Kurt Salmon

THE CHANGING LANDSCAPE OF THE PRIME BROKERAGE INDUSTRY

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INTRODUCTION

For the past two years, the prime brokerage industry has undergone a major transformation in response to the financial crisis. Hedge funds have adjusted their business model in order to diversify counterparty risk, causing prime brokerages to adjust their services and offerings. This, in turn, has opened new opportunities and caused a reorganization in the business model and competitive landscape of the prime brokerage industry.

In this paper, we examine the prime brokerage industry and the challenges it will have to overcome in response to changes caused by the financial crisis.

The prime brokerage industry, a business based on a set of services provided by investment banks and securities firms to hedge funds and professional investors, was largely self-funded and revenue was mainly derived from spreads on financing and lending. While the risk – primarily counterparty risk – was well known, the sheer size of the players made the idea of a prime broker failure seem like a ‘remote’ possibility.

As the prospect of bankruptcy became a harsh reality for prime brokers and their clients, the business model of the prime brokerage industry has been challenged in all of its core aspects; from revenue generation, to risk management, to its operating model. This paper examines the significant consequences on the business model and how this created a complete reconfiguration of the market, challenging the historic duopoly and creating opportunities for newcomers and challengers.

Finally, this paper reviews the prospects in the new, three tier competitive landscape that emerged from these changes: going forward, what are the challenges each tier will face in order to succeed? From the Top Tier – whether historic, dominant or challenger, to the Mini Primes/Boutique Primes, what does the future hold for them?

I hope you enjoy reading this report on the Prime Brokerage industry and the challenges it faces ahead. We look forward to further engaging in discussion on this topic in the future.

Chiheb Mahjoub
President & CEO

THE PRIME BROKERAGE INDUSTRY

Prime Brokerage is a set of services provided by investment banks and securities firms to hedge funds and professional investors. These services include execution and clearance of transactions; financing and securities lending; centralized custody; and risk reporting.

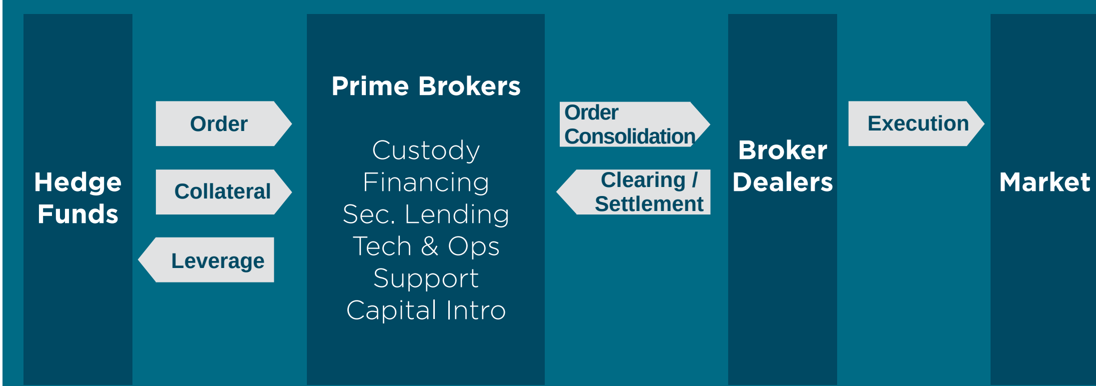


Illustration 1: Prime Brokerage operating model

Prime broker service allows hedge funds to execute with multiple brokers and then centralize clearing and settlement through a single prime broker. Prime brokerage core services typically include global custody (clearing, custody and asset servicing), margin financing to facilitate leverage of client assets, security lending (sourcing stock in order to satisfy short selling requirements of their hedge fund clients) and operations and technology support. Additionally, prime brokers offer value-added services such as capital introduction and risk management support.

Prime brokers do not charge a fee for many of services they provide. Rather, they derive revenue from three sources: spreads on financing and lending; trading commissions; and fees for the settlement of transactions done via an executing broker. The financing and lending spreads make up the vast majority of prime brokerage revenue. Therefore, hedge fund clients who undertake substantial short-selling and/or leverage generate more revenue. The revenue opportunity, as always, is commensurate with risk.

By providing financing and leverage, prime brokers are exposed to the risk of hedge fund default. In other words, if the value of collateral held as security declines relative to the loan it secured, the client may not be able to repay the deficit. Other forms of risk inherent in Prime Brokerage include operational risk and reputation risk. Operational risk is associated with systems and process failures. Reputation risk represents the impact on revenue as a result of damage to a firm's reputation or standing.

Historically, the prime brokerage market had been dominated by two players: Morgan Stanley and Goldman Sachs. Combined, they serviced two-thirds of hedge fund assets. However, the collapse of Lehman Brothers, which punctuated the Financial Crisis of 2008, forced a re-ordering of the competitive landscape. Hedge funds that had received financing from Lehman Brothers Prime Brokerage, through their London branch, could not reclaim their collateral. The lack of adequate asset protection rules in the United Kingdom had facilitated leverage but did little to protect hedge fund assets from prime broker insolvency. This was one of the many events that led to massive deleveraging in capital markets. In the context of various market events, hedge fund assets under management went from $2.7 trillion to $1.8 trillion according to Hedge Fund Intelligence. The consequence for the prime brokerage industry was a complete re-ordering of the business model and competitive landscape.

BUSINESS MODEL IMPACT

Multi-Prime Model: More Clients, Less Share of Assets, Operational Challenges

As hedge funds registered the reality of prime brokerage insolvency risk, they acted quickly to diversify their counterparty risk. Prime brokerage diversification saw the largest flows of client assets out of Morgan Stanley and Goldman Sachs, the prime brokerage duopoly, towards firms which were perceived to be the most creditworthy. The banks which captured these flows to the greatest degree were Credit Suisse, JP Morgan, and Deutsche Bank.

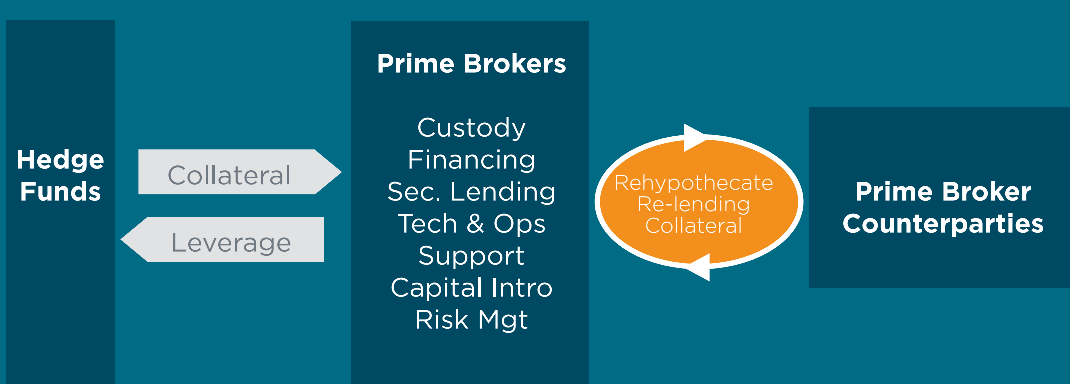
This move to multi-prime is altering competitive dynamics. Prior to the crisis, large hedge funds were using a multi-prime model. However, the prime relationships were organized by fund, strategy, or trading market. The large hedge funds are now compelled to leverage the multi-prime model in a meaningful way to mitigate prime brokerage insolvency risk. Small sized hedge funds relied on a single prime model, but market dynamics have moved them towards a multi-prime model also. As a result, few of the largest prime brokers can claim to be the primary prime broker for a majority of their clients.

The diversification presented operational challenges for successful prime brokers who struggled to keep up with new client on boarding during the crisis. It takes a few months to onboard a hedge fund client due to extensive documentations and operational set up. While the imperative was to capture market share, it became evident prime brokers needed to bolster their client on-boarding teams with scalable processes and operational efficiencies.

Revenue Generation Revisited: Increased Cost of Financing

Prime brokers earn their revenues by lending money and securities to hedge funds. Before the market events of 2008, the main prime brokers were almost completely self-funded thanks to hedge fund collateral and the rehypothecation of assets.

Illustration II – Rehypothecation: use of pledged securities provided as collateral by the hedge fund to secure leverage from a bank. This reduces the cost of financing for the Prime Broker and consequently the Hedge Fund.



Hypothecation is a process by which a prime broker would extend credit to Hedge Fund clients in return for collateral. Rehypothecation, in turn, is the method by which the prime broker would pledge the hypothecated client-owned assets by re-lending or posting them as collateral for one of its own obligations. This “traditional” model made the prime brokerage business profitable by reducing the cost of financing.

However, the Lehman collapse may have changed this model permanently - of the $40bn of collateral posted, $22bn had been rehypothecated. Hedge funds efforts to reclaim those assets were hindered by bankruptcy proceedings. Stung by Lehman, hedge funds are trying to limit rehypothecation and associated risks. Without rehypothecation, banks will have to borrow at higher rates in order to lend to hedge funds.

Illustration III – Hedge Funds' efforts to reclaim their assets after the bankruptcy of Lehman Brothers were hindered as more than half had been rehypothecated.

Service Offering Evolves: Prime Custody, Real Time Reporting

Hedge funds' solution to prime broker insolvency risk was to demand that prime brokers segregate collateral from their prime broker accounts, often with an unaffiliated custodian with a high credit rating. However, this was not ideal as it raised the cost of financing prohibitively. A better solution has emerged, where prime brokers create an affiliated custody service, known as prime custody. In this new model, hedge fund assets are kept within a single, but segregated account, and both the hedge fund and the prime broker counterparties (the lender) have access to the account and the collateral. In this new model, all parties are protected. Should the hedge fund fail, the collateral would flow to the lender. Should the Prime broker fail the contract between the hedge fund and the lender would remain intact. Since late 2008, major financial players have launched prime custody services. Goldman Sachs has recently chosen BNY Mellon to provide a segregated sub-custody service to its clients while JP Morgan allows its clients to hold their assets at their subsidiary, JPMorgan Chase Bank, N.A.

As a consequence of rehypothecation risk, hedge funds demand increased transparency. Prime brokers have responded by improving their reporting capabilities on assets. As a first step, prime brokers need to be able to classify assets that were rehypothecated and the entities they reside with in real time. They will also need to provide integrated reporting across all asset classes and positions.

NEW COMPETITIVE LANDSCAPE

The market events and Lehman Brothers bankruptcy compels a redesign of the competitive landscape. As clients shift to a multi-prime model, new entrants are trying to capture market share. The landscape is segmenting into three categories: Top Tier (Dominant and Challengers); Mid Tier; and Mini Primes/Boutiques. Each type of player will need to define their competitive strategy and position themselves accordingly.

The Top Tier is characterized by large investment banks and securities firms. The Top Tier separates into the historically dominant industry players (Dominant Primes) and then the banks that benefited from counterparty diversification (Challenger Primes). Each segment has its own differentiators and challenges.

- **The Dominant Primes** are Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan, and Morgan Stanley. Their strategy has been to compensate for eroding market share, as clients moved to multi-prime, with higher returns per client Hedge funds are attracted to the Dominant's reputation/brand, large balance sheets and ability to provide a full service prime brokerage. Dominant Primes first assess client profitability before onboarding new clients. The challenge will be appropriate client segmentation and targeted marketing. Dominants will have to control operating costs while servicing all of their hedge fund client's prime brokerage needs. Some solutions are outsourcing service providers, technology solutions and continuous process and operations improvements.

- **The Challenger Primes** benefited from the rise in use of multiple prime brokers. They were able to leverage their reputation to capture market share. The Challenger Primes are Bank of America/Merrill Lynch, Barclays Capital, BNP Paribas, Citi Prime Finance, Fidelity Prime Services, and UBS. They are able to differentiate themselves from the others by being a full service prime brokerage business that offers a nice alternative to established hedge funds looking to diversify prime brokers. The challenges they face are delivering excellent client service with a seamless multi-prime experience and scaleable on-boarding processes, while controlling operating costs. Being able to offer an internally integrated platform for clients will be a key differentiator. Equally important, will be focusing on client segmentation and subsequent allocation of resources.

The Mid Tier prime brokers focus on mid-sized hedge funds with assets from $20mn to $500mn. Examples of Mid Tier prime brokers are BTIG, Merlin Securities, and Jefferies. They focus on hedge funds that don't have sufficient assets for Top Tier Primes. They attract hedge fund clients largely ignored by the Top Tier with their high level of client service and attention. They tailor their services to the needs of the client while still providing them with most, if not all, of the other prime broker services. The Mid Tier model also differentiates itself by offering advisory services and access to investor networks. Providing full service to less profitable clients questions the long term sustainability of this model. The Mid Tier will have to understand their competitive advantage and allocate resources appropriately. Another challenge they face is client retention – as clients grow, they may prefer a multi-prime model.

The Mini Primes and Boutiques Primes service hedge funds with $20mn and below. They act as execution only brokers and outsource clearing, settlement and custody to one of the major broker-dealers. Some examples are Cantor Fitzgerald, North Point, FBR Capital Markets. They usually have niche offerings and try to attract clients that do not traditionally have access to prime brokerage. These niche offerings may be capital introductions, consulting/marketing services, or technology solutions. They traditionally have lower operating costs and allocate their resources to clients differently. However, with the influx of new entrants, the major challenge for primes competing in this space is surviving inevitable consolidation. In this new environment, they will have to build out a more robust offering to include multi-asset capability; a broad array of financing, custody and execution solutions; bespoke technology and customized high-touch client service.

LOOKING FORWARD, LIKELY SCENARIOS

As the landscape evolves, the Dominant Primes will move to protect market share. Being highly selective with their clients, they will deepen relationships and provide access to the whole suite of investment banking services. They have already proved to be responsive to client demands for custodial diversification by developing prime custody offerings (e.g., Goldman Sachs partnership with BNY Mellon). They are well positioned to aggressively recapture and grow market share.

At the other end of the landscape, the Mini Prime tier will be the most active and challenged segment. With regulations and competitive dynamics forcing consolidation, the challenge will be to survive. Likely growth will be through acquisitions and strategic hires. As most hedge funds enter and exit at the size that the mini-primes service, this tier will be very dynamic, with client retention the benchmark of quality.

Mid-size clients are satisfied captives of the Mid Tier Primes. The Mid Tier Primes are able to provide hedge funds the industrialized infrastructure that their investors demand. With a high level of client service and breadth of offerings, Mid Tiers will look to design a viable cost structure. This tier will have to identify their competitive advantage and trade away or outsource other functions.

Finally, for the Challengers who benefited most from market events, the post crisis era is an inflection point. There is an opportunity for those that commit resources and nurture their clients to migrate to the Dominant Top Tier. To compete with and even challenge the Dominants, the Challengers will be required to invest in fully integrated technology solutions and develop customized client services. For others, as competitive pressure from the Dominants and Mid Tiers tightens the Challengers space, the price of complacency will be loss of market share. Half hearted commitment of resources won't suffice to hold and secure the assets acquired during the crisis. For those that push forward and commit to this business, there is a unique opportunity to capture more of the Prime Brokerage market, establish a brand name and be a Dominant player.

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About the authors:

Matthieu Mercusot - Mr. Mercusot is a Partner at Kurt Salmon and the Financial Services Industry practice leader in North America. He has 12 years of experience in management consulting in financial services and capital markets.

Diviya Sharma - Ms. Sharma is a Manager at Kurt Salmon specializing in capital markets. She has more than eight years of experience managing and implementing strategic technology integration and operations performance improvement solutions for Fortune 50 clients.

CONTACT

Matthieu Mercusot
Partner
Financial Services Industry Practice Leader
Kurt Salmon North America
Mobile: +1 917 239 8128
Office: +1 212 521 0200
Fax: +1 212 319 9476
matthieu.mercusot@kurtsalmon.com
650 Fifth Avenue, 30th floor
New York, NY 10019

Kurt Salmon

OUR OFFICES

BELGIUM - BRUSSELS
Bd la Woluwelaan 2 box 4
1150 Brussels
T +32 (0)2 663 79 20

CHINA - HONG KONG
99 Queen's Road
66/F, The Center
Central
T +1 852 3960 6448

CHINA - SHANGHAI
#1702 Evergo Tower
1325 Central Huaihai Rd
200031 Shanghai
T +86.21.6121.3668

FRANCE - LYON
Immeuble "Le Front de Parc"
109, boulevard de Stalingrad
BP 11259
69608 Villeurbanne cedex
T +33 4 72 82 52 00

FRANCE - MARSEILLE
5, place de la Joliette
13002 Marseille
T +33 4 26 84 58 50

FRANCE - NANTES
Impasse Augustin Fresnel
BP 80363
44816 Saint-Herblain cedex
T +33 2 51 80 14 06

FRANCE - PARIS
159, avenue Charles de Gaulle
92521 Neuilly-sur-Seine cedex
T +33 1 55 24 30 00

GERMANY - DÜSSELDORF
Königsallee 11
40212 Düsseldorf
T +49 (0)211 7595 0

ITALY - ROME
Via Attilio Regolo, 19
I-00192 Roma

JAPAN - TOKYO
Akasaka Nakagawa Bldg.
3-11-3 Akasaka, Minato-ku
107-0052 Tokyo
T +81.3.3586.6840

LUXEMBOURG - LEUDELANGE
41, Zone d'activité Am Bann
L-3372 Leudelange
T +352 26 37 74 1

MOROCCO - CASABLANCA
Twin Center, Tour Ouest
Angles des Bd Zerktouni & Al Massira
20100 Casablanca
T +212 (0)5 22 95 83 21

SWITZERLAND - GENEVA
105, rue de lyon
1203 – Genève
T +41 2 23 89 42 00

TUNISIA - TUNIS
Immeuble Carthage centre
rue du Lac de constance
Bloc A 2eme étage
1053 Les Berges du Lac – Tunis
T + 216 71 96 50 57

UNITED KINGDOM - LONDON
10 Fleet Place
London, EC4M 7RB
T +44 20 7710 5200

UNITED STATES - ATLANTA
1355 Peachtree Street, N.E,
Suite 900
Atlanta, GA 30309
T +1 404 892 0321

UNITED STATES - SOUTHERN CALIFORNIA
100 Pacifica, Suite 470
Irvine, CA 92618
T +1 949 609 0123

UNITED STATES - MINNEAPOLIS
120 S. 6th Street, Suite 1600
Minneapolis, MN 55402
T +1 612 378 1700

UNITED STATES - NEW YORK
650 Fifth Avenue, 30th Floor
New York, NY 10019
T +1 212 319 9450

UNITED STATES - SAN BRUNO
1250 Bayhill Drive, Suite 315
San Bruno, CA 94066
T +1 650 616 7200

UNITED STATES - FRANCISCO
345 California Street, Suite 2500
San Francisco, CA 94104
T +1 415 296 9200

www.kurtsalmon.com