



Freeman & Co. LLC

Investment Banking
Back to Basics

February 2002

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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.

Freeman & Co. provides in-depth management consulting and strategic advisory services to the financial services industry worldwide. Our highly focused specialization has been invaluable in helping our clients develop and prosper in this dynamic industry. Freeman & Co. offers assistance to companies in the areas of:

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

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Investment Banking	Equity Research – Will Equity Research Survive 2001?	April 2001
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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

During the last decade the financial services industry grew rapidly and enjoyed the longest bull market run in its history. The most significant growth in investment banking and trading revenues took place in 1999 and 2000. The major contributor to this growth was the expansion of the technology, media, telecom (“TMT”) industries, which in 2000 contributed close to half of all investment banking fees.

The Past – Not a Preview of the Present

Investment banks’ infrastructure grew substantially from 1997 to 2000 to meet the need for increased investment banking and trading services. By the end of 2000, however, growth in compensation costs exceeded the growth in revenues.

In 2001, investment banking fees declined by 21%, and trading profitability also decreased, partially due to the decimalization of stock quotes. As a result, firms became considerably less profitable. These harsher market conditions caused investment banks to reduce costs, compensation and headcount. In 2001, the industry reduced headcount by six percent, while investment banking departments suffered even more significant layoffs, ranging from seven percent to 18%. Overall, compensation was down by 25% to 50%.

The Future – Focus on Franchise Strengths; Forget Nursing Orphans

Freeman & Co. estimates that investment banking and trading revenues are likely to remain at 1997/1998 levels for at least the next two years (2002 and 2003). The IPO market is likely to pick up from 2001 levels, but will still be considerably less active than it was in 1999 and 2000. M&A activity will pick up as firms look to either consolidate or acquire niche expertise. There is no single industry or group of industries that is likely to drive revenues as the TMT sector did prior to its collapse. Furthermore, Freeman & Co. believes that the headcount reductions made in 2001 may be insufficient and firms will need to make further cuts.

Investment banks will be faced with tough market conditions and reduced deal economics as more firms vie for limited fees. As bank-owned investment banks deal with increasing bad debts, they will have to reconsider their strategy of using the balance sheet to source investment banking business. Many players will consider making strategic acquisitions or divestitures to balance out their business and revenue flow.

To be successful over the next few years, investment banks will need to:

- ⇒ Focus on their firms’ unique franchise strengths in terms of relationships, industries, products and geography
- ⇒ Concentrate on the most lucrative revenue generating areas for the franchise
- ⇒ Focus on near-term profitability and resist expensive investments with distant revenue payoffs
- ⇒ “Right-size” their investment banking departments
- ⇒ “Re-shape” industry groups to suit the current market environment
- ⇒ “Re-engineer” processes, in terms of calling and processing, to increase effectiveness and cost efficiency

The efficiency with which firms carry out these tasks will determine their ability to survive and bounce back when the market rebounds.

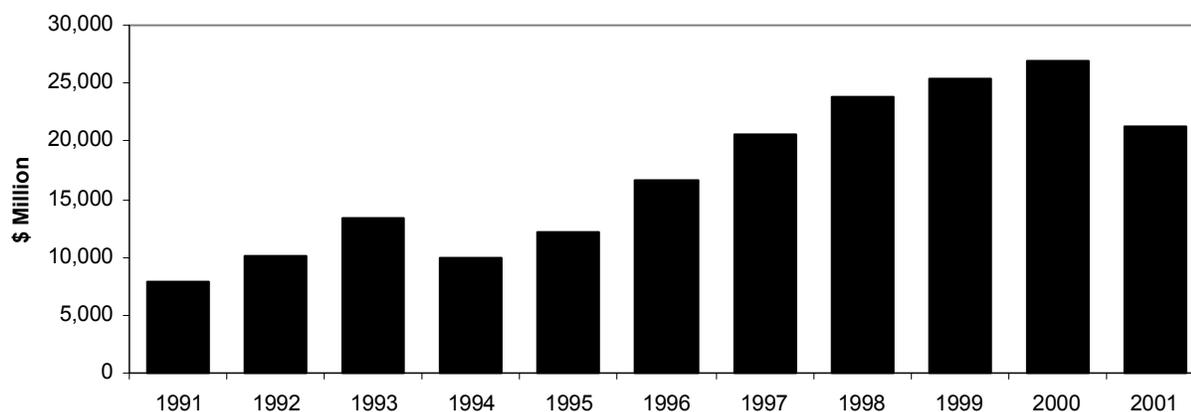
Freeman & Co.'s Historical Market Analysis

Investment Banking

Revenues

Investment banking revenues grew rapidly over the decade. The business faced minor setbacks in 1994 and 1995 due to a fear of inflation, with the Federal Reserve increasing rates numerous times during this period. The biggest growth in revenues was in 1999 and 2000 due to the technology, media and telecom ("TMT") boom, with the industry experiencing record growth in M&A and equities. There was a market correction in 2001 and investment banking revenues dropped by 21%.

Figure 1: U.S. Investment Banking Revenues – 1991 to 2001



Source: Freeman & Co. estimates

Notes: Products included are Equity, High Yield, High Grade and M&A

Cost Analysis

From 1997 to 2000 firms grew rapidly to meet the increased demand for investment banking services. Freeman & Co. has analyzed a representative group of publicly held investment banks. A closer look at these investment banks reveals that headcount, compensation and revenues all increased substantially. Despite significant revenue growth, ambitious hiring and compensation increases forced compensation to grow at a faster pace than revenues. In 2001, however, investment banks ruthlessly focused on compensation and headcount reduction to ensure that their compensation to net revenue ratios remained constant. Freeman & Co. believes that some of these firms are still overstaffed and will need to reduce additional headcount.

Figure 2: Growth in HC, Compensation and Revenues for Select Investment Banks – 1997 to 2001

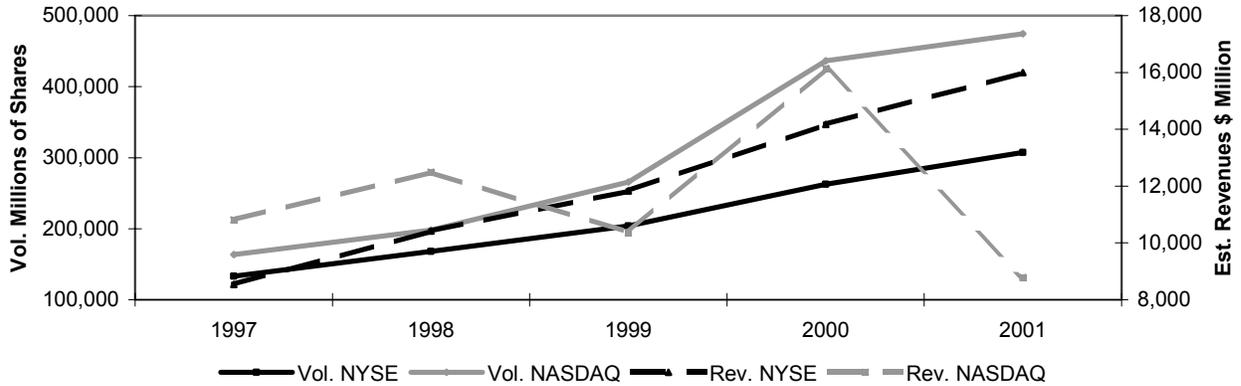
Investment Bank	Headcount			Compensation (\$ Million)			Net Revenues (\$ Million)		
	1997	2000	2001	1997	2000	2001	1997	2000	2001
Bear Stearns	8,309	11,201	10,452	1,727	2,814	2,527	3,526	5,476	4,907
Goldman Sachs	10,622	22,627	22,700	3,097	7,773	7,700	7,447	16,590	15,811
Lehman Brothers	8,340	11,326	13,000	1,964	3,931	3,437	3,873	7,707	6,736
Merrill Lynch	56,600	72,000	57,400	7,962	13,730	11,269	16,512	26,787	21,880
Morgan Stanley	47,000	62,392	60,442	6,019	10,936	9,397	14,833	25,999	21,896
Average for IB's	26,174	35,909	32,799	4,154	7,837	6,866	9,238	16,512	14,246
% Change/Prev. Period		37.2%	-8.7%		88.7%	-12.4%		78.7%	-13.7%

Source: Annual Reports

Trading

The trading volumes on both the New York Stock Exchange and the NASDAQ more than doubled from 1997 to 2001. In 2001, the growth in trading activity on both the NYSE and the NASDAQ marginally slowed down. An analysis of the trading desks shows that despite an unprecedented increase in trading volume on the NASDAQ from 1997 to 2001, actual revenues fell due to the decline in spreads in 1999 with the advent of trading in “sixteenths” and the decimalization of stock quotes in 2001. Listed desks saw a gradual slide in profitability, but the overall increase in volume appears to have more than compensated for the reduction in margins.

Figure 3: U.S. Annual Trading Volume and Revenues – 1991 to 2001

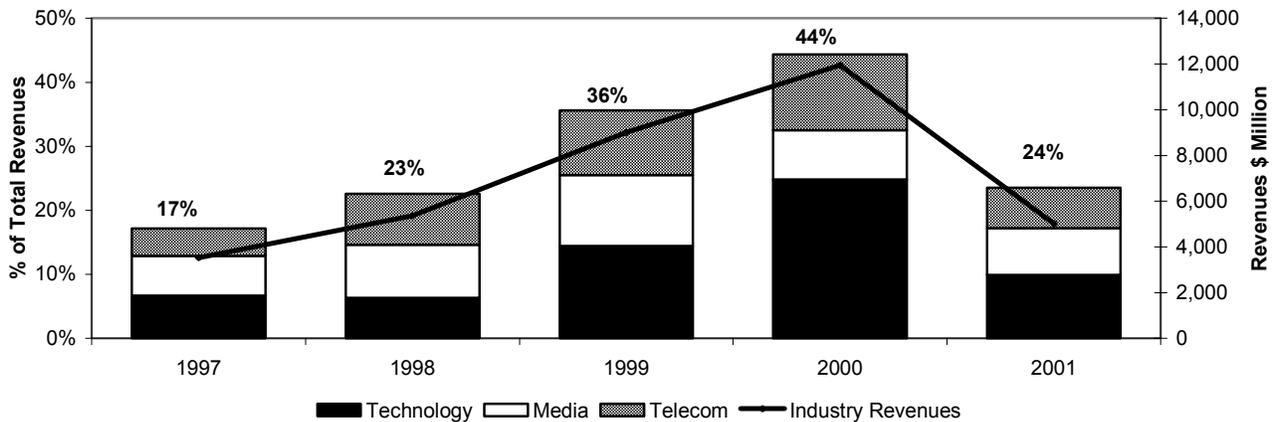


Source: New York Stock Exchange and NASDAQ, Freeman & Co. estimates
 Note: Listed Revenues - Estimated Cents Per Share: 1997 - 6.4, 1998 - 6.2, 1999 - 5.8, 2000 - 5.2, 2001 - 5.2
 OTC Revenues - Estimated Cents Per Share: 1997 - 6.6, 1998 - 6.3, 1999 - 3.9, 2000 - 3.7, 2001 - 1.85

TMT – The Biggest Contributor to Growth

Investment banking fee growth over the last few years was atypical, mainly due to the TMT bubble. From 1997 to 2000, U.S. investment banking revenues grew from \$20.6 billion to \$26.9 billion. At the same time, TMT revenues grew 342%, from \$3.5 billion in 1997 to \$12.0 billion in 2000, and contributed close to half of all Street fees in 2000. By 2001, TMT fees were down more than 50% to \$5.0 billion. Given the present TMT industry conditions, there is little hope for significant fee recovery in these areas.

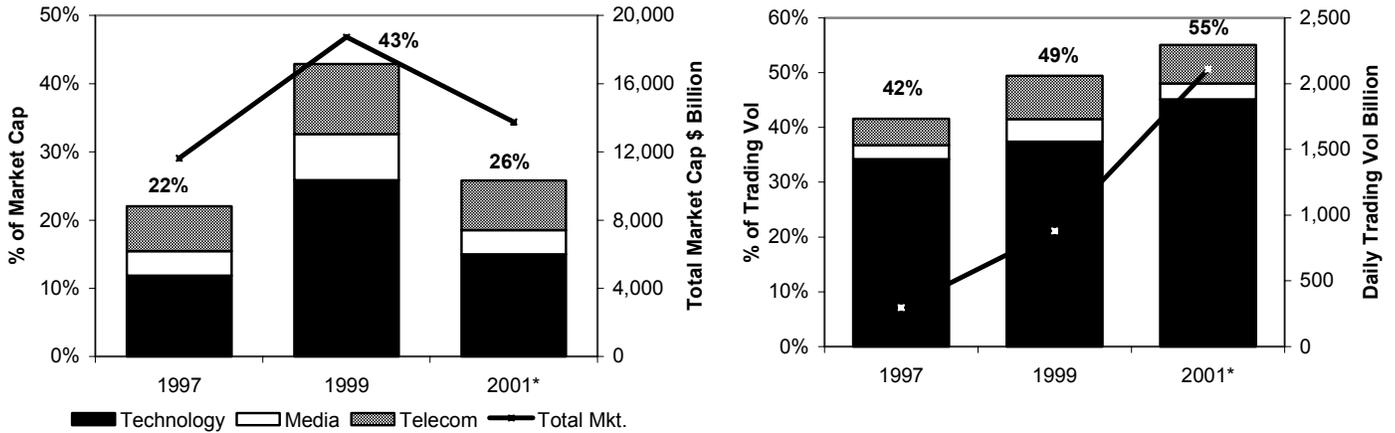
Figure 4: TMT Market Share of U.S. IB Revenues - 1997 to 2001



Source: Freeman & Co. estimates
 Note: Products included are Equity, High Yield, High Grade and M&A.

An examination of the average market capitalization and daily trading volume of these industries reveals the same trend. The large spike in trading volume was driven by TMT stocks. However, as the chart below reveals, this situation is not sustainable. In 1997, TMT stocks constituted 22% of total stock market capitalization. By 1999, these stocks comprised 43% of the total market cap. The current ratio of TMT market capitalization is now closer to 1997 ratios (26%), and it is highly probable that the TMT trading ratios, and hence trading values, will also decline to 1997 levels.

Figure 5: TMT's Share of Total Market Capitalization and Daily Trading Volume – 1997 to 2001



Source: Ford Investor Services
 *As of Sep 28, 2001

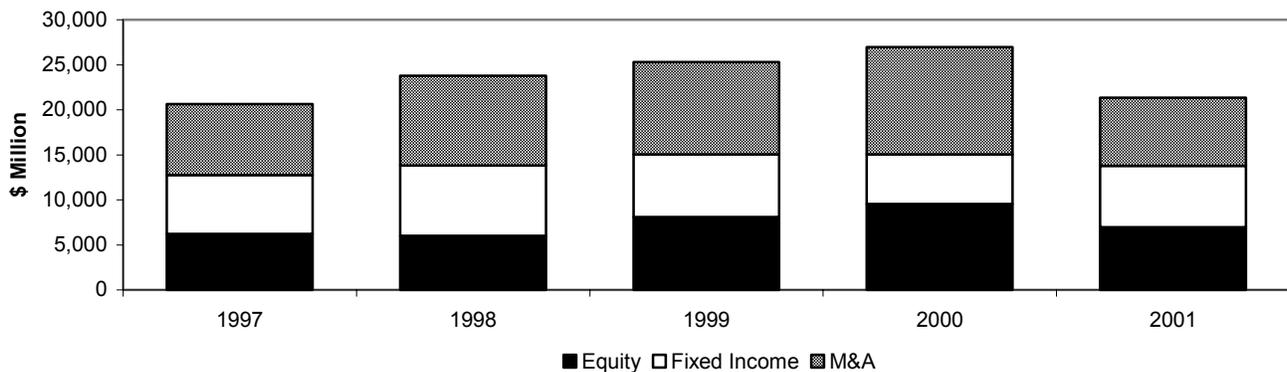
Freeman & Co.'s Forward Looking Market Analysis

Freeman & Co. expects 2002 and 2003 revenues to be considerably lower than 1999 and 2000 and closer to revenues generated during 1997 and 1998. We have analyzed the business by product, industry and type of investment bank to forecast the revenue potential in each area.

By Product

The industry experienced an unprecedented growth in M&A and equity underwriting in 1999 and 2000. In 2001, the first two quarters were better than expected, due to a number of M&A deals that closed during that period, but were initiated in 2000. The fixed income market did exceptionally well. However, business in the third and fourth quarters was poor and overall fees in 2001 were down 21% from the previous year.

Figure 6: U.S. Investment Banking Revenues by Product – 1997 to 2001



Source: Freeman & Co. estimates

In 2002, there is little encouraging product news.

Equity -The current weak equity market will deter many issuers from IPO or secondary offerings, though some companies in select industries have started coming to market. The deals that come to market will provide limited upside revenue potential to institutional and retail investors, due to the shaky market conditions. There will be some convertible business, but it will not provide underwriters with substantial revenues.

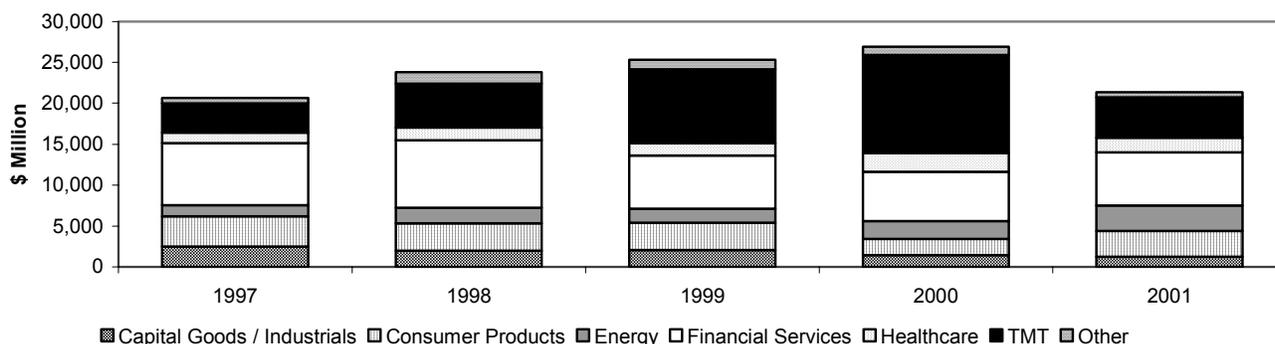
Fixed Income - Most of the corporations that needed to refinance their debt have already done so, which means that there will be few new debt deals during the coming years. On the sales and trading side, the negative market conditions will deter many investment banks from actively participating in the market.

M&A -The current backlog for the M&A business is building, but is still relatively weak. Strategic deals should take place in some industries like retailing, insurance and financial services. Financial sponsors, who play a substantial role in M&A deals, are finding prices more to their liking, but could face some difficulty raising financing in the tougher credit environment. Another drawback to this business is the increasing oversight by regulatory bodies, both in the US and Europe, that has resulted in some large deals (e.g. GE/Honeywell) being overturned. Lastly, the “Enron effect”, resulting in greater accounting scrutiny, may further chill the deal atmosphere.

By Industry

The financial services industry was the leading fee generator for seven of the last ten years. During the the last few years, all industries grew rapidly, with TMT leading this growth. In 2000, these industries overtook financial services to become the market leaders.

Figure 7: US Investment Banking Revenues by Industry – 1997 to 2001



Source: Freeman & Co. estimates

Note: Products include Equity, High Yield, High Grade and M&A

During 2002 and 2003, Freeman & Co. believes that no one industry will dominate the market to the extent that TMT had from 1997 to 2000.

Capital Goods/Industrial – The capital goods sector will likely pick up. Fees may increase as companies that were unable to raise capital in the hot technology environment can come to market. Also, a number of smaller firms in this industry might get acquired. Small deal size and the relatively low activity levels, however, will result in a minimal impact on an investment bank’s bottom line.

Consumer Products/Retailing – There is likely to be a substantial amount of business in this sector, but it will be reduced from 2001, which featured the record-setting Kraft IPO. A number of retailers are facing financial difficulties and will need to either raise debt, sell themselves or sell non-critical operating units.

Energy – This industry did well during 2001, and consolidation possibilities remain. Going forward, the business may not be as robust as it was in 2001. The Enron debacle could significantly affect the performance of a number of the smaller energy companies. The lower price of oil will most likely hurt the equity business.

Financial Services - The financial services industry faces mixed prospects. In the near term, insurance equity issuance will continue to be sizeable and some M&A opportunities remain in this sector. In the investment bank and commercial bank sectors, substantial M&A possibilities exist with a number of the smaller boutiques looking to get acquired and many weaker players targeting to sell themselves. Overall, the financial services industry is likely to regain its status as the leading fee-generating sector.

Healthcare – The healthcare industry has historically been counter-cyclical and is expected to do well in the coming year. Also, the potential deregulation of patents could encourage a number of new entrants into the market.

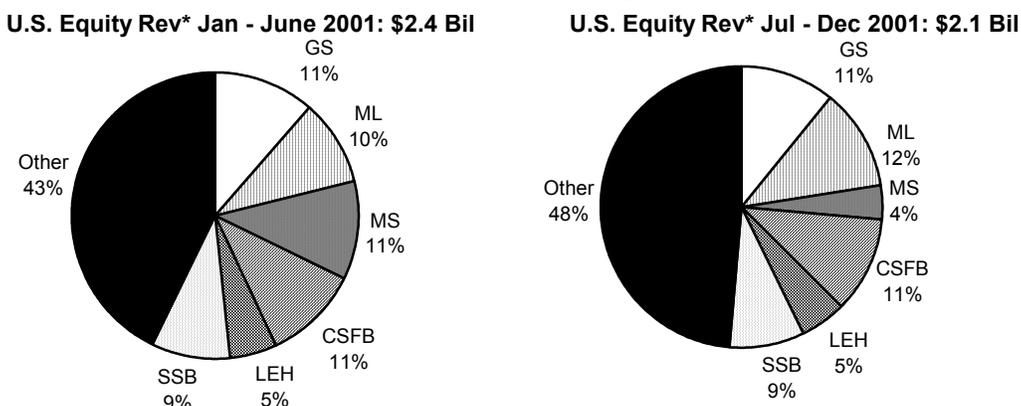
TMT - Since 2000, the technology business has dropped by about 66%. During the next few years, Freeman & Co. expects TMT to continue to grow slowly as many technology and telecom companies restructure.

By Type of Investment Bank

The slow market will impact securities firms in different ways:

Bulge Bracket - The bulge bracket investment banks will continue to move further down-market on deals. During the market boom, these firms focused only on larger deals and the lead underwriting position. However, during the last six months, there has been an increase in the number of lead managers on deals, regardless of deal size, as bankers struggle to generate revenues to cover operating costs. This has resulted in less attractive deal economics for the bulge bracket players, and hence a smaller share of the market, a trend that will continue until markets improve.

Figure 8: Impact of Down-Market Focus of Bulge Bracket Investment Banks



Source: Freeman & Co. estimates
 * Includes IPOs and Follow-on issues only

Bank-Owned Investment Banks – The bank-owned investment banks did exceptionally well in the last few years. Going forward, the increase in loan loss write-offs will force many of these firms to focus on tightening their lending requirements.

Small to Mid-Sized Investment Banks - The down-market focus of the large firms will put further strain on the profitability of the small to mid-sized investment banks. Smaller players may be forced to consolidate or downsize if they lack the critical mass to be competitive.

Stand-Alone Investment Banks - M&A activity in the financial services industry is expected to pick up. The stand-alone bulge and the major investment banks will contemplate acquiring or being acquired by commercial banks. The regional or boutique investment banks may sell themselves or maintain critical mass through selective industry or product specific acquisitions. There will be an interest in asset management acquisitions, as firms seek to acquire steady, fee generating businesses.

Figure 9: Mergers and Acquisitions in the Brokerage Industry from 1997 to 2001

Acquirers	Count of Deals	Est. Deal Value (\$ Bil)	Median Deal Size (\$ Bil)
Domestic Commercial Banks	26	\$149.5	\$0.5
Global Commercial Banks	16	\$41.0	\$3.2
Investment Banks	12	\$41.2	\$4.2
Total	54	\$231.8	\$0.6

Source: Freeman & Co. estimates

Impact of the Current Market Conditions

In 2001, the industry was faced with a substantial decline in revenues in all areas: underwriting, advisory and trading. The scenario of declining revenues was combined with the residual high compensation costs, some of which were guaranteed. September 11 exacerbated the woes of the industry. As a result, the profit margins of investment banks were severely affected and, toward the end of the year, firms took drastic measures to address revenue, cost and profitability issues.

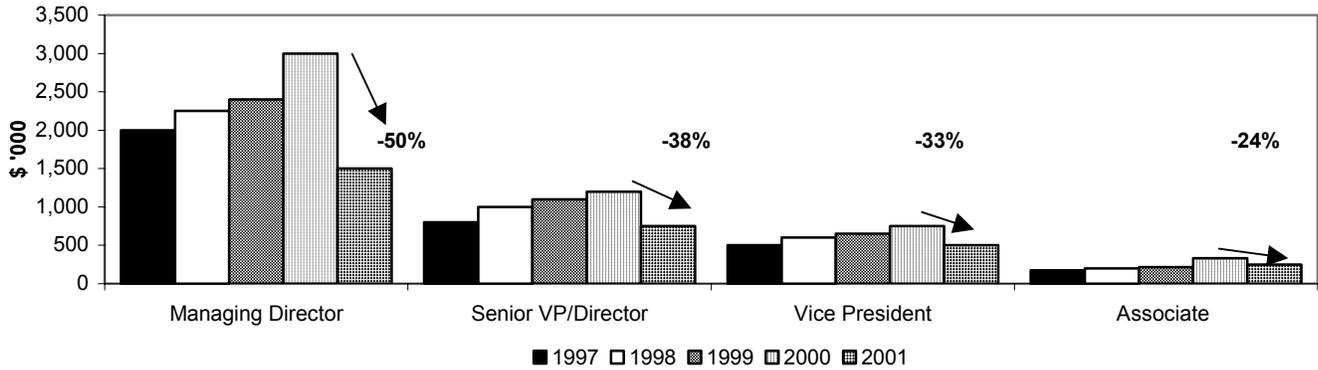
Freeman & Co. anticipated the following evolutionary steps (See Freeman & Co.'s "*Investment Banking Under Siege*", August 2001 for details) would take place in a market slowdown. Investment banks took the initial step of expense reduction in late 2000 and early 2001 by eliminating excesses in travel and entertainment, delaying investments in systems and technology and cutting non-performers.

Figure 10: Evolution of a Market Slowdown



Firms dealt with headcount and compensation reduction throughout 2001. Some of the larger firms, such as Merrill Lynch, cut headcount by about 20%. (Goldman Sachs and Lehman Brothers were the two exceptions that either increased or maintained headcount.) The cuts in compensation of investment bankers and research analysts ranged from 25% to 50% at most of the bulge bracket firms. Some technology-focused boutiques cut compensation as much as 75%.

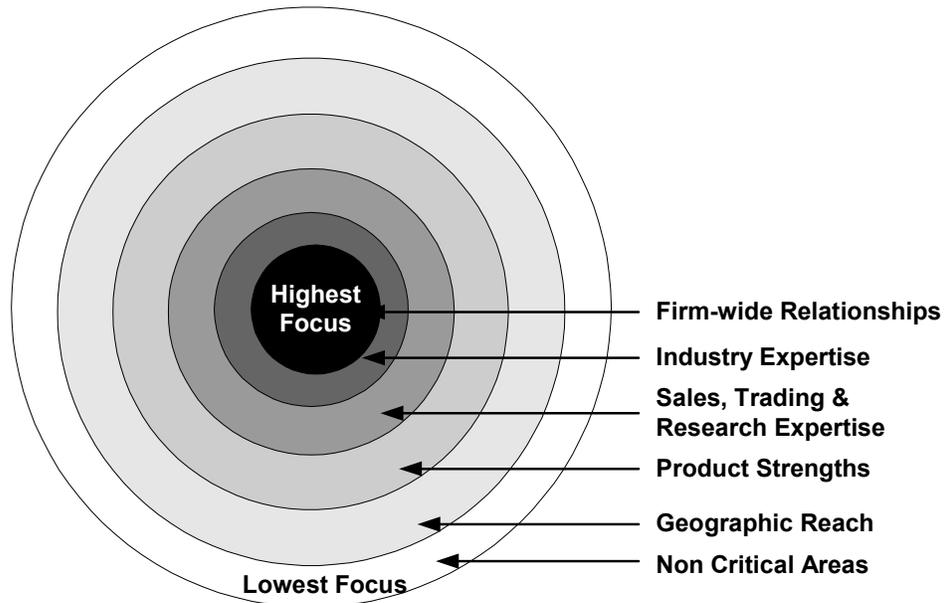
Figure 11: Compensation By Title for U.S. Investment Bankers



Source: Executive Search Firms

In down cycles, investment banking departments, when fully costed, tend to lose money or just about break-even. To achieve stand-alone profitability, banking departments need to focus on their firms’ franchise skills and relationship areas (industries, products, geographies) and limit investments in emerging or non-critical areas. Managers often erroneously nurture under-performing areas with long-term potential instead of expanding the profitable areas. Focusing on the firm’s core competencies will enable each revenue generating department to maximize its earning potential.

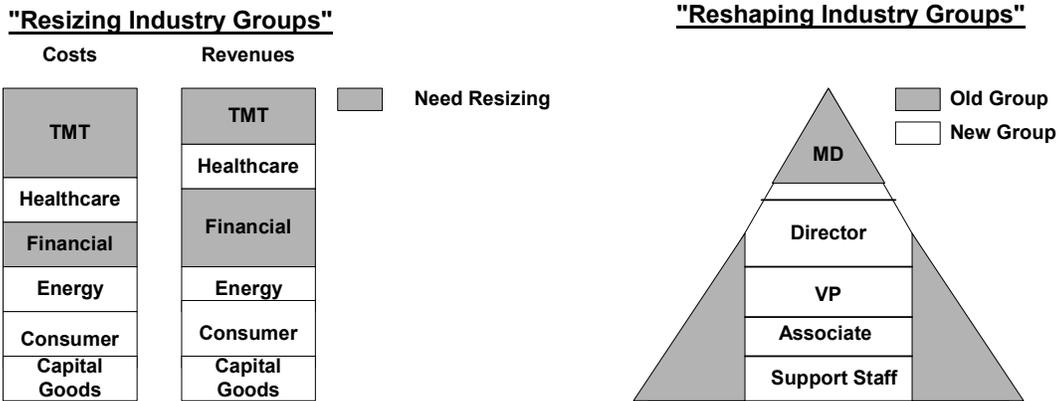
Figure 12: Focusing on the Firm Franchise



Freeman & Co. believes that the last two steps of “resizing/reshaping” the business and “reengineering processes” are critical actions that firms will need to take to deal effectively with the changed market environment.

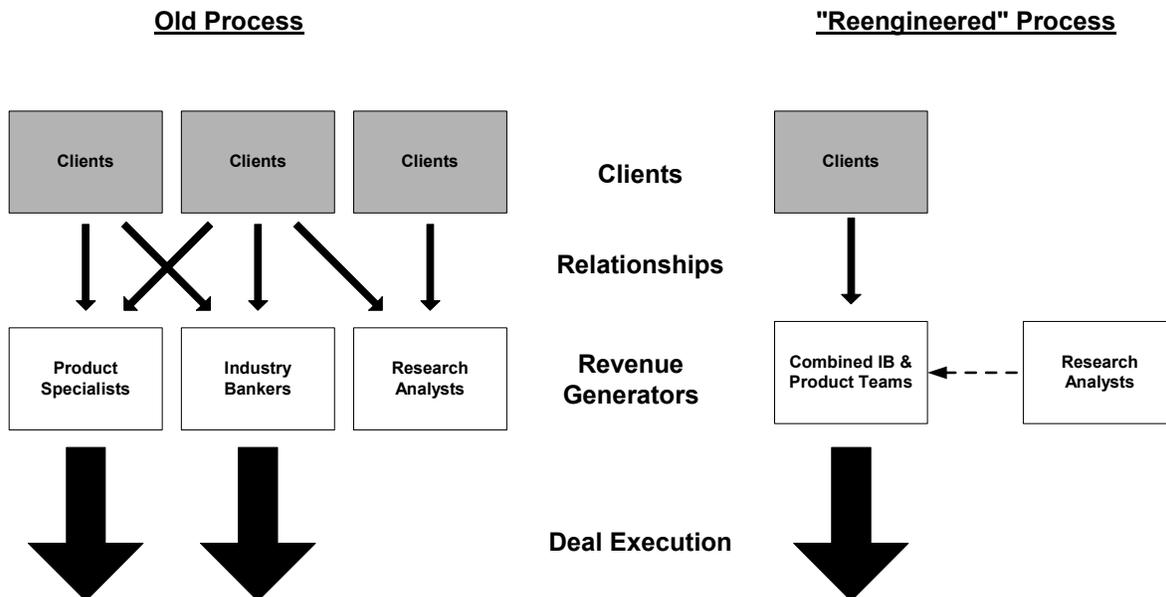
“Resizing” involves examining the industry and product group revenues and costs to identify inconsistencies, determining focus industry and product sectors and eliminating or drastically downsizing the rest. “Reshaping” involves determining the optimal size and shape of each group based on the characteristics of the industry (e.g. pyramid shaped, with less senior bankers but more junior officers and support staff, or missile shaped, with more senior to mid-level calling officers and proportionately less junior processors).

Figure 13: “Resizing/Reshaping” Investment Banking



“Reengineering” involves examining the business to determine ways to streamline processes from trading to corporate finance, from securitization to custody, to cut costs and regulate product quality and quantity flow. For example, technology has already helped investment banks lower the cost of fixed income and stock trading.

Figure 14: Sample Diagram for Reengineering the Corporate Finance Processes



Conclusions

During the next few years, business will likely remain at 1997/1998 levels. While the IPO market may pick up, it will still be considerably weaker than it was in 2000. There is a possibility of increased M&A activity as firms explore strategic acquisitions or divestitures.

Investment banks will be faced with tougher market conditions and increased competition from the leading players for the limited banking business. Firms have already focused on reducing costs, headcount and compensation. Freeman & Co. believes that many firms may need to further reduce headcount to meet current market conditions.

To be successful during the coming two years, investment banks will need to:

- ⇒ Focus on their firms' franchise strengths in terms of relationships, industries, products and geography
- ⇒ Concentrate on near-term firm profitability
- ⇒ Avoid nursing the weaker, less attractive areas with long-term revenue potential
- ⇒ "Right-size" the less profitable product and industry groups and selectively acquire firms to fill any gaps in the existing business
- ⇒ "Re-shape" industry groups to meet the changed market conditions
- ⇒ "Re-engineer" departments and processes to be more efficient and cost effective

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