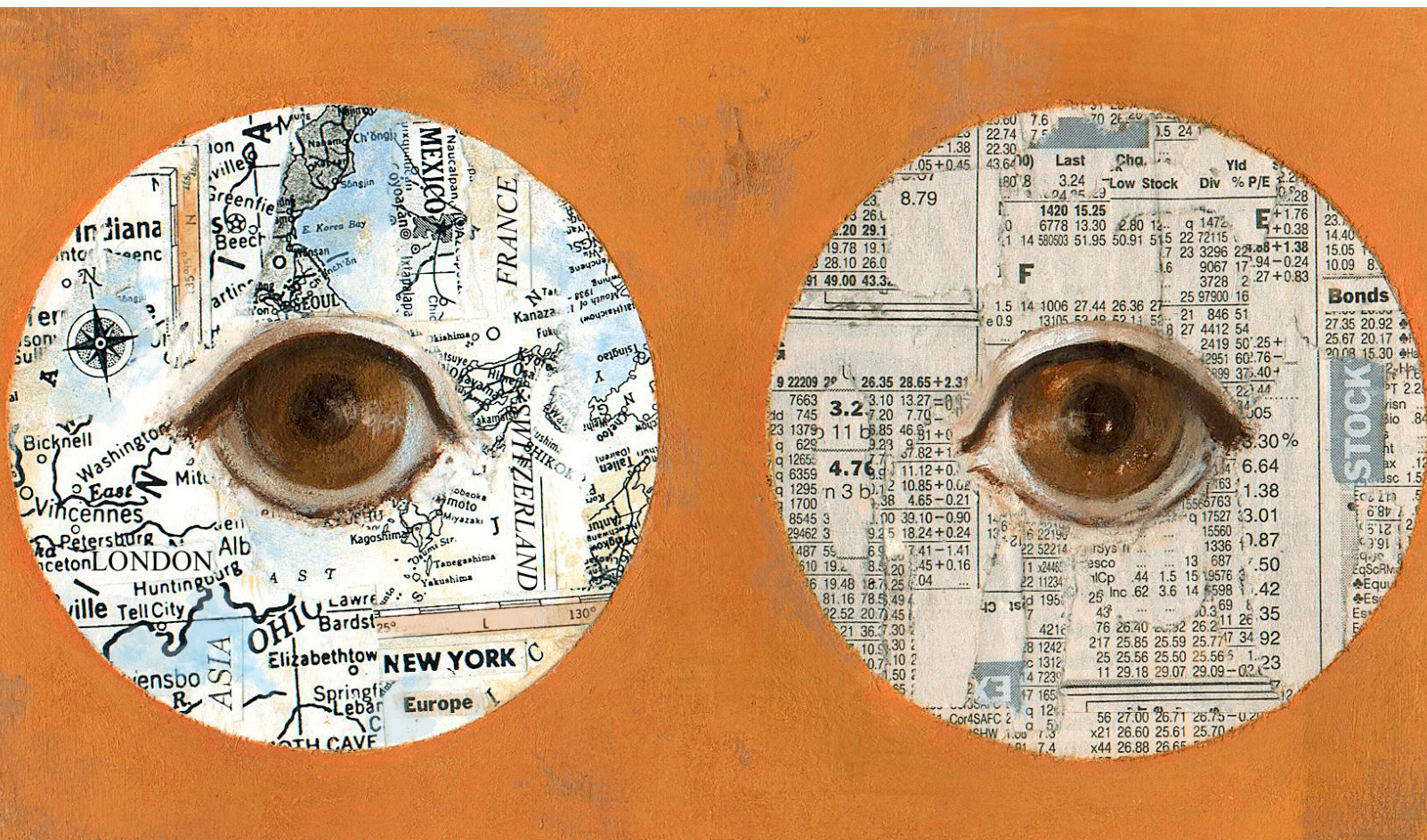


McKinsey on Corporate & Investment Banking



January 2006

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The **next challenges** for global securities firms

Hedge funds, financial sponsors, weak credit markets, new advisory business—a lot of opportunity, but not for the fainthearted.

**Sandra Boss and
Sanoke Viswanathan**

It was a good year for the global securities industry. Origination volumes were up and, although trading had a tough second quarter, overall year-end results were excellent for many players. Yet the longer-term health of the industry is less clear. A lot of key businesses are evolving in fundamental ways, and banking executives will have to rethink their traditional assumptions about how to operate successfully on a global scale.

Shaping strategy

Successful banks will adopt fresh strategies for changing times. Big companies will continue to seek strategic advice, but banks will also need to serve the middle market. In addition, private and public capital market boundaries are blurring, which makes financial sponsors an increasingly important market segment.

Advising mega-institutions

Companies are getting bigger, and so are M&A deals. Since 1995, the 100 largest global companies' share of total market capitalization has grown to 41 percent, from 35 percent. The average top ten M&A deal has grown as well—to \$17 billion, from \$6 billion, in the past two years alone.

Unfortunately, bigger companies and bigger deals don't guarantee bigger M&A fees

to advisers. Over the past ten quarters, the top ten deals accounted for 30 percent of volume, on average, but contributed only 16 percent of fees. Spreads for the biggest deals have fallen to 20 basis points—not counting in-house transactions, which pay much less.

Too many bankers continue to pursue big deals. The most serious competition is relatively new, however: internal finance teams at the biggest companies, independent advisers (Greenhill Capital Partners, for example), and law firms that are redefining what big companies receive from Wall Street. Some commentators worry that these changes at the large end of the market foretell a full-scale identity crisis for the traditional advice model.

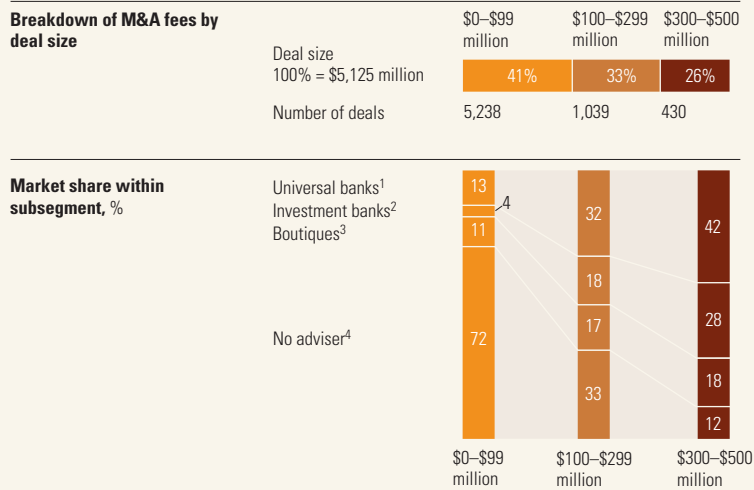
We would not go so far; in our view, for example, big companies will still pay for strategic advice. Since the mid-1990s, Fortune 500 companies have paid from 25 to 35 percent of total advisory fees, and this trend most likely will continue. Relationship banks will capture a good share of the more straightforward business, while credit is here to stay as a tiebreaker in awarding mandates. We expect that more strategic deals will still go to banks with deep personal connections to management as well as global reach, strategic industry perspectives, and deep technical skills.

Big companies are nevertheless likely to redirect their spending from advice on acquisitions and divestitures to advice about other financial issues. Mature, slow-growth companies with large retiree populations, for example, are reaching out for help on looming pension liabilities. Globally diversified companies want to minimize volatility in commodity prices and exchange rates. Some of these trades—and the associated profits—can

EXHIBIT 1

Three distinct segments in middle-market M&A

European and US M&A fees, 2004



¹ Citigroup, Deutsche Bank, Royal Bank of Scotland (RBS), UBS, J. P. Morgan Chase, Credit Suisse, HSBC, Bank of America, BNP Paribas, ABN Amro, Barclays, Société Générale, Wachovia, Crédit Agricole, Dresdner Bank.

² Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, Bear Stearns.

³ N. M. Rothschild & Sons; Lazard; Keefe, Bruyette & Woods; Houlihan, Lokey, Howard & Zukin; Allen & Company; Evercore Partners; Jefferies; First Annapolis Consulting; Greenhill; Relational Advisors; Sandler O'Neill; Friedman, Billings, Ramsey; Robert W. Baird; Thomas Weisel Partners; William Blair.

⁴ Includes accountants, lawyers, and financial advisers not listed as official M&A advisers.

Source: Dealogic; McKinsey analysis

relationship economics work. Universal banks that can afford some of the costs of coverage with credit and cash management clearly have an advantage here but are in no way dominant. In fact, apart from the high end of this market (transactions of \$300 million to \$500 million), the universals face tough competition from boutiques such as Keefe, Bruyette & Woods and Sandler O'Neill.

One untapped opportunity could be the lowest end of the market (transactions of less than \$100 million), where a majority (72 percent) of deals are done without banks or boutiques as advisers. This fragmented, costly-to-serve segment of the M&A market is ripe for a different kind of advice model—a model spurred by demand for an efficient, scaled, national “brokering” capability for small- and midcap companies. CIT Group may be only the first of a few new entrants that reinvent this business by taking on national universal banks, regional broker-dealers, accounting firms, and independent company brokers.

By focusing on the largest clients, most traditional investment banks have chosen to stay out of this space. But as the economics at the top end of the market come under further pressure, many banks will look harder for a way to gain access to smaller clients for sell-side mandates and sponsor introductions. If successful, the banks that can flex their muscles in both advisory and financing markets will have a significant edge with the financial sponsors.

Blurring private and public boundaries

Financial sponsors are undeniably an important customer segment for investment banks, having driven 31 percent of all M&A fees paid to them in the last quarter. During the past five years, private equity

be enormous. The best investment banks will expand the definition of “strategic advice” to encompass a wide range of risk-management issues.

The middle market

At the same time, the total wallet for smaller deals (those of less than \$500 million), though highly fragmented, is significant, constituting nearly 35 percent of total M&A revenues in Europe and the United States. Historically, no business model has dominated this space; boutiques, investment banks, universal banks, and independent advisers (such as law firms) all fight for it (Exhibit 1).

Success calls for establishing a regular dialogue with a broad set of smaller corporations while making sure that the

firms raised \$130 billion in buyout capital (Exhibit 2). Furthermore, hedge funds increasingly play in the private markets, thus blurring the boundary with financial sponsors and multiplying the number of potential participants in any deal.

EXHIBIT 2

The growing importance of financial sponsors

Buyout capital raised by top private equity firms, Q1 2000 to Q3 2005

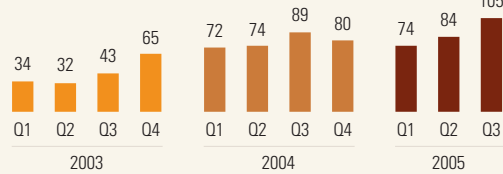
Fund	Size, ¹ \$ billion
Blackstone ¹	19.0
Carlyle	14.4
Apollo Advisors ¹	13.8
Goldman Sachs	13.8
Thomas H. Lee Partners ¹	13.6
Warburg Pincus	13.5
CVC Capital	11.2
BC Partners	10.8
Kohlberg Kravis Roberts	10.5
Cinven ¹	9.4
Total	130.0

¹Totals include announced funds.

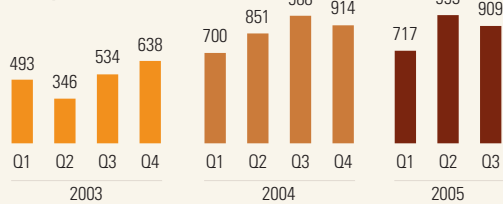
Source: Capital IQ; Thomson; McKinsey analysis

M&A driven by financial sponsors

Deal volume, \$ billion



Fees paid, \$ million



Source: Dealogic; McKinsey analysis

Financial sponsors (and hedge funds acting like them) are going straight to companies to put together bigger, more ambitious deals, such as the GMAC Commercial Mortgage spin-off, crafted by Kohlberg Kravis Roberts and Goldman Sachs Capital Partners. They are working together in new ways, as the “privatization” of SunGard Data Systems by a seven-member consortium shows. What’s more, they are pushing into corporate boardrooms: ESL Investments’ stake in Kmart and Sears is one of the most public examples of this phenomenon in the United States. Financial sponsors are also becoming increasingly flexible on exits: hold times of less than a year and sales to other private equity firms are increasingly common. Europe is not far

behind, with more than ten large European companies—including Metso, Lindex, IWKA, and Deutsche Börse—targeted last year by activist hedge funds (such as Cevian Capital and Icahn Partners) that often push for changes in management.

Banks require a new model to serve sponsors and sponsorlike hedge funds. They must be the first to uncover creative investment opportunities and stand ready to deliver equity coinvestors and debt financing at short notice. The new coverage model is closer to the markets, with faster response times than those of traditional pitch-book-oriented investment banking. Granted, finding change-of-control situations before sponsors do will be tough, but brokering large private ownership stakes is also a growth business. As target deals get larger, facilitating private equity investor syndicates will become even more important for banks.

At the same time, banks should rethink what they can bring to companies in a world dominated by sponsors and hedge funds. After all, unless financial buyers have unique plans for creating value, strategic corporate buyers and public equity markets may still offer better deals for existing shareholders. Target companies, more than ever, need advice on how to assess trade-offs between private and public financing alternatives.

Financing growth

Challenges await banks that are planning how to finance their clients’ growth in the years ahead. In mature countries and sectors, equity is becoming one financing product among many. While investment-grade corporate-credit fundamentals appear stable, consumer-credit and noninvestment-grade corporate-credit markets are looking shakier.

Equity: Just another financing product

The initial-public-offerings market finally rebounded in 2005, with growth sectors pushing primary-issuance volumes over 50 percent ahead of last year’s levels. Thus far, the traditional equity syndicate model is holding firm against auction-style experiments such as those of Google and Morningstar. Moreover, despite the challenges in equity research, first-time issuers still appear to care about its quality and availability when they award IPO mandates, thus ensuring attractive returns to strong research houses. In addition, Asian and European equity markets are prospering, with volumes 20 to 25 percent higher than those of 2004; Chinese, French, and Russian IPOs dominate the global list of mega-offerings. As the amount of equity in proportion to GDP outside the United States comes closer to the US level (Exhibit 3), banks that have strong international franchises will capture most of the value.

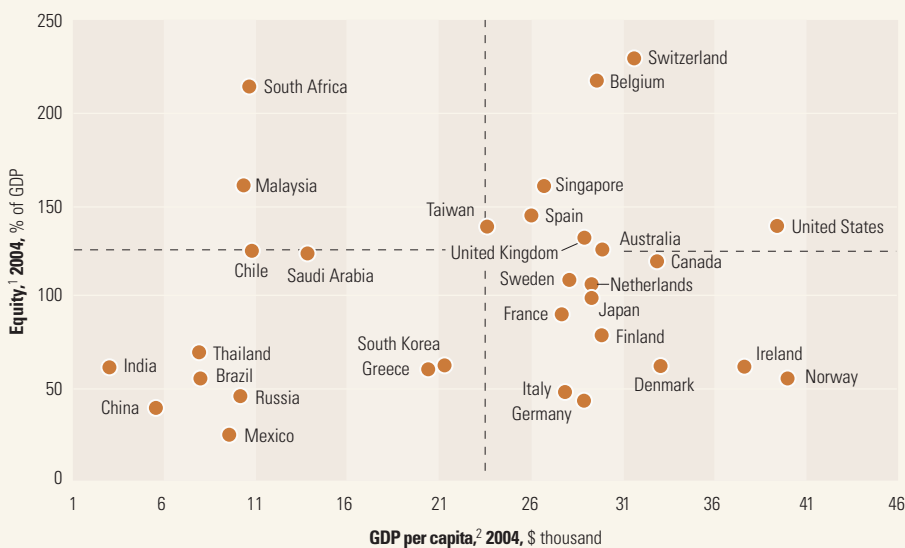
In contrast, follow-on and hybrid equity—collectively accounting for 60 percent of equity issuance fees—have become commoditized forms of financing. Since the market downturn in 2000, spreads have dropped by 44 percent. Lending has become a necessary entry ticket for these products: the originating banks had lending relationships with the issuers for 48 percent of issuance volume. Even the top five “pure” investment banks had lending relationships with the issuer for 47 percent of their volume, up from 24 percent in 2003.

After adjustments have been made for a few mergers, the league tables in primary equities are remarkably unchanged from 10 or 15 years ago, reinforcing the power of the traditional model. But in the follow-on and hybrid markets, winners will need to bring a new, capital market perspective that seamlessly integrates debt, equity, and hybrid-financing alternatives.

EXHIBIT 3

Significant international equity opportunity

Market capitalization and GDP for selected countries



¹Measured by country’s market capitalization; selected countries are those with 2004 market capitalization >\$100 billion.

²Adjusted for purchasing-power parity.

Source: Global Insight; World Bank; McKinsey Global Institute financial-stock database

Stable corporate-credit fundamentals

Rising cash levels are strengthening balance sheets and ratings for investment-grade companies. Spreads are low but proportional to loan losses, and corporate-governance reforms should make major fraud less likely.

Conversely, the markets for high-yield bonds and leveraged loans are showing clear signs of froth. Banks are loosening the underwriting criteria for lower-quality credit. Across rating classes, spreads have fallen to recent actuarial loss levels—far below historical loss levels. While average leveraged borrowers seem stable, more recent marginal ones may show signs of stress as heavy refinancing in 2006 and 2007 increases debt service.

Similarly, the European midsize corporate-lending market seems to have learned little

from the last downturn. After stepping hard on the brakes in 2003, most banks have again embraced the optimistic underwriting standards and relationship-oriented pricing of the late 1990s.

Single-name CCC- to C-rated defaults will likely be too small to trigger a marketwide reaction. The market, after all, smoothly absorbed the recent losses from automotive company downgrades. But downgrades of high-yielding BBB-rated names common in synthetic collateralized-debt obligations could transmit problems across sectors and geographies. A protracted economic downturn would have a similar effect.

As the dominant providers of credit protection, banks need to anticipate what such disruptions could bring in a world of broadly distributed credit. Shorter-term investors such as hedge funds lack the sort of relationships with borrowers and issuers that banks enjoy. With the newly developed short market, investors are pulling in different directions. Increasingly popular second- and third-lien positions are as yet untested.

Shakier consumer-credit markets

Of the \$9.8 trillion in outstanding US consumer debt, nearly 80 percent is now backed by residential real estate. With several investment banks increasingly dependent on the mortgage market for profit growth, the average homeowner's financial-obligation ratio (FOR) has spiked to near-historic highs. In our view, the question is not *whether* the quality of consumer credit will deteriorate but *when* it will do so.

The mortgage market has posted several warning signs—some familiar, some new. Home prices are appreciating at dizzying

rates in “hot” metropolitan statistical areas (MSAs). Meanwhile, as higher interest rates slow down refinancing activity, banks are trying to stimulate demand and attract market share through looser underwriting standards (such as low or no documentation) and riskier structures (such as interest-only or negative-amortization loans). More and more people are buying houses for investment purposes.

In the near term, the upcoming wave of resets into higher rates (9 percent over the next 12 months) will raise debt burdens and could trigger defaults. More broadly, the combination of sustained higher interest rates and weakening economic conditions could soften prices in overheated MSAs. Potentially, this situation could trigger defaults in adjacent consumer-credit markets. The agency-backed prime-conforming market was set up to absorb these shocks; the private-label securitization markets may be in for some surprises.

Over the past few years, most banks have focused on selling new mortgages; however, a turning market cycle will require new capabilities. Banks with superior risk analytics, disciplined pricing, and active portfolio management, for example, will make better buy and hold decisions. Those with well-honed skills in collections and real-estate-owned (REO) properties will deliver better on- and off-balance-sheet performance, differentiate themselves in the eyes of investors, and avoid accusations of predatory lending; they may also find new turnaround investment opportunities. (See “The right fix for fixed income.”)

Adjusting to flat trading markets

At most banks, sales and trading revenues were down by 6 percent for the 12 months ending with the second quarter of 2005,

EXHIBIT 4

What's trading electronically?

Product	Average daily trading volume, \$ billion	Traded electronically, %	
		2005	2004
Foreign-exchange futures	27.0	75	70
European government bonds	102.9	74	75
US equities	66.0	60	55
Foreign-exchange cash	2,200.0	58	50
European energy	2.6	55	55
US bonds	945.0	35	30
European nonsovereign bonds	40.7	27	24
Japanese government bonds	65.0	25	25
European repurchase agreements	22.0	23	20
US energy	6.2	17	17
US repurchase agreements	820.0	12	10
Credit derivatives	40.0	7	5
Interest-rate swaps	750.0	5	3
Freight derivatives	0.1	4	2
Japanese repurchase agreements	121.0	3	3
OTC IRDs ¹ (nonswap)	475.0	1	0
Ship brokerage	0.4	0	0

¹Over-the-counter interest-rate derivatives.

Source: Celent; McKinsey analysis

though they rebounded again in the third quarter. Equity trading continues to feel the pressure as market volatility remains low. At the same time, fixed-income revenues continue to increase. While the flattening yield curve has taken some long-reliable spread out of the carry trade, the structured credit markets continue to be robust. Many firms are trying to diversify trading into new markets such as commodities, but the most pressing challenge is reinventing a core business that is in itself fast commoditizing.

Industrializing trading

As the automation of cash equities accelerates and execution is unbundled from research, competitive lines are blurring in the struggle for a share of dwindling profits. With 50 percent of institutional volume now in programs or direct market

access, commissions paid to broker-dealers are often too low to offset block losses. At the same time, the NYSE-Arca and Nasdaq-Instinet deals expand offerings in client connectivity, order management, and smart order routing. Further consolidation among global exchanges will continue to strengthen their value proposition to broker-dealers and, indirectly, to institutional investors. Through investments in the Philadelphia Stock Exchange (PHLX), the Boston Options Exchange (BOX), and the International Securities Exchange (ISE), banks and hedge funds are already anticipating the consolidation of equity derivatives and cash trading.

Other liquid-asset classes still generate trading profits for broker-dealers, but increased automation and transparency are shifting the advantage toward the customer (Exhibit 4). Dealer spreads in foreign exchange—the first trading market to automate—are now virtually nonexistent in major currencies. In fixed income, electronic trading accounts for 35 percent of US Treasuries and agencies and for 15 percent of US mortgage-backed securities. Order-driven exchanges for corporate bonds by NYSE and Borsa Italiana–Euronext MTS may benefit from recent investigations into the large dealer markups imposed on small corporate-bond trades.

As markets commoditize, efficient end-to-end electronic trading and processing has become the most important differentiator in attracting and profitably executing client business. Industry leaders continue to substitute technology for traders, while those firms that postponed investments in trading technology are playing a painful game of catch-up. Shifting to leaner, more productive client coverage models is also important, as we note later in this

article. Finally, as efficient front offices become more common, the competitive battleground will increasingly shift to middle and back offices. (See “Rethinking wholesale-banking operations.”)

Bringing together fixed income and equity

Practically every Wall Street institution has tried to integrate its fixed-income and equities businesses to some degree. In a few cases, these are combinations in name only, with powerful fixed-income leaders trying to right faltering equity franchises. Many banks are redrawing their organizational charts and putting functions together in a quest for greater client impact.

The earliest successes have come in trading and desk-based research (as opposed to “publishing”). An integrated, multiasset-class electronic-trading platform offers clear strategic advantages, particularly in dealing with hedge funds. Several firms are generating ideas for capital structure arbitrage trading on behalf of their clients by bringing together equity, debt, and hybrid research. Everyone is watching Goldman Sachs’s ambitious side-by-side trading system in Europe.

In the long term, integrated institutional client service should deliver real value, but this aspiration remains elusive. Providing an integrated service to multistrategy hedge funds across products is likely to create peer relationships with chief investment officers. However, traditional asset managers and some larger hedge funds expect product specialist coverage mirroring that of their own more siloed organizations. A multiproduct, institutional sales force may promise higher productivity, but this approach won’t work if it gets ahead of clients’ demands.

In our experience, those institutions that get it right pay their people appropriately for working well across boundaries, install the right leaders to drive change, and invest in training and support to expand their product knowledge. It will take a lot more than redrawing organizational structures to change behavior learned over decades.

Sell side–buy side convergence

Regulatory efforts to strengthen Chinese walls are more intense now than they have been since the birth of modern US securities law, in the early 1930s. The overhaul of trade-order-handling rules and pricing rules that started with over-the-counter (OTC) equities in the 1990s has gradually transferred profits from agency trading to the buy side. Moves to cleanse equity research of privileged company insights and to ensure independence from banking have transferred much of the value of research to investors and issuers.

To replace easy profits “lost” to regulatory reform, most sell-side firms increased their proprietary trading activity—essentially joining the buy side. They were active, early participants in quantitative equity arbitrage strategies. More recently, they have joined hedge funds and private equity firms in making directional bets in unusual, illiquid assets. Some have gone so far as to enter operating businesses directly—not just owning but also operating power plants, oil tankers, railcars, and the like.

In the latest twist, leading hedge funds trying to cut costs and find new growth are entering market making, securities lending, and clearing. Some of the largest hedge funds (Citadel Investment and Ramius Capital, for example) are now market makers on the Chicago Board of Trade and

the International Stock Exchange. In fact, Citadel and other hedge funds with broker-dealer affiliates that make markets in equities are seeking regulatory approval to clear their own trades. With the right skills and infrastructure, top hedge funds could assert their independence and internalize some of the fees they pay to prime brokers.

We expect institutional investors to begin asking more questions about this growing ambiguity. Broker-dealers that clearly separate buy-side from sell-side activities—which probably means separate management, reporting units, and locations—may miss some opportunities, but they will be better positioned to weather future scrutiny.

With several traditional sources of profits now under extreme pressure, the best firms are those that are getting ahead of changes in market structure. In the next few quarters, we expect to see significant announcements as successful players accelerate their lead and others reorient to focus on niches. **MoCIB**

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