Industry profits take big hit in Q3

A deep decline in IPOs, secondary issues and debt issues has led to depressed profits in the securities industry

By James Langton

The profit picture for the Canadian securities industry continued to deteriorate in the third quarter as the credit crunch morphed into a full-scale stock market meltdown. Some of Wall Street's strongest pillars began to crumble, creating chaos that sets the stage for a wholesale industry makeover.

So far, Bay Street hasn't been hit as hard as Wall Street, but it hasn't escaped the market turmoil unscathed. Final figures for the third quarter weren't available as *Investment Executive* went to press in early November, but a forecast from the **Investment Industry Association of Canada** suggests that industry profitability came under increasing pressure in the quarter.

At press time, the IIAC had compiled final numbers for July and August, but not September. Nevertheless, it forecasts that total industry operating profit probably slipped below $800 million in the quarter, coming in at an estimated $781 million, down about 30% from the prior quarter's $1.1 billion and 36% off the same quarter a year ago.

For the nine months ended Sept. 30, the estimated decline in operating profit is also about 36%, to an estimated $3.1 billion, compared with the more than $4.9 billion the industry earned in the same period of 2007.

Although industry profits appear to have taken a thumping in the latest quarter, revenue is holding up much better. The IIAC estimates that operating revenue was $3.4 billion in the quuarter, down just 11.5% from the prior quarter.

Investment banking was the biggest weak spot, as revenue there slumped to just $580 million in Q3 from $900 million in Q2. This is hardly surprising as the new- issue market suffered a complete drought in the quarter.

PricewaterhouseCoopers LLP research indicates that Q3 didn't see a single initial public offering on the **Toronto Stock Exchange**. The **TSX Venture Exchange** did manage to record 14 new issues, raising just $66 million during the period. In the year to date, PwC reports that there have been 53 IPOs, raising $680 million; this is down sharply from the $1.2 billion raised in the same period in 2007.

However, PwC indicates that this decline in the Canadian IPO market is not a recent phenomenon. In fact, the withering of this market has been coming for some time. It reports that $4.7 billion was raised through the first nine months of the year in 2006; and that was itself a decline from $5.4 billion raised in the same period in 2005. So, the real plunge in Canadian IPO activity began in 2007; that much lower result has now been cut deeply again, and PwC doesn't see a revival anytime soon.

Although the dearth of IPOs is startling, that market is notoriously capricious. More significant, there's been a much bigger falloff in secondary issuance. The latest data from **Thomson Reuters Corp.** show that total equity and equity-related issuance for the nine months is down 41% from the same period a year ago. Furthermore, it reports that $19.4 billion was raised during the period this year, down from $32.9 billion last year.

In the first nine months of 2007, secondary equity issues raised $26.5 billion; that's down to $15.9 billion this year. Structured product issuance has also been slashed to just more than $2 billion this year from $5.3 billion in 2007.

The one bright spot on the equity side is preferred securities, which have managed to grow to $4.9 billion in the nine months from $3.9 billion in new issuance last year.

Things aren't much rosier on the debt side, either. According to Thomson Reuters data, overall debt issuance dropped in half in Q3 this year, to just $21.2 billion from $45.3 billion in the prior quarter. The so-called Maple bond market remains completely shuttered; there was not a single Maple bond priced in Q3, for the second consecutive quarter, the firm notes.

However, the year-to-date picture isn't nearly as bad on the debt side. Through the first nine months of the year, overall Canadian debt issuance has dropped, but not nearly as dramatically as in the equity segment. Total issuance for the period is down to just less than $110 billion from just more than $120 billion in the same period a year ago.

Moreover, the good news for Canadian dealers is that the part of the debt underwriting business that has been weakest is the segment dominated by global investment banks — the cross-border market. In that segment, total issuance dropped to just $43.3 billion this year from $59 billion in the first nine months of 2007. The segments that the Canadian dealers dominate — the markets for domestic corporate debt and Canadian government debt — have actually seen total issuance rise a bit year-over-year.

The mergers and acquisitions business has also suffered. According to Thomson Reuters, the value of worldwide M&A dropped 25% year-over-year through the first nine months. In Canada, the drop-off was even more pronounced, with the value of announced M&A deals plunging to US$80 billion this year from US$214.5 billion in 2007, down almost 63%; the value of completed deals was also down 42.4% year-over-year.

Despite the sharp drop in M&A volume through the first nine months, Thomson Reuters also notes that the business appears to be picking up a bit as consolidation intensifies in the financial industry and market declines make strategic acquisitions more attractive; it reports that in Q3 alone, worldwide M&A was down just 1% from the same quarter last year.

Of course, investment banking isn't the only business that's suffering. The IIAC forecasts that commission revenue (including mutual fund commissions) likely dropped to $1.24 billion in the latest period from almost $1.5 billion in the second quarter. Moreover, fee revenue is estimated to have slipped to $604 million in Q3 from $654 million in the previous quarter. Interest revenue, at least, is expected to tick up quarter over quarter.

On the trading side, Q3 likely saw fixed-income trading revenue drop sharply, but that is more than offset by a rebound in equity trading revenue back into positive territory. The IIAC forecasts that fixed-income trading revenue dropped to just $152 million in Q3 from $246 million in Q2. However, the equity trading business had $173 million in negative revenue for Q2 — and that is forecast to recover to $94 million in positive revenue for Q3.

There's no doubt that Q3 was an ugly one for the securities industry, and the fourth quarter got off to a rough start. As well, October was the scene of unprecedented turmoil on Wall Street and extreme market volatility. The investment-banking business remains depressed, although trading volumes ramped up amid dramatic stock market price swings.

Amid all of this weakness, the pain is starting to be felt in the wallets of industry workers, as the easiest way for firms to tighten their belts is by chopping salaries. The IIAC doesn't yet have a forecast for a Q3 head count, although the IIAC's director of capital markets, Jack Rando, notes that overall industry employment as of Aug. 31 was 41,707, down by just 200 from the end of June.

However, there are signs that the number of layoffs may still grow. Most notably, Vancouver's **Canaccord Capital Inc.** said ahead of its quarterly earnings announcement that it is cutting about 10% of its staff and trimming executive salaries by between 10% and 20%.

According to industry recruiter Bill Vlaad, president of Toronto's **Vlaad & Co.,** there will likely be more job losses ahead. He says that moves such as the one by Canaccord reflect an effort by firms to cut expenses as much as possible before their yearend, giving them a lean operation and a low starting point heading into fiscal 2009.

Throughout the year, various other firms have cut jobs as well, although there haven't been any large-scale layoffs like those witnessed on Wall Street and at some of the large European firms.

These cuts aren't coming easily, however. Vlaad suggests that the current layoffs are more likely to involve strong performers, whereas the cuts taking place earlier this year probably targeted "the low-hanging fruit." And he indicates that firms are also taking a hard line on severances, sending workers off with packages that are closer to legislated minimums than they have been in the past, when layoff deals were far more generous.

More worrying, those jobs likely aren't coming back anytime soon, he warns. Vlaad says that as the financial business changes and firms deleverage, they are not going to be able to support previous staffing levels. Nor are they going to be interested in building new-look businesses with old-school talent.

As a result, he advises bankers, brokers and traders that are let go in the current environment to retool themselves if they hope to get back into the business in the future, either by enhancing their education or by going into a different field and gaining valuable experience. **IE**