Freeman & Co. LLC

Investment Banking

2002 and Beyond

October 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*

In addition, look for these other Freeman & Co. industry reports, most of which are available on our web site (www.freeman-co.com/news):

Investment Banking	Equity S&T: End of the Line for Old Reliable	October 2002
Investment Banking	Equity Research – The Rocky Road Ahead	June 2002
Investment Banking	Investment Banking – Back to Basics	February 2002
Investment Banking	Investment Banking in Europe – Map to the Holy Grail	August 2001
Investment Banking	Investment Banking – Under Siege	August 2001
Investment Banking	Equity Research – Will Equity Research Survive 2001?	April 2001
Investment Banking	Electronic Investment Banking: Where Will it Survive?	November 2000
Investment Banking	State of Investment Banking – 2000 and Beyond	October 2000
Investment Banking	Investment Banking in Europe –Quest for the Holy Grail	September 2000
Investment Banking	Technology Slowdown – How Serious?	May 2000
Investment Banking	Trends in Investment Banking – 1997 to 2000	March 2000
Investment Banking	E-Investment Banking: Evolution or Revolution	October 1999

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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Table of Contents

Table of Figures

Introduction

The current year has been extremely difficult for investment banking firms. They have been faced with a plague of woes including the stock market decline, lawsuits by the New York Attorney General and other regulators, and high profile scandals such as Enron, WorldCom and Tyco.

These events have been the catalyst for investment banking firms to make a number of **structural** and **functional** changes. On the structural side, investment banks are reinforcing the firewalls between their investment banking and research divisions and changing compensation methods. Regulators may now demand a total separation of research from investment banking. On the **functional** side, firms are combining industry groups, merging capital markets operations and moving M&A bankers to industry groups. At the same time, headcount reductions continue, seemingly endlessly.

Freeman & Co. believes that most investment banking firms are likely to continue cutting headcount, in some areas (mainly investment banking and institutional equity departments) as much as 15% to 20%, before they are "right-sized" to meet the changed market environment. Average 2002 compensation levels for investment bankers are expected to be down by 30% to 50% at most levels.

An analysis of investment bank profitability reveals a dependence on two high margin products: equity underwriting and mergers and acquisitions ("M&A"), which are under severe volume and margin pressure. Regulatory scrutiny of the IPO allocation process could put additional downward pressure on equity profitability. In 2002, Freeman & Co. expects the fixed income business to be the largest contributor to firm profitability, with investment banking departments actually posting losses (on fully allocated costs).

Investment banking division revenues will remain at depressed levels for the remainder of 2002, and pick up only slightly by mid-2003. Overall revenues will return to near 1997 levels. There appear to be few signs that either M&A or equity underwriting will pick up significantly in the short term. Freeman & Co. expects fixed income to come off the highs of recent years. No single industry or group of industries will fill the gap left by technology, media, telecom ("TMT"). There is likely to be considerable business in restructuring, however.

The history of investment banking has been one of constant change. During each market cycle, firms have refused to believe that the market would change direction. As such, they often take drastic measures to deal with short-term market conditions. However, today's prolonged depressed market conditions will result in a number of changes that may fundamentally change the nature of the business:

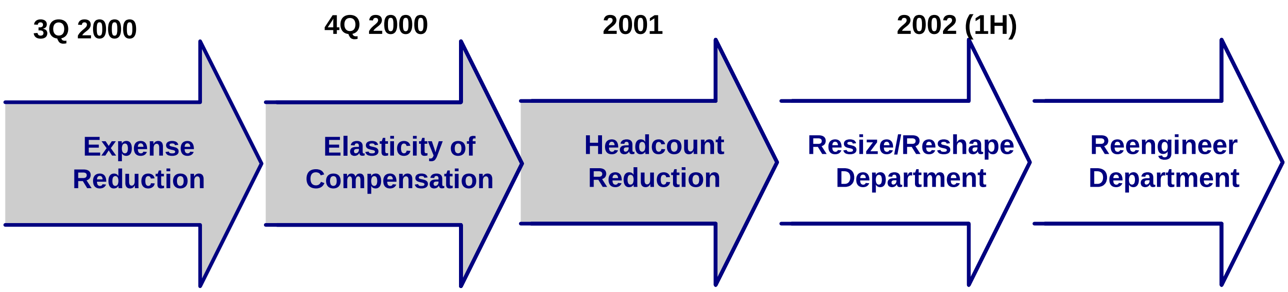
- Investment banking department profitability will remain under pressure as M&A remains slow and regulators scrutinize the IPO allocation process and demand more transparency
- Regulatory pressure to separate research from the investment banking department will test firms, both financially and functionally. Research budgets are likely to be reduced by a further 30% to 40% to come in line with the new revenue outlook
- Investment banker compensation will drop to levels not seen since the mid-1990's
- Another large merger is needed to reduce excess capacity
- Many marginal players are likely to exit the business
- A new group of boutiques will emerge that will be either research or M&A focused
- Some of the "super-financial" firms may need to spin off parts of their operations
- Increased scrutiny from regulatory authorities will result in further lawsuits. Firms will hire additional compliance people as a result

2002 - A Year of Change

In an earlier report, ("Investment Banking – Back to Basics", February 2002) Freeman & Co. was not optimistic about the industry outlook. We recommended that investment banks needed to further "resize and reshape" their investment banking and research departments and to reengineer entire groups. This process has been going on in earnest for the last six to nine months and has included:

- Consolidating industry coverage into a few "super-groups" and one general industrial group, which is the "umbrella" group for several industry sectors
- Moving M&A professionals back to industry groups to reduce headcount
- Combining capital market groups (debt and equities, high yield and high grade)

Figure 1: Evolution of a Market Slowdown

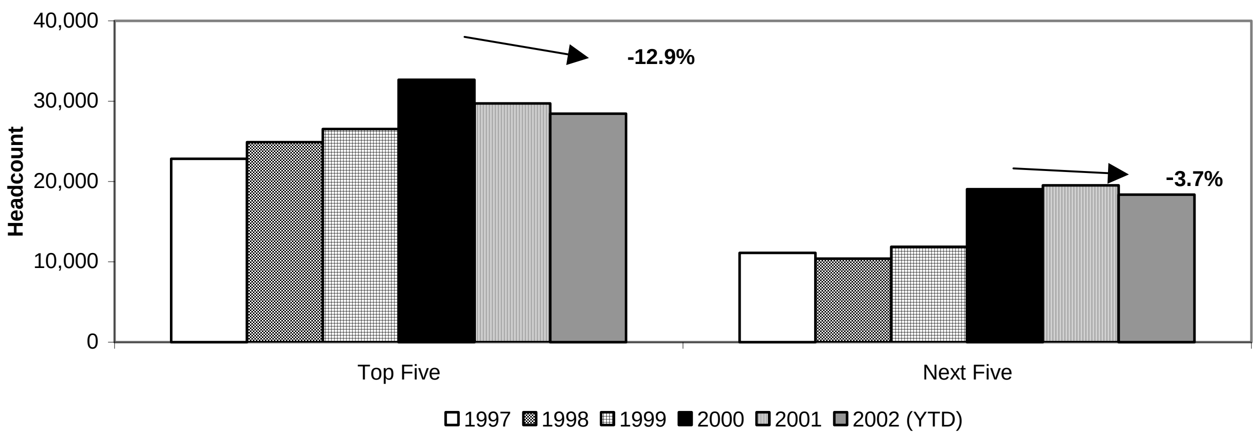


Headcount and Compensation

Since the end of 2000, the industry has cut 32,287 employees, or 8.8% of its workforce. As we move into the last quarter of 2002, firms are still faced with anemic bonus pools and headcounts that are still too high.

While earlier cost reduction goals focused solely on reducing headcount, later rounds seem more focused on reducing dollars spent. As such, the focus has shifted from reducing the number of analysts and associates, who are cheaper but more numerous, to reducing unproductive senior employees. At some firms, certain classes and groups will be hit harder than others, with personnel in TMT and the classes of 2000 and 2001 (which were still relatively larger at most firms) being likelier targets.

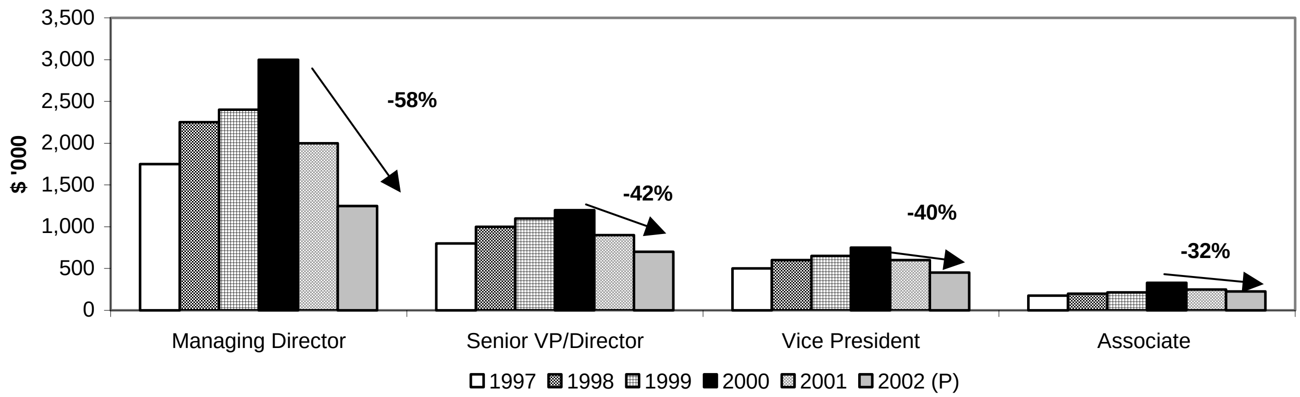
Figure 2: Average Global Investment Bank Headcount



Source: Firm Annual and quarterly reports
Top Five includes CSFB, GS, MS, ML*, SSB. Next Five includes BSC, DB, LEH, UBS. We have excluded JPM as we were unable to get headcount information for the investment banking side of the business*
** Excludes Private Client Financial Advisors*

Investment banker compensation has been under severe pressure for the last two years. Compensation to net revenue ratios have gradually risen from 43.7% in the early 80's, to 49.7% in the early 90's, to 51.6% today. (1) In 2002, Freeman & Co. expects compensation compression to be most severe at the managing director level. A number of firms have already started warning senior management to expect minimal, and in some cases, no bonuses. Compensation levels in 2002 are likely to be near or below those of 1997.

Figure 3: Average U.S. Investment Banker Compensation



Source: Executive search firms, Freeman & Co. estimates

For all the discussion on headcount reduction at investment banks, a comparison with revenues, from the investment banking side of the business, still reveals an imbalance. Until recently, firms were reluctant to do wholesale firings lest they miss the market upside when it returns. The chart below shows that for the leading investment banks, firm-wide revenues are near 1999 levels. At the same time, 2002 headcount is still higher than 1999.

Freeman & Co. believes that investment banks will need to further review their revenue and cost models to achieve equilibrium. To correct this imbalance, we expect additional headcount reductions of 15% to 20% to take place prior to year-end. Firms have already started making announcements to cut additional personnel.

Figure 4: Investment Bank Revenues and Headcount for Select Firms

Investment Bank	1997	1998	1999	2000	2001	2002 (3 Qtrs)	2002 vs. 1999
Top Five							
Avg. Revenues ($ Mil)	7,554	8,574	12,466	15,306	13,895	9,407	
Avg. Headcount	22,831	24,900	26,543	32,677	29,706	28,457	7.2%
Next Five							
Avg. Revenues ($ Mil)	4,823	4,371	6,927	10,753	9,914	7,176	
Avg. Headcount	11,123	10,406	11,886	19,057	19,540	18,356	54.4%

Source: Firm annual and quarterly reports

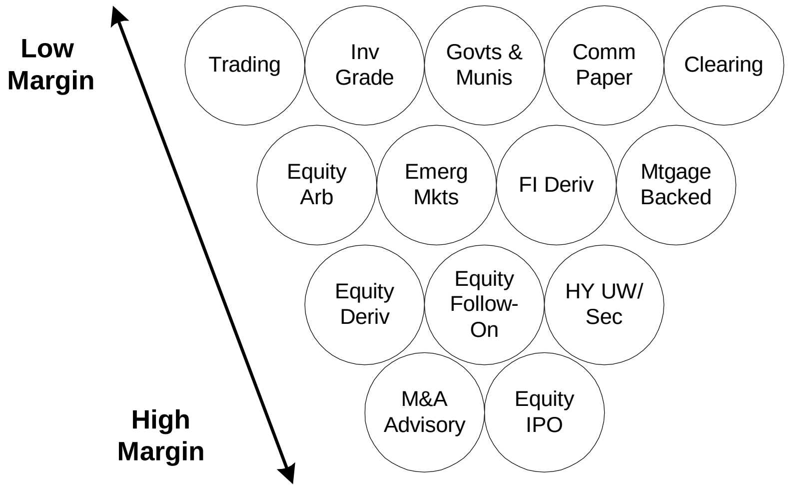
Top Five includes CSFB, GS, MS, ML, SSB. Next Five includes BSC, DB, LEH, UBS. We have excluded JPM as we were unable to get headcount information for the investment banking side of the business

(1) SIA statistics

Analysis of Product Profitability

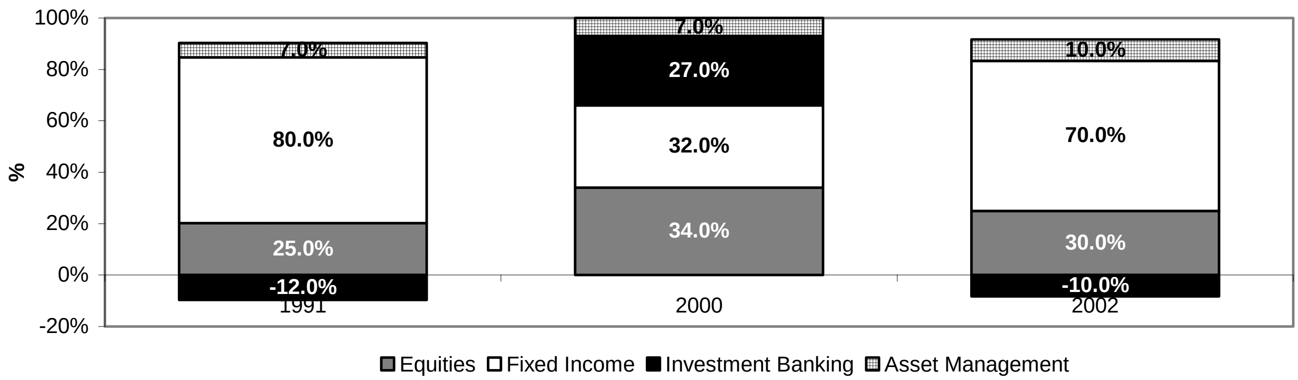
In today's investment banking world, a limited number of high margin products (equity underwriting and M&A) support a number of low margin businesses. These high margin businesses are under considerable volume and margin pressure right now. Competition has reduced margins in most other areas as well.

Figure 5: Investment Bank Products and Margins



The industry has seen a dramatic shift in product profitability. In the early 90's, the fixed income business was the largest revenue generator, with equities and asset management contributing modestly to firm profitability. Investment banking departments at the same time generated losses. Freeman & Co. believes that during down cycles, investment banking departments, when fully costed, tend to lose money. During the market boom of 2000, investment banking departments generated substantial profits, while fixed income contributed only about one-third of firm profitability. In 2002, Freeman & Co. expects the contribution of each product towards firm profitability to be similar to1991.

Figure 6: Investment Banking Firms Profitability by Division



Source: Freeman & Co. estimates
Note: Equities includes sales and trading and derivatives, fixed income includes sales and trading and derivatives. Investment banking includes underwriting and advisory fees.

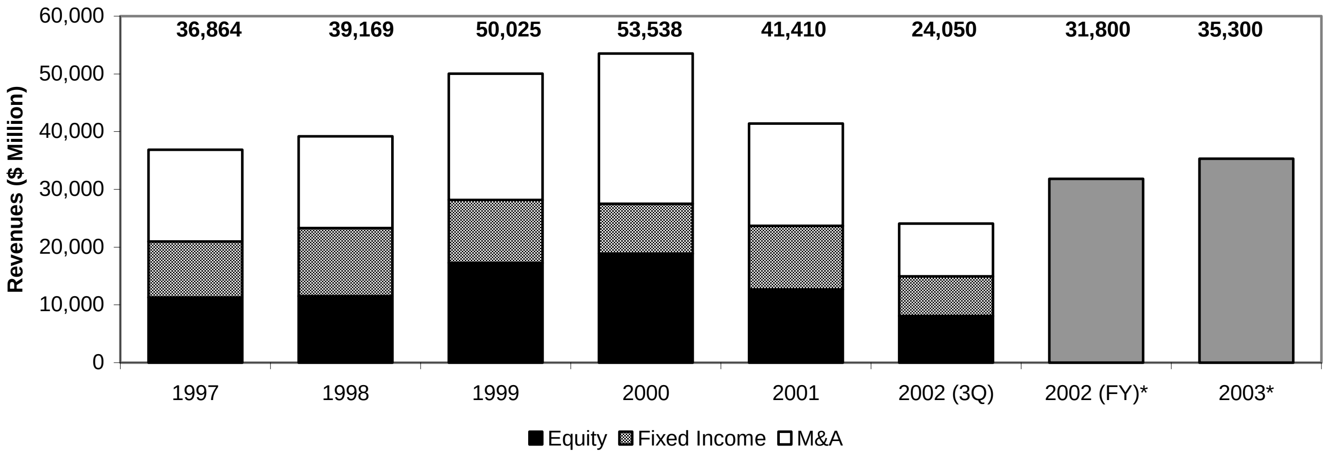
Freeman & Co.'s Forward-Looking Market Analysis

Freeman & Co. expects the investment banking division's business to remain slow for the remainder of 2002 and to pick up slightly in 2003. The current revenue run-rate is at 1997 levels. We have further analyzed the business by product and industry.

By Product

The recent market boom was driven by historical highs in equity underwriting and M&A. The fixed income market, which had been relatively depressed from 1997 to 2000, picked up during 2002.

Figure 7: Investment Banking Division Fees by Product – 1997 to 2003



Source: Freeman & Co. estimates
**Freeman & Co. projections*

An analysis of each product reveals grim market conditions.

Equity Underwriting – Shaky market conditions and the management and accounting scandals have closed the equity markets for the time being. There has been some early optimism as investment banks have seen a slight build-up of their pipelines. Freeman & Co. believes that some of this optimism might be misplaced. For example, in September, no IPOs were priced. The SEC scrutiny of IPO allocations and the demand for greater transparency could result in the market being closed for even longer than at first expected.

A closer analysis of the IPO business reveals that more than half of 2002 revenues came from spin-offs, with CIT and Travelers being the largest deals. At the same time, from the beginning of 2002, deals worth more than $6.2 billion have either been withdrawn or postponed.

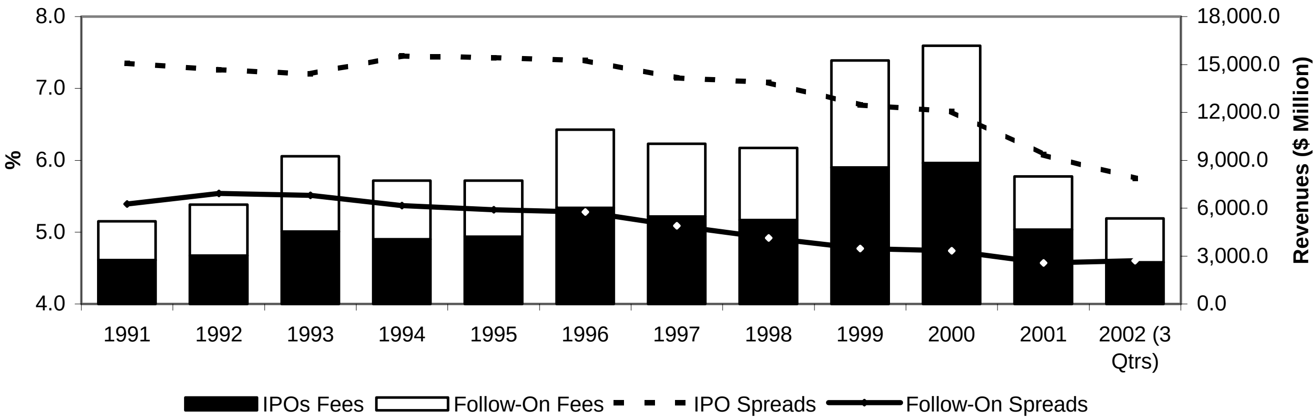
Figure 8: Initial Public Offerings in 2002 (3Q)

	Initial Public Offerings		% of Total	
	Count	**Est. Value ($ MM)**	**Count**	**Value**
Spin-Offs	5	11,783.25	8.8%	56.7%
New	52	9,009.38	91.2%	43.3%
Total	**57**	**20,792.63**	**100.0%**	**100.0%**

Source: IPO.com

Equity underwriting spreads have gradually declined during the decade and are currently at their nadir. Margin pressures are likely to continue as investment banks try to muscle their way into as many equity deals as possible. The inquiry on the IPO allocation process is also hurting the business. Keeping all these factors in mind, Freeman & Co. believes that the business will not pick up until early or mid-2003.

Figure 9: Equity Underwriting Spreads

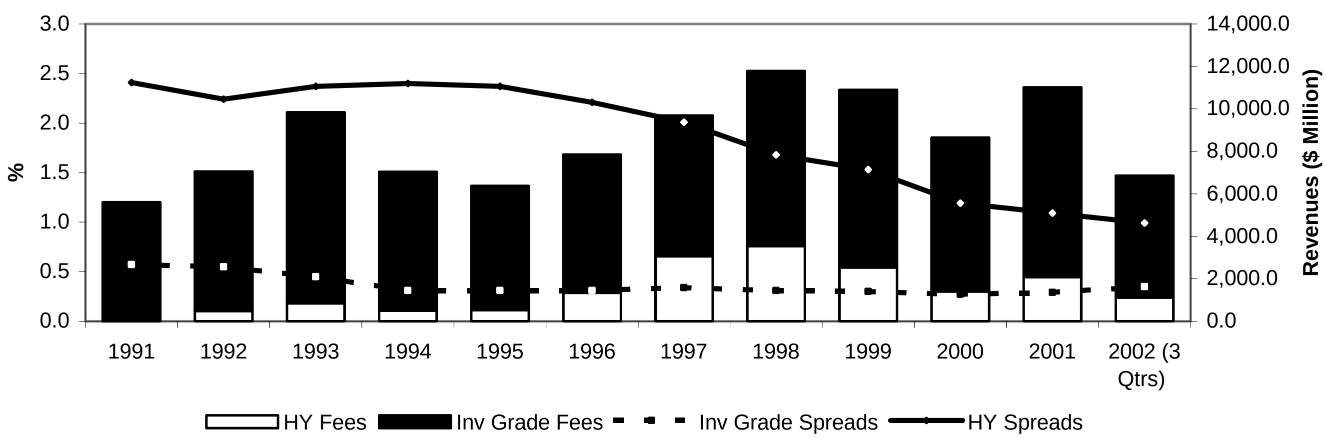


Source: Securities Data Corp and Freeman & Co. estimates

Fixed Income Underwriting – The fixed income business propped up investment banking revenues in the last few years, moving from 15% profit share in 2000 to a 30.1% share in 2002 (1H). The fixed income markets have started to slow down as low interest rates, widening spreads and the steep yield curve take effect. High yield spreads have been steadily declining while investment grade spreads, which had dropped slightly from 1991 to 1994, have started rising again in 2002.

The investment banks that depended on the fixed income business have, until recently, been able to maintain their profit margins and headcount. However, the slowdown in the fixed income market is beginning to take hold, and even these firms are announcing cuts.

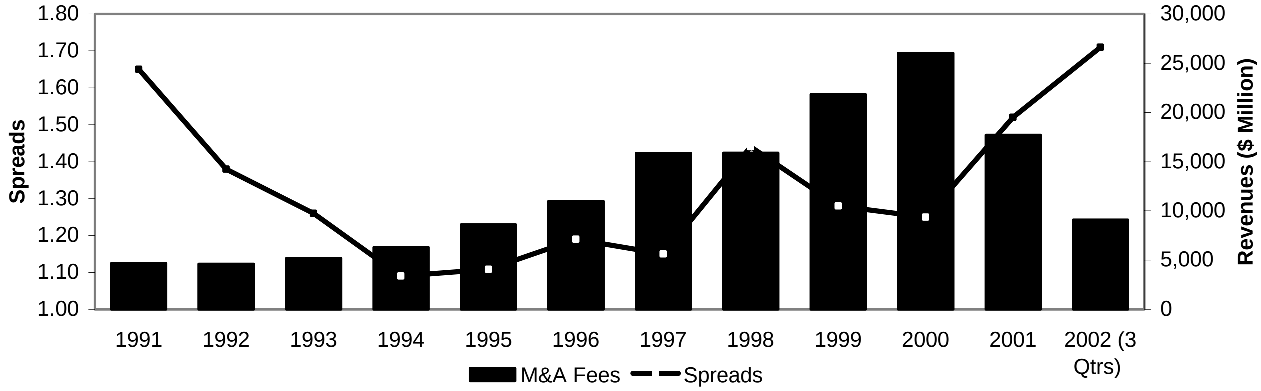
Figure 10: Fixed Income Underwriting Spreads



Source: Securities Data Corp and Freeman & Co. estimates

M&A – The M&A business had seen a substantial decline in the last few years. In 2000, mergers and acquisitions generated close to half of all investment banking fees. In 2002, only one-third of revenues have come from this product. M&A spreads have essentially stayed within the same range during the entire decade. Freeman & Co. expects the M&A business to pick up slightly by mid-2003, as firms continue to be shut out of the equity markets. Margins in the business are likely to come under additional pressure, given the weak M&A market and the significant number of competitors in the business.

Figure 11: M&A Spreads from 1991 to 2002



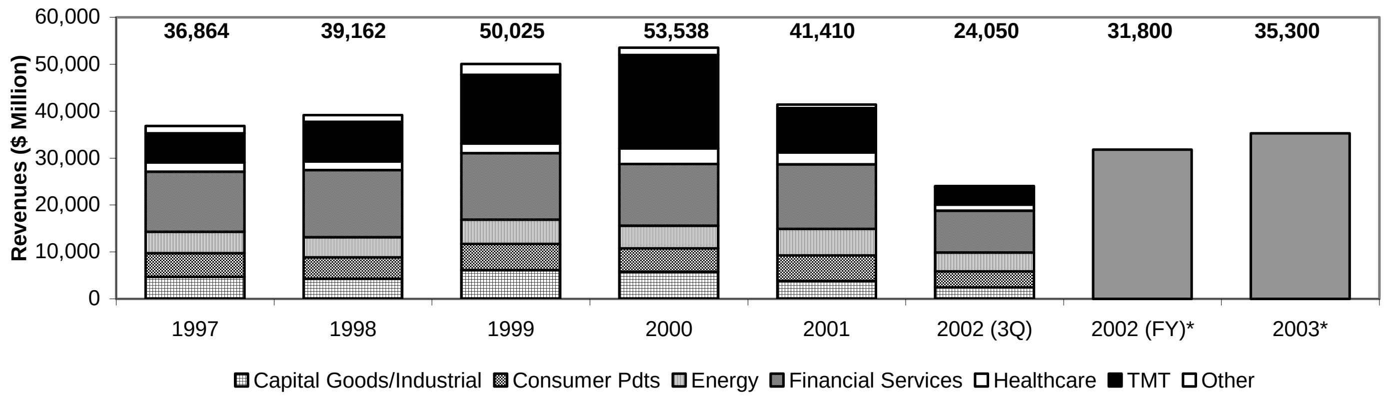
Source: Securities Data Corp and Freeman & Co. estimates

By Industry Sector

Financial services, the largest revenue generator of the decade, briefly lost its leadership status in 2000 to TMT, but is once again back on top.

Freeman & Co. believes that there are very few bright spots in the business apart from restructuring, particularly in telecom. Financial services will continue to do well, but will be off a bit from earlier years. One of the main revenue generating areas in financial services is reinsurance capital raising, where some deals are now coming to market. The consumer products/retailing, healthcare and industrial sectors will remain strong as some large deals get completed. The technology business will continue to be slow for the next few years.

Figure 12: Investment Banking Fees by Industry – 1997 to 2003

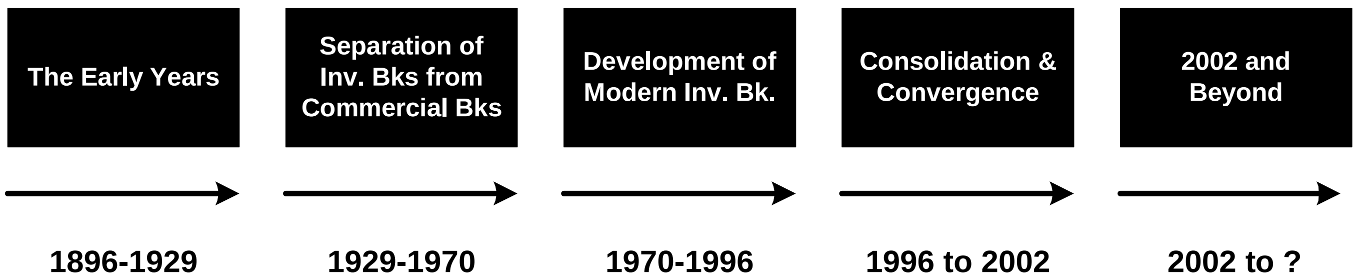


Source: Freeman & Co. estimates
****Freeman & Co. projections***

History of Investment Banks

Freeman & Co. has briefly examined the history of investment banking during the last century, to better explain the current market trends, as history often tends to repeat itself. The market can be characterized by sharp up-trends followed by larger declines.

Figure 13: History of Investment Banking



The Early Years: 1896-1929

This period was considered a golden era for investment banking with the industry experiencing a prolonged bull market. As a result, a number of investment banks and commercial banks emerged, with John Pierpont Morgan (JP Morgan) and Charles E. Mitchell (National City Bank) being the market leaders, and often stepped in to influence and sustain the financial system. Excess market speculation, especially by banks using Federal Reserve loans to bolster the markets, resulted in the famous crash of 1929, started on Black Thursday, October 24.

Separation of Investment Banks from Commercial Banks: 1929 to 1970

The crash of 1929 resulted in the regulators stepping in to make a number of significant changes to the market structure (similar to their intervention in the current environment). The Glass-Steagall act of 1933, was signed, to separated banks from investment banking in an attempt to ensure that no firm or group of firms was able to control the market. At the same time, the Securities Exchange Act was created to prevent securities manipulation. During 1935 and 1936, the SEC prosecuted many individuals working in financial services for market violations; however, no criminal convictions took place until 1959. The exchanges were told to reform or face federal intervention.

Development of the Modern Investment Bank: 1970-1996

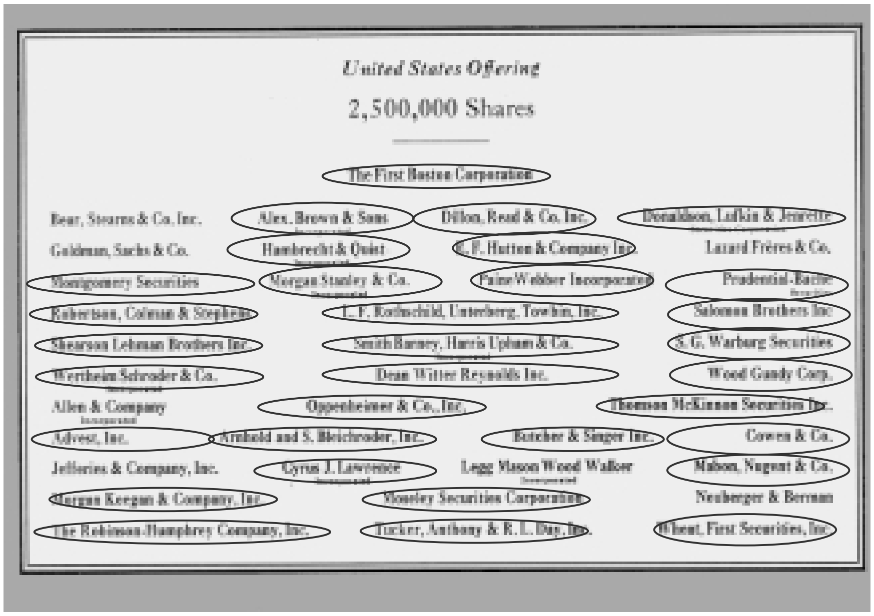
On May Day, 1975, negotiated rates were repealed, resulting in the collapse of trading commissions and ending the golden era of research-focused boutiques such as Wainwright and Grumman. The reduction in trading profitability started the trend of the integrated investment bank providing sales, trading, research and investment banking under one roof.

The late 70’s and early 80’s saw the rise of a number of financial products such as derivatives, high yield and structured products, which provided lucrative returns for investment banks. Due to the technological backlash from portfolio insurance and stock futures, the market crashed in October 1987 with the Dow dropping 508 points (nearly 25%) in a day. The markets remained depressed for the next few years, until the early 90’s. In 1988, the high yield market collapsed, burying Drexel and vilifying Michael Milken. In 1991/1992 huge derivatives losses resulted in the downfall of Barings and Kidder Peabody, and almost did the same to Bankers Trust, which was later acquired by Deutsche Bank.

Consolidation and Convergence: 1996 -2002

During this time Wall Street witnessed a period of prosperity driven by the dot-com boom. To meet the challenges of the new environment and take advantage of regulatory changes (repealing of the Glass-Steagall act), the industry witnessed tremendous consolidation. A look at this 1987 tombstone shows that most of the players on the list either merged or were acquired.

Figure 14: Consolidation in the Investment Banking Business


United States Offering

2,500,000 Shares

The First Boston Corporation

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Goldman, Sachs & Co. Hambrecht & Quist E.F. Hutton & Company Inc. Lazard Frères & Co.
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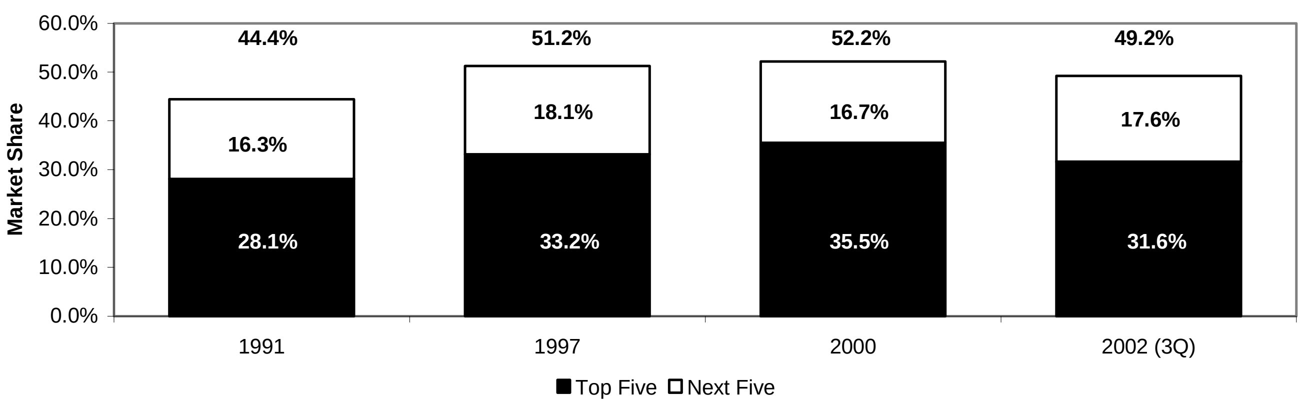
The other major trend during the last few years was the creation of "super-financial" firms such as Citigroup, Credit Suisse Holdings, JP Morgan Chase and UBS AG. Until recently, these firms performed well. Historically, this strategy has had mixed results. Firms such as American Express and General Electric tried but failed to run integrated financial services firms and ended up exiting the investment banking business.

Despite the consolidation, firms have been unable to significantly increase their share of market fees. The industry has turned into a consortium where a group of ten U.S. and global investment banks dominate the market and control about half the fees on the Street.

Figure 15: Global Market Share by Type of Investment Bank – 1991 to 2002 (3Q)



Source: Freeman & Co. estimates
Top Five includes CSFB, GS, MS, ML, SSB. Next Five includes BSC, DB, JPM, LEH, UBS

2002 and Beyond

The financial services industry has always been notoriously volatile, and is characterized by overly extreme optimism or pessimism during market highs and lows, respectively. Freeman & Co. believes that these slow market conditions, too, shall pass. However, the short term presents the following challenges:

- Regulatory focus on the IPO allocation process will increase the need for transparency in allocations and could further negatively affect equity profitability
- Research budgets will be reduced by 30% to 40% to balance the new revenue models within the investment bank
- The demand for separation of research from investment banking will result in dramatic changes. There is no clear indication at this time what the ultimate solution is likely to be. Freeman & Co. believes that firms may need to:
  - Separate the research department from the rest of the firm and have it report directly into the CEO/CFO
  - Appoint an internal senior management committee that would monitor research (i.e. rating changes, interaction between research and other areas, etc.)
  - Hire an external body to annually or semi-annually audit research for independence and provide a "seal of approval"
  - Reduce research compensation to levels that are better indicative of research's true value to the firm
  - Have analysts refocus on fundamental quantitative research
  - Re-examine the function of the capital markets group that currently straddles the Chinese wall and liaises between investment banking and research
- Investment banking compensation will drop to levels not seen since the mid-1990's
- There is a possibility of another large merger to take out excess capacity. Many of the large investment banks are rumored candidates: CSFB, Deutsche Bank, JP Morgan, Goldman Sachs, Lehman Brothers and Merrill Lynch. Drops in market capitalization may make previously impossible deals thinkable
- Some additional marginal players will exit the business
- There will be an emergence of a new group of boutiques that will be either research or M&A focused
- Increased scrutiny from regulatory authorities will result in increased compliance costs
- As "super-financial" firms face scrutiny for tying their commercial banking and investment banking businesses, they may need to spin off parts of their operations
- Investment banking departments will increase the number of regulatory/planning personnel
- Some investment banks will utilize this opportunity to examine their business model and devise new strategies for gaining market share, as some of the traditional players stumble.

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