Biting the bullet

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INVESTMENT BANKS GIVE HIGH BONUSES DESPITE A DOWNTURN.DOES THIS SIGNAL A SHAKE-OUT ASK CHARLES PRETZLIK AND GARY SILVERMAN

Investment banks were throwing around tickets for the baseball World Series last week as if they were holding their own ticker-tape parade. At about $300 each, it was a clear sign of good times on Wall Street. The same jubilant mood had been in evidence a few weeks earlier in London, where Lehman Brothers hired the Millennium Dome - all 25,000 tickets - to throw a party in celebration of its 150th anniversary.

As companies around the world have plunged into the capital markets for debt and equity and corporate merger activity has intensified, this year - even more than last - has been one of the most profitable on record for investment bankers.

But all that may be about to change. The sector, always highly cyclical, is starting to worry about an impending industry slowdown. And to make matters worse, many banks may be ill-prepared: after 18 months of intense competition, they have hired recruits on enormous bonuses guaranteed for two or even three years.

As the finance director of one leading investment bank says: "There are quite a lot of people who built their cost base up implicitly believing it would continue, and they will struggle next year."

The changing climate is not yet easily detected from casual conversations: professional optimists by nature, investment bankers will never admit to being not busy, or having a "pipeline" of transactions that is anything but full.

The market, however, tells its own story. In recent week’s investment banking stocks have fallen sharply. From a peak four or five weeks ago, when US investment banks were trading at 20 times earnings, to last Friday, Goldman Sachs has declined 29.7 per cent and Morgan Stanley 27.5 per cent. JP Morgan was down 12.7 per cent, UBS 8.5 per cent, and Credit Suisse 7.5 per cent.

In part, this sell-off reflects fears about the banks' exposure to poorly-performing loans and high yield n-bonds issued by telecommunications companies. But it is not the only bad omen. Business is slowing: between the second and third quarters, trading revenues slid 35 per cent at Morgan Stanley and underwriting revenues tumbled 27 per cent at Goldman Sachs.

The technology-heavy NASDAQ stock market is off 22 per cent this year and the high-yield bond market, which helped fund the rapid expansion of telecom companies and the boom in leveraged buy-out activity, is so weak that it can be hard to get a price on some issues.

Equity capital markets desks are littered with the prospectuses of initial public offerings that have been pulled amid fears of insufficient investor demand. "The calendar for IPO’s suddenly looks quite modest," says the head of one European investment bank - who adds that he is still telling clients to go to market now because the climate is only getting worse.

According to research by Morgan Stanley Dean Witter, third-quarter total global underwriting in debt and equity declined 2.3 per cent compared with the same period a year ago and 9.3 per cent compared with the previous quarter.

Finally, the record level of M&A activity is unlikely to be sustained into next year, largely because

the state of the debt and equity markets makes it more difficult for companies to raise cash or use their stocks as currency.

The unresolved question is how investment banks will react to the downturn. Will they cull staff heavily, as they did in 1990, 1994 and 1998, or hang on tight and hope things do not get too painful?

Headhunters and bankers agree that there is no let-up in the scramble to hire good people. Indeed, previous shake-outs may lead many banks to think twice about wholesale redundancies. The experience of Merrill Lynch, which slashed its payroll after Russia's default in 1998 only to resume hiring when the stock market rebounded a few months later, is still remembered.

"Merrill laid off 5 per cent of their workforce and by January 1999 they were replacing that 5 per cent and trying to add," says Brian Sullivan, managing partner of Heidrick & Struggles, the recruitment firm. "Everyone else looked at that and said, 'We dodged a bullet.' "

According to the head of investment banking at one of the major firms, bonuses are likely to be attacked long before he tries to cut staff. He fears the effect redundancies would have on morale and on the message it would send to clients. Conveniently, the downturn comes as investment banks are entering bonus season.

However, cutting bonuses may not suffice. Judah Kraushaar, banking analyst at Merrill, says: "I don't think firms are going to tolerate a massive contraction in profitability." If markets remain weak, he says, job cuts could follow "by early in 2001," he adds.

Senior bankers in hot areas who moved firms this year may have doubled their total pay to up to $5m. Many others received similar "golden handcuffs" not to move. The competition, aggravated by the exodus to internet-related companies at the beginning of the year, was at its most acute for staff specializing in telecommunications, media and technology, or advising private equity houses.

Optimists point out that this summer's spate of mergers has already helped to cut costs. Donaldson Lufkin & Jenrette, the leading junk bond house, has been acquired by Credit Suisse. UBS has bought PaineWebber, Chase Manhattan acquired JP Morgan and Wasserstein Perella is now owned by Dresdner Bank.

But as the head of investment banking at one Wall Street firm argues: "The number of big firms competing for the big business has actually increased: there are now six giants prepared to put money into beating the others. If anything, consolidation is going to make things worse."

Banks have been keeping a grip on costs in other ways too. Goldman Sachs, for example, increased its headcount to 18,666 in the third quarter from 16,512 in the second, while keeping its ratio of compensation to revenues at 50 per cent.

Philip Panaro, global head of mergers and acquisitions integration at IM2, the professional services group, says he completed a project that helped one bank slash its technology and operations budget by $100m a year, or about 10 per cent of the total. Investment banks are also farming out more operations work to contractors.

Many people on Wall Street argue that, in the long term, investment banking is sure to remain a growth industry - and that this should be remembered during cyclical swings.

Wall Street's long-term optimism is based on demographics - the large population of well-off US baby boomers who will need help investing their money. "The Street has made a bet . . . and the bet is that if you staff up significantly that you are essentially believing the medium to longer-term outlook is good," says Guy Moszkowski, securities industry analyst at Salomon Smith Barney. "Over the last 10 years, when significant cutbacks have been made on the expectation that the environment has been weakening, those have been losing bets. The winning bets have always

been in favor of growth."

In Europe, industries are restructuring and more companies will need to tap the capital markets. Many banks have also sought to diversify away from the volatile earnings of investment banking and are increasingly reliant on the more steady fees earned from asset management or private banking-related services. UBS's acquisition of PaineWebber was such a move.

Nevertheless, in the short term, some banks are likely to fare better than others. Analysts believe Goldman Sachs and Morgan Stanley, the industry leaders, have felt less pressure to pay huge two or three-year guarantees: but some mid-tier firms are likely to lose business. Either way, investment banks will find home runs harder to hit over the next few quarters.

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