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GE under siege

For years GE Capital's profits powered its parent's earnings and helped finance its vast array of businesses. Now GE's biggest asset has turned into a liability that puts the future of the entire company at risk.

By [Geoffrey Colvin](#), senior editor at large, and [Katie Benner](#), writer
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(Fortune Magazine) -- When Warren Buffett went to bed at his Omaha home on the evening of Tuesday, Sept. 30, he asked his wife, Astrid, to wake him in the morning at 6:55 a.m. He had an important call coming in. By 7:30 the call was over. Buffett walked into the kitchen, still wearing an old robe he likes, and announced to a breakfast visitor that he had agreed to send General Electric \$3 billion of Berkshire Hathaway money in return for a new issue of preferred stock and warrants allowing Berkshire to buy an equal amount of common stock over the next five years.

It was the beginning of one of the more dramatic days in GE's 130-year history.

The deal was done, but the news wasn't yet out, and in the meantime GE's world was deteriorating fast. By 9:14 Eastern time, a GE spokesman had e-mailed the media with a message that Congress must act "urgently" on the pending financial bailout package. By 11 an analyst at Deutsche Bank had announced that he was sharply cutting his forecast for GE's 2008 profits - though only three months remained in 2008 - and the stock dropped 9% almost immediately. By 11:23 the price of credit default swaps - lenders' insurance - on the bonds of GE Capital had rocketed: The market was saying that the bonds of this great and storied company, one of only six corporations on planet Earth with a triple-A credit rating, were junk.

Finally, at 1:44 p.m., GE ([GE](#), [Fortune 500](#)) announced its deal with Buffett and said it would sell \$12 billion of common stock to the public the following day. The statement contained an important sentence from Buffett: "I am confident that GE will continue to be successful in the years to come." GE stock edged up - though by day's end it was still way down since the start of the year.

So here's what had just happened: General Electric had arranged to raise \$15 billion on a few days' notice. For perspective, remember that in March, Visa had culminated months of preparation by staging the largest stock offering ever, raising \$18 billion. In other words, GE needed a sudden, huge, and utterly unexpected emergency infusion of cash. Only six days before, when a Wall Street analyst had asked GE chief Jeff Immelt about the possibility of the company's selling new equity, Immelt had answered unequivocally: "We just don't see it right now. We feel very secure about how the funding looks."

The idea that GE might ever be desperate for cash would have seemed ludicrous a year ago and looked unworthy of concern even this past summer. After all, this is history's most famously well-managed company. But now the stock trades for less than half its price 12 months ago. More than \$200 billion of value has vaporized.

In its [most recent earnings announcement](#), on Oct. 10, GE said profits fell 22% in the third quarter, driven down by a 38% drop in earnings from financial services; profits there should continue to decline, the company said. GE remains highly profitable; analysts expect it to earn about \$20 billion this year, but that's 10% less than last year, a sharp change from earlier forecasts of robust growth. And for the first time in memory, investors are pricing GE at a level that indicates that they expect it to shrink rather than grow, a surreal situation.

Managing this crisis is certainly the sternest test Immelt has faced in his seven years as chief, and it may well become the episode that defines his legacy. Says Tom Priore, who runs the credit hedge fund ICP Structured Investments: "If you thought AIG was important, GE is many times a multiple of AIG." And now GE's future, like the economy's, looks as if it could tip either way.

The source of GE's strength - and its problems

To see how GE got so badly beaten up, consider first what the company really is. Its strength and curse is that it looks a lot like the economy. Over the decades GE's well-known manufacturing businesses - jet engines, locomotives, appliances, light bulbs - have shrunk as a proportion of the total. Like America, GE has long been mainly in the business of services. The most important and profitable services it offers are financial. In fact, though the average citizen probably thinks of GE as a great industrial company, its industry classification in the Fortune 500 is diversified financials. It is by far the largest company in that industry group. The next biggest - and here we begin to glimpse GE's troubles - are Fannie Mae ([FNM](#), [Fortune 500](#)) and Freddie Mac ([FRE](#), [Fortune 500](#)).

The reality is that for years, about half of GE's prodigious profits have come from General Electric Capital, a 100%-owned affiliate that files its own reports with the SEC. GE Capital, headed by 29-year GE veteran Michael Neal, has ventured into practically every kind of financial service, from making car loans in Europe to investing in commercial real estate in Florida. If you have a credit card from Wal-Mart or Lowe's, it's really from GE Capital. The business owns almost 1,800 commercial airplanes and leases them to 225 airlines. Until last year it made subprime mortgages in the U.S.

But GE Capital is more than just a major profit contributor to GE. The relationship is symbiotic. GE Capital helps GE by financing the customers that buy GE power turbines, jet engines, windmills, locomotives, and other products, offering low interest rates that competitors can't match. In the other direction, GE helps GE Capital by furnishing the reliable earnings and tangible assets that enable the whole company to maintain that triple-A credit rating, which is overwhelmingly important to GE's success. Company managers call it "sacred" and the "gold standard." Immelt says it's "incredibly important."

That rating lets GE Capital borrow funds in world markets at lower cost than any pure financial company. For example, Morgan Stanley's cost of capital is about 10.6% (as calculated by the EVA Advisers consulting firm). Citigroup's is about 8.4%. Even Buffett's Berkshire Hathaway ([BRKA](#), [Fortune 500](#)) has a capital cost of about 8%. But GE's cost is only 7.3%, and in businesses where hundredths of a percentage point make a big difference, that's an enormously valuable advantage. And thanks to the earnings strength of GE's industrial side, GE Capital can maintain its rating without holding much capital on its balance sheet.

GE Capital also performs another critical function: It helps GE manage earnings. Though earnings management is a no-no among good-governance types, the company has never denied doing it, and GE Capital is the perfect mechanism. Since financial assets are, under normal conditions, far more liquid than tangible assets, the company can buy or sell them in the final days of a quarter so that reported earnings rise with comforting smoothness, right in line with Wall Street expectations. Investors happily pay extra for companies whose profits rise steadily rather than erratically, so this function is valuable. Michael Lewitt, president of the hedge fund Harch Capital Management, says GE Capital "has become such a necessary part of GE's legendary earnings results that General Electric could not perform as well or consistently if anything happened to it."

The good times

For GE Capital, the business world from 2002 to 2006 was a nearly perfect environment. Executives Gary Wendt and Denis Nayden had aggressively globalized the business, and now all the major economies (and most of the minor ones) were growing simultaneously at healthy clips, an unprecedented occurrence. Interest rates were low. Every kind of asset seemed to be appreciating. For a big finance operation with low funding costs, opportunity was everywhere. During that period GE Capital levered up, growing its ratio of debt to equity from 6.6 to 8.1. Profits quadrupled to almost \$11 billion, more than the profits of Procter & Gamble or Goldman Sachs.

Good times never last forever, but GE is known for seeing changes ahead of time - recognizing early, for example, that it had to go "green" - and responding to them faster and more creatively than the competition. Last year, however, signs began turning up that this admirable pattern wasn't holding at GE Capital. For example, the company had left the home mortgage business in 2000 but reentered it in 2004 when it was flying high, buying a subprime lender called WMC Mortgage from a private equity firm (the price was never announced). Home prices peaked in June 2006, yet it wasn't until a year later, with the subprime crisis on the front page of every newspaper, that GE Capital finally decided to bail out. WMC lost almost \$1 billion in 2007 before GE dumped it in December. A Japanese consumer-lending company called Lake was another lousy business, but GE Capital again didn't face the music until it was too late. GE took a \$1.2 billion loss on it last year after deciding in September to sell it - but by then consumer credit was deteriorating so fast that unloading it (to Shinsei Bank) took another year.

This emerging pattern of confronting problems only after they could no longer be fixed was disturbing, but Immelt remained confident in GE Capital coming into this year. Despite its stumbles, GE has a long history of strict financial discipline. Immelt told shareholders in February, and repeated to employees recently, that GE had no exposure to collateralized debt obligations (CDOs) or structured investment vehicles (SIVs). It uses derivatives for hedging, which is relatively safe, but prohibits speculating in them, which is dangerous. It subjects its financial positions to shock tests - for example, assuming that interest rates rise a full percentage point across the board and stay there for a year; if that happened in 2008, Immelt said at the beginning of the year, GE's positions were so well hedged that the effect on profits would be negligible. His upbeat conclusion in February: "Our financial businesses should do well in a year like 2008."

That was more than just talk. In late 2007 and early 2008, Immelt spent about \$10 million of his own money buying GE stock at prices in the middle to upper 30s.

'Get a gun out'

Evidence that such optimism wasn't justified - and a hint of much bigger problems to come - finally arrived with a bang in April. That's when GE announced that first-quarter profits had fallen short of Wall Street's expectations by \$700 million, a mammoth miss that by GE standards is historic. It's what prompted former CEO Jack Welch to rant on CNBC that he'd "get a gun out and shoot [Immelt] if he doesn't make what he promised now" for following quarters.

Making matters worse, Immelt had assured investors only 18 days before the quarter's end that everything was on track. GE's just-released annual report was titled "Invest and Deliver," significant because inside GE "deliver" is a special word. You deliver on commitments - always. As Welch said on CNBC, "Just deliver the earnings. Tell them you're going to grow 12% and deliver 12%."

So Immelt committed the ultimate GE sin and failed to deliver. How come? That's easy. He reassured investors on March 13, and the quarter ended on March 31. But something unimagined happened in between: Bear Stearns failed, causing credit markets nationwide to freeze up. GE had been counting on GE Capital to do its usual end-of-quarter rescue act, but this time it couldn't.

Result? Uproar and a further slide in the stock. Investors felt betrayed and disillusioned. Analyst Nicholas Heymann of Sterne Agee spoke for many when he wrote: "Investors now understand that GE uses the last couple weeks in the quarter to 'fine-tune' its financial service portfolios to ensure its earnings objectives are achieved. It turns out it really wasn't miracle management systems or risk-control systems or even innovative brilliance. It was

the green curtain that allowed the magic to be consistently performed undetected."

GE under siege (pg. 2)

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Unhappily, the causes of that first-quarter debacle haven't disappeared. GE's managers, like everyone else, failed to foresee how bad things could get in today's vast, interlocking financial system. Managers thought they were being bold in stress-testing their model against a percentage-point jump in rates, but didn't conceive of a sudden and nearly complete stop to interbank lending, a total absence of buyers for some securitized debt, and investors so panicked they're willing to accept negative interest rates to gain the safety of T-bills. In that world even GE Capital's business model doesn't work the way it's supposed to.

Bad news piled up through the summer. GE had announced it would sell its businesses that make light bulbs, appliances, and certain electrical equipment (yes, the company founded by Thomas Edison wanted out of light bulbs); profits were piddling and unlikely to improve in these commodity-like businesses. But it was too late. In a slowing economy no one would pay a respectable price. GE also wanted to sell its private-label credit card business, but again - too late. In traumatized credit markets, no one wanted to buy \$30 billion of credit card receivables, much of which was owed by subprime borrowers, according to company statements. So GE is still stuck with those businesses.

The stock, which had been around \$40 a year ago, drifted down into the 20s over the summer before collapsing in mid-September as the financial crisis entered its acute phase with the failure of Lehman Brothers.

Desperation

Immelt, wanting to avoid another disastrous earnings surprise (and escape getting shot by Welch), announced five days before the quarter's end that profits would be lower than previously forecast by about \$700 million. Yet that's also when he set the stage for a different jolt to investors by saying he foresaw no need to sell new equity. Six days later he sold new equity.

The desperation of that move is even greater than its unseemly haste may suggest. Remember the importance GE attaches to acquiring low-cost capital. Equity is not low-cost - it's more expensive than debt - and the special preferred shares issued to Buffett carry a 10% coupon, which is paid out of after-tax profits. So that \$3 billion was about the most expensive capital it's possible to get. But Immelt, who has journeyed to Omaha for meetings with Buffett and has consulted him often, was willing to pay a steep price for the reassurance the famed investor's endorsement would bring. He and CFO Keith Sherin also agreed to hold at least 90% of their personal GE stock until Berkshire's preferred shares are redeemed (Immelt had long ago promised never to sell a share in any case).

There was further evidence of the company's dire state in the stock offering: Until late September, GE had been buying back its own shares on the open market. Last year it bought about \$14 billion of them and this year over \$1 billion, all at prices in the 30s. Now, just six days after suspending the repurchase program, it was selling \$12 billion of shares to the public at about \$22. That is, it was buying high and selling low.

Why was it so desperate for cash? The company offers only the blandest reasons for its move, but investors were clearly worried that commercial paper was an important factor. Commercial paper is how corporations borrow for short periods, typically just a few days, for immediate purposes; it's attractive because companies borrow only what they need, and interest rates are low. Lots of firms use commercial paper, frequently just for paying day-to-day bills, but no company uses it anything like GE. GE Capital alone has about \$74 billion of commercial paper outstanding; the next largest player, J.P. Morgan, has about \$47 billion. GE understood there was risk in relying so heavily on this source of funding but believed it was well prepared for any disruption through access to other sources, such as bank lines of credit.

On the morning of Oct. 1, the markets swirled with rumors that GE couldn't roll over its commercial paper coming due. Like so much else that has happened in recent weeks, this possibility would have seemed outlandish just a month before; a spokesman insists the company has experienced no such problems. But in light of GE's huge commercial paper obligations and the disruption of global credit markets, the rumors became just barely plausible. That's when the stock suddenly dropped 10%, and the price of GE credit default swaps jumped. Regardless of how realistic the market's fears were, the episode puts the Fed's decision five days later to backstop the commercial paper market in a new light, as a signal of support for the commercial paper market's biggest player.

What's next?

Which leaves GE where? All the bad news in its recently lowered full-year profit forecast is in GE Capital; its profits should fall by 20% to 25% from last year's. The other side of the company, the part most people think of when they think of GE, hasn't shown signs of deterioration, at least not yet. Power turbines, locomotives, jet engines, CT scanners - the world still wants lots of those, and the profits they produce at GE are still rising strongly. Of course, should the financial crisis spark a widespread recession, virtually all of GE would suffer.

What's not in doubt is that GE Capital will be changed profoundly by these events. Immelt has announced a goal of "resizing" GE Capital so that it accounts for just 40% of total GE earnings (down from 46% last year), but that may be making a virtue of necessity. It appears he'll reach his goal next year with no problem whatever. The company's big problem now is that investors just don't know how the galloping financial crisis will affect GE. For example, the company holds some \$53 billion of off-balance-sheet assets that are pieces of securitized debt, some of which are hooked to interest rate swaps with counterparties that are now troubled, such as ABN Amro, owned by Fortis and RBS Group. Individually, none of those is enough to cause a major problem. But investors are justifiably spooked by the poorly understood web of connections interlocking global financial firms, which have caused such havoc over the past month, and they're unsure how GE might ultimately be affected.

Another example: GE Capital says that some of the debt it holds is extra-safe because it's covered by credit insurance. But in today's environment, how reliable are the credit insurers?

Investors worry also because GE Capital oversees one of the world's largest commercial real estate portfolios. Tom Shapiro of GoldenTree InSite Partners, a real estate investment firm, says commercial property values have declined 10% to 20% in some regions and are still falling. In addition, GE's portfolio includes residential-mortgage-backed securities, some with subprime exposure, for which there's virtually no market now. More uncertainty for investors.

Another concern is that the leverage in GE could be much higher than stated. Egan-Jones, an independent rating agency, calculates that GE is levered ten-to-one, a more conservative and higher number than the company's eight-to-one figure. Cofounder Sean Egan believes that, depending on the off-balance-sheet holdings, actual leverage could be still higher. His firm rates the company single-A.

In addressing these many uncertainties, Immelt has hammered home the message of GE's commitment to its sacred triple-A rating. He took several steps to conserve capital, such as deciding not to increase the dividend next year and suspending the stock buybacks; Moody's (in which Buffett's Berkshire Hathaway is the largest shareholder) and Standard & Poor's immediately reaffirmed their ratings on the company.

But Immelt may be fighting a battle that investors no longer care so much about. The credibility of bond ratings in general tumbled when it was revealed that securitized subprime mortgages had been rated double- or triple-A. GE's rating clearly meant nothing to investors who bid credit default swaps on company bonds up to a price of 700 basis points (the price subsided recently to about 500). Remember, triple-A means creditworthiness on a par with that of the U.S. Treasury, and credit default swaps on Treasury bonds have never traded above 35 basis points. The message of the markets: The rating agencies can say what they like; we'll decide for ourselves.

Recent events raise the question of whether Immelt's job is safe. The stock is down by half since he took over in September 2001, one reason the company has lost a number of excellent executives. A source close to the board says it still supports him, and he has done a good job of involving directors in major decisions. They regard the

present crisis as a 100-year flood that Immelt is managing about as well as anybody could.

He may take solace in the story of Reg Jones, GE's chief from 1972 to 1981. The stock, adjusted for inflation, went nowhere during his tenure. But it was a terrible era for stocks generally, and just before he retired, Fortune asked the Fortune 500 CEOs to name the company and the CEO they admired most. The winners were GE and Jones.

Whether Immelt and GE can ride out the current crisis with their reputations intact is unknowable at the moment. But given that the company is a microcosm of the world's economic health, we'd all better hope that they can. ■

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