Freeman & Co. LLC

Equity Research

The Rocky Road Ahead

June 2002

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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.

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

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- *Performance Improvement Consulting*
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Investment Banking	Electronic Investment Banking: Where Will it Survive?	November 2000
Investment Banking	State of Investment Banking – 2000 and Beyond	October 2000
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Asset Management	Drivers of Consolidation	October 2000
Asset Management	Moving from Client Ownership Focus to Specialized Product and Service Focus	March 2000

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Introduction

The Past

The last twelve months have seen equity research departments making headlines due to legal inquiries, angry investors and fallen superstar analysts. Research departments have the complex task of pleasing various constituents (both internal and external) who often have conflicting agendas. The glare of the spotlight has made this job even tougher.

The Present

Eliot Spitzer took up arms on behalf of retail investors and subpoenaed a number of the leading investment banks. Merrill Lynch bore the brunt of his probe, but managed to escape relatively unscathed with a fine of $100 million and no admission of criminal wrongdoing. These actions hammered investment banks' stock prices, reduced shareholder value by billions of dollars and further shook the confidence of the retail investor. Spitzer is still active, but the industry's worst fear – of having to separate research from investment banking -- did not come to pass. However, the compliance procedures that need to be put in place will be onerous and expensive. Investment banks will need to treat the additional expense of hiring compliance personnel as a cost of doing business. Investment banks are working furiously to meet the deadlines set by the NASD regarding disclosures and disclaimers. They are also setting up committees and appointing outside directors to ensure independence of research. However, investors still have a bad taste in their mouths.

The Future

The recent changes in research department procedures are a near-term reaction to the hostile legal and regulatory environment. We believe that the real changes, both economic and structural, are yet to come.

Economic Change

Equity research departments, in their current size and format, are not a profitable economic proposition. Many senior executives know little about measuring research's financial value and are afraid to ask in the present hostile environment. The revenue generating businesses that support research, including sales and trading, investment banking and retail, have been badly hit by the market downturn and are unlikely to be able to continue to shoulder the cost burden. Second quarter earnings for some of the leading investment banks show that earnings per share are down by about 15% to 30% from the same period last year. Institutions that hold brokerage stocks are pressuring investment banks to make additional headcount reductions. Equity research was largely spared during the earlier rounds of headcount reduction, but will have to address department size and compensation in the next budgeting cycle.

Structural Change

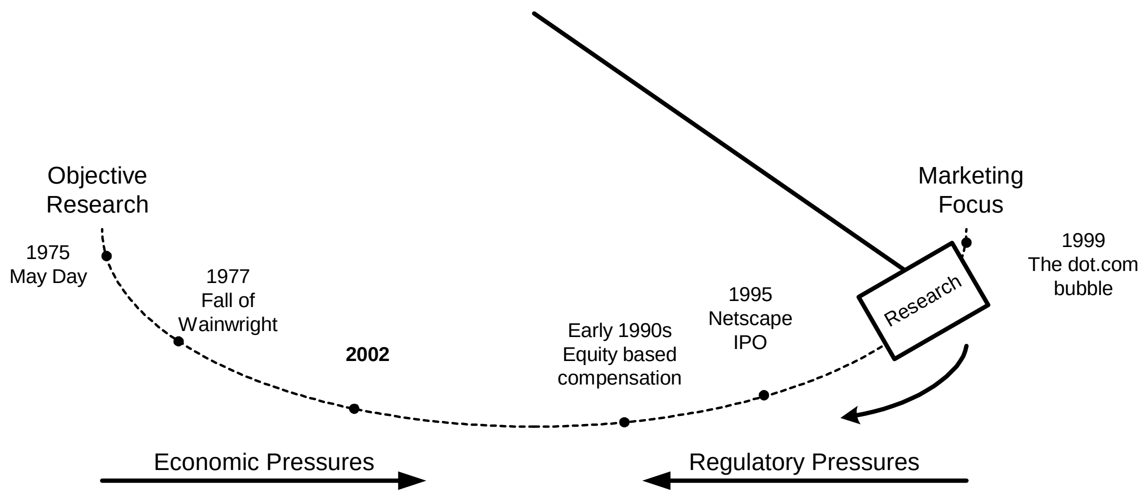
The days of superstar free agency trading in research analysts are largely over. Firms must raise research's quality, consistency and morale and lower costs by home-growing analysts.

Some firms have successfully moved away from the integrated investment banking, sales and trading and research model and have adopted other models. Other investments banks will need to examine and assess the viability of their existing research models. Freeman & Co. believes that the next few months are going to be critical ones for research departments across the Street. Firms will have to define their client base and match products offerings, costs and personnel size to fit their aspirations.

The Pendulum Swings

The equity research pendulum has swung dramatically from the early 70's when research focused primarily on the needs of institutional investors. Fixed commissions ended on May Day 1975, cutting trading commissions by almost half, making it difficult for sales and trading desks to continue to independently support research costs. Research analysts started migrating to investment banks with diversified revenue bases. The fall of Wainwright (1977), the research house considered the "gold standard", was seen as a turning point in the history of independent research. During the dot.com bubble of 1999, research became largely focused on assisting investment banking.

Figure 1: The Equity Research Pendulum



Historically, investment banks provided highly quantitative objective research that was thoroughly vetted by oversight committees. Research quality, both written and oral, was critical. Analysts focused primarily on researching companies, studying their financial statements and preparing in-depth market analyses.

During the last decade, major changes occurred. Corporate managers were paid in stock options, giving them the incentive to push near-term growth and earnings outlooks (and, as a result, stock prices) as high as possible. Analysts came to be seen as mouthpieces for this effort.

Research departments soon came to be recognized as powerful relationship tools for winning investment banking business. The dot.com craze turned analysts into media darlings, putting them on the covers of magazines and on television to espouse their views. The research superstars were born, with Mary Meeker, Henry Blodget and Jack Grubman leading the pack.

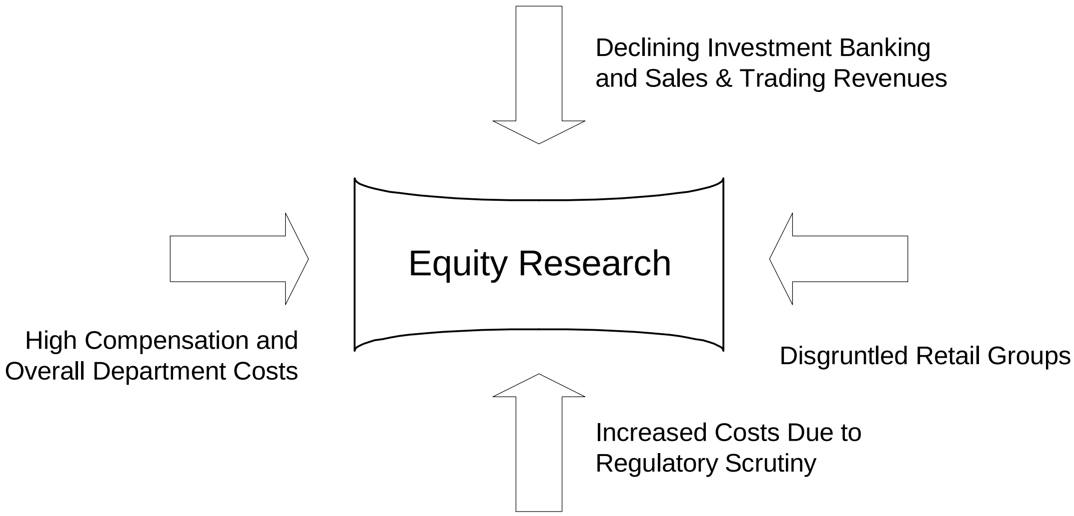
Analysts were soon compensated at levels that exceeded even those of their investment banking brethren. Analysts' compensation was closely linked to the investment banking business they were able to generate. As a result, the focus of research moved too far to the right of the spectrum, with research being viewed as the *de facto* marketing arm of the investment bank.

The dot.com debacle and the subsequent inquiries by the New York State Attorney General's office, NASD and the SEC have been a wake-up call for Wall Street. This intense focus on research will push the pendulum back to the left of the center, where it is likely to stay until the next bull market.

Equity Research Under Pressure

Freeman & Co. believes there are still substantial issues facing equity research departments, both internally and externally. The businesses that support research have seen substantial revenue declines. Retail investors' confidence in research analysts is low. At the same time, compliance expenses have increased and analyst compensation remains "sticky", keeping the cost of research at relatively high levels.

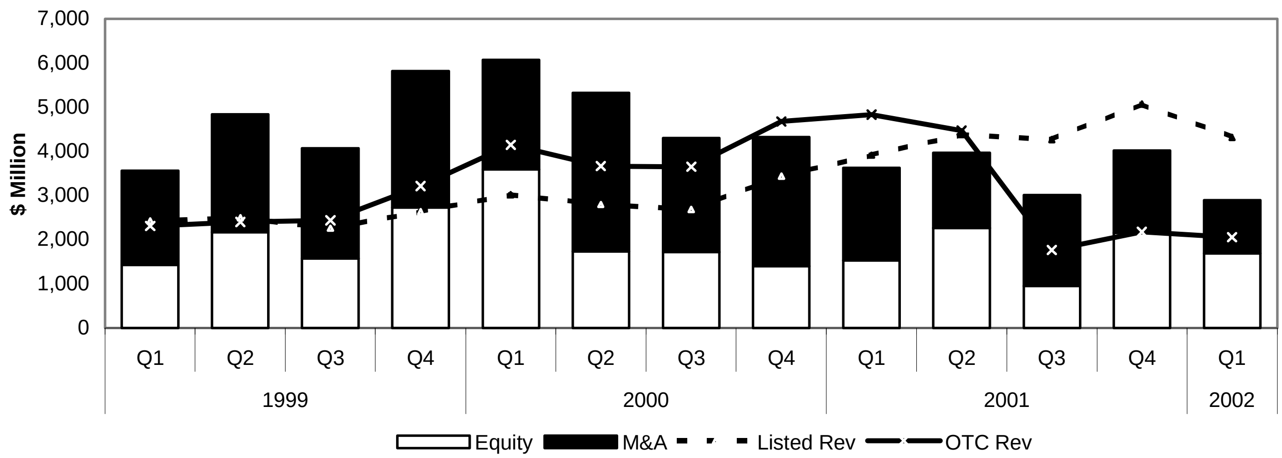
Figure 2: Issues facing Equity Research Departments



Declining Investment Banking and Sales & Trading Revenues

The U.S. investment banking revenues that pay for research have dropped substantially from 1999 to 2002. Annualized 2002 (Q1) revenues are about 50% of 2000 revenues. The market conditions in 2002 (Q2) show little improvement. Market recovery is not expected until at least 2002 (Q4). The equity calendar is starting to build, but the M&A pipeline remains weak. On the trading side, decimalization has reduced the OTC margins and listed margins are under pressure. At the same time, reduced volatility has brought down the profitability of the derivatives desks.

Figure 3: U.S. Trading and Equity Underwriting and M&A Revenues



Source: New York Stock Exchange and NASDAQ, Freeman & Co. estimates
Note: Listed Revenues - Estimated Cents Per Share: 1999 - 5.8, 2000 –5.2, 2001- 5.2, 2002 – 5.2
OTC Revenues - Estimated Cents Per Share: 1999 – 3.9, 2000 – 3.7, 2001- 1.85, 2002 – 1.85

Disgruntled Retail Groups

Retail departments have also faced declining profitability due to fewer transactions, reduced assets and lower market values for securities traded. Moreover, these departments are questioning the allocated cost of equity research and are growing more reluctant to pay for it. Some retail groups would like to pay for research based on the stock picking ability of the analysts. Other retail departments are said to want to conduct their own research or have access to research from several sources, similar to asset management divisions. Such solutions would only add to the cost and quality control problems facing the Street.

Increased Cost Due to Regulatory Scrutiny

Research departments were already under pressure from the SEC and the NASD to strengthen the “Chinese wall” between investment banking and research. Investment banks now need to ensure that compliance officers monitor interactions between research and investment banking departments.

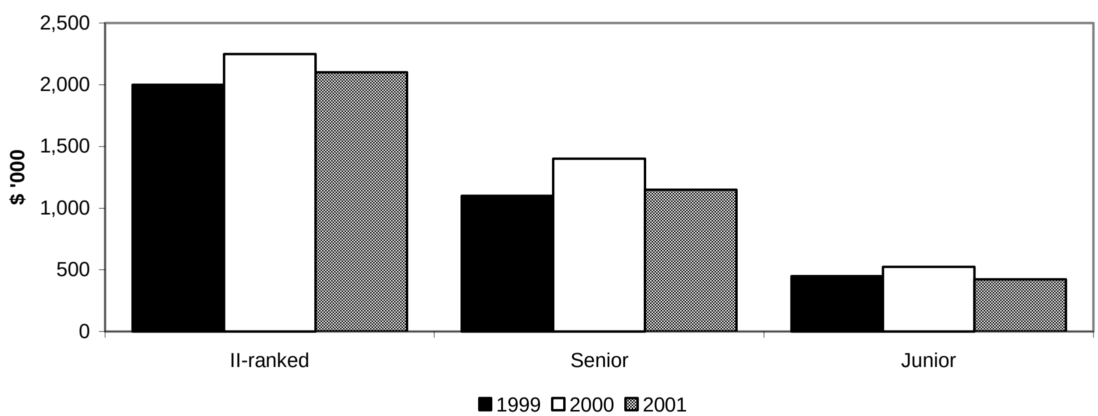
In addition, investment banks need to hire independent directors and perform annual audits to ensure that the new regulations are properly implemented. These practices are likely to increase research costs by about 3% to 5% at a time when additional costs cannot be easily absorbed.

High Compensation and Overall Department Costs

During 1999 and 2000, many investment banks bought analysts at very high compensation levels, a substantial portion of which were guaranteed. Most of the guarantees end in 2002. However, the “spot market” is still costly for ranked analysts in heavy “issuing calendar” sectors such as biotechnology and consumer/retail.

Overall equity research analyst compensation has dropped marginally over the last few years, but still remains high. Compensation levels in 2001 were slightly higher than the 1999 levels.

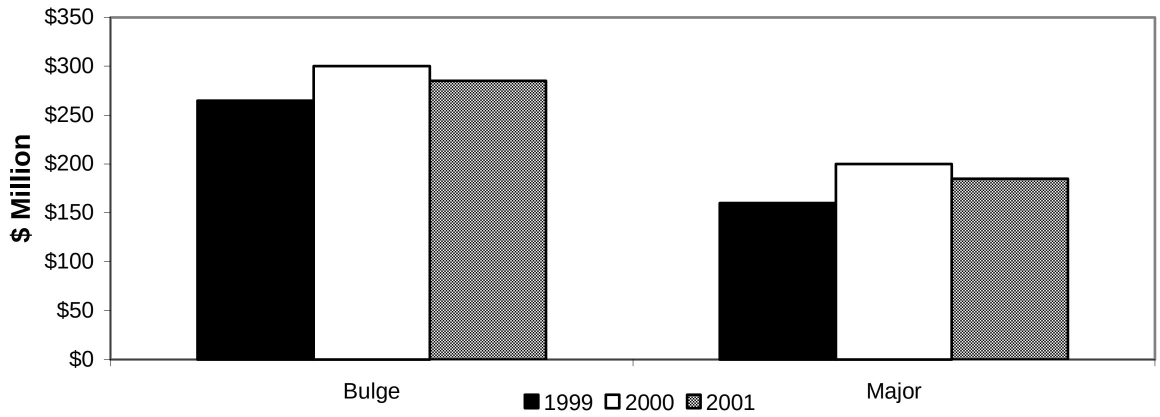
Figure 4: U.S. Equity Research Analyst Compensation



Source: Freeman & Co. Equity Research Benchmarking Study
Note: Senior analysts cover more than 5 stocks, junior analysts cover five or less than 5 stocks

As a result, the cost of research for the U.S. bulge bracket firms is between $250 million and $350 million. The cost of research for the major bracket firms in the U.S. is between $150 and $225 million. The overall cost of research has dropped slightly from 2000 to 2001, but is still higher than in 1999.

Figure 5: Cost of U.S. Equity Research Departments



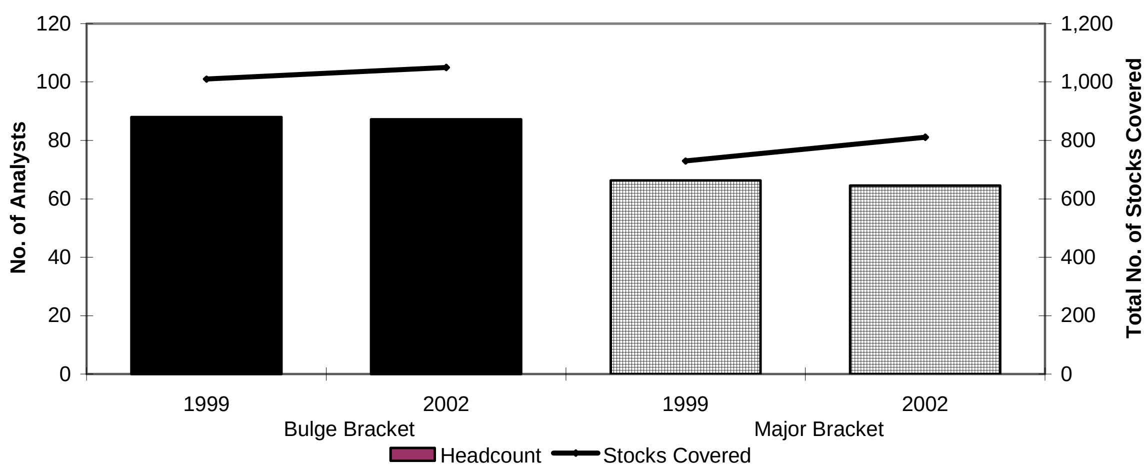
Source: Freeman & Co. Equity Research Benchmarking Study
Bulge Bracket: CITI, CSFB, GS, MS, ML. Major Bracket: BAC, BSC, CIBC, DB, LEH, JPM, UBSW

Current Market Scenario

Headcount

During the last three years, the average number of U.S. publishing analysts at the leading investment banks has remained essentially unchanged – around 90 for the bulge bracket firms and 70 for the major bracket firms. Interestingly, the investment banking departments at these firms have seen headcount reductions between 10% and 35% during the same period. The average number of stocks covered by the bulge bracket firms is about 1,050. Major bracket firms saw a marginal increase in average stock coverage, from 775 stocks to 835 stocks.

Figure 6: U.S. Equity Research Headcount and Stock Coverage

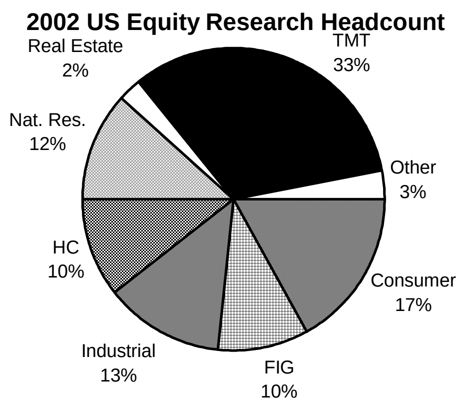


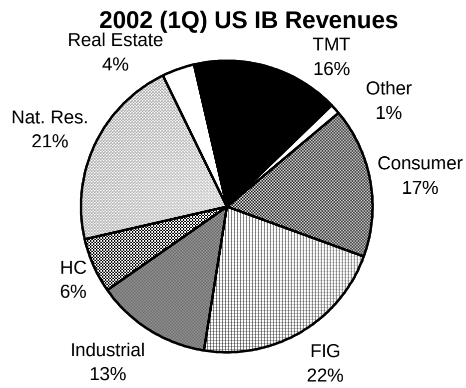
Source: Freeman & Co. Equity Research Benchmarking Study
Bulge Bracket: CITI, CSFB, GS, MS, ML. Major Bracket: BAC, BSC, CIBC, DB, LEH, JPM, UBSW
Note: Headcount and stock coverage data is as of Dec 31,1999 and May 15, 2002

Industry Mix of Analysts

The current mix of equity research analysts across various industry sectors was appropriate for the 2000 and 2001 markets, when one-third of all fees came from the TMT sector. At present, the distribution of equity research analysts does not match the sources of investment banking fees. As such, research groups are over-weighted in technology analysts and under-weighted in financial institutions and natural resource analysts.

Figure 7: Split of U.S. Equity Research Headcount and Revenue by Industry



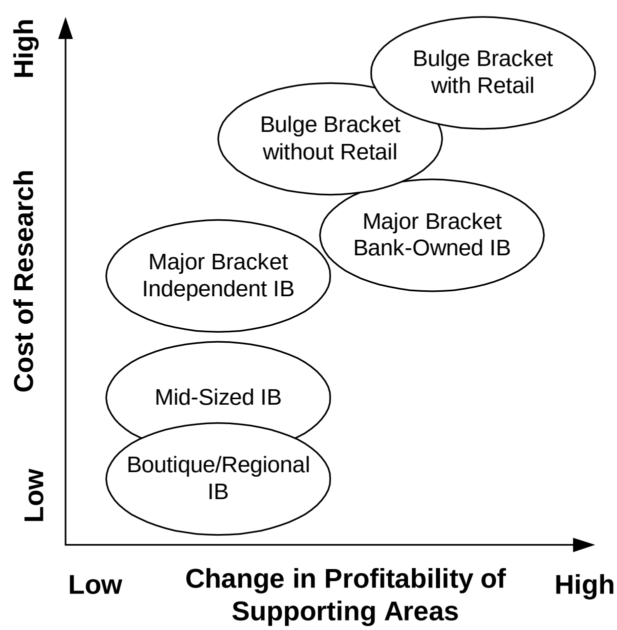


Sources: Firm Sources, Freeman & Co. Estimates
Investment banking revenues are for equity underwriting and M&A only

Impact on Types of Investment Banks

Freeman & Co. has divided investment banks into six categories and analyzed how recent events in equity research have impacted each category.

Figure 8: Freeman & Co.'s Assessment of Investment Banks



Bulge Bracket Investment Banks with Large Retail Groups

These full-service firms have been the focus of the New York State Attorney General and continue to face considerable scrutiny. These firms tend to have diversified revenue streams and will consider any fines as a cost of doing business. They will, however, need to reassure retail investors of the integrity of their research departments and will need to put more checks and balances in place, which will add to their cost of research.

Bulge Bracket Investment Banks with Limited/No Retail Groups

Freeman & Co. believes that these investment banks are unlikely to be substantially affected by the legal action being taken against some of their colleagues. However, these firms will want to assert the credibility of their research departments and will implement the regulatory procedures agreed to as part of the Merrill settlement.

Major Bracket Bank-Owned Investment Banks

Bank-owned investment banks have paid handsomely to build up their investment banking and research departments. At present, profit pressures on the investment banks are making the commercial banks' profitability look relatively more attractive. There is a possibility that if the investment banks continue to remain unprofitable, their loss-averse commercial banking parents might decide to sell them.

Major Bracket Independent Investment Banks

Major bracket investment banks have managed to do reasonably well, despite the tough market conditions. These firms have either sales and trading or fixed income strengths that have helped them maintain profitability. (These investment banks could be in trouble if the fixed income market falters.) At the same time, these firms have concentrated on maintaining their research strength by building a strong firm culture and by home-growing analysts who will be loyal to the firm.

Mid-Sized Investment Banks

Investment banking and sales and trading revenues are being concentrated in the hands of a few top investment banks, resulting in a profitability squeeze for mid-sized firms. At the same time, the cost of hiring experienced investment bankers and analysts still remains high. These firms will need to make some tough decisions regarding the depth and breadth of their research franchises.

Boutique/Regional Investment Banks

Most of the technology boutiques that flourished during the boom have been considerably reduced in size. The regional investment banks have had mixed fortunes. A number of the regional firms have faced tough times as fees became concentrated in the hands of the bulge and major bracket firms. However, a few regional investment banks have been doing exceptionally well by focusing on small to mid-sized issuers in a few select industries and by creating expertise around those sectors.

The Future

In our report "Equity Research - Will Research Survive 2001?" dated April 2001, we attempted to predict the future of research departments under various market conditions. Our worst-case scenario predicted market recovery in 2002 (Q3), with equity underwriting, M&A and sales and trading revenues dropping by 45% and research analysts being considered fallen angels.

Freeman & Co. expects research departments to be faced with major economic and structural changes. With the Spitzer settlement, the NASD and NYSE edict, and announcements by the largest firms, we have seen the first wave of the reaction to get within a "safety zone". But this is only the beginning…

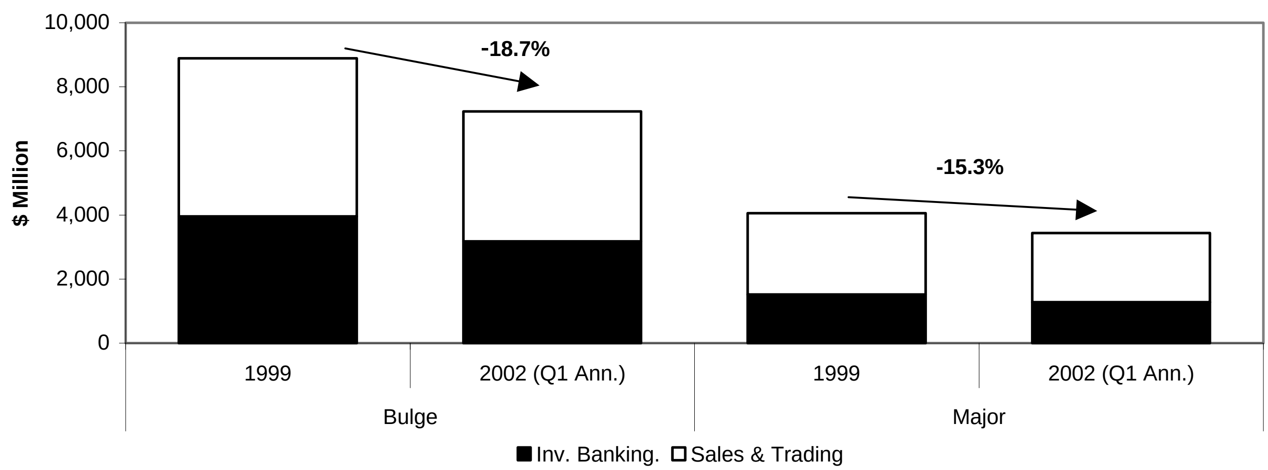
Economic Changes

Research departments at their current cost levels are no longer economically viable. On the revenue side, investment banking and sales and trading revenues for the bulge and major bracket investment banks dropped between 15% and 20% from 1999 to 2002 (2002 Q1 numbers annualized). A few of the leading firms have already announced their second quarter results. The market conditions continue to be depressed and firms are gearing for another round of headcount reductions.

On the cost side, research has actually become more expensive since 1999. Firms have already substantially pared investment banking headcount and compensation to maintain margins. They will now need to do the same for research.

Up to now, the "plastic surgery" answer has prevailed – a little nip here, a little tuck there, and things never looked better. This will not prevail through the year-end pay cycle. Investments banks will need to reconcile the value of research with analyst compensation. Firms will need to reduce research headcount to be able to sufficiently pay remaining analysts. The sector shift in investment banking fees will make it necessary for firms to examine the industry mix of analysts.

Figure 9: U.S Investment Banking and Sales and Trading Revenues for Select IBs



Source: Annual Reports, Quarterly Earnings Releases
Bulge Bracket: CITI, CSFB, GS, MS, ML. Major Bracket: BAC, BSC, CIBC, DB, LEH, JPM, UBSW

Structural Changes

Investment banks will need to address the following questions:

– Who are equity research's clients?
– How should these clients and deliverables be prioritized?
– Should analysts be paid for their stock-picking ability, as against their industry knowledge and marketing skills?

Freeman & Co. believes that the time is near when analysts will:

– Return to writing their own high quality reports
– Spend time cultivating their relationships with the sales force and investors
– Take pride in the quality of their models, reports and stock selection
– Be enthusiastic about marketing their products

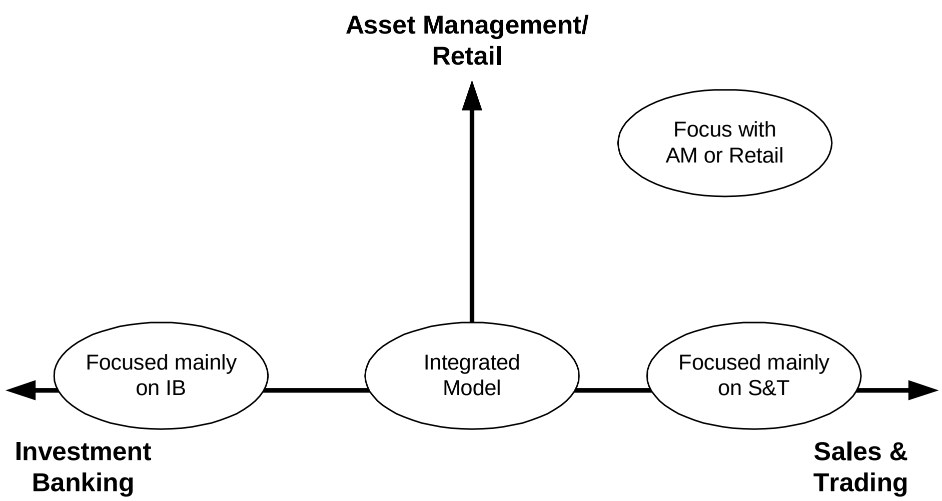
The structural changes may seem subtle, but will be important. Firms are likely to return to a research culture of home-growing analysts, because it has many advantages:

– It will cost less
– The quality of the research product will be better
– There will be less turnover as the analysts will be more loyal to the firm
– There will be more product consistency as everyone has learned from a similar base
– The morale within research departments will improve

Alternative Research Department Models

Some investment banks might need to consider moving away from the integrated investment banking, research and sales and trading model. Some firms have successfully been able to make the transition. Freeman & Co. has examined the alternative equity research models on the Street to determine which might be prototypes for future research departments.

Figure 10: Alternative Equity Research Models



Research Focus with Asset Management or Retail

The firms in this category such as Sanford Bernstein, Prudential Securities and A.G. Edwards have done well in maintaining quality equity research departments with several ranked analysts (Prudential was ranked 11th and Bernstein was ranked 12th in the 2001 *Institutional Investor* rankings), while having little or no investment banking businesses. Instead, these firms have large asset management or retail operations that bear the cost of research. However, the average size of the research departments at these firms is substantially smaller than the rest of the departments on Wall Street. Also, compensation levels at these firms do not rival that of larger research houses. This model has proved to be very successful in creating established, well-respected research departments and is the most viable alternative for investment banks with strong asset management or retail operations.

Research Focused mainly on Sales and Trading

Bear Stearns and boutiques such as Soundview have successfully adopted this model. The sales and trading desks at these investment banks generate substantial revenues and are capable of supporting the cost of the entire research department. The research departments at these firms have gained significant respect (Bear Stearns was ranked 6th in 2001 *Institutional Investor* rankings). The major drawback for this type of research department is the declining profitability of sales and trading desks. As alternate trading systems draw more of the business away from investment banks and buy-side firms increase in-house trading, this trend is likely to continue. Trading desks will be unable to continue to support large and expensive research departments.

Research Focused Mainly on Investment Banking

The research departments at these firms solely support the investment banking department. In the current environment, the major issue would be the credibility of these analysts, who will be viewed as marketing spokesmen for the firm.

Conclusion

The last year has been extremely difficult for equity research departments. The industry is in the process of salvaging the reputation of its research departments by escalating analyst supervision, changing analyst compensation systems and increasing disclosures. Freeman & Co. believes that most of these changes are unlikely to alter the fundamental economic issues that still need to be addressed.

The next few months will be critical for investment banks, as they will need to make drastic changes to their research departments. At the same time, analyst credibility is so badly damaged that firms will need to rebuild the quality and image of their research franchises. Some investment banks might need to study alternate research models to determine their suitability.

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