Some Investment Banks May Prosper

Smaller Companies Are Likely to Survive Despite Hard Times

BY CRAIG KARMIN

Don't tell these guys that the investment-banking model is finished.

While the biggest U.S. players are exiting from the pure-play investment-banking scene, about a dozen smaller investment banks remain. Analysts expect them to survive and keep the stand-alone business model alive, albeit at a much more modest level than on Wall Street.

Institutions, such as **Piper Jaffray** Cos., Minneapolis; **Raymond James Financial** Inc., St. Petersburg, Fla.; **Thomas Weisel Partners Group** Inc., San Francisco, and **Jefferies Group** Inc., New York, have a different business strategy that relies less on risk-taking than that of the more-prominent investment-banking firms.

"They don't need to raise capital because they don't have the same problems," says David Trone, head of commercial and investment-banking research at Fox-Pitt Kelton Cochran Caronia Waller, a closely held investment bank.

The past week has seen Wall Street remake its profile. Industry giants Goldman Sachs Group Inc. and Morgan Stanley are morphing into bank-holding companies and Merrill Lynch & Co. is merging with Bank of America Corp., while Lehman Brothers Holdings Inc. has sought bankruptcy-court protection. Some pundits have declared that investment banks can't endure the current environment without accepting deposits as a safer alternative to traditional, capital-intensive investment-banking services, like trading, underwriting and advising.

Courtesy of the St. Petersburg Times

Thomas A. James, chairman and chief executive of Raymond James Financial

Too Small to Fail?

Smaller firms aim to buck the trend and remain pure investment banks

Market capitalization, in billions

Firm	Market capitalization, in billions
Raymond James Financial	$3.67
Jefferies Group	$3.44
KBW Inc.*	$0.93
Thomas Weisel Partners	$0.19
Cowen	$0.12
Goldman Sachs	$47.56
Morgan Stanley	$30.04

*Owns Keefe, Bruyette & Woods

Source: WSJ Market Data Group

But these other, smaller players tend to borrow less money and to avoid mortgages and structured financial products. They aren't as dependent on short-term funding. Their clients tend to be small companies that need investment-banking services but often lack the scale to attract the larger banks.

That isn't to say the coming months will be easy for these small investment banks. They are reliant on buoyant stock and bond markets to boost their underwriting business, and the recent slumps could weigh on earnings and pummel their stock prices. Indeed, some of their shares had double-digit losses during Monday's selloff.

After last week's two-day surge, moreover, some of these companies already were looking expensive. Monday, Sandler O'Neill analyst Devin Ryan downgraded both Piper Jaffray and Raymond James, citing valuation concerns after both shares rose more than 25% in a matter of hours. In cutting Piper Jaffray to a "sell" recommendation from a "hold," Mr. Ryan said he expects the company to post its third consecutive quarterly loss.

But Mr. Ryan said that the two downgrades reflected cyclical issues that were unlikely to undermine a positive longer-term outlook. The two companies' market values, which are now at $4 billion or less, are a fraction of Morgan Stanley's or Goldman Sachs's market capitalizations.

Some analysts suggested that these boutique investment banks resemble in some ways the businesses that Goldman and Morgan Stanley had 25 years ago, when they were much smaller private partnerships. The focus was advising on mergers and acquisitions and stocks and bond underwriting. Only later did the larger investment banks begin to rely on prime-brokerage services to hedge funds and proprietary trading to power their earnings.

For the most part, Fox-Pitt's Mr. Trone says, the smaller firms don't participate in these higher margin but more volatile businesses. The result is less explosive profitability but cleaner balance sheets. For one, the smaller firms typically have leverage at a rate of about one or two times to 1, says Mr. Ryan. That compares with more risky borrowing rates of 25-to-1 or 30-to-1 at Wall Street firms.

In the past, some of these boutique banks made for attractive acquisitions targets. The former Hambrecht & Quist, for example, is now a part of J.P. Morgan Chase & Co. Onetime Montgomery Securities is now part of Bank of America. But these deals haven't always worked out. French bank Société Générale acquired Cowen in 1998, only to spin it off a few years later. Similarly, U.S. Bancorp acquired Piper Jaffray in the late 1990s, and also spun off that business after a few years.

Mr. Trone says many former Bear Stearns employees who didn't stick with J.P. Morgan after that acquisition have looked to the smaller investment banks. "I suspect former Lehman employees will, too," he says.