Evolution of sales & trading profitability

- The sales and trading operations of the Top 12 banks have, as a group, been profitable in each of the last six years; even the post-'Crunch' nadir – reached in 2011 - was only 10% below 2007.
- In 2012, banks accelerated their adjustment to the 'new' trading environment. Top performers have cut unprofitable/unviable business lines and put in place sales coverage models that reduced costs *and* boosted cross-selling opportunities.
- The Top 12 banks' profits declined 20% year-on-year in 1Q13; we do not see this as indicative for the rest of 2013.

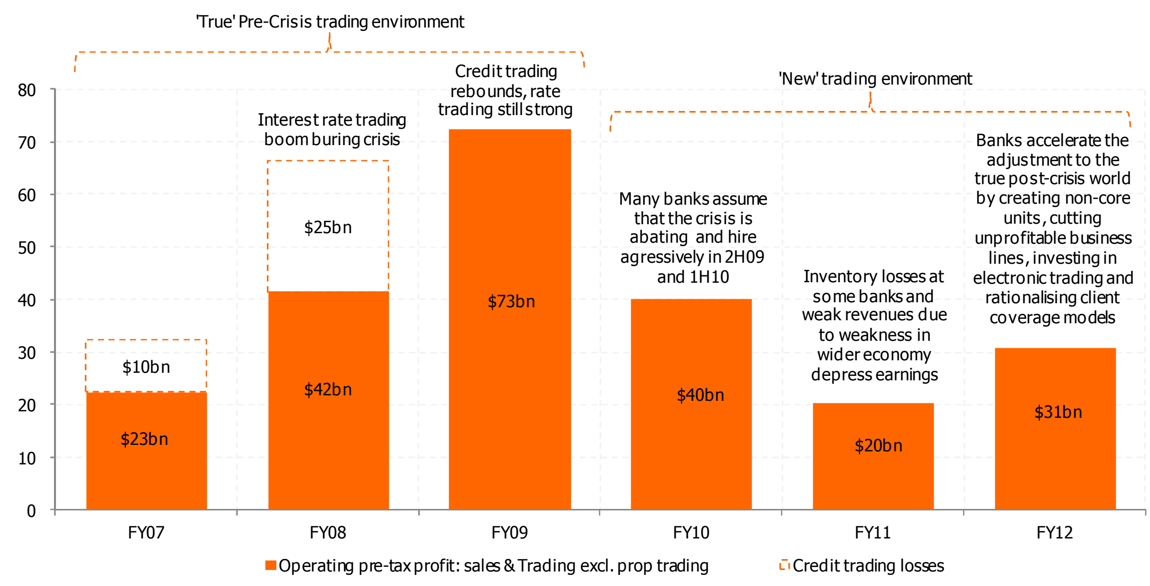
The turbulence in capital markets in recent years has, to a degree, masked the more complex story: that of the evolution of 'true' sales & trading profitability. By 'true', we mean sales & trading operating profits from FX, rates, credit, commodities, cash equities, equity derivatives and prime services products. This analysis excludes securitisation, proprietary trading and principal investments as well as businesses that were placed into 'bad banks' or 'non-core' units.

The sales & trading units of Top 12 investment banks were profitable in every one of the last 6 years. Profits almost doubled from 2007 to 2008 – *during* the crisis – largely due to the boom in interest rates trading, especially at the 'short end'; then advanced another 74% y/y in 2009 as credit trading revenues also surged. Seeing growth opportunities – especially in APAC - many banks started rehiring in late 2009 and early 2010. Few of these opportunities materialised, however, leaving banks burdened with higher staffing costs, contracting revenues - and the Eurozone crisis.

There was no respite in 2011 either; equities, commodities and FX trading revenues all weakened, while costs remained were flat as an increase in technology & operations investment, necessitated by the new regulation (e.g. move to CCP) and the rise of electronic trading partially offset the reduction in comp & benefits. Profits in 2011 halved relative to 2010, but were only 10% below the 2007 level; all considered, this was a good result.

In 2012, banks accelerated their adjustment to the 'new world': the focus rapidly switched from preservation of revenue and/or market share to growing the profits. Many businesses that were unprofitable – or indeed, unviable, e.g. from the RWA/capital angle – were wound down or hived off into 'non-core' units. New business models emerged; in particular investment into electronic platforms, and moves to integrate transaction banking products – e.g. cash management and/or securities services – with capital markets products.

Figure 1: Pre-tax operating profit of sales & trading units of the Top 12* investment banks (FY07-FY12)

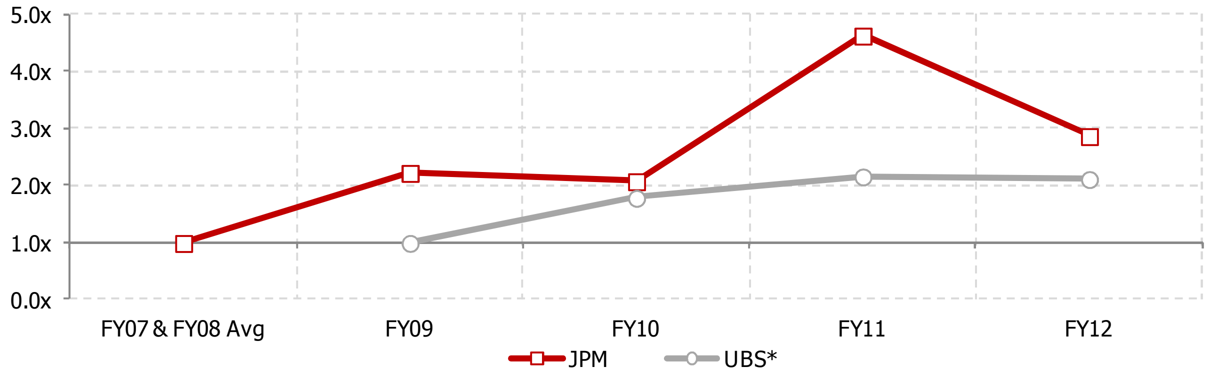


Source: Tricumen. Notes: (1) The Top 12 peer group comprises capital markets units of: Bank of America Merrill Lynch, Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley, Societe Generale, and UBS. (2) Pre-Tax Profit: Operating Revenue net of comp & benefits and allocated non-comp operating expenses. M&A/Advisory, ECM, DCM, loan capital markets, securitisation, prop trading operations and principal investments are excluded. (3) All financial data is reconciled against the published financial statements and to banks' most recent reporting standards.

To identify the outperformers, we indexed the share of the profit pool generated by each of Top 12 banks, using the average of 2007/2008 as the base period (thus smoothing the immediate effects of the 'original' crisis). Few will be surprised that J.P.Morgan leads the pack, and by some margin. A lot of the bank's growth was due to the surge in 2008; but it has more than held its ground since then.

Perhaps surprisingly to some, the runner-up is UBS. In part, this is due to the bank's weak position in 2007 and losses in 2008 (due to which we indexed our calculations to 2009); we also note, however, UBS' proactive improvement to its equities franchise (a latecomer to electronic trading) and, more recently, the recasting of their fixed income franchise (which is reflected in our analysis).

Figure 2: Share of the profit pool: J.P.Morgan and UBS (indexed to FY07/FY08 average, and FY09)

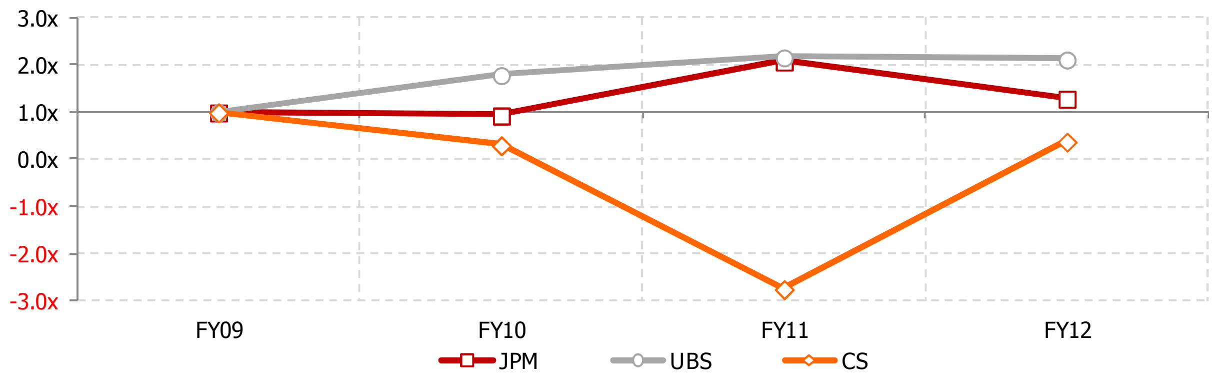


Source: Tricumen. Notes: (1) see footnote to Figure 1. (2) Data in this chart is based on the percentage change of featured banks' share of the total sales & trading profit generated by the Top 12 banks in each year, indexed to the base period. (3) UBS is indexed to 2009, due to losses in 2008.

With data indexed to 2009, J.P.Morgan and UBS remain in the lead, but two other banks also stand out. The first is Credit Suisse. The bank's share of the Top 12' sales & trading profit pool declined in 2010 and 2011, but then rebounded strongly in 2012 and continued gaining ground in 1Q13. There are several drivers of this dynamic - for example, cost-control is often mentioned as one of the key challenges for CS. Here, though, we highlight the bank's early preparation for the introduction of Basel 3 in Switzerland, and clear parallels with UBS: two positive 'stories' are those of banks that have adjusted early to Basel 3.

Societe Generale is, in our view, the key underperformer. We estimate that SG's sales & trading operation suffered losses in 2007, 2008 and 2009 (which invalidates indexed comparisons with peers); following a profitable 2010, the bank then again suffered a loss in 2011. In profitable years, SG performed well - our calculations show a slight increase in the share of the overall profit pool in 2012 versus 2010 - but we see little sign of forward momentum in some of its key revenue generating areas, and also believe that SG lags behind some of its peers in streamlining its technology and operations area and in its electronic trading offering[1].

Figure 3: Share of the profit pool: Credit Suisse, J.P.Morgan, UBS (indexed to FY09)



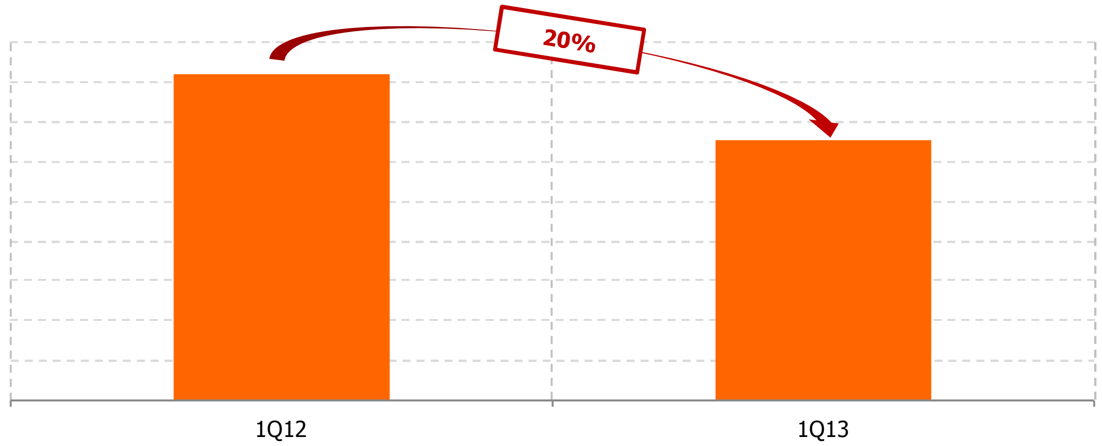
Source: Tricumen. Notes: (1) see footnote to Figure 1. (2) Data in this chart is based on the percentage change of featured banks' share of the total sales & trading profit generated by the Top 12 banks in each year, indexed to the base period.

[1] *See our 'Investment banks technology initiatives' note, published in Apr-13.*

In 1Q13, the Top 12 banks' sales & trading profits declined by 20% year-on-year. A sharp decline, indeed, but we do not see it as an omen for the remainder of 2013; instead, barring unforeseen market shocks, we expect a better year-on-year performance than that seen in 1Q13 as a result of:

- Further closures/'right-sizing' of less profitable/unviable/'asset-heavy' business lines;
- New 'invest-to-save' measures, especially in operational processes and risk management;
- Continued move to electronic trading;
- The rationalisation of sales coverage models and fresh cross-divisional sales initiatives.

Figure 4: Pre-tax operating profit of sales & trading units of the Top 12 investment banks (1Q12 & 1Q13)



Source: Tricumen. Notes: see footnote to Figure 1.

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Situated near Cambridge in the UK, Tricumen is almost exclusively staffed with senior individuals with an extensive track record of either working for or analysing banks; and boasts what we believe is the largest capital markets-focused research network of its peer group.

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