Freeman & Co. LLC

Investment Banking

Credit: The Rite of Passage for Investment Banks?

June 2003

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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 business associates 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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Table of Contents

Table of Figures

Introduction

A variety of opinions have been offered in heated debates within the investment banking circle on the viability and necessity of merging investment banks and commercial banks. One school of thought asserts that the only way to protect investment banking relationships is to provide balance sheets, thereby equating the survival of the "Pure" Investment Bank with the ability to link up with a commercial bank. Another equally prevalent camp of thinking, however, suggests that the combination of credit plus investment banking is not profitable; therefore, merging commercial and investment banks is inherently a mediocre proposition.

Based on our extensive research, we do not believe that balance sheets alone can save or elevate a second tier investment bank to super bulge status. Although there is some anecdotal evidence to the contrary, statistical data indicate that credit is only one of many competitive advantages. This is especially true in a tight credit market. There are also considerable transactional, operational and strategic risks as a result of these mergers:

Short-term transactional risks - disruptions due to cultural and structural mismatch

Mid-term operational risks - lack of discipline in utilizing balance sheet

Long-term strategic risks - inconsistent strategy implementation due to wavering risk appetite and unrealistic aspirations

What follows is Freeman & Co.'s evaluation of the commercial bank/investment bank merger landscape, with a special focus on the results of those mergers that were consummated from mid to late 1990's, including:

- An examination of the motivations behind these mergers
- An assessment of the outcomes
- An evaluation of the critical success factors for firms that chose to merge or those that chose not to merge
- A forecast of the future of these alliances and those firms that chose to remain independent

A Retrospective on the Investment Banking Mergers

U.S. commercial banks and investment banks began consolidating in earnest in 1997, almost immediately after the Federal Reserve increased the allowable Section 20 (investment banking) revenue from 10% to 25% of total revenue. With the repeal of the Glass Steagall Act in November 1999, the flurry continued, peaking in 2000 with such mega-mergers as CSFB/DLJ, JP Morgan/Chase, and PaineWebber/UBS.

Unlike mergers of similar businesses (similar products/different customers), which can often capitalize on the significant cost-cutting and economies of scale opportunities immediately, many of these mergers of dissimilar businesses (different products/different customers) have much greater integration difficulties. While some of these commercial/investment banks mergers have proved to be successful, many of the commercial banks, as we predicted, were unable to stomach the volatility and capital needs, as well as the conflicts in management and compensation structures. Many of them also experienced challenges in wedding divergent corporate cultures, restructuring relationship coverage and have already started to sell off and shut down these acquisitions at distressed prices.

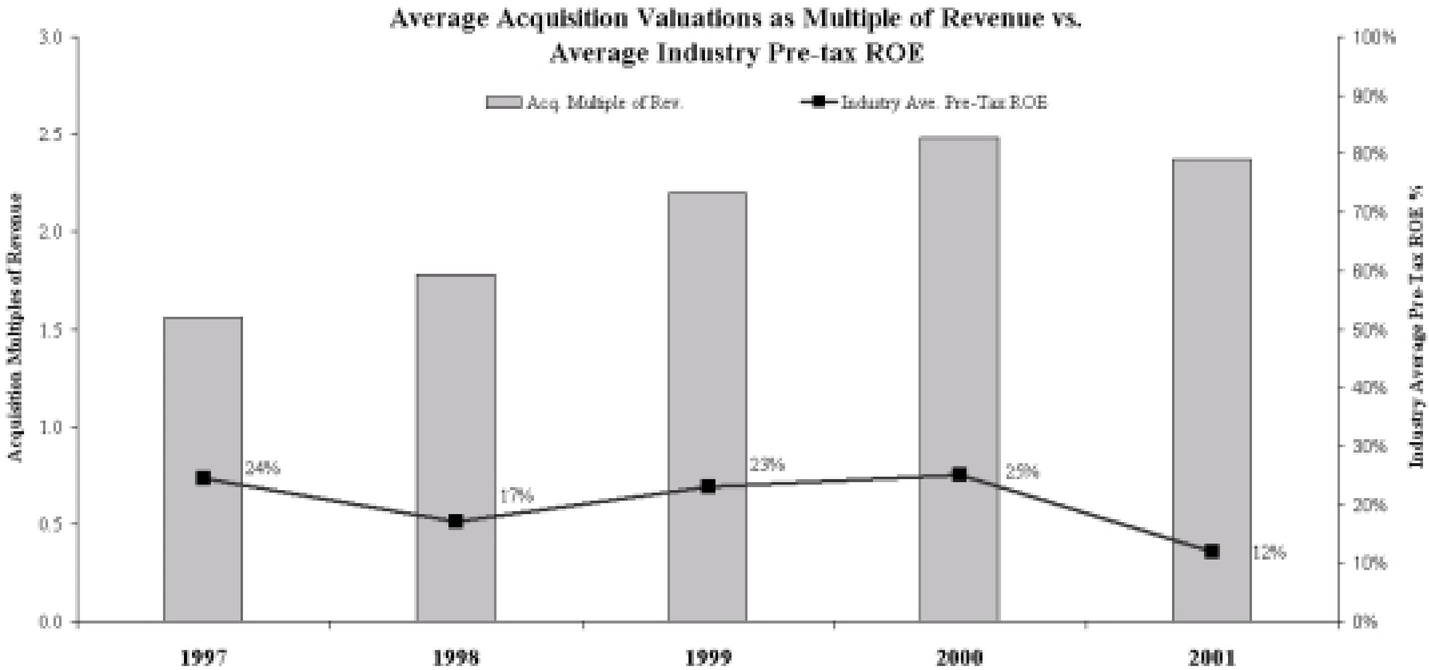
"The future, like the past, will see a continuation of these trends (convergence) followed by an enormous disgorging of these properties during the first prolonged business slowdown."

Freeman & Co., "State of Investment Banking – 2001 and Beyond", Page 7 (January 2001)

Many reasons were cited by the management of commercial banks for such acquisitions. In many instances, commercial banks felt compelled to offer one-stop shopping for existing clientele in order to compete against European banks that were not restrained by regulations. Many bankers found the opportunities to attain higher margins by providing equity and advisory products and a platform to maximize cross-selling revenues appealing. It seemed sensible to take advantage of cost savings opportunities through leveraging existing client and industry knowledge base. Perhaps more importantly, many investment banks also believed that the ability to provide credit, hence a strong balance sheet afforded by a well-heeled commercial bank with a high credit rating, would be essential to win business as competition intensified. This is essential not only for the traditional corporate finance businesses such as securities underwriting and mergers and acquisitions, but also for the derivatives and structured products businesses that require the bank to have an investment grade corporate rating.

During the early phase of the merger boom, commercial banks were able to immediately build market share and improve their relative ranks with the acquisition of investment banks at a reasonable cost. Unfortunately, as the acquisition frenzy continued and the number of remaining independent investment banks dwindled, the premium/multiples paid increased (See Figure 1) while the corresponding pre-tax ROE remained stagnant. This suggests that unless the buyers were able to realize significant synergies from the acquisitions, many of the transactions actually will not pay for themselves. Freeman & Co. is not purporting that all these mergers have failed to produce results but that in many cases, the marginal improvement achieved may not justify the lofty premiums demanded.

Figure 1: Timeline of U.S. Investment Banking Acquisitions and Valuation Multiples



Qtr.	Target	Acquirer	Qtr.	Target	Acquirer	Qtr.	Target	Acquirer	Qtr.	Target	Acquirer	Qtr.	Target	Acquirer
1	Wheat First Butcher	First Union	2	Cowen	Societe Generale	2	Vector Securities	Prudential Securities	2	Beacon Group	Chase	1	Dain Rauscher	Royal Bank of Canada
1	Morgan Stanley	Dean Witter, Discover	2	Robertson Stephens	BankBoston	3	Hambrecht & Quist	Chase	2	JC Bradford	PaineWebber	3	Alliant Partners	Silicon Valley Bancshares
2	Dillon Read	SBC Warburg	2	McDonald	KeyCorp	4	Volpe Brown Whelan	Prudential Securities	3	JP Morgan	Chase			
2	Alex. Brown	Bankers Trust	3	Patricof	BNY	4	Soundview	Wit	3	DLJ	CSFB			
2	Montgomery Securities	NationsBank	3	Scott & Stringfellow	BB&T				3	Wasserstein	Dresdner			
2	Robertson Stephens	BankAmerica							3	PaineWebber	UBSW			
3	Oppenheimer	CIBC							4	Morgan Keegan	Regions Financial			
3	Furman Selz	ING Groep							4	Wallach Co.	KeyCorp			
3	Salomon Bros.	Travelers Group												
4	Piper Jaffray	US Bancorp												

Dec. 1996
Allowable revenue from Section 20 increased from 10% to 25% of banks total revenue

Nov 1999
Restrictions on affiliations with securities firms contained in Sections 20 and 32 of the Class-Steagall Act were repealed

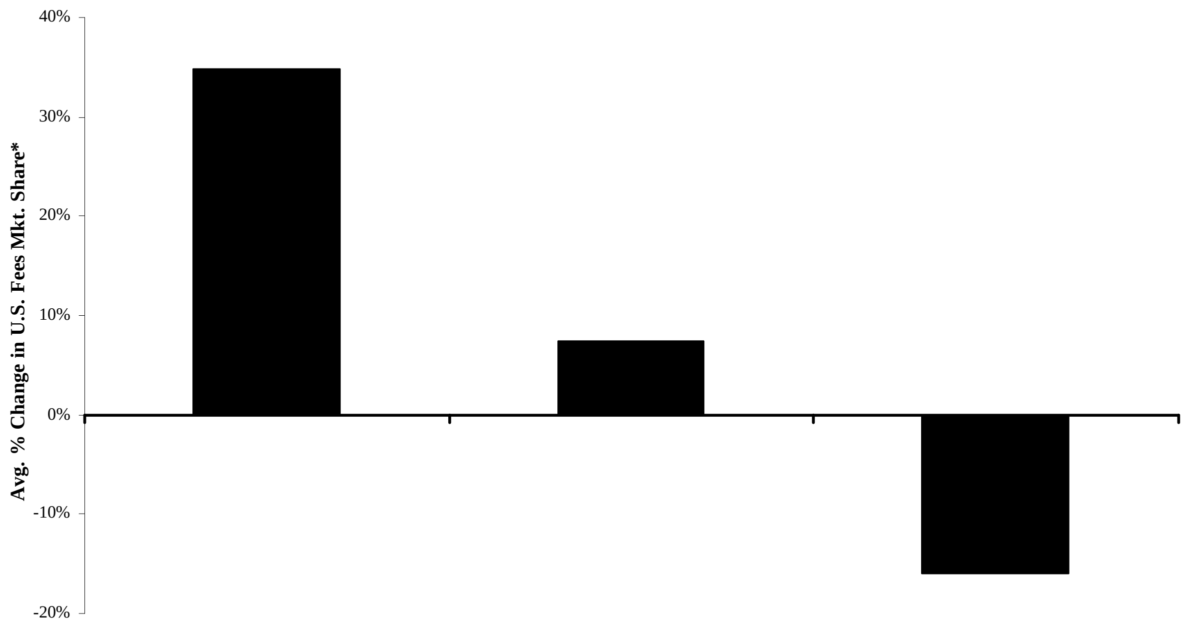
Source: Freeman & Co. estimates, Bloomberg and Company Filings

Merger Results

Wall Street is plagued with ever-changing management, mobility of star bankers and research analysts, and most recently, countless corporate mishaps and a particularly volatile market environment. As a result, it is difficult to isolate the immediate benefits of the mergers between commercial banks and investment banks. While it may be simpler to generalize the overall viability of these mergers based upon a few anecdotal examples, we also believe such analyses to be fundamentally flawed, hence inconclusive.

In order to objectively assess the success of these mergers, therefore, Freeman & Co. structured the analysis based on three distinct groups of mergers/acquisitions: "Titan" Investment Banks (large US commercial banks with substantial investment banking operations), Regional Boutiques and Industry Specialists. We begin by analyzing whether the mergers resulted in market share gains as measured by the change in average fee market share[1] of the combined entities, two years prior (Pro Forma pre-merger market share) and two years after the merger (post-merger market share) (See Figure 2).

Figure 2: Merger Results: Impact on Investment Banking Fees Mkt. Shr. by Investment Bank Type



Regional Acquisitions

2 Yrs Avg Invest. Bk. Mkt Shr

Pro Forma	Post-Merger	% Chg
0.42%	0.56%	34.8%

Includes: Key Corp/McDonald, First Union/Wheat, US Bancorp/Piper Jaffray, CIBC/Oppenheimer, and Regions Financial/Morgan Keegan

Industry Specialist Acquisitions

2 Yrs Avg Invest. Bk. Mkt Shr

Pro Forma	Post-Merger	% Chg
2.14%	2.30%	7.5%

Includes: SG/Cowen, Chase /H&Q, BA/Robertson Stephen, BT/Alex Brown and Nationsbank/Montgomery

"Titan" Acquisitions

2 Yrs Avg Invest. Bk. Mkt Shr

Pro Forma	Post-Merger	% Chg
5.96%	5.01%	-15.9%

Includes: Citicorp/SSB, JPM/Chase, CSFB/DLJ, UBS/SBC and Deutsche Bank/BT Alex Brown

* Pro Forma Market share based on average of 2 years prior to merger versus average of 2 years following merger

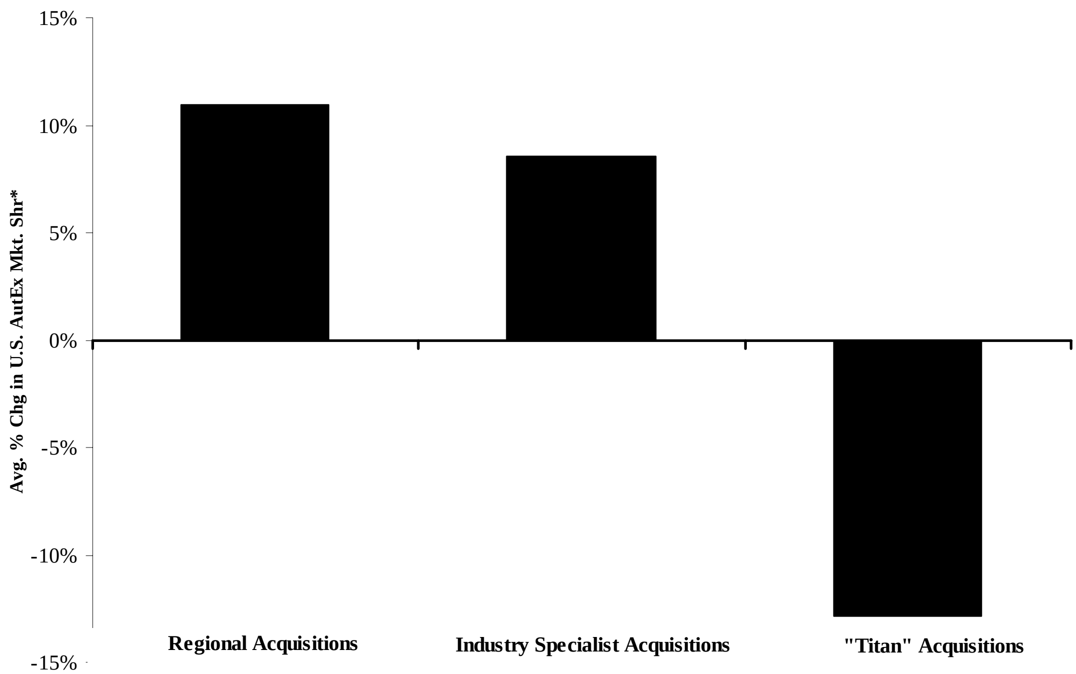
Source: Freeman & Co. estimates, Thomson Financial Securities Data, Bloomberg and Company Filings

[1] Fee market share defined as fees on High Grade, High Yield, Equity Underwriting, and M&A Advisory

Regional/Industry Specialists Merger

Our statistical data indicates that two years after the mergers, the investment banking fee market share of both the Regional and the Industry Specialists improved. This is in large part due to the relatively fewer competing or redundant operations at the merging entities and the ability that the combined banks have in offering their middle-market clients access to capital markets. Furthermore, with the larger balance sheets, these banks have also been able to afford the more capital-intensive trading operations (See Figure 3) that strengthen the banks' capability to provide more investment banking products.

Figure 3: Merger Results: Impact on AutEx Trading Vol. (OTC & Listed) Mkt. Shr. by Investment Bank Type



	Regional Acquisitions			Industry Specialist Acquisitions			"Titan" Acquisitions		
	2 Yrs Avg Autex Mkt Shr			2 Yrs Avg Autex Mkt Shr			2 Yrs Avg Autex Mkt Shr		
	Pro Forma	Post-Merger	% Chg	Pro Forma	Post-Merger	% Chg	Pro Forma	Post-Merger	% Chg
	1.0%	1.1%	11.0%	2.7%	2.9%	8.6%	6.47%	5.63%	-12.9%

Regional — Includes: Key Corp/McDonald, First Union/Wheat, US Bancorp/Piper Jaffray, CIBC/Oppenheimer, and Regions Financial/Morgan Keegan

Industry Specialist — Includes: SG/Cowen, Chase /H&Q, BA/Robertson Stephen, BT/Alex Brown and Nationsbank/Montgomery

"Titan" — Includes: Citicorp/SSB, JPM/Chase, CSFB/DLJ, UBS/SBC and Deutsche Bank/BT Alex Brown

* Pro Forma Market share based on average of 2 years prior to merger versus average of 2 years following

Source: Freeman & Co. estimates and AutEx

It is arguable, however, whether performance improvement has continued after two years. Freeman & Co. believes there are a number of reasons that contribute to much of the recent negative press surrounding these acquisitions. One possible reason is that many parent regional banks have been distracted by their own wave of consolidation and have failed to focus on integrating their newly acquired investment banking assets. The overall poor market conditions, especially in the technology sector in which many of the Industry Specialists are engaged, have no doubt also wiped out some of the earlier gains.

"Titans" Merger

Perhaps not surprisingly, our analyses show that the "Titan" mergers resulted in minimal market share improvement. Clearly, most mergers are driven by the expectation of "synergies", the belief that the whole will be greater than the sum of the parts. Interestingly, the larger the combined investment banking operations of the merging firms, the more often the whole was equal to *less than the sum of the parts.* This suggests that there were probably more redundancies than originally anticipated.

The areas where redundancies are most obvious are equity underwriting and M&A. In pre-merger M&A deals, the two firms could each represent one side but after the merger, the newly merged firm could represent only one side despite the strength of its relationships. Similarly, in an equity underwriting deal, the two firms would have aggressively fought for the lion's share of the deal economics. After the merger, ironically, the portion of the deal economics was rarely equal to the sum of what the two firms may have earned independently.

As a result, careful examination of the positions of the "Titans" indicates that their market share ranks in 2002 are practically unchanged compared to before the easing of Section 20 restrictions in December 1996, on a pro forma basis (See Figure 4).

Figure 4: League Tables based on U.S. Investment Banking Fee Pools (excluding syndicated loans)

Section 20 Restriction Eased → **Post -Repeal of Glass Steagall** → **Back to Square One?**

1996*			2000			2002		
Rk	**Firm**	**Fees Shr. %**	**Rk**	**Firm**	**Fees Shr. %**	**Rk**	**Firm**	**Fees Shr. %**
1	SSB/Citi	9.6%	1	CSFB/DLJ	11.6%	1	SSB/Citi	9.7%
2	Merrill Lynch	8.5%	2	Goldman, Sachs	10.4%	2	Merrill Lynch	8.2%
3	CSFB/DLJ	8.1%	3	Morgan Stanley	8.3%	3	CSFB/DLJ	7.7%
4	Goldman, Sachs	7.8%	4	Merrill Lynch	7.7%	4	Goldman, Sachs	7.3%
5	Morgan Stanley	7.3%	5	JP Morgan/Chase	7.2%	5	Morgan Stanley	6.7%
6	JP Morgan/Chase	4.9%	6	SSB/Citi	6.9%	6	JP Morgan/Chase	6.5%

*Pro Forma Pre-Merger Market Share

Source: Freeman & Co. estimates, Thomson Financial Securities Data, Bloomberg and Company Filings

Although one may argue that these mergers have prevented the deterioration and possible demise of some of the old franchises, the data indicates that the impact on market shares have not been significant among the top players.

Common Risks – Integration Risks and Others

In theory, all investment bank/commercial bank mergers should allow bankers to provide a broader product suite to their clients. In reality, a variety of short-term transactional risks, mid-term operational risks and long-term strategic risks threaten the success of these mergers.

Short-term transactional risks increase with the size of the merger. The cost of derailment, due to loss of valuable producers and massive layoffs, take a major toll on the morale of the newly merged firms. In fact, failure to effectively address these short-term risks did thwart the ultimate success of some of the mergers within months.

Mid-term operational risks increase with the ability of management to adopt a consistent, disciplined and equitable approach in deploying capital and other resources. In some cases, the acquired investment banks find that the companies with whom the acquiring commercial banks have lending relationships are not the same companies they could or would like to cater to. Alternatively, not being able to offer credit to priority investment banking clients due to lack of credit worthiness issues creates client dissatisfaction that leaves the combined firm the same or worse than before in terms of revenue, market share and client satisfaction.

Long-term risks increase as a result of wavering financial and operational risk appetites and unrealistic aspirations fostered by lofty valuations paid during the high-flying years for investment banks. Many of the Regional and Industry Specialists were acquired during the bull market by commercial banks who did not expect and had little experience in managing the investment banking business during a downturn. Often embattled with rising defaults and profitability in the commercial banking operations, management of these merged entities were ill prepared to tackle the simultaneous, additional plummet in investment banking revenues. The substantial costs required to sustain the investment banking business became harder to stomach as well. Risk appetite began to taper off as a result, which often led to management shakeout, revision in strategies and eventually, orphaned or closure of the investment banking business.

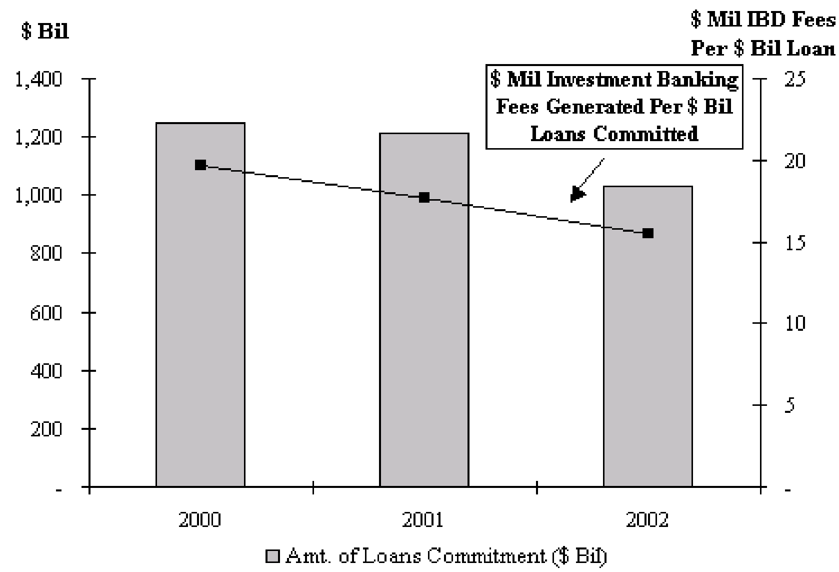
In the in-depth product analysis in the next section, we examine which products the commercial banks have been successful with, and why. Since many of the Regional and Industry Specialist mergers have already disintegrated or are currently being spun off, the focus of our remaining analysis will be on the performance of the "Titans" versus their similar size "Pure" Investment Bank competitors.

The Products that Pave the Road

Credit

Proponents of many investment banks/commercial banks mergers regularly argue that the ability to extend credit enhances the investment banks' ability to win valuable mandates. To understand whether the assertion is accurate, Freeman & Co. examines the ratio of investment banking fees[2] generated per $ billion of syndicated loan commitment. Although the amount of loan committed from the banks has decreased over time, the results show a decreasing return for every dollar committed (see Figure 5).

Figure 5: Ratio of U.S. Investment Bank Fees to Syn. Loan Commitment: Too much $ chasing too little fees



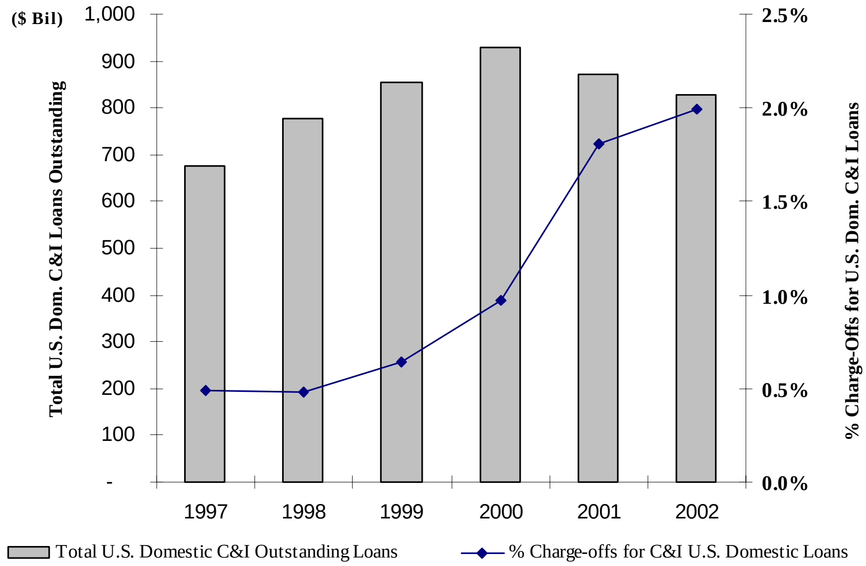
Source: Freeman & Co. estimates, Thomson Financial Securities Data and Bloomberg

A fact that is even more worrisome is that the net commercial and industrial loan charge-off average during the same period has increased dramatically (See Figure 6). The trend is consistent with the detailed analysis Freeman & Co. conducts with the financial statements of several of the merged banks. Based on this information, we can deduce that many of the "pay to play" deals have turned out to be expensive propositions. With the exception of a few "Titans" who managed to "beat the house" by selecting their transactions very carefully, this reflects a general deterioration of lending discipline as banks desperately sought to throw in the credit "carrots" to their less credit-worthy clients giving out investment banking fees.

Freeman & Co.'s analyses have shown that perhaps the more important issue for the investment bankers to consider is not whether credit is necessary to win investment banking mandates, but rather, whether profitability and risk management have been compromised in the quest for league table status.

[2] Investment banking fees defined as fees generated from High Grade, High Yield, Equity Underwriting, and M&A Advisory

Figure 6: U.S. Domestic Commercial and Industrial Loans Outstanding and Charge-Offs

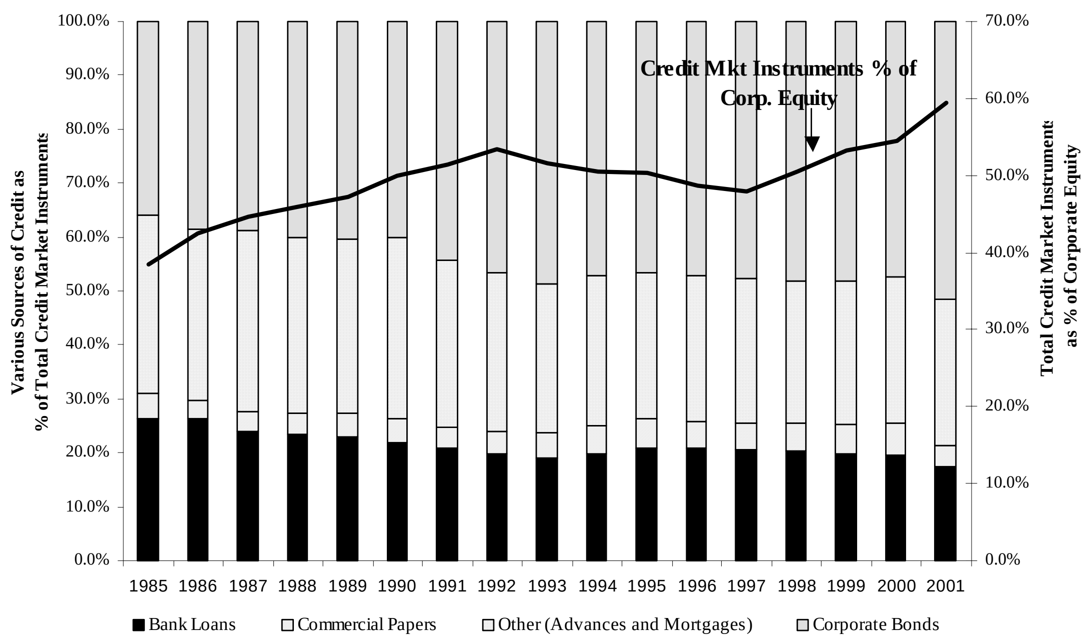


Source: Freeman & Co. estimates, FDIC and Company Reports

Debt-underwriting

Like individual Americans, U.S. corporations have leveraged themselves to historical heights. The low interest rate environment has encouraged a flurry of refinancing activity. However, dependency on bank loans has decreased proportionately over time as corporations have increasingly tapped the capital markets (See Figure 7). More and more, corporations are utilizing the bond market for their long term needs and commercial papers for their short-term needs.

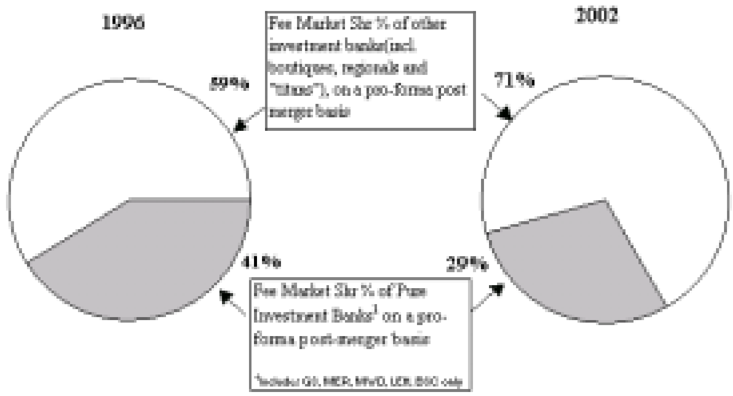
Figure 7: U.S. Corporations Source of Credit and Credit Instruments as a % of Equity



Source: Freeman & Co. estimates, FDIC and Company Reports

It seems logical, therefore, for commercial banks that acquired investment banks to immediately leverage upon their credit expertise, balance sheet and lending relationships to elbow their way into fixed income underwriting deals. The shift from bank loans to debt underwriting, in particular high yield, derivatives and structured products, also represents an opportunity for higher returns and the opportunity to move riskier assets off their balance sheets. As a result, while "Pure" Investment Banks controlled 41% of the total fee pool from debt underwriting in 1996, fee market share of these firms dropped to 29% by 2002 (see Figure 8).

Figure 8: U.S. Fee Market Share of Debt Underwriting



Source: Freeman & Co. estimates, Thomson Financial Securities Data, Bloomberg and Company Filings

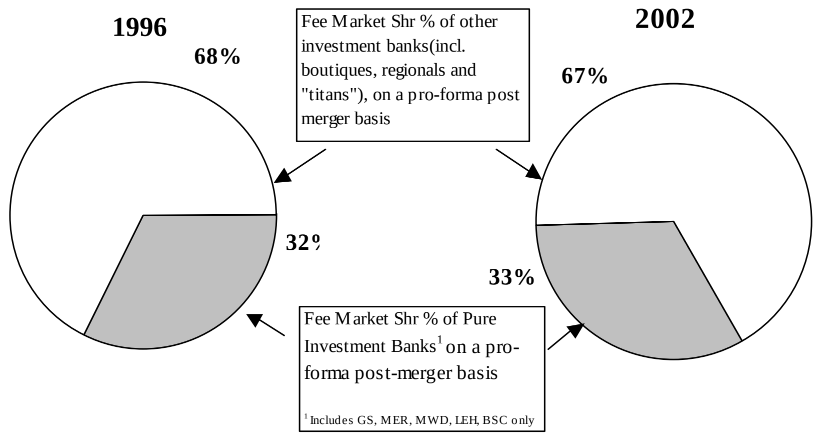
While this erosion of the market share of the "Pure" Investment Banks suggests that commercial banks are making inroads in this business, the added competition has also contributed to the "commoditization" of debt products, thereby pushing down the overall margins. Indeed, many of the bulge bracket investment banks have consciously decided against building market share at the expense of profitability and are conserving their precious capital for higher margin businesses such as equity, securitized products, structured products and proprietary trading.

Equity-underwriting

Historically, the three most important considerations for an issuer in selecting investment banks for their equity transactions are: banker relationships, equity sales and trading prowess and research support. In theory then, with the acquisition of investment banks, commercial banks should be able to substantially increase their equity revenues by combining their relationships with the investment banks' sales and trading and research capabilities.

Contrary to such expectations, the equity underwriting fee market share of the "Pure" Investment Banks did increase from 1996 onwards and peaked simultaneously with the overall market in 2001. However, the extreme dominant position of the "Pure" Investment Banks was short-lived as their fee market share has returned to 1996 levels since then (See Figure 9), consistent with our earlier findings (See Figure 4).

Figure 9: U.S. Fee Market Share of Equity Underwriting



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

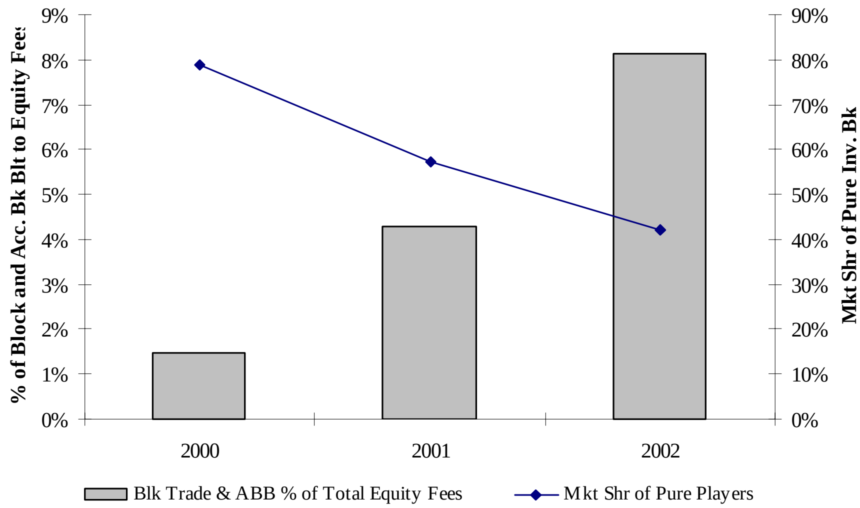
A number of explanations are offered for the apparent stranglehold of "Pure" Investment Banks on the equity underwriting business. Once again, failure to integrate fully the research and sales and trading arms was probably one of the most likely culprits. As many of the "Pure" Investment Banks can attest, effectively aligning the operations of the three departments to serve clients seamlessly is a time-consuming process. For example, when the research department's role, especially during the late 1990's, was heavily geared towards assisting the investment bankers to win business, the failure to structurally align research coverage to meet that need was fatal. Similarly, where the research salespeople and traders failed to build core competencies in securities that mattered for the investment bankers, commercial/investment banks will continue to suffer a handicap against "Pure" Investment Banks in distribution and market support. These weaknesses are further magnified in a volatile market where the ability to take advantage of small windows of opportunities is most crucial.

It is likely, given the recent legal developments regarding Wall Street's research departments, that the role of research in winning investment banking mandates will be greatly diminished. However, it may still be premature to write off the significance of research as most investment banks continue to search for a solution that allows them to preserve this competitive advantage while addressing the new legal requirements.

One would assume that the surge in underwritten block trades in adverse markets would play to the strength of commercial banks whose possession of a sizable balance sheet would allow them to take on additional risks. In this case, market analysis does prove this hypothesis (See Figure 10).

In reality, Bulge Bracket "Pure" Investment Banks do have strong enough capital base set aside for block trades commitment. Whether credit is a sustainable advantage for commercial bank based firms in this product is therefore, debatable.

Figure 10: U.S. Block Trades and Accel. Bk. Build % of Total Equity Fees vs. "Pure Players" Fees Mkt. Shr. %

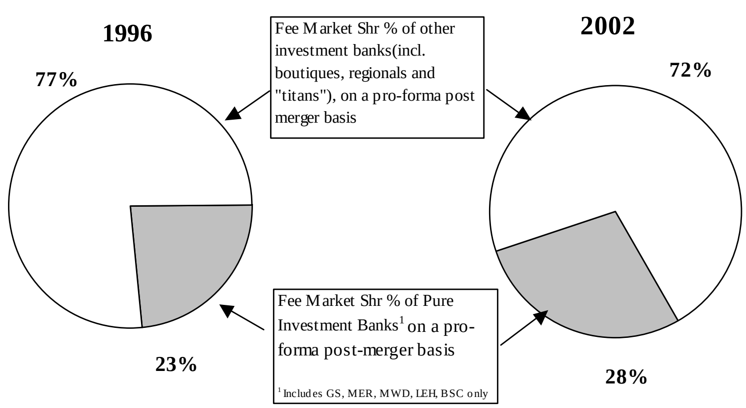


Source: Freeman & Co. estimates, Thomson Financial Securities Data and Bloomberg

M&A

As the spreads are pushed down on underwriting, investment banks look to M&A to enhance their margins. Despite the strength in the Titans' historical market share in this area, "Pure" Investment Banks have improved their market share since 1996 (See Figure 11).

Figure 11: U.S. Fee Market Share of M&A Advisory

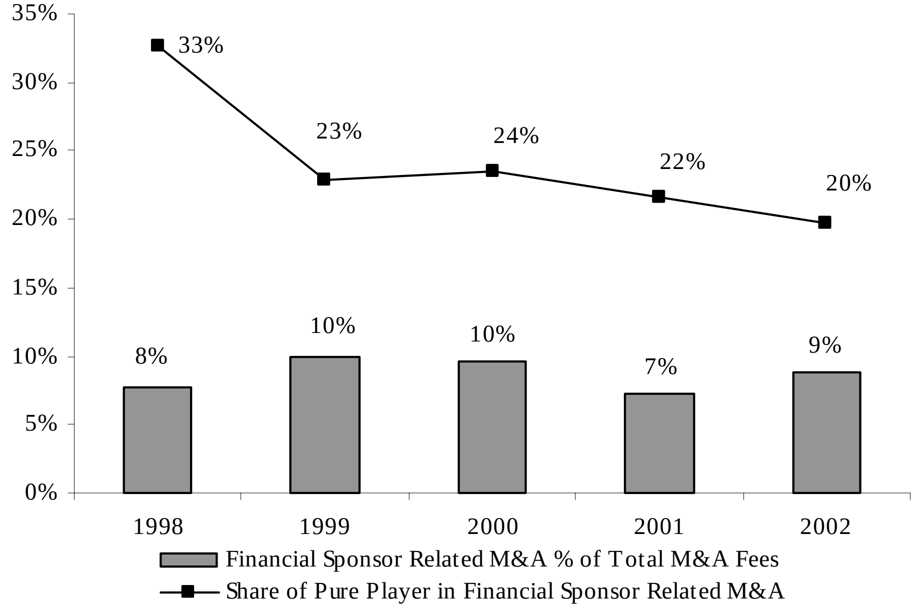


Source: Freeman & Co. estimates, Thomson Financial Securities Data and Bloomberg

Freeman & Co. analysis has found that M&A fees generated from deals involving lending have not been significant. Stock swaps were favored in the late 1990's as companies utilized their increasingly valued currency. However, if the depressed equity market and the low interest rate environment persist, using cash or debt to finance acquisitions may then be in favor, which will play to the strength of the "Titans".

One area where a lending relationship seems to play an important role is in the Financial Sponsor related M&A deals. The top 100 Financial Sponsors have been responsible for generating on average 9% of the total M&A fee pool over the last five years. Concurrently, the "Pure" players' market share in this area has declined steadily over the same time period. (See Figure 12). We believe this possibly reflects the Titans' ability to commit large credit lines necessary to finance buyouts and acquisitions. No doubt, the ability to stand behind their financial sponsors' clients enhances their competitive edge.

Figure 12: U.S. Fee Market Share of Financial Sponsor Related M&A Advisory



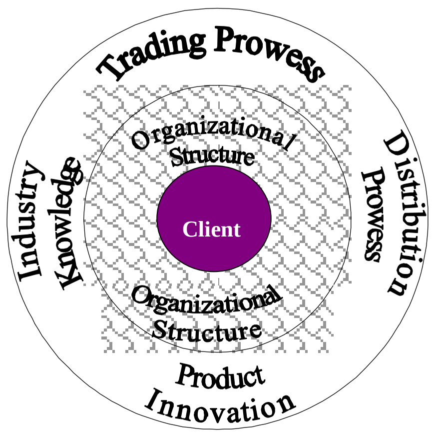
Source: Freeman & Co. estimates, Capital IQ, Thomson Financial Securities Data and Bloomberg

Freeman & Co.'s Conclusions

Core Formula for Success Has Not Changed

Regardless of the size, structure and industry focus of a bank, Freeman & Co. believes that the original recipe for success in investment banking remains unchanged. Numerous studies we conducted have demonstrated that the ability to harvest relationships still depends on industry knowledge, distribution and trading prowess, product innovation and the organizational structure (see Figure 13). The success in implementing this strategy transformed the bulge bracket from profitable small businesses in the 1970's to hugely profitable firms in the 1980's to global leaders in the 1990's and will continue to distinguish the winners from the losers in every category.

Figure 13: Investment Banking Strength Matrix



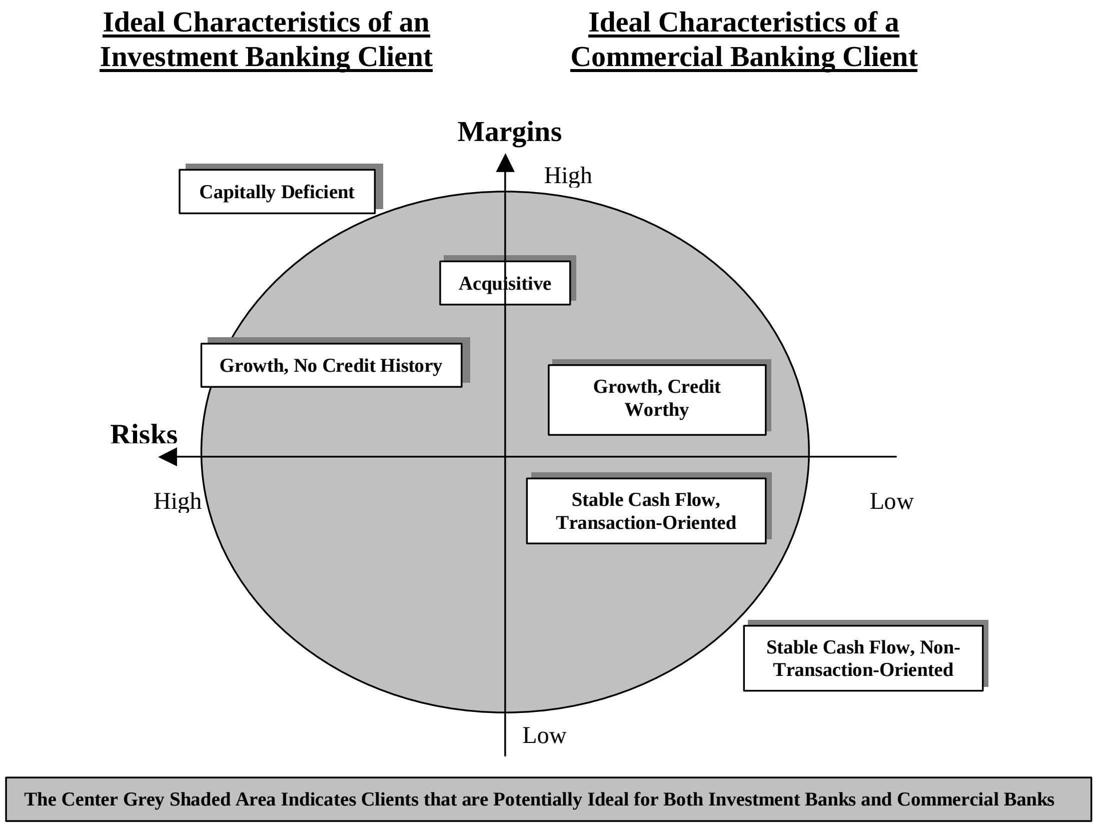
Source: Freeman & Co.

The quality of a firm's existing relationships is determined by the quality of that firm's industry knowledge and, often, reputation, which in turn directly impacts the ability to attract other new clients. Distribution prowess is essential to ensure that the "right" products are sold and held by the "right" investors based on the mutual needs of issuers and investors. Trading capabilities allow the investment banks to provide critical after-market support and maintain competitive knowledge on market trends and movements. Product innovation is necessary to keep the "pipeline" full and satisfy ever-changing demands and market conditions. Organizational structure is the cement that binds industry knowledge, distribution, trading and product innovation around client relationships.

Variations to this original recipe for success are permissible. In fact, it is necessary for each of the investment banks to develop their appropriate niche in order to compete effectively. The ability to extend credit is one such variation. If seamlessly integrated into an already successful core strength matrix, such ability can be a potent competitive advantage.

However, the addition of credit capability does add another level of complexity to the core strength matrix, namely, client focus. Specifically, the profile of an ideal investment banking client and an ideal commercial banking client could be divergent and conflicting (See Figure 14). Also, there are only a finite number of clients in the market worthy of leveraging a lending relationship into an investment banking relationship and vice versa.

Figure 14: Profile of an Ideal Client



Over the last eight years, Freeman & Co. studies have consistently found that an investment bank's knowledge about a client (as measured by Freeman Index) is directly proportional to its share of fees from that client. It is therefore crucial that investment banks/commercial banks have the correct procedures and disciplines in place to institutionalize such client knowledge in order to maximize their competitiveness and deploy their capital resources accordingly.

Myths and Truths – Mergers of Investment Banks and Commercial Banks

Freeman & Co. does not believe that the lack of balance sheet capacity will signal the demise of the "Pure" Bulge Brackets. Retention of acquired relationships is not solely dependent on credit, and the bulge bracket firms have capital to make selective lending facilities. Many commercial banks were wrong to believe that balance sheet alone would help them gain permanent market share. Instead, identification of the right client base and the seamless integration of the different departments to serve that client base are far more crucial.

Freeman & Co. believes that the disgorging of investment banking properties that began in 2001 will continue as some commercial banks determine that the financial and operational risks, costs and cultural headaches of these mergers outweigh the benefits. The acquisitions with the highest premiums that failed to deliver will be the most likely candidates for divestitures, spin-offs, and in the most extreme cases, liquidations, as the expectations were the highest going into the merger and the economics the worst.

It must be noted, however, that as the role of Equity Research continues to diminish, investments banks are increasingly dependent on other aspects of the business such as sales and trading and quality of advisory work to differentiate themselves from their competitors. Naturally, commercial banks with their huge balance sheets can and will continue to leverage their credit strength to their advantage as long as they can afford it.

"Titans"

Freeman's analyses have shown that there has not been marked improvement in the performance of the "Titans" so far. This can be the result of overall economic conditions, short-term and long-term integration challenges and other reasons such as legal/regulatory problems. Before the dust settles, it is probably too early to conclude that the "Titans" have failed. It is clear that the "Titans" are no sure winners though. Freeman believes that the dissatisfaction associated with some of the less than stellar mergers will likely affect the strategies of these management teams over time, making them more risk averse and reducing their aspirations.

In order to compete against "Pure" Bulge Brackets, the "Titans" must capitalize on their strengths by carefully scrutinizing their client base to identify opportunities that do not compromise their overall profitability and balance sheet quality.

"Pure" Bulge Brackets

Many of the "Pure" Bulge Bracket Investment Banks are almost as well capitalized, if not better, than many commercial banks. The Bulge Bracket firms can execute many of the trades (e.g. market making, block trades, derivatives, dispersion books, proprietary trading books etc.) that require a huge balance sheet. Lending is therefore a matter of choice rather than restriction.

The Bulge Bracket firms developed and benefited from the knowledge of "core formula for success" (see Figure 13) very early in the game. This knowledge barrier, however, is not unbreakable and their survival and ability to flourish will depend on continued product innovation, client relationships, dexterity and discipline.

Regional/Industry Specialists

Pessimists claim that larger players will eventually go down-market to the mid-cap space and squeeze the smaller firms out of the market. In reality, many bankers, especially those who were made redundant recently, did go down market as competition for deals became intense. In retrospect, such efforts proved to be strategic and financial mistakes both for the bankers and for their companies. Unless the mid-sized transactions are from the firm's large priority clients, smaller deals are not lucrative for the large firms. Over time, they will avoid competing in that market as the cost of differentiating their firms to smaller clients outweighs the potential profits. This was evident in 2001/2002 when many of the "Titans" and "Pure" Bulge Brackets laid off thousands of employees as a result of overstaffing in the late 90's.

The recent scrutiny that the major firms have received into their research departments and IPO allocation practices has resulted in significant disillusionment amongst many corporate clients. As the bigger players battle the damage to their reputations and continue to rationalize their banking and research coverage as well as market-making footprint, these clients will likely seek better service from boutiques. Indeed, in recent months, there have been a flurry of new boutiques opened by recently laid off bankers, bankers who are seeking better lifestyles or those who are tired of the incessant conflicts of interest within their old firms.

As a result, Freeman & Co. expects to see a resurgence of boutiques, especially in the area of advisory services where balance sheet requirements are minimal.

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