The Future of Wall Street

An Interview with Roger C. Altman, Chairman, Evercore Capital Partners L.P., New York

EDITORS' NOTE *Forecasting what the future holds, both for Wall Street and the greater global economy, Evercore Capital Partners' Roger Altman paints a contrasting portrait of long-term gains and short-term challenges. For, "the world financial system is indeed quite fragile," he observes, and in this context, although stock prices and the IPO market will eventually rebound, such recovery "won't happen quickly." Further, "the growth that Wall Street saw in 1998 and 1999" will not "return for a very long time." The fact is, individual "investors feel severely burned by the collapse of the Nasdaq and the dotcom bubble," not to mention by corporate financial engineering. Nevertheless, in this cloudy landscape, the chairman envisions several silver linings, including a widespread "return to the fundamentals" and "higher professional standards" across the board. In addition, "the future will reward chief executives who are capable of delivering organic performance," as well as the few financial firms, such as Evercore, that follow a "classical advice model" – an approach that "has largely disappeared." Although "Wall Street has moved from a world of true advisors to one in which there are very few," Evercore Capital Partners remains sharply focused, he concludes, on "giving our clients the same advice we would give ourselves."*

Prior to cofounding Evercore in 1995, Altman spent 14 years at Lehman Brothers, where he served as managing director, co-head of investment banking, and a member of the management committee and the board of directors. From 1987 to 1992, he was vice chairman of the Blackstone Group, and he twice served in the U.S. Treasury Department, most recently as deputy treasury secretary. Altman holds a B.S. from Georgetown University and an M.B.A. from the University of Chicago.

COMPANY BRIEF *Evercore Capital Partners L.P.'s investing business includes $1.3 billion private equity and venture capital partnerships funded by large U.S. and international investors, including corporate pension funds, endowments, insurance companies, investment trusts, banks, and families. Based in New York, the firm makes private equity investments in established businesses through its Evercore Capital Partners affiliate, and venture investments through its Evercore Ventures affiliate. Major investments include American Media, Vertis, Resources Connection, Energy Partners, Continental Energy Services, and Telenet. In addition, the advisory side of Evercore provides strategic, financial, and restructuring advisory services to large multinational corporations.*

Many people are terrified by what's happened in the stock market. Could it truly take 20 years to reach the stock prices and rates of individual participation we saw in 1999?

First, we should differentiate between recovery in stock prices and recovery in investor participation. I don't think it will take 20 years to recover the stock prices we saw at the market's peak, although I don't know whether it will take two years or five. In any case, it won't happen quickly, but we will surpass those prior levels just by virtue of economic growth and corporate profits.

Regarding individual participation, investors feel severely burned by the collapse of the Nasdaq and the dotcom bubble. So I think it will take a long time for the individual investor to recover the extraordinary enthusiasm he had at the beginning of 2000. In fact, it might take 20 years.

You've stated that the era of accounting gamesmanship in the corporate and financial communities is dead. What characterized the game, how was it played, and what were the rules that drove it?

For the past 10 to 15 years, there has been an intense focus on short-term corporate performance as measured by earnings per share and by so-called EBITDA, meaning gross cash flow. There has also been a strong connection between such short-term performance and stock prices and, in turn, between stock prices and senior-level-executive compensation. This produced a gamesmanship mentality. Senior corporate officers were consistently outdoing themselves in accounting and financial creativity to produce better results. Financial engineering became the rule of the day, more than underlying organic performance. So one saw very aggressive accounting and, as a result, decreasing transparency of corporate performance. Ultimately, accounting practices had as much to do with reported earnings as did the actual performance of companies.

Of course, not every CEO and CFO became preoccupied with such gamesmanship. And the capital markets have now rejected companies that practiced extreme gamesmanship and lack of transparency. It will be a long time before those companies are embraced again.

Will they ever truly be embraced?

If they return to basics, eventually they will. But over the medium term, senior executives who made their careers by virtue of financial engineering won't be as favored by the capital markets or by boards of directors as they've been in the past. What comes now – and I think it's to be saluted – is a return to the fundamentals. The capital markets want transparency and organic performance, not accounting gamesmanship. So companies that practiced gamesmanship are out, and executives who made their careers by virtue of those practices are at best out of favor and at worst out of a job.

The world turns on trends, and now the trend is toward honesty.

I would say it's toward transparency. I'm not saying that there was a lot of dishonest behavior; there wasn't. Indeed, there were very few cases in which corporate behavior was actually dishonest. The fact is, the collapse of confidence in corporate America, and particularly in corporate accounting, hasn't represented dishonesty; instead, it has represented the triumph of financial engineering over true performance. Now the pendulum has swung back in favor of organic performance and transparency.

How would you describe the next generation of CEOs? Will these old-school gamesmen be pushed aside?

I wouldn't describe them as old

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school. In fact, a few years ago, most people would have described them as new school. They were very sophisticated financial officers who knew myriad balance-and-earning-statement management techniques, which enabled companies to report, for example, a string of consecutive increases in quarterly earnings on top of businesses whose very natures didn't permit that. In any event, it's not a matter of the old school being dismissed. Instead, it's that the future will reward chief executives who are capable of delivering organic performance and whose stock in trade is integrity. Many companies will do better with investors in the future by having policies of openness, warts and all, rather than sharing only selective good news, even when there is plenty of bad news around.

As the job market shrinks, Wall Street whiz kids may be considering careers in potato farming. When will the job market change?

I don't think the growth that Wall Street saw in 1998 and 1999 will return for a very long time. That will be looked back upon as one of the two or three true booms in its entire history. I don't expect to see that level of expansion again for 20 years, especially in terms of personnel and compensation. In particular, technology and telecom accounted for about 40 percent of Wall Street profits from 1997 to 1999, and that's gone for as long as I'll be an observer of the scene. That absence alone means those levels of profits and jobs won't return for a long time.

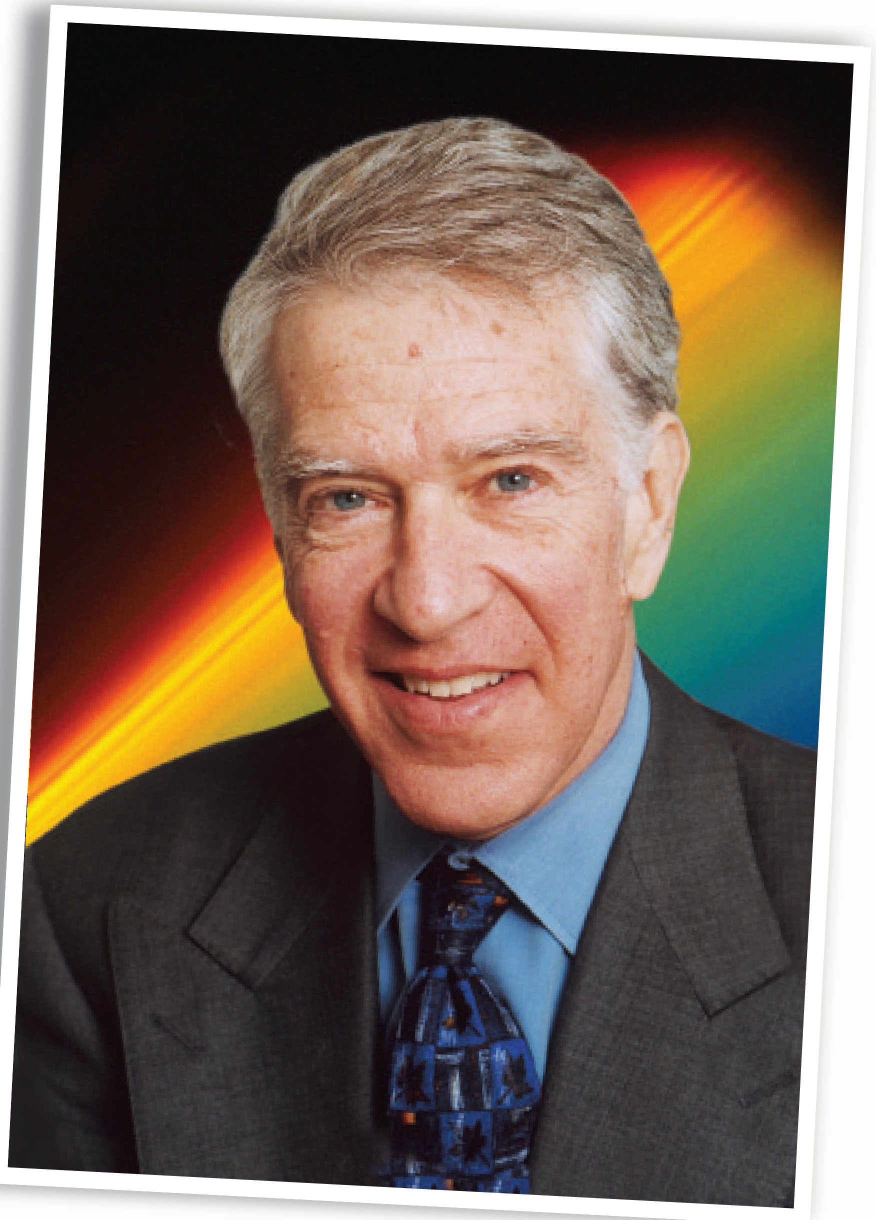
You've said that there's virtually no IPO market now and that there are very limited opportunities for small- and medium-size companies to sell their securities to the public. Will this have a damaging effect on the economy, and when will it change?

It will probably take two to three years to right itself. For the first time in several years, in January 2003, we literally saw not a single IPO. Wall Street cycles aren't extraordinarily long term, so I think we'll see a full recovery in the IPO market in two to three years, although not to the levels of late 1990s. I don't expect to see that again in my lifetime, but there will be a recovery such that the IPO market will be a functioning, available market for good companies, both young and more established.

For the time being, however, the closed IPO market is quite damaging to the American enterprise because the capital available to developing companies has been cut back. The trust investors had in the capital markets has been damaged because the late-'90s bubble is now looked upon as a delusion – the madness of the crowds. And probably no area saw greater damage than the IPO market.

Financial markets in Latin America and Asia seem to be very fragile. What's the possibility of another severe global financial crisis?

In my view, the world financial system is indeed quite fragile. People quickly forget, but the Asian financial crisis almost brought about the collapse of worldwide finance. There was a domino effect in Southeast Asia, with currency and securities prices collapsing in Thailand, Korea, Malaysia, and the Philippines. That then began to spread throughout the developing world. This worldwide financial collapse was only avoided through, in my opinion, brilliant intervention by the central banks and finance ministries. Further, right now, Latin America faces enormous fragility. The countries in the northeast,



including Venezuela, Colombia, Peru, and Bolivia, are in various states of collapse, and there is contagion potential. Given the current difficulties in Latin America, it wouldn't take much to trigger a replay of the 1997 crisis.

The other instance that comes to mind was the sudden and very welcome rescue of Long-Term Capital Management in 1998. The Federal Reserve Board, through its agent the Federal Reserve Bank of New York, orchestrated a rescue of that fund because it feared its collapse would threaten the entire financial system in this country and beyond. In a world where the Asian crisis almost torpedoed the world financial system and the collapse of a single hedge fund was so threatening, these are testimonies to the fragility of the system.

What about the major securities firms that may change hands via sales or spin-offs?

Over the past 20 years, almost none of the acquisitions of major securities firms by companies that weren't already participants in the industry have been successful. Just look at Sears Roebuck and Dean Witter, American Express and Lehman, or General Electric and Kidder, Peabody & Co. These are some of Amer-

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ica's greatest industrial companies, but the securities industry is an entirely different animal. It doesn't lend itself to integration with classic American industry.

Furthermore, it's impossible to meld the cultures of these industries. Wall Street cultures are famously independent, and time and time again, efforts to meld two different cultures and two sets of leaders have failed. So there are very few parties who could enter the securities industry or expand into it successfully through acquisition.

Does the same pattern hold true for banks?

In most cases, organizations that were essentially commercial banks have failed in their efforts to acquire securities firms for the same reasons. So, again, it's unlikely that successful commercial banks, most of which have different mentalities than securities firms, can successfully integrate securities firms into their businesses. The fact is, the history of consolidation in this industry has been one of failure.

Why are certain banks going through difficult times?

There are many reasons. In Deutsche Bank's case, the biggest reasons would be the German economy and the plight of German industry. The DAX, the primary German stock index, has lost 50 percent of its value over the past three years, which reflects the greater overall stagnation in that country. It's possible that Deutsche's expansion into the securities industry will prove itself, but it certainly hasn't yet.

Citigroup, however, stands out as a success. It has emerged as one of the most powerful financial institutions in the world, and its business is centered on banking rather than insurance, for example. The jewel in the Citigroup crown is the consumer financial business, which isn't an area most banks have prioritized in recent years. To its credit, Citigroup has continued to build that business, which is now their biggest engine of performance, profit, and growth.

Most other banks are focused on so-called wholesale operations or investment banking and securities, where they haven't done well. They're not all doing poorly, but many external expansions and acquisitions that large banks have undertaken in the past 5 to 10 years essentially haven't worked. The securities field hasn't proved hospitable.

What's the next big headline in the banking industry?

I think many of these acquisitions are going to be unwound. A lot of the banks will extricate themselves from the securities industry, lick their wounds, and return to their original businesses. I can't tell you which ones or when, but I expect to see a number of them retreat from the securities industry in two to three years.

Is there room for bank mergers?

There is, because many banks are doing so poorly that they don't have enough capital to compete globally. If you look at the market valuations of the largest banks, less than five or six are powerfully capitalized. I'm not sure if many others even have strong enough balance sheets to truly compete globally, especially if they see themselves as both commercial banks and investment banks.

You haven't painted a pretty picture for the future of the world economic scene. In this context, how is Evercore doing?

When we founded this firm eight years ago, we elected the boutique approach. We knew the future was going to lie with a small number of huge financial entities and a few skillful boutiques, so one had better not be in the middle. As a boutique, the challenges we face are much more manageable than the challenges that enormous financial institutions face. For example, we operate in businesses that don't require us to have an enormous capital base, such as mergers and acquisitions advisory, bankruptcy advisory, private equity investing, and venture capital.

Moreover, these areas permit a relatively small group of people to do well. So we don't need armies of people, and we're not confronted with large administrative challenges. In fact, we only have 80 people, while Wall Street is primarily populated by gigantic institutions with enormous overheads, management challenges, and gyrating stock prices. And in my book, ours is an awfully good business model. Historically, it has proved a better approach to the securities business than the leap into capital-intensive, cyclical, and management-intensive areas.

Evercore has been unique in taking a relationship- and advice-driven approach, rather than a transaction-driven one. Why is this so unusual?

I can't speak for the rest of Wall Street, but we've chosen to return to a classical advice model. When I first entered Wall Street, which was in 1969, I and others like me were trained to be true advisors, giving our clients the same advice we would give ourselves and not worrying about the short-term economic effects on us. At Evercore that's the approach we take today, and it's one that has largely disappeared from Wall Street. But the fact is, many CEOs around the world actually value advice, as long as it's provided objectively by experienced people. Unfortunately, over the past 30 to 35 years, Wall Street has moved from a world of true advisors to one in which there are very few. Furthermore, if a securities firm is focused primarily on its own short-term performance, it will be difficult to provide classic long-term advice because that advice may not lead to short-term income for the firm. It's a classic conflict. So the classic advisory role has largely disappeared.

What should CEOs focus on to be successful in today's challenging market?

First, there's no substitute for long-term performance. The number-one task of any CEO is to put in place the building blocks that will lead to consistent long-term results. In this country, we need to get away from this extraordinary focus on the short term, and I applaud the recent decision made by many companies to move away from giving quarterly or monthly guidance to analysts.

Second, a motivated workforce is indispensable to any business's success. A really good CEO will find ways, even in a big company, to motivate his workforce. You have to admire companies such as Southwest Airlines, which have consistently found ways to motivate their workforce.

Third, in the long run, the quality of your products or services will largely determine whether you're successful. For example, General Motors, to its credit, has been producing better products over the past few years. That is showing itself in the marketplace, and its market share and customer-satisfaction ratings are up.

How about the large Wall Street organizations? What must they do to be successful?

The foundation must be teamwork, a motivated workforce, and a limited line business strategy. Those are the first things I would do if I became the CEO of a large Wall Street firm. Yet very few firms have succeeded in doing these. The second approach would be to focus on the long term, rather the short term. And third, just like corporate America, Wall Street needs to return to higher professional standards. A lot of the financial gamesmanship I referred to earlier was driven – and in effect, created – by Wall Street, which hasn't done Wall Street or the industry any good.

Would you be happy even if you weren't rich?

Yes, I certainly would be. I didn't grow up well-off, and I had a happy youth. I'm not one of those people who think money buys happiness. In fact, I know many people who'd be better off without it.

Are you having more fun now than you did in the government?

The challenges one faces in government are entirely different than those one faces in business, particularly on Wall Street. I enjoyed every minute of my two incarnations in the federal government, with the Carter Administration and the Clinton Administration. It was enormously stimulating and a privilege to serve, but it was very different from Wall Street. One of the appealing things about Wall Street is that there are quantifiable ways to measure how you and your firm are doing. In Washington there are no real measures of performance; if one is perceived to be doing well, that's tantamount to doing well, which is inherently a bit ephemeral. On Wall Street, there's no getting around the quantifiable measures, and in the long run, I prefer a world in which everyone knows how well he or his firm is doing. ●

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