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Rising Stars

By Michael Santoli

Some hungry upstarts emerged from the financial crisis to grab their slice of banking-industry pie. Most likely to succeed: Jefferies Group.

Imagine that the near-failure of two of Detroit's Big Three prompted a wave of start-ups to enter the auto-making game, while a bunch of existing auto-parts makers began assembling their own cars, hiring top engineers and executives and allying with idled dealerships—all in a bid to grab some of the market share ceded by the hobbled giants.

And further imagine that among the executives-turned-entrepreneurs were Lee Iacocca and Roger Smith, the faces of the industry from earlier days, returning to seize the main chance produced by the tumult.

This, essentially, is what has been happening in the securities industry. The financial crisis that caused the collapse of Bear Stearns and Lehman Brothers drove the remaining giants to take government help, shrink their balance sheets, purge thousands of employees, scramble for capital and absorb tremendous political pressure. And that opened the door for scores of smaller firms to grab trading and banking talent, enter new businesses and woo "bulge-bracket" trading and banking clients.

This herd of strivers includes both well-established players such as Jefferies Group (ticker: JEF), Stephens and Cantor Fitzgerald, along with newer shops like BroadPoint Gleacher (BPSG) and Cowen Group (COWN), constituted from multiple existing and new components. Also in the game: a gaggle of relative upstart institutional brokerages and advisory boutiques.

Some of the leaders of these contenders have Wall Street pedigrees stretching back to the 1980s or earlier. Among them are:

- Peter Cohen, who ruled over Shearson Lehman Brothers in the '80s. Late last year, he merged his investment firm, Ramius Group, with the old Cowen & Co.'s remains and became CEO of the resulting company.
- Bart McDade, Lehman's last president. He recently joined advisory-boutique Evercore Partners (EVR) to build out a capital-markets business.
- Former Drexel Burnham Lambert banker and UBS investment-banking chief Ken Moelis. He now runs 270-person Moelis & Co., which is branching into the corporate-finance game.
- Eric Gleacher, a longtime Morgan Stanley banker. He helped form Broad-Point Gleacher last year by combining his advisory firm with BroadPoint, which had been assembled by Lee Fensterstock, who once ran banking at PaineWebber and was Gruntal & Co.'s president.

What's led these eminences to forestall comfortable retirements—to jump off whales and hop on minnows? In great part, it was bullishness on the prospects of small- and mid-sized financial firms.

In the heat of the crisis, once-scarce senior talent with great client relationships became available and affordable. Traders, bankers and salespeople became eager to work at smaller firms, where their contributions would be easier to discern and their payouts wouldn't be vulnerable to being cut, should some derivatives trader in London lose $500 million on a bad call. Firms outside the bulge bracket can pay more cash rather than the stock-heavy compensation that the big guys are under pressure to offer. And because the bulge-bracket banks have reduced their leverage and withdrawn capital from some operations, small firms' usual big disadvantage—having less capital than the giants—has diminished.

Says Cowen's Peter Cohen: "As we looked at the world in turmoil a year ago, we saw the industry roll up into a few very large institutions and saw a void in the middle that would be filled by a handful of firms in a number of ways. It looked like an opportunity, and we saw the availability of a lot of talent." Signing up recruits was eased by the reality, as he puts it, that "a number of people are less than thrilled to work in very large organizations."

Many of the smaller fry bulked up in a hurry, sending out press release upon press release over the past year announcing the hiring of managing director-level personnel with resumes featuring decade-plus tenures with Merrill Lynch, Citigroup, UBS or some other biggie.

Since September 2007, BroadPoint Gleacher has added 250 client-facing employees—a majority of its 350 total staff members—in fixed income, banking and equities. Jefferies, which already had far larger scale than any other firm in this discussion, took its head count up a remarkable 17% in calendar 2009, mostly by adding big-firm defectors, including UBS's former health-care banking team.

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FBR Capital Markets (FBCM), once part of Friedman Billings Ramsey, grabbed the entire Bear Stearns convertible-securities sales desk, part of an expansion that added 70 senior personnel in 2009 and eight new businesses or revenue categories since 2007.

Privately owned Stephens has boosted its investment-banking ranks by 40% since December 2007, to 89 professionals, while its institutional salesforce jumped more than 25%, to 37. And the brokerage firm plans further additions.

Clearly, taking on lots of Wall Street veterans, even at a discount to their peak earnings, is expensive, and reflects a bet by their new employers that markets will remain active and that deal action will quicken—and that smaller firms will get more than their usual share of the action.

One reason the securities industry habitually spawns new and spun-off firms is that the aggregate pool of available fees and trading profits remains enormous. Combined, the fees from investment banking and the spread income from bond market-making total an estimated $150 billion a year in the U.S. alone.

As in most pursuits, however, the perceived opportunity exceeds the actual one, especially given that the largest firms have stabilized their finances and are trying to rebuild their franchises.

"The window of opportunity was wide open over the past 18 months," says Lauren Smith, who follows the brokerage industry for Keefe Bruyette & Woods. "It's still open, but the real opportunity is past." She adds that in coming months, as bonuses are collected from the large banks, there probably will be one more go-around in which some folks move to what they view as up-and-coming firms.

But the big guys are hardly ceding ground willingly. They panicked and over-fired a year ago, and are bidding for talent again, with reports of outsized compensation guarantees being discussed (quietly).

At some of the new, narrowly focused trading boutiques, the winnowing-out is under way. Morgan Stanley (MS) has said that it needs to add back some 400 traders. JPMorgan Chase (JPM), which essentially was anointed the indispensable bank during the crisis, is more than equipped to outinvest smaller rivals and outlast their patience.

In a report that followed a meeting with top Goldman Sachs (GS) executives, Sandler O'Neill analyst Jeff Harte wrote to clients last week that the co-head of Goldman's securities division, David Heller, "stressed that in his 21 years at [Goldman], he has never felt better about the firm's ability to retain talent than he does today."

Rick Hendrix, FBR Capital's CEO, notes that dozens of institutional bond-brokerage businesses were created over the past 1 1/2 years by traders who'd formerly worked at big firms and wanted to woo fixed-income institutions as the giants pulled back. But some newbies already have folded or merged.

Steve Starker is a former partner of floor-trading firm Spear Leeds & Kellogg. After Goldman acquired Spear Leeds, he started running BTIG, an institutional equity and bond brokerage, with Goldman as an investor. BTIG has become one of the most successful members of a now-populous field. "The space got crowded with a lot of start-ups," he says. "There will be consolidation."

Start-ups frequently find that it's easy to get into a business, but hard to reach profitable scale. It's a lesson learned in the land rush that follows every cataclysm on Wall Street. (For example, the number of online discount brokers exploded in the 1990s. But now there are just four dominant players.)

In the next few years, asserts Hendrix, "There will be a smaller number of bulge firms and a clearer picture of a different set of the four or five other competitors" directly behind them.

In this tier of the market, executives at companies with large balance sheets usually say that providing capital is crucial. Those at firms lacking large balance sheets often say that risking capital for clients isn't as important as it used to be.

Mark Standish, co-CEO of RBC Capital, a Royal Bank of Canada (RY) unit in New York, is in the former camp. Having methodically built a sizable trading, research and banking outfit, he's now enjoying having the backing of a large, well-capitalized Canadian bank as he seeks business. RBC has quietly moved up the underwriting ranks, and Standish has increased RBC's New York-based staff by 88% in the past three years

Among the other contenders, Cowen is worth watching, mainly for the involvement of Peter Cohen and his strategy of marrying Ramius' real-estate and hedge-fund efforts to the sell-side research and banking platform of the old Cowen. The firm could help end the scarcity of growth-stock-focused specialty brokers, a group that was in surplus until firms like Montgomery Securities, Robertson Stephens and Hambrecht & Quist were subsumed into banks that degraded their DNA.

BroadPoint Gleacher is an underrated up-and-comer. Fensterstock bought control of the shell of the old First Albany, a public company, and added several businesses to it, including a mortgage-bond sales unit, the American Technology Research equity firm, Bank of New York Mellon's high-yield division and, last year, the Gleacher & Co. corporate-advisory boutique. Says Fensterstock: "We believe we can be the next DLJ"—the old Donaldson Lufkin & Jenrette, a research-focused, entrepreneurial, midsized outfit that punched above its weight in deal-making and profitability.

BroadPoint Gleacher's Revenue ramped to $341 million in 2009 from $134 million a year earlier, thanks mostly to fixed-income sales and trading. The company is seeking to bulk up its equities capability, probably via acquisition. Despite this growth record, its shares trade at just six times 2009 earnings, perhaps because its meager $415 million stock-market value keeps it off most radar screens.

But the firm with the clearest shot at truly challenging the biggies is Jefferies, which has been in build-up mode so long and has such broad scale that it more closely resembles a bulge-bracket firm than the strivers with which it's often grouped.

With a market value of $4 billion, $2.1 billion in 2009 revenue and research coverage of some 1,400 companies, it's got heft. And it's spent the better part of the past decade using each market and sector downturn to pick up new talent and add specialties, whether a defense-industry investment bank or a muni team from Depfa First Albany.

KBW's Smith says that "Jefferies is well on its way to becoming the next Bear Stearns or Lehman." No, she's not referring to the reckless entities that helped blow up Wall Street two years ago, but rather to the old Bear and Lehman, which had a lean, hungry culture, and grew from relatively narrow bond-trading shops into global investment banks. Smith notes that Jefferies' revenue about equals what Bear and Lehman each clocked in the mid-1990s. The littler houses gunning for a larger place in the industry commonly cite Jefferies—the nation's biggest independent broker-dealer—as a role model.

Down the road, there won't be more than one or two DLJs; Jefferies is pretty much there already, and likely on its way to even bigger things. ■