

Investment Banking in Europe - The Quest for the Holy Grail

September 2000



Freeman & Co.

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- *Performance Improvement Consulting*
- *Strategic Advisory and M&A Services*
- *Compensation and Incentive Plans*

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I. Executive Summary

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IV. How do the US Bulge Bracket Firms do it?

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VI. Outlook for European Boutique Investment Banks

VII. Conclusion

I. Executive Summary

- Geographic fees percentage mix has moved from 70:30 (US:Europe) to 60:40 in two years.
- This trend will continue through the substitution of capital markets activities for the extremely high bank loan base in Europe.
- Capital markets activities will be further supported by the demand for new securities from the high growth of assets by institutional investment management.
- European investment banking has received so much focus that several US bulge bracket firms have relocated many key decision makers and producers to Europe.
- The Top Three US firms (Goldman Sachs, Merrill Lynch and Morgan Stanley) made an early commitment and now dominate Europe.
- The next five US investment banks are spending heavily to catch up through acquisitions and aggressive builds.
- The available talent pool in Europe is thin. Many US firms are recruiting abroad and are sending senior management to run groups globally out of London.

I. Executive Summary

- Several European acquisitions have been made by US investment banks:
 - SSB - Schroders
 - Chase - Flemings
 - Merrill Lynch - Smith New Court
- The European build-up has become very expensive in terms of infrastructure and recruiting, making late entry extremely expensive.

Is this costly battle for market share worth it?

How to emerge a winner?

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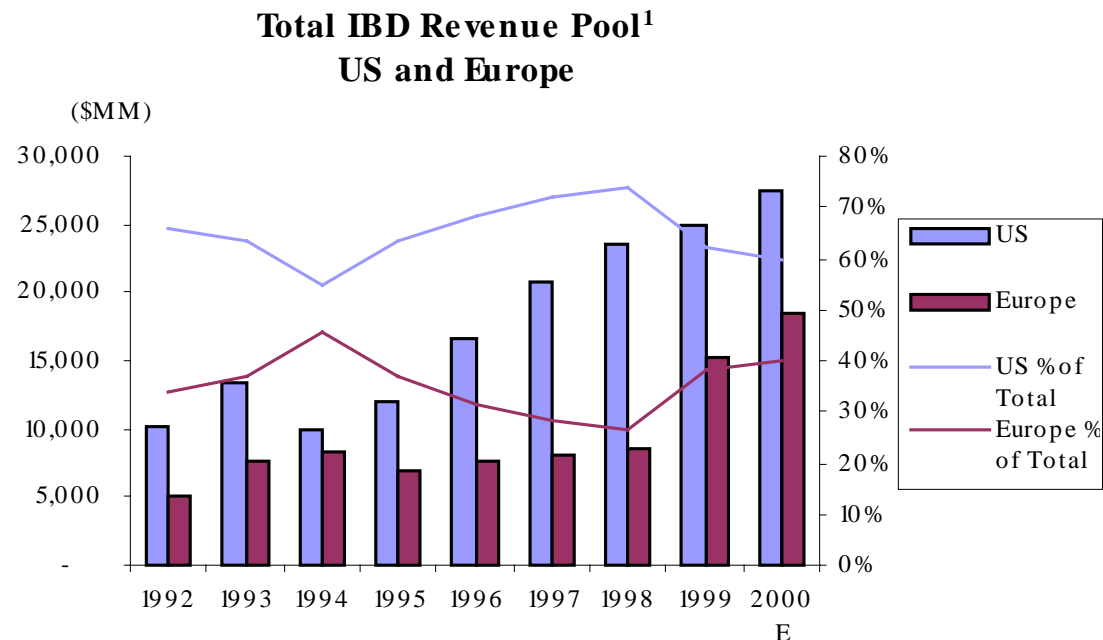
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II. Overview of the European Capital Market

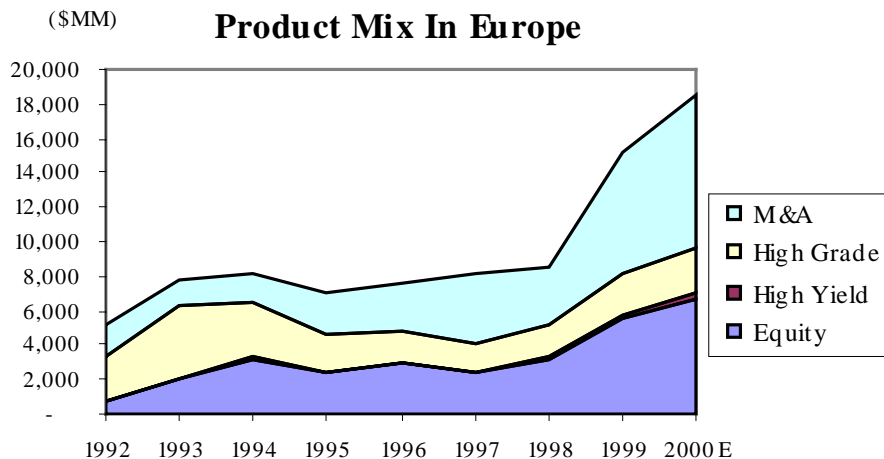
- Over the last four years, investment banking revenues in Europe have been growing at a CAGR of 32% as compared to 10% in the US.
- Geographic fees percentage mix have shifted from 70:30 (US:Europe) to 60:40 in 2 years.
- The formation of the European Monetary Union is spawning capital markets to rival the US leadership and predominance among the world capital markets.



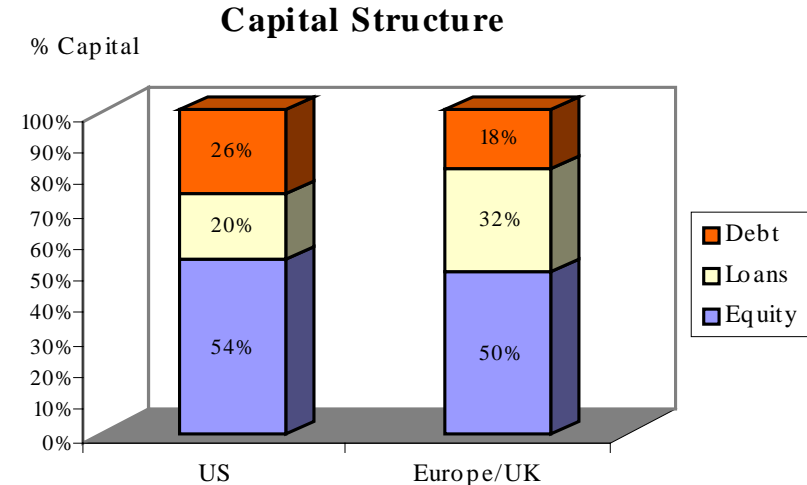
*1: Includes Equity and Equity linked, High Yield, High Grade and M&A
Source: Thomson Financial and Freeman & Co. Estimates*

II. Overview of the European Capital Market

- European corporations hold 60% more loans in their capital structure than US firms.
- With the creation of a single EU market, firms face Pan-European competition. In addition, shareholders are expecting higher returns on equity.
- In response to these pressures, firms will be forced to gain market position, more efficient operations and capital structure.
- This translates to greater M&A and financing activities in the capital markets, shifting the focus away from traditional bank loans.



Source: Thomson Financial and Freeman & Co. Estimates

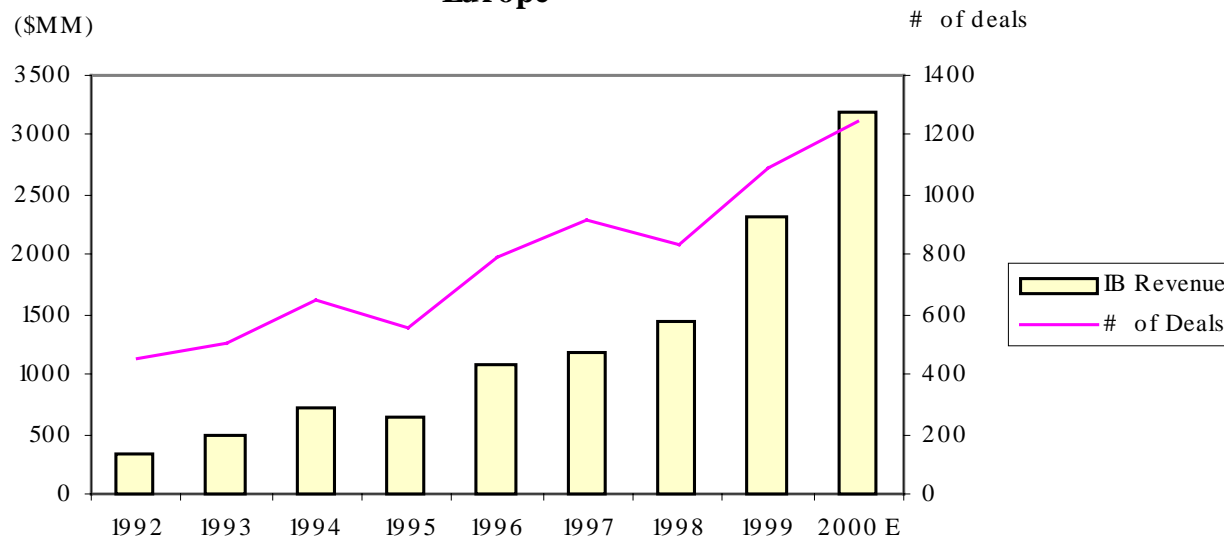


Source: OECD, Merrill Lynch

II. Overview of the European Capital Market

- 23% of the investment banking revenue generated from Europe in 2000 involved cross border deals with the US.
- Compared to 1992, this represents an eight-fold increase, in capital raising and acquisitions activities.

Total IB Revenue and # of Deals From Cross Border Deals In Europe

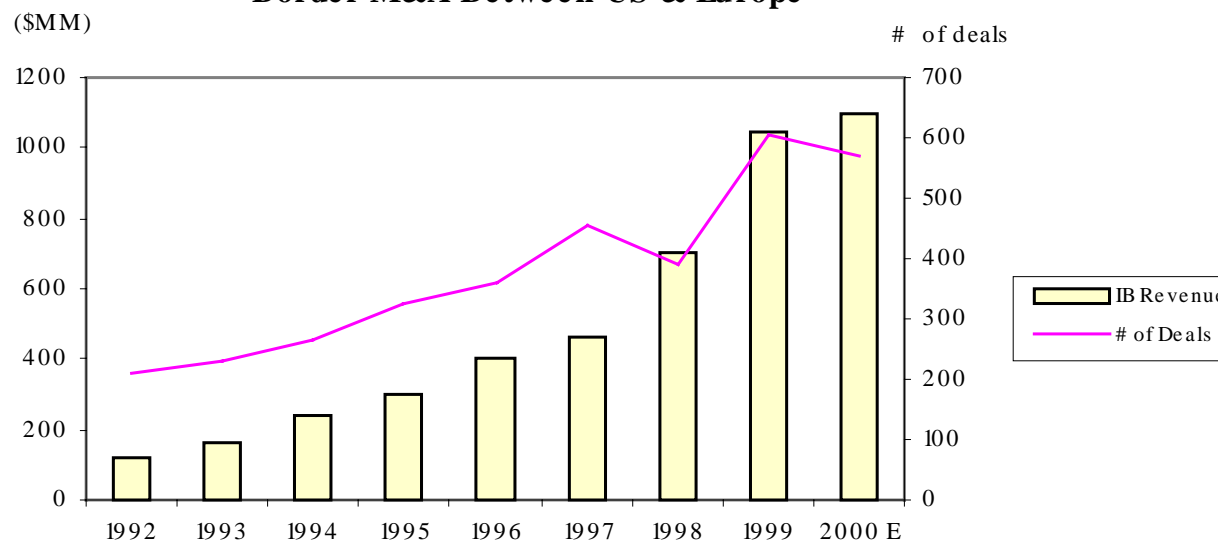


Source: Thomson Financial and Freeman & Co. Estimates

II. Overview of the European Capital Market

- Cross border M&A is increasing at a rapid pace, both in terms of number and size of deals.
- Most of these transactions involved European acquirers buying US targets, despite the higher P/E in the US and the weakening Euro.
- Historical fragmentation of the European banking system makes industrial logic but is hindered by political difficulties.
- Until recently only US investment banks took a Pan-European approach - a major reason for the rise of the Top Three (GS, ML and MSDW).

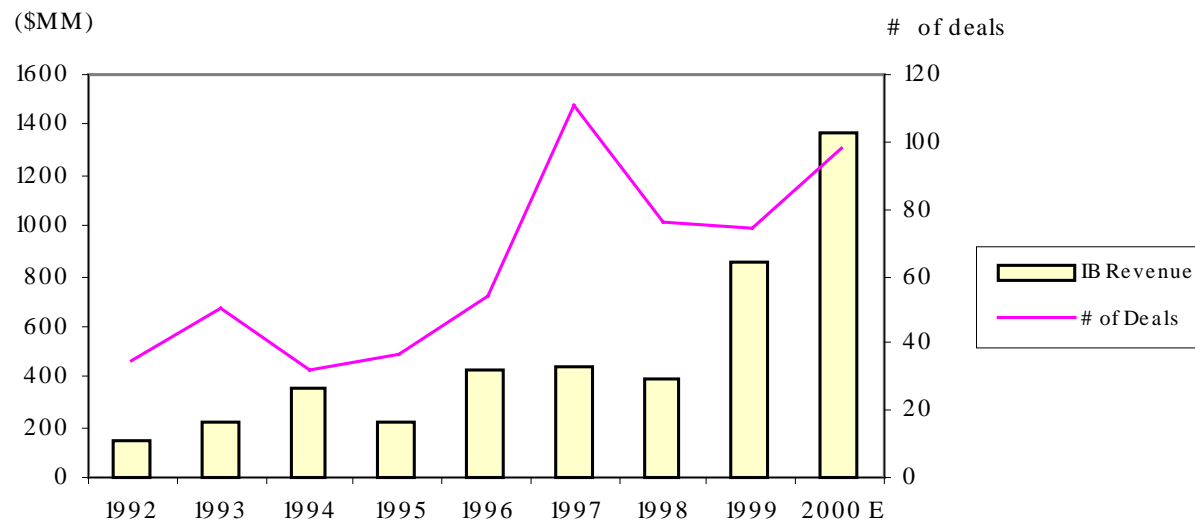
Total IB Revenue and # of Deals In Europe Involving Cross Border M&A Between US & Europe



II. Overview of the European Capital Market

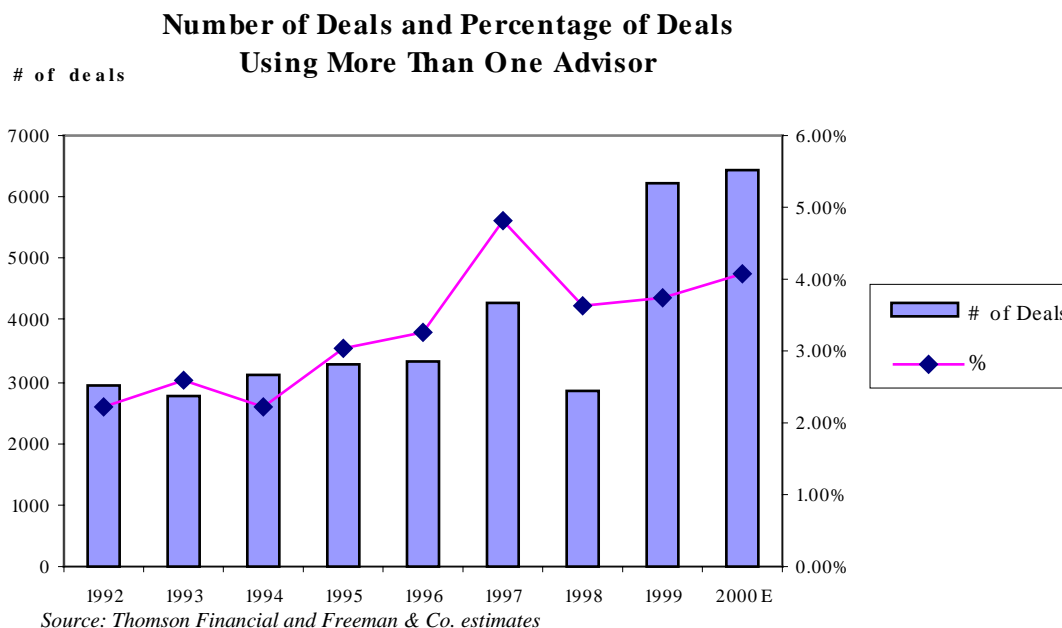
- Although the volume of fees generated from distributing European equity into the US equity market has increased, the number of deals has decreased compared to 1997.
- Most European companies doing medium to small-sized deals are seeking listing in Europe. Larger deals are still distributed in the US.
- This implies that the European equity capital markets are reaching levels of liquidity and interest similar to the US.

Total IB Revenue and # of Deals In Europe Involving European Equity Distributed into US



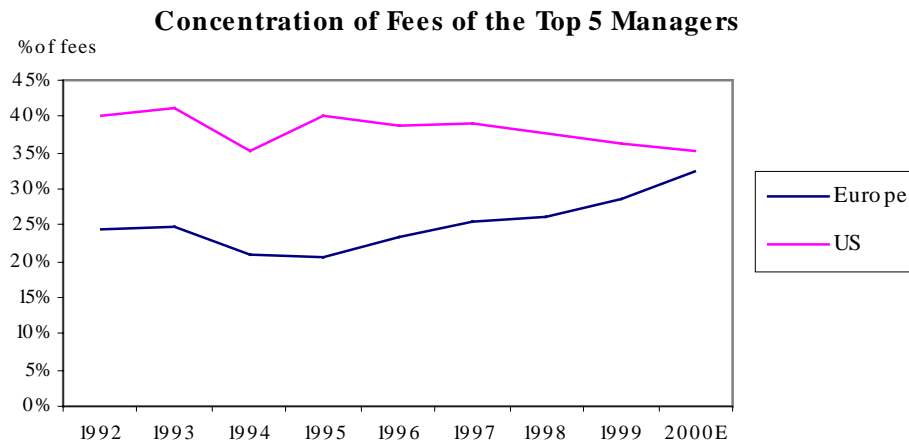
II. Overview of the European Capital Market

- There is a growing trend for European companies seeking M&A to use more advisors in M&A assignments than they had in the past.
- US investment banks are typically used for their M&A expertise, while additional European banks are brought in for their lending or historic relationships.
- Freeman & Co. believes that this trend will converge as top US investment banks and European super banks consolidate their position, using their balance sheets to elbow local players out of the deals.



II. Overview of the European Capital Market

- The concentration of fees among the top five players in the US and Europe is converging.
- The Top Three Players who dominate in the US are the same three firms which now dominate in Europe.
- Global presence is a prerequisite to be a successful Top Five Player in any one geography, given the global nature of many businesses.
- This is especially the case for investment banks focusing on Media, Telecom, Technology, Banks and Insurance.



Source: Thomson Financial and Freeman & Co. estimates

Top 5 Investment Bank in 2000

Europe		US		
Rank	Firms	Mkt Shr %	Firms	Mkt Shr %
1.	Goldman, Sachs	8%	Goldman, Sachs	8%
2.	MSDW	7%	Merrill Lynch	7%
3.	Merrill Lynch	6%	MSDW	7%
4.	Deutsche Bank	6%	CSFB	7%
5.	UBS Warburg	5%	SSB	7%

Top 5 Investment Bank in 1996

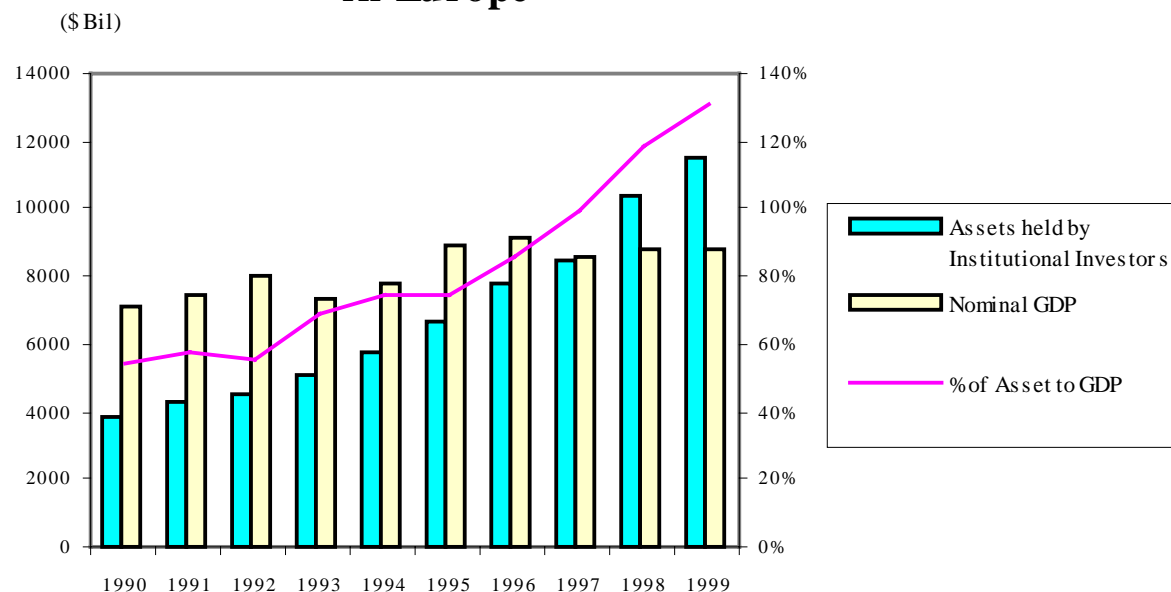
Europe		US		
Rank	Firms	Mkt Shr %	Firms	Mkt Shr %
1.	UBS Warburg	7%	SSB	11%
2.	MSDW	4%	Merrill Lynch	8%
3.	Deutsche Bank	4%	MSDW	8%
4.	Merrill Lynch	4%	Goldman, Sachs	7%
5.	Dresdner	4%	Lehman	5%

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III. Revenue Growth Potential in Europe

- Growth of institutional assets in Europe has dramatically outpaced the growth of GDP. This is the beginning of an important trend similar to the US in the 1980's and 1990's.
- The amount of assets flowing to institutional investors signals a change in the investment climate in Europe. This change would increase the liquidity pool and demand for investment vehicles, particularly for equity products.

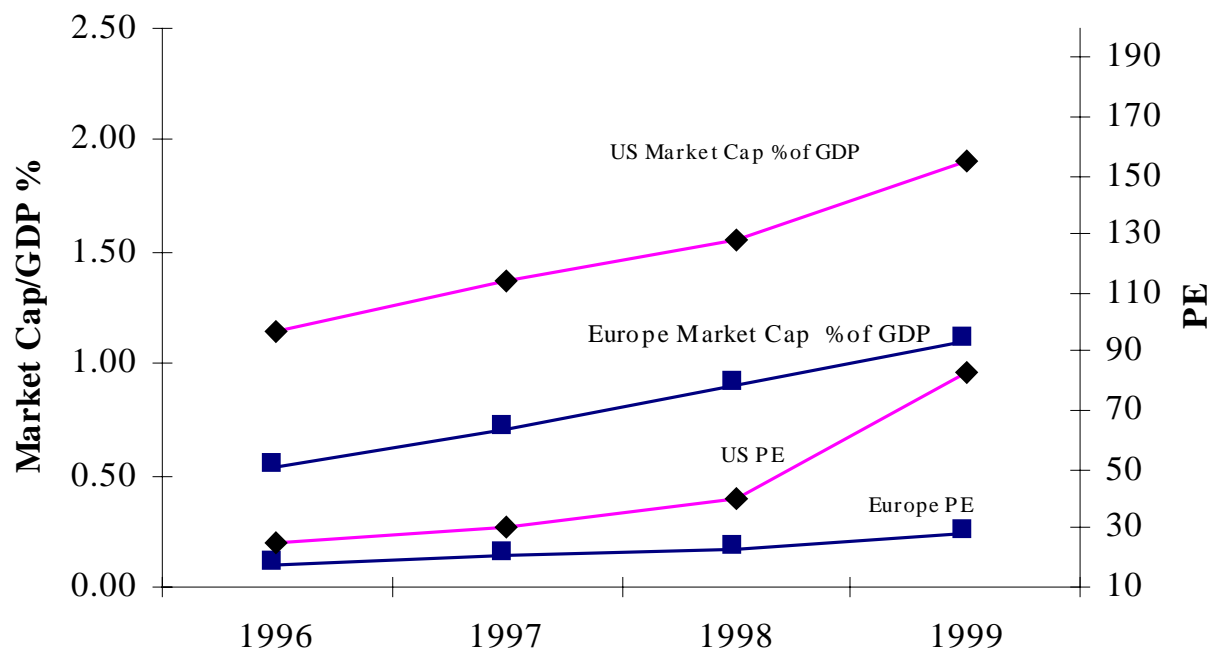
**Growth of Institutional Assets
in Europe**



Source: OECD and Freeman & Co. estimates

III. Revenue Growth Potential in Europe

- Europe's GDP is 94% of US GDP, but EU market capitalization is only 54% of the US.
- As European investors increase their appetite for equity products and issuers seek more funding in the European capital markets, European market cap as a percentage of GDP may eventually increase to a level similar to the US.



Source: EIU, Euromoney and Freeman & Co. estimates

III. Revenue Growth Potential in Europe

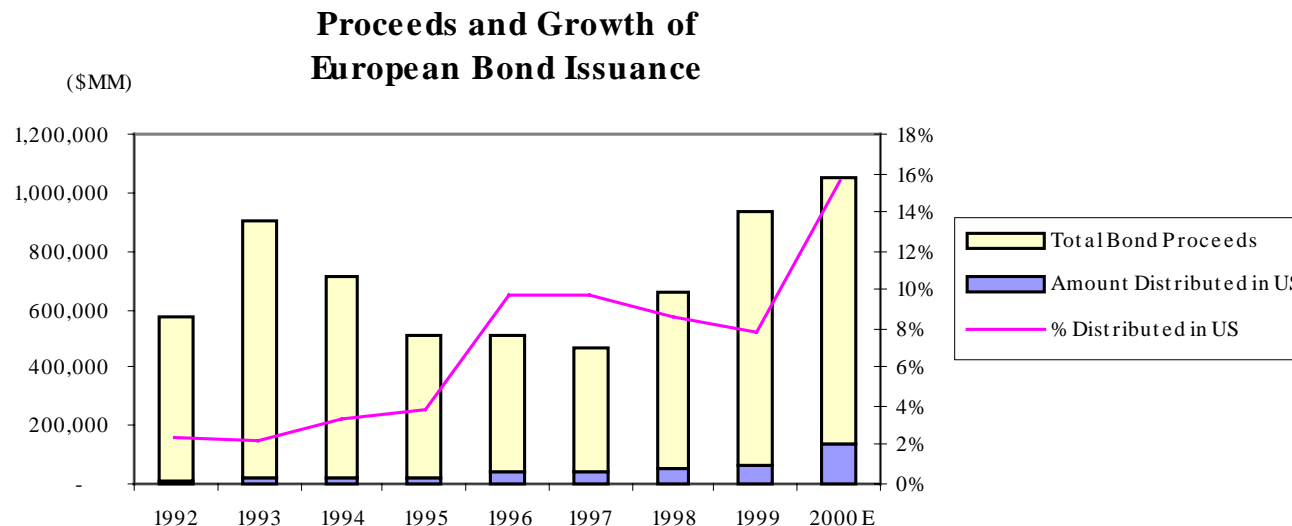
- Assuming 1.5% growth in GDP in the next three years and a four year lag in the European capital market compared to that of the US, \$4.5 trillion of additional market capitalization will be created by 2002, of which \$913 billion will come from new issues or secondary offerings.
- This would translate to approximately \$27 billion in equity underwriting revenue in the next three years.

	Market Cap % of GDP		P/E		Nominal GDP (\$ Bil)		Market Cap (\$ Bil)	
	US	Europe	US	Europe	US	Europe	US	Europe
1996	114%	53%	25.0	16.5	\$7,813	\$9,077	\$8,939	\$4,840
1997	137%	71%	30.0	20.2	\$8,301	\$8,512	\$11,410	\$6,057
1998	155%	91%	39.8	22.7	\$8,760	\$8,770	\$13,606	\$7,978
1999	191%	110%	82.7	29.0	\$9,256	\$8,744	\$17,643	\$9,608
2002 E	NA	155%	NA	39.8	NA	\$9,144	NA	\$14,127

Market Cap Creation in 2002	\$4,520
Mkt Cap Resulting from:	
Change in P/E	\$3,606
New Equity Offering	\$913
Spread on Equity	3%
IB Revenues to Street	\$27 Billion

III. Revenue Growth Potential in Europe

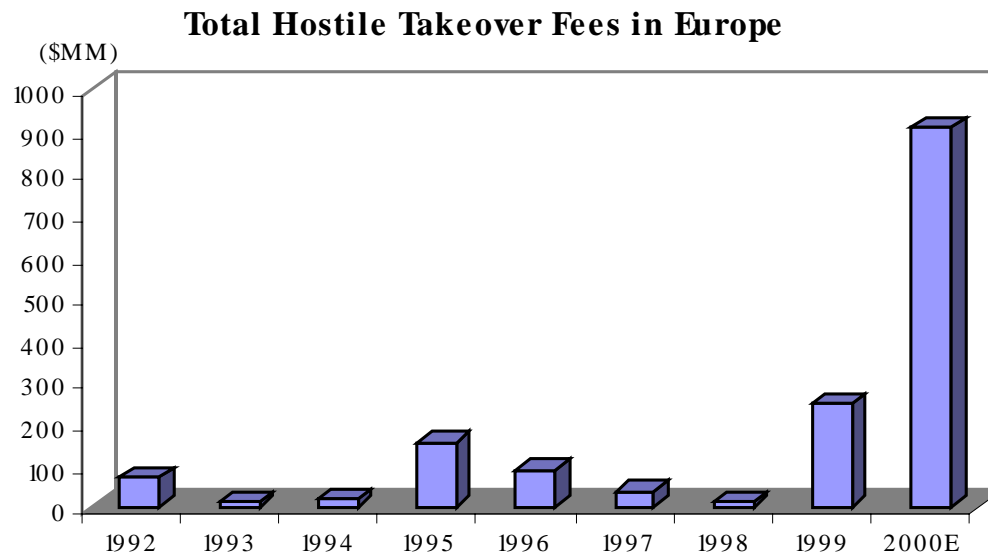
- The value of corporate bonds outstanding as a percentage of GDP is approximately 5% in Europe versus 29% in the US.
- The primary European corporate bond market (high yield and high grade) has grown at a CAGR of 11% since 1996, of which an increasing amount is distributed in the US debt market. Europe must and will grow its debt capital markets.
- With a single currency in Europe, there will be more liquidity in the debt capital market further promoting investors appetite for fixed income products in Europe.



Source: Thomson Financial and Freeman & Co. estimates

III. Revenue Growth Potential in Europe

- Corporations and investment banks in the US have already lived through the frenzied days of leveraged buyouts.
- The formation of EU is forcing European firms to go through a similar capital restructuring in a shorter time frame.
- This opens a window of opportunity for US investment banks and European super banks, who have expertise in this area which may include hostile deals.



Source: Thomson Financial and Freeman & Co. estimates

III. Revenue Growth Potential in Europe

- The average size of public companies in Europe is 40% smaller than that of US.
- Of the Fortune 500 global companies, 31% are European vs. 37% US.
- European industries are still more fragmented than in the US.

Year	US		Europe	
	# of Companies	Ave. Mkt Cap (\$ MM)	# of Companies	Ave. Mkt Cap (\$ MM)
1996	9,214	\$970	6,511	\$743
1997	9,305	\$1,226	6,821	\$888
1998	9,492	\$1,433	7,092	\$1,125
1999	9,052	\$1,949	8,229	\$1,168

Source: EIU, Euromoney and Freeman & Co. estimates

	Global Fortune 500 by Revenue	
	# of Co.	%
US	183	37%
Europe	153	31%
Other	164	33%
	500	100%

Source: Fortune

III. Revenue Growth Potential in Europe

- In summary, increased European investment banking revenues will likely continue at an exponential rate due to:
 1. Change in investment climate in Europe - With more assets under institutional management, demand for investment products will increase.
 2. Change in capital market structure - With a more competitive environment, companies are able to seek financing through the capital market. This will provide new investment opportunities for investors and profit opportunities for investment banks.
 3. Consolidation of markets as geographic and regulatory boundaries break down - This will force companies to expand through acquisition. Consolidation across industries is likely to continue.
 4. Consolidation of competitors - Top US investment banks and European super banks will squeeze out local competition.

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IV. How do the US Bulge Bracket Firms do it?

“There is no question that capital will be used as an incremental marketing tool.”

John Studzinski, Head of European Investment Banking
Morgan Stanley
Financial Times, August 18, 2000.

IV. How do the US Bulge Bracket Firms do it?

- Most European investment banks have used their country of origin as their unique strength.
- It is commonly believed that the successful penetration of the European market by the US bulge bracket firms was due to their transactional expertise versus the regional expertise of European investment banks.
- US firms had no “local Franchise” and went to the Pan-European industry platform because:
 1. US firms are comfortable with an industry coverage model
 2. The lack of regional relationships put US firms at a disadvantage
 3. Intensive country coverage is too expensive
 4. Country coverage tends to lead to more employees of mediocre quality

IV. How do the US Bulge Bracket Firms do it?

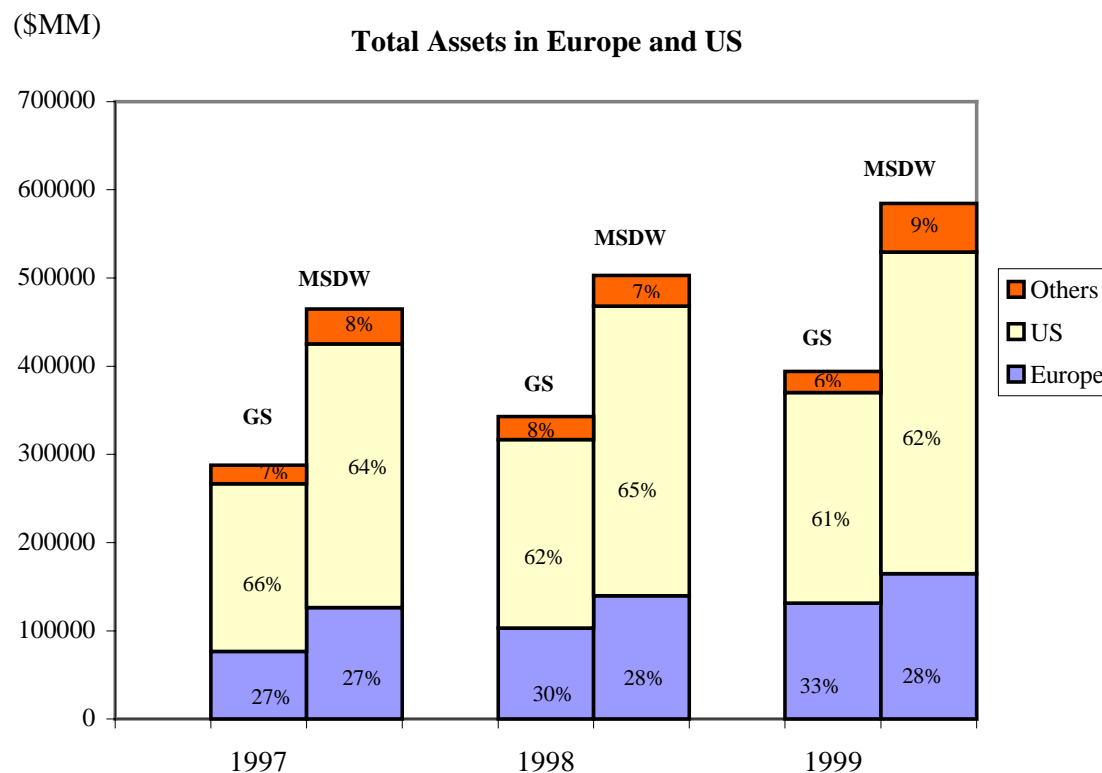
- The successful European market penetration by US investment banks is due to the following reasons:
 1. The US capital markets are the largest thus offering US investment banks an advantage in product and distribution, transaction experience, industry-based league table leadership, and a large fee pool
 2. Because of (1), US investment banks have been at the center of innovation and product expertise
 3. The Pan-European industry franchise creates the best business platform for today and in the future
 4. Many of the best European investment banking franchises are buried in large commercial banks and diversified financial institutions. Until now, the management of those combines have not been led by entrepreneurial investment bankers
 5. The balance of power will change if and when a European super bank commits to a global investment banking platform led by high quality investment bankers

IV. How do the US Bulge Bracket Firms do it?

- Operationally, this is achieved through:
 1. Retention of personnel at all levels through equity, merchant banking and high cash pay. These firms have high ROEs and need to use it to pay key employees
 2. Institutionalized client relationships through disciplined client calling efforts and exacting prioritization systems
 3. High profile industry franchises built by disciplined alignment of Investment Banking, Research and Sales & Trading
 4. Mobility of top management and development of global industry and product teams
 5. Innovative product expertise used in both client transactions and in proprietary trading and private equity profitability
 6. Smart and aggressive hiring over decades
 7. Commitment of balance sheet (next page)

IV. How do the US Bulge Bracket Firms do it?

- Two of the major US bulge bracket firms, Goldman, Sachs and Morgan Stanley are committing an increasing percentage of assets to Europe, demonstrating their willingness to use their balance sheets.



Source: Company annual reports
 Note: Merrill Lynch asset breakdown is not available

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V. Outlook for Large European Investment Banks

“The order of the leading firms in Europe is far from fixed and there isn’t a firmthat’s not targeting Europe as the key battleground”

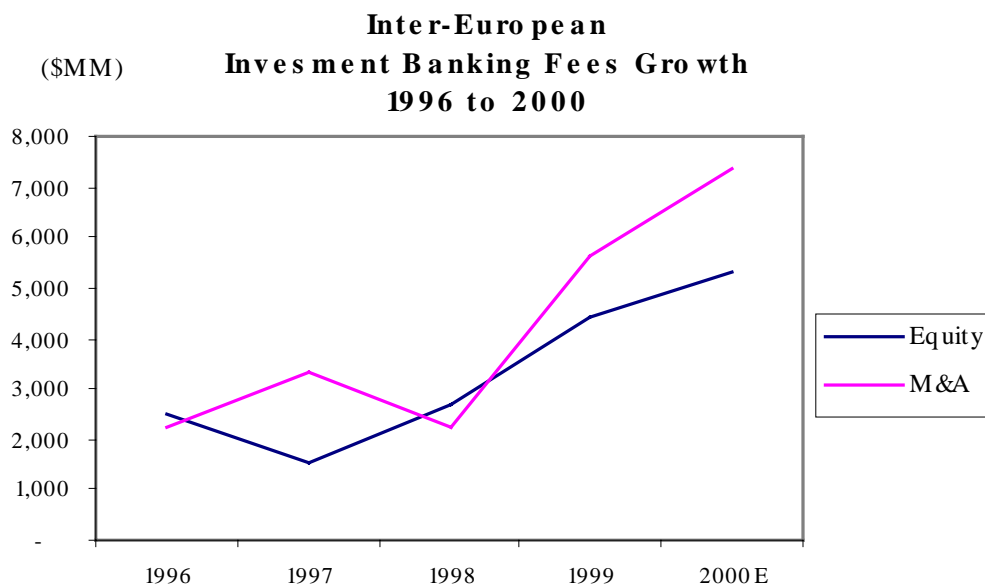
*Grant Kvalheim, Global Head of Debt Capital Market
Deutsche Bank
Financial Times, August 18, 2000.*

“There is going to be a European bulge, as in the US..... Unfortunately, unlike in the US, the Europeans won’t totally dominate Europe by themselves”

*Andrew Pisker, Head of Bonds
BNP Paribas Group
Euromoney, February, 2000.*

V. Outlook for Large European Investment Banks

- Freeman & Co. views large European investment banks as having substantial international presence and operations across Europe.
- Fees generated from domestic equity underwriting within Europe have doubled, while fees from Pan-European M&A have more than tripled since 1996.
- So far, large European investment banks have been able to hold their underwriting positions better than their M&A positions.



Source: Thomson Financial and Freeman & Co. estimates

Top 5 Investment Bank in M&A

Rank	1996		2000	
	Firms	Mkt Shr %	Firms	Mkt Shr %
1.	UBS Warburg	8%	MSDW	11%
2.	MSDW	5%	Goldman, Sachs	10%
3.	Lazard Houses	4%	Merrill Lynch	9%
4.	JP Morgan	4%	UBS Warburg	8%
5.	Goldman, Sachs	4%	JP Morgan	8%

Top 5 Investment Bank in Equity

Rank	1996		2000	
	Firms	Mkt Shr %	Firms	Mkt Shr %
1.	UBS Warburg	7%	Goldman, Sachs	10%
2.	Dresdner	6%	Deutsche Bank	6%
3.	Deutsche Bank	5%	MSDW	6%
4.	Goldman, Sachs	4%	UBS Warburg	5%
5.	ABN AMRO	4%	ABN AMRO	5%

V. Outlook for Large European Investment Banks

- “If you can’t beat them, join them”. Major European investment banks have been on a shopping binge in the US.
- Acquisitions tend to be strategic in nature, securing highly sought after US investment banking relationships.

Date Completed	Acquirer	Target	Comments
1988	Credit Suisse	First Boston	High premium investment banking franchise
1997	Warburg	Dillon Read	White shoe corporate finance relationship
1997	ING	Furman Selz	Middle market investment banking
1998	Societe Generale	Cowen & Co.	Boutique investment bank focused on technology and biotechnology industries
1999	Deutsche Bank	Bankers Trusts Alex Brown	Corporate banking with investment banking franchise in growth industries
2000	UBS Warburg	PaineWebber	High net worth retail distribution channel

V. Outlook for Large European Investment Banks

- While domestic underwriting is a competitive advantage for large European investment banks, their local franchise value is quickly deteriorating as US bulge bracket firms build European distribution channels and relationships.
- Freeman & Co. believes that survival and profitability of large European investment banks will depend on:
 - Continuous relationship development through highly disciplined client prioritization followed up with exacting calling efforts, and performance monitoring
 - Commitment of balance sheet resources to clients who will generate transaction fees
 - Acquisition of distribution channels in the US to capture large transatlantic mandates
 - Willingness to buy US expertise and ability to transport product expertise into Europe
 - Retention of key producers and management
- Given all of these concerns, Freeman & Co. expects that there will be two to three more major acquisitions in the US by European firms.

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VI. Outlook for European Boutique Investment Banks

“Niche players will have to focus on old economy industries as the TMT industries become more global.....However, the [European boutique investment banks] margins will decrease even when transaction volume increases as they undercut pricing”

*Daniel Gresch, Equity Research, FIG
UBS Warburg
August 24, 2000.*

VI. Outlook for European Boutique Investment Banks

- Freeman & Co. defines European boutique investment banks as firms that narrowly focused on either a few European countries, industries or one or two products.
- Most of these firms have a country or regional focus.
- Revenues of European boutique investment banks have continued to rise as the available fee pool expands
- As larger firms grow in the European marketplace, they will inevitably poach talent from the European boutique investment banks .
- Furthermore, larger players will move downstream to mid-cap companies in fast growing industries.
- Freeman & Co. believes there will be a place for focused, highly disciplined boutiques.

VI. Outlook for European Boutique Investment Banks

- Freeman & Co. believes that European boutique investment banks should adopt some of the following strategies to survive:
 1. Transformation beyond geographical boundaries - Boutique firms are likely to have natural industry focuses, based on home country competitive advantages. (Example: a technology boutique similar to Robertson Stephens might emerge in Germany or a media boutique similar to Allen & Co. might emerge in the UK)
 2. Consolidation among the boutiques or acquisition by larger investment banks
 3. Align focused research capability with investment banking expertise
 4. Focus on M&A expertise which is more cost efficient
 5. Combine industry expertise, M&A and private equity to create highly profitable boutique merchant banks
 6. Potential alignment with a commercial bank - Source capital backing and lending relationships from large European institution.

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VII. Conclusion

- This study gives a broad strategic overview of the dynamics and opportunities in the European investment banking business. It is by no means an attempt to address all issues or to provide a crystal ball into the future.
- As much as Freeman & Co. tries to segment the market into three types of players, we understand each firm has unique strengths and should see its business model as unique.
- Freeman & Co. believes any investment bank that aspires to a top 10 position in Europe must have a truly global business.
- European boutique investment banks will survive and remain profitable so long as they know their strengths and weaknesses and are able to focus themselves by industry and product expertise accordingly.
- Middle players are likely to be squeezed out as they are not able to leverage their infrastructure to generate enough revenues to support expensive product platforms.
- Large European investment banks will have to make a major decision. They will need to either make a substantial commitment by using their balance sheets, adding substantial personnel or making acquisitions, both in the US and in Europe, or cut back on core strengths as a boutique.