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Lehman shares rise as earnings beat forecasts

By Riley McDermid, MarketWatch
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NEW YORK (MarketWatch) - Lehman Brothers Holdings Inc. shares leaped by more than a third Tuesday as investors digested better-than-expected earnings for the first quarter, hoping the news could allay recent market speculation that the securities firm could be next on the chopping block.

Lehman reported Tuesday that it had net income or $489 million, or 81 cents a share, for the quarter ended Feb. 29, beating analyst estimates of earnings of 72 cents a share. But the broker's first-quarter net income dropped 57% as the firm was slammed by mark-to-market adjustment of $1.8 billion.

"The quarter was better than investors' worst-case fears. Revenue from all business lines exceeded our expectations, with the exception of financial advisory," said Goldman Sachs analyst William Tanona Monday. "[Lehman]'s positive results are likely to drive the stock significantly higher this morning."

Lehman shares were up almost 37% in midday trading Tuesday, above $43 a share, after trading as low as $20.25 on Monday amid speculation the company could be the next bank to face a federal bailout and acquisition by a larger competitor.

The decline Monday, about 19% at the close, was the biggest one-day drop in the firm's shares since it went public in 1994, and reflected just how nervous investors are after being rattled by an 11th-hour bailout of Bear Stearns.

And Lehman may not be the only bank to be worrying Wall Street: market players released opinions Tuesday that although Lehman remains pressured, investment bank Merrill Lynch may be a riskier bet.

"[Merrill] is the riskiest of the remaining monoline banks," Wachovia Securities analyst Douglas Sipkin wrote in a research note, citing Merrill's gross subprime mortgage exposure of $30.4 billion as more than three times as large as its nearest competitors.

"[Merrill] also had the worst liquidity ratio at 52% compared to [Goldman Sachs] and [Lehman] and now has the highest leverage in the industry at 31.9 times," Wachovia said.

The roller-coaster ride experienced by Lehman showed how volatile the market can be when innuendo and speculation decides the fate of liquidity, a major worry just days after the storied Bear Stearns (BSC) was taken down.

Those fears, however, may be overblown--at least in Lehman's case.

"Just commenting on it seems to give it more credence," said Samuel Hayes, the Jacob H. Schiff professor of investment banking, emeritus, at Harvard Business School. "It's not clear whether Lehman is in trouble, but I don't think there's a fire there."

Investor confidence may be shaken by recent ratings actions, however. Although Deutsche Bank maintained its "buy" rating on the stock, Moody's Investors Service trimmed its outlook on the investment bank's debt rating, heightening concerns about liquidity and UBS also downgraded Lehman to neutral.

But investors should take heart in what is being seen as a commitment by the Federal Reserve to prop up struggling markets, some analysts said Tuesday.

"The Federal Reserve has promised to provide whatever funding that may be required to keep primary dealers liquid," Punk Ziegel analyst Dick Bove said Tuesday. "To assume that Lehman would fail means that one assumes the Fed will not or cannot honor its commitments. This is a bad bet to make."

Still, despite the Fed's public display of support for the troubled investment banking system, what comes next for Lehman will be determined entirely by market forces.

"Similar to Bear Stearns, the greatest risk for Lehman Brothers is the risk that once speculation begins, it becomes a self-fulfilling prophecy, and no level of liquidity will be sufficient," BMO Capital Markets analyst George Lazarevski told investors Monday.