GRANT'S
INTEREST RATE OBSERVER®
Vol. 32, No. 18c Two Wall Street, New York, New York 10005 • www.grantspub.com SEPTEMBER 19, 2014

Sell advisory

Physicians get sick, lawyers run afoul of the law and financiers make ill-advised financial choices—these things happen. Now under way is a skeptical look at the recent doings of some of the leading lights of Wall Street. In preview, *Grant's* is bearish on Evercore Partners Inc. (EVR on the Big Board).

In August came the news that Evercore, Roger Altman's M&A advisory gold mine, is preparing to buy International Strategy & Investment, the Ed Hyman-led research group. While the ultimate consideration will depend on what ISI can deliver to the combined entity (assuming the transaction closes as it's expected to do in the fourth quarter), the immediate consequence of the purchase will be a sizable increase in the Evercore share count. More shares to what end? Curious people have been asking the question since the transaction was announced in August.

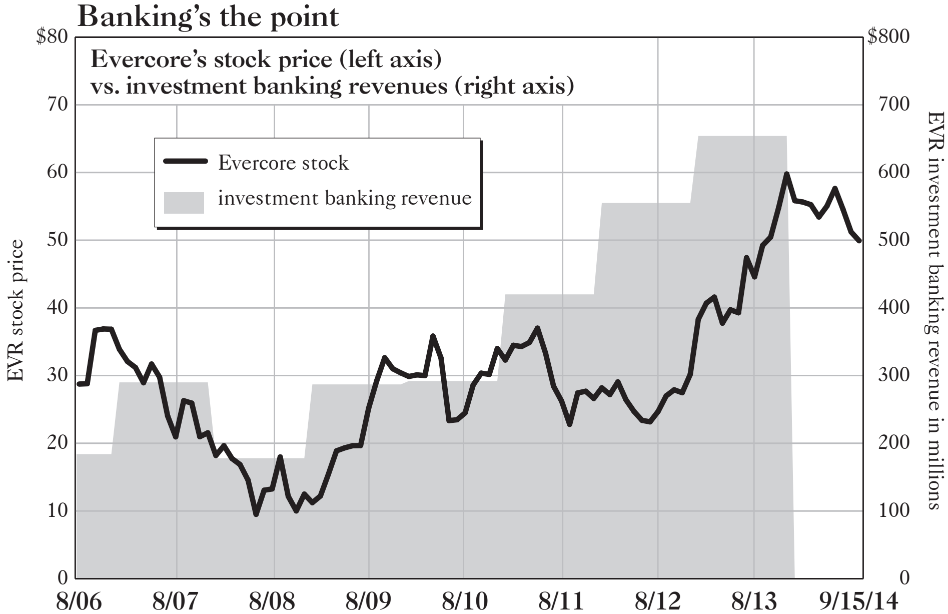
Whether a hugely successful M&A advisory boutique has any business diversifying out of that profitable niche is the immediate point of focus. There are others, to wit: Central banks that have seeded a boom in corporate M&A. Now that the Fed is preparing to un-seed, might the Evercore brains' trust be preparing for an un-boom? Then, too, the acquisition raises questions about the utility of institutional equity research. In the service of investment banking, how much value do the analysts add? Even without reference to deal doing, how much value do the analysts add?

The basic point of puzzlement is the Evercore business model. To judge by results, it could hardly be improved upon. Evercore was founded in 1995. It went public in 2006, weathered the storms of 2007 and 2008 and has proceeded to generate continuously rising revenues and earnings ever since. "Our company earned a record $104 million in net income on record revenues of $760 million in 2013, our fifth consecutive year of significant growth in net revenues and earnings," write Altman and Ralph Schlosstein, respectively chairman and president/CEO, in the 2013 Evercore annual report. M&A advisory work, broadly defined, chipped in all but $100 million or so of the top line. Investment management revenues added most of the balance. Returns from equity underwriting amounted to not quite $25 million. The straw that stirs the Evercore drink—as it does the drinks of lookalikes Moelis & Co. (MC on the NYSE) and Greenhill & Co. (GHL on the NYSE)—is the capital-light and fee-fat work of advising other people what to do with their money.

"Boutiques typically derive 50% to 100% of revenues from corporate advisory, compared to 5% to 10% of revenues at the bulge bracket firms," Bernstein Research advises. "Mergers and acquisitions advisory is a headcount intensive business and these firms have grown their M&A business by hiring senior sector heads and senior M&A bankers from the large banks…." And: "[B]y pursuing M&A advisory to the exclusion of most other revenue streams, the boutiques are skimming 'the cream' off the pool of investment banking fees."

Evercore produces cream, half-and-half and a kind of skim milk. To fatten the latter—the nascent equity underwriting side of the business—is the purpose of

Banking's the point



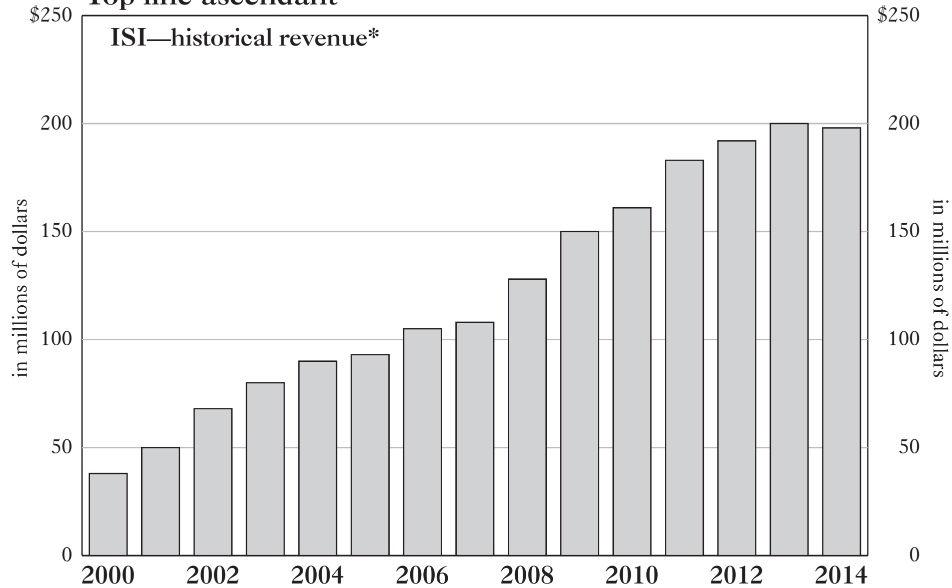
sources: The Bloomberg, company filings

the pending deal. "Some Wall Street observers," relates colleague David Peligal, "used to look at Evercore's asset management business and institutional equities' business as mere sideshows. They didn't make a lot of money, and they didn't lose a lot of money. Yes, they added people, complexity and compliance, but 'don't worry about it—it's not that material' was the general train of thought. Evercore's investment management division, with $14.6 billion of assets as of June 30, was sub-scale, especially when compared to Lazard Ltd. (LAZ on the NYSE), which had assets under management of $205 billion on the same date. As for Evercore's institutional equities business, which dates from 2010, it contributed $21.3 million of revenues in the first half of 2014, but had $23.9 million of expenses against it. So when Evercore formally disclosed its intention to acquire ISI on Aug. 3 (EVR fell by 8% on Aug. 1, the day Bloomberg broke the story), the previous way of thinking about Evercore changed. Debunked was the notion that the non-advisory businesses were just a hobby, or the residue of a momentary urge to diversify. Even though institutional equities is an extremely competitive business—certainly not aided by the fact that margins in the traditional execution business are narrow and U.S. equity trade volumes have declined over time—Evercore was really going to go for it in the hopes of gaining additional equity underwriting business."

It's worth reiterating that a good part of the consideration for ISI, perhaps 70%, "is on the come and dependent on performance," in Altman's words. Even so, as far as Evercore's shareholders are concerned, the deal is much bigger than a bread box. Between 6.9 million and 7.4 million shares of EVR will be issued right off the bat. The total could reach 8.1 million if ISI meets certain operating hurdles over the next five years. The overall value could reach $400 million.

"When you read the transcript of the Aug. 4 conference call," Peligal points out, "it kind of makes you wonder that the same guys who give all this M&A advice to large companies around the world probably could have used some advice themselves. Altman, age 68, was out of the office, though he called in. First thing Altman said was: `[T]his is an exciting day for us, but it is not one that changes the character of Evercore. Evercore is an advisory firm whose only income is fees. Evercore is not a firm which ever has or ever will use capital in its day-to-day conduct of its business. We have never positioned a security or a loan, and we never will.' Okay, fine. When Altman is finished with his opening remarks, Schlosstein, 63, starts to speak. First thing he says is not what the synergies are, not what the opportunities are, not how great ISI is—it's we're still not going to put up any capital with this deal. `Many of you have heard me say countless times that the only businesses that Evercore will be in are businesses where you compete on the basis of your ideas, your intellectual capital, and your relationships, and where the only source of revenue is fees.' Okay, fine. Around 9:30 a.m., Schlosstein announces, `Well, Ed Hyman has just walked in.' Hyman, 69, with the now-detached Nancy Lazar, founded ISI in 1991. He will become a vice chairman of Evercore and chairman of the combined equities businesses. Hyman answers a question about getting the expense side of the equation down; 10 minutes later the call's over."

Top line ascendant



*fiscal year ending March 31
source: company filings

At its founding, ISI was a macroeconomic research shop that featured the former teammates at the broker-dealer C.J. Lawrence. The Ed and Nancy Show grew and grew. Many years later, the firm that caught Evercore's eye employs 28 research analysts, a third of whom ranked either No. 1 or No. 2 in their respective fields on the 2013 *Institutional Investor* survey. Many are relatively new hires. ISI has been building its equity research presence only since the time of the financial crisis. Today, 345 companies across 10 industry sectors are in the ISI analytical crosshairs. In a devilishly cyclical industry, Hyman et al. have managed to expand their revenue at a compound annual rate of 12.5% since the year 2000.

"It's not exactly a secret on Wall Street that Hyman has been trying to sell his firm," Peligal notes. "It would have proved a difficult sale, or maybe an impossible one, if the firm was about him, or chiefly about him. It was, therefore, necessary to diversify and, in essence, to take his own name off the door. Hence, the push into equity research. The growth hasn't come on the cheap. Hyman, who, according to an Aug. 4 Bloomberg story, owns at least 75% of the firm, lured a number of highly regarded sell-side analysts from other firms with above-market salaries. Significantly, the salaries are paid in cash."

ISI had an exemplary crisis. Its revenues jumped from $108 million in 2007 to $128 million in 2008 to $150 million in 2009 to $161 million in 2010. In the fiscal year ended March 31, its top line reached $198 million, $2 million short of the record set in 2013. The choice to pay his analysts in Janet Yellen's money rather than in the equity that he himself controlled, said Hyman in an e-mail to this publication, had put ISI at a competitive disadvantage. "EVERY other firm pays with cash and deferred shares (including Evercore)," Hyman wrote. "So our analysts have been viewed as attractive to hire away from ISI. . . . And it's made it expensive to hire from other firms."

Disadvantaged as it might have been in the compensation department (by Hyman's own choices, to be sure), ISI was advantaged by its ability to say that its analysts had no interest other than in the quality of their research. ISI was independent—independent of investment bankers, among other things. Such was the pitch to clients.

In so many words, a dialer-in on the aforementioned Aug. 4 conference call asked the following question: If being independent was an advantage for ISI, how could not being independent also be an advantage? Schlosstein's answer would have been improved by the observation that, as it is, ISI rarely gives offense to a client or potential client. Its research is almost invariably bullish or "neutral" (a search by Peligal turns up only one "sell" rating, on Sears Holdings, and a single judgment of "cautious" on Staples). Besides, Schlosstein might have added, one shouldn't idealize the "independence" of an analytical community whose job isn't disinterested truth but—first and foremost—the generation of revenue.

To produce those essential revenues, ISI is a dealer in "corporate access," Hyman relates: "Clients pay/value for 'corporate access.' We have a dedicated team at ISI dedicated to just that. They work with our analysts to create corporate access opportunities." How much different would things be if one called the access functionaries "investment bankers"? Anyway, Hyman says, the analysts are gung-ho for the Evercore deal.

The crux of the matter, then, isn't about independence. It's about a high-margin M&A advisory boutique turning itself into a different, and—initially, at least—lower margin advisory-cum-underwriting-cum sales-and-trading business, along with the requisite infrastructure that such an expansion entails. "So the market isn't going to focus on the fact that, this year, Evercore advised Shire on their $55 billion sale to AbbVie or that Evercore advised AstraZeneca relating to Pfizer's $124 billion unsolicited offer," Peligal observes. "Instead, they're going to focus on questions that pure advisory firms like Moelis and Greenhill don't have to deal with. Asked about this on the conference call, Altman said: `I would challenge your premise a little bit. I think the driver here, or at least a key driver, is the degree to which we think the equity underwriting side of the business can grow fast. So the premise of your question, aren't you moving into a slower growing area, we don't look at it that way. In fact, quite the opposite.'"

To borrow from David Ogilvy, "the assets go up and down in our elevator every day." Will the people who rode the elevator up to ISI not scruple to hop on the next available car to ascend to an even higher pay grade? On this score, the supposed synergies of the deal bear scrutiny. To say, as Evercore does, that the combined business will be expected to operate at a 55% compensation ratio is tantamount to saying that the compensation paid to ISI analysts must fall. It implies, too, a steady reduction in expense account amenities, with which ISI has been relatively lavish. (Pro forma 2013 non-compensation expense per person of $248,000 of the combined business compares to $159,000 for Evercore's investment banking business).

Evercore, which yields 2%, trades at 15.5 times the consensus 2015 sell-side earnings estimate of $3.25 per share and at six times tangible book value. The P/E multiple is on par with Lazard's multiple, but at a discount to the multiples of Moelis and Greenhill. As Evercore moves further away from its pure advisory niche, one can imagine a further discount. Citigroup, which can commit capital and be saved by the government and whose stock trades at 0.92 times tangible book value and at 9.7 times the 2015 consensus sell-side earnings estimate, can't be Altman's favorite point of comparison with his own corporate flesh and blood. But there it is. On Aug. 3, Keefe, Bruyette & Woods had this to say about the evolving Evercore model: "While management does not expect to use its balance sheet to commit capital to any of its businesses, the increased revenue contribution and the potential upside from increased underwriting assignments make EVR more similar to the more diversified brokerage firms that trade at much lower TBV [tangible book value] multiples and lower EPS multiples. Consequently, the premium P/TBV multiple that the firm trades at could become more of a focus of investors."

Why a 69-year-old entrepreneur would choose to realize the value of a portion of his life's work is no mystery. Why a 68-year-old entrepreneur would choose to put at risk a successful business model is not entirely clear. To hedge against a cyclical downturn? To seek protection against the persistent nibbling of such pint-size advisory "kiosks" as PJT Capital LLC (Paul Taubman's shop), Zaoui & Co. or Robey Warshaw LLP?

We're sure we don't know, but bearish we are.

•