To Crack Wall Street's Top Tier, Lehman Gambles on Going Solo

Firm Built on Bonds Expands Without Seeking a Merger; Investment Banking Is Key

No New Gorilla for Mr. Fuld

Lehman, founded in 1850 as an Alabama cotton trader, has in the past seven years beefed up stock trading and research businesses and expanded asset-management services for wealthy individuals. Rather than trying to cover all bases, Lehman initially focused on specific areas, such as technology, telecommunications and health care, and is now extending its reach. It has also pushed to expand its investment-banking franchise, one of the most prestigious businesses for Wall Street banks, but progress there has been harder.

While Lehman has more than doubled its share of the U.S. mergers-and-acquisition business since 2000, it's still overshadowed by the market leader, Goldman Sachs. Last year, Lehman captured 19.1% of that business, compared with 9.6% in 2000, according to financial-information provider Thomson Financial. The growth came largely at the expense of Morgan Stanley, whose share fell to 22.8% from 32.7% in the same period. Goldman slipped slightly to 42.8%. Lehman's top clients now include SBC Communications Inc., Kohlberg Kravis Roberts & Co. and MetLife Inc.

Lehman's bid to challenge Wall Street's largest firms will soon be tested. Despite its advances, two-thirds of Lehman's 2003 revenue came from bond-related businesses such as trading in mortgage-backed securities and selling corporate debt. That market, which boomed as stocks swooned after the Internet bubble, is now a dicier proposition. Many on Wall Street think a bond-market retreat is likely, although such predictions have yet to materialize. Lehman has continued to make money in the bond market even as rivals stumble.

There are few Wall Street firms that have managed to diversify without teaming up with a larger rival or becoming part of a conglomerate. Venerable names that used to compete with Lehman such as Salomon Bros., Kidder Peabody and Donaldson, Lufkin & Jenrette have been swallowed up by bigger firms or disappeared altogether. To succeed, Lehman must break some of the seemingly impenetrable ties that bind many of the world's most-desirable corporate clients to its rivals.

Ford Motor Co., for example, has given Lehman some work over the years but the auto maker has a close relationship with Goldman, which led Ford's initial public offering of stock in 1956. When Lehman banking chief Skip McGee made a recent courtesy call to try winning more business, he was gently rebuffed.

"You know we like you, but there are a lot of mouths to feed," Ford's Treasurer Malcolm Macdonald told Mr. McGee, both men recall. Mr. Fuld says the firm has already managed to break some of those key relationships. "We're not there yet," he acknowledges. "But today we are now a top-tier player, which is something no one on Wall Street would have said about us even four years ago."

Lehman is the only firm for which Mr. Fuld has worked, dating back to his days as a student at the University of Colorado in 1967. In Boulder, he did everything from photo-copying documents to helping create financial spreadsheets. In 1969, he moved to New York for a full-time job trading corporate debt. He earned an M.B.A. attending night classes at New York University, and landed his first big assignment in 1972, running the desk that traded in real-estate investment trusts.

RAUCOUS CULTURE

At that time, Lehman was infamous for the jocular, often raucous culture typical of bond-trading firms. The 1989 book "Liar's Poker," written by former Salomon salesman Michael Lewis, told...
of traders at that firm throwing phones at each other and swearing constantly. Former Lehman CEO Lewis Glucksman is well-known on Wall Street for tearing off his shirt in a rage on the trading floor.

Mr. Fuld fitted neatly into that culture and for years kept a stuffed gorilla in his office as a wink to his nickname. Saul Cohen, a former Lehman general counsel, recalls Mr. Fuld in the 1980s offering to "smack" someone on his behalf. Mr. Cohen declines to say who, but adds that Mr. Fuld "was quite sincere about it." Mr. Fuld doesn't remember the incident but concedes he could have said something along those lines as a joke.

Lehman almost didn't survive the 1980s after a bitter fight between the firm's bankers and traders led to its being acquired by American Express Co. Mr. Fuld, who at the time was head of Lehman's capital-markets division, opposed the merger, arguing that Lehman should hang onto its independence.

Life under the financial-services giant was little better. Lehman staffers, used to running their own show, bridled at being part of a rigid corporate structure. One year, Lehman left its parent's name off the cover of its annual report. It took American Express nine years to realize the combination wasn't working. With its commitment to the financial-supermarket concept flagging, American Express sold its stockbroking unit and spun off Lehman.

The company that emerged was a shell of its former self and Mr. Fuld, who by then had been made CEO, says it was apparent the securities firm needed to wean itself off dependency on bond revenue to survive.

His first task was to heal Lehman's rifts. Mr. Fuld used a point system he developed in the mid-1990s to teach his son Richie the value of teamwork. After recording notes on tape during Richie's hockey games, Mr. Fuld would award one point for a goal but two for an assist. Richie's reward at the end of season based on his score: cash or Lehman stock. He took the latter.

At Lehman, Mr. Fuld set up a similar compensation plan whereby the company's senior managers were paid roughly the same and were rewarded on their teams' performances. He also decided to increase the use of stock to pay other employees, hoping to align their interests with that of the firm. Today, 33% of the firm is employee-owned.

To counter Lehman's image as a scrappy bond house, Mr. Fuld overruled a unanimous decision by the firm's executive committee, at the height of the dot-com boom, to allow for casual dress on Fridays. He even showed up to a Saturday rehearsal for Lehman's annual meeting in a suit, while his colleagues dressed in weekend attire.

The overhaul began in earnest in 1996, when Mr. Fuld tapped two top bond managers to fix the firm's money-losing stock operations, an area that includes stock research and sales. "Figure it out," Mr. Fuld says he told the two executives.

"It was the ultimate losing locker room," Lehman's now-president, Joe Gregory, says of the stock-trading floor. Mr. Gregory, one of the two picked for the task, recalls looking at the beige stained carpet and the tattered chairs.

Lehman knew it couldn't compete with bigger, more-established rivals on every front. So Mr. Fuld picked spots, specifically growth sectors such as telecommunications, technology, energy and health care, where Goldman and Morgan Stanley didn't have their deepest relationships.

One of Mr. Gregory's first moves was to fire 25 of the division's 29 managers. Then he turned his attention to filling those seats. Salomon had just merged with Smith Barney and employees there were restless. "This is a great opportunity to get some of the best people in the industry," Mr. Fuld recalls telling a group huddled in a conference room on the 10th floor of Lehman's old headquarters in Manhattan's World Financial Center. In the following months, Lehman hired at least 50 people from Salomon, including top stock analysts covering wireless, energy and retail companies.

Lehman's nascent recovery took a dent in 1998 as financial markets around the world were roiled by a Russian debt default and the near collapse of hedge fund Long Term Capital Management. Although Lehman's financial health was sound, rumors began to spread on Wall Street that it was on the brink of bankruptcy as investors worried about the ripple effects of the market turmoil.

Lehman shareholders put pressure on Mr. Fuld to consider selling the firm to a bigger, more-diversified rival. A number of financial firms, including Germany's Deutsche Bank AG, approached Lehman but Mr. Fuld deflected the advances.

In a 1998 executive-committee meeting, Lehman's then chief financial officer, John Cecil, said the firm needed "to consider that we may need to merge with someone else to get more capital," according to several people who were there.

"This is going to be a short discussion because this firm is not for sale," Mr. Fuld shot back.

PRESSURE TO CUT STAFF

Two years later, the collapse of the Internet bubble put pressure on the CEO to cut staff just as his expansion into stock-related businesses was taking hold. Trading activity collapsed across Wall Street as did the mergers-and-acquisitions business. Two of Lehman's favored sectors, telecom and tech, were particularly hard hit.

Rather than follow other firms in slashing jobs across the board, Mr. Fuld made cuts in hard-hit areas such as investment banking while increasing Lehman's total number of employees. Between 2000 and 2002 total headcount rose nearly 9% as Mr. Fuld argued that Lehman didn't add as many staff during the Internet bubble as many of its rivals. In the same period, Goldman lowered staff levels by 13% while Morgan Stanley chopped 14%.

After the terrorist attacks of Sept. 11, 2001, Lehman's bankers were forced to move from their offices opposite the World Trade Center and set up temporary quarters at a Sheraton Hotel in midtown, ripping out beds to make room for desks. Less than a month after the attacks, Mr. Fuld negotiated a deal to buy a new, never-occupied building in midtown from rival Morgan Stanley. Lost in the old downtown offices was Mr. Fuld's stuffed gorilla. It wasn't replaced. "I think we've moved beyond that image," Lehman President Mr. Gregory told Mr. Fuld, both men recall.

Lehman bought the brokerage business of SG Cowen Securities Corp. in 2000 and went further into that market in July 2003 with its largest acquisition ever: a $2.63 billion deal for Neuberger Berman Inc., a well-heeled money manager. "This is our first large deal -- one of what could be many -- and we can't afford to screw this up," Mr. Fuld recalls telling the two firms' executives during a lunch at the Park Avenue Cafe on Manhattan's Upper East Side. Lehman is now in talks to buy London-based hedge fund GLG Partners, according to people familiar with the matter.

Meanwhile, the company's investment-banking business has moved ahead in fits and starts. To excel on Wall Street, a brokerage house needs a top-flight investment-banking franchise. Woody Young, one of Lehman's top investment bankers, recalls getting an
11 p.m. call at home on May 10, 1998, from Ameritech Corp. Chairman Richard Notebaert, informing him that Ameritech had chosen Goldman as its banker for a proposed $62 billion merger with SBC Communications, cutting Lehman out of a big payday.

Nonetheless, Mr. Young attended the news conference at the Waldorf-Astoria Hotel announcing the deal. He snagged a front-row seat alongside the Goldman bankers and Mr. Notebaert. Mr. Young says he wanted Ameritech to know that Lehman was still interested in a long-term relationship, despite being shut out of the deal.

Mr. Young kept in touch with Mr. Notebaert, who is now chairman of Qwest Communications International Inc. Lehman is now one of Qwest's top bankers. Last year, Lehman advised the telecom-equipment maker on its $7.1 billion sale of a yellow-page subsidiary.

"In 1998, some of us felt Lehman didn't have the presence they needed," Mr. Notebaert says. "But I think they have come a long way under Dick Fuld."

Write to Susanne Craig at susanne.craig@wsj.com