

State of Investment Banking - 2001 and Beyond

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Freeman & Co.

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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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Investment Banking	Investment Banking: Under Siege	July 2001
Investment Banking	Equity Research-Will Research Survive 2001?	April 2001
Investment Banking	Electronic Investment Banking: Where Will it Survive?	November 2000
Investment Banking	Investment Banking in Europe – The Quest for the Holy Grail	September 2000
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Asset Management	Drivers of Consolidation	October 2000
Asset Management	Moving from Client Ownership Focus to Specialized Product and Service Focus	March 2000

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Introduction

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Competition

Consolidation

Cost/Profit Trends

Convergence

The Future

Introduction

- The investment banking industry is facing enormous changes. But what is new?
- Key trends are marked by the four “C”s:
 - **Competition** - no cost barred attempt to reach critical mass and be a “Top 3/Top 5” competitor
 - **Consolidation** – acquisition of major investment banks and numerous boutiques as a rational alternative to organic growth
 - **Cost/Profit Trends** – tremendous increases in volume of business have been accompanied with smaller but less increases in costs and decline in margins
 - **Convergence** – the creation of “super-financial” firms. How many Sandy Weill’s are there to manage these behemoths is the question?

Introduction

The future, like the past, will see continuation of these trends followed by an enormous dis-gorging of properties during the first prolonged business slowdown

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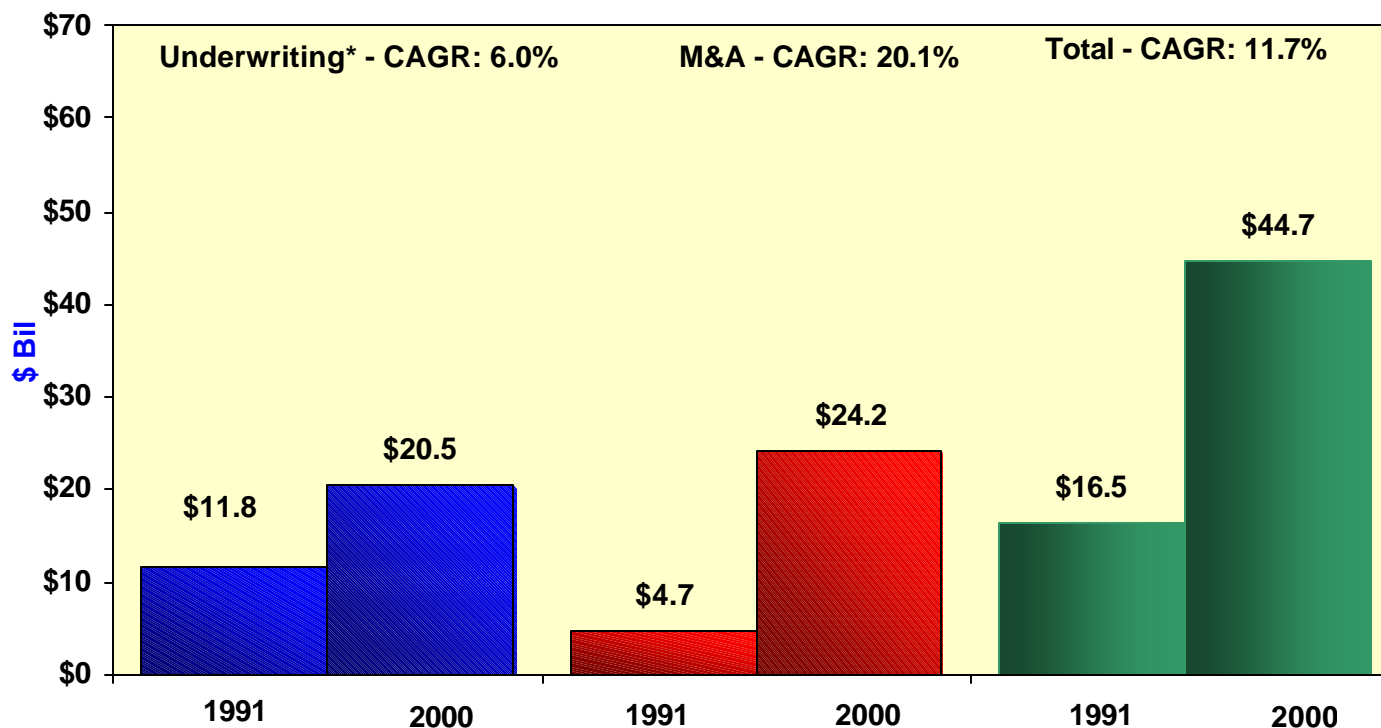
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Industry Overview

- Global IBD revenues, driven largely by equity underwriting and M&A, grew at a CAGR of 14% during the decade

Growth of Global IBD Revenues

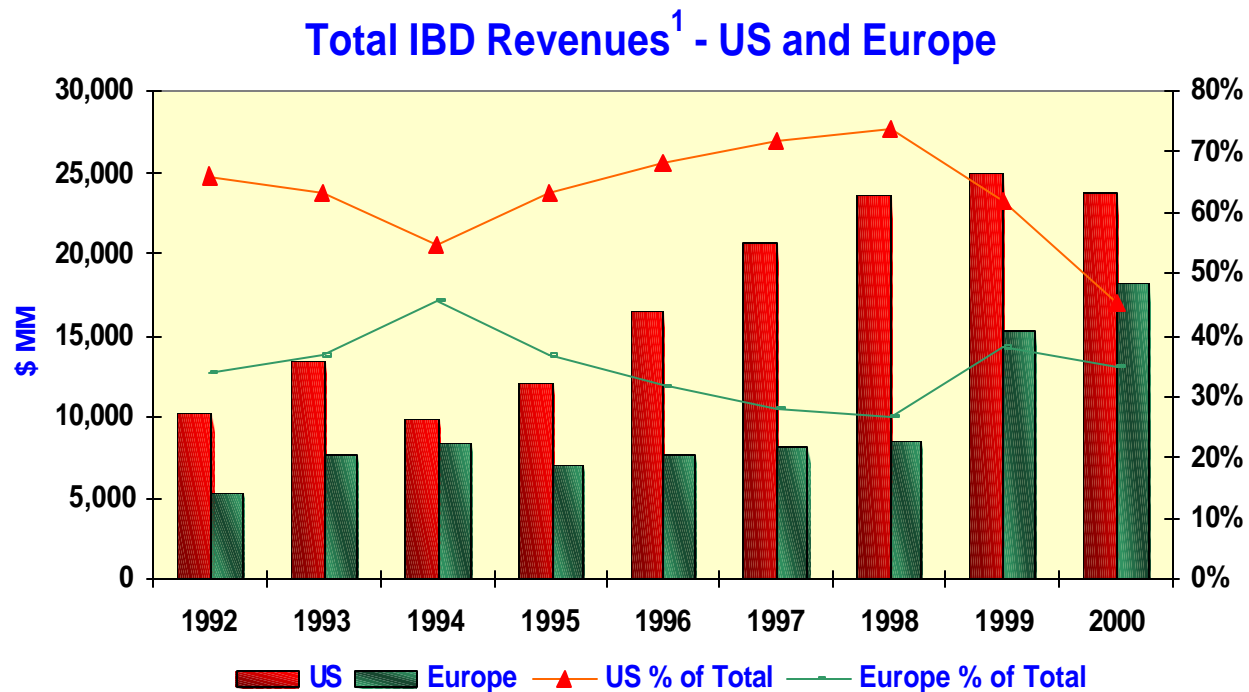


Source: Thomson Financial Securities Data, Freeman & Co. estimates

*Equity and Equity linked, High Yield, High Grade

Industry Overview

- European deals have been a significant driver of growth. Over the last four years, European IBD revenues grew at a CAGR of 32% as compared to only 10% in the US

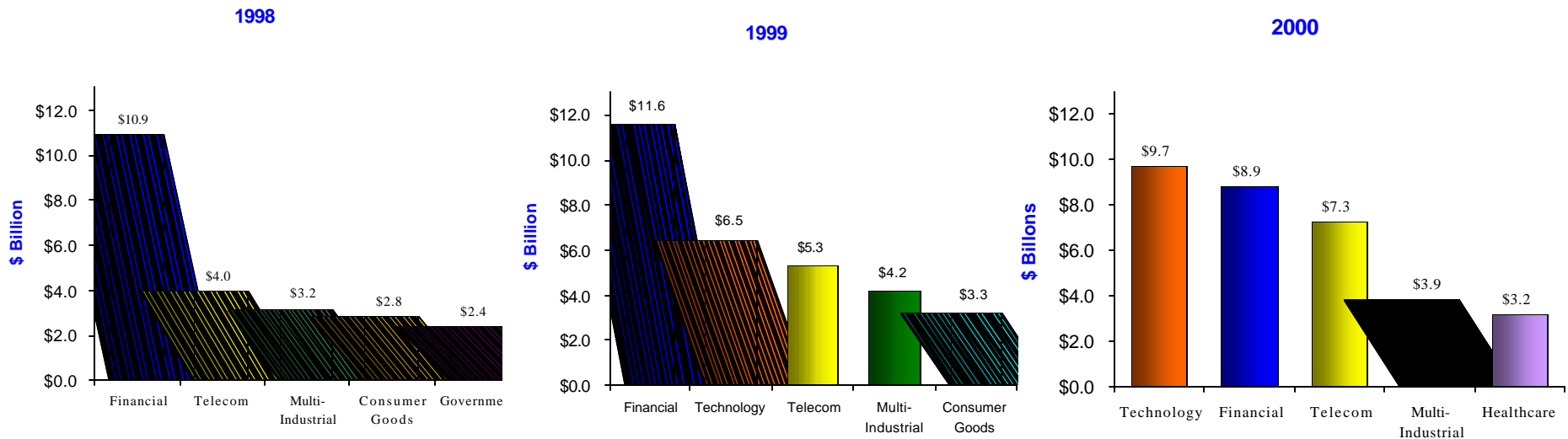


Source: Thomson Financial and Freeman & Co. estimates
1: Includes Equity and Equity linked, High Yield, High Grade and M&A

Industry Overview

- There has been a global shift in industry focus from the “old-economy” toward the “new-economy” industries
- Technology and Telecom are spearheading this growth, with a CAGR of 140% and 42% respectively

Top Five Industry Sectors by IB Fees



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

Industry Overview

- Observations:
 - During the last decade, investment banking revenues have grown steadily with substantial growth coming from Europe during the last four years
 - The “new economy” industries - Technology, Telecom, Media and Healthcare have been spear-heading the growth
 - FIG was the decade’s biggest industry revenue generator
 - Bulge bracket investments banks head these league tables for these industries but boutiques are extremely vital as co-managers on large deals and lead managers on mid-sized deals

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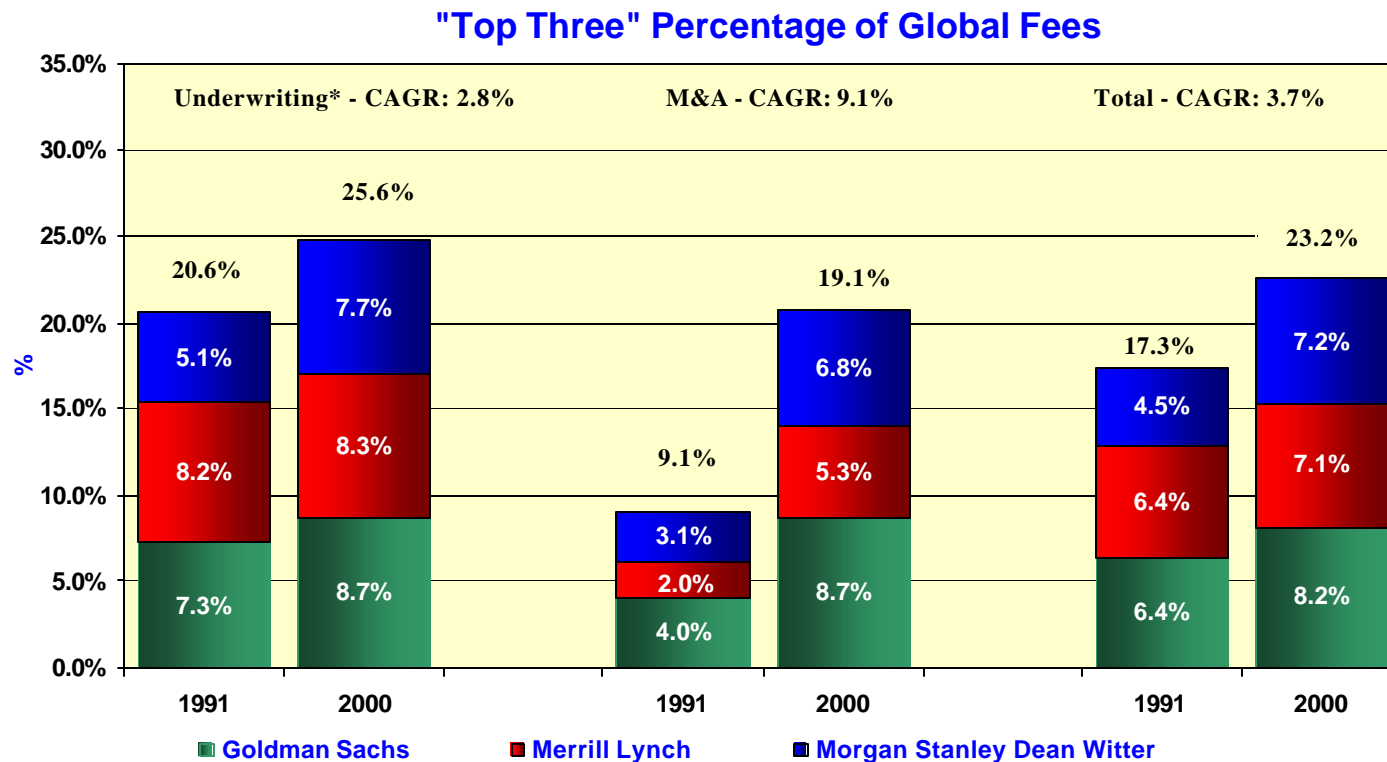
Cost/Profit Trends

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Competition

- The “Top Three”* investment banks have greatly increased their global market share because ...



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

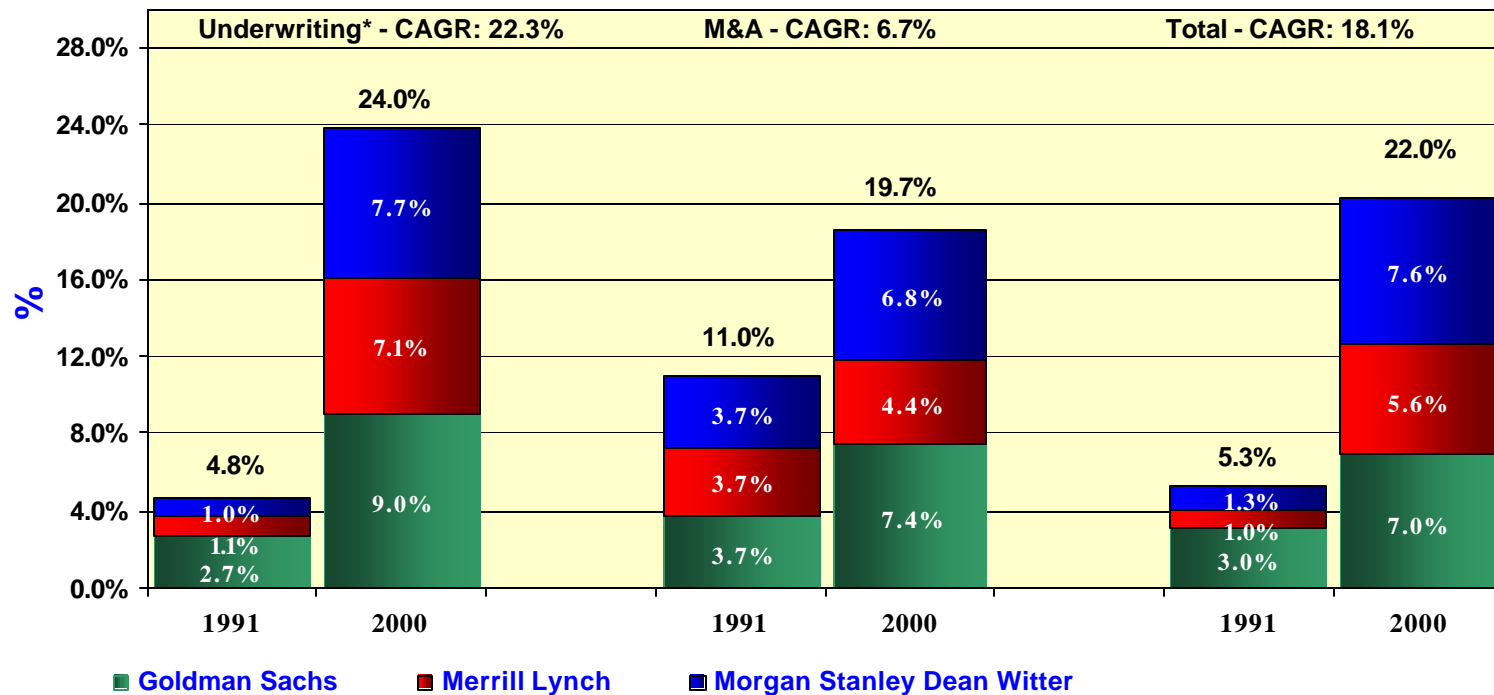
* Top Three - Goldman Sachs, Morgan Stanley Dean Witter, Merrill Lynch

** Equity and Equity linked, High Yield, High Grade

Competition

- The “Top Three*” have captured an increasing share of the European business

"Top Three" Percentage of European Fees



Source: Thomson Financial Securities Data, Freeman & Co. estimates
 * Top Three - Goldman Sachs, Morgan Stanley Dean Witter, Merrill Lynch
 ** Equity and Equity linked, High Yield, High Grade

Competition

- Observations:
 - An “oligopoly” has formed, which has been effective in capturing both US and European business
 - Global presence is a prerequisite for being a successful top player given the global nature of many industries
 - Other Investment and Universal Banks will have to focus on “Areas of Excellence” with industries, products, and geographies where they can compete head-on with “the oligopoly” to stay profitable
 - **BOTTOM LINE:** Stay focused, provide world class services in your areas of expertise

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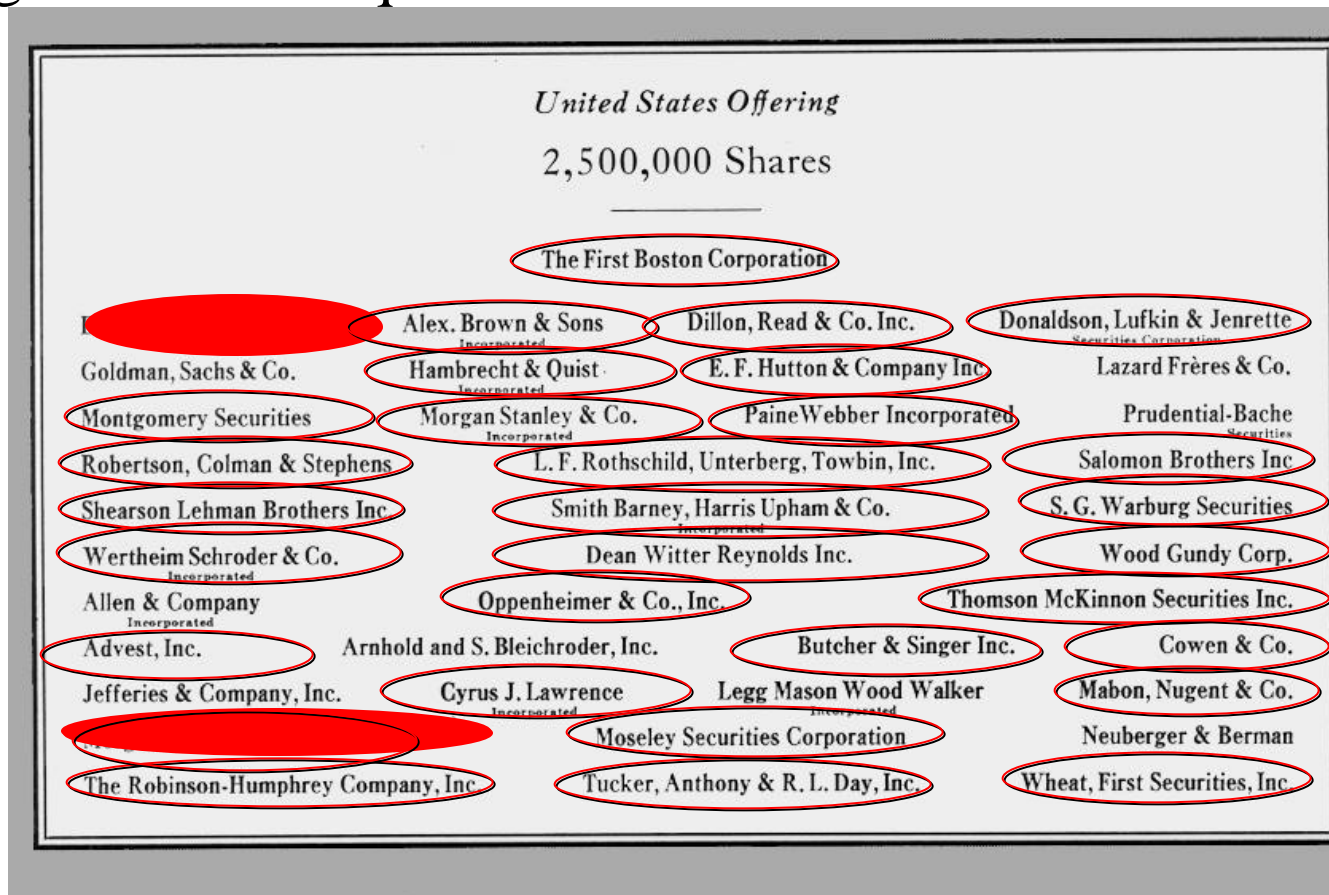
Cost/Profit Trends

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Consolidation

- Since this 1987 tombstone, many investment banks have merged or been acquired:



Consolidation

- The M&A activity in the industry can be categorized into three main categories:
 - **Banks Dipping Their Toes** - Bankers Trust/Alex Brown; NationsBank/ Montgomery
Purpose: To create a manageable platform, generate investment banking synergies and gain product expertise
 - **Daring Strategic Moves** - Chase/JP Morgan; Travelers/Citicorp et. al.
Purpose: To build a franchise that expands the scope of either firm's capabilities
 - **Bolt-Ons** - Prudential/Vector or Volpe; Merrill Lynch/Herzog Heine
Purpose: To expand the range, capacity and capabilities of the existing businesses

Consolidation

Global Rankings by Gross Fees for All Products - 2000 1H

Before Consolidation			After Consolidation		
Rank	Firm	Mkt. Share	Rank	Firm	Mkt. Share
1	Goldman Sachs	8.6%	1	CSFB/DLJ	8.9%
2	Morgan Stanley Dean Witter	8.1	2	Goldman Sachs	8.6
3	Merrill Lynch	7.3	3	Morgan Stanley Dean Witter	8.1
4	Credit Suisse First Boston	6.3	4	Merrill Lynch	7.3
5	Salomon Smith Barney	5.0	5	JP Morgan Chase	5.7
6	Lehman Brothers	3.3	6	Salomon Smith Barney	5.0
7	Deutsche Banc Alex. Brown	3.2	7	Lehman Brothers	3.3
8	Chase H&Q	2.9	8	Deutsche Banc Alex. Brown	3.2
9	JP Morgan	2.8	9	UBS Warburg/Paine Webber	3.0
10	Donaldson Lufkin & Jenrette	2.7	10	Bank of America Corp.	1.8
11	UBS Warburg	2.6			
36	Paine Webber	0.3			
	Total Fees (\$ MM)	27,157.4		Total Fees (\$ MM)	27,157.4

Consolidation

- Observations:
 - The industry will face continued consolidation with many banks continuing to enter the arena
 - There will be ongoing acquisition of boutiques, lift-outs of groups and sales out of existing businesses to fill in holes and rationalize business models
 - **BOTTOM LINE:** Size has value but critical mass in focus areas of expertise is the key to expanding franchise values and profitability-
Get bigger where you are the best

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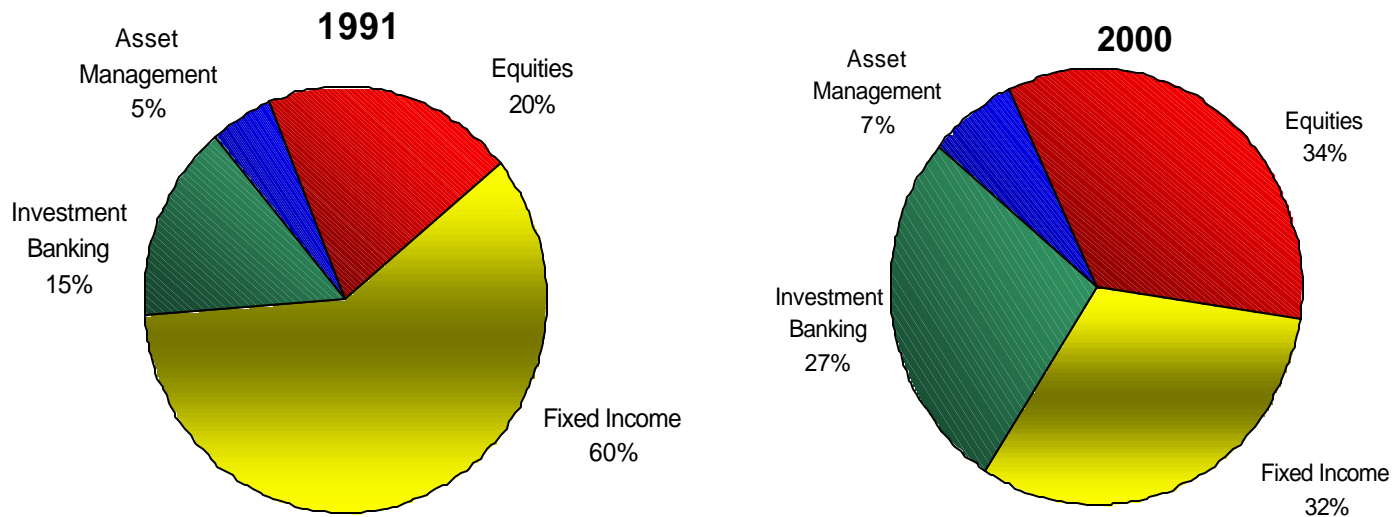
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Cost/Profit Trends

- In the last decade profitability has shifted away from Fixed Income to Equity and Investment Banking

Industry Product Profitability

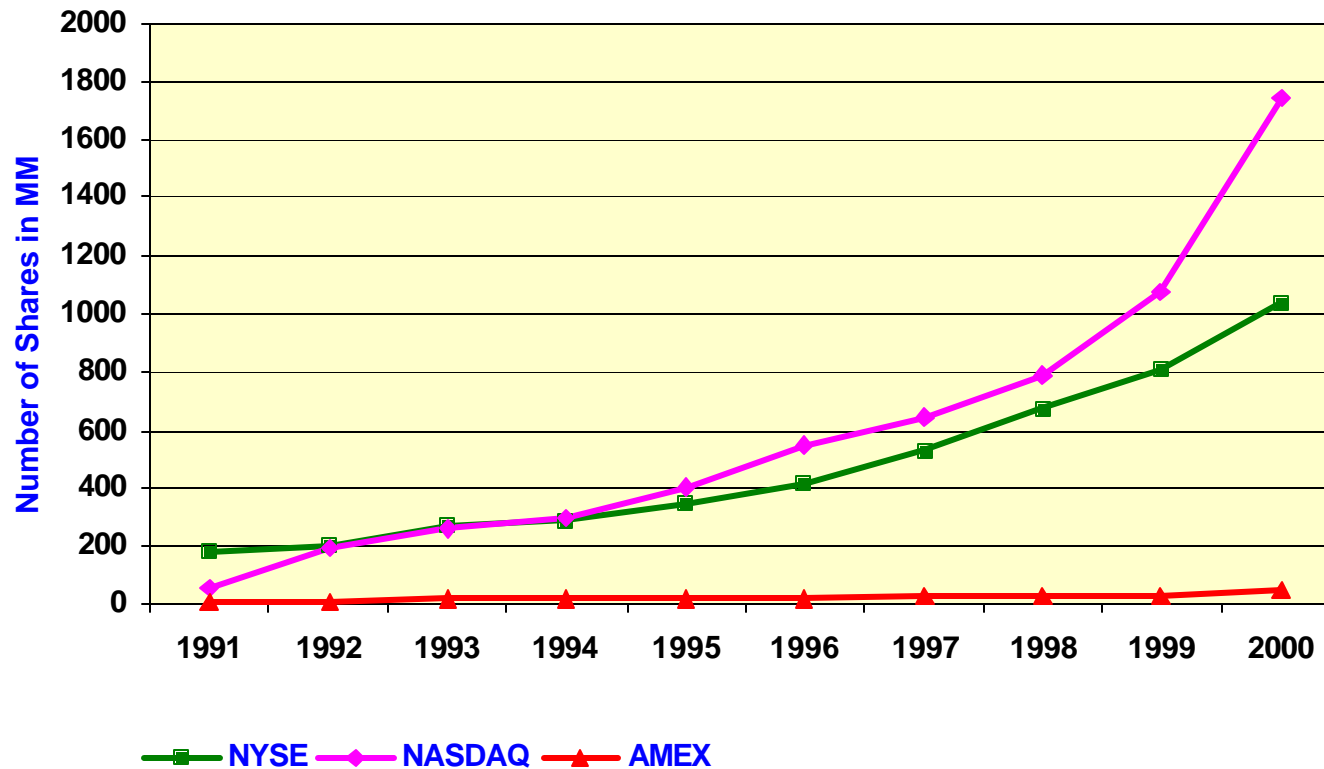


Source: Freeman & Co. estimates

Cost/Profit Trends

- Average daily trading volumes have grown dramatically

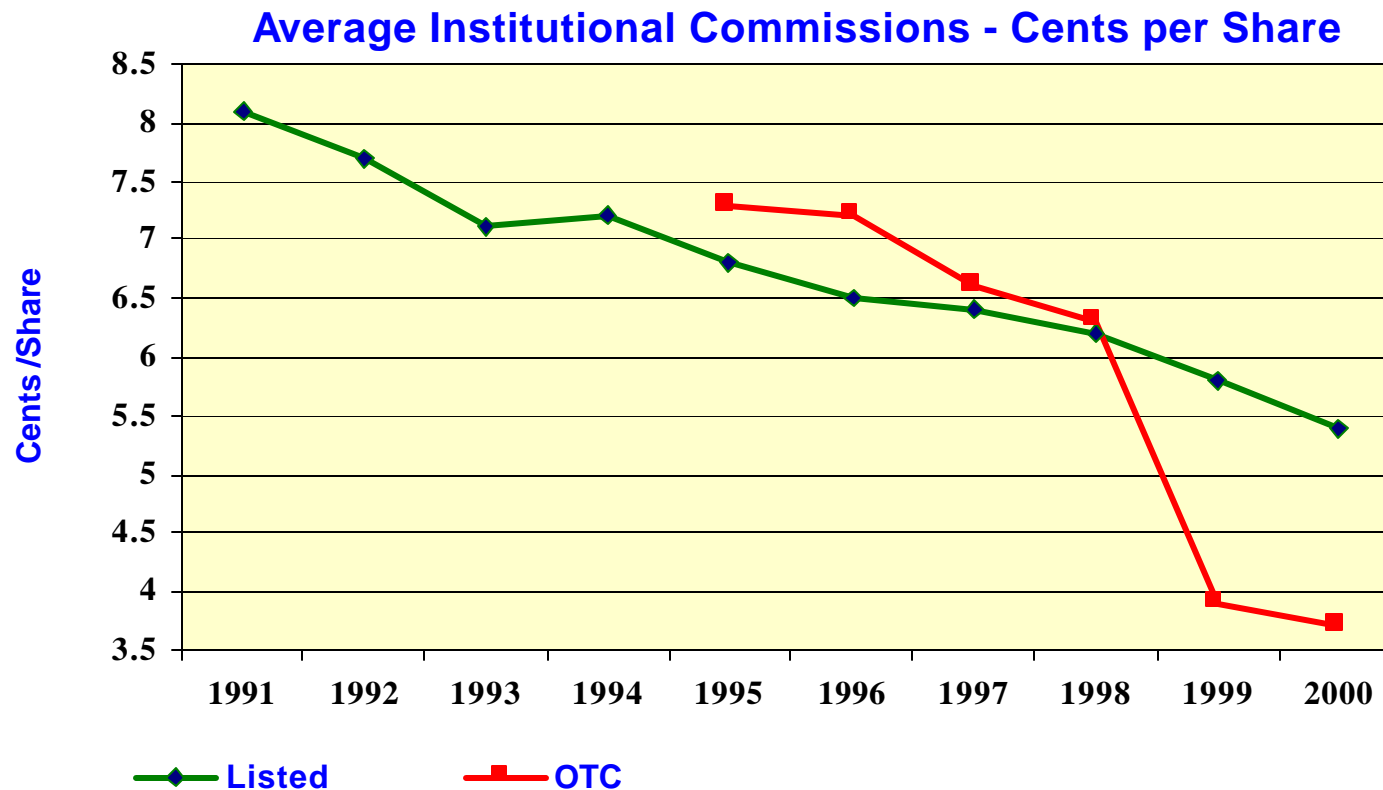
Average Daily Trading Volume - CAGR: 26.5%



Source: New York Stock Exchange, NASDAQ, American Stock Exchange

Cost/Profit Trends

- At the same time, institutional trading commissions have dropped steadily

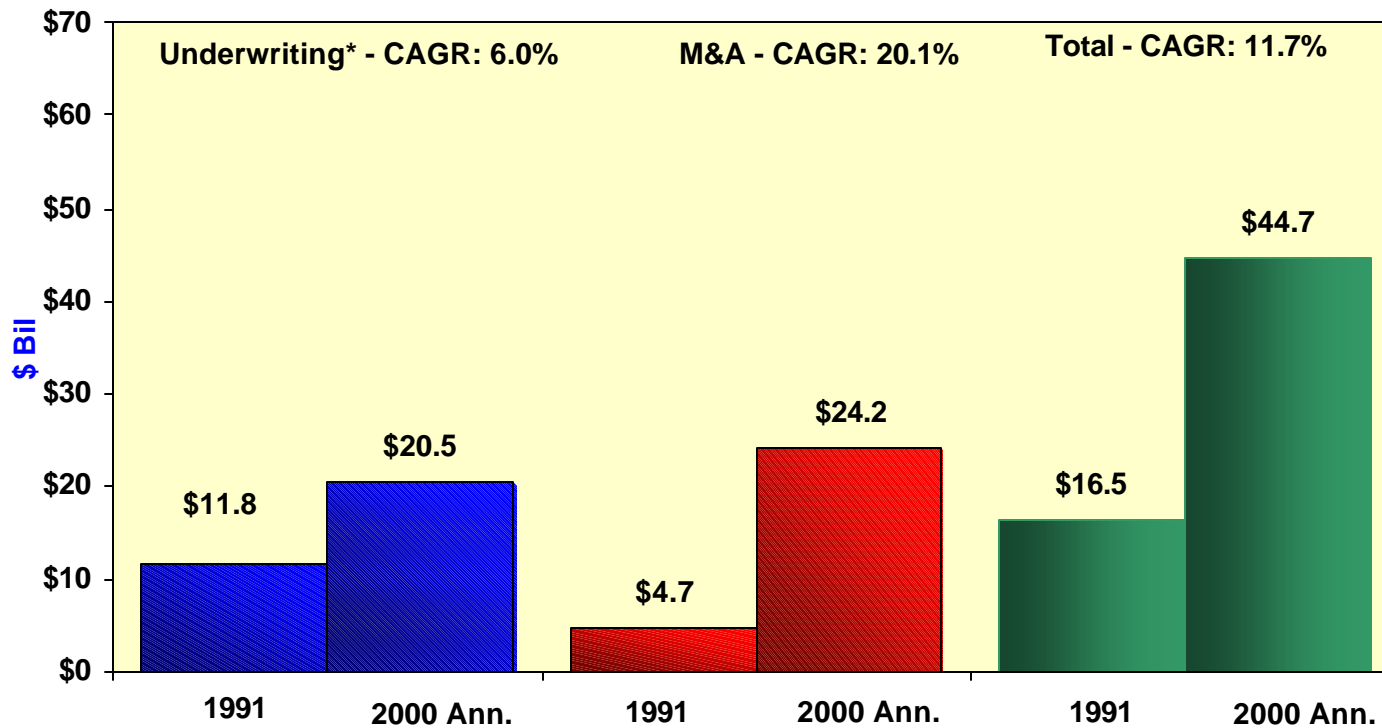


Source: Greenwich Associates, Freeman & Co. estimates

Cost/Profit Trends

- Investment banking revenues have also grown significantly

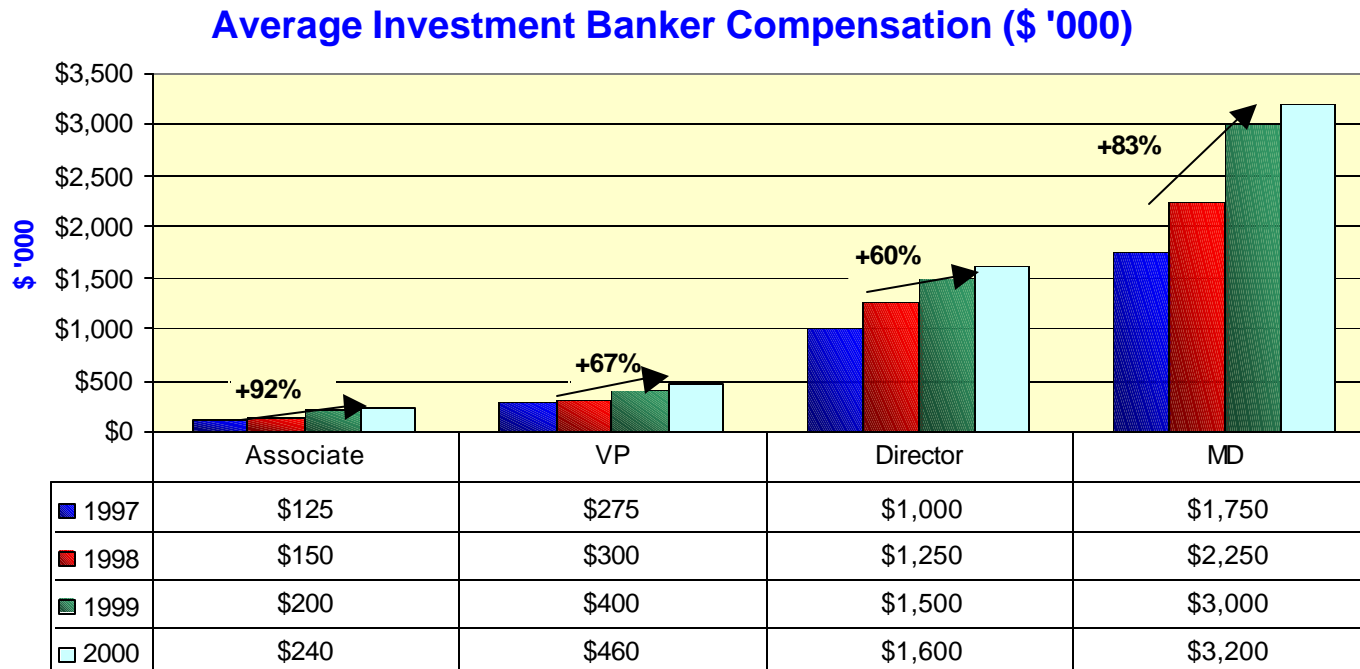
Growth of Global IBD Revenues



Source: Thomson Financial Securities Data, Freeman & Co. estimates
*Equity and Equity linked, High Yield, High Grade

Cost/Profit Trends

- However, investment banking department compensation per person has gone up faster than revenues, the result of highly competitive compensation

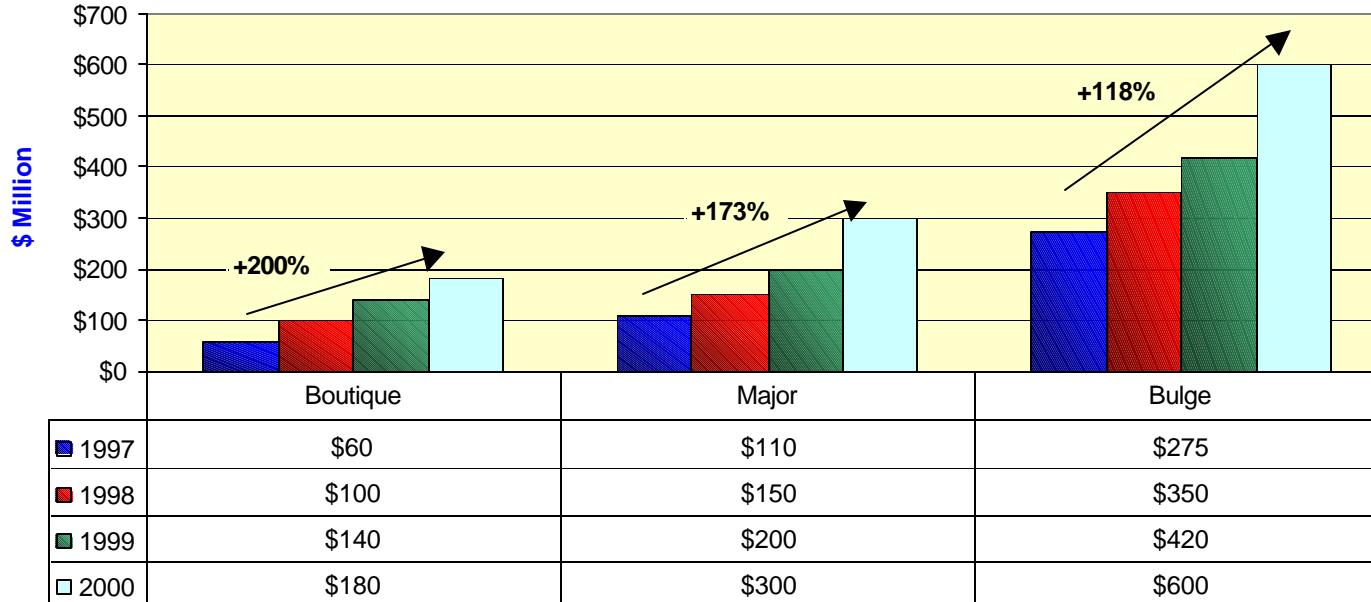


Source: Thomson Financial Services data, Freeman & Co. estimates

Cost/Profit Trends

- Research costs have risen due to competitive pressures to pay analysts to win banking deals and increase trading

Average Cost of Global Research Departments (\$ Million)



Source: Institutional Investor, Nelson's Directory of Investment Research 1999, Freeman & Co. estimates

Cost/Profit Trends

- Observations
 - Investment banking and trading volumes have been increasing significantly
 - Trading commissions have been dropping steadily
 - Non compensation costs have been controlled. Compensation costs have tracked revenues, i.e. margins reached a peak in 2Q 2000
 - **BOTTOM LINE:** Costs may be less variable than revenues on the downside as well as on the upside

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- The other major trend that will lead to even greater change is the creation of “super-financial” firms
 - Citigroup - Citibank, Travelers, SSB, Associates First Capital
 - CS Holdings - Credit Suisse, CSFB/DLJ, Winterthur
 - JP Morgan – JP Morgan, Chase, Hambrecht & Quist
 - UBS AG - UBS/SBC, UBS Warburg, PW
- This strategy has been tried in the past with little success:
 - American Express - American Express, IDS, Shearson Lehman
 - General Electric - General Electric, GE Capital, Kidder Peabody, etc.

Convergence

- Observations:
 - Excellent management along with a strategic business model is needed to integrate diverse but converging businesses
 - Firms need to sell, swap, or MBO pieces that do not meet the strategic model before they cost the enterprise in management time, operating losses or bad publicity
 - Convergence strategy has had limited success in the past

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SURVIVORS

Battle of the Megas

Citigroup
CS Holdings
JPMorgan Chase
Deutsche Bank
UBS AG

Focused Winners

Focused Giant – Goldman Sachs
Focused Industry – Robertson
Stephens
Focused Geography – Cazenove
Focused Strategy – Fidelity
Focused Product – Schwab

Entrepreneurs

Merchant Banking – KKR
Venture Capital – Kleiner Perkins
Niche Boutique – Allen & Co.
General Jonah - Gleacher & Co.
Focused Jonah – Thomas Weisel