Sand Spring Advisors LLC

E-Commerce Paired Trades

By,

Barclay T. Leib

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Recently, I embarked upon a significant amount of research into the e-commerce efforts of major brokers, banks, alternative trading systems (ATSs) and preexisting exchanges. Regardless of what the equity market does in the forthcoming weeks and months, there is little doubt that increased electronic trading is coming, and this will slowly spread from simple retail equity transactions into other more institutional product lines. What people are currently able to do on Charles Schwab, institutions may soon be able to do between themselves in complicated swaps, bonds, and over-the-counter options. Maybe this will be good for liquidity, maybe it will be bad – but it is coming for better or worse. `

Many banks have already joined consortiums to electronically trade everything from cash foreign exchange (EBS), foreign exchange options (Volbroker.com), and credit derivatives (CreditEx and Creditrade). The plethora of potentially duplicitous products to trade traditional fixed income is also dizzying - TradeWeb, BrokerTec, SecuritiesHub, CFOWeb, and MarketAxess all basically offering multi-dealer pricing and electronic trading platforms for bank customers. If nothing else, this promises a huge change in transparency to a market that as recently as the early 1990s had only one broker, Cantor Fitzgerald, providing real-time intraday pricing to the public. The changes are likely to be so dramatic that consulting firm Meridien Research bluntly warned in a recent report: "There is no long-term career track for Treasury salespeople in the USA."

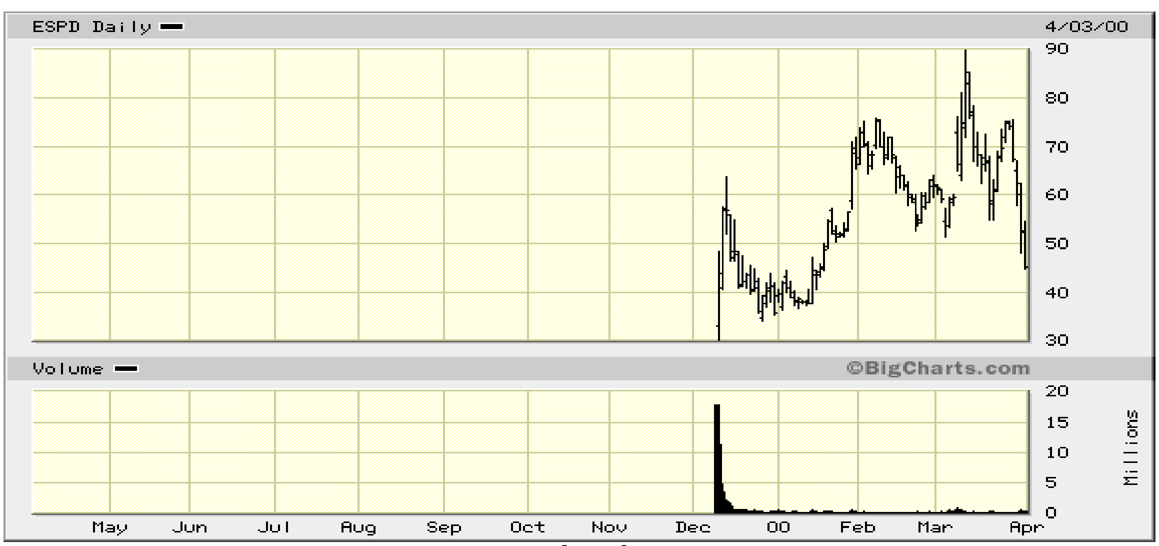
What is not immediately clear to most people is: who will be the big winners in this capital markets e-commerce industry and who are likely to be the big losers. Moreover, it would appear to us that there are many disparities and opportunities in the pricing of companies in this industry.

I am going to approach this topic less from an immediate trading opportunity, but more from a long term prognostication of where this is all going to end up. As one looks at the current landscape, which companies are likely to be left standing and benefit? As this is typed, the major equity markets are having something of an apoplectic drop and rebound, so it is important not to run out and put on any of these spread trades, but to look at this analysis more as a fundamental overview. The most probable usefulness here is to end up knowing what companies not to buy within the capital market e-commerce universe, and to consider the ones that we like only when the short-term timing appears propitious.

eSPEED is a Likely Dud…

Have you heard about the electronic brokerage company eSpeed, recently spun off by Cantor Fitzgerald last December? Cantor has long been among the most active and well-respected fixed income brokers on the Street, and they have also been an early pioneer in on-screen trading. But in an era where the large banks are already banding together to trade bonds on their own joint electronic platform, one wonders whether Cantor's eSpeed will ever really have a true chance for lasting success.

Yes the company is targeting to trade "everything" in the B2B market - energy, bandwidth, and even weather. And yes, the system already handles $150 billion in fixed income securities daily. But even with this volume, total revenues before costs were only $14 million in the 1999 4^{th} Quarter, and the company still net lost $6 million after expenses. We're sorry, but this does not make this company worth the $2.4 billion market capitalization currently assigned to it. Maintaining market share in the e-commerce age is going to be an uphill struggle for eSpeed, not a lay-up. They are going to be competing directly with pre-established exchanges and with former bank clients who are launching their own electronic consortiums. Already TradeWeb, owned by a dozen or so of the largest banks, has changed the face of the Treasury market dramatically. Institutional clients can now dial up on the web and see multiple banks falling all over themselves to bid or offer bonds, whereas these clients used to be captive to schlocky salesmen marking prices up or down to suit their own pockets. The institutional clients will benefit, but much of Wall Street's traditional "trading revenue" is already under pressure. In such an environment, are any of these banks going to be in any mood to pay commissions or access fees to use an outside broker's product? No, they are going to try to cut the brokers out completely in order to reduce their costs of transacting business to the bare minimum. They are going to find platforms to electronically trade among themselves.



eSpeed Daily

To a great extent, the bank consortium attack on broker products (electronic or otherwise) has already occurred in the world of foreign exchange. The EBS Partnership between 12 money center banks went live in 1993, and has since already stolen a whopping 65% of the interbank spot currency trading business and 20% of total global flows. The voice brokers are already either completely gone or on their way out. If something similar transpires in fixed income, it is no wonder that eSpeed is trying to grope its way into other products like electricity and weather. They currently stand at risk of losing their entire traditional customer base! This is not a huge opportunity, but a fight for survival. Unless Cantor's eSpeed is tremendously lucky, I see it as a wannabe also-ran.

…Whereas OM Gruppen is a Likely Star

On the other side of our paired trade discussion, we take a look at the Swedish company OM Gruppen, parent of OM Technology Inc.(www.omtechnology.com) and not to be confused with the U.S. based chemical company OM Group which is a completely different concern.

OM Gruppen was originally formed in 1985 to operate the electronic Swedish Options Exchange, and started trading as a public company the following year. By 1989, OM had established an electronic link between the Swedish and London stock exchanges, by 1990 had started a clearing business, by 1991 was selling its OM Click Exchange System to the Austrian Stock Exchange, and by 1994 was selling the same technology to exchanges in the U.S. It moved into the clearing of electricity derivatives in 1995 and was selling its technology to SE Banken (now relatively advanced in e-commerce among the European Banks) by 1996. More recently, it has sold its OM Click Exchange to the Toronto Stock Exchange as well as the futures exchange in Korea. Most importantly perhaps, OM Technology software is the powerhouse behind the new International Securities Exchange in the U.S that within the next two months will open its doors to electronically compete with the CBOE in U.S. equity option trading. OM Technology is also the software behind the U.S. fixed income platform BrokerTec that is scheduled to go live shortly.

OM Gruppen not only has over 10-years of established growth in selling its electronic trading platform, but it has been profitable throughout, earning 480 million SEK (approximately $55 million) in 1999. This represented a 24% operating margin and a 14% return on equity. The company's average annual return on equity between 1989 and 1999 was 21%. OM not only gets paid a fee for every software system that they help design, but they earn a share of the transactional fees once trading systems come on line. In short, this is a true growth company that is the engine behind several substantive new projects . Because these projects emanate from the big banks and pre-established exchanges, the chances of success are very high. And even if one or two projects don't work out, OM has in all instances already adequately charged for its time and effort. It simply moves on to the next electronic trading project of which there are many. By that point, the company doesn't have much to lose in the terms of hard dollars. All that is ever at jeopardy is a potential bonus and the company's general reputation -- which to date has remained excellent. The stock even pays a small dividend, something as yet unheard of in Silicon Valley.

But what is OM's latest project -- the International Securities Exchange (ISE) – you ask? Perhaps you have never heard of it. Well, here is a bit of background.

On May 26th, the International Securities Exchange (ISE) will open for business -- the first new U.S. options exchange to be approved by the SEC since 1973. This exchange will not only be completely electronic, but it will be the first electronic exchange to try to maintain an "affirmative obligation" for market makers who make prices within it.

It will be a quote display, a market-making tool, and a position-management tool all rolled into one. Better yet, the ISE's order-routing capabilities are designed so that customer orders will find their way to the best market for prompt and fair execution -- even if that means trading on a traditional equity options floor.

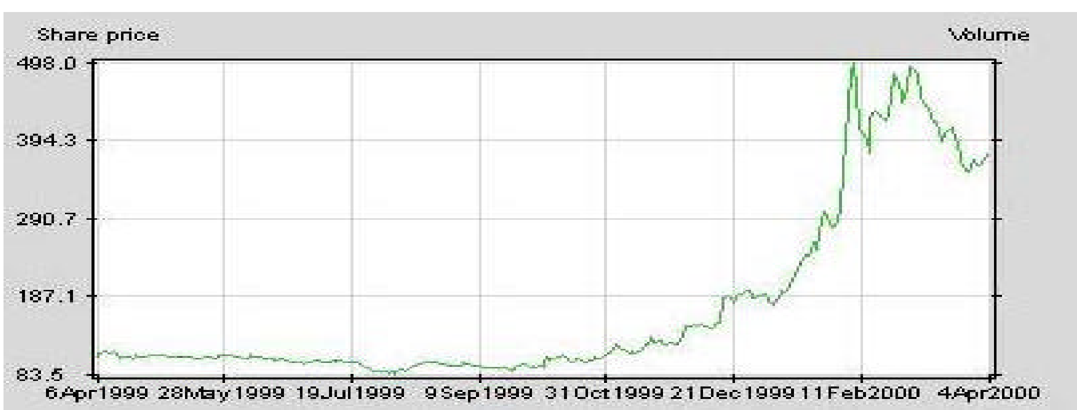
As explained to me by Gary Katz, one of the exchange's founders: "Options are a logistical nightmare for most people.. None of the ECNs out there currently have the technology to deal with them efficiently. Hopefully we do. If we had wanted to design a simple black box market without any sophisticated features we probably could have been up and running two years ago. But we wanted to avoid the blank screen syndrome. We wanted to do this right, and combine the best features of the traditional auction markets with the speed of today's technology."

What the exchange plans to do is to initially offer options trading on 600 underlying securities. They have divided these securities into 10 groups or "bins" of 60 securities each, with a Primary Market Maker (PMM) assigned to each bin. The PMM will be obligated to maintain reasonable bid-offered prices within the system, loading option parameters into the ISE's TORQUE system, which will then dynamically reprice thousands of options as the underlying securities move. The PMM may widen its prices or reduce the amount of size that it is willing to trade in a "fast" market, but it cannot simply run-away and stop quoting. The PMM will also hold the responsibility for handling customer orders in the fairest manner possible.

In return for providing these services, the PMM will stand the best chance -- among all of those who contribute bid-offered prices to the system -- to get traded upon when a market order or other executable limit order hits the screen. In effect, after customer orders are considered, the PMM will have the first rights of refusal on a piece of business.

And who are going to be the PMMs? Why Goldman, and Morgan Stanley, and Merrill, and Deutsche et al. Now tell me they will not have a vested interest to see this market work and put all those floor-based Chicago locals on the CBOE out of business.

So although at first blush the chart below may look like just another potention high tech Internet "flame-out," we see real value here. Aligned with the banks and not against them, OM Gruppen is likely to find itself with a growing true franchise in global capital market trading. With a total market cap similar to that of eSpeed -- approximately $2.4 billion – it beats that company hands-down as a better investment. Better yet, few in the U.S. have ever heard of it, or even follow it – at least not yet. When the ISE comes on line, all that may change.



OM Gruppen (in SEK)

Now let's move to our second paired trade e-commerce comparison.

CSFB vs Lehman Brothers

Each of the Wall Street banks are of course not only looking to use e-commerce to streamline their costs of transacting business, but they are also looking to e-commerce as a potential way to attract and maintain their customer bases. Perhaps more adroitly stated, most of the banks know that if they wait too long to develop a user-friendly e-based access to their products, they are at risk of being put out of business. So here we took a look across all the banks and sampled some of the products that they have in development. The banks with the best trading/research products and best delivery thereof should over time thrive. Those without the e-based delivery mechanism are going to be in trouble.

Here I speak a bit from experience. I have seen how a second-tier institution like SG-Cowen makes its money, particularly on the foreign exchange side of the transactional business. A corporate client calls up who doesn't have a Reuters screen or is trusting (and dumb enough) not to look on the Internet to see where a given currency is trading. The client makes the fatal mistake of telling the salesman (who he considers his friend) what he needs to do. The salesman looks at the high and low of the day and pitches his price accordingly within the day's range but egregiously against the customer. The guy still deals and the bank prints money.

All that, or most of it, is now ending. Trading rooms aren't going to be able to make much money "spreading" their clients anymore. Where they will be able to make money is in charging for custodial functions, availing themselves of free float from customer transactions, and collecting commissions on low-cost electronic-based business. The banks with the best-designed mousetraps – or platforms, call them what you will – with the lowest processing costs will win.

Here, there is little doubt in my mind who is first and who is last.

Whereas investment bank Lehman Brothers has done virtually nothing to embrace the Internet (save for launching a few bond auctions on the web), CSFB has been working non-stop for five years with 150 full-time programmers to build a state-of-the-art integrated electronic trading platform. Whereas JP Morgan has been flailing around with over twenty different capital market e-commerce initiatives – none particularly well coordinated with the other – CSFB has been launching a uniform platform around their PRIMETRADE system. Whereas Morgan Stanley Dean Witter is still trying to decide how to handle the retail problem of e-commerce with thousands of broker mouths to feed, CSFB is already well on the way to designing a soup-to-nuts system that when finished will revolutionize the institutional trading business.

This is what one money manager already using the CSFB platform said to me: "PRIMETRADE gives us more information than anyone on the phone could ever provide with regard to the depth of the market, speed of execution, and detail in the reconfirmation process. Any floor games that might otherwise happen in illiquid times, can't be played here. The system is very user friendly and we love it."

PRIMETRADE and PRIMEFX, which dovetail with each other, are the two central electronic execution lynchpins of CSFB's futures and foreign exchange trading. Any exchange in the world that offers an API price gateway (the largest being the Eurex, Liffe, and Matif) feed seamlessly into PRIMETRADE, and each money manager may customize his own

PRIMETRADE screen. Click on a displayed contract, and a real-time order book appears, the volume bid and offered showing up as well. Click on a designated button and a trade entry screen allows you to instantaneously join the trading crowd. The total turn-around time on a market order occurs within the flash of an eye. If an exchange does not offer an API electronic feed, you can still use the system to trade. Your order is simply routed to a human salesperson who sends it to the exchange floor. The fill still comes back to one electronically –- it just takes a little longer.

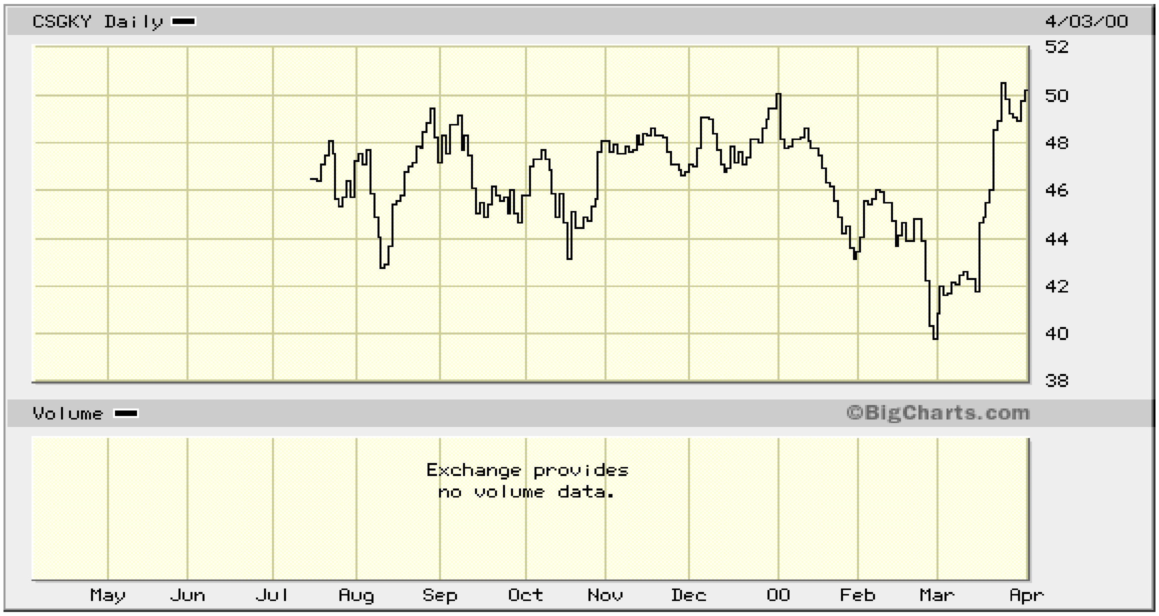
Want to trade cash FX? Not a problem. Maneuver yourself into the FX platform, and ask for a dealing price in the euro or yen or whatever. For anything up to $5 million, the price comes automatically back with a scroll bar at the bottom of the page timing how long you may ponder the price before dealing. Too slow reacting to the price the first time, or waiting for a small price change? Just ask again -- ask as many times as you wish. There is no human salesperson hanging on the other end of the phone slowly getting irritated with your indecision. There is just a computer spewing out prices automatically derived from electronic feeds.

But most customers want to roll their cash foreign exchange forward outright. CSFB is once again a step ahead of their competition: the forward points page are all dealable prices as well.

A few more clicks and the trade is headed to PRIMECLEAR, CSFB's prime brokerage offering where you may also monitor your positions in real time. If you are trading with other firms, but still giving up CSFB, PRIMECLEAR also sweeps CSFB's back office systems throughout the day, and will pick up any trading activity that you have done away. There is even a button to reconcile your personal computer trading log to the PRIMECLEAR back office, highlighting any differences. Your overall position monitoring may not be quite real-time, but it is getting very close. Everything you trade during a given day – equities and fixed income as well – can all end up feeding into a single location, and if you want to run VAR reports on your total amalgamated position, it's as simple as having another switch flipped on to enable CSFB's PRIMERISK II system to do its thing.

Europe is already of course virtually all-electronic, a large glass-enclosed computer sitting in the midst of the ornate MATIF trading floor. CSFB now maintains a staff of zero on the LIFFE. As electronic trading of futures and options sweeps into the U.S. markets later this year (The CBOT has already authorized daytime electronic trading, but have not set the definitive timetable for implementing it), floor clerks on the CBOT or CBOE should probably have their eye out for new jobs.

As a firm over time CSFB is doing all the right things in electronic capital markets commerce, and have already expensed much of the cost. Lehman is doing exactly the wrong thing which is to stick their head in the mud. Left to the natural forces of competition, CSFB should garnish an increasing share of customer flow and Lehman less and less. Already several laps behind, Lehman's research is still first rate, but nothing else about the firm is. If they were smart, they would negotiate themselves into a takeover, but having tried that once with Shearson, we fear Lehman may now allow themselves instead to slowly die on the vine.



ADR's of CS Group (CSGKY)

Lehman Brothers (LEH)

And what about relative valuations? Well, as pictured above, both stocks are just off their all time highs. Lehman trades at just 12 times earnings while CSFB is at a bit loftier 13.8x. We'd buy CSFB on spread there any day of the week, takeover possibilities on Lehman notwithstanding.

Overall, we are equity market bears at Sand Spring. We think people are soon going to re-learn the definition of a bear market, now generally forgotten. But even so, there are always good companies around that should thrive. And the Internet *is* real. OM Gruppen in Sweden and CS Group look to us two such companies poised for further success. eSpeed and Lehman don't.

Send us your comments at info@Sandspring.com.

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