

Further cuts on the cards

There's still a lot of overcapacity in the investment banking sector, says **Ray Soifer** - and in the light of recent figures, there is reason to believe that further consolidation may be on the way

The investment banks of Wall Street, the City, Taunusallee and Bahnhofstrasse, great and small, are undergoing a painful process of adjustment from the glory days of 1998-2000, when even eight-figure bonuses could not keep up with income growth, to some lower level, as yet undetermined, of operating expense that is likely to prove more sustainable.

While US securities firms have already cut more than 30,000 jobs since the end of 2000 and comparable numbers are expected in London by mid-2003, operating figures show that far larger cuts than those may well be ahead. **Table 1** shows the aggregate income, expense and employment figures for New York Stock Exchange member firms doing business with the general public, ie those which do not solely trade for their own accounts or act only as floor brokers or specialists dealing with other members, for the ten years ending in 2001 and the first nine months of 2002.

TABLE 1

Income, Expense & Employment Trends
NYSE Member Firms Doing a Public Business
 (Millions of dollars except headcount)

	Total Revenue	Compensation Expense	Non-Comp Expense	Net Income	Pretax Margin	Comp to Rev Ratio	Comp Expense Ratio	Headcount
1992	\$ 62,840	\$ 24,163	\$ 32,491	\$ 4,842	9.84	38.5	79.6	230,472
1993	73,132	28,968	35,614	6,404	11.7	39.6	77.2	243,595
1994	71,355	27,340	42,887	839	1.6	38.3	96.0	253,881
1995	96,303	30,309	58,590	6,092	7.7	31.5	80.4	255,703
1996	120,249	36,768	72,210	8,965	9.4	30.6	76.5	264,603
1997	145,004	41,666	91,130	10,182	8.4	28.7	77.3	285,596
1998	170,805	47,344	113,671	8,119	5.7	27.7	82.9	300,618
1999	183,367	60,098	107,000	12,103	8.9	32.8	78.7	326,151
2000	245,201	68,958	155,268	16,170	8.6	28.1	76.7	365,381
2001	194,766	60,606	123,749	8,333	5.3	31.1	85.3	346,221
9 Mo. 02	113,167	41,838	65,448	3,822	5.2	37.0	87.7	325,506

Sources: SIA, NYSE and Soifer Consulting analysis

In 1995-97 – a period which excludes not only the ‘bubble’ years but also the difficult markets of 1994 and 1998 – the firms’ pretax margin, the percentage of total income carried down to profit before tax, averaged 8.5%. For the first nine months of 2002, it was only 5.2%, and that figure was inflated by the exceptionally strong income from own-account trading, mainly in fixed-income instruments and derivatives, in the first half of the year.

In the same three-year period, the firms paid out as compensation expense 30.1% of total income and 77.9% of pre-tax profit before compensation expense; for the first nine months of this year, the figures were 37.0% and 87.7% respectively. From year end 1994 through year end 1997, total headcount averaged just under 265,000; even after the aforementioned redundancies, as of 30 June 2002 it was 333,000. From these figures, Wall Street would have to shed roughly another 20% of its workforce just to return to the level of 1996, when Alan Greenspan was holding forth about the dangers of irrational exuberance.

These particular figures were cited from the NYSE because they were readily available; just about any other set of figures could have been used from other securities-industry sources and derived comparable conclusions.

When faced with such overcapacity in the past, investment banking firms often have resorted to mergers and acquisitions, and in due course, this cycle is likely to prove no different.

Table 2 ranks each firm by the market capitalisation of its shares, as of 2 December 2002. While it is rare for the firm with the smaller market cap to attempt to take over a larger one, and rarer still for such an attempt to succeed, larger fish far more frequently consume smaller ones.

Moreover, when two firms with approximately equal market caps come together, the result, more often than not, is a nil-premium merger of equals. (Bear in mind, however, that this table is only an attempt to show what might be financially possible as of a point in time, not a specific prediction of things to come.)

Some readers might wonder why Bank One, a midwestern US regional bank, is included in this table. Although it is not an investment bank at present, some press reports have attributed remarks to CEO Jamie Dimon, a former president of Citigroup, that he might consider buying one. However, there have been no comments to date for or against from Mr Dimon of which we are aware.

TABLE 2

**Global Strategic Alternatives:
The Effect of Market Cap**

	MKT CAP 2-Dec-02
	(\$ Billions)
Citigroup	\$194.79
HSBC	109.92
Bank of America	103.44
UBS	62.67
J.P. Morgan Chase	50.35
Morgan Stanley	49.20
Barclays	47.34
Bank One	45.82
Goldman Sachs	37.87
Merrill Lynch	37.52
Deutsche Bank	32.04
Credit Suisse	28.31
ABN AMRO	26.06
Lehman Brothers	14.31
Bear Stearns	6.08

Table 3 illustrates one way of assessing the market's current view of how the major investment banks are doing relative to one another and to their own historical performance. Rather than the traditional 52-week high/low, it compares each firm's current share price, in its home market, against its high and low prices since September 1997 – a period long enough to include the 1998 bear-market lows as well as those of 2002, and also the 2000 bull-market highs. It then ranks each according to the percentage by which it is now trading below its 5-year high, and again by the percentage by which it is above its 5-year low.

TABLE 3 Market-Sensitive Stocks: A Long-Term View

	Currency	Closing Price 12/3/06	5-Year High	5-Year Low	Pct. Off 5-Year High
Credit Suisse	CHF	35.70	90.00	19.35	60
J.P. Morgan Chase	USD	25.22	35.70	15.95	60
Morgan Stanley	USD	45.32	109.38	20.41	59
Deutsche Bank	EUR	52.24	103.00	35.64	49
Merrill Lynch	USD	43.40	75.13	21.47	42
ABN AMRO	EUR	17.00	28.50	10.35	40
Goldman Sachs	USD	78.78	132.31	57.00	40
Citigroup	USD	38.52	58.88	17.26	35
HSBC	GBP	7.68	10.90	3.25	30
Lehman Brothers	USD	60.25	86.20	14.01	30
UBS	CHF	75.30	106.00	42.00	29
Barclays	GBP	4.66	6.25	2.08	25
Bank of America	USD	69.11	87.94	38.00	21
Bear Stearns	USD	63.29	72.13	25.77	12

	Currency	Closing Price 12/3/06	5-Year High	5-Year Low	Pct. Above 5-Year Low
Goldman Sachs	USD	78.78	132.31	57.00	38
Deutsche Bank	EUR	52.24	103.00	35.64	47
J.P. Morgan Chase	USD	25.22	35.70	15.95	58
ABN AMRO	EUR	17.00	28.50	10.35	64
UBS	CHF	75.30	106.00	42.00	79
Bank of America	USD	69.11	87.94	38.00	82
Credit Suisse	CHF	35.70	90.00	19.35	84
Merrill Lynch	USD	43.40	75.13	21.47	102
Morgan Stanley	USD	45.32	109.38	20.41	122
Citigroup	USD	38.52	58.88	17.26	123
Barclays	GBP	4.66	6.25	2.08	124
HSBC	GBP	7.68	10.90	3.25	136
Bear Stearns	USD	63.29	72.13	25.77	146
Lehman Brothers	USD	60.25	86.20	14.01	330

As may be seen, firms whose 2002 results to date have generally disappointed investors tend to be clustered near the top of both lists, while those which have weathered the recent storms better are generally to be found near the bottom.

It is also interesting that many of the firms – though not all – near the top of both lists, ie those whose shares have fared the worst, are universal banks rather than stand-alone investment banks nor institutions with large retail banking franchises. While the market's ultimate verdict on the one-stop-shopping model of corporate and investment banking remains to be determined, its current report is none too encouraging.

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