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Case Study

FINANCIAL CRISIS IN USA: AN EXPLORATION OF FACT

A CASE STUDY OF LEHMAN BROTHERS HOLDINGS INC. NEW YORK, UNITED STATES OF AMERICA

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A COMMERCE graduate usually gets the input on Banking Crisis and is aware of the common banking & accounting practices. But sometimes, the well-learned authorities ignore those simple but very important practices by exercising their wrong discretion as and when they get chance. The Current financial crisis in an economic superpower like United States of America has left all the economies and intellectuals of the world unanswered. One obvious question comes in the minds of analysts that despite the visible bad health of the leading financial institutions, what stopped the officials from taking corrective measures in order to avoid the entirely unexpected culmination of these institutions.

Present case makes an attempt to explore the facts behind financial crisis in USA by analyzing the financial statement of a Leading financial institution, having a Legacy of More than 150 years, i.e. Lehman Bros. as a case and puts some glaring and obvious questions which are still folded.

Why this Shockwave came?

Macro Factors: If we look into the factors which have resulted into this financial crisis, we find the following three major reasons for the current shockwave in a country which is called as an economic Superpower.

Reason 1 : Low income or Sub-Prime US households that had borrowed heavily from banks and financial Institutions to buy house properties, were defaulting rampantly on their debt obligations.

Reason 2 : Size of this Sub-Prime housing loan market was huge at about $1.4 trillion.

Reason 3 : The financial experts of US packaged these loans into very complicated financial instruments popularly known as CDOs (Collateralized Debt Obligations).

American and European banks had invested heavily in these products. Though, no amount of financial engineering could protect investors from a well known and irrefutable principle – if all these housing loans turned bad, the instruments which were based on these loans would lose value.

CDO Prices stared plummeting with the rise in defaults of housing loans. Falling prices dented the investment portfolio of these bankers and resulted into the loss of capital.

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Panic Bytes Panic

In nut-shell, the financial crisis faced by US today is the culmination of the above mentioned problems in the global banking system which can broadly be said as banking crisis.

Result is:

- Blue-chips of Wall Street, like Bear-Stearns and Merrill Lynch who have been acquired by other more 'solvent' banks at bargain-basement prices.

- Lehman Bros. went bust apart from its great legacy of 158 years.

IMF has also endorsed this that this disruption could trigger a global recession (i.e. 3% Growth in 2009 for all economics put together)

CHANGING WALL STREET (Important
May 2008: JP Morgan Chase buys Bear Stearns for $2.2bn, ending its 85 years as an independent firm **September 2008**: Lehman Brothers files for bankruptcy, the largest in US history, ending its 158-year history **September 2008**: Bank of America acquires Merrill Lynch, founded in 1918, in a $50bn deal **September 2008:** Goldman Sachs and Morgan Stanley request to change their status

Introduction

Lehman Brothers was founded in 1850 by two cotton brokers in Montgomery, Ala. The firm moved to New York City after the Civil War and grew into one of Wall Street's investment giants. On Sept. 14, 2008, the investment bank announced that it would file for liquidation after huge losses in the mortgage market and a loss of investor confidence crippled it and it was unable to find a buyer.

Lehman's slow collapse began as the mortgage market crisis unfolded in the summer of 2007, when its stock started facing a steady fall from a peak of $82 a share. The fears were based on the fact that the firm was a major player in the market for sub prime and prime mortgages, and that as the smallest of the major Wall Street firms, it faced a larger risk that large losses could be fatal for the company.

Lehman managed to avoid the fate of Bear Stearns, the other of Wall Street's small fry, which was bought by JP Morgan Chase at a bargain basement price under the threat of bankruptcy in March 2008. But by summer of 2008 the rollercoaster ride started to have more downs than ups. A series of write-offs was accompanied by new offerings to seek capital to bolster its finances.

Lehman also fought a running battle with short sellers. The company accused them of spreading rumors to drive down the stock's price; Lehman's critics responded by questioning whether the firm had come clean about the true size of its losses. As time passed and losses mounted, an increasing number of investors sided with the critics and made the situation worsen for the company.

On June 9, 2008, Lehman announced a second-quarter loss of $2.8 billion, far higher than expectations of analysts. The company said it would seek to raise $6 billion in fresh capital from investors. But those efforts could not be materialized and the situation grew direr after the government on Sept. 8 announced a takeover of Fannie Mae and Freddie Mac. Lehman's stock plunged as the markets wondered whether the move to save those mortgage giants made it less likely that Lehman might be bailed out.

Sept. 10, the investment banker said that it would spin off a majority of its remaining commercial real estate holdings into a new public company. It also confirmed plans to sell a majority of its investment management division in a move expected to generate $3 billion. It also announced an expected loss of $3.9 billion, or $5.92 a share, in the third quarter after $5.6 billion in write-downs.

On weekend of Sept. 14, it was clear that it was do or die situation for Lehman. The Treasury had made clear that no bailout would be forthcoming. Federal officials encouraged other institutions to buy Lehman rather than proposing for any bail-out arrangements.

Lehman filed for bankruptcy Sept. 15. After this Barclays said it would buy Lehman's United States capital markets division for $1.75 billion, a bargained price. Nomura Holdings of Japan agreed to buy many of Lehman's assets in Europe, the Middle East and Asia. Lehman also said it would sell much of its money management business, including its prized Neuberger Berman asset management unit, to Bain Capital and Hellmann & Friedman for $2.15 billion.

This demise of Lehman set off tremors throughout the financial system. The uncertainty surrounding its transactions with banks and hedge funds exacerbated a crisis of confidence. In the wake of all these realities author has analyzed the financial statements of Lehman Bros. to examine whether this demise of Lehman was unwarranted or is the result of ignoring financial health barometers.

After analyzing the Financial Statements of Lehman Bros. for four consecutive years ending on November 30, 2004, November 30, 2005, November 30, 2006 and November 30, 2007 respectively the following inferences are drawn and some obvious questions are raised to the management of Company:

Inferences

1) If we look at the Net Operating Cash flow of the Company, for four consecutive years, it indicates the *sharp increase in the net operating cash outflow of the company by surprising 235.99%,* which clearly endorses the fact that company is making huge operating losses.

2) On the contrary, if we look at the *Net Investing Cash outflow of the company*, it indicates the *sharp increase of 219.77% from the 2004 figures*, which clarifies that company, has made huge payments irrespective of the continuous operating losses.

3) Another constituent of Cash flow Statement, i.e. Net Cash Flow from Financing Activities gives an entirely disturbing figure in terms of substantial increase in *Net Cash Inflow from Financing Activities by 318.21%.*

4) Another important aspect is of Cash Taxes Paid by the Company which involves the total cash involvement of USD 3940 million (638+789+1037+1476). The pertinent question comes, that if company is continuously incurring operating losses, then why it is making payment of Taxes to the Government, which they should not have paid.

We as an analyst raise the following observation to the Officials of Lehman Bros. Inc.:

1. Why cash Dividends of USD 1320 Million(258+302+342+418) were paid in spite of heavy operating losses ?

In my opinion it is nothing but payment of Dividends out of borrowings (instead of profits as there are no profits) which is a reflection of absurd behaviour of BOD validating their empty mind.

2. Why cash Taxes of USD 3940 million (i.e. 638+789+1037+1476) were paid in spite of heavy operating Losses ?

   The officials of Lehman Bros. should have asked the US Government to refund the TAX OF USD 3940 MILLION BEFORE FILING FOR BANKRUPTCY, as these taxes have been wrongly paid on capital rather than on income.

3. Why did Lehman Bros. resort to borrowings to finance its cash operating losses instead of taking appropriate measures to reduce operating losses?

   Such heavy losses would not have occurred and borrowings would not have increased , if the company officials would have shown due-diligence.

Conclusively, we can say that an overall analysis of Financial statements of Lehman Bros . indicates that the case of Lehman Bros,. is an open case of raising the borrowings to meet out the operating losses. In my opinion , the company should neither have paid the cash dividend nor Taxes by following the accounting Common sense. Not only Lehman Bros. any company which will follow these absurd practices will be bound to declare itself as insolvent. So, all that has happened with Lehman Bros is nothing but *a Naked Abrogation of liberties provided in Capitailism.*

Financial Statements of Lehman Bros.

This case leaves financial analysts, thinkers & Authorities with the following glaring and pertinent questions to be unfolded by them in the light of this unexpected financial masscre on Wall Street ,leaving all the authorities speechless.

Questions

1. *It's often quoted that when the US coughs, the world gets flu*, what will happen when the US gets flu such as this? What are the prospects for emerging market such as Asian Economies amidst all this? Will they stay insulated from this crisis?

2. How do you assess Fed's policies after the outbreak? What is your opinion about the role of Federal Bank?

3. What triggered this US sub prime crisis? Can you compare it to past crises such as the 80s crisis?

4. What is the lesson to be learned from this crisis, and what kind of precautions should be taken by developing vis-à-vis developed Economies?

Financial Statements of Lehman Bros.

In Millions of USD (except for per share items)	**12 months Ending Nov.'30 2007**	**12 months Ending Nov.'30 2006**	**12 months Ending Nov.'30 2005**	**12 months Ending Nov.'30 2004**
Net Income/Starting Line	4,192.00	4,007.00	3,260.00	2,369.00
Depreciation/Depletion	577.00	514.00	426.00	428.00
Amortization	-	-	-	-
Deferred Taxes	418.00	-60.00	-502.00	-74.00
Non-Cash Items	1,677.00	1,662.00	2,233.00	1,372.00
Changes in Working Capital	-52,459.00	-42,499.00	-17,622.00	-17,665.00
Cash from Operating Activities	**-45,595.00**	**-36,376.00**	**-12,205.00**	**-13,570.00**
Capital Expenditures	-966.00	-586.00	-409.00	-401.00
Other Investing Cash Flow Items, Total	-732.00	-206.00	-38.00	-130.00
Cash from Investing Activities	**-1,698.00**	**-792.00**	**-447.00**	**-531.00**
Financing Cash Flow Items	7,744.00	7,340.00	4,857.00	2,420.00
Total Cash Dividends Paid	-418.00	-342.00	-302.00	-258.00
Issuance (Retirement) of Stock, Net	-2,162.00	-2,041.00	-1,999.00	-734.00
Issuance (Retirement) of Debt, Net	43,428.00	33,298.00	9,556.00	10,191.00
Cash from Financing Activities	**48,592.00**	**38,255.00**	**12,112.00**	**11,619.00**
Foreign Exchange Effects	-	-	-	-
Net Change in Cash	**1,299.00**	**1,087.00**	**-540.00**	**-2,482.00**
Cash Interest Paid, Supplemental	39,454.00	28,684.00	17,893.00	9,534.00
Cash Taxes Paid, Supplemental	1,476.00	1,037.00	789.00	638.00

Source: ***http://finance.google.com/finance?fstype=bi&q=OTC:LEHMQ***