Are banks cutting too deep?

To beat the tough times, Asia's investment banking leaders are focusing on long-term opportunities and not overreacting with short-term solutions. By **Jim Hildebrandt** and **Allen Merrill**.

Last summer, investment bankers were saying they had learnt from the last downturn in 1997-98. They said they had cut staff numbers too deeply the last time, making it difficult to capture the full potential from the upturn. But have they really learnt, or are they making the same mistakes again?

Investment banks are seeing their market struggle again in Asia. Merger and acquisition values, excluding Japan, have fallen from US$196 billion in 2000 to US$108 billion in 2001. Equity underwriting also fell from US$64 billion to US$31 billion. Debt markets have held up better, with only a 10 per cent decline, but margins are under pressure.

How have investment banks responded to the downturn?

They have sold non-profitable businesses in countries where they had weak market positions or where the market was unattractive. They have shut down start-ups and cut staff by 25 per cent or more overall. Many have imposed wage and hiring freezes. But are they cutting too deep again? On balance, we think not.

NEW MARKET CONDITIONS

Investment banks in the region have changed substantially in the last decade. The large US banks now dominate, with only the biggest and boldest European players still participating. Local banks have become much less successful in capturing the domestic investment banking business. The few regional investment banks have either shut, merged or focused their business on areas where they can better compete.

CEO SUMMARY

Some strategies undertaken by investment banks under the current tough market conditions include:

- "Staffing down" technology, country or regional teams. The challenge is to keep the core team that will form the foundation of future growth.
- Bonuses are substantially down.
- Minimal recruiting, and flat or lower starting packages.
- Further constraints on lending and a more extensive portfolio reassessment.
- Treading carefully with regard to institutional and retail brokerage.

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The big remaining players offer a full range of services to large local and multinational clients. Leaders such as JPMorgan Chase, Morgan Stanley, Goldman Sachs, Salomon Smith Barney (Citicorp) and Merrill Lynch have improved their competitive positions through both mergers and organic growth.

These large, consolidated players are able to adjust fairly quickly to new market conditions, and develop new businesses that thrive in a downturn. For example:

- Convertible bonds, which grew rapidly last year in the US, are now emerging in Asia with recent issues by PCCW and Korea Telecom.
- Banks are reselling non-performing loans to private investors. This is a huge potential opportunity in China and as much as a US$20 billion opportunity in the rest of the region, excluding Japan.
- JPMorgan Chase, Goldman Sachs and Morgan Stanley are also involved in the growing private equity market.
- In the long term, there are substantial growth opportunities in Asia, particularly in China. The sharper players have not cut staff excessively. Some have been investing in China for years. China's entry into the World Trade Organisation will accelerate the potential opportunities for investment banks. There is also likely to be substantial demand for initial public offering (IPO) advisory and underwriting services. China could account for as much as 40 per cent of the IPO pipeline in Asia, excluding Japan, in 2002.

LONG-TERM STRATEGIES

What are investment banks doing in response to the current tough market conditions?

- The "staffing up" of technology, country or regional teams is now "staffing down". The challenge is to keep the core team that will form the foundation of future growth as well as business unit, country and industry capabilities.
- Bonuses are substantially down.
- The intense focus on acquiring the best junior talent is off. Many firms are doing minimal recruiting and starting packages are flat or down.
- The Enron debacle has generated further constraints on lending and a more extensive portfolio reassessment than was already under way. Systems to control risk are further enhanced.
- Technology gurus have exited or shuffled to other areas of the bank. Technology and telecommunications experts are now focused on mainstream manufacturing and operating units again.
- Investment banks are also advising their investor clients to realign their expectations towards single digit returns.
- In China and Japan, investment banks are set for growth opportunities that justify scaleable operations and long-term investment in capabilities.
- Finally, investment banks are treading carefully with regard to institutional and retail brokerage, after paying a heavy price for pursuing the online brokerage market during the Internet boom.

There are difficulties ahead for investment banks overall in this challenging market environment. But the real leaders in Asia do not appear to be overreacting with short-term responses that might damage their longer-term opportunities. They appear to be here to stay. **BOL**

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