is one of the largest railroads in North America. UP has 32,000 miles of track in the western part of the U.S.UP recorded sales of $18 billion in 2008 by hauling coal, industrial products, intermodal containers, agriculture goods, chemicals, and automotive goods. UP also receives around $1 billion hauling freight to and from Mexico.



UP has outperformed the market significantly over the past 5 years. UP moves with high correlation with the market because of the material it carries. UP has benefited tremendously from the U.S.'s reliance on coal, and especially in the past five years when coal consumption has increased. This has allowed it to stay above the market and never fall into a negative return.

Annual Earnings Estimates	12-10		12-11	
	$	Growth %	$	Growth %
High	4.65	24.0	5.93	36.0
Low	3.97	5.9	4.60	5.5
Mean	4.36	16.3	5.17	18.6

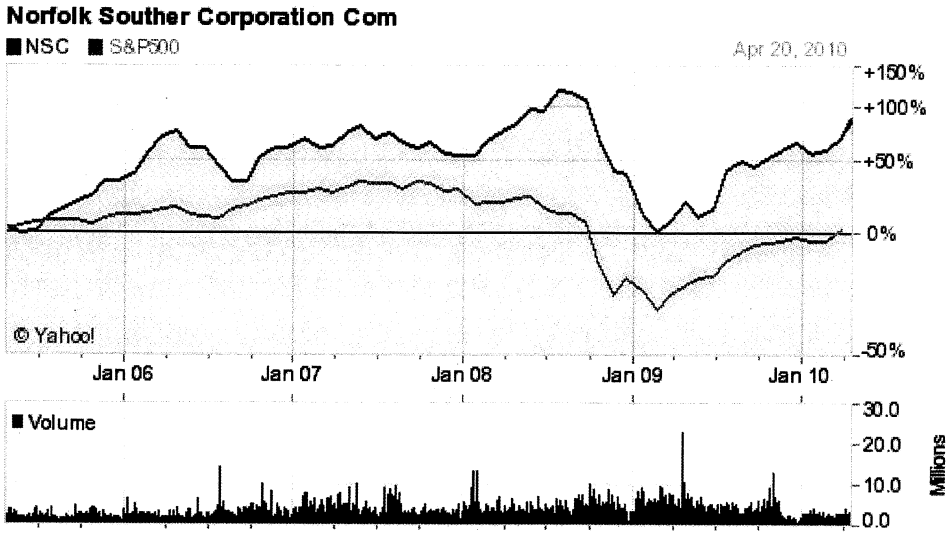
Forward Comparisons	Next 5 Years' Estimated Growth%	Forward P/E
Stock	12.8	14.8
Industry	14.9	---
S&P 500	10.6	14.4

We rate UP as a buy; in the short run UP have coal and a partnership with General Motors on its side. In the long run UP is investing in terminals and infrastructure to help it succeed. Up also is one of the largest rail companies at $14,143 in revenues, which is about

20.44% of the industry. Given its size and the positive outlook of the industry, this is a good investment to consider. The five year growth of UP outperforms the market and its estimated earnings for the next two years according to Morningstar look favorable. The P/E looking forward also is encouraging for the future outlook of this company. The current P/E of 20.58 is a strong indicator that UP is undervalued compared to other companies in the industry. Overall, UP has access to many important points such as Los Angles ports, Power River Basin, and Mexico. These points give UP the ability to grow in the future as well as have access to resources and central hubs that are vital to this country and countries around us.

Norfolk Southern Railway

Norfolk Southern operates on 21,000 miles of track, in 22 states in the eastern, southeast, and Midwestern US and in Ontario, Canada. Norfolk Southern hauls shipments of coal, intermodal traffic, and a mix of automobile, agriculture, metals, chemical, and forest products. NS is looking to expand its operations and improve the existing rail. It is doing this partially by partnering with Kansas City Southern to improve the efficiency between the west and the southeast United Sates.



NS like the other railroad companies is highly correlated to the market and is also outperforming the market over the past 5 years. NS, much like UP, is heavily reliant on coal transportation and this fact has allowed it to somewhat weather the storms of the recent economy downturn. Also, as the southeastern United States has grown, NS has become more profitable since it is a leader in that region.

Annual Earnings Estimates

	12-10		12-11	
	$	Growth %	$	Growth %
High	3.65	32.2	4.58	35.5
Low	3.19	15.6	3.60	6.5
Mean	3.38	22.5	4.07	20.4

Forward Comparisons

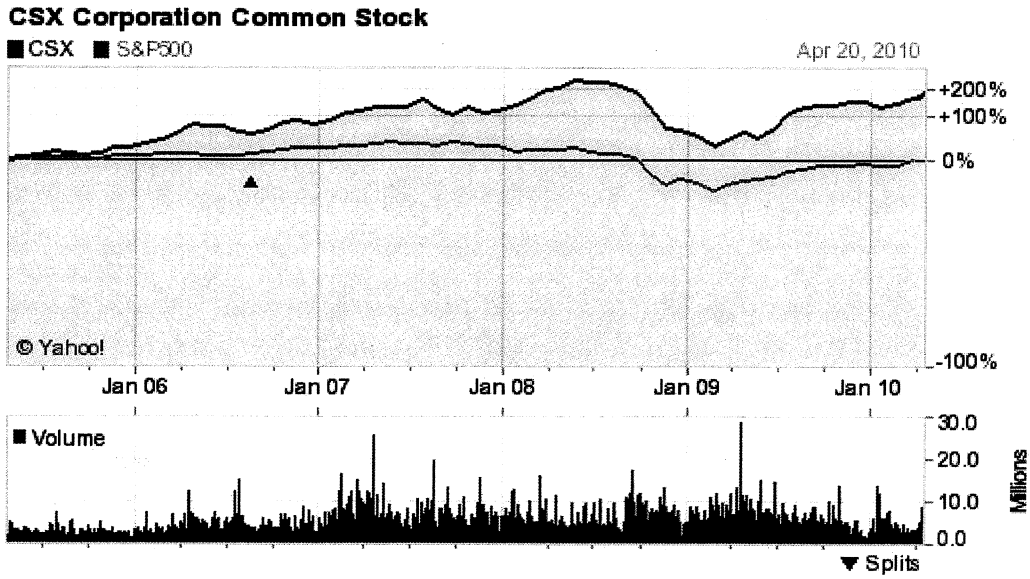
	Next 5 Years' Estimated Growth%	Forward P/E
Stock	10.8	14.8
Industry	14.9	---
S&P 500	10.6	14.4

We rate NS a buy. The long term outlook for NS is favorable and we believe that its presents in the south as well as it expansion prospect all over will lead it to be a leader in the future. In the short run, NS might see a small downturn while it raises capital to expand.

According to Morningstar the five year growth will outperform the market and the next two years earnings estimates look very good. The P/E ratio looking forward also is encouraging. While the current P/E of 22.12, is average for the industry. The return of NS stock over the past 5 years is 15%, while the industry average is 14.6%. NS has outstanding safety practices and has one of the lowest injuries per hours worked. It also pays a high dividend with a long term target payout ratio of 33%. It own over 1 million acres of land rich in coal and has an intermodal franchise called Triple Crown Services that adds a lot of capability. NS future looks very bright and its competitive edge in coal will lead it to be an industry leader in the future.

CSX Transportation Inc.

CSX operates in the eastern United States. On its 21,000 miles of track, CSX hauls shipments of coal, intermodal traffic, chemicals, and a mix of other products. They link 23 states, 70 ports, the District of Columbia, and two Canadian provinces. CSX has about the track as Norfolk but the track location of CSX goes all the way from New England to Florida. This give CSX access to resources that need to transported over a highly populated area.



CSX outperforms the market over the past five years, and has not been as volatile has the other rail companies. Its stability can be attributed to its location in many big eastern cities that are resources rich. CSX is highly correlated with the market because of the goods it transports. CSX has taken advantage of the recent health in the rail industry and invested in technology and safety, while cutting out unprofitable routes.

Annual Earnings Estimates

	12-10		12-11	
	$	Growth %	$	Growth %
High	3.65	27.2	4.62	33.9
Low	3.05	6.3	3.39	-1.7
Mean	3.45	20.2	4.11	19.1

Forward Comparisons

	Next 5 Years' Estimated Growth%	Forward P/E
Stock	10.5	13.4
Industry	14.9	---
S&P 500	10.6	14.4

We rate CSX as a buy. Even though its five year growth is below market we think that its stability and long term growth potential in coal along the east coast will make it a good investment long term. In the next two years, CSX estimated growth looks good, while its P/E is not up to par with its competitors. However the current P/E is 18.96, which shows strong earnings compared to its price, especially compared to other rail companies. CSX stock return over the past 5 years was 24.7%, while the industry average return was 14.6%. Also, CSX has improved its operations by making waiting time less and improving safety on its railways. The eastern U.S., where CSX is primarily, is home to 2/3 of the population of the U.S. as fuel costs go

up and environmental concerns grow, this high population area will look to CSX for its resource transportation.

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Securities Brokerage Industry

Denson Henry
Hal White
FI 514
11/26/01

Industry Analysis

I. Overview

The securities industry is made up of establishments primarily engaged in the purchase, sale, and brokerage of securities. This industry also encompasses investment bankers, which originate, underwrite, and distribute issues of securities. Firms in the industry essentially serve as financial intermediaries, matching investors with entities that need money. They also provide a pricing mechanism for the investment market, and furnish a vehicle for the liquidation of investors' assets. Many of these firms also provide investment consultation. According to WSJ.com, the market value of this industry totals $190.2 billion. Additionally, the P/E ratio is currently 58.28 and because of the recent slowdown of the economy coupled with the events of September 11th, the industry is down 35.08% from last year.

II. Organization and Structure

As alluded to above, securities brokerage firms have three major functions in financial markets: they provide a mechanism that links people who have money with those seeking to raise money, they deliver a means of valuing and pricing investments, and they offer a vehicle that investors can use to liquidate their investments.

Types of Securities – Firms buy and sell an enormous variety of securities for their customers. These securities can generally be categorized as either equity or debt instruments. In addition to trading in traditional corporate stocks and bonds, securities firms were selling increasing amounts of alternative investment vehicles in the 1990s. These vehicles included municipal (state and local) bonds, junk bonds, options, mutual funds, asset and mortgage-backed securities, futures, and real estate investment trusts. The two vehicles that continue to receive increased emphasis in security markets are futures and options, which are both derivatives.

Types of Firms – Securities brokerage firms basically fall into one of the following categories: full-service firm, investment banking firm, regional firm, or discount broker. *Full-service firms* provide a range of services for both retail and institutional customers. These companies usually have many offices nationwide. Examples include Merrill Lynch and Paine Webber. *Investment banking firms*, such as Goldman Sachs and First Boston, primarily provide institutional customers with services related to underwriting new securities issues, and mergers and acquisitions. They may also act as brokers and dealers. *Regional firms* offer full lines of securities products to customers within a particular geographic area. *Discount brokers* allow retail customers to buy and sell securities for less than they would have to pay to a full-service broker. Because discount brokers usually do not offer investment advice, have sales staffs, or act as marketers for financial products, they are able to charge lower commissions.

Primary Marketplaces – Industry participants buy, sell, and issue securities in three primary markets: exchange, over-the-counter (OTC), and money. *Exchange markets* provide organized trading facilities for stocks, bonds, and/or options. These facilities act as auction houses, where securities brokers and dealers essentially bid for securities. Examples include the New York Stock Exchange, American Stock Exchange, and the Chicago Board Options Exchange. *OTC markets*, in contrast to organized exchange facilities, consist of a network of brokers and dealers that represents customers in the purchase or sale of securities. No central location exists for this type of market. Trading departments of securities firms negotiate price with customers or their agents over the telephone. OTC markets usually trade in securities of companies that are small in comparison to those on organized exchanges. The *money market* trades mostly in short-term securities that have maturities of one year or less. These instruments are characterized by high liquidity and typically trade in high denominations. As with OTC markets, money markets do not have central trading places. The market is composed primarily of banks and firms that borrow or invest large amounts of money for a short term.

III. Recent Trends

Until 1975, the securities brokerage sector consisted mainly of investment banks, such as Merrill Lynch and Goldman Sachs, offering a complete brokerage service from research and advice on securities trading, to execution, custody and settlement. Since then there have been several transformations including deregulation, diversification, Internet trading, and mergers and acquisitions.

Deregulation – From the mid-1970s, deregulation in the US triggered the transformation of the industry by enabling new entrants, the discount brokers, to enter the marketplace. Initially the discount brokers, for example Charles Schwab, specialized in only one part of the traditional brokerage's array of capabilities – trade execution – for which they used aggressive marketing and lower commission charges to gain customers. Furthermore, with the repeal in the fall of 1999 of the Glass-Steagall Act, the last barriers between banks, brokerage firms, and insurance companies had been torn down. This allowed companies to take advantage of other financial services through diversification.

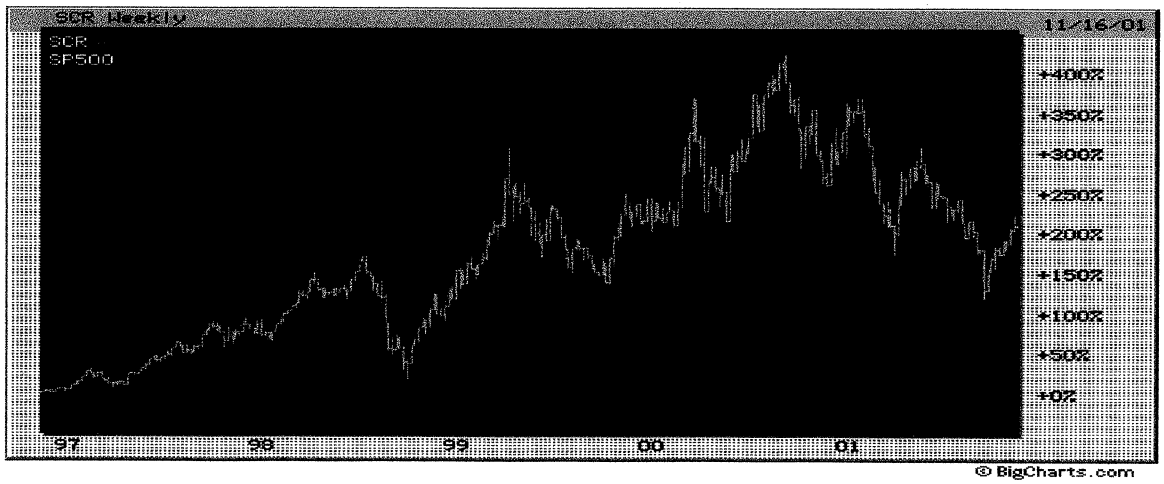
Diversification – Currently the discount brokers are pushed toward diversification by competitive and customer pressures. Trade execution has become "commoditized" and, as the price of trading has hit rock bottom, profits are being squeezed. Many brokers now see their future as a one stop shop for financial services – offering research, advice, loans, deposit accounts, financial planning and IPO offerings. In addition, they want to reduce their back office costs, and expand into new geographic regions, while customers are demanding improvements to service, security, and channels. The success of the discount brokers over the last few years has encouraged the traditional 'full service' players to expand their existing offerings to include cheap execution-only trades via the Internet – an area once the sole preserve of the discounters.

Internet trading – The late 1990s saw the advent of online trading, a trend that revolutionized and changed the industry. One of every six shares traded during 1999 was traded through the Internet, or 500,000 shares per day. As an example of the rapid growth of this phenomenon, in 1994 there were no online brokerage accounts; by 1999, 5 million of these accounts were active. The discount brokers saw a step-change in their business – a simplified trading process, free or cheaper investment information and advice, and lower commissions. Online brokerage firms were typically discount brokerages, with an average commission of $15 per trade, much less than the full-service brokerage fee of $100 to $300 per trade. Although traditional brokerages such as Merrill Lynch appeared not to be concerned with the rising competition arguing that the discount online brokerage model was not sustainable in a business sense, they soon realized its value and followed suit entering the market in the last few years. These factors, combined with demographic changes, triggered a surge in mass-market share trading.

M&A – The development and implementation of the European Monetary Union (EMU) on January 1, 1999, as well as economic recovery in many international markets has had a positive impact on U.S. ownership of foreign securities. The EMU and the Euro – its established currency – have sparked a merger and acquisition explosion throughout Europe. Global investment banks could have ignored Europe 5 or 10 years ago and still be top-ranked in merger and acquisition activity, but today that is not the case. In fact, booming European merger and acquisition activity bodes well for the future profitability of U.S.-based global investment banks, since European industry is well behind the massive corporate consolidation and downsizing wave American industry has witnessed in the last decade.

IV. Recent Industry Performance (vs. S&P 500)

As indicated in the chart below, the securities brokerage industry has grown at a rate considerably above the S&P 500 for the past 5 years. According to Zacks Investment Research, Inc., the industry has grown 22.2% over the last five years compared to 8.4% for the S&P 500. However, the economic downturn of the economy coupled with the events of September 11th has hit the securities brokerage industry harder than the market as a whole. For example, over the last year the S&P 500 declined 20.1% while the securities brokerage industry was down almost twice as much at 35.08%.



V. Industry Projections

As shown in the chart on the previous page, the industry has rebounded in the last couple of months and is projected to continue this upward trend in the future. In fact, Zacks Investment Research, Inc. predicts the industry to grow 29.2% over the next year, which is double the projected growth of the S&P 500 of 14.6%. Looking at the 5-year growth projections, the industry is expected to grow at a rate of 16.6%, considerably above the S&P 500 at 12.3%.

VI. Future Trends

We feel there will be a continued increase in the amount of trading online. Today, 20% of the shares traded are online and we expect this to grow substantially in the future. Part of this expected growth is due to the increase of available financial information on companies. With databases like Bloomberg and a plethora of other online alternatives, investors are finding it increasingly easier to find whatever information they may need to make better investment decisions. As such, there will be an increase in individual investors as well as an increase in the number of trades. Additionally, competitor and consumer pressure has and will continue to squeeze profits resulting in decreased brokerage fees and a push for firms toward diversification. This diversification trend will "snowball" even further as a result of the repeal of the Glass-Steagall Act allowing firms to enter previously forbidden financial arenas. Finally, Europe will continue its explosion of consolidations in the wake of the U.S.'s decade of mergers and acquisitions.

Company Analysis

We chose to analyze the following three securities brokers from our industry report: Goldman Sachs, Merrill Lynch, and E*Trade. We chose the first two because of their dominance and longevity in the industry. We chose the last company, E*Trade, because we wanted to include a newer firm operating primarily online for comparison reasons. After careful analysis, we believe Goldman Sachs and Merrill Lynch are good investments for the long-term while E*Trade is a great short-term investment.

I. Goldman Sachs

The recent purchase of market makers Spear, Leeds & Kellogg and Benjamin Jacobson & Sons has made Goldman Sachs one of the largest specialist firms on the NYSE. It has grown from its humble beginnings in 1885 to a leader in IPOs in Europe and the U.S. Today, it is a public company valued at just over $41 billion.

Company Structure - The firm's major business lines are Global Capital Markets, which includes trading, principal investments and investment banking, and Asset Management and Securities Services, which includes investment management, merchant banking and institutional brokerage. The Global Capital Markets division makes up 20% of the firm's revenues.

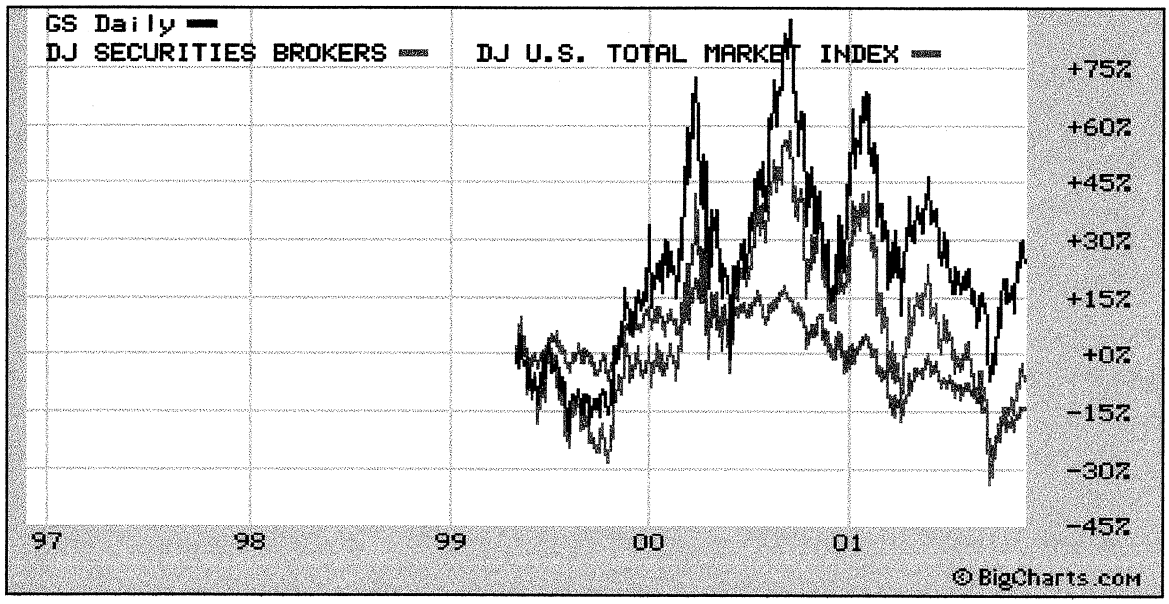
Company Trends - The firm has maintained its focus on its target consumer segments. GS has traditionally targeted institutional clients and high net-worth individuals. The firm has sought to further strengthen its relationship with its core customers by expanding its service offerings.

Recently, Goldman has entered in to a number of alliances in order to grow. In late 2000 the company started an online bond-trading venue with Merrill Lynch and Morgan Stanley Dean Witter. Goldman teamed up with Merrill Lynch again in order to develop Primex Trading. It is an auction block for stocks traded on major exchanges. Most recently, the company joined GE Capital to invest in the debt-laden commercial lender, The FINOVA Group.

Goldman has also opened up a trust bank to better serve its high net-worth individual consumers. The company sees this segment as an attractive growth opportunity. Since 1995 its assets under management has expanded an average of 41% per year. Today, Goldman manages $492 billion in assets.

Performance Over the Last Two and a Half Years - The graph below shows Goldman Sach's performance over the past few years. Since its IPO in early 1999, the company has been able to outperform, for the most part, the securities brokerage industry as well as the market as a whole. Like other companies in its industry, though, it has felt the

impacts of the recent economic turmoil. Goldman is down from it's high in mid-2000, but as of late 2001 it has started to rebound with the industry.



Projected Company Growth – Goldman Sachs is in a solid position to continue as one of the leaders in its industry. Despite it's worse than industry average earnings growth; Goldman is predicted to rebound next fiscal year with a growth rate of 15.5%. The firm's estimated average earnings growth for the next five years is 13.3%. While these numbers do not outperform the projected industry averages, they still are higher than projections for the S&P 500. Analysts expect the industry to grow at 29.2% over the next year and 16.6% over the next five years while the S&P 500 is projected to grow at 14.6% over the next year and 12.3% over the next five years.

Recommendation - We agree with nine of the nineteen analysts from WSJ.com that Goldman Sachs is at least a BUY. We believe this security is a solid investment for the long term. We do not recommend it for a less risk averse investor who is looking for a quick turn around on their investment. The firm is rated as a buy because it is a stable company with an industry leadership position. Goldman continues to expand in its most profitable trading businesses and will provide a good investment for those seeking a reliable slow growth firm.

II. Merrill Lynch

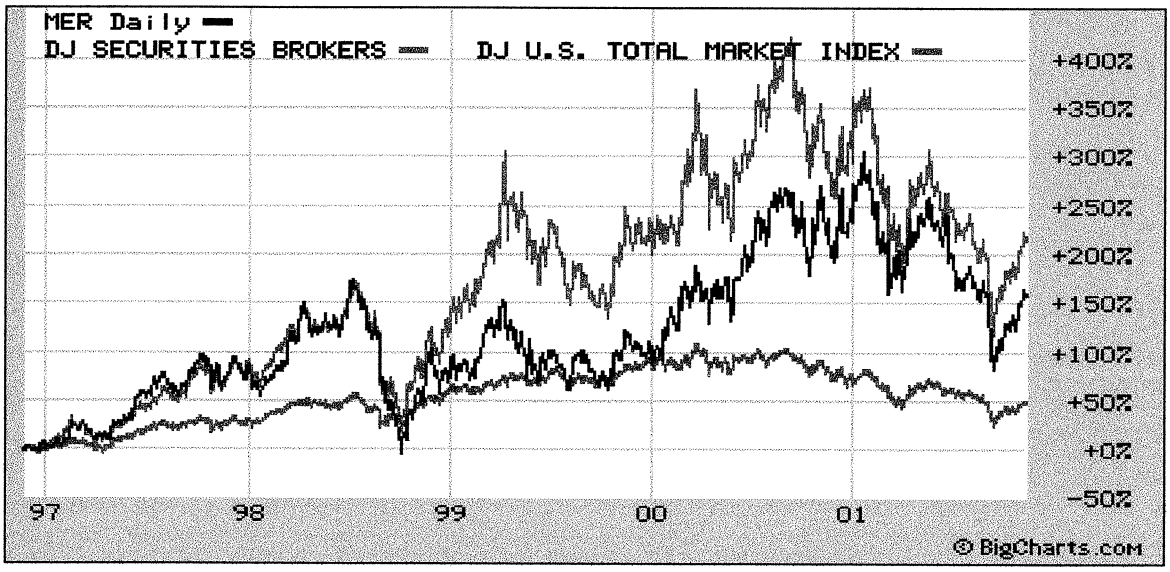
Merrill Lynch is one of the world's leading financial management and advisory companies with offices in 43 countries and total client assets of about $1.5 trillion. As an investment bank, Merrill Lynch is the top global underwriter and market maker of debt and equity securities and a leading strategic advisor to corporations, governments, institutions, and individuals worldwide. Through Merrill Lynch Investment Managers, it is one of the world's largest managers of financial assets. In 2000, Merrill Lynch record earnings of $3.8 billion, a 41 % increase over the $2.7 billion figure of the previous year.

Company Structure – In mid-1995 Merrill Lynch became the largest investment bank in the world in terms of equity sales, trading, and research through its acquisition of England's biggest independent securities firm, Smith New Court PLC. With the $803 million purchase, Merrill Lynch not only increased its presence in England but also gained businesses in several countries where it had none, such as South Africa, Malaysia, and Thailand. The acquisition thus brought further geographic diversification to Merrill Lynch's operations, at the same time that it significantly enhanced the firm's position in the mergers and acquisitions side of investment banking in Europe. Further international deals and branch openings meant that by 1996, 30% of revenues was generated outside the United States. Among the deals were the acquisitions of brokerages in Spain (FG Inversions) and Australia (McIntosh Securities Limited) and the purchases of stakes in brokerages in Italy, India, Thailand, Indonesia, and South Africa. Further expansion in Asia came in 1998 with the purchase of 33 branches and the hiring of 2,100 employees from the failed Japanese firm Yamaichi Securities. Today Merrill Lynch has over 70,000 employees.

Company Trends – Merrill Lynch belatedly took the plunge into online trading in December 1999 with the launch of Merrill Lynch Direct. This website offered brokerless trading at $29.95 for stocks, mutual funds, and bonds; access to initial public offerings being underwritten by Merrill Lynch; more research offerings; and other enhancements.

Early in 2000, Merrill Lynch moved into banking with the rollout of a federally insured, interest-bearing account that was tied to customers' investment accounts. Any cash in such accounts not invested in securities would be swept into the new bank accounts. In December 2000, Merrill Lynch and London-based HSBC Holdings launched a joint venture aiming to offer online banking and investment services to people in Europe and Asia having more than $100,000 to invest and wanting to make their own financial decisions. Also in 2000, Merrill Lynch acquired Herzog Heine Geduld Inc., a leading NASDAQ market maker.

Performance Over the Last Five Years – As shown in the chart below, Merrill Lynch has outperformed the market for the past five years. In contrast, Merrill Lynch has mimicked the movement of the securities brokerage industry but has consistently grown at a lesser rate. This is due to the fact that it is a mature company, which is well established in the industry. According to Zacks Investment Research, Inc., Merrill Lynch has grown at a rate of 21.9% over the last five years. This compares to the industry rate of 22.2%, which is slightly higher.



Projected Company Growth – Due to the financial soundness Merrill Lynch, both as an industry leader and as a financial powerhouse, we feel confident in analysts' projections of 25.4% growth over the next year and 12.9% average growth over the next five years. This keeps with the trend of Merrill Lynch outperforming the market and staying below the industry. Analysts expect the industry to grow at 29.2% over the next year and 16.6% over the next five years while the S&P 500 is projected to grow at 14.6% over the next year and 12.3% over the next five years.

Recommendation –We concur with the majority of analysts from WSJ.com that Merrill Lynch is a BUY. Out of 15 analysts surveyed, 7 felt it was a buy, 4 felt it was a strong buy, and 4 placed it in the hold category. Several factors support our recommendation. To begin, Merrill Lynch had a record-setting year for earnings in 2000 and is expected to continue to grow year after year. Furthermore, the market in Europe, of which Merrill Lynch is a major player, looks very attractive for future revenue streams. The online market has just recently been entered with tremendous growth opportunities. Finally, because of Merrill Lynch's huge asset base, it is situated in a great position as the market turns toward diversification as a result of the push from consumers for brokerages to serve as a "one stop shop" for financial services.

III. E*Trade

E*Trade differs from Goldman Sachs and Merrill Lynch by mainly targeting individual investors. Since its inception in 1982 the company has grown to be a global leader in personal financial services. Currently, E*Trade is valued at nearly $3 billion. It has revenues of close to $300 million and some 2.9 million households use its services. The company offers value-added investing, banking, research and educational tools for novice investors.

Company Structure – The E*Trade Group is centered on four global divisions. The divisions operate in North America, Latin America, Asia-Pacific, and Europe, Africa and the Middle East. Each one is involved in managing the key operations of the company such as retail and institutional brokerage, residential mortgages, banking and asset gathering, as well as insurance.

The firm offers trading services via online services, the Internet, and the phone to more than three million clients. The majority of its transactions are over the Internet. E*Trade also offers market data, cash and portfolio management, and options and fund trading.

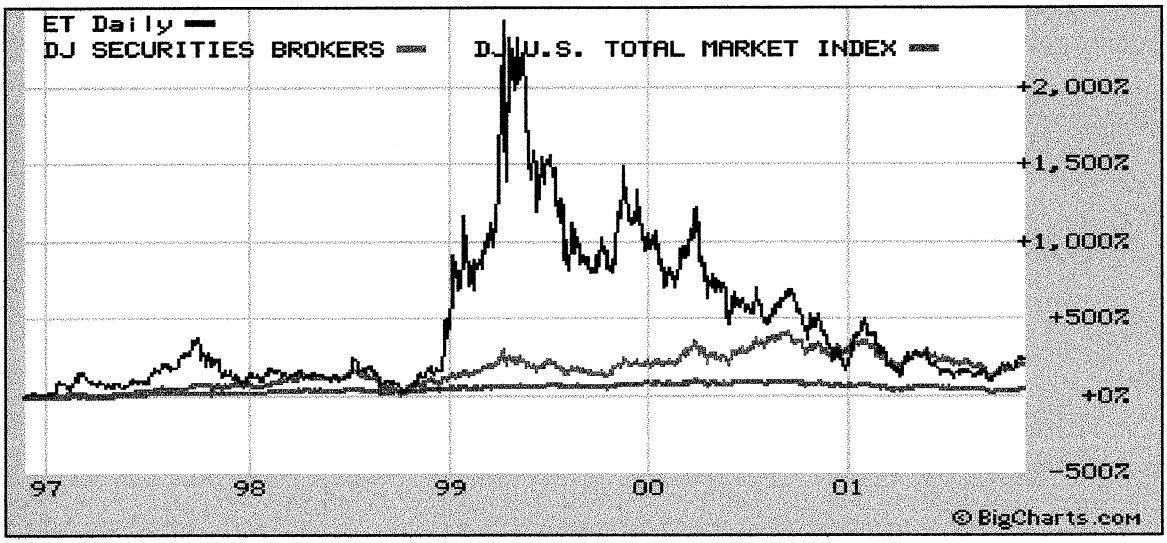
Company Trends - The E*Trade group wants people to use its services for everything financial. Since the recent downturn in the economy has spurred lower online trading volumes, the company is diversifying its service offerings through acquisitions. Since December of 1997 the company has purchased eleven different concerns. E*Trade has entered the stock market-making game with its most recent acquisition of Chicago-based specialist firm, Dempsey & Company.

Last year, retail banking was a major focus for the firm. The company bought Telebanc Financial, an online bank with more than 100,000 depositors and started E*Trade Bank. This branch of the company offers retail-banking products through its E*Trade web site.

In attempts to reach more consumers, the company is veering away from its traditional on line strategy and attempting to have a more physical presence. In order to provide its clients with "real world" access to their money, it bought Card Capture Services. With this acquisition, E*Trade now operates more than 9,000 ATMs across the U.S. The company has also opened up two superstores in Denver and New York and plans on opening several more in major markets.

This year, the E*Trade Group has entered into the consumer lending business with its purchase of the online mortgage originator, LoansDirect. The new company is now E*Trade Mortgage. The company has also announced that it may begin bond underwriting.

Performance Over the Past Five Years - As shown in the chart below, E*Trade closely tracked the performance of the industry until 1999. In the beginning of 1999, the company began to strongly outperform the industry as well as the market in general. This was in part due to some key acquisitions and the approval from the SEC to enter into the asset management business. Since then, E*Trade's performance has gradually moved back in line with that of the industry.



Projected Company Growth – The E*Trade Group has positioned itself to be a leading provider of complete financial solutions for a broad consumer base. While this fiscal year the industry's earnings were down 27.9%, E*Trade was able to grow its earnings by an impressive 75%. Next fiscal year, it is predicted the company will have an astonishing 383% growth in earnings. This figure far exceeds the industry's predicted average of 29.2%. E*Trade's estimated five year growth rate is 17.8%. Once again, analysts expect the industry to grow 16.6% over the next five years while the S&P 500 is projected to grow at 14.6% over the next year and 12.3% over the next five years.

Recommendation – Out of the fourteen analysts that recently rated the stock on WSJ.com, 12 of them rated E*Trade as at least a BUY. We agree with these analysts and believe this security is an investment for the short term. We do not recommend it for a risk averse investor who is looking for a stable, slow-growth security. It is a riskier stock to purchase compared to Merrill Lynch and Goldman Sachs. E*Trade's beta is just over 3 where as the industry average is about 1.5.

The firm is rated as a short-term buy due to its explosive earnings potential next fiscal year as well as the company's concerted effort to diversify the company's risk through offering more services to a broader range of consumers.

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Analysis of the Air Transport Industry

Kazuyoshi Ishida
Dominick Ferrara

Overview of the Air Transport Industry

The Air Transport industry plays an important role in America. People need to use airplanes to travel long distances. Also, goods are delivered by air over long distances, greatly increasing the efficiency of businesses and the economy. Thus, the Air Transport industry is indispensable in this country. The recent terrorist attacks on September 11th inflicted a severe impact on this industry, causing huge losses. Though some companies are attempting to cut employees and reduce routes now, passengers are expected to return and the earnings of the entire industry will recover.

The Air Transport industry is composed of airfreight companies and passenger airlines. There are many passenger airline companies in the United States, and the sizes of the companies are varied from the giant companies, like United Airlines, American Airlines, and Delta Airlines, to small regional companies. Also, there are many air cargo companies in United States, including FedEx and Airborne Inc

In 1978, Congress deregulated the U.S. airline industry, allowing carriers to serve any domestic market and charge whatever they thought the market would bear. Airline deregulation was intended to promote competition, improve customer service, and lower the price of services to consumers. Numerous studies have shown that the deregulation was successful and improved the Air Transport industry.

The effect of deregulation is that the prices of airline tickets actually dropped. The deregulation made it easier for airline companies to enter the market, expand operations, and increase competitiveness within the industry. The deregulation also removed the minimum price floor on fares. So, airline companies tried to reduce their costs and lower their prices to keep and increase customers. In effect, the major companies established "hub and spoke" route network in which an airline uses a few cities as major bases and flies to other airports from there. It decreased the parking expanse of their planes in the airport, as the planes were usually parked only in the hub airports.

The deregulation also created the severe business environment for the airlines in the United States. In the 1990s, many companies went bankrupt or merged with another company. Thus, the number of airlines decreased. Pan American Airlines, a major carrier, disappeared altogether at that time. Among this situation, some regional companies survived and succeeded. Southwest Airlines was a small airline company in Texas, but found success in this intensified competition. This company tried to lower costs by giving no-frill service to its customers and hedged its gasoline costs, and got the price of airline cheaper.

Air Cargo Industry

This industry delivers goods across America and overseas by air. Popular companies in this area are UPS, FedEx, and Airborne. Some companies deliver the total service for the customer. UPS, in the past few years, has begun efforts to put itself at the center of every crucial logistics step of corporate clients' operations, from shipping of raw materials for a product to processing the payments for final sales.

The demand in this industry has increased recently. Many online companies appeared, and attracted people to buy goods on the Internet. So, the air cargo companies have the business of delivering them from the online purchase.

Current Conditions and Recent Performance of the Air Transport Industry

The Air Transport industry is having a difficult time this year due to the combination of several factors. Since the early part of the year, traffic has been below last year's levels. The most devastating drop off in air traffic has been the decline of business travel. The drop in business travel has taken a severe toll on profits because business travelers typically pay premium fares, which account for over half of airlines' profits. Business travel has been hindered by the sluggish economy and especially because of the tech industry's downturn.

Rising costs are also adding to the Air Transport industry's problems. Labor costs are rising across the industry as salaries and benefits continue to grow. Fuel costs have also been very high this year, as petroleum prices have remained at inflated levels. To the relief of airlines, however, petroleum prices have dropped significantly towards the end of the year.

Another problem has been a slow international market. Foreign business had provided healthy growth in recent years, but has realized a decline of 1.3% through the first half of this year. Part of the reason for the drop in international business, besides the slow economy, has been the decline in Europe's tourism industry since the outbreak of Mad Cow disease.

What may be the worst problem for the airlines is the fact that all of these negative circumstances existed before the September 11th terrorist attacks. Since the attacks, the value of the entire industry has plunged and earnings estimates have been further downgraded. There are two main problems facing he airlines in the wake of the terrorist attacks, passengers' fears of further attacks and the cost of security. Heightened security, as well as the cost of investing in new high-tech security devices, will create another area of rising costs for airlines. Fortunately, the airport security bill signed into law last Monday by President Bush will shift airport security screeners to the federal payroll, relieving airlines of some of the costs of security. As far as relieving passengers' fears, only time can heal the wound created on September 11th. Unfortunately, no one can really foresee exactly how much time will be necessary for passengers to return to the skies once again. Airlines hope passengers will return sooner than later, as the industry is down over 45% on the year. Figure 1 shows the current financials for the industry.

FIGURE 1. **Financial Information for the Industry**

	Air Cargo	Passenger Airlines
Price ($US)	$ 351.99	$ 165.61
Market Cap ($US)	$ 33.8 billion	$ 26.2 billion
Dividend Yield	No dividends paid	No dividends paid
P/E Ratio	29.67	Negative
52-Week Range ($US)	$ 291.51 to $ 408.37	$ 116.63 to $ 266.81
1-Year Change	-13.81%	-29.07%

Data provided by CBS's MarketWatch.com

Figure 2 illustrates the performance of the airline industry against that of the market. The fluctuation in the airline industry, for the most part, has mirrored that of the market with a couple of exceptions. At the beginning of the year, the airline industry enjoyed a 20% surge in value, while the market only increased by about 5% over the same period. The other exception occurred after the September 11th attacks when the airline industry suffered a 40% drop in value on September 17th, the first day the stock markets reopened. We can also see what may be signs

of a recovery this month. The recovery is due in part to President Bush's signing of the airport security bill into law and the lower prices of crude oil.

FIGURE 2. **1 Yr Performance of Airline Industry vs. Market**

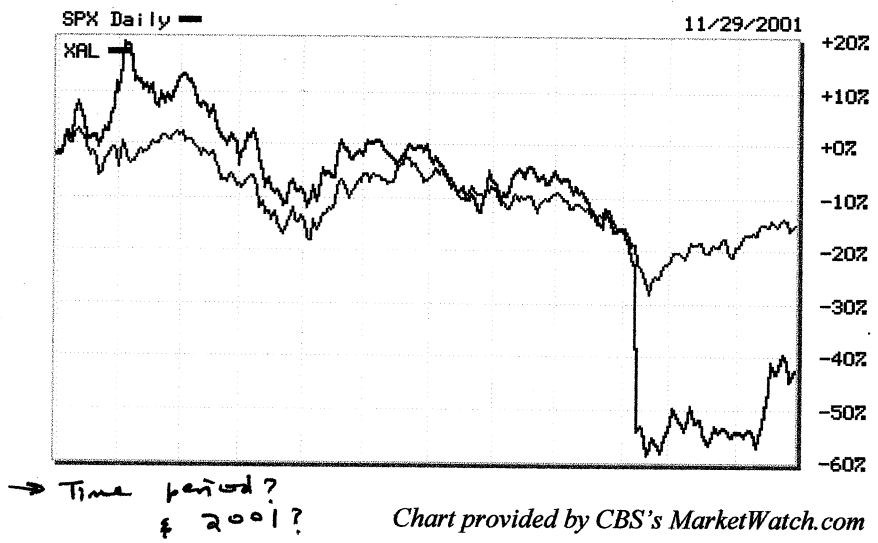

Chart provided by CBS's MarketWatch.com

Current Government Involvement in the Airline Industry

The government currently has a very keen eye on the airline industry due to the September 11th attacks. Of primary interest to the government is the safety of passengers and security inside airports and airplanes. Airlines will not have much leeway when it comes to security. Breakdowns in security will not be tolerated by passengers or by the federal government. This means that airlines have had to increase their spending for security and look at investing in new, expensive high-tech security devices to outfit airports. Also, the security crunch has caused long lines in airports and added to passenger frustration.

In an effort to relieve the industry, the federal government has recently passed the airline security bill that brings airport passenger and baggage screeners under the federal payroll. The bill will also bolster cockpit security and increase the number of federal marshals on all flights. The bill aids airlines in that it will have the federal government assume much of the cost of security. The other measures provided in the bill are designed to improve passenger confidence and safety. The aim of the bill is to make Americans feel safe to fly again and have them return to the skies, a much needed result for airlines.

Shortly after the attacks, the government took measures to bailout the reeling airline industry by approving a $15 billion relief package. $5 billion of the package was used to compensate airlines for operating losses resulting from the government's decision to ground or halt air traffic for several days after the attacks. The remaining $10 billion will provide loan guarantees to help ensure adequate liquidity in the industry as it struggles with declining demand.

As part of the federal bailout legislation, the airlines will also receive a break on some, but not all, of their federal taxes. The tax break deferred the payment of payroll taxes as well as about $1 billion in federal excise taxes, such as taxes on fuel, tickets, and cargo. The payment of

payroll taxes was deferred until November 15, while excise taxes will not be due until January 15. The tax deferment will give the cash-strapped airlines more time to recover from the September 11th attacks and provide them with much needed short-term liquidity.

The White House has further supported the airline industry by stepping into the dispute between UAL, United Airlines' parent company, and its mechanics union. UAL and its mechanics union remain at a contract impasse and the union has declared that it will strike as soon as it is legally able to do so. President Bush has promised to do everything he can to avert a walkout by exercising his power to delay the union's ability to strike. This support by the Bush administration underlines the federal government's commitment to providing stability in the airline industry.

Industry Consolidation?

Over the past decade, the airline industry has become more competitive as smaller regional carriers, such as Southwest Airlines and JetBlue, have expanded and become very successful. The last major consolidation in the airline industry occurred in April when AMR Corp., the parent company of American Airlines, purchased the assets of TWA. More consolidation is possible, but is not expected in the near term. Due to the hardships created by the September 11th terrorist attacks, consolidation in the industry may occur via bankruptcy. America West Airlines was poised to declare bankruptcy before the federal government passed the airline bailout package, which included the provision of guaranteed loans. The government has taken many steps, as mentioned earlier, to bring stability to the airline industry and provide the necessary liquidity for airlines to remain in business. Early results show that the government aid is having the effect it was designed to. However, if passenger demand remains low for an extended period of time and government aid does not meet the airlines' needs, mergers or acquisitions may begin to occur.

Future Outlook for the Air Transport Industry

The Air Transport Industry is vital to the economic strength of the United States and is a necessary means of transportation that has no comparable substitute. Because the industry is so important, the government is doing all it can to provide it strength. For businesses, there is no comparable substitute that delivers the benefits that air travel provides. Even if some alternative is ever innovated, it will not happen for a very long time. For these reasons, the long-term health of the industry is virtually guaranteed.

After all of the events of the past year, the short-term outlook for the industry was bleak at best. However, as so many factors had combined this year to hurt the industry, so are many factors presently combining to give the airline sector a bright outlook. The passage of the airline bailout package and resolution of security and insurance issues have helped bring stability to the industry. In addition to these factors are declining fuel prices, seasonal timing, and low valuations combined with an economy that is showing signs of a rebound. Also aiding in the positive outlook is the successful military campaign in Afghanistan which is nearing completion. The defeat of the Taliban regime and terrorist cells inside Afghanistan is restoring Americans' confidence in their safety. Assuming that no further terrorist activity occurs in the coming year,

there is a good chance that the industry's valuation could rebound to its pre-September level by the end of next year.

If the industry is able to quickly recover by next year, airlines should be able to resume many of the projects they were forced to put off after the terrorist attacks. This will be especially important because it would mean a return to positive growth for the industry and its components. The projects will also bring new options and services to customers, improving the quality of air travel.

FIGURE 3. **Industry Estimates**

Estimate Period	Change (%)
This Quarter	-717.3
Next Quarter	N/A
This Year	-223.5
Next Year	N/A
5-Year Future	10.73

Data provided by www.finance.yahoo.com

Companies in the Air Transport Industry

With so much recent activity in the airline industry, many companies have had newsworthy stories and are quite interesting to analyze. We will analyze three companies specifically: AMR, the parent company of American Airlines; UAL, the parent company of United Airlines; and Southwest Airlines. Though the industry has seen much turmoil this year and especially since the September 11th terrorist attacks, many of the stock ratings may be surprisingly high. When the industry was losing much of its value in late September, short-term expectations were extremely gloomy and were very difficult to predict. These expectations along with a highly emotional sell-off may have left the airline stocks undervalued and, therefore, attractive as investments. Also, as the industry has begun to stabilize itself with the aid of the federal government's relief packages, the short-term picture for the industry has begun to shine in a positive light.

AMR Corp.

AMR Corp., the parent company of American Airlines, was one of the unfortunate companies involved in the September 11th terrorist attacks. AMR had shown signs of weakness before the attacks as they had posted losses in the second quarter and were already expecting even larger losses in the third quarter. After the attacks, those numbers were obviously downgraded even further. FIGURE 4 below shows the five-year performance of AMR against the airline industry, represented by the AMEX Airline Index (XAL), and the market, represented by the S&P 500 Index (SP500).

***FIGURE 4.* 5-Year Performance of AMR, Industry, Market**

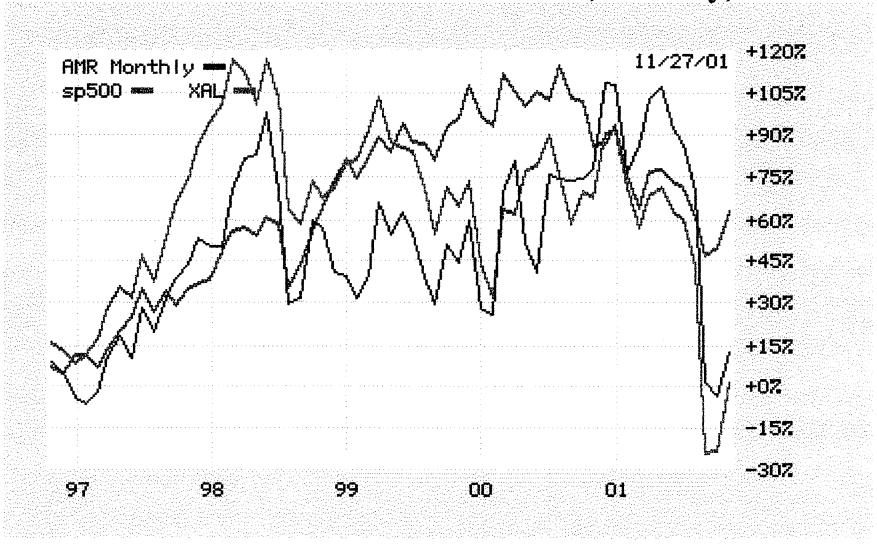

Chart provided by CBS's MarketWatch.com

The graph illustrates that AMR has mostly under performed the market and the industry. However, AMR did see success between the time it acquired TWA and the September 11th attacks. During this time period, AMR greatly outperformed both the market and the industry. Since the attacks, they have managed to outperform the industry, but have slipped far below the market. FIGURE 5 shows the one-year performance of these three assets.

***FIGURE 5.* 1-Year Performance of AMR, Industry, Market**

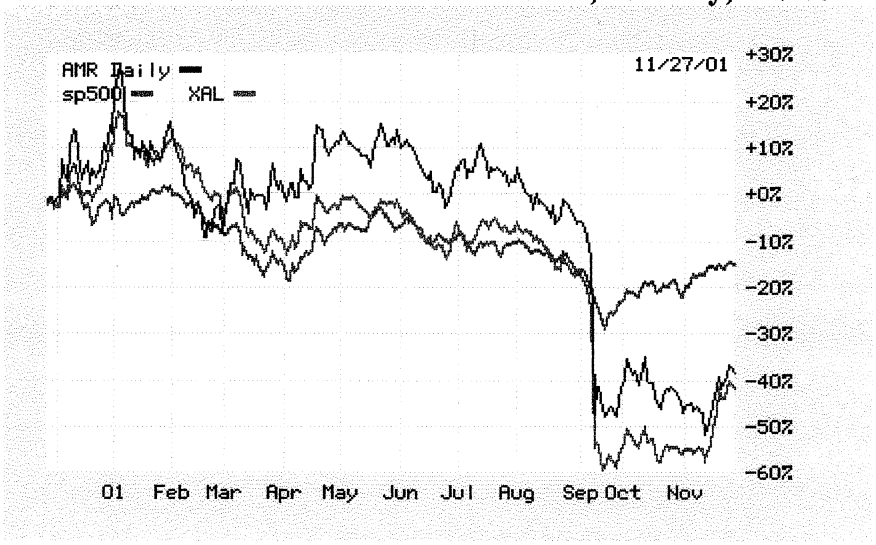

Chart provided by CBS's MarketWatch.com

AMR had dropped about 30% since January, which was better than the nearly 40% industry-wide drop. AMR also consistently outperformed the market before the September 11th attacks, but fell dramatically after the markets reopened. Since that initial sell-off in mid-September, AMR's value has rebounded by about 10%. Though industry recovery is seemingly close, we would still consider this stock to be a risky investment. Because the country is still at a heightened state of anxiety, any further attacks, even those not involving airlines, may have a devastating impact on the airline industry. Because of this factor, we would consider this stock to be at a "*HOLD*" status in the short-term and at a "*BUY*" status over the long-term.. Below, in FIGURE 6, are the company's financials and market ratings.

***FIGURE 6.* AMR Corp. Profile**

AMR Financials			
Market Cap	$3.30 B	Debt/Equity	1.42
Annual Div	none	P/E Ratio	N/A
Beta	0.94	P/B Ratio	0.53

AMR Earnings		
	EPS	*Growth*
This Quarter	- $4.37	- 1385.3%
Next Quarter	- $2.58	N/A
This Year	- $8.73	- 287.7%
Next Year	- $4.20	- 51.9%
Past 5 Years	----	- 4.5%
Next 5 Years	----	8.0%

AMR Broker Recommendations		
Strong Buy	4	Mean Rating
Buy	5	1.7
Hold	1	
Sell	0	Industry Mean
Strong Sell	0	2.1

Data provided by www.finance.yahoo.com

UAL Corp.

UAL Corp., the parent company of United Airlines, was the other unfortunate company involved in the September 11th attacks. United Airlines serves airports in 28 countries and is the 2nd largest domestic carrier in the United States. As is the case with most airlines, UAL had been hurt by the slowing economy before the attacks. They had been especially hard hit by the drop in business travel because more than half of UAL's revenues came from these premium fares. The severe drop in UAL's business travel is a result of the downfall of heavy tech-based areas in the western United States and Asia, which United heavily serves. Since the massive tech sell-off, many business customers have cancelled flight plans altogether or have opted for cheaper discount fares.

Adding to UAL's difficulty is the fact that their expenses are above the industry average and growing. UAL is currently in a battle with its mechanics union, as mentioned earlier, which

will most likely lead to even higher labor costs. UAL is currently in a major cost cutting mode and is retiring many of its older, less fuel-efficient planes. FIGURE 7 below shows the five-year performance of UAL versus the industry and the market.

FIGURE 7. **5-Year Performance of UAL, Industry, Market**

Chart provided by CBS's MarketWatch.com

Since late 1997, UAL has fallen far below both the market and the industry's performances. In FIGURE 8 below, we can see that UAL's performance over the past year versus the market and the industry has improved. The stock has moved along with the indices until the September 11th attacks. Since the attacks, UAL has experienced another short sell-off that has put its performance below that of the industry.

FIGURE 8. **1-Year Performance of UAL, Industry, Market**

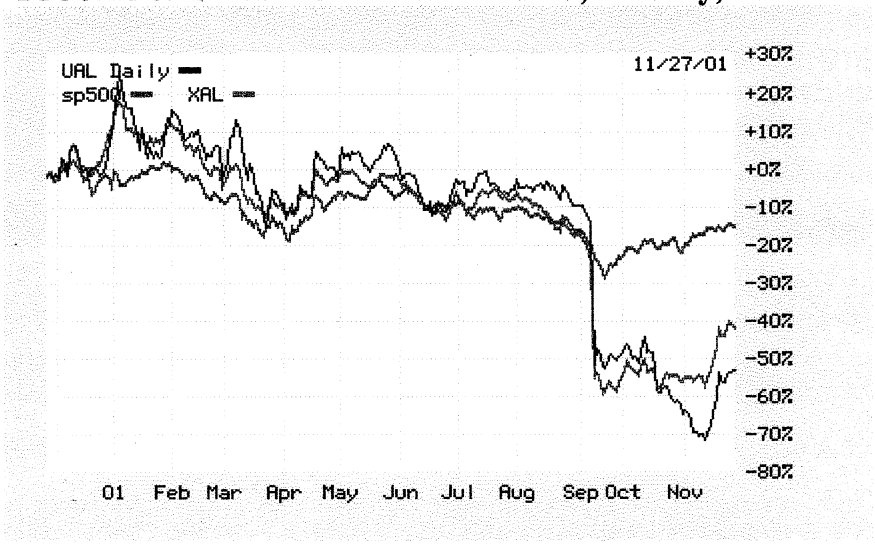

Chart provided by CBS's MarketWatch.com

For the same reasons we stated for AMR Corp., and because of UAL's labor and cost problems, we would consider this stock to be at a "*HOLD*" status in the short-term and at a "*BUY*" status over the long-term. Below in FIGURE 9 are UAL's financials and market ratings.

FIGURE 9. **UAL Corp. Profile**

AMR Financials			
Market Cap	$919.4 M	Debt/Equity	2.98
Annual Div	$0.20	P/E Ratio	N/A
Beta	1.34	P/B Ratio	0.30

AMR Earnings		
	EPS	*Growth*
This Quarter	- $15.17	N/A
Next Quarter	- $10.25	N/A
This Year	- $36.54	- 1635.3%
Next Year	- $23.63	- 35.3%
Past 5 Years	----	- 23.3%
Next 5 Years	----	8.0%

AMR Broker Recommendations		
Strong Buy	0	Mean Rating
Buy	3	2.7
Hold	7	
Sell	0	Industry Mean
Strong Sell	0	2.12

Data provided by www.finance.yahoo.com

Southwest Airlines

Southwest Airlines, a regional carrier, is the 4th largest domestic airline in the United States. Southwest specializes in low fares (with "no thrills") and short hauls. Over the past two decades, Southwest has enjoyed strong management and leadership from CEO and industry maverick Herb Kelleher. Southwest is an innovative company that performs most of its operations differently from that of other carriers. They offer "ticketless travel" that adds convenience for customers and reduces commissions paid to agents. In the mid-1990's Southwest began offering fares online and implemented other cost control measures before other major airlines. This foresight has been especially important for Southwest, as they have weathered the recent industry conditions much better than their competitors. Southwest has lost only about 18% of its value this year while the industry is down nearly 45%. FIGURE 10 below shows Southwest's performance over the past five years along with that of the industry and the market.

FIGURE 10. **5-Year Performance of LUV, Industry, Market**

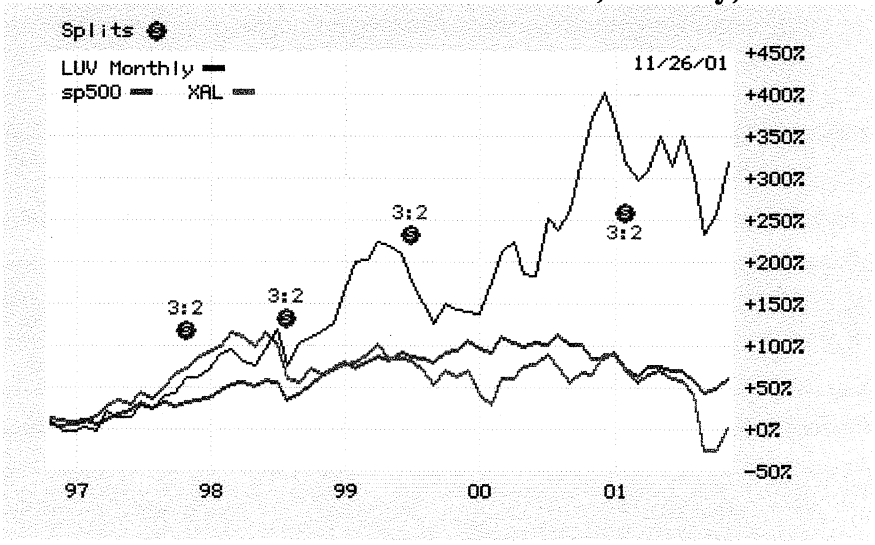

Chart provided by CBS's MarketWatch.com

It is easy to see how Southwest's growth has far outpaced that of the market and the industry over the past five years. In FIGURE 11, which shows the same three assets over the past year, we see that Southwest had performed along with the industry and the market before September 11th. You can see the major difference between Southwest and the two previous companies in that Southwest did not suffer huge losses after the attacks and has rebounded quickly. For the year, Southwest is down only about 18%, while the market is down by about 15%.

FIGURE 11. **1-Year Performance of LUV, Industry, Market**

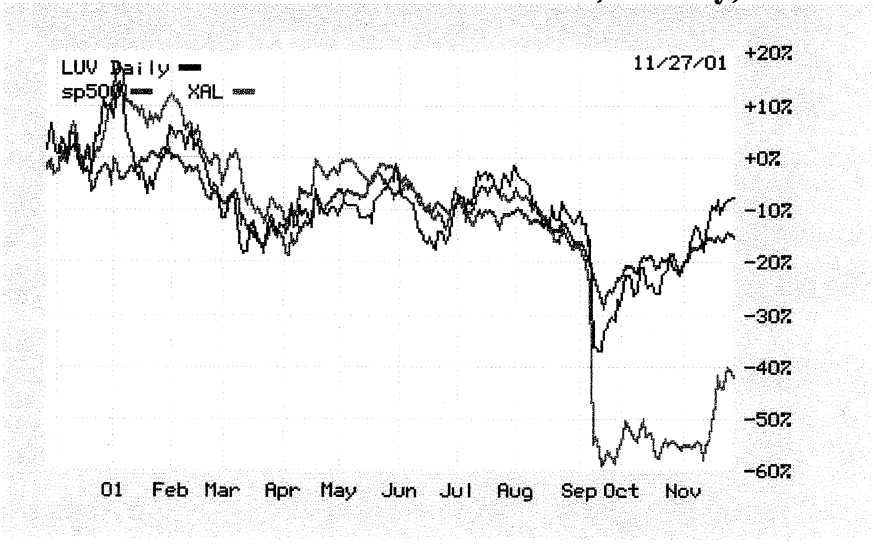

Chart provided by CBS's MarketWatch.com

Another reason that Southwest may have fared better than the major airlines is the fact that they are a regional airline. This is significant because Southwest only owns smaller 737 jets and does not own the larger 767 jets used in the terrorist attacks. The smaller planes are considered to be safer because it is believed that they are less likely to be used in a terrorist attack. Another factor in Southwest's favor is that they have the youngest fleet of aircraft in the industry. These younger aircraft are much more fuel-efficient and do not require the same level of maintenance as the older aircraft. This has helped Southwest to weather the high fuel costs that have been prevalent throughout the year. Also, Southwest has not been as badly hurt as the major airlines by the sluggish economy. This is because Southwest offers only one class of seating and does not rely on premium business class fares. Southwest's strong leadership, foresight, and current position relative to its competitors contribute to our rating of "*BUY*" for this stock in the short-term. As conditions improve in the airline industry over the coming years, we see this stock as being a "*STRONG BUY.*" Below are Southwest's financials and market ratings.

FIGURE 12. **LUV Corp. Profile**

AMR Financials			
Market Cap	$ 14.4 B	Debt/Equity	0.31
Annual Div	$0.02	P/E Ratio	25.10
Beta	0.86	P/B Ratio	3.63

AMR Earnings		
	EPS	*Growth*
This Quarter	- $0.01	- 105.3%
Next Quarter	$0.05	- 66.7%
This Year	$0.46	- 41.8%
Next Year	$0.63	37.0%
Past 5 Years	----	25.1%
Next 5 Years	----	13.5%

AMR Broker Recommendations		
Strong Buy	4	Mean Rating
Buy	6	1.9
Hold	2	
Sell	0	Industry Mean
Strong Sell	0	2.12

Data provided by www.finance.yahoo.com

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Cosmetic and Toiletries Industry Report

Amanda Shannon
Drew Hayes
November 28, 2001
Investments 514

INTRODUCTION

This report will give a detailed background of the cosmetic and toiletries industry. Provided within this report is an industry analysis discussing the characteristics and trends that are taking place in the industry today. Some of the market leaders within this industry will be analyzed and, finally, a recommendation of each stock will be provided. A breakdown of the paper is provided below:

Industry Analysis:
- Market Maturity
- Competition
- Industry Specific Issues
- Regulation

Industry Trends:
- Mergers and Acquisitions
- Demographics
- Global Brands
- Powerful Retailers

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INDUSTRY ANALYSIS

In this section a background of the cosmetics and toiletries industry will be provided. Also, discussed are the characteristics of the market currently. Some of the major categories included are the market maturity, increased competition, industry specific issues, and regulation. Finally, provided at the end of the section is a chart and explanation of how this industry performs in relation to the S&P 500.

Background

The cosmetics and toiletries industry (also referred to as personal care) is a $75 billion industry. It includes companies that manufacture such items as skin care products, make-up, women's and men's fragrances, body/bath products, and women's hygiene products as well. There are over 225 companies in the industry with some of the major ones being Gillette, Colgate Co., Avon, L'Oreal, and Procter & Gamble. This industry is considered to be very dynamic and competitive with many new products being developed and introduced to the public each year.

Market Maturity

This is also a mature and stagnant market within the United States. Personal care companies only realized a 1.7% sales growth with an earnings decline of 5.6% in 1999. Part of this is due to Gillette's losses and its massive impact on the industry. In 2000, the total industry only grew 4%, which was the lowest rate of growth since 1995. Because of the industry's maturation in the U.S., companies are looking to increase market share internationally. There are several less developed countries that have become more attractive to the big players in this industry, as they offer new market share growth opportunities.

Increased Competition

Because of the makeup of the companies within the industry competition is intensified. Many smaller companies are eating away market share from the giant market leaders. Part of this is due to increased ease of bringing new products to market. Another extremely important factor is the ability to balance price with value so as to attract more consumers. Smaller companies are able to reproduce popular products without having to research their success rate; thereby they are able to price them at a discount.

Industry Specific Issues

Some problems that are unique to the industry include animal rights and chemical related issues. The personal care industry is one that is highly dependant on the extensive use of chemicals. It is estimated that more than 125 chemicals that are available for use in the cosmetics industry are suspected of being carcinogenic. If this turns out to be the case for even one of these chemicals it represents potential health consequences, and possible legal trouble as well. Also the testing of cosmetics has been extremely controversial in recent years, as animal awareness has increased. Many times when companies test ingredients or finished products on animals, they risk a possible boycott or bad press by animal rights activists. This has created an increased demand for more natural and organic chemicals.

Regulation

Because of the make up of certain products, this industry has several regulatory agencies and concerns that are applicable. The Food and Drug Administration (FDA) regulates the manufacturing, labeling and sale of OTC drug and cosmetic products. The Environmental Protection Agency (EPA) regulates the substances used in the manufacturing of disinfectant products. The Consumer Product Safety Commission is responsible for regulating the labeling of household products. The FTC regulates packaging and labeling of all consumer products. All of these regulations, in addition to all applicable state laws or any in foreign jurisdictions, affect the cosmetic and toiletry industry significantly.

Industry Performance vs. S&P 500

Demand is affected by many factors. Some of these include price, demographics, household income, and innovation. Most of the personal care products are considered to be necessities; therefore, the quantity that is consumed by the public usually remains steady during periods of both recession and prosperity. This chart helps to illustrate this point. It shows the cosmetic industry performance versus that of the S&P 500 for the past year. The S&P 500 is shown in purple while the cosmetics industry line is orange. This graph demonstrates how this industry performs in relation to the market. For the past few months the industry was somewhat in line with that of the overall market. However, during the period of economic decline in early September the drop in the industry, ending up around –6%, was not as severe as that of the market, which ended up at around –15%. This demonstrates the defensive nature of this industry.

INDUSTRY TRENDS

This section will discuss several trends that are significantly impacting the cosmetic and toiletry industry. The major categories included are mergers and acquisitions, demographics, global brands, and powerful retailers. Following this section is company specific information for some of the market leaders in the industry.

Mergers and Acquisitions

Slow growth and mature market lead to consolidation. This is true in the cosmetics and toiletries industry as well. By undertaking mergers and acquisitions, companies hope to boost revenue and sales. However, while many of these might accomplish the goal, oftentimes what happens is that growth is improved at the cost of profitability. For example, Procter and Gamble and Gillette have sold several product lines to salvage profitability from some of its prior acquisitions.

Demographics

The aging of the population is a driving force behind the manufacturing of new products. Approximately 20% of the population is over 55, and this number is expected to grow to 33% by 2030, and continue throughout the next decade. Many new products are being offered that cater to this aging population of Baby Boomers' needs. Studies have shown that this group is greatly concerned about looks. Therefore, producers of cosmetics are focusing on age defying products and other types of age and health related items. This means breakthrough formulas and products can provide some companies with good brand name image.

Several ethnic groups represent a large portion of spending power so cosmetics will follow this trend by focusing products that will accommodate a diverse array of preferences. These individuals will have their needs catered to with the introduction of several desirable products, so tapping into this area is key to more growth for individual companies and brand image.

Global Brands

Since global expansion is so critical during market maturity, global branding has become more important. This is when the same formulas have different packaging so that manufacturing and inventory costs can be reduced. When a product is in a group with well known brands it saves costs on advertising as well.

Powerful Retailers

There are a few major retailers such as Wal-Mart, K-mart, and Target who have lots of clout concerning what product lines to offer. In addition, they can easily remove slower moving items from their shelves. In this industry it is crucial to get adequate shelf space. This is why the retail power is something that has to be dealt with carefully. Another concern related to the retailers is the increased use of private label brands. These offer attractive substitutes to those to wish to balance out their price and value when buying these products. They are easy to switch to without consumers incurring heavy costs. This turns these powerful retailers into competitors as well. Since consumers are becoming more and more value-oriented since the early 1990's, this is a growing concern for the industry. Many of these private label brands are up to 15% cheaper than their branded counterparts. This is why brand image is so important. Establishing this loyalty can be one way to stay ahead of the pack. National brands typically have loyal customers in certain product categories.

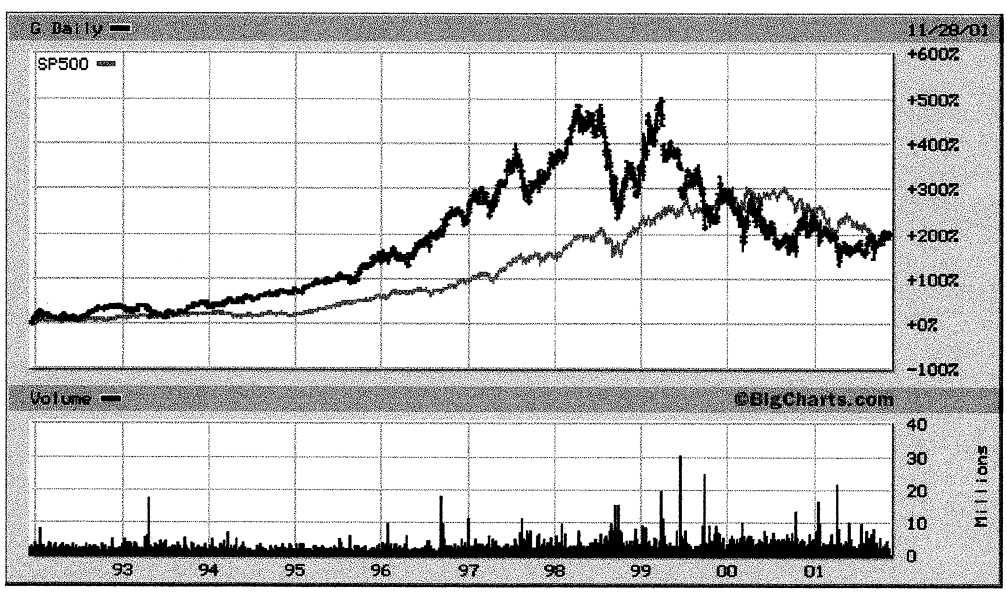
COMPANY ANALYSIS

In an effort to follow the current industry characteristics, we decided to look at three companies that differentiate themselves from their competitors. The three companies are: The Gillette Company, Avon Products, and Proctor & Gamble. It should be noted that there are many other companies that we could have analyzed. For example, L'Oreal is a great example of a strong cosmetic company that many competitors have tried to mimic, but often have failed. What sets L'Oreal apart from other companies is its goal to be the best cosmetic company in the industry by focusing on research and development. Its research and development mission is to bring products to the market that make skin look younger and feel better. Our goal is to briefly describe the company, focus on its investment strengths and weaknesses, describe its long-term growth predictions, and make a recommendation to buy or sell the stock.

The Gillette Company

Founded in 1901, The Gillette Company is the world leader in male grooming, a category that includes blades, razors, and shaving preparations. Gillette also holds the number one position worldwide in selected female grooming products, such as wet shaving products. In addition, the company is the world leader in alkaline batteries, toothbrushes, and oral care appliances. Gillette manufacturing operations are conducted at 38 facilities in 19 countries, and products are distributed through wholesalers, retailers and agents in 200 countries and territories. It is important to note that Gillette's core toiletry product line (outside of blades and razors) make up only 10% of its annual sales.

According to Edward DeGraan, President and COO, the 1980s and much of the 1990s, Gillette was not only an undisputed leader within its core product categories but also was one of the top growth companies in the S&P 500. He noted that while the stock prices of consumer product peer companies had a compound average growth rate of 22.7% from 1990 to 1997 and the S&P 500 growing at 16.7% for the same period, Gillette had a remarkable growth rate of 30.4%. These comments certainly mirror the 10-year chart noted below. However, this same chart clearly shows that over the last three to four years, Gillette has experienced some major challenges and has seen its stock price hit a low of $24.50 from nearly a high of $65 during the "good" times. (Some of the reasons are noted below.)



There are several key investment positives that separate Gillette from its competitors. First of all, Gillette has a sound business proposition. It offers superior products to customers globally. Its supply chain management and distribution techniques link customers to its products. Secondly, it is a market leader in its businesses and that is critically important in a mature market with strong competition. Gillette holds more than two thirds of the world razor and blade market, or four times that of its closest competitor. Since 1998, for example, the Mach3 triple blade shaving system has generated over $2.5 billion in worldwide sales. DeGraan believes that his company does not have any true competition in the razor and blade market, but its competition is seen in the toiletries market. Next, Gillette has a full pipeline of new product launches, which is imperative in this competitive environment. In 2001, Gillette launched Venus, a three-blade shaving system for women. Next year (April 2002), Gillette will introduce the Mach3Turbo, a new triple-blade, wet shaving system for men. Gillette's blades and razor business illustrates its technology leadership and has more potential for solid growth and increased market share. Along with shaving products, Gillette will also introduce a new line of Oral B toothbrushes in the near future. Finally, new leadership and improved growth prospects play a key role in long-term development. James Kilts recently was named CEO of the Gillette Company in January 2001. Kilts is changing the company's philosophy and operating mechanisms. Since he was able to turn around Nabisco in the late 1990s by an aggressive restructuring plan, cutting costs, selling non-strategic assets, and closing plants, Gillette will see growth next year of 3 to 5% in sales and 10% in earnings.

There are a few investment risks that need to be considered when analyzing Gillette. Firstly, Gillette has battled the problem of inventory levels that have increased costs at an accelerating pace. In the past, Gillette had "stuffed" the channel ahead of consumption to meet the company's sales goals. Part of this problem was poor planning and a disconnect with what customers wanted to purchase. According to DeGrann, the company has recently launched a "global supply chain management" initiative to give managers control of inventory levels, managing assets, and procurement responsibilities. This initiative is lined up to control the costs that have hurt their performance in the past. Secondly, Kilts is launching a $650 million advertising campaign to increase brand support with its core products. This advertising blitz is clearly more than its competitors and it something the company has not done in the past. These types of expensive marketing campaigns are risky given the cost of Gillette's superior products. You can't force a consumer to buy expensive products especially in a recessionary period, so the hope is for the campaign to help build brand awareness. If sales do not increase, these costs could hurt the bottom line in the next quarter. Finally, Gillette generates over 60% of its sales from overseas. The Asian Crisis and the current devaluation of many Latin America and European currencies (i.e. the euro) have hurt the company's financial situation and growth prospects. Since this trend is likely to continue over the next six months given a world recession, sales look to be stunted by this negative trend.

The following table describes Gillette's long term growth prospects for its EPS and its P/E ratio:

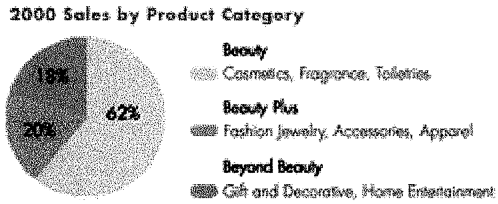
	2000	**2001**	**2002**	**5 yr growth projection**
EPS	$1.18	$1.00	$1.10	11.00%
P/E ratio	23.3	27.5	25	

Recommendation

Given Gillette's dominance in many of its core products, it unprecedented technological leadership in product development, and positive growth prospects, we rate this company as a **long term buy**. Clearly, Gillette has seen better days, but we believe the worst is over. We expect continued growth of the Mach3 product, which commands 16% of the $7 billion global razor and blade market as well as growth in its current 27% market share with Oral B toothbrushes. Again, long term is viewed as over one year and with the hopes of the economy making a push for recovery over the next 12 –18 months, Gillette should also see marked improvement.

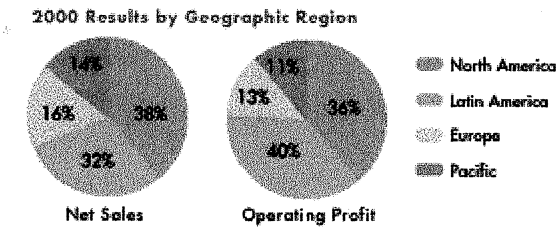
Avon Products

Avon Products is the world's leading direct seller of beauty and related products, with $5.7 billion in annual revenues. It markets to women in 139 countries through 3.4 million independent sales representatives and its Web site. Avon also markets fashion jewelry, apparel, gifts, and collectibles. As noted in the pie chart, over 60% of its sales come from beauty products versus its other diversified product lines.



Avon has four major key investment positives when analyzing the company. First of all, Avon has a global presence in the cosmetics industry. Its reputation helps Avon recruit and retain representatives and command consumer loyalty. Avon is the sixth largest cosmetics company in the world and the largest direct seller in beauty care with a 14% market share. In international markets, the company holds strong positions in Latin America (16%), and the United Kingdom with a 10% market share. Again, since we know that this market is competitive and sales are flat, growth in international markets is critical. Therefore, Avon is looking to Eastern Europe and China for company growth and market share gains. Secondly, Avon has embarked on a marketing campaign with US Magazine. It displays all of Avon's product listings in tandem with an advertising campaign in the magazine. Next, its direct selling technique differentiates itself from its rivals. This requires little capital and can be an advantage during global economic weakness. Avons' needs for working capital are low; therefore, its cost of entering new markets is small. A direct channel to the consumer bypasses trade resistance to holding inventory when interest rates are high (unlike Gillette), as well as inventory tightening as retailers consolidate. Finally, Avon is focusing on operational efficiencies over the next few years. These focal points include: (a) top-line growth, (b) its value chain, and (c) limiting the number of high growth initiatives. In a same type effort in 1997, the company was able to save over $400 million by the end of 2000, and increased operating margins by 3.2%.

Avon has to manage against negative currency trends and economic volatility in emerging markets. Although we pointed out that its international growth in new markets is important to the future, it can also be a risky proposition. Avon's earnings could be hurt by foreign currency devaluations, and a limit on its ability to increase prices if economic growth decelerates in Argentina, Brazil, or Mexico. Argentina generates 7% of Avon's revenue, and Argentina and Brazil account for an estimated 1/5 of its profit. Recently, the International Monetary Fund (IMF) has been working extremely hard to bail Argentina out of its economic downturn. The IMF pledge over $1.5 billion to help stimulate the economy; however, with it poor economic infrastructure and lack of legal framework, Avon could find itself with lower profits in this region in the short term. The following charts show a break down of sales and profit in the different global regions:



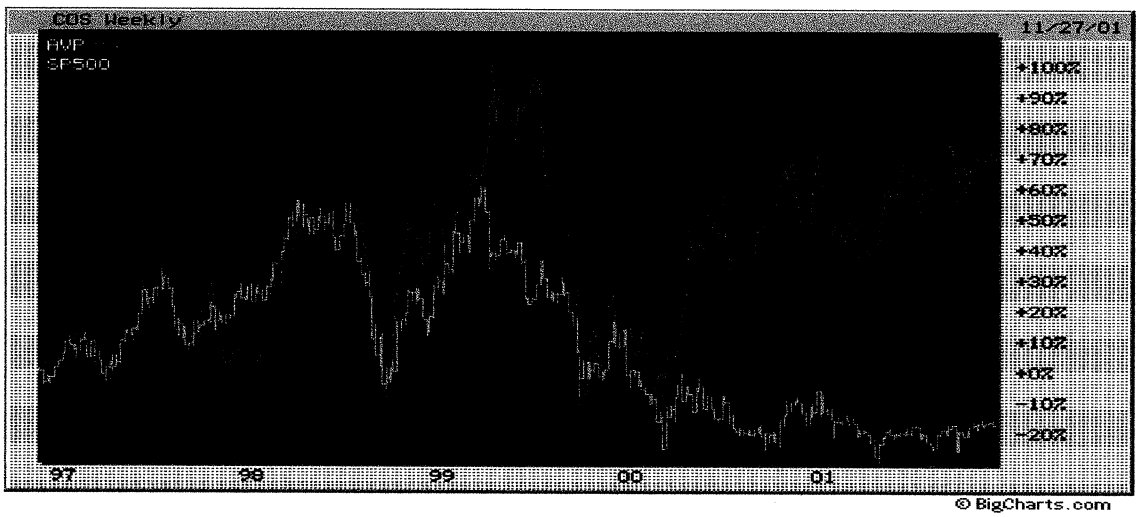
Secondly, Avon could face operating disruptions as it enters retailing partnerships. For example, Avon is opening "stores within a store" in retail chains like JC Penney to sell its products. Since this is a new delivery model, it may be challenging in the near term.

The following table describes Avon's long-term growth prospects for its EPS and P/E ratio:

	2000	2001	2002	5 yr growth projection
EPS	$1.88	$2.08	$2.32	13.00%
P/E ratio	23.9	21.6	19.4	

Recommendation

Even in a tough year for most investors, Avon stock has only declined 1% vs. a drop of 2% in its global peer group. However, with the S&P 500 down nearly 20% for the year, this looks to be a very strong investment. Avon is doing something right to keep its current investors happy. Avon predicts that its sales growth will be 10% over the next three years, while its annual cash flow from operations to hit $700 million. Who can argue with these numbers? Just by looking at the past, one can see it growth. Compounded annual growth over the last five years shows a return of 23% vs. an 18% for the S&P 500 (see graph below). In addition, Avon has had twelve consecutive years of sales and earnings growth while its sales were up 6% in the last quarter. We can't argue with that and, therefore, rate Avon as a **long term buy**.



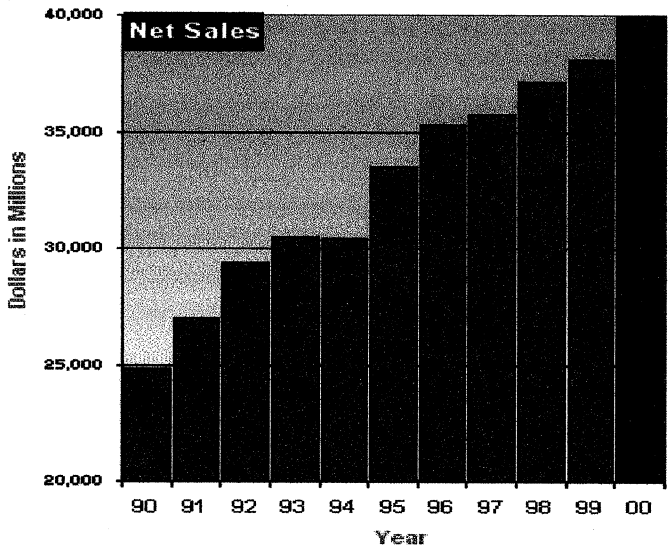
Procter & Gamble

Established in 1837, The Procter & Gamble Company began as a small family operated soap and candle company in Cincinnati. Today, P&G markets more than 250 products to more than five billion consumers in 130 countries. P&G is a global manufacturer of consumer products, with leading market shares in hair care, laundry detergent, and disposable diapers.

There are several key investment strengths that P&G has leveraged over the last several years to make it a strong buy. First of all, in the toiletries industry P & G is a market leader in shampoo, tissue, and towels. These products have large market shares and high profit margins, as well as room for long term growth. Secondly, P&G has strong leadership within upper management. CEO A. G. Lafley is focused on cost discipline and has been able to manage his company's expectation with analysts. As mentioned with Gillette, another large global entity, P&G continues to restructure its organization in order to increase cash flow. For example, Organization 2005, a formal restructuring plan is aimed to save the company

over $2.1 billion by the end of 2005. The program consists of improving P&G's asset allocation and streamlining the company to become more competitive in the long run. Finally, P&G has structured itself globally in order to protect itself from any one regional economic downturn.

P&G must also protect itself from some key investment risks in order to meet its expectations. Sales from P&G's cosmetic product line dropped 4% over the last fiscal year. This trend is likely to continue given the recent global economic conditions. Although net sales have increased over the last 10-year (see chart below), certain product lines may remain flat unless the global economy changes.



Secondly, in fiscal 2001, P&G's return on invested capital declined to 19.3% from 21.3%. In addition, cash flow should increase to over $3.0 billion in the next year; however, this is significantly less than the average of its peer companies. Finally, P&G generates 49% of its revenues overseas, exposing its operating results to negative foreign-currency translations. Over the last year, adverse currency trends slowed sales growth by 3.5%. This could continue as countries devalue their currency against the dollar in order to enhance their own country's economy. In order to manage volatility from these factors, P&G must perfect its ability to hedge against these currencies and look to increase prices in certain markets.

	2001	2002	2003	5 yr growth projection
EPS	$3.27	$3.41	$3.78	11.00%
P/E ratio	22.1	21.1	19.1	

Recommendation

Although the stock is down 7% for the year, it is still performing better than the S&P 500 (see chart on follow page). Given its aggressive restructuring plan over the next few years, solid distribution channels, target sales growth of 4 – 6%, and 5 year EPS growth in the double digits, we recommend this stock as a **long term buy.** In addition, the company clearly is a market leader with strong global brand awareness. Its recent acquisition of Clairol for nearly $5 billion will certainly be a catalyst in helping its market growth in the cosmetic industry.

COS Weekly
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+60%
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+40%
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-10%
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Interview

Edward DeGraan, President and COO, The Gillette Company, Boston, MA, 11/20/2001