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Citadel Wades Into Credit Crisis With E*Trade Deal (Update2)

By Jenny Strasburg - Nov 29, 2007

Nov. 29 (Bloomberg) -- Citadel Investment Group LLC, the hedge-fund manager run by Kenneth Griffin, is increasing its bets on the credit market as losses leave more companies seeking financial rescue.

Citadel today pumped $2.55 billion into E*Trade Financial Corp., whose holdings of home loans and asset-backed securities caused customers to pull their cash from the online bank and brokerage. Citadel, which oversees $17 billion, took a 17 percent stake in New York-based E*Trade and bought about $800 million of securities linked to residential and commercial mortgages for 27 cents on the dollar.

E*Trade's debt holdings fell in value after the world's largest banks including Citigroup Inc. and Merrill Lynch & Co. wrote down more than $50 billion in trading losses and bad loans. As Wall Street firms cut about 10,000 jobs, Citadel is hunting for distressed assets it can buy and hold until the prices rise.

``We stepped in to buy the piece of the business that causes angst'' for investors and customers, Joe Russell, head of Chicago-based Citadel's U.S. and European credit business, said in a telephone interview. ``By removing this issue and showing that as one of the largest stock and bondholders we're stepping up to the plate, we're making a statement.''

Sowood Collapse

Griffin, 39, has profited this year after finding bargains amid the failure of others. In July, Citadel acquired most of the assets of Sowood Capital Management LP after the Boston-based hedge-fund firm lost $1.5 billion, one of the first victims of a credit squeeze triggered by rising defaults of mortgages to homebuyers with poor credit histories.

Citadel paid $180 million in a bankruptcy auction in June for the assets of subprime lender ResMae Mortgage Corp., including a $160 million pool of loans sold for 98 cents on the dollar.

Last year, Citadel and JPMorgan Chase & Co. took over the energy trades of Amaranth Advisors

LLC after the Greenwich, Connecticut-based hedge fund lost a record $6.6 billion on wrong- way natural-gas bets. In August, Citadel also bought assets controlled by Sentinel Management Group Inc. after the cash- management company based in the Chicago suburb of Northbrook, Illinois froze client withdrawals.

Citadel's funds have gained 27 percent this year, helped by investments in stocks, convertible bonds and emerging markets. Hedge funds globally returned an average of 12 percent through October as the S&P 500 advanced 10.8 percent, according to Chicago-based Hedge Fund Research Inc.

`Bottom-Feeding'

``You're seeing a lot of bottom-feeding from Citadel and other hedge funds who are raising enormous sums to buy these distressed assets,'' said Ross Intelisano, a lawyer who specializes in hedge funds at New York-based Rich & Intelisano LLP. ``Citadel isn't afraid of these risks, as hedge funds and the private-equity firms have become the lenders of last resort in this environment.''

The E*Trade transaction diluted existing shareholders' stake by more than 40 percent, Bank of America analyst Michael Hecht wrote today in a report titled ``Christmas Comes Early for Citadel, Existing Shareholders Get a Lump of Coal.''

``Citadel is the clear winner in this transaction,'' said Hecht, who has a ``neutral'' rating on E*Trade shares.

The mortgage-backed securities Citadel got for $800 million are worth more than that, said Jaime Peters, an analyst at Morningstar Inc. in Chicago who covers E*Trade and doesn't have a rating on the stock. The securities have a face value of $3 billion.

Asset-Backed Holdings

``It would take such gross charge-offs and people defaulting'' for the securities to decline to that value, Peters said in an interview today. ``Citadel has the power to hold these things until they play out.''

Of the asset-backed securities Citadel bought, $2.6 billion, or 84 percent, had an A rating or higher as of Sept. 30, according to an Oct. 17 disclosure report from E*Trade. Non-rated securities and those below investment grade together made up $46 million, or 0.3 percent, of the asset-backed holdings, the company said. Some investment-grade securities have declined in value as losses from mortgage defaults and investors' distaste for leveraged-buyout debt spread to broader credit and equities markets.

The assets Citadel bought from Sowood and Sentinel have performed ``very well,'' Russell said, declining to provide figures. ``We created great opportunities for our investors, and we solved problems that others couldn't at the time.''

CEO Steps Down

E*Trade, the fourth-largest discount brokerage by assets, is ``extremely valuable'' as an online brokerage, Russell said. ``It was about a broken balance sheet, not a broken business. This is what makes great investment opportunities.''

E*Trade's chief executive officer since 2003, Mitchell Caplan, stepped down and Chief Operating Officer Jarrett Lilien took over as acting CEO, the company said today in a statement. Caplan, who joined E*Trade in 2000, oversaw the company's strategy of boosting revenue by expanding its loan business, a tact that failed as mortgage borrowers defaulted.

Prashant Bhatia, a Citigroup Inc. analyst, said earlier this month that E*Trade faced a 15 percent chance it would be forced to seek protection from creditors. Customers pulled about $6 billion, or 15 percent, of the cash held in E*Trade accounts since September, Lilien said today in an interview.

Griffin started Citadel in 1990 with less than $5 million. The firm's assets can be invested in everything from stocks and bonds to foreign currency and natural gas.

Citadel returned more than 30 percent last year while hedge funds globally gained 13 percent on average, according to data compiled by Hedge Fund Research Inc.

Hedge funds are private, largely unregulated pools of capital whose managers can buy or sell any assets and participate substantially in profits from money invested.

To contact the reporter on this story: Jenny Strasburg in New York at jstrasburg@bloomberg.net

To contact the editor responsible for this story: Larry Edelman at ledelman3@bloomberg.net

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