Profit drivers

- Cost management, while important, is at best a short-term play. Revenue generation has a far greater – and more immediate – impact on the underlying profitability and share price.
- Investment banks seeking to improve their long-term returns should therefore focus on creating new business lines and finding new revenue sources. The challenge for investment banks is to do what they do best - innovate.

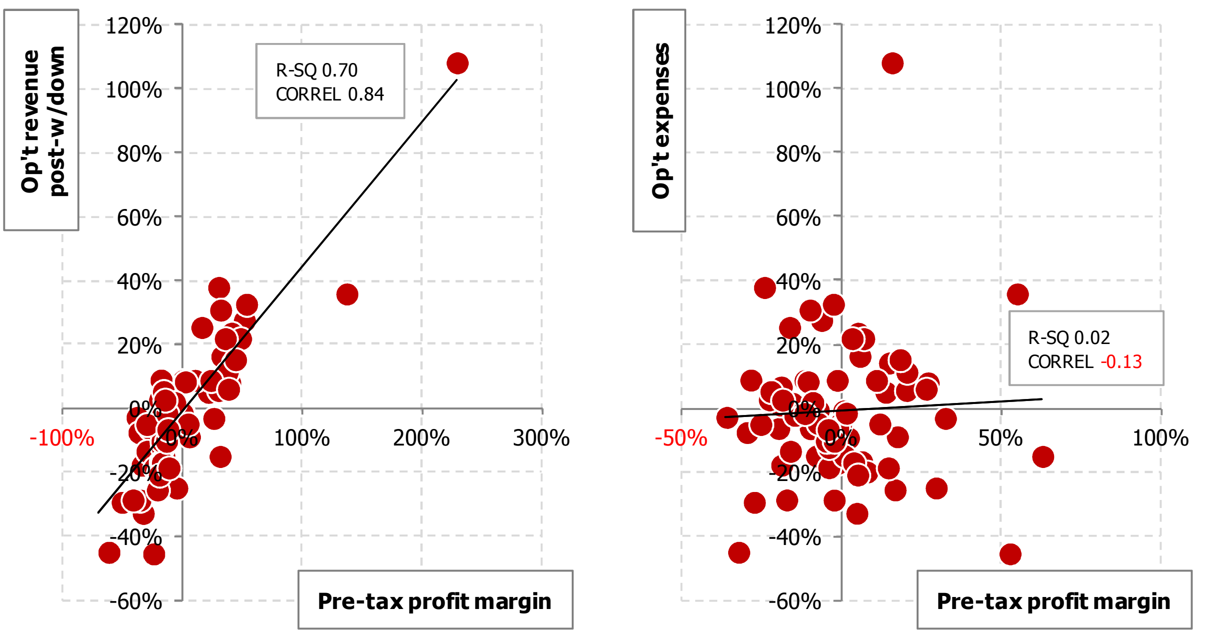
One of the more striking features of the 3Q13 reporting season was the unusually strong emphasis on cost-cutting, with banks and the analyst community commenting that, while revenues were down, some banks managed to offset this to a large degree with decisive cost-cutting. In principle, that's great, but could also be misleading – to state the most obvious example, inter-year comp & benefits are accrued, not paid out, and 4Q is often the balancing period for the full year.

More importantly, most banks have, over the past year or so, already effected the bulk of their major cost-cutting and/or wholesale restructurings. The focus has now shifted to underperforming units (which are usually small in the overall capital markets operations) and to variable cost component of operating costs in revenue-generating units; both of these are, at best, short-term plays …

… that have no *lasting* impact on banks' underlying profitability: ultimately, what matters is the revenue generation. Below, we plot the quarterly movement in operating revenue and expenses against the sequential quarterly movement in pre-profit margin for 12 banks[1], for 6 periods ranging from 1Q12 (which is, roughly, the first quarter which reflected the impact of major re-orgs) to 3Q13. The chart on the left shows a very strong 0.70 R-squared and 0.84 correlation value between revenue generation and pre-tax profitability; even excluding the two outliers (both of which represent HSBC), R-squared remains above 0.60, in both total capital markets and sales & trading revenue and profits (see Appendix). Running the same analysis with operating costs produces a *negative* 0.13 correlation.

There are several obvious explanations for this counterintuitive finding: a sizeable portion of costs are variable[2] and/or accrued and so the management has great influence on both the size and the timing of recognition of costs; revenue, by comparison, is booked in 'real time'. Also, expenses are smaller than revenue (for most banks and most of the time, anyway) and so have a smaller impact on profits.

Q/Q movement: pre-tax profit margin vs operating revenue and expenses
(12 banks*, US$, 1Q12-3Q13)



Source: Tricumen.

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[1] *The 12 banks are investment banking/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] *Though shrinking, in no small part due to Brussels' politicians determined effort to regulate bonuses, even if doing so plainly restricts banks' ability to adjust their cost base to revenue shifts. Please see our 'EU bonus cap' note, published 1-Mar-13.*

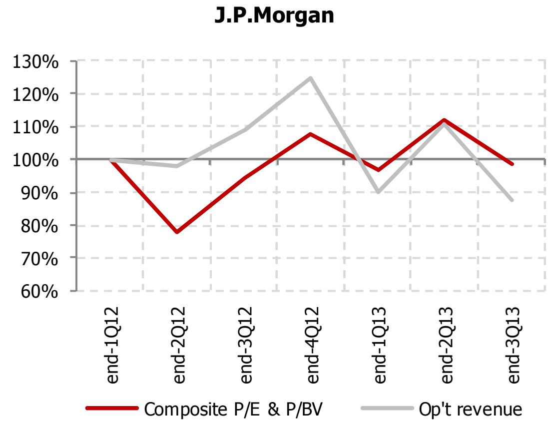
Equity investors heavily favour revenue generators, too. Below, we focus on banks which generated 50%+ of their normalised Group 9m13 pre-tax profit from capital markets activities (MS' Institutional Securities contributed 45%, but the bank's share price is heavily influenced by capital markets earnings, so we include it in this peer group).

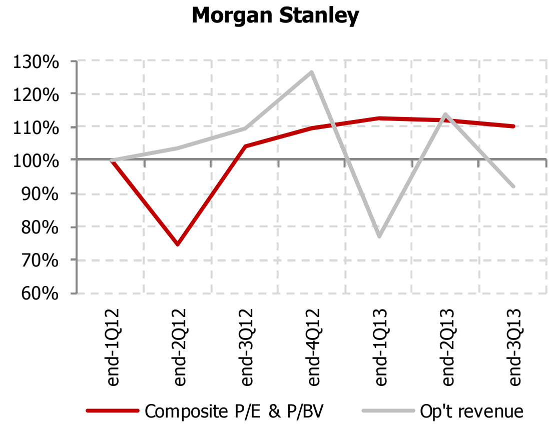
For these banks, we compare capital markets revenues with Group historical book value and earnings valuations. This is an imperfect comparison, not least because capital markets earnings are but one of the factors influencing share valuation, especially at global universals (here, mainly Citigroup) and 'specials' (e.g. the 'Swiss finish' for CS and UBS). And yet, the link between operating revenue and valuation dynamics is evident, particularly for banks that have avoided 'transformational' restructuring from 1Q12 to date: Bank of America Merrill Lynch, Barclays, Deutsche Bank and J.P.Morgan – all of which have generated well over half of their 9m13 Group profit from capital markets activities.

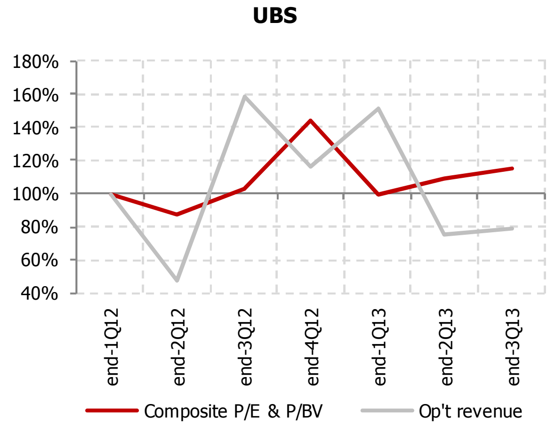
Operating revenue vs P/E and P/BV* valuations (US$, 1Q12-3Q13, indexed to 1Q12)

Source: Tricumen analysis; share price sourced from FT.com. Notes: (1) composite price/earnings (P/E) and price/book value (P/BV) calculations are based on actual period-end values and share prices; (2) P/E outliers falling outside the 3-standard deviation band for the 12 banks peer group are excluded.

Operating revenue vs valuations (US$, 1Q12-3Q13, indexed to 1Q12) *(cont.)*







Source: Tricumen analysis; share price sourced from FT.com. Notes: (1) composite price/earnings (P/E) and price/book value (P/BV) calculations are based on actual period-end values and share prices; (2) P/E outliers falling outside the 3-standard deviation band for the 12 banks peer group are excluded.

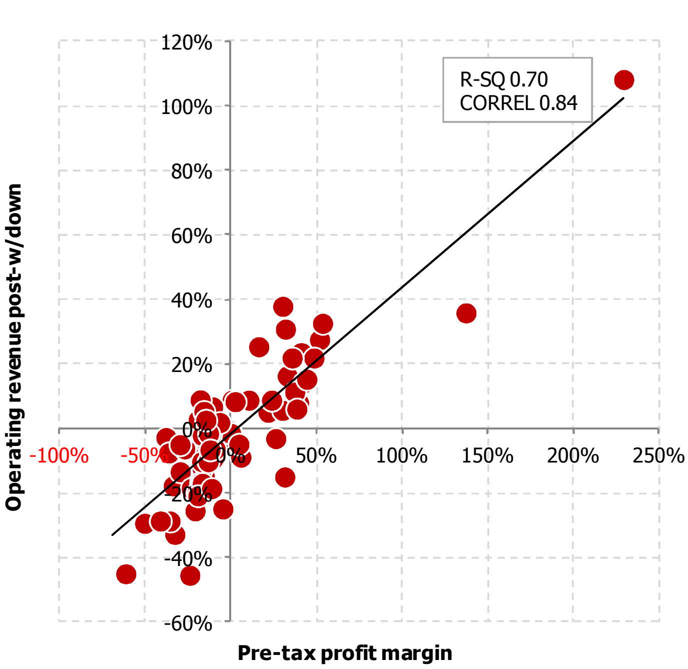
In conclusion, we believe that in the current ROE-constrained environment, the winners will need to find new revenue sources, or new ways of generating revenue from existing businesses. Most banks are already exploring more effectively partnering with their commercial, transaction or private banking divisions.

We also expect more progress in genuine product innovation to create new markets. Arguably, the last large-scale innovation was the birth of credit derivatives; since then, new markets have emerged – e.g. longevity derivative, property derivatives and carbon trading - but none has grown enough to make a meaningful impact on capital markets revenues. The challenge for investment banks is to do what they do best - innovate.

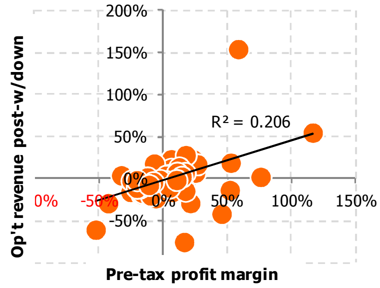
Appendix

Q/Q movement: pre-tax profit margin vs operating revenue (12 banks*, US$, 1Q12-3Q13)

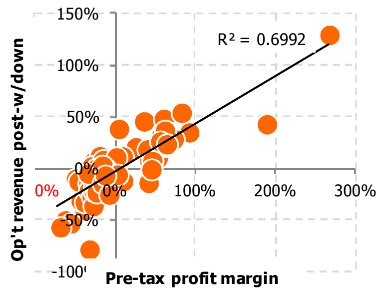
Capital Markets



Primary activities

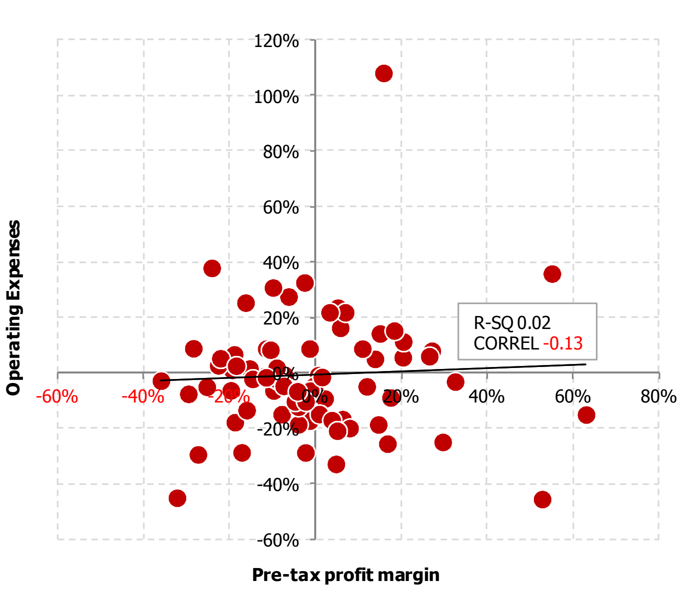


Sales & Trading

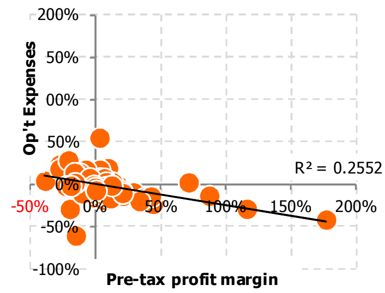


Q/Q movement: pre-tax profit margin vs operating expenses (12 banks*, US$, 1Q12-3Q13)

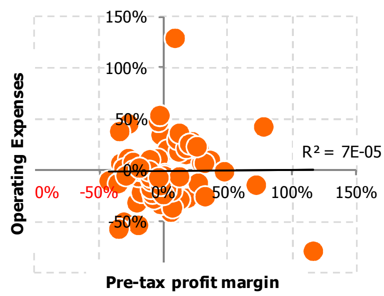
Capital Markets



Primary activities



Sales & Trading



Source: Tricumen. Note: The 12 banks are investment banking/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.

About Tricumen

Tricumen was founded in 2008. It quickly become a strong provider of diversified market intelligence across the capital markets and has since expanded into transaction and corporate banking coverage. Tricumen's data has been used by many of the world's leading investment banks as well as strategy consulting firms, investment managers and 'blue chip' corporations.

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.

Caveats

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