



**Freeman & Co. LLC**

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**Investment Banking**  
*Under Siege*

**July 2001**

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## Freeman & Co.

Welcome to Freeman & Co.'s research report on the historical and future trends in Investment Banking. We hope to provide our clients, friends and future clients with an overview of the business. We draw upon our consulting background and knowledge of Investment Banking to evaluate the business from a strategic perspective and to provide our thoughts on how these strategies impact the industry and individual firms.

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## Introduction

Investment banking profitability is under siege. Firms are faced with declining investment banking revenues, limited deal prospects for the remainder of the year, and deteriorating profit margins. This situation is exacerbated by high fixed costs, as most firms invested heavily in growing their investment banking and research departments, mainly in the technology, media and telecom industries (“TMT”). Costs, unlike revenues, tend to be sticky on the way down, and could leave a number of investment banks struggling to cover their fixed overhead.

### Shift in Industry Focus

From 1998 to the early part of 2000, the new economy industries – technology, media and telecom, boomed and generated nearly half the revenues on the Street. However, during the latter part of 2000 and early part of 2001, the TMT sectors imploded leaving a number of investment banks with a substantial decline in revenues. During this period, most of the old economy industries such as financial services and industrial, held their ground, while energy experienced a surge in investment banking activity.

### Declining Equity Profitability

Equity capital markets and M&A are the “twin pillars” of the investment banking department’s profitability. From 1998 to the first half of 2000, these areas grew rapidly, but have slowed down over the last few quarters. In 2001, the fixed income new issue business revived considerably and has enabled a number of investment banks to generate substantial revenues.

The profitability of the equity business is currently under considerable pressure both from a revenue and cost perspective. Equity businesses tend to have expensive research and sales and trading platforms attached to them. Recently, investment banking and trading revenues are down due to decreased volume and spreads. Also, deal economics for co-managers are becoming increasingly unattractive. On the cost side, the equity platform has seen substantial increases in compensation costs in investment banking and research.

### The Future

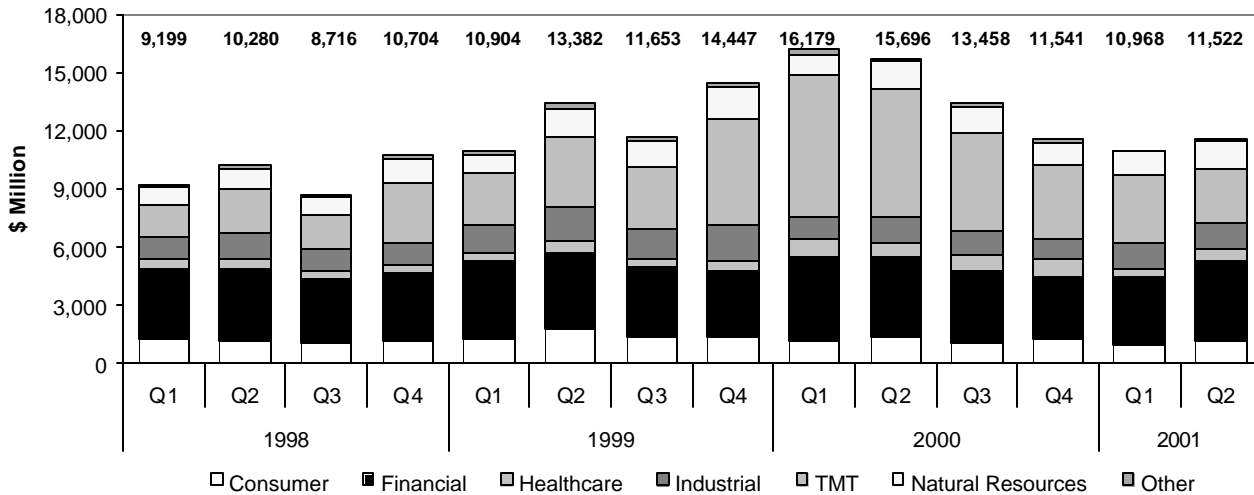
Freeman & Co. anticipates that significant changes will take place over the next few quarters. The impact of the changes will vary across firms. The large diversified investment banks will benefit from product and industry rotations, but will need to closely examine their huge infrastructure costs. Many bank-owned investment banks, currently using their balance sheets to generate investment banking business, will face margin pressures and increased risk. This may result in a credit shake-out over the next few years. The TMT focused boutiques will be most adversely affected and will need to return to their entrepreneurial roots to survive. They will need to focus on a broader spectrum of growth industries beyond TMT. The regional investment banks will face further revenue pressures and will need to diversify their product and revenue streams.

Freeman & Co. expects investment banks to go through an evolution. The initial stages in the evolution include expense, compensation and headcount reduction. Most investment banks have already gone through these stages. The next phases will be resizing and reshaping departments and then reengineering businesses. These tasks will need to be done by investment banking departments in conjunction with research and sales and trading to be most effective. The efficiency with which firms deal with the remaining challenges will determine their ability to survive this market slowdown, maintain a reasonable expense base and retain the flexibility to bounce back once the market picks up.

### Investment Banking Revenues by Industry

Technology, media and telecom generated close to half the investment banking revenues during the latter part of 1999 and early 2000. Freeman & Co. expects a sector rotation with financial, industrial and natural resources - particularly oil, gas and power - remaining in favor throughout the current year.

Figure 1: Global Investment Banking Revenues by Industry

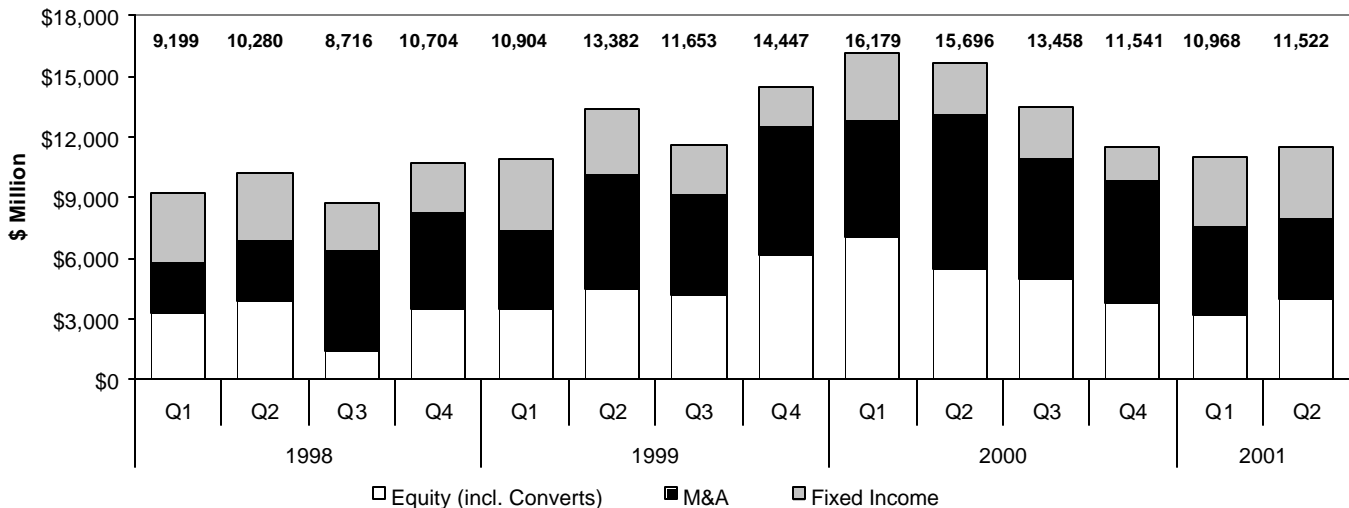


Source: Thomson Financial Securities Data, Freeman & Co. estimates

### Investment Banking Revenues by Product

Globally, investment banking revenues grew rapidly from 1998 through the first half of 2000. Equity underwriting and M&A were the largest contributors to the growth, with an annual growth rate of 37%, and 29% respectively, from 1998 to 2000. In the fixed income area, the high yield market has been slow, with many firms either downsizing or closing their operations. In the first and second quarters of 2001, US high grade revived considerably, enabling investment banks with strong fixed income operations to curb their overall decline in firm-wide revenues.

Figure 2: Global Investment Banking Revenues by Product

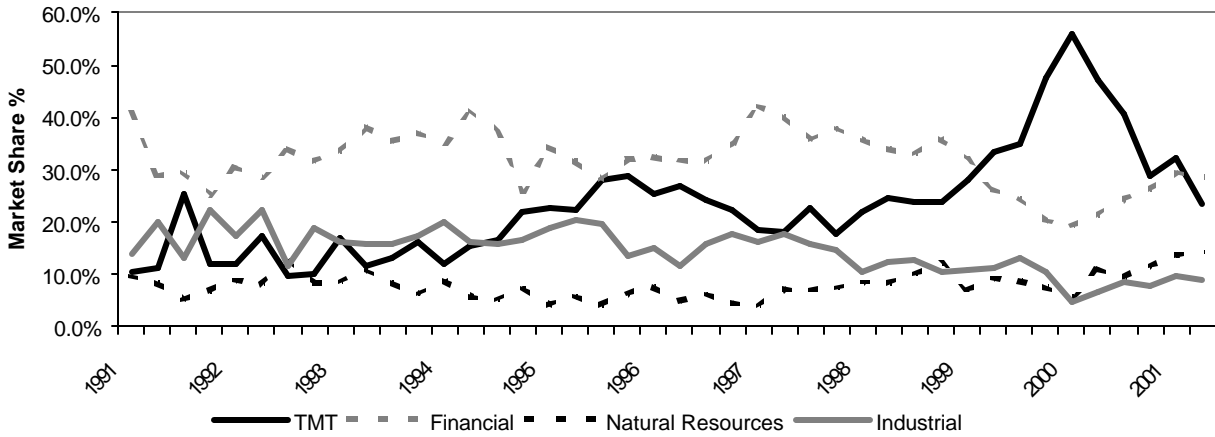


Source: Thomson Financial Securities Data, Freeman & Co. estimates

### Shift in Industry Focus

Most investment banks have spent heavily on expensive TMT investment banking and research departments. These industries experienced a surge in business during the last two years, but have historically been much smaller. Few people involved in these industries remember the period from 1984 to 1991 when technology was out of favor. The industries that are resurging are financial services, industrial and natural resources.

Figure 3: Shifting Industry Focus in the Americas

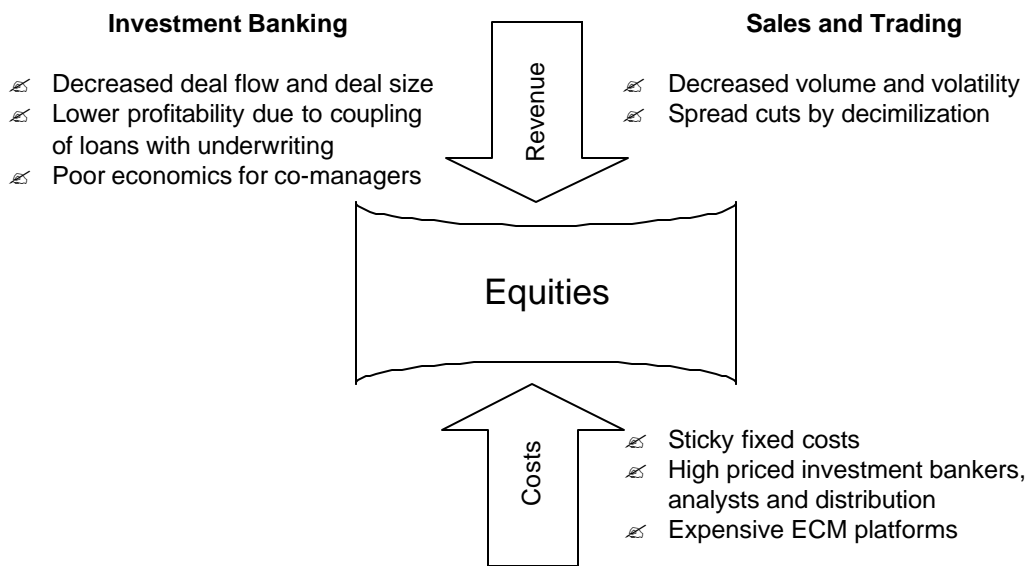


Source: Thomson Financial Securities Data, Freeman & Co. estimates

### Equity Profitability Under Siege

The equity business is one of the largest sources of investment banking profitability and is currently under serious threat as a result of revenue and cost pressures.

Figure 4: Factors Impacting Equity Profitability

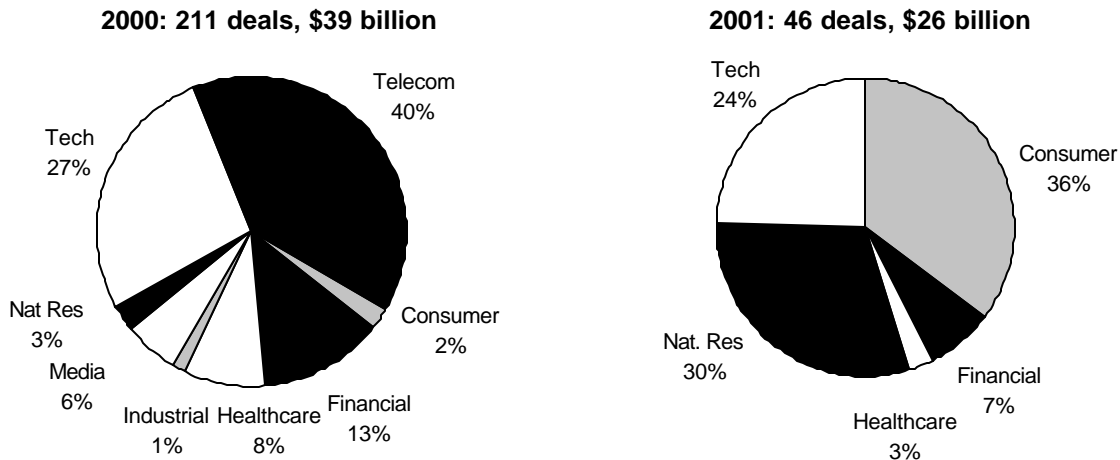


**Investment Banking Revenue Pressures**

**Decreased Deal Flow**

The technology and telecom collapse has decimated the IPO market. The number and size of the deals have fallen and the focus has shifted towards older economy sectors. Follow-on offerings have also been affected.

**Figure 5: US IPO Proceeds from Jan to June - 2000 versus 2001**



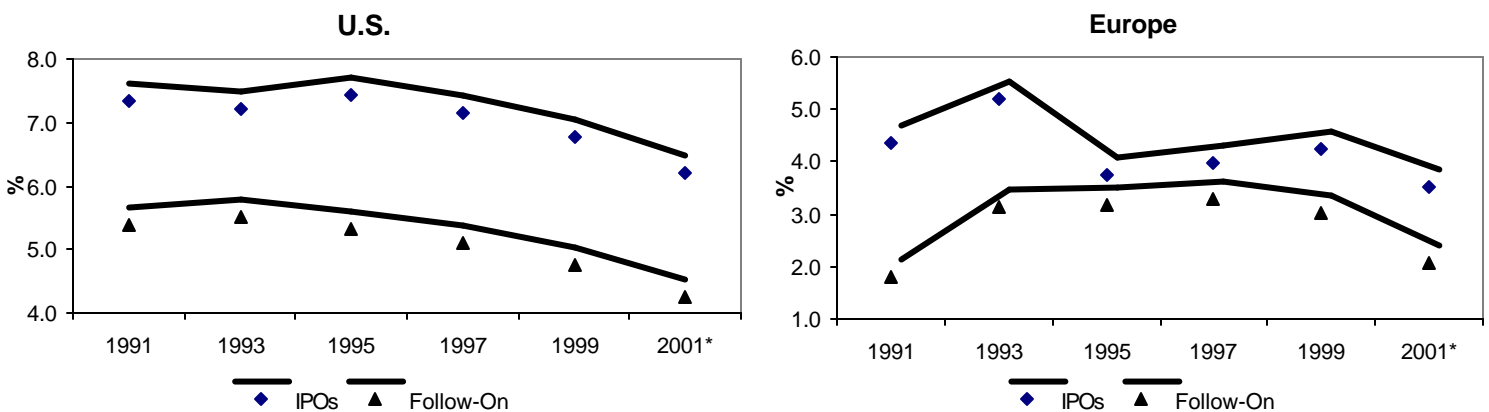
Source: IPO.com, Bloomberg

**Lower Spreads**

On the equity underwriting side, there has been commoditization of the product resulting in a reduction in both IPO and follow-on offering spreads. The competition in the convertible market has resulted in investment banks cutting fees and buying entire issues.

Actual return on invested capital has dropped quickly as universal banks are linking lending with equity underwriting. The “blended” profitability of the two products is less than underwriting alone, as the lending business remains capital-intensive and has low margins.

**Figure 6: Equity Gross Spread Trends**

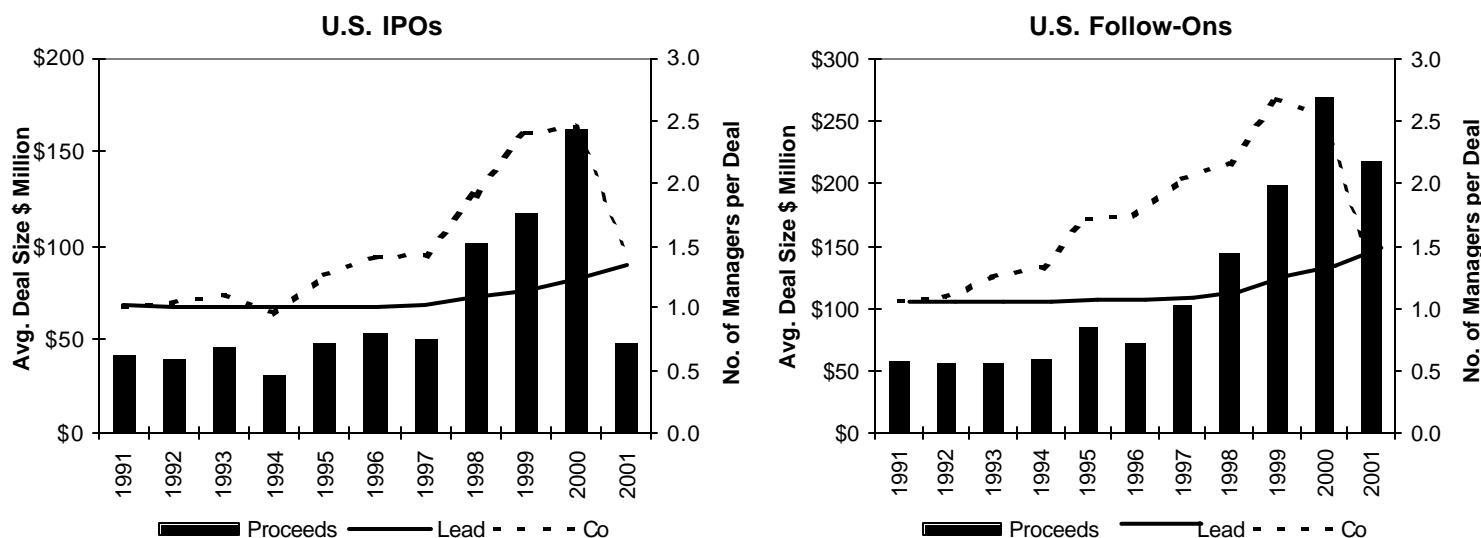


Source: Thomson Financial Securities Data  
\* 2001 First Half

**Decreased Economics for Co-Managers**

One trend that is most troubling for non-bulge bracket firms is worsening deal economics for co-managers. The number of lead managers, often the bulge bracket investment banks, is increasing. These firms are using their clout to grab larger portions of deal economics, leaving less for co-managers. As a result, the number of co-managers on deals is decreasing, from 2.5 in 1999 to 1.5 today.

**Figure 7: Number of Lead and Co-Managers on Deals**



Source: Thomson Financial Securities Data

The overall impact of the increasing number of lead managers is illustrated below. A decline in investment banking revenues has a larger than proportionate effect on the revenues of co-managers. The lead managers are able to maintain positive revenue streams even under marginally declining market conditions. Freeman & Co. anticipates that this trend could result in a number of the smaller investment banks being pushed out of the underwriting business or left to support unprofitable equity platforms.

**Figure 8: Impact of Changing Deal Economics**

	IPOs		Follow-Ons	
	2000	2001	2000	2001
<b>Number of Managers</b>				
Lead	1.2	1.4	1.3	1.4
Co	2.4	1.4	2.5	1.3
<b>Deal Economics</b>				
Lead	55%	60%	60%	70%
Co	35%	25%	35%	25%
Syndicate	15%	15%	5%	5%
<b>Impact on IBD Revenues</b>				
<b>Current</b>				
Lead		+27%		+26%
Co		-58%		-63%
<b>25% Decline</b>				
Lead		-5%		-6%
Co		-69%		-72%

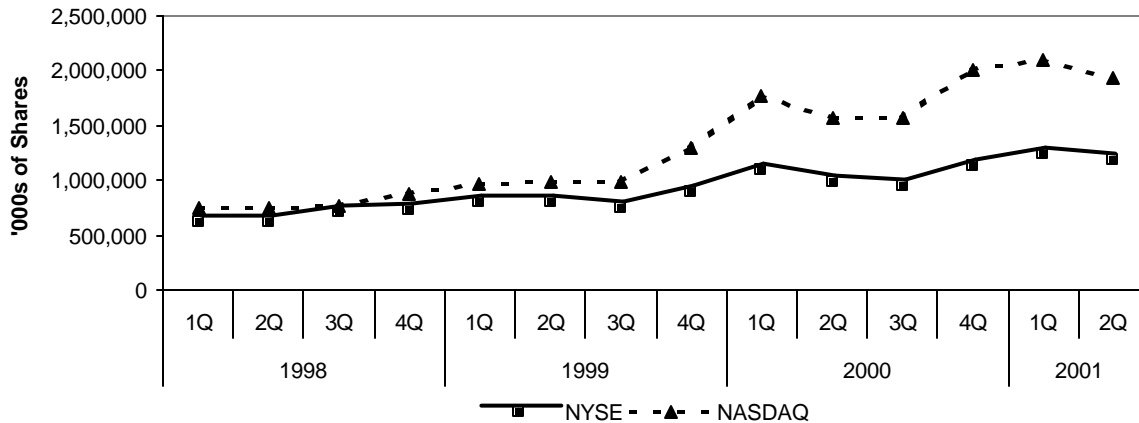
Source: Freeman & Co.

**Sales and Trading Revenue Pressures**

*Decreased Volume and Volatility*

From 1998 to 2000 trading volumes grew 24% annually on the New York Stock Exchange and 48% on the NASDAQ. The explosion in the technology sector fueled this growth. However, volumes started to recede in the second quarter of this year. Market volatility peaked during the last quarter of 2000 and the first quarter of 2001, during which period a number of the derivative desks were able to achieve record earnings. The volatility in the market has slowed down considerably in the recent months.

**Figure 9: Average US Trading Volume**

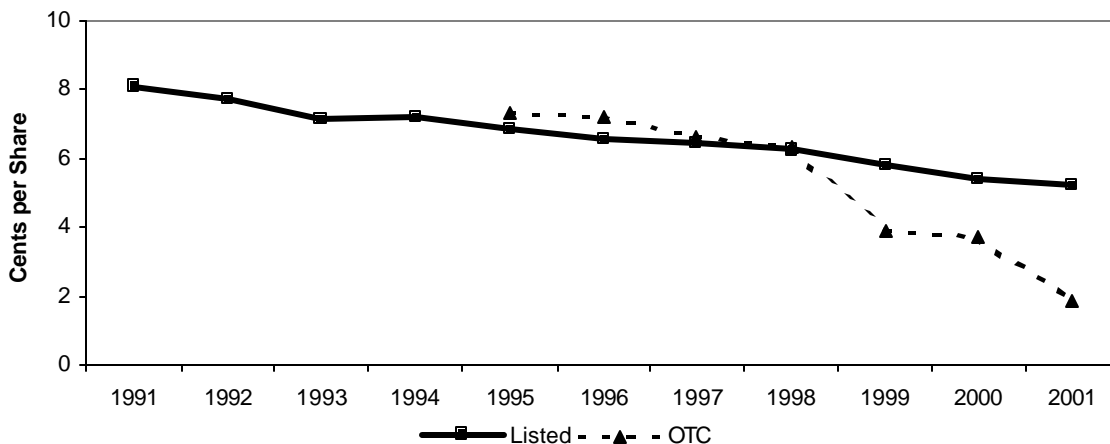


Source: New York Stock Exchange, NASDAQ

*Lower Spreads*

Trading is faced with narrower spreads, as a result of the decimalization of the NASDAQ markets. The combination of decreased volume combined with lower spreads will make sales and trading desks significantly less profitable.

**Figure 10: Average US Institutional Trading Commissions**



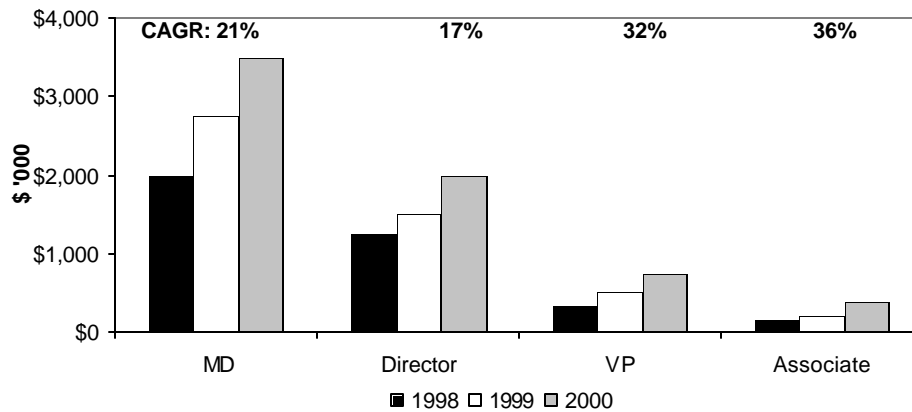
Source: Greenwich Associates, Freeman & Co. estimates

**Cost Pressures**

**Investment Banking Costs**

Investment banking costs have risen rapidly over the last few years. Along with increasing their overall compensation levels, most of the bulge and major bracket firms increased their IB department headcounts by about 25 to 50%. A substantial portion of this growth was in the TMT area. Many investment banks, in an attempt to grow their investment banking franchises, hired experienced bankers and research analysts, offering large guarantees as incentives. Compensation for the junior to mid-level staff also grew at a fast rate, as investment banks competed with internet startups.

**Figure 11: Average Investment Banking Compensation**



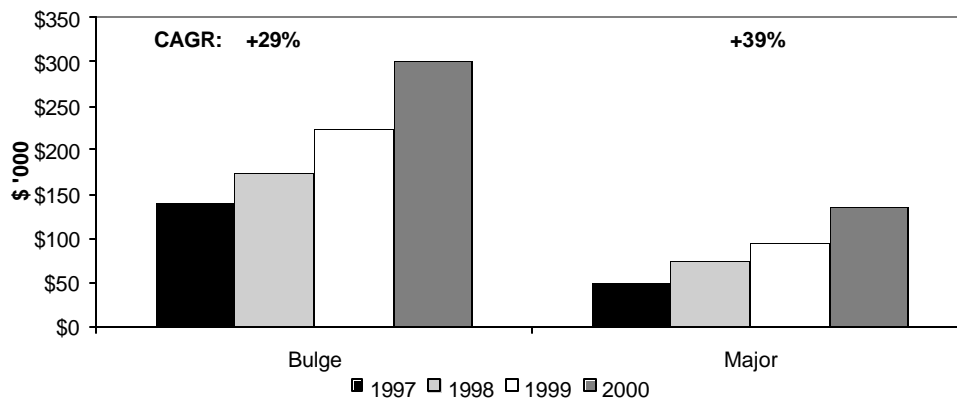
Source: Executive Search Firms, Freeman & Co. estimates

**Research Costs**

Research costs have also risen due to a combination of increased size of departments and compensation of analysts. The costs of major bracket investment banks have risen faster, on a percentage basis, than those of the bulge bracket competitors.

Last year, compensation constituted close to three-fourths of the cost of research, approximately half of which was fixed due to guarantees.

**Figure 12: Average Cost of US Equity Research Departments**



Source: Freeman & Co. estimates

## **Impact on Various Types of Investment Banks**

Firms will be affected differently based on their business models. Freeman & Co. has examined the impact of the slowdown on the large diversified, the bank-owned, the TMT-focused and the regional/boutique investment banks:

### **Large Diversified Investment Banks**

These investment banks will benefit from the increase in the financial services, industrial and energy businesses. Expertise in high grade will also be rewarded. However, the increase in fees in these areas will in no way compensate for the crater left by the decline in TMT revenues, but it will occupy the hearts and minds of numerous bankers.

Further, most of the investment banks still have huge infrastructure costs surrounding equity new issues. Many firms have capital markets groups of more than 100 people, as well as large M&A groups and research budgets exceeding \$1 billion. This model will need to be reengineered to fit a more flexible, less ebullient, fee environment expected in the next few years.

### **The Bank-Owned Investment Banks**

The bank-owned investment banks and commercial banking aspirants to the investment banking business will face numerous obstacles. The current trend of linking loans, which provide low returns, to investment banking fee business, will hurt margins and raise risk for most of the bank-owned investment banks. Freeman & Co. expects to see a gradual drain on returns for the next three to four years, followed by a credit shake-out, which will last until the middle of the decade. The factors that separate the winners from the wounded will be: balance sheet strength, industry and product diversification, well-hedged credit risk and some good luck.

Many of the large independent investment banks will need to carefully orchestrate their strategies to avoid being rolled over during this process. Meanwhile, after ten years of above average results, universal banks are starting to feel bulletproof against any major credit shake-out. This is always a dangerous sign.

### **The TMT-Focused Boutiques**

These firms have an even bigger hurdle to clear. They must fully reorganize their business models and return to their entrepreneurial roots, so that they can endure the tough times. These firms will need to offer survival compensation during the current market conditions and continue to provide employees with entrepreneurial compensation and capital opportunities that benefit them when the market picks up. Freeman & Co. expects to see a return to a broader definition of “growth” than the late 1990’s parochial TMT mantra. We do not expect this to be an easy mission.

### **The Regional/Boutique Banks**

The regional and boutique investment banks were historically focused on narrow, but profitable, industry and product franchises. In the last few years, a number of these firms saw profitability drop due to increased competition from major investment banks moving downstream and a focus on a number of traditional industries that were then out-of-favor. These investment banks will get some benefit from the resurgence of the old economy industries, but will continue to face competitive pressures and will need to diversify their product and revenue streams.

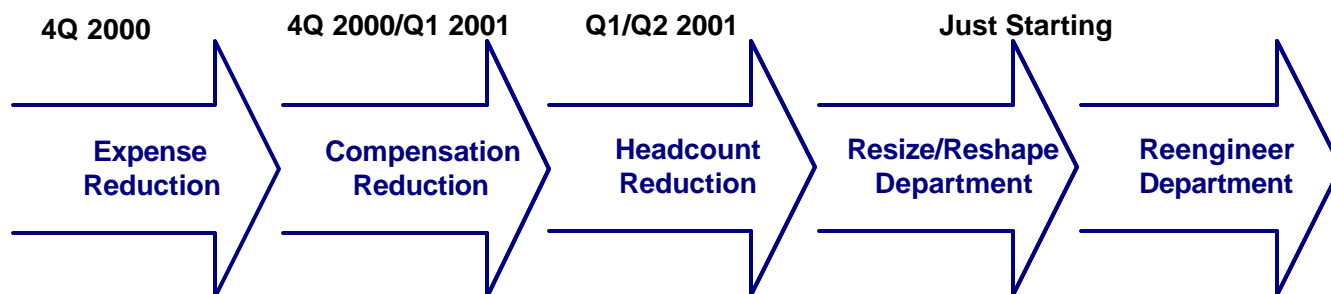
## Through The Looking Glass

Freeman & Co. believes that the following changes will take place during the remainder of the year:

- ? ?Decline in investment banking revenues to 1998 - 1999 levels due to fewer and smaller deals. The NASDAQ is down 60% from its high, which will significantly affect deal sizes and thus deal fees
- ? ?Reduction in investment banking and research compensation to 1998 - 1999 levels, with investment banks offering fewer guarantees. The size of groups is likely to drop approximately 25 to 40%. The decline in costs is likely to be more delayed than the weakening in revenues and could result in some firms facing short-term margin squeezes
- ? ?Deterioration in product profitability as margins decline due to increased competition and use of the balance sheet to generate investment banking revenues
- ? ?Slowdown in capital expenditures in the technology area, which grew approximately 40% per annum during the last few years
- ? ?The curse of “too much of a good thing” in the telecom high yield market during 1998 to 2000 will likely stall fees for a few years. A large amount of telecom debt restructuring will take place providing an opportunity for investors, but not produce significant fees

Freeman & Co. expects the following evolutionary steps to take place in the current market environment. Most investment banks have already taken the initial few steps. The last two stages are extremely critical and firm-specific as each investment bank has to first examine its product and industry mixes and determine its strengths and weaknesses.

Figure 13: Evolution of a Market Slowdown



### *Expense Reduction*

Investment banks initially focus on areas that can easily be cut: travel and entertainment expenses, investments in information technology, administrative costs, etc. Eliminating underperformers is typically the next move.

### *Compensation Reduction*

The next stage involves assessing the flexibility in the cost structure. In investment banking, approximately 60% of costs are compensation-related. In recent years, this percentage has reached 80% for some investment banks that offered multi-year guarantees but have not yet seen the benefit of their investments. For a number of the firms, close to 50% of the bonus pool will be used to pay guarantees. Investment banks will need to identify products and industry groups that have flexible cost structures.

### ***Headcount Reduction***

This is a difficult step, as investment banks make the decision to reduce the cost of specific departments by a flat percentage. Headcount reductions may be across the board, with most industry and product areas contributing toward the cut. However, some profitable groups such as financial services and energy may simultaneously be expanded.

### ***Resize/Reshape Department***

“Resizing” involves looking at all the industry and product groups, determining focus industry and product sectors and eliminating or drastically downsizing the rest. Investment banking should work closely with research and sales and trading to ensure that all areas are coordinated. Because research plays an important role in bringing in investment banking deals, and is an expense that is partially borne by investment banking, it works in the best interest of both areas to make joint resizing decisions.

“Reshaping” involves looking at each industry and product to determine how the group should look in the context of the changing marketplace. In industries where there are many small companies, such as technology and healthcare, groups need few senior bankers and a large group of junior calling officers and processors (a pyramid structure). Some industries, such as financial services, may require a large number of senior calling officers and less support staff (inverted pyramid structure). Other industries may need an even balance of junior and senior bankers.

### ***Reengineer Department***

The final stage of this evolution will be to examine the way the business is conducted to see whether it can be reengineered to provide more efficient service at a lower cost. For example, technology has helped firms lower the cost of research delivery and fixed income and stock trading. Reengineering in the current environment will focus on all areas of investment banking. Other opportunities include examining the equity capital markets groups to determine whether the execution process can be streamlined (new business generation, documentation, syndication, execution, stabilization, research follow-through etc.) or rethinking the fully integrated research model, while assessing the implications for the support areas and the impact on compensation.

## **Conclusion**

The investment banking business is currently going through difficult times as a result of declining investment banking revenues, limited forward pipelines and declining product profitability. These circumstances are further exacerbated by high fixed costs. Costs, unlike revenues, tend to be sticky on the way down and will leave a number of investment banks with high uncovered fixed cost.

The industry will go through a market evolution as a result of the slowdown. The first few stages of this evolution have already taken place. Investment banks have already reduced expenses and analyzed the elasticity of their compensation. Headcount reduction is currently in progress. The remaining two stages are extremely critical: resizing and reshaping the departments and reengineering processes. The effectiveness of the execution of these steps will determine the ability of investment banks to survive the current market conditions, maintain profitability and bounce back once the market returns.

Investment banks are going to need to proactively plan for the changing market conditions to avoid any unpleasant P&L surprises. Freeman & Co. recommends that firm’s plan their strategies under various market scenarios. Planning should be done by investment banking, along with research and sales and trading, to be most effective.

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