



Freeman & Co. LLC

Equity Research
Will Research
Survive 2001?

April 2001

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Freeman & Co.

Welcome to Freeman & Co.'s research report on the historical and future trends in Equity Research. 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 Equity Research 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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We would like to thank our clients and friends for their continued support. We encourage you to share your thoughts with us and look forward to working with you to develop and build your firms.

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Introduction

Freeman & Co. believes that Equity Research departments on the Street cannot survive 2001 with their current configurations and compensation structures intact. Investment banks, in a frenzy to either consolidate their positions or to enter the US or European market, have spent significantly on building up their research departments.

From 1997 to 2000, department costs grew at an annual rate of more than 35%. The largest increase in costs was due to compensation as many senior analysts entered into multi-year contracts. A “star analyst” in a hot sector could make about seven to ten times that of a quality analyst in an out-of favor sector.

Freeman & Co. believes that 2001 will bring dramatic changes to research departments across the Street. Research departments will be resized for the new environment. A number of investment banks will reduce coverage by exiting sectors that generate little banking or trading business. The compensation of analysts without contracts will drop dramatically to near 1998 levels and the disparity in compensation will narrow. Increased investor and issuer skepticism will threaten the star analyst. The role of the analyst will come under further scrutiny due to falling underwriting and trading revenues.

Directors of Research will need to take a more proactive role in controlling their costs and maximizing the flexibility of their cost structures. Department sizes, levels of compensation and compensation structures will become important areas of focus. Alignment of research with investment banking and sales and trading will be critical in determining industry groups and sectors that need to be right-sized.

Freeman & Co. believes the firms that are best able to weather this market turbulence are the top three investment banks who have a small number of cash guarantees. They generate substantial income from diverse revenue sources and are able to maintain more flexible cost structures. The next level of bulge bracket firms that have narrower revenue bases and a higher percentage of cash guarantees will be more adversely affected.

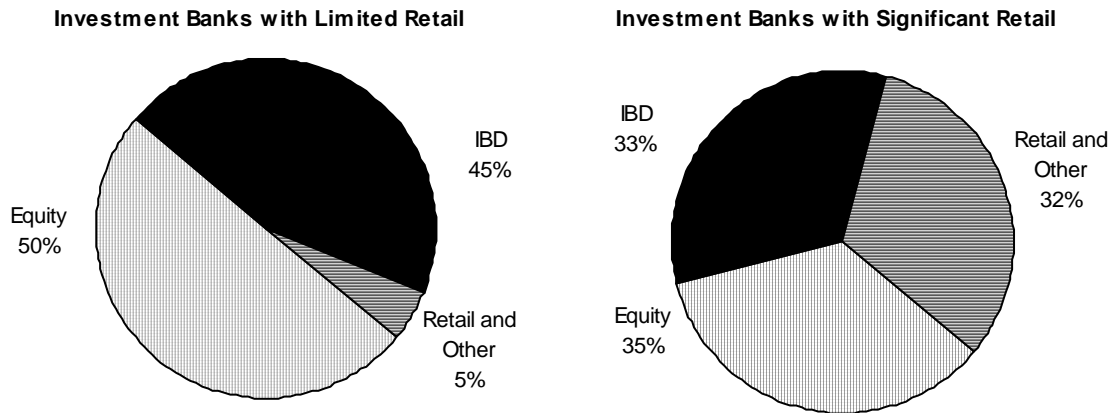
The major bracket investment banks are likely to be most adversely affected, which is shown in tabular form on page 10. They have the narrowest revenue spectrum and have a large number of multi-year guarantees. They will face declining revenues combined with high fixed costs.

Industry focused boutiques should have size and cost flexibility. However, some new-economy focused firms were swept away in the enthusiasm of the hour. How management capitalizes on this flexibility will be a challenge and may separate the winners from the losers in the years to come.

The Role of Research

“Who pays for research?” has always been a contentious issue, which has become even more controversial with the substantial rise in the cost of research departments. Investment banks that have a limited retail presence split costs almost equally between equities and investment banking. Investment banks with large retail operations tend to split costs three ways among equities, investment banking and retail. A number of the major bracket firms place research under an equity capital markets umbrella that includes investment banking and sales and trading with one consolidated P&L for the entire group. This eliminates the need for allocating research costs.

Figure 1: Allocation of Research Costs



Source: Freeman & Co. Estimates

1 Others include Asset Management, Merchant Banking and Private Banking.

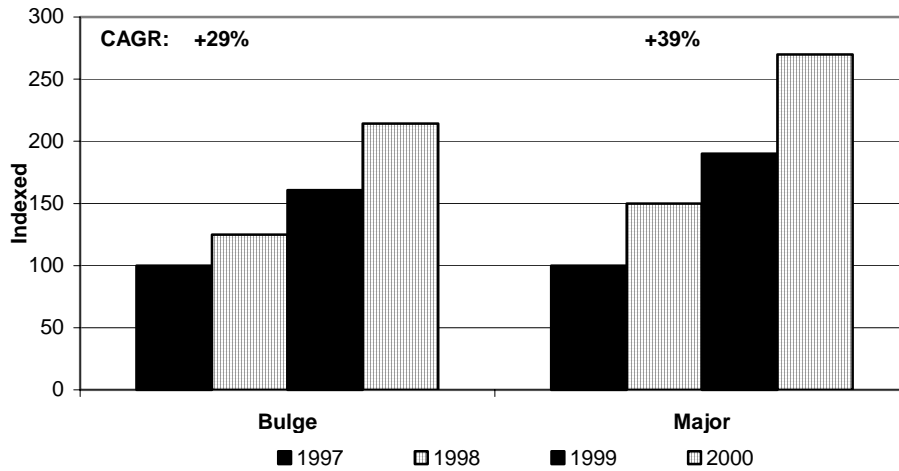
The fact that several departments contribute to research costs has led to conflicting roles for analysts. Investment Banking departments want analysts to cover companies and sectors where there is potential for underwriting business. Meanwhile, the equities desk would prefer that analysts focus on bellwether stocks that generate trading revenues and be motivated to get on investor lists and achieve *Institutional Investor*-type rankings. Investors want unbiased research, untainted by the interests of investment bankers. Lastly, issuers demand positive analyst recommendations, or they will take their banking business elsewhere.

With the boom in equity underwriting, the needs of the bankers and issuers took precedence. As a result, the work of the analyst changed from pure research, which offered investors an unbiased view on the performance of companies, to business generation, whereby analysts became important sources of investment banking leads. It remains to be seen what the future role of analysts will be in the wake of the market correction.

Analysis of Research Costs

The cost of research departments has grown substantially over the last four years. The costs of major bracket firms have risen faster, on a percentage basis, than those of their bulge bracket competitors. Major bracket firms have had a harder time retaining analysts and have used higher compensation packages and multi-year contracts to lure star analysts from larger investment banks.

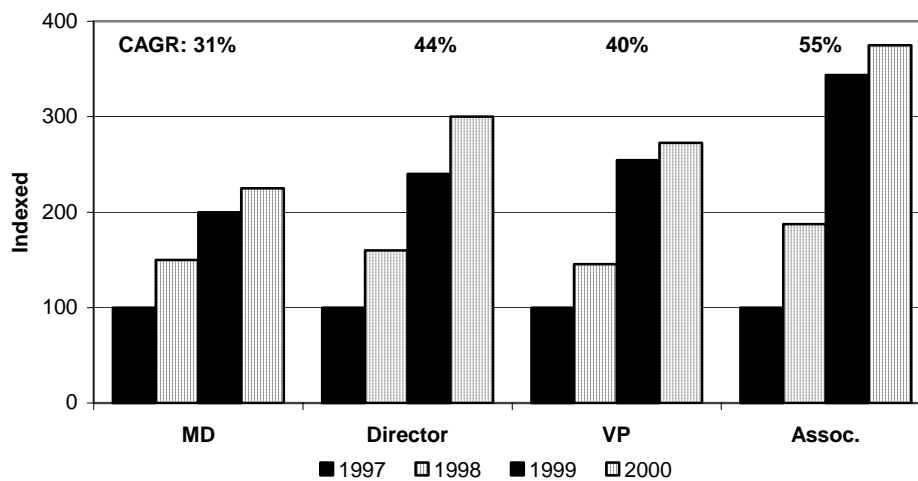
Figure 2: Indexed Cost of US Equity Research Departments



Source: Freeman & Co. Estimates
 Bulge Bracket includes: MS, ML, GS, LEH, CSFB/DLJ, SSB, Major Bracket includes: BOA, BSC, Chase H&Q/JP Morgan, CIBC, Dain Rauscher, DBAB, RS, SG, Thomas Weisel, UBS Warburg, Piper Jaffray

Compensation is the leading cause of the rise in research costs. The concept of a “star analyst” has emerged in the last two years, with senior analysts such as Jack Grubman and Mary Meeker commanding eight figure compensation packages. In many cases, analyst compensation is on par with, if not exceeding, that of investment bankers. Compensation for the mid to junior level staff has the highest growth rate, as firms have had to compete with startups.

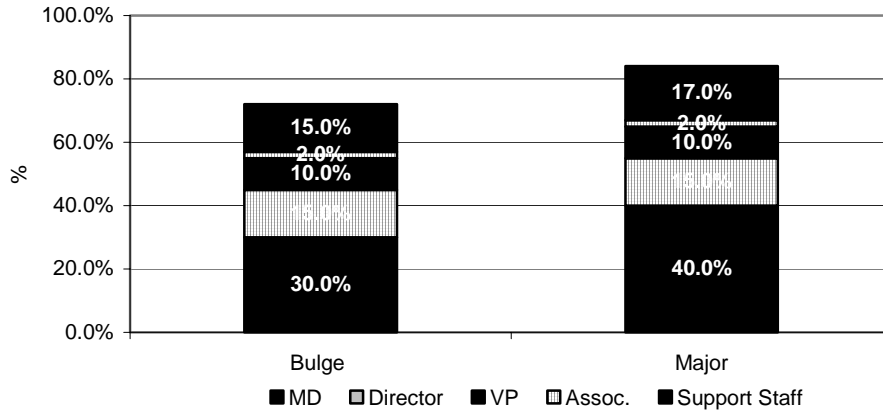
Figure 3: Indexed Research Compensation



Source: Freeman & Co. Estimates

Overall, compensation now constitutes close to three-fourths of the cost of research. For bulge bracket firms, about 72% of their research costs are compensation-related. This number is 84% for the major bracket firms, with MD's receiving the bulk of the compensation. Currently, about half of the compensation costs are fixed as a result of the large guarantees put in place during mergers or when analysts were poached from larger firms.

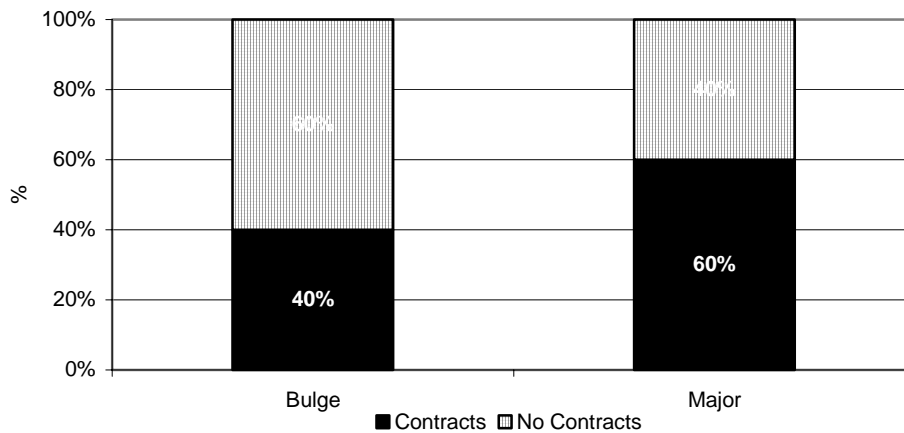
Figure 4: 2000 Compensation as a % of Total Research Costs



Source: Freeman & Co. Estimates

According to Freeman & Co. research, the major bracket investment banks have a larger proportion of their research staffs on guarantees. However, within each category there are discrepancies. Among the bulge bracket investment banks, the top three investment banks have fewer analysts on guarantees than the other bulge bracket firms. Within the major bracket, the new economy-focused investment banks have fewer guarantees than the diverse industry-focused bank-owned firms. In an attempt to build their research departments, the bank-owned investment banks have relied on contracts to attract analysts or have made acquisitions that require analyst retention contracts.

Figure 5: 2000 Percentage of Analysts with Contracts

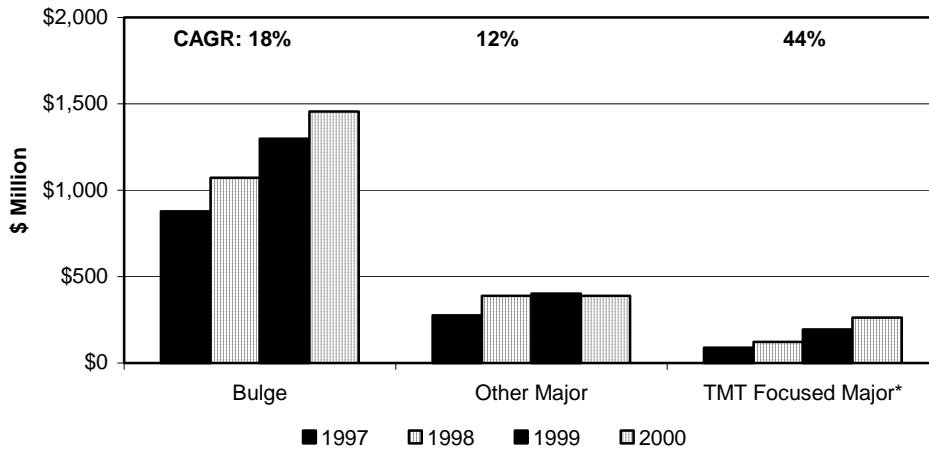


Source: Freeman & Co. Estimates

Analysis of Revenues Supporting Research

The two main areas that pay for research are the investment banking department and sales and trading. From 1997 to 2000, investment banking department revenues grew substantially for all investment banks. Among the bulge bracket, Credit Suisse First Boston has the largest growth in revenues as a result of its acquisition of the Frank Quattrone group. Last year was exceptional for the technology/media/telecom (“TMT”) focused firms, such as Thomas Weisel Partners and Robertson Stephens, who achieved close to 50% growth in revenues.

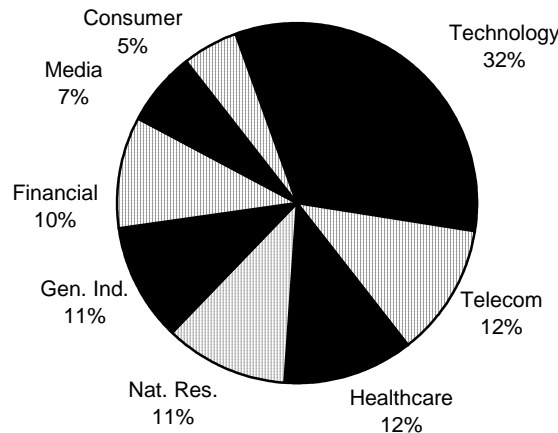
Figure 6: Average US Equity and M&A Revenues



Source: Thomson Financial Securities Data, Freeman & Co. Estimates
 Bulge: ML, MSDW, GS, LEH, CSFB, SSB, Other Major: BOA, BSC, CIBC, DBAB, UBS
 TMT Focused Major: RS, TW, Piper, Dain Rauscher, COW

In 2000, approximately half of the Street revenues were in the new economy industries: technology, telecom and media. These banking sectors now have large and expensive investment banking and research groups. Unfortunately, these industries are now faced with a substantial decline in revenues.

Figure 7: 2000 Equity and M&A Revenues by Industry

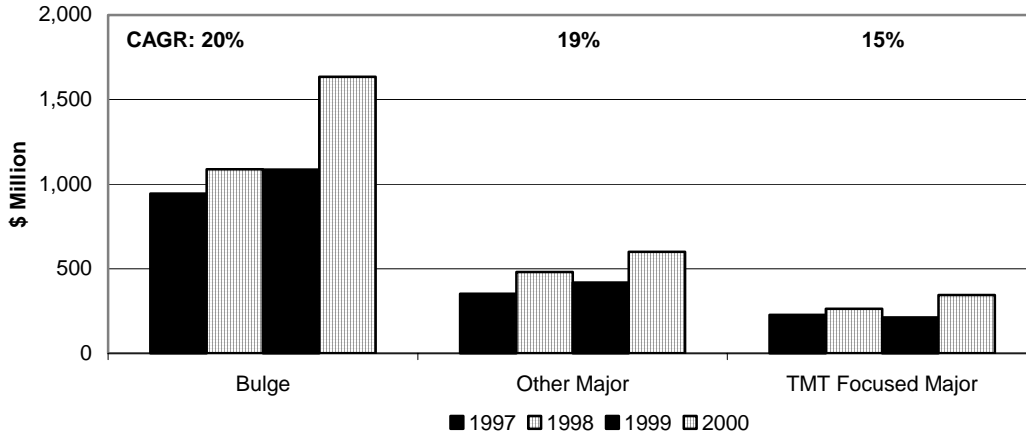


Source: Thomson Financial Securities Data, Freeman & Co. Estimates

From 1997 to 2000, trading volumes grew steadily each year. In 2000, OTC volumes almost doubled as a result of the explosion in the technology sector. However, the growth in OTC volume has been offset somewhat by a recent decline in trading margins.

The bulge bracket firms have seen the largest increase in trading volume due to Merrill Lynch’s acquisition of Herzog Heine & Geduld and Goldman Sachs’ acquisition of Spear, Leeds & Kellogg. The TMT focused firms saw a drop in trading revenues in 1999, despite an overall increase in volume, due to a large decline in OTC margins.

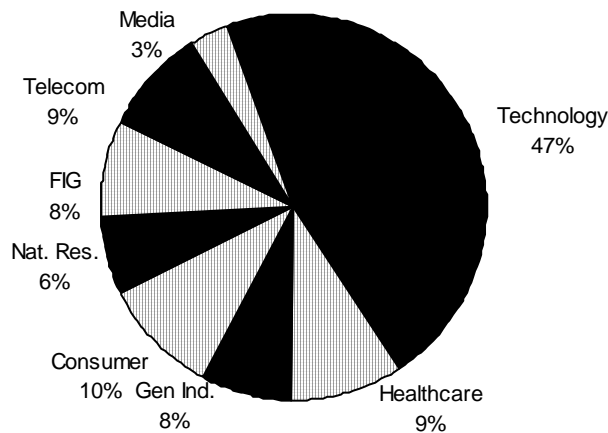
Figure 8: Average US Trading Revenues (\$MM)



Source: AutEx, Freeman & Co. Estimates
 Note: Listed Revenues (CPS): 1997: 6.4, 1998: 6.2, 1999: 5.8, 2000: 5.5
 OTC Revenues (CPS): 1997: 6.6, 1998: 6.3, 1999: 3.8, 2000: 3.6

A substantial amount of trading took place in technology and telecom stocks. Freeman & Co. anticipates that the volatility in the market is likely to keep the trading volumes high, but margins are going to continue to decline with the decimalization of quotes.

Figure 9: 2000 Trading Volumes by Industry



Source: Ford Investor Services, Freeman & Co. estimates

Implications of a Slowdown

In the last four years, research costs have grown at a faster rate than the revenues that support them. In a period of increasing investment banking department and trading revenues, rising costs were not a cause for concern. However, in a year that is fraught with uncertainty such as this one, research departments will be hard pressed to justify their costs.

The first quarter results indicate that revenues have dramatically decreased for a number of the investment banks. In the first quarter of 2001, bulge bracket firms witnessed a one-third drop in investment banking revenues, as compared to the first quarter of the prior year. This number was closer to 40% for many of the bulge bracket firms and 60% for the technology-focused firms. The overall drop in earnings was significantly lower for firms such as Morgan Stanley and Lehman Brothers that had strong fixed income earnings.

Equity underwriting was down significantly, as companies were reluctant to issue equity in such a market. In the US, equity underwriting revenues were down by an estimated 55% and M&A fees were down 27%, as compared to the first quarter of 2000.

With the decimalization of stock quotes, trading margins are likely to drop dramatically. Trading volumes are also likely to be down considerably from 2000. This combination could result in overall trading revenues declining by 20% to 30%.

Freeman & Co. examined the ratio of revenues to research costs in 2000 for the different types of investment banks.

Figure 10: Ratio of 2000 Revenues to Equity Research Costs

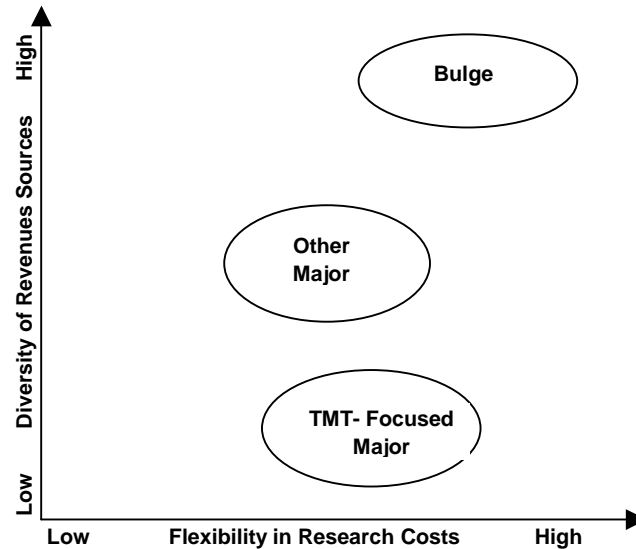
	Equity Underwriting	M&A	Equity Trading	Total
Bulge	\$2.5	\$2.4	\$5.4	\$10.3
TMT-Focused Major	\$2.7	\$0.8	\$4.6	\$8.1
Other Major	\$1.5	\$1.0	\$4.0	\$6.6

Source: Thomson Financial Securities Data, AutEx, Freeman & Co. Estimates

According to our research, there is a large disparity among investment banks. The bulge bracket firms earn 50% more revenues per dollar spent on research than the major bracket investment banks. As the chart indicates, a significant decline in underwriting and trading revenues can be catastrophic for smaller or TMT focused research departments.

Freeman & Co. classifies investment banks in three groups: Bulge, TMT Focused Major and Other Major.

Figure 11: Freeman & Co.'s Assessment of Investment Banks



Bulge

The top three bulge bracket firms are able to cover their research costs most effectively. These firms have substantial revenue bases with diverse revenue sources. In the event of a market downturn, they are most likely to remain profitable. All three firms have strong investment banking and trading departments. At the same time, these firms do not have a large number of investment bankers and research analysts on guarantees. Their large revenue bases combined with the flexibility in their cost structures, allows them to sustain their cost structures and hence their profitability. The next tier of bulge bracket investment banks also tend to generate substantial revenues and effectively cover their research costs. However, they are likely to be more affected by weak market conditions. These firms have substantial revenues combined with significant and widespread guarantees as a result of recent mergers or efforts to bolster their research and investment banking departments. They have less flexibility in their cost structures, but some diversity in their revenues sources.

TMT Focused Major

The TMT-focused investment banks are going to be hit the hardest from a top-line perspective because they tend to focus on equity underwriting. These firms are also heavily dependent on sectors, such as technology, where business has severely declined. In the first quarter 2001, these firms have seen revenues drop by about two-thirds. Under such a scenario of declining revenues, flexibility in cost structure becomes very critical. Until last year, a substantial portion of compensation was paid in the form of investment in technology-related merchant banking funds and employees were allowed to invest in start-ups. Only a minimal percentage of the analysts and bankers were on guarantees.

Other Major

The other major bracket investment banks are likely to be the most adversely affected. These investment banks are faced with declining revenues combined with high cost structures. For 2000, their revenues to research cost ratio is the lowest. A number of the firms pay 60-65% of their revenues in compensation. The high cost-to-revenue ratio, combined with too many guarantees, indicates that these firms could be in significant trouble. In a market downturn, these investment banks will probably see falling, if not negative margins. The investment banks that are owned by European or US commercial banks will need to utilize the deep pockets of their parents to sustain their businesses.

The Future

Freeman & Co. examined the market under three scenarios: a quick market recovery, a year-long bear market and a protracted market slump.

Case I: A Bump in the Road

- Market recovers by 3Q 2001
- Equity underwriting, M&A and equity sales and trading revenues fall by 20%
- Investors return greedy and eager to listen to analysts

The top three investment banks, as a result of their product breadth and revenue streams, will be able to maintain the bulk of their research departments, but will see a drop in margins. These firms may have some layoffs, but will be able to maintain most of their research coverage. The other bulge and major bracket firms with expensive contracts and guarantees will have more significant layoffs and will be forced to reduce coverage to fewer, more lucrative sectors. Some of the smaller independent players will look for parents to help them survive volatile markets. Margins will be significantly down for all investment banks. However, a 3Q 2001 market recovery would reaffirm the existing research and underwriting business model. Compensation will drop to more sane levels.

Case II: Tough Times

- No sign of market recovery until 1Q 2002
- Equity underwriting, M&A and equity sales & trading revenues fall by 35%
- Investors will maintain a love/hate attitude toward analysts

The top three, with their product breadth and cost flexibility, will tough it out. These firms will selectively downsize their research departments. The other bulge and major players will be pressured by high fixed costs and a prolonged drought in the underwriting business. Layoffs will be across the board and investment banks will have to carefully choose which sectors to cover. Smaller firms that are capable of finding new revenue streams will survive. Some marginal players will exit the business through mergers. The ranks of multimillion-dollar analysts will dwindle to a handful of celebrity analysts. Guarantees will become a distant memory. Everyone will get squeezed and compensation will drop 40-50% from the highs of 2000.

Case III: The Apocalypse

- No sign of recovery before 3Q 2002
- Equity underwriting, M&A and equity sales and trading revenues fall by 45%
- Research analysts will be viewed as heretics

The business model of equity research maintaining relationships with issuers and driving underwriting business will be over. Multimillion-dollar analysts will become extinct. Investors will pay little attention to analysts who will have to learn how to provide objective research to survive. Compensation will drop 50-75%.

Layoffs will be across the board. The top three and some other bulge and major investment banks will survive with dramatically reduced research departments. A number of the European and US commercial bank parents will consider spinning off their investment banking arms after having seen losses and supporting their investment banks for close to a year. Many smaller firms will exit the research business.

Conclusion

Freeman & Co. believes that the existing equity research model is under tremendous pressure as a result of recent significant market volatility. In this environment, the departments supporting research are going to closely scrutinize both the costs that they are bearing and the benefits they are deriving.

Research departments face some tough times ahead. Directors of Research are going to need to focus on controlling their costs and maximizing the flexibility of their cost structures. Since compensation is the largest proportion of research costs, the size of the department, levels of compensation and compensation structures will become important area of focus. Alignment of research with investment banking and sales and trading revenues will be critical to determining where to allocate scarce resources.

The firms that will survive in this turbulent environment are firms with diverse revenue flows and flexibility in their cost structures. As such, it is essential that Directors of Research conduct thorough scenario planning, in conjunction with their supporting departments. While such planning is difficult, management will be better poised to handle tough situations without significant P&L surprises.

We hope you have enjoyed our research and we encourage you to contact us with questions or comments. This work would not have been possible without the contribution of James L. Freeman, Linda Huber, Susan Laskey, Susannah Flanagan and Eric Schwarbach.

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